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Foreign Issuer Disclosure and Accounting Compliance in US Public Offerings and Securities Listings

Jorge Gonzalez, Jr.¹
Christopher D. Olive²

I. Introduction

One of the principal capital markets for Mexican and South American issuers is the United States. The general policy of the United States government and its primary enforcement agency of the capital markets, the Securities & Exchange Commission (SEC), is to promote the U.S. capital markets by permitting such issuers to directly access U.S. investors and by allowing the free flow of capital in and out of the U.S. through the freemarket mechanisms that set currency exchange rates.³ Hence, the competitiveness of the U.S. markets in attracting such "foreign issuers"⁴ to offer and subsequently list their

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3. See Casar L. Alvarez, *Latin Securities Laws 1994*, LatinFinance, No. 59, July 1994, at S11.
4. The term "foreign issuer" refers to "foreign private issuer" as defined in Rule 405 under the Securities Act of 1933, 15 USC §§ 77a-77aa (1988) [hereinafter the "Securities Act"], and Rule 3b-4(c) under the Securities Exchange Act of 1934, 15 USC §§ 78a-78H (1988) [hereinafter the "Exchange Act"]. 17 CFR §§ 230.405, 240.3b-4(c) (1994). These rules define a "Foreign Private Issuer" as

Any foreign issuer other than a foreign government except an issuer meet the following conditions:

(1) more than 50% of the outstanding voting securities of such issuer are held of record either directly or through voting trust certificates or depositary receipts by residents of the United States; and

(2) any of the following:

(i) the majority of the executive officers or directors are United States citizens or residents,

(ii) more than 50% of the assets of the issuer are located in the United States, or

(iii) the business of the issuer is administered principally in the United States.

securities for public trading on one of the U.S. national exchanges is of great importance to the SEC. The U.S. public securities market continues to be one of the world's most attractive markets for raising capital and the listing of foreign securities for a number of reasons: The depth and breadth of the issuer and industry base; the sophistication of the market professionals who have demonstrated an enormous capacity to produce innovative financial products and to respond to changing market needs; the efficiencies of the public trading markets as well as the clearance and settlement systems; and, most importantly, confidence in the fundamental integrity and fairness of the U.S. securities markets.⁵ Other reasons that guide foreign issuers to access the U.S. markets include the enhancement of share values; protection against hostile take-over bids; and the idea of increasing U.S. market presence for their securities and products.⁶ The ability of Mexican and South American issuers to fully access the U.S. capital markets through public offerings of their securities represents a crucial element of the successful implementation of trade agreements such as the NAFTA, in terms of promoting corporate finance and development and encouraging cross-border and international trade between Mexican, South American and U.S. firms. While the SEC's rules and regulations governing foreign issuer securities offerings in the U.S. are undoubtedly complex when compared to the securities laws of Mexico or other South American nations, they are nonetheless quite manageable given the proper allocation of time, motivation and effort by foreign issuer management necessary to prepare the issuer to successfully meet the SEC-mandated disclosure requirements inherent in the registration process.⁷ Thus, the purpose of this article is to provide guidance to Mexican and South American issuers and their counsel on the particular issues involved in meeting the financial disclosure requirements of the SEC in lieu of a public offering and subsequent listing of securities on the U.S. national exchanges.

II. Foreign Issuers and the U.S. Securities Laws

A. OVERVIEW OF THE U.S. LEGAL FRAMEWORK

Since 1934, the SEC has been responsible for "maintaining the efficiency and integrity of the American securities market" by "full and fair" disclosure to investors.⁸ The SEC has

5. Richard M. Kosnik, *Comments on "Barriers to Foreign Issuer Entry Into U.S. Markets"*, 24 Law & Pol'y Int'l Bus. 1237, 1237-38 (1993).
6. 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, S12 (1994).
7. See, e.g., 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 (1994) (discussing listing of securities and subsequent public offering of Fletcher Challenge Ltd., a diversified international company headquartered in New Zealand); Pat McConnell, *Practical Company Experience in Entering U.S. Markets: Significant Exchanges and Hurdles From the Advisor's Perspective*, 17 Fordham Int'l L.J. S120 (1994) (discussing proper approaches that foreign issuers should utilize in preparing to meet SEC-mandated accounting competition).
8. Michael A. Schneider, Note, *Foreign Listing and Their Preeminence of U.S. Securities Exchanges: Should the SEC Recognize Foreign Accounting Standards?*, 3 Minn. J. Global Trade 301, 307 (1994).

historically emphasized the goal of maximizing market integrity and investor protection by increasing issuer disclosure requirements.⁹ However, foreign issuers have clearly recognized that U.S. disclosure requirements are not in line with the requirements of their home countries as the globalization of capital markets continues and the competition among worldwide exchanges to list securities of foreign companies intensifies. While the SEC readily agrees that disclosure costs must be minimized in order to increase foreign listings in the U.S., it will insist that any reforms must be consistent with the goal of protecting U.S. investors.¹⁰ In meeting this challenge, the SEC primarily uses the Securities Act of 1933 (Securities Act), the Securities Exchange Act of 1934 (Exchange Act), and rules and regulations promulgated thereunder.¹¹

In order to protect investors and the integrity of the U.S. securities markets, the Securities Act has two basic objectives: (1) to provide investors with adequate and accurate material information concerning securities offered for sale, and (2) to prohibit fraudulent practices in the offer or sale of securities.¹² The first objective of the Securities Act is the concept of *full disclosure*. The theory behind this cornerstone is that if the business and prospects, management, and financial condition of a company are fully and properly disclosed in a registration statement and the accompanying prospectus, then the investor can make up his own mind regarding the appropriateness of the price and the fairness of the transaction.¹³ The second objective of the Securities Act is the concept of *registration*. In the United States, every offer and sale of a security via the jurisdictional means — primarily interstate commerce and telecommunications — must be registered with the SEC unless

9. See Homer Kripke, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose*, at 28-29 (1979) (citing the comments of then-SEC Chairman A.A. Sommer, Jr.).

10. See Schneider, *supra* note 8, at 308.

11. In addition to the Securities Act of 1933 and the Securities Exchange Act of 1934, federal securities law is comprised of three other statutes enacted in 1939 and 1940. The Trust Indenture Act of 1939 applies to public offerings of debt securities in excess of \$10 million. See 15 USC §77aaa-77bbb (1988). The Investment Company Act of 1940 requires the registration of investment companies and also regulates the actions and structure of such companies. See 15 USC §80a-1 to 80a-64 (1988). Finally, the Investment Advisors Act of 1940 regulates the activities of investment advisors. See 15 USC §80b-1 to 80b-21 (1988).

12. See Marc I. Steinberg, *Securities Regulation*, at 245 (2d ed. 1993).

13. Frode Jensen, M. *The Attractions of U.S. Securities to Foreign Issuers and the Alternative Methods of Accessing the U.S. Markets: From a Legal Perspective*, 17 Fordham Int'l L.J. S25, S27 (1994). See also Securities Act, 15 USC §§77a-77aa (1988 & Supp. 1993) (requiring disclosure of material information); Exchange Act, 15 USC §§ 78a-7811 (1988 & Supp. 1993) (requiring disclosure of material information).

exempt.¹⁴ This means that all companies, issuers, broker-dealers and investors who issue securities must register them or avail themselves of a specific exemption from registration.

The Exchange Act covers the post-distribution trading of securities,¹⁵ and requires that securities be registered with the SEC before any trading occurs on a national securities exchange or in the over-the-counter (OTC) market.¹⁶ Although registration under the Securities Act does not constitute registration under the Exchange Act,¹⁷ previous registration under the Securities Act greatly simplifies registration under the Exchange Act.¹⁸ Upon registration with the SEC, publicly-traded companies must adhere to a continuous disclosure system by filing quarterly and annual reports.¹⁹ The Exchange Act, therefore, provides for an on-going set of disclosure documents for publicly-traded companies. Moreover, SEC rules promulgated under the Exchange Act provide investors purchasing securities in either a direct U.S. offering or a U.S. tranche of a multinational offering commenced by a foreign

14. Jensen, *supra* note 13, at §28. See 15 USC §§ 77e (a) (1988), which provides:

Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly —

(1) to make use of any mean or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

15. Louis Loss, *Fundamentals of Securities Regulation*, at 36 (1988). The Exchange Act also requires that broker-dealers, national exchanges, and dealer associations be registered with SEC. See 3 Harold S. Bloomenthal, *Securities and Federal Corporate Law*, §1.03[i] (1993). In addition, the Exchange Act formally established the SEC, its structure, and charged it with the administration of the federal securities law. See K. Fred Skousen, *An Introduction to the SEC*, at 22 (5th ed. 1991).
16. 15 USC §781(a)(g)(1)(1988).
17. Harold S. Bloomenthal, *Securities Law Handbook*, § 12.06[1] (1993 ed.).
18. *Id.* A U.S. issuer must register any non-exempt security under the Exchange Act if (1) the issue is listed on an exchange or NASDAQ, or (2) if the issuer has total assets in excess of \$5 million and 500 or more shareholders. See 15 USC §781(g)(1)(1988). The Exchange Act originally applied to issuers with total assets in excess of \$1 million, but Rule 12g-1 of the Exchange Act modified the threshold to \$5 million. See 17 CFR §240.12g-1 (1993); *System of Classification for Purposes of Exempting Smaller Issuers from Certain Reporting and Other Requirements*, Exchange Act Release No. 18, 647 (Apr. 15, 1982), 47 Fed. Reg. 17, 046-047 (1982). In addition, the category of "exempt" securities under the Exchange Act is wholly different from those under the Securities Act. Both are discussed *infra* in this paper.
19. The principal reports required under the continuous disclosure system for U.S. issuers are the annual Form 10K and the quarterly Form 10-Q. See 17 CFR §249.308a, .310 (1994). Form 10-K must be filed within 90 days of the fiscal year-end and Form 10-Q must be filed within 45 days of the quarter-end in all quarters except the year-end quarter. *Id.* Companies registered under the Exchange Act must also distribute annual reports to shareholders as part of proxy rules relating to the annual shareholder meetings. See 17 CFR §240.14a-3 (1994).

