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Accounting Issues in Cross-Border Securities Offerings

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ACCOUNTING ISSUES IN CROSS-BORDER SECURITIES OFFERINGS

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INTRODUCTION

I want to discuss just a few of the key accounting and disclosure issues that foreign registrants face when they decide to make a U.S. public offering. Many of the issues that I am going to cover have already been referred to by some of the previous speakers, such as Richard Breeden,[1] Richard Kosnik,[2] and Pat McConnell.[3]

As you have heard before, U.S. accounting and auditing standards do tend to be more specific and far-reaching than standards in many other countries, and these differences can create compliance difficulties for companies coming into the U.S. market.[4] That, so to speak, is the bad news.

But the good news is that the staff at the Securities and Exchange Commission ("SEC") is sensitive to these problems and very interested in working with foreign registrants to assist them in coming into the U.S. market with a minimum of problems.[5] On a case-by-case basis, in addition to the proposed changes that you heard about a few minutes ago in some of the specific rules,

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1. *See* Richard C. Breeden, *Foreign Companies and U.S. Markets in a Time of Economic Transformation*, 17 FORDHAM INT'L L.J. S77 (1994) (discussing need to maintain basic principles of U.S. securities laws).

2. *See* Richard Kosnik, *The Role of the SEC in Evaluating Foreign Issuers Coming to U.S. Markets*, 17 FORDHAM INT'L L.J. S97 (1994) (discussing flexibility of SEC in evaluating and accommodating non-U.S. companies entering U.S. capital markets).

3. *See* Pat McConnell, *Practical Company Experiences in Entering U.S. Markets: Significant Issues and Hurdles from the Advisor's Perspective*, 17 FORDHAM INT'L L.J. S120 (1994) (discussing disclosure system in United States and how it promotes efficiency and liquidity in U.S. capital markets).

4. *See* William E. 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 (1994) (discussing increased attraction of non-U.S. companies to U.S. capital markets and options available for accessing those markets).

5. *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, S117-18 (1994) (discussing how Fletcher Challenge Ltd. met with SEC prior to filing registration statement to resolve certain issues).

you will find the staff willing to help you accommodate individual problems that you may have.[6] I cannot over-emphasize the importance of that flexibility as you contemplate an offering in the United States. It doesn't relieve you of the necessity of complying with the U.S. rules, but it does give you the ability to, where appropriate, modify the form or content of certain disclosures so long as the result is consistent with the underlying spirit of U.S. disclosure requirements.

I. *GENERAL FILING REQUIREMENTS*

Before I talk about some of the specifics, let me give you a little background in terms of some of the SEC filing forms that I will refer to. There are basically two sets of forms that foreign registrants use in SEC filings. Form 20-F is in many respects the "core form," the one that's used to register for exchange listings and subsequently for annual reports.[7] The "F Series" forms are used for specific sales of securities. There are several of these F Series forms.[8] The differences basically revolve around how much information you have to reprint in the form as contrasted with how much you can incorporate by reference or deliver in a separate document.[9] But the basic disclosure rules themselves are included in Form 20-F,[10] and that is the key document that you will become very familiar with as you plan a filing.

Form 20-F has two sets of financial statement rules, which are referred to as Item 17[11] and Item 18.[12] Basically, Item 17 is

6. *See* Kosnik, *supra* note 2, at S97-99, S110-11 (discussing flexibility of SEC in evaluating and accommodating non-U.S. companies entering U.S. capital markets); Warbrick, *supra* note 5, at S117-18 (discussing how Fletcher Challenge Ltd. met with SEC prior to filing registration statement to resolve certain issues).

7. 17 C.F.R. § 249.220f (1993).

8. *See, e.g.* Form F-1, 17 C.F.R. § 239.31 (1993); Form F-2, 17 C.F.R. § 239.32 (1993); Form F-3, 17 C.F.R. § 239.33 (1993).