issuer with protection against price manipulation by persons or entities interested in the offering.²⁰

B. FOREIGN ISSUER LIABILITY CONSIDERATIONS UNDER THE U.S. SECURITIES LAWS

The registration framework of the Securities Act seeks to meet its objectives by imposing certain obligations and limitations upon persons engaged in the offer or sale of securities. The registration of securities with the SEC does not mean that the securities are considered to be fair, attractive, or a good investment. The SEC does not have the authority to prevent securities from being offered to U.S. investors because it considers the underlying investment to be of a speculative nature. On the other hand, a number of state regulatory commissions apply "merit" to certain securities offerings. Under this standard, the pertinent state securities administrator can prevent an offering from going forward because it is not "fair, just and equitable." Under merit regulation, therefore, adequate disclosure is not the only criterion: the substantive fairness of the offering may also be scrutinized.²¹ Further, neither the SEC nor the state regulators verify the truthfulness of the disclosures made in the registration statement or other offering documents pertaining to the securities being offered. Both the SEC and state regulators do, however, prohibit materially false or misleading statements pertaining to the registration and offering of securities, with both civil and criminal remedies available to redress such violations. For example, §11²² of the Securities Act imposes civil monetary liability against designated persons who fail to establish due diligence (except the issuer of the securities, which is strictly liable) for any misstatement or omission of a material fact contained in a registration statement. Section 12(1)²³ of the Act

20. These rules generally include SEC Rules 10b-6 (17 CFR §240.10b-6 (1994); Rule 10b-6 is an anti-manipulation rule that, subject to certain exemptions, prohibits persons engaged in a distribution of securities ("distribution participants") and their affiliated purchasers' from bidding for or purchasing, or inducing others to bid for or purchase, such securities, any security in the same class and series as such securities or any right to purchase any such security, *until they have completed their participation in the distribution*); *Id.* §240.10b-7 (Rule 10b-7 applies to any person who utilizes the price of a security in order to facilitate an offering of any security; to "stabilize" means to place any bid or effect any purchase for the purpose of pegging, fixing or stabilizing the price of any security; the stabilizing bids or purchases are prohibited by the Rule unless they are necessary to prevent or retard a decline in the open market price of a security and otherwise comply with the specific requirements of the Rule; among other things, the price at which a stabilizing bid may be initiated is restricted and thereafter may not be increased except in limited circumstances); *Id.* §240.10b-8 (Rule 10b-8 applies to any person participating in a distribution of securities being offered through rights on a pro-rata basis to security holders, and restricts the price at which securities being distributed, or securities of the same class or series, may be offered or sold by participants and the manner in which participants may bid for and purchase the rights). See George H. White, *Distributions of Securities of Foreign Issuers—Application of Trading Rules: Recent Developments*, PLI, International Securities Markets 1994 (May 12-13, 1994), available on Westlaw (discussing these rules in depth and providing analysis of recent SEC developments under these rules).

21. Steinberg, *supra* note 12, at 245.

22. 15 USC §77K (1988).

23. *Id.* §77I(1).

provides that a purchaser may rescind his purchase, or alternatively recover damages against any person who offers or sells a security in violation of §12(2)²⁴ of the Act's registration provisions. This section of the Act likewise grants the purchaser the right to rescind or to recover damages against any person who sells a security by means of a prospectus or oral communication which contains a materially false or misleading statement if such person fails to show the exercise of reasonable care. In addition, §17(a)²⁵ of the Act provides the SEC with redress for any fraudulent or deceptive conduct committed in the offer or sale of securities; and §24²⁶ provides for criminal penalties for a willful violation of any provision of the Securities Act or any rule or regulation promulgated by the SEC thereunder.²⁷ Moreover, under certain conditions, civil lawsuits may be successfully brought against the issuer under §10(b)²⁸ of the Exchange Act and Rule 10b-5²⁹ promulgated thereunder for any materially false or misleading statements contained in the registration statement.

Beginning with the premise that the Securities Act governs the issuance of securities in the U.S., there are three principle types of primary offerings that foreign issuers can use to issue securities in and thus raise capital through the U.S. markets. These include traditional private placements under §4(2) of the Securities Act and the "safe harbor" provisions of Regulation D,³⁰ Rule 144A³¹ U.S. resales in conjunction with Regulation S³² offshore offer-

24. *Id.* §771(2).

25. *Id.* §77q(a).

26. *Id.* §77x.

27. Steinberg, *supra* note 12, at 246.

28. 15 USC §78j(b)(1988).

29. 17 CFR §240.10b-5 (1994).

30. Section 4(2) of the Securities Act provides an exemption from registration for "transactions by an issuer not involving a public offering." 15 USC §77d(2) (1988). While the legislative history of §4(2) is sparse, practice in perfecting exemptions under §4(2) has been in accordance with several landmark decisions. See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 73 S.Ct. 981, 97 L.Ed. 1494 (1953); *Doran v. Petroleum Management Corp.*, 545 F.2d 893 (5th Cir. 1975). Some of the common-law requirements for perfecting a §4(2) private placement include (i) the absence of any public advertising or solicitation; (ii) the fact that the offering is made to a limited number of offerees who must be sophisticated investors; (iii) the provision of sufficient information even though no registration statement need be filed; (iv) investor representations regarding investment intent (because in a private placement an investor cannot purchase securities with a view towards further distribution of the securities); and (v) restrictions on subsequent resales. See Jensen, *supra* note 13 at §34. However, in 1982 the SEC adopted Regulation D, which provided investors and issuers with a more comprehensive set of rules comprising a "safe harbor" that, if followed, issuers of a §4(2) private placement for offerings. See *Regulation D—Revision of Certain Exemptions from Registration Under the Securities Act of 1933 for Transactions Limited United Offers and Sales*, Securities Act Release No. 6389 [1981-82 Transfer Binder], Fed. Sec. L. Rep. (CCH) 183, 106 (Mar. 8, 1982). Regulation D exempts from SEC registration certain offers and sales made primarily to "accredited investors" with no general solicitation or advertising within the scope of insurance that subsequent purchasers of the securities are not "underwriters" within the scope of the Securities Act. See 17 CFR §§230.504-506 (1994) (delineating the specific exemptions provided for qualifying issuers under Rules 504, 505 and 506); *Id.* §230.501(a) (describing qualifications for

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entities and natural persons necessary in order to meet the "accredited investor" requirement; *Id.* §230.502(c) (prohibiting the issuer from engaging in general solicitation or advertising relating to the offering); *Id.* §230.502(d) (providing a non-exclusive list of steps which, if followed, satisfies the "reasonable care" standard to assure that purchasers of securities are not underwriters). Of the three safe harbor rules promulgated under Regulation D, the one most frequently utilized by foreign issuers is Rule 506, most notably that Rule (unlike Rules 504 and 505) does not impose monetary restrictions on the size (in terms of dollar amounts) of the offering. *See Id.* §230.506. However, the safe harbor provisions of Rule 506 also limit the number of non-accredited investors to thirty-five or less. *Id.* §230.506(b)(2)(i) (stating that as a condition to perfecting the Rule 506 exemption, the issuer must reasonably believe that there are no more than thirty-five purchasers of securities in the offering; however, Rule 501(a) excludes accredited investors' from this calculation; *Id.* §230.501(e)(iv). Thus, the number of accredited investors in a Rule 506 private placement is technically unlimited).

31. In order to make the U.S. capital markets more appealing to foreign issuers and to promote the international competitiveness of the U.S. securities market, the SEC undertook the difficult task of promulgating regulations that directly or indirectly affected foreign issuers in the private placement market. Hence, after significant modifications, Rule 144A was adopted in April 1990. *See Resale of Restricted Securities: Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145*, Securities Act Release No. 6862, 1990 SEC LEXIS 739 (Apr. 23, 1990) (the Rule 144A "adopting release"), available on LEXIS. In adopting Rule 144A, the SEC made clear that the primary purpose of the Rule was to enhance the U.S. private placement market's competitiveness in the international arena by relaxing a number of restrictions on private placement trading, and thus increasing the willingness of foreign companies to issue their securities in the U.S. without the rigors and expense of registering the securities, whether in separate offerings or in conjunction with larger multi-national offerings. *See Robert A. Barron, Some Comments on SEC Rule 144A*, 18 Sec. Reg. L. J. 400, 400-01 (1990); Louis F. Moreno Trevino, *Access to U.S. Markets for Foreign Issuers: Rule 144A Private Placements*, 16 Hous. J. Int'l L. 161, 174 (1993). Although the specific mechanics of Rule 144A are complicated and beyond the scope of this article, it basically provides a non-exclusive resale safe harbor from the Securities Act's registration requirements. In order to fall within the safe harbor, the foreign issuer must meet the following requirements: (1) securities must be offered or sold only to a qualified institutional buyer (QIB) or to an offeree or purchaser that the seller and any person acting on his behalf reasonably believes is a QIB, *see Id.* CFR §230.144A(b)(1)(1994); (2) the seller of the securities must take "reasonable steps" to ensure that the purchaser is aware that the seller may rely on Rule 144A as an exemption from the registration requirements of the Securities Act, *see Id.* §230.144A(b)(2); (3) the securities must not be of the same class of securities as those listed on a U.S. national securities exchange or quoted on the NASDAQ system, *see Id.* §230.144A(b)(3); and (4) the issuer, if other than a reporting company under the Exchange Act, foreign government or foreign private issuer that has qualified under an Exchange Act exemption, must provide certain "reasonably current" information to the seller and his prospective purchaser upon request, *see Id.* §230.144A(b)(4). Rule 144A securities have their own trading market in the U.S., which is called the Private Offering Resale and Trading Through Automated Linkages (PORTAL), created by the National Association of Securities Dealers, Inc. (NASD) in response to the need for an organized market that would encourage potential investors to trade in such securities and to help signifi-

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ings,³³ and public offerings of securities. Traditional private placements and Rule 144A U.S. resales in conjunction with Regulation S constitute separate means by which foreign issuers

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cantly reduce the liquidity shortage in secondary market transactions. See *Self-Regulatory Organizations*, Exchange Act Release No. 27, 956, 1990 SEC LEXIS 815 (Apr. 27, 1990), available on LEXIS. The PORTAL market is an automated electronic trading market for Rule 144A securities as well as an international net of physical facilities in which domestic and foreign 144A securities are traded. See Trevino, *supra* at 182. The central features of the PORTAL market are mandatory pre-qualification of Rule 144A securities, market participants, and limitations on a participant's ability to trade securities outside of the system. See Lawrence R. Seidman, *SEC Rule 144A: The Rule Heard Round the Globe—Or the Sounds of Silence?*, 47 Bus. Law. 333, 345 (1991).

32. The registration requirements set forth in the Securities Act are triggered by the use of "any means or instruments of transportation or communication in interstate commerce or of the mails" in connection with the offer or sale of a security. See 15 USC §77e (1988). In adoption Regulation S (concurrently with Rule 144A), the SEC embraced a territorial approach to the extra territorial application of the Securities Act; this approach is based on the notion that the registration requirements of the Securities Act are intended to protect the U.S. capital markets and all investors in such markets, whether they are U.S. persons or foreign nationals. See *Offshore Offers and Sales*, Securities Act Release No. 6063, 1990 SEC LEXIS 740 (Apr. 24, 1990), available on LEXIS (the Regulation S adopting release); see also Marc I. Steinberg & Daryl L. Lansdale, Jr., *Regulation S and Rule 144A: Creating a Workable Fiction in an Expanding Global Securities Market*, 29 Int'l Law. 43, 45 (1995). Regulation S contains four rules: Rules 901, 902, 903 and 904. See 17 CFR §§230.901-904 (1994). Hence, the primary inquiry under Regulation S is whether the offer and sale of securities in question occurs outside of the United States. To this extent, Regulation S provides two non-exclusive safe harbor provisions in Rules 903 and 904 as exemptions from SEC registration for offerings and resales of securities made outside of the U.S. Rule 903 provides an issuer safe harbor and Rule 904 provides a safe harbor for resales of securities. In addition to the safe harbor provisions in Rules 903 and 904 and conditions therein, all offers and sales, whether made in reliance on the issuer or the resale safe harbor, must satisfy two general conditions of Regulation S: (1) the offer or sale must be made in an "offshore transaction," see 17 CFR §230.902(i); and (2) no "direct selling efforts" can occur in the U.S. in connection with the distribution or resale of the securities, see *Id.* §230.902(b). See Steinberg & Lansdale, *supra*, at 47-49.
33. In this regard, the combination of Rule 144A and Regulation S provide for two alternative methods for the securities of foreign issuers to reach the U.S. by means of the exemption route. First, under Regulation S, foreign issuers can sell their securities off-shore to a U.S. broker-dealer, who can then immediately resell them to a U.S. QIB under Rule 144A. Second, under Regulation S, foreign issuers can sell their securities offshore to a foreign brokerdealer, or foreign bank, who can then immediately resell them to a U.S. QIB or group of QIBs under Rule 144A. Thus, by treating Rule 144A as an exemption from registration, the party reselling the securities does not violate the "directed selling efforts" or "offshore transaction" requirement of Regulation S. See Steinberg & Lansdale, *supra* note 32, at 58-59. In sum, foreign issuers can place their securities in the U.S. market pursuant to Regulation S and Rule 144A without adhering to the registration requirements of the Securities Act. This technique would thereby eliminate the need for foreign issuers to comply with the transactional exemptions inherent in Regulation D in order to have their securities traded in the U.S. See Edward F. Greene & Janet P. Plache, *U.S. Private Placements and Rule 144A*, PLI, *International Securities Markets 1994* (May 12-13, 1994), available on Westlaw.

can place their securities with U.S. investors in transactions that are exempt from the SEC registration process inherent in public offerings. While both of these exemptions are heavily utilized by foreign issuers, each one certainly has its disadvantages and even a partial discussion of either exemption merits a complex analysis which is beyond the scope of this article. Therefore, this article will focus upon the SEC disclosure requirements involved in public offerings of securities by foreign issuers, with particular emphasis on the required financial disclosures and accounting compliance with U.S. generally accepted accounting principles (GAAP).

III. SEC Regulation of Foreign Issuers: SEC Registration and the Disclosure Process

A. HISTORICAL UNDERPINNINGS OF THE FOREIGN ISSUER DISCLOSURE REQUIREMENTS

Foreign issuers have historically been subject to different securities registration and disclosure requirements than U.S. issuers under the federal securities laws.³⁴ Form 20-F, adopted by the SEC in 1979, is the combined registration statement and reporting form authorized for use by foreign issuers under the Exchange Act and the core document of the SEC's integrated disclosure system for foreign issuers.³⁵ In the adopting release, the SEC asserted that Form 20-F represented a "significant improvement in the amount of information required of foreign issuers in the United States, placing the required disclosures on a level closer to that required of domestic issuers."³⁶ Conversely, in recognition of the "differences in various national laws and businesses and accounting customs [to be taken] into account when assessing disclosure requirements for foreign issuers," the SEC indicated that substantial reductions in the proposed disclosure requirements had been made.³⁷ Shortly after the adoption of Form 20-F, the SEC, following favorable comment, published for comment and subsequently adopted an integrated disclosure system for foreign issuers based on three simplified, short-form registration forms (Forms F-1, F-2 and F-3) and significant revisions to the presentation of financial information on Form 20-F.³⁸

Forms F-1, F-2 and F-3 are designed for use by foreign issuers to register offerings under the Securities Act.³⁹ Form F-1, which requires the furnishing of a traditional registra-

34. See Roberta S. Karmel & Mary S. Head, *Barriers to Foreign Issuer Entry into U.S. Markets*, 24 Law & Pol'y Int'l Bus. 1207 (1993).

35. See *Foreign Private Issuers*, Exchange Act Release No. 14, 128, 42 Fed. Reg. 58, 684 (Nov. 2, 1977) (proposing release for Form 20-F); *Rules, Registration and Annual Report Form for Foreign Private Issuers*, Exchange Act Release No. 16, 371, 44 Fed. Reg. 70,132 (Nov. 29, 1979) (adopting release for Form 20-F).

36. Exchange Act Release No. 16, 371, *supra* note 35, at 70, 133.

37. *Id.* at 70, 133. Simultaneous with the adoption of Form 20-F, the SEC also adopted amendments to Form 6-K, the interim reporting form used by foreign issuers. Karmel & Head, *supra* note 34, at 1213 & n. 30.

38. See Securities Act Release No. 6360, 46 Fed. Reg. 58, 511 (Nov. 20, 1981) (proposing release for SEC integrated disclosure system); *Adoption of Foreign Issuer Late Disclosure System*, Securities Act Release No. 6437, 47 Fed. Reg. 54, 764 (Nov. 19, 1982) (adopting release).

39. Karmel & Head, *supra* note 34, at 1214.

tion statement under the Securities Act, is used by both foreign issuers registering their securities in the U.S. for the first time and issuers subject to SEC reporting requirements under the Exchange Act for less than three years.⁴⁰ As the focus of this article is on disclosures pertinent to first-time foreign registrants, the discussion of these items herein will entail analysis under the basic Form F-1 and Form 20-F requirements, without further reference to Forms F-2 and F-3. As such, the key non-financial disclosures required under the Securities Act on Form F-1 are discussed *infra* in the next section.⁴¹

40. 17 CFR §329.31 (1994).

41. Certain "world class" foreign issuers or foreign issuers subject to SEC reporting requirements under the Exchange Act for at least three years are eligible to use Form F-2. See 17 CFR §239.32(b)(1)(1994). The concept of "world class issuer" refers to "foreign private issuers that have an equity float of at least \$500 million, at least \$150 million of which is beneficially held by U.S. residents, or that are registering 'investment grade debt securities.'" Securities Act Release No. 6360, *supra* note 38, at 58, 516. Form F-3 is generally used by world class foreign issuers subject to the SEC reporting requirements under the Exchange Act for at least three years. *Id.* at 58, 517. See Karmel & Head, *supra* note 34, at 1215. *Discussion and analysis of Forms F-2 and F-3 are beyond the scope of this Article.* However, the author would note that several of the recent SEC initiatives to simplify the registration, reporting and other requirements imposed upon foreign issuers have included amendments to SEC rules that are relevant to Forms F-2 and F-3. For example, in Securities Act Release No. 7053, 59 Fed. Reg. 21,644 (April 19, 1994), discussed *infra* in other respects, the SEC adopted amendments to Form F-3 to expand the class of foreign companies eligible to use short-form prospectuses and shelf registration for their securities, much as the amendments to Form S-3 have done for domestic issuers. The amendments shorten the form F-3 minimum reporting history from 36 months to 12 months, provided the issuer has filed at least one annual report, and reduce the minimum "public float" requirement from \$300 million to \$75 million. *Id.* The minimum public float standard for Form F-2 was similarly reduced from \$300 million to \$75 million. *Id.* Moreover, the same Release adopted revisions to Rule 139 (see 17 CFR §230.139 (1994), which generally provides safe harbor protection from §5 of the Securities Act with respect to the distribution of information, opinions or recommendations concerning reporting companies in the process of registration to provide an alternative offshore trading history test for offerings by reporting foreign companies that would be Form F-3-eligible but for the twelve month reporting history condition. Securities Act Release No. 7053, *supra*, at 21, 645-46. As amended, Rule 139 provides that broker-dealers may rely upon the more lenient conditions of the safe harbor with respect to such issuers if such issuers have had securities listed or quoted on a "designated offshore securities market" as defined in Rule 902(a) of Regulation S for at least twelve months. *Id.* at 21, 648. As in the case of Form F-3-eligible issuers, the research reports covered by the revised safe harbor are those that are distributed with reasonable regularity in the normal course of business. *Id.*