9. *See* Form F-1, 2 Fed. Sec. L. Rep. (CCH) ¶ 6952, at 6061 (Apr. 7, 1993) (requiring disclosures by non-U.S. companies making initial public offerings); Form F-2, 2 Fed. Sec. L. Rep. (CCH) ¶ 6962, at 6071 (Dec. 8, 1993) (permitting previously registered non-U.S. issuers to incorporate information by reference to reports already filed with SEC); Form F-3, 2 Fed. Sec. L. Rep. (CCH) ¶ 6972, at 6081 (Dec. 8, 1993) (permitting previously registered non-U.S. issuers to incorporate information by reference to reports already filed with SEC).

10. Form 20-F, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,701, at 21,745 (Nov. 18, 1992); *see* Form F-1, 2 Fed. Sec. L. Rep. (CCH) ¶ 6952, at 6061 (Apr. 7, 1993) (requiring disclosure of information required by Part I, Item 17, and Item 18 of Form 20-F).

11. Form 20-F, Item 17, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,701, at 21,763 (Nov. 18, 1992).

the central repository for most of the rules.[13] It applies to periodic reports and to certain limited types of security offerings.[14] However, for most sales of securities you are going to be looking at Item 18. The essential difference between these two is that Item 18 typically calls for vastly expanded footnote disclosure.[15] Under Item 17 the footnote disclosures are primarily what is required in the local country,[16] whereas under Item 18, in addition, registrants are expected to include virtually all required U.S. disclosures.[17] Since the number of Financial Accounting Standard Board ("FASB") statements now exceeds one hundred, you can readily recognize that this can impose a substantial additional burden on many companies.

II. *ITEM 17 AND ITEM 18 REQUIREMENTS*

A. *Item 17*

Item 17 requires inclusion of audited consolidated financial statements.[18] These financial statements typically must include balance sheets for the two most recent fiscal years,[19] three years of income statements, statements of cash flows,[20] and changes in shareholders' equity.[21]

In addition, the SEC rules require certain additional schedules providing supplemental details of accounts such as marketable securities, reserves, and property, plant and equipment. The SEC has recently proposed eliminating some of the schedule requirements for foreign registrants because certain schedules, like the detailed activity in the property, plant and equipment account, often require enormous amounts of work to develop

12. Form 20-F, Item 18, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,701, at 21,764 (Nov. 18, 1992).
13. Form 20-F, Item 17, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,701, at 21,763 (Nov. 18, 1992).
14. *Id.*
15. Form 20-F, Item 18, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,701, at 21,764 (Nov. 18, 1992).
16. Form 20-F, Item 17, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,701, at 21,763 (Nov. 18, 1992).
17. Form 20-F, Item 18, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,701, at 21,764 (Nov. 18, 1992).
18. Form 20-F, Item 17, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,701, at 21,763 (Nov. 18, 1992).
19. Regulation S-X, 17 C.F.R. § 229.3-19(a)(1) (1993).
20. *Id.* § 229.3-19(a)(2) (1993).
21. *Id.* § 229.3-04 (1993).

and, at the same time, are deemed to have limited value for many companies.

Another reason for proposing to eliminate some of the schedule requirements is that the SEC has other rules, specifically a staff interpretation related to the Management's Discussion & Analysis ("MD&A") for foreign companies, which says that if a U.S. GAAP disclosure would be particularly significant, a company filing under Item 17 would be expected to make some mention of that information in the MD&A, even though under Item 17 the company would not have to provide that specific U.S. GAAP footnote.[22] The sum and substance is that eliminating some of these schedule requirements should not really affect the substance of full and fair disclosure. If there is something that is really important, it would still be required to be included.

In addition to the audited annual financial statements, if the effective date of a filing is more than ten months after year-end, then there is a requirement for condensed interim financial statements.[23] Until very recently, the requirement for interim financial statements was triggered after only six months. In other words, previously interim statements were required for all filings with effective dates more than six months after the date of the year-end statements, which means that calendar year companies had to have interim statements for offerings after June 30th. Since many foreign companies don't prepare statements more frequently than semi-annually, and many times those statements aren't available until the fall, the result was that companies could be "blacked out" of the market for substantial periods.