In adopting the April 1994 amendments discussed above, the SEC intended that broker-dealers would be able to rely upon Rule 139 for sizable foreign private issuers with respect to which there is a stream of corporate information available in the marketplace, including qualifying foreign issuers registering securities for the first time. As drafted, however, the amendments did not make clear that the elimination of the reporting history requirement included the elimination of the requirement that a foreign issuer be previously reporting pursuant to the Exchange

(Continued on page 49)

B. PUBLIC OFFERINGS: KEY NON-FINANCIAL DISCLOSURES UNDER THE SECURITIES ACT

A public offering under the federal securities laws requires the filing of a registration statement, which includes the prospectus to investors.⁴² The prospectus is Part I of the registration statement⁴³ and is the portion of the registration statement that is delivered to the investor, offeree or purchaser, in compliance with the federal securities laws requirements for prospectus delivery.⁴⁴ A registration statement is not delivered to the investor, but is

(Continued from page 48)

Act and have filed at least one annual report. As such, the SEC proposed (see *Amendments to Clarify Safe Harbors for Broker-Dealer Research Reports*, Securities Act Release No. 7120, 59 Fed. Reg. 65, 641 (Dec. 20, 1994)) and subsequently adopted (see *Adoption of Amendments to Clarify Safe Harbors for Broker-Dealer Research Reports*, Securities Act Release No. 7132, 60 Fed. Reg. 6965 (Feb. 6, 1995)) revisions to Rule 139 to make clear that the special provisions adopted in 1994 for sizable foreign issuers are also available to those issuers' initial public offerings in the United States. In order to make the Rule available to first-time sizable foreign registrants, the SEC adopted amendments to the first sentence of the Rule to provide that a foreign private issuer that meets the requirements of §(a)(2) of the Rule need not previously have been reporting pursuant to the Exchange Act. *Id.* at 6965. In addition, language has been added to §(a)(2) to provide that such foreign private issuers need not have filed an *annual* report as a condition of eligibility for the Rule. *Id.*

In addition, the SEC adopted amendments to Rule 138 (see 17 CFR §230.138 (1994)). Rule 138 under the Securities Act permits publication of information, opinions and recommendations concerning qualifying issuers by broker-dealers that are participants in a distribution, so long as the reports contain information, opinions or recommendations regarding a specified class of the issuers' securities which is not the subject of the offering in which the broker-dealer is a participant. *Id.* The Rule defines eligible issuers as those that may register securities on Forms S-2 (See 17 CFR §239.12 (1994)) or P-2 (See 17 CFR §239.32 (1994)). In Release No. 7120, the SEC noted that reference to Forms S-2 and F-2 was intended to include issuers eligible to register on Forms S-3 and F-3 as well. See Securities Act Release No. 7120, *supra*, at 65, 641. Hence, the SEC proposed and thereby adopted amendments to the Rule to clarify that Form F-3-eligible issuers would qualify for the Rule 138 safe harbor, as would qualifying first-time foreign issuers that meet the alternative offshore trading history test proposed and subsequently adopted for Rule 139. *Id.* at 65, 641; Securities Act Release No. 7132, *supra*, at 6965. In addition, in light of the fact that shelf registration statements often register both debt and equity securities (on either allocated or unallocated basis), the SEC also amended Rule 138 to add an instruction codifying the staff interpretation that the Rule should be applied on an offering-by-offering basis for issuers which are eligible to use Forms S-3 or F-3 and are using the SEC's shelf registration procedures. *Id.* at 6965. Thus, the filing of a shelf registration statement covering different classes of securities does not impede the availability of the Rule. *Id.*

42. See 15 USC §77e (1988) (requiring filing of registration statement); 15 USC §77j(b)(1988) ("A prospectus permitted under this subsection shall ... be filed as part of the registration statement...").

43. See Regulation C, 17 CFR §230.404 (1994). Item 404 of Regulation C provides that "[a] registration statement shall consist of ... a prospectus containing the information called for by Part I..." *Id.*

44. See Jensen, *supra* note 13, at §30.

instead filed with the SEC.⁴⁵ The registration statement has to be reviewed, cleared and declared effective by the SEC before sales of securities can be confirmed.⁴⁶ The form of registration statement most frequently utilized by foreign issuers in initial public offerings is the Form F-1, a full-disclosure, long-form registration statement analogous to the domestic Form S-1, which does not permit incorporation by reference and, therefore, is the lengthiest, most detailed, and most expensive form of registration statement to prepare.⁴⁷ Form F-1 requires various disclosure of selected financial information and accounting reconciliations discussed *infra*. However, Form F-1 also requires the foreign issuer to make various non-financial disclosures in the registration statement in accordance with SEC Regulation S-K. Several of the key disclosures which may present important concerns to foreign issuers include the following:

1. Business Segment Disclosure

The registration provisions also require separate businesses to be described separately in the registration statement.⁴⁸ If a foreign issuer with more than one line of business not otherwise required to disclose the profitability of one of the business segments in its home market or to its competitors, SEC business segment disclosure would require it to provide for such disclosure.⁴⁹

2. Disclosure of Material Contracts

If the foreign issuer is dependent upon one or two suppliers, and that dependency is subject to or part of a contractual relationship, the SEC will require full disclosure of the terms of the contract.⁵⁰ However, there are provisions for confidentiality, and it is possible to obtain confidential treatment for certain information that would be extremely damaging to the foreign issuer if disclosed.⁵¹

3. Disclosure of Risk Factors Pertinent to the Offering

The SEC will also require the company to disclose in fact why an investor making an

45. 15 USC §77f(a) (1988 & Supp. 1994).

46. See Jensen, *supra* note 13, S30.

47. *Id.* at S30 & n.23.

48. *Id.* § 229.101(b).

49. See Jensen, *supra* note 13, at S31.

50. *Id.* at S31. See Regulation S-K, 17 CFR § 229.601(b)(10)(1994).

51. *Id.* at S31-32. See Regulation C, 17 CFR § 230.406(a) (1994). Item 406(a) of Regulation C provides for confidential treatment of certain information.

Any person submitting any information in a document required to be filed under the [Securities] Act may make written objection to its public disclosure by following the procedure in para. (b) of this section, which shall be the exclusive means of requesting confidential treatment of information included in any document (hereinafter referred to as the material filed) required to be filed under the [Securities] Act ... *Id.*

investment in its securities might not succeed, what the risks are in making the investments and why the investor may eventually lose money in purchasing the company's securities.⁵²

4. Executive Compensation

The registration disclosure provisions require lengthy and extensive disclosure of both executive compensation⁵³ and in transactions with officers, directors, and shareholders.⁵⁴

5. Management Discussion & Analysis (MD&A)

The SEC has focused increasingly on the MD&A as a means of providing a window in the prospectus for investors to management's views of the future for the company and its⁵⁵ relevant industry. There are also SEC requirements relating to the disclosure of both nega-

52. *Id.* at S33. See Regulation S-K, 17 CFR § 229.503(c) (1994). Item 503(c) of Regulation S-K requires disclosure of certain risk factors:

(c) *Risk factors.* Registrants, where appropriate, shall set forth on the page immediately following the cover page of the prospectus (or following the summary, if included) under an appropriate caption, a discussion of the principle factors that make the offering speculative or one of high risk; these factors may be due, among other things, to such matters as an absence of a operating history of the registrant, an absence of profitable operations in recent periods, the financial position of the registrant, the nature of the business in which the registrant is engaged or proposes to engage, or if common equity or securities convertible into or exercisable for common equity are being offered, the absence of a previous market for the registrants common equity. *Id.*

53. See Regulation S-K, 17 CFR § 229.402 (1994).

54. *Id.* § 229.404. Item 404 provides:

(a) *Transactions with management and others.* Describe any transaction, or series of similar transactions, since the beginning of the registrant's last fiscal year, or any currently proposed transaction, or series of similar transactions, to which the registrant or any of its subsidiaries was or is to be a party, in which the amount exceeds \$60,000 and in which any of the following persons had, or will have, a direct or indirect material interest ... *Id.*

55. *Id.* at S32. See Regulation S-K, 17 CFR 229.303 (1994). Item 303 of Regulation S-K requires certain disclosures in "Management's Discussion and Analysis of Financial Condition and Results of Operations."

(a) *Full fiscal years.* Discuss registrant's financial condition, changes in financial condition and results of operations. The discussion shall provide information as specified in paragraphs (a) (1), (2) and (3) with respect to liquidity, capital resources and results of operations, and also shall provide such other information that the registrant believes to be necessary to an understanding to its financial condition, changes in financial condition and results of operations...

(b) *Interim.* If interim period financial statements are included or are required to be included by Article 3 of Regulation S-X (17 CFR § 210), a management's discussion and analysis of the financial condition and results of operations shall be provided so as to enable the reader to assess material changes in financial condition and results of operations between the periods specified in paragraphs (b) (1) and (2) of this type Item. The discussion and analysis shall include a discussion of material changes in those items specifically listed in para. (a) of this Item, except that the impact of the inflation and changing prices on operations for interim periods need not be addressed. *Id.*

tive trends and information that investors might use themselves to determine whether or not there are negative trends applicable to the issuer's business or investments.⁵⁶

C. PUBLIC OFFERINGS: FINANCIAL DISCLOSURES AND ACCOUNTING COMPLIANCE UNDER TITLE SECURITIES ACT

As previously discussed, one of the most significant areas of information included in the prospectus, certainly from a time and effort standpoint, is a discussion of the foreign issuer's business, which includes a concise discussion of risk factors pertinent to the offering of its securities.⁵⁷ However, the area of greatest concern to foreign issuers, however, is in the development and disclosure of the required financial statements and related financial information in accordance with SEC Regulation S-X.⁵⁸ A registration statement filed on Form F-1 generally requires two years of audited balance sheets⁵⁹ along with statements of income, cash flows,⁶⁰ and changes in shareholders' equity for those years.⁶¹ In addition, the financial statements must be audited in accordance with U.S. GAAP.⁶² In sum, most of the contents of Form 20-F must be furnished in the Form F-1 offering document.⁶³

1. Accounting Requirements for Foreign Issuers

Foreign issuers may present financial statements in conformity with either Item 17⁶⁴ or 18⁶⁵ of Form 20-F. Foreign issuers that file Form F-1 must conform to Item 18, while other

56. *Id.* at §32. See Regulation S-K, 17 CFR § 229.303(a)(3)(ii) (1994).

57. See Decker, *supra* note 6, at §17; Form F-1, 2 Fed. Sec. L. Reg. (CCH) 16952, at 6062 (Apr. 7, 1993) (listing information required in prospectus by reference to Regulation S-K and Form 20-F).

58. *Id.* at §17. See Regulation S-X, 17 CFR §210.4-01(aX2)(1994). Rule 4-01(aX2) of Regulation S-X requires foreign issuers that do not apply U.S. generally accepted accounting principles (GAAP) to reconcile their accounting principles with U.S. Standards:

In all filings of foreign private issuers . . . except as stated otherwise in the applicable form, the financial statements may be prepared according to a comprehensive body of accounting principles other than those generally accepted in the United States if a reconciliation to U.S. generally accepted accounting principles and the provisions of Regulation S-X of the type specified in item 18 of Form 20-F . . . is also filed as part of the financial statements. Alternatively, the financial statements may be prepared according to United States' generally accepted accounting principles. *Id.*

59. See Regulation S-X, 17 CFR §210.3-19(a)(1)(1993) (setting out special instructions and requirements for financial statements of foreign private issuers).

60. *Id.* §210.3-19(a)(2)(1993). SEC Rule 3-19(a)(2) requires "[audited] statements of income and cashflows for each of the three fiscal years preceding the date of the most recent audited balance being filed." *Id.*

61. *Id.* §210.3-04 (1993). See Decker, *supra* note 6, at §17-SIB.

62. *Id.* §210-2.02(b)(1994).

63. See Registration Statement under the Securities Act of 1933, Form F-1, pt. 1, item II, Fed. Sec. L. Rep. (CCH) ¶6951, at 6953 (Apr. 7, 1993).

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

65. *Id.* Item 18, at 21, 764.

foreign issuers may file under Item 17.⁶⁶ Items 17 and 18 are essentially identical, with the important difference between the two being that Item 18 typically calls for vastly expanded SEC footnote disclosure.⁶⁷ In addition to the basic financial information required of foreign issuers by the SEC, Item 18 further requires all other disclosures called for by U.S. GAAP and Regulation S-X, including information regarding income taxes, nonconsolidated affiliates, borrowing arrangements, related parties, industry segment information, leases and employee pensions.⁶⁸

Hence, Item 18 requires that financial statements on Form 20-F must disclose information substantially similar to U.S. GAAP and Regulation S-X. A foreign issuer may satisfy this requirement by either presenting financial statements in accordance with U.S. GAAP,⁶⁹ or alternatively by presenting financial statements in accordance with the accounting rules of another jurisdiction if (1) the accountant's report indicates the comprehensive body of accounting principles applied; (2) a narrative discussion of material variances from U.S. GAAP is included; (3) reconciliation of net income and stock holders' equity from the home country to U.S. GAAP is furnished; and (4) all U.S. GAAP and SEC footnotes and disclosures are presented.⁷⁰

2. Major Compliance Difficulties for Foreign Issuers with U.S. Accounting Standards

A. U.S. AUDITING AND INDEPENDENT REQUIREMENTS

First, U.S. auditing and accounting standards are normally far more detailed and comprehensive than those of Mexico and South American nations. 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 for foreign issuers to perform on an *ex post facto* basis. For example, one commentator has recognized that the observation of inventories is a mandatory U.S. auditing procedure, and if foreign companies do not already follow this procedure and their inventories are significant, those issuers may be in a position where they have to delay their public offering in order to have audits that comply with U.S.

66. *Id.* Item 17 financial information is required for Exchange Act registration statements and annual reports on Form 20-F. See Securities Act Release No. 6360, *supra* note 38, at 58, 515. However, use of Item 17 is also permitted for public offerings of non-convertible debt securities issued by "world class" foreign issuers registered on Form F-3 and in certain offerings to shareholders or employees. *Id.* Hence, Item 18 disclosure is required in all other offerings under the Securities Act. *Id.* For this reason, the SEC has urged foreign registrants, especially those eligible to use Forms F-2 and F-3, which generally incorporate the most recent filing on Form 20-F, to prepare their annual reports on Form 20-F in compliance with Item 18. *Id.* at 58, 515 n. 34.

67. See M. Elizabeth Rader, *Accounting Issues in Cross-Border Securities Offerings*, 17 *Fordham Int'l L.J.* S129, 8131 (1994); Form 20-F, Item 18, *supra* note 64, at 21, 764.

68. See Securities Act Release No. 6360, *supra* note 38, at 58, 515. Under Item 17, the footnote disclosures are primarily what is required in the foreign issuers' home country. See Form 20-F, Item 17, *supra* note 64, at 21, 763.

69. Form 20-F, Item 18, *supra* note 64, at 21, 764.

70. *Id.* at 21, 764. See also Eric M. Sherbet, *Bridging the GAAP: Accounting Standards for Foreign SEC Registrants* (1994) (on file with the Southern Methodist University School of Law).

auditing standards.⁷¹ However, if other types of additional procedures are necessary, such as confirmation of receivables, they can usually be done later and the prior years' audits brought up to U.S. GAAP standards.⁷² Moreover, the independence requirements can also be a concern to foreign issuers. 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 affiliate relationships and indirect investments that the auditors must comply with.⁷³

B. RECONCILIATION TO U.S. GAAP

Second, there is the SEC-implied reconciliation requirement to U.S. GAAP.⁷⁴ In order to prepare the reconciliation to U.S. GAAP, the foreign issuer must not only have a thorough understanding of U.S. accounting principles, but also of related SEC staff interpretations and positions.⁷⁵ In general, the U.S. GAAP requirements typically proceed on a far more detailed and transactional level than foreign issuers find under the accounting principles of their home countries. In addition to the quantitative U.S. GAAP reconciliation, the SEC requires further narrative descriptions of material differences.⁷⁶ Finally, the selected financial data is another part of financial disclosures that are beyond the actual financial statements: The SEC requires such data to be summarized over a five-year period in order to provide a trend picture.⁷⁷ Although these rules require presentation of U.S. GAAP equivalents for all years presented, the SEC staff has typically been recognized as being quite flexible in working with foreign companies if there are legitimate difficulties in reconciling the figures for prior years.⁷⁸ One commentator closely associated with these accounting issues has identified a list, which is by no means conclusive, of some of the principle reconciliation differences that foreign issuers must consider in conducting an initial public offering of securities: (1) accounting changes; (2) business combinations and goodwill; (3) deferred income taxes; (4) equity method and consolidation; (5) foreign currency translation; (6) leases; (7) pensions; (8) revenue recognition; and (9) stock compensation.⁷⁹ Many of these items will be addressed *infra* in subsequent sections of this article.

71. Rader, *supra* note 67, at S134.

72. *Id.* at S135.

73. *Id.*

74. See Regulation S-X, 17 CFR §210.4-01(a)(2)(1994) (requiring reconciliation with U.S. GAAP).

75. Rader, *supra* note 67, at S135.

76. *Id.* In May 1993, the SEC staff published a *Survey of Financial Statement Reconciliations by Foreign Registrants*, which summarizes by country and by type of difference what the SEC staff has seen in the several hundreds of these reconciliations it has considered. See Securities and Exchange Commission, Division of Corporation Finance, *Survey of Financial Statement Reconciliations by Foreign Registrants* (May 1, 1993). In that survey, the SEC observed that the types of narrative descriptions of GAAP differences currently being provided are often not sufficient to allow U.S. investors to understand what accounting procedures are followed in the foreign issuer's home country, and why and how these procedures differ from U.S. GAAP. See Rader, *supra* note 67, at S135.

77. See Regulation S-K, 17 CFR §229.301 (1994).

78. Rader, *supra* note 67, at S136.

79. *Id.* at S136.

C. U.S. GAAP FOOTNOTE DISCLOSURES AND OTHER SEC REQUIREMENTS

U.S. issuer financial statements are generally replete with mandatory disclosures, and under Item 18 foreign issuers 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;⁸⁰ industry segment information;⁸¹ and loss contingencies.⁸² Moreover, related-party transactions, a sensitive area in many foreign countries, is another area of disclosure that is quite important in the U.S., and one that the SEC staff will likely scrutinize with particularity.⁸³

Finally, other additional SEC requirements may present significant problems for foreign issuers. These requirements typically involve presenting additional financial statements or extensive additional statistical disclosures in a filing.⁸⁴ The additional financial statements are usually the financial statements of acquired businesses, nonconsolidated subsidiaries, or investees.⁸⁵ Moreover, foreign companies in certain industries must provide significant additional financial information that is not technically part of the financial statements. For example, U.S. financial institutions (normally banks) are required to disclose extensive details concerning their loan portfolios; property and casualty insurance companies are required to disclose a ten-year development of loss reserves.⁸⁶ All of this information usually goes far beyond what similarly situated foreign companies are accustomed to providing.⁸⁷

D. DAIMLER-BENZ AG: THE EFFECTS OF ACCOUNTING COMPLIANCE WITH U.S. GAAP

It is true that some firms have avoided the U.S. capital markets due to their perceptions that the costs of compliance with U.S. GAAP will be overwhelmingly significant. In lieu of these compliance differences, and principally because of the differences between U.S. GAAP and German GAAP, German firms have been especially reluctant to list and/or register their securities in the U.S.⁸⁸ However, in early October 1993, Daimler-Benz AG, the parent company of Mercedes-Benz, became the first German company to present U.S. GAAP financial statements in its registration statement as a part of listing its shares in the U.S. on the New York Stock Exchange (NYSE).⁸⁹ This was an event of enormous significance because (i) Daimler-Benz is the largest manufacturer in Europe, and by any measure, it is a truly global

80. See Regulation S-X, 17 CFR §210.4-08(h)(1994).

81. See Regulation S-K, 17 CFR §229.101(b)(1994).

82. Rader, *supra* note 67, at §137.

83. *Id.* at §137.