In some circumstances there are requirements for further financial statements in addition to the consolidated financial statements. Specifically, depending on debt covenant restrictions and other restrictions on flows of funds, there may be requirements for condensed parent company only statements.[24] There may also be requirements for audited financial statements of non-consolidated subsidiaries or affiliates that are more than

22. Regulation S-K, Instruction 12 to Paragraph 303(a), 17 C.F.R. § 229.303(a) (1993).

23. Regulation S-X, rule 3-19, *reprinted in* 6 Fed. Sec. L. Rep. (CCH) ¶ 69,160, at 61,032 (Dec. 8, 1993) (to be codified as amended at 17 C.F.R. § 210.3-19(b) & (c)).

24. Form 20-F, Item 17, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,701, at 21,763 (Nov. 18, 1992).

twenty percent owned,[25] as well as for recently acquired companies if any of these entities are "significant," based on certain calculations specified in the SEC rules.[26]

I will talk about these additional financial statement requirements in more detail shortly. They do frequently cause problems for foreign registrants because non-U.S. companies typically are not accustomed to presenting such financial statements, and certainly not to reconciling them to U.S. GAAP.

One of the key disclosure requirements under both Item 17 and Item 18 is the reconciliation of net income and shareholders' equity as measured under local GAAP to equivalent U.S. GAAP amounts, along with, where relevant, reconciliation of balance sheet accounts and discussion of other classification differences on the balance sheet and income statement.[27] This reconciliation has typically been one of the major stumbling blocks for foreign companies coming into the United States, and one of the areas that takes the most time when preparing for a U.S. offering.[28]

As mentioned above, another SEC disclosure that is separate from but integrally related to the audited financial statements is the MD&A.[29] It is intended to be an expansive and customized discussion of exactly what has been going on in the company in terms of results of operations, financial position and liquidity, and what is expected to be going on in the future based on currently available information.

The MD&A is, in the staff's view, one of the most important parts of an offering document. Also, because the disclosure rules are rather general, this is an area where the staff has the discretion to ask for a discussion of anything else that they think is material to the company that is not otherwise disclosed. Specifically, the SEC staff has stated that if there is a U.S. GAAP

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25. Regulation S-X, 17 C.F.R. § 210.3-09 (1993).

26. *Id.* § 210.3-05.

27. *Id.*; Form 20-F, Item 18, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,701, at 21,764 (Nov. 18, 1992).

28. *See* Decker, *supra* note 4, at S23-24 (discussing U.S. GAAP reconciliation required of non-U.S. companies registering in United States). *But see* James L. Cochrane, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?*, 17 FORDHAM INT'L L.J. S58, S61-67 (1994) (discussing goal of attracting non-U.S. companies to U.S. capital markets and further steps that should be taken to encourage non-U.S. companies to enter U.S. markets).

29. Regulation S-K, 17 C.F.R. § 229.303 (1993).

footnote that is not contained in financials prepared under Item 17 but that includes very material information, then that information should be provided in the management's discussion.

B. *Item 18*

If a company is not eligible to use Item 17, then Item 18 governs the form and content of the financial statements.[30] Item 18 basically calls for everything that is in Item 17 plus full U.S. GAAP and SEC footnote disclosures.[31]

III. *MAJOR COMPLIANCE DIFFICULTIES*

Having outlined the contents of the Item 17 and Item 18 financial statement requirements, I would like to summarize what I see as the four major areas of difficulty for companies coming into the U.S. market in terms of financial statement compliance: first, the U.S. auditing and independence requirements; second, the requirement for reconciliation to U.S. GAAP; third, the U.S. GAAP footnote disclosures; and, fourth, a group of additional disclosures required specifically by the SEC.

A. *U.S. Auditing and Independence Requirements*

The audit and independence requirements are sometimes a sort of "sleeper" in this process. U.S. auditing standards, like U.S. accounting standards, tend to be more detailed and more comprehensive than those of many other countries. The SEC staff, while they're actively involved in the discussions on development of international auditing standards, at this time are not yet comfortable with international auditing standards for use in U.S. filings.

There are some specific procedures that are required for U.S. audits that may not necessarily be performed as a regular part of an audit in other countries and may be difficult to perform on an *ex post facto* basis. For instance, observation of inventories is a mandatory U.S. auditing procedure. If that hasn't been done and if inventories are significant, companies may simply be in a position where they have to delay their offering in order to have audits that comply with U.S. auditing standards.