84. *Id.* at §137-38.

85. *Id.* at §138. See Regulation S-X, 17 CFR §§210.3-05 & 210.3-09 (1994) (requiring in certain circumstances separate financial statements of acquired businesses and investees). These items will be further addressed *infra* in the next section.

86. *Id.* at §138.

87. *Id.*

88. See Anipa Raghavan & Michael R. Sesit, *Financing Boom: Foreign Firms Raise More and More Money in the U.S. Markets*, Wall St. J. Oct. 5, 1993, at A1.

89. *Id.*

company of the highest stature; (ii) there are more differences between U.S. GAAP and SEC disclosure rules and the functional German equivalents than there are with any other country in the world;⁹⁰ and (iii) in complying with U.S. GAAP, the financial statements included in Daimler-Benz's 1993 Form 20-F converted 1993 \$354 million German GAAP income to a \$1.057 billion U.S. GAAP loss.⁹¹

There are many reasons why German companies have not sought to raise capital in the U.S. securities markets. For instance, with a German savings rate far higher than that of the U.S., very strong profits, and the pervasive rule of German banks in corporation finance, most German companies had access to abundant quantities of capital within Germany, and probably had little need to raise capital in the U.S. markets.⁹² Moreover, the U.S. accounting rules have been viewed in Germany as a significant barrier to U.S. market access because German accounting rules give its companies wide latitude in how they choose to portray current earnings or financial conditions.

The specific case of Daimler-Benz AG provides a demonstration of how two very different approaches to these issues reflect the principles underlying accounting and disclosure policies. As former SEC Chairman Richard C. Breeden reflected in a recent securities symposium:

Under German accounting policies, companies are allowed great latitude to create so-called 'hidden reserves,' or what are sometimes known in the accounting world as 'provisions.' When a company is making high levels of profit, income reported to investors can be reduced by creating generous reserves or provisions for potential future adverse events.

Under U.S. GAAP, an adverse event must be probable and estimable in amount before a reserve may be booked. Under German GAAP, a company may book reserves largely without restriction, and German companies do so freely. In the future, if the company is incurring losses or low profits, the company may determine that some or all of its provisions for future adversity are no longer needed, and it can then release its reserves into current income in a manner that masks current losses. At one time, roughly 40% of the entire balance sheet of Daimler-Benz was represented by the single-line item 'Provisions.'

Though its sales had plummeted in the face of a steep downturn in Germany's economy, for the first half of 1993, Daimler-Benz reported a profit under German GAAP of almost DM 200 million, a terrific result given the state of the German economy. However, this reported DM 200 million profit came after an undisclosed release of more than DM 1.5 billion in provisions into income. Under German GAAP, the story for investors would have ended at the DM 200 million profit, though its board members and its largest shareholder, the Deutsche Bank, would have known about the results of the company before adding back the provisions from prior years.

90. See Richard C. Breeden, *Foreign Companies and U.S. Securities Markets in a Time of Economic Transformation*, 17 *Fordham Int'l L. J.* S77, S85 (1994). The following discussion of Daimler-Benz AG is largely drawn from Mr. Breeden's comments in this article.

91. See Daimler-Benz Aktiengesellschaft, 1993 Form 20-F, F-12 (1994), available on LEXIS.

92. Breeden, *supra* note 90, at S86. As of December 1993, only 16 Germany companies listed their stock in any market outside Germany, even in markets lacking securities regulation. *Id.* at S86.

For the same period under U.S. GAAP, the company reported a loss of just under DM 1 billion. That fact is clearly shown in a two-page reconciliation to U.S. GAAP where addition reserves earned in prior periods is simply backed out of the current year's results, along with other changes. *Thus, all the investors in Daimler-Benz, but only a favored few in other German companies, are now able to evaluate the company's current performance without the considerable layer of camouflage that other German companies are allowed to use to smooth out the reported earnings.* Since the top managers of German banks routinely sit as board members of German companies, the banks have access to far superior financial information than non-insiders. Once Germany enacts legislation outlawing insider trading, having such a disparity of information and being major players in securities trading markets, may create considerable exposure for Germany's banks that would be reduced by better public disclosure. [emphasis added]⁹³

A review of the Daimler-Benz AG 1993 Form 20-F, including financial statements conforming to the Item 18 requirements for presenting financial statements in accordance with other comprehensive bodies of accounting principles, clarifies the differences in U.S. and German accounting standards. The financial statements are in accordance with the German GAAP, but include a narrative discussion of the differences between U.S. and German GAAP as well as a quantitative reconciliation of net income and stockholders' equity under German GAAP to net income and stockholders' equity under U.S. GAAP. In addition, all footnote disclosures required under U.S. GAAP are included therein.⁹⁴ An excellent discussion of the issues raised in the 1993 Form 20-F filed by Daimler-Benz is set out in the ensuing *Annex* to this article.

E. CONSORCIO G. GRUPO DINA, S.A. DE D.V.: A CASE STUDY OF MEXICAN ACCOUNTING COMPLIANCE WITH U.S. GAAP

It is true that many foreign firms have avoided the U.S. capital markets due to their perception that the costs of compliance with U.S. GAAP will be overwhelmingly significant. However, in contrast to German companies such as Daimler-Benz AG, Mexican companies have traditionally been more willing to take advantage of the U.S. capital markets by registering their securities with the SEC. This can be attributed in part to the fact that (i) while German companies have access to a huge and favorably regulated domestic capital market, Mexican companies often need to look beyond Mexico's borders in order to raise capital through securities offerings; and (ii) the differences between Mexican GAAP and U.S. GAAP tend to be much narrower in scope. Thus, Mexican companies have recognized that SEC registration (to facilitate a public offering or listing of securities) is a necessary part of raising much needed capital abroad. For example, both Telefonos Mexicanos, the second largest company in Mexico, and Vitro of Mexico, a prominent glass manufacturer, currently list their shares on the NYSE. Although both companies initially "tested the waters" by using Rule 144A private placements, they soon followed these placements with full Exchange Act

93. *Id.* at S91-S92.

94. See Eric M. Sherbet, *Bridging the GAAP: Accounting Standards for Foreign SEC Registrants*, at 7 (1994) (on file with the Southern Methodist University School of Law).

registration.⁹⁵ Despite the similarities between Mexican and U.S. accounting principles, they still differ in several respects.

A review of the 1994 Form 20-F filed by Consorcio G Grupo Dina S.A. de C.V. (Grupo Dina), which includes financial statements presented in accordance with the Item 18 requirements, clarifies some of the differences between U.S. and Mexican accounting standards. Grupo Dina is the leading supplier of medium and heavy duty trucks in Mexico. It is the only domestic manufacturer of European-style intercity coaches in Mexico and the leading supplier of intercity coaches used primarily in the executive and first-class service segments of the Mexican intercity coach market. The company also manufactures and distributes replacement parts for trucks and plastic components for the truck, coach, and other industries.⁹⁶ Grupo Dina prepares its consolidated financial statements in conformity with Mexican GAAP, which differ in several significant respects from U.S. GAAP. For example, under Mexican GAAP, inflation adjusted accounting is mandatory for most Mexican companies. Grupo Dina's financial statements contained in its Form 20-F are prepared in accordance with Mexican GAAP, but as required by SEC rules, the Form 20-F also contains a narrative discussion of the differences between U.S. and Mexican GAAP, as well as a quantitative reconciliation of net income and stockholders' equity under Mexican GAAP to net income and stockholder's equity under U.S. GAAP. However, under the SEC rules, this reconciliation to U.S. GAAP does not include the reversal of the restatement of the financial statements to comprehensively recognize the effect of inflation.⁹⁷ This method of inflation accounting, generally known as price level restatement, is required by Mexican GAAP Bulletin B-10.⁹⁸ In other words, inflation adjustments are deemed not to be a reconciling item in a foreign issuer's U.S. GAAP reconciliation.

The heart of the accounting disclosure analysis is captured in Note 1 to the consolidated financial statements of the Grupo Dina 1994 Form 20-F. Note 1 describes the differences between U.S. GAAP and Mexican GAAP. Essentially, these differences are reconciled by adjusting the net income applicable to majority ownership interests under Mexican GAAP and the stockholders' equity under Mexican GAAP to reflect the material differences between Mexican GAAP and U.S. GAAP. The following analysis, which the authors acknowledge represents only a cursory review of very detailed and complex accounting issues, summarizes some of these differences.

95. See SEC Staff to Clarify Regulation S, Rule 144A, Quinn Says, 24 Sec. Reg. & Law Rep. (BNA) No. 3, Jan. 17, 1992, at 67.

96. Consorcio G. Grupo Dina, S.A. de C.V., 1994 Form 20-P, at F-5 (1994), available on LEXIS.

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

98. Bulletin 10-B, "Recognition of the Effects of Inflation on Financial Information," was issued by the Mexican Institute of Public Accountants. The application of Bulletin B-10 represents a comprehensive measure of the effects of price level changes in the inflationary Mexican economy and, as such, is considered a more meaningful presentation than historical cost-based financial reporting for both Mexican and U.S. accounting purposes. Grupo Dina 1994 Form 20-P, *supra* note 96, at F-8.

Cash Flow Information

Under Mexican GAAP, the issuer is required to present consolidated statements of changes in financial position. Furthermore, Mexican GAAP requires that the financial statements be restated in constant New Pesos.⁹⁹ The intended effect of the restatement is to present all information for comparable periods in comparable monetary units and thereby eliminate the distorting effect of inflation in the financial statements.¹⁰⁰ In accordance with Mexican GAAP, the reduction in current and long-term debt due to restatement in constant pesos is presented in the consolidated statements of changes in financial position as a resource used by financing activities, and the net gain from monetary position is presented as a component of operating activities.¹⁰¹ Under U.S. GAAP, the Statement of Financial Accounting Standards No. 95, Statement of Cash Flows, does not provide guidance with respect to inflation adjusted financial statements.¹⁰²

Deferred Income Taxes

These are reflected under U.S. GAAP but not under Mexican GAAP. Deferred income taxes under U.S. GAAP arise principally from the deduction of purchases and production costs remaining in inventory for book purposes which are expended for tax purposes.¹⁰³ Grupo Dina's accounting reflects deferred income taxes for U.S. GAAP reconciliation purposes.

Cost of Pension Plans and Other Employee Benefits

Under U.S. GAAP, employers must account for pensions. This is not required under Mexican GAAP prior to 1993. However, in 1993, Mexican companies were required to prevent liabilities for employee benefits in their financial statements using actuarial computations.¹⁰⁴ Thus, prior to 1993, an adjustment was required of Mexican issuers to account for the cost of pension plans for U.S. GAAP reconciliation purposes. Today, that adjustment is no longer necessary.

Stock Sales Plans

Under Mexican GAAP, the net present value of the receivables from trusts for the stock plans is recorded as an asset.¹⁰⁵ Under U.S. GAAP, such receivables are deducted from stockholders' equity to reflect the reduction of the capitalization of the company.¹⁰⁶

99. Effective January 1, 1993, the Mexican Congress approved the establishment of a new currency, the New Peso, which replaced the Peso at the rate of one New Peso per one thousand Pesos. Grupo Dina 1994 Form 20-F, *supra* note 96, at F-3.

100. The third amendment to Bulletin B-10, which has been effective since January 1, 1990, calls for all financial information (including historical statements) to be presented in constant New Pesos as of the date of the most recent balance sheet. *Id.* at F-3.

101. *Id.* at F-8.

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.* at F-9.

106. *Id.*

Income Received on Zero-Coupon Bonds

Under Mexican GAAP, investments in securities are valued at market. Hence, the income recorded for zero-coupon bond investments includes interest income as accrued, and also includes the unrealized capital gain or loss for the year.¹⁰⁷ Under U.S. GAAP, investments in securities are recorded at the lower of cost market, and no capital gains are recorded until the security is sold.¹⁰⁸ Thus, the interest on zero-coupon bonds received by Grupo Dina should be amortized to income using the interest method.

Minority Ownership Interests in Subsidiaries

Under Mexican GAAP, minority ownership interests in subsidiaries must be included as a component of stockholders' equity. Consequently, a minority interest in subsidiary income is not presented as an expense in the income statement. Under U.S. GAAP, minority interests in subsidiaries is designated as below the liabilities section of the balance sheet, and is not part of stockholders' equity.¹⁰⁹

The overall effect of these accounting differences, after net income and stockholders' equity under Mexican GAAP is reconciled to net income and stockholders' equity under U.S. GAAP, is a reduction of both the Mexican issuer's net income and stockholders' equity. For example, the 1993 net income of Grupo Dina under Mexican GAAP was approximately \$79,907,000, while under U.S. GAAP it was \$68,000,000.¹¹⁰ Thus, reconciliation to U.S. GAAP may impose some disclosure burdens on Mexican issuers because it may cause them to appear less profitable to prospective investors. However, Mexican GAAP has been conformed in some respects to more closely approximate the requirements of U.S. GAAP. For instance, as of 1993, Mexican GAAP requires companies to recognize liability for pensions and other labor obligations.¹¹¹ Although this reduces the net income reflected in the financial statements of Mexican companies, it may serve to make Mexican companies more competitive in the long run, as they try to find ways to make up for the downward adjustment of income reflected in their reconciled financial statements. In addition, any changes which conform Mexican GAAP more closely to U.S. GAAP will undoubtedly lessen any burdens of financial disclosure that Mexican issuers would confront in registering securities with the SEC to facilitate a public offering in the U.S.

D. PUBLIC OFFERINGS: REGISTRATION OF FOREIGN ISSUERS' SECURITIES UNDER THE EXCHANGE ACT

A public offering also subjects a foreign issuer to the ongoing reporting requirements of the Exchange Act. Unless an exemption is available under Rule 12g3-2(b)¹¹² of the

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.*

111. These amounts were converted from New Pesos into Dollars solely for the convenience of the reader at the rate quoted by the Bank of Mexico for 31 December 1993 of 3.1071 New Pesos per U.S. Dollar. *Id.*

112. 17 CFR §240.12g3-2(b)(1994). For a detailed analysis of the various applications of the Rule 12g3-2(b) exemption, see Walter Stahr & John Palenberg, *Rule 12g3-2(b) Under the Securities Exchange Act: A Primer for Foreign Companies*, 27 Int'l Law. 963 (1993).

Exchange Act, a foreign issuer with more than 300 U.S. shareholders is required to register its equity securities pursuant to §12(g) of the Exchange Act,¹¹³ provided that it has more than 500 shareholders worldwide and total assets in excess of \$5 million. A foreign issuer that desires to become listed on a U.S. exchange is further required to register under §12(b) of the Exchange Act.¹¹⁴ To register under §§12(b) or (g), a foreign issuer must file a registration statement on Form 20-F, and thereafter must file an annual report on Form 20-F within six months after each year-end and a Form 6-K to report interim financial results and certain other events.¹¹⁵ Foreign issuers subject to reporting requirements under the Exchange Act as a result of a previous Securities Act public offering may also file annual and interim reports on Forms 20-F and 6-K.¹¹⁶ Although annual reports on Form 20-F may be prepared on the basis of Item 17 information, which as previously discussed does not require full reconciliation to U.S. GAAP; first-time foreign issuers will need to fully reconcile their financial information to U.S. GAAP and thus should prepare annual reports on Form 20-F in accordance with Item 18 and U.S. GAAP.¹¹⁷ Notably, by virtue of Rule 3a12-3 promulgated under the Exchange Act,¹¹⁸ foreign issuers whose securities are registered under the Exchange Act are exempt from the proxy solicitation and information statement provisions of §14 of the Exchange Act¹¹⁹ and the short-swing trading profits provisions of §16 of the Exchange Act.¹²⁰ However, foreign issuers do remain subject to the Foreign Corrupt Practices Act.¹²¹

IV. SEC Initiatives to Alleviate Registration and Disclosure Requirements for Foreign Issuers

Although the U.S. public markets have been successful in attracting foreign issuers, the SEC has nonetheless clearly acknowledged and maintained the initiative for taking an active role in the international area with respect to foreign issuers. This recognition has manifested itself both within the SEC in administering its rules and regulations as well as through its international participation in attempting to craft solutions to common difficulties faced by

113. 15 USC §781(g)(1)(B)(1988).

114. *Id.* §781(b).

115. See 17 CFR §§240.13a-16a, 249.220f(a)(1994).

116. *Id.* §249.220f(a).

117. See Karmel & Head, *supra* note 34, at 1216-17.

118. See 17 CFR §240.3a12-3(1994).

119. 15 USC §78n (1988).

120. *Id.* §78p.

121. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 101-04, 91 Stat. 1494 (1977) (codified as amended at 15 USC §78m(b), (d)(1), (g)-(h), 78dd-(l), (2), 78ff(a), (e) (1988)). The Foreign Corrupt Practices Act of 1977 provides criminal penalties for corrupt practices to the extent that U.S. jurisdiction is possible. *Id.* In addition, the Act requires that foreign companies establish and maintain an accurate and adequate internal accounting system so that accounting records "reflect transactions in conformity with accepted methods of recording economic events and effectively prevent off-the-books slush funds and payments of bribes." See Bloomenthal, *supra* note 17, at §22.05.

issuers active in securities markets world-wide and regulators which oversee those markets.¹²² In recent years, the SEC has undertaken major initiatives within its own regulatory program to address the concerns and difficulties of investors and intermediaries in the U.S. markets, as well as foreign issuers wishing to access those markets.¹²³ Most importantly, the SEC has attempted to facilitate the registration process for foreign firms through several recent Securities Act and Exchange Act Releases, discussed in greater detail below.

A. AMENDMENTS TO RULE AND FORM REQUIREMENTS WHICH GOVERN AGE OF FINANCIAL STATEMENTS OF FOREIGN PRIVATE ISSUERS

In June 1991, the SEC published for public comment a proposal to amend Rule 3-19 under Regulation S-X, governing the age of financial statements used in Securities Act and Exchange Act registration statements of foreign issuers, to reconcile its requirements with the financial statement updating requirements of the home jurisdictions of most foreign issuers.¹²⁴ Until the SEC's later action in adopting these amendments, Rules 3-19(b) and (c) taken together previously required that on the effective date of a Securities Act registration statement: (1) financial statements in the filing had to be as of a date within six months of the effective date, and (2) the audited year-end financial statements had to be included in the filing if the effective date falls more than five months after the registrant's fiscal year end.¹²⁵ The SEC understood that the periodic reporting requirements of many foreign jurisdictions do not require quarterly reporting and, even where interim as well as annual reporting is required, interim reporting periods frequently are longer than that prescribed in the U.S.¹²⁶

Hence, in order to improve foreign issuers' access to the U.S. public markets without requiring them to produce quarterly financial information, in November 1993 the SEC adopted amendments to these Rules requiring foreign issuers to provide both audited fiscal year financial statements within six months following the end of the fiscal year, and unaudited interim financial statements only to the extent necessary to bring the most recent financial statements included in a filing to a date within *ten months* of the effective date of the filing.¹²⁷ Under this system, a foreign issuer may have uninterrupted access to the U.S. public market by providing, within four months following the end of its fiscal year, either its audited financial statements for that year or unaudited interim financial statements as of the end of the third quarter of that year.¹²⁸ The amendments thus enable registration state-

122. See Kosnik, *supra* note 3, at 1244.

123. *Id.* at 1244.