30. Form 20-F, Item 18, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,701, at 21,764 (Nov. 18, 1992).

31. *Id.*

On the other hand, if other types of additional procedures are necessary, such as confirmation of receivables, many times those can be done later and the prior years' audits brought up to U.S. GAAS standards.

The independence requirements can also be troublesome. Although most countries' auditing standards prohibit financial interests in clients by auditors, U.S. standards have a host of other rules related to matters such as family relationships and indirect investments that the auditors must comply with.

B. *Reconciliation to U.S. GAAP and Principal Difficulties Involved*

Next, there is the reconciliation to U.S. GAAP.[32] In order to prepare the reconciliation to U.S. GAAP, it is necessary not only to have a thorough understanding of U.S. accounting principles, but also of related SEC interpretations and staff positions. In their entirety the U.S. GAAP requirements go down to a much more detailed, transaction-by-transaction level than you find in many other countries' accounting principles. In coming into the U.S. market, companies have to deal with the U.S. level of specificity. They not only have to identify, but also to measure, all significant differences. From a practical standpoint, it is often necessary to measure all the identified differences in order to know which ones are significant.

In addition to the quantitative U.S. GAAP reconciliation there is a requirement for a narrative description of the material differences. Last May, the SEC staff published a *Survey of Financial Statement Reconciliations by Foreign Registrants*.[33] I think you will find it very interesting and helpful. The survey summarizes by country and by type of difference what the staff has seen in the several hundreds of these reconciliations.

One point the survey makes is that the SEC staff believes that the types of narrative descriptions of GAAP differences currently being provided are often not sufficient to allow investors to understand what is being done in the home country, and why, and how it differs from U.S. GAAP.

32. *See* Regulation S-X, 17 C.F.R. § 210.4-01(a)(2) (1993) (requiring reconciliation with U.S. GAAP).

33. SECURITIES AND EXCHANGE COMMISSION, DIVISION OF CORPORATION FINANCE, SURVEY OF FINANCIAL STATEMENT RECONCILIATIONS BY FOREIGN REGISTRANTS (May 1, 1993).

The GAAP reconciliation is typically required for three years,[34] although recently proposed rule changes would reduce that to two years for initial filers.[35] The proposed rules would also make it acceptable to file cash flow statements prepared under international accounting standards.[36]

The selected financial data is another part of the financial disclosure that is outside the actual financial statements. The SEC rules call for these summarized data for five years in order to provide a trend picture.[37] Although the rules require presentation of U.S. GAAP equivalents for all years presented, the staff has typically been very flexible in working with companies if there are legitimate difficulties in reconciling the figures for back years.

PRINCIPAL RECONCILIATION DIFFERENCES

- Accounting Changes
- Business Combinations and Goodwill
- Deferred Income Taxes
- Equity Method and Consolidation
- Foreign Currency Translation
- Leases
- Pensions
- Revenue Recognition
- Stock Compensation

This is a list, by no means inclusive, of some principal reconciliation differences. I would like to comment on just one or two of these reconciliation issues.

Business combinations, for instance. In the United States there are very strict rules on the use of pooling versus purchase accounting, and there are certain circumstances in which companies may prefer to have one treatment over the other. With respect to poolings particularly, the U.S. rules may not always track foreign rules and so it may be necessary to conform those

34. Regulation S-X, 17 C.F.R. § 210.4-01(a)(2) (1993).

35. *See* Simplification of Registration and Reporting Requirements for Foreign Companies; Safe Harbors for Public Announcements of Unregistered Offerings and Broker-Dealer Research Reports, Securities Act Release No. 7029, Exchange Act Release No. 33,139, 58 Fed. Reg. 60,307-01 (Nov. 15, 1993).

36. *Id.*

37. Regulation S-K, 17 C.F.R. § 229.301 (1993).

financial statements and go from "put-together" financials to purchase price-adjusted financials, or vice-versa. That may involve some fairly significant and pervasive changes.

Equity method and consolidation is another area. In the United States, the standards require consolidation of all majority-owned subsidiaries. That is not necessarily the case in all countries overseas. Some subsidiaries in very different lines of business may be carried on the equity method.

Then, there is lease accounting, the famous "operating vs. capital lease" distinction. In many foreign countries, operating lease treatment is common for transactions that would be considered capital leases in the United States.

C. *U.S. GAAP Footnote Disclosures*

So those are some of the reconciliation differences. What about disclosures that are required by the 115 or 116 U.S. accounting standards, not to mention the related interpretations, technical bulletins, and consensuses of the Emerging Issues Task Force?

U.S. financial statements are replete with disclosures, and filings under Item 18 must provide similar information. Some of the areas that typically go beyond what many foreign countries require are: income taxes — in particular, details of the reconciliation of the statutory tax rate to the effective tax rate and details of deferred taxes;[38] industry segment information,[39] which simply is not required in many other countries; and, loss contingencies. This last area becomes more sensitive almost by the day, particularly with the current focus on environmental remediation costs in the United States. Related party transactions is a very sensitive area in many foreign countries, but it is another area of disclosure that is extremely important in the United States, and one that the SEC looks at closely.

D. *Additional SEC Requirements*

The last category that can present some very significant problems is additional SEC requirements.[40] The additional SEC

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38. 17 C.F.R. § 210.4-08(h) (1993).

39. 17 C.F.R. § 229.101(b) (1993).

40. *See* 17 C.F.R. § 229.101 (1993) (requiring detailed description of business); 17 C.F.R. § 229.303 (1993) (requiring Management's Discussion and Analysis); 17 C.F.R.

requirements typically involve presenting additional financial statements or extensive additional statistical disclosure in a filing. As I mentioned earlier, the additional financial statements are usually financial statements of acquired businesses, non-consolidated subsidiaries, or investees carried on the equity method. The SEC feels strongly that if a company has recently acquired a business, then the investor needs to understand something about that business' track record if it is significant. Similarly, if subsidiaries that are not consolidated or major investees are picked up on the equity method, additional information on those entities may be needed to give readers of the financial statements a full picture of the various components of operating results and financial position.

There is a current proposal to increase the threshold for requiring reconciliation of these investee and acquiree financial statements. That has been one of the major stumbling blocks. It wasn't necessarily so hard to get the financial statements themselves, either in full form or in condensed form, but it was often extremely difficult to get a U.S. GAAP reconciliation, particularly, let's say, for an equity investee. If a company in Germany owns twenty-five percent of a company in France, they may have a seat on the board and some influence over the operations; but if they go to that company and say "I'd like you to incur significant expense to reconcile your financials to U.S. GAAP," the other company frequently, and understandably, would not be cooperative or receptive.

In addition to these additional financial statement requirements, companies in certain industries must provide significant additional financial information that is not technically part of the financial statements. For instance, financial institutions, such as banks and thrifts, are required to include extensive details on their loan portfolio; property and casualty insurance companies are required to disclose triangles showing ten-year development of loss reserves. All of this information usually goes beyond what companies are accustomed to providing.

The last consideration is timeliness of financial statements, the question of how frequently a company has to provide interim statements in order not to be blacked out of the market. As I

§§ 210.3-05 & 210.3-09 (1993) (requiring in certain circumstances separate financial statements of acquired businesses and investees).

discussed a little earlier, that is another area where the staff has very recently adopted some rules which I think will make life a lot easier for foreign registrants.

CONCLUSION

In summary, preparing financials statements for a U.S. filing is not an easy process, but neither is it an impossible process. It often takes longer than non-U.S. companies would like or anticipate when they first start to contemplate coming into the U.S. market. But with proper planning, it is very definitely do-able. And it's important to remember, as I said at the beginning of my remarks, that the SEC staff is very interested in working with foreign filers.[41] They are very interested in facilitating access to the U.S. market. But they are concerned that in accommodating the problems, the difficulties of foreign filers, they not do anything which is inconsistent with investor protection. Their objective is to provide practical relief but also to maintain the overall high quality and credibility of U.S. financial disclosures.

41. *See* Kosnik, *supra* note 2, at S97-99, S110-11 (discussing flexibility of SEC in evaluating and accommodating non-U.S. companies entering U.S. capital markets); Warbrick, *supra* note 5, at S117-18 (discussing experience of Fletcher Challenge Ltd. registering in United States).