124. See Securities Act Release No. 6895, 56 Fed. Reg. 27, 562 (June 5, 1991).

125. See Regulation S-X, 17 CFR §210.319(b), (c) (1992).

126. Kosnik, *supra* note 3, at 1251. In recognition of foreign reporting requirements, the SEC's interim reporting requirements for foreign private issuers under the Exchange Act are limited to requiring information on Form 6-K only to the extent it is otherwise provided to shareholders, exchanges or others.

127. *Adoption of Final Amendments to Rule and Form Requirements Which Govern Age of Financial Statements of Foreign Private Issuers*, Securities Act Release No. 7026, 58 Fed. Reg. 60, 304 (Nov. 3, 1993).

128. Securities Act Release No. 7026, *supra* note 127, at 60, 304.

ments of foreign private issuers to go effective with audited financial statements as old as eighteen months, with the most recent interim statements as old as ten months.¹²⁹

In addition, Rule 3-19(f)¹³⁰ previously required interim financial information that is made available to shareholders, exchanges or others on a more frequent basis than that required by Rules 3-19(b) and (c) to be included in any registration statement filed with the SEC. The Rule has required the additional information to be reconciled to U.S. GAAP.¹³¹ The amendments to these Rules provide, however, that such additional information need not be reconciled to U.S. GAAP if adequate narrative disclosures are provided.¹³² Specifically, if a registration statement includes reconciled financial statements as of a date which complies with Rules 3-19(b) and (c), more current financial information which is included in the filing need not be reconciled to U.S. GAAP, *provided that* any material variation in accounting underlying the more recent information which was not previously disclosed and quantified in the reconciliations of earlier periods is described and the quantified effects of the material variation are disclosed.¹³³

B. SIMPLIFICATION OF REGISTRATION AND REPORTING REQUIREMENTS FOR FOREIGN PRIVATE ISSUERS

In April 1994, the SEC adopted amendments to streamline the registration, reporting and reconciliation requirements for foreign issuers.¹³⁴ The amendments were initially proposed in November 1993 and were adopted substantially as proposed.¹³⁵ The amendments included revisions to Securities Act Forms F-1, F-2, F-3 and F-4, Form 20-F and Rule 139 under the Securities Act.

First, and most importantly, the SEC adopted, with certain clarifications, amendments to accept, without reconciliation, a foreign issuer's cash flow statement prepared in accordance with International Accounting Standards No. 7, "Cash Flow Statements," as amended (IAS-7).¹³⁶ The SEC, in response to comments to the proposal also added General Instructions to Form 20-F to provide that the presentation of cash flow statements should be consistent for all periods presented in the filing.¹³⁷ Furthermore, the SEC adopted, as proposed, amendments to Form 20-F that would permit first-time foreign issuer registrations with the SEC to reconcile the required financial statements and selected financial data for only the two most recently completed fiscal years and any required interim

129. *Id.* at 60, 304.

130. See Regulation S-X, 17 CFR §210.3-19(f) (1993).

131. Securities Act Release No. 7026, *supra* note 127, at 60, 305.

132. *Id.* at 60, 305.

133. *Id.*

134. *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. 7053, 59 Fed. Reg. 21, 644 (Apr. 19, 1994) (adopting release).

135. *Simplification of Registration and Reporting Requirements for Foreign Countries: Safe Harbors for Public Announcements of Unregistered Offerings and Broker-Dealer Research Reports*, Securities Act Release No. 7029, 58 Fed. Reg. 60, 307 (Nov. 3, 1993) (proposing release).

136. Securities Act Release No. 7053, *supra* note 134, at 21, 646.

137. *Id.* at 21, 646.

periods.¹³⁸ Where financial statements of an acquired business or significant investee must also be furnished, the amendments eliminate the requirements to reconcile the earliest of the three years if that information was not previously included in a filing with the SEC.¹³⁹ The SEC also noted that reconciliation of interim information was not required for periodic reporting purposes under the Exchange Act.¹⁴⁰ In each subsequent year, an additional year of reconciliation would be required.¹⁴¹ The amendments did not, however, change the requirements with respect to the primary financial statements to be included in the filings (i.e., audited balance sheets for the two most recently completed fiscal years and audited income and cashflow statements for the three most recently completed fiscal years)¹⁴² and separate financial statements of significant acquirees or significant investees.¹⁴³ Furthermore, the requirement to include selected financial data for the five most recent fiscal years remained unchanged.¹⁴⁴ Moreover, the SEC clarified Form 20-F to indicate that the transitional reconciliation relief also applies to financial disclosures required by U.S. GAAP and Regulation S-X.¹⁴⁵ The SEC also adopted, as proposed, amendments to allow the simpler reconciliation pursuant to Item 17 of Form 20-F for all offerings of non-convertible investment grade securities (whether debt, preferred stock or other securities) regardless of the registration form used by the foreign private issuer.¹⁴⁶

Second, the SEC amended the former requirement that foreign private issuers furnish audited financial statements for significant acquired businesses reconciled to U.S. GAAP. As adopted, the financial statements of an acquiree need not be reconciled unless the acquiree exceeds a thirty percent (30%) "significance level" based on (i) the size of the foreign registrant's investment in the business, (ii) the total assets of the business and (iii) the business' pre-tax income relative to amounts reported in the registrant's most recently audited financial statements, as calculated on a U.S. GAAP basis.¹⁴⁷ Similarly, financial statements of significant equity investees need not be reconciled unless the investee exceeds the thirty percent (30%) significance level, using the investment and pre-tax income test for

138. *Id.*

139. *Id.* at 21, 646 n. 35.

140. *Id.* at 21, 646 n. 36.

141. *Id.* at 21, 646. For example, the SEC noted that a foreign company with a calendar fiscal year-end entering the U.S. markets in November 1994 would be required to provide reconciled information with respect to 1993 and 1992 and interim periods. *Id.* In the annual report the company would file for 1994 and any registration report filed thereafter (until the filing of the 1995 annual report), the reconciled data would be provided for three years, i.e., 1992, 1993 and 1994 and interim periods applicable. *Id.*

142. If the financial statements are prepared in accordance with U.S. GAAP, the audited income statement and statement of cashflows would only be required for two years. Selected financial data for the full five fiscal years would still be required, using the accounting principles used for reporting to its shareholders. *Id.* at 21, 646 n. 37.

143. *Id.* at 21, 647.

144. *Id.*

145. *Id.*

146. *Id.* at 21, 647 & n. 38.

147. *Id.* at 21, 647 & n. 39-40.

significance.¹⁴⁸ Further, as suggested by several commentators, the SEC asserted that compliance with Item 18 of Form 20-F would be acceptable for financial statements of all significant acquirers and investees.¹⁴⁹

Third, reconciliation was also streamlined with respect to foreign private issuers that use pro-rata consolidation for certain joint ventures that would be accounted for under the equity method pursuant to U.S. GAAP.¹⁵⁰ Such an issuer is now able to provide summarized financial information of the current assets and liabilities, non-current assets and liabilities, net sales, gross profit and net income relating to its pro-rata interests in the joint venture.¹⁵¹ Separate financial statements of a joint venture accounted for using the pro-rata method are not required.¹⁵²

Fourth, the SEC eliminated the following rules and accompanying financial statement schedules that were previously required to be furnished by foreign issuers:

- (1) Rule 12-02 — Marketable Securities—Other Investments;
- (2) Rule 12-03 — Amounts Receivable from Related Parties and Underwriters, Promoters, and Employees Other Than Related Parties;
- (3) Rule 12-05 — Indebtedness Of and To Related Parties—Not Current;
- (4) Rule 12-06 — Property, Plant and Equipment;
- (5) Rule 12-07 — Accumulated Depreciation, Depletion and Amortization of Property, Plant and Equipment; and
- (6) Rule 12-08 — Guarantees of Securities of Other Issuers.¹⁵³

C. ADOPTION OF RULES TO STREAMLINE FINANCIAL STATEMENT REQUIREMENTS OF FOREIGN PRIVATE ISSUERS

In 1994, the SEC proposed and subsequently adopted amendments to Form 20-F of the Exchange Act and Regulation S-X of the Securities Act designed to streamline the financial information and reconciliation requirements for foreign issuers.

1. Reporting Currency & Accounting for Operations in Hyper-Inflationary Environments

In April 1994, the SEC proposed to facilitate registration and reporting by foreign private issuers by allowing flexibility in the selection of the reporting currency used in filings with the SEC and by streamlining financial statement reconciliation requirements for foreign private issuers with operations in countries with hyper-inflationary economies.¹⁵⁴ As initially proposed, a foreign private issuer could state amounts in its financial statements in

148. *Id.* at 21, 647.

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.* at 21, 648; see also Securities Act Release No. 7029, *supra* note 135, at 60, 310-11 (proposing to eliminate enumerated financial schedules).

154. *Selection of Reporting Currency for Financial Statements of Foreign Private Issuers and Reconciliation to U.S. GAAP for Foreign Private Issuers with Operations in a Hyper-Inflationary Economy*, Securities Act Release No. 7054, 59 Fed. Reg. 21, 810 (Apr. 19, 1994).

any currency which it deemed appropriate, so long as it reports to a majority of its nonaffiliated security holders using that currency.¹⁵⁵ In addition, a foreign private issuer that accounts for its operations in hyper-inflationary environments in accordance with IAS-21, "The Effects of Changes in Foreign Exchange Rates" (amended in 1993), would not need to reconcile the differences that would have resulted from application of the U.S. standard, Statement of Financial Accounting Standards No. 52, "Foreign Currency Translation" (SFAS-52).¹⁵⁶

A. SELECTION OF A REPORTING CURRENCY

Before the new amendments were adopted, the SEC's rules required a foreign issuer to present its financial statements in the currency of either its country of incorporation or of its primary economic environment.¹⁵⁷ This requirement was increasingly troublesome for foreign issuers entering the U.S. markets because some of those issuers that historically reported in their domestic market using the U.S. dollar sought to report on that basis in the U.S., but the SEC rules would not permit them to do so in filings with the SEC.¹⁵⁸ In addition, reporting currency issue was particularly troublesome for the foreign private issuers that operated in several countries or had their securities traded in a number of markets because (i) for some companies, the country of incorporation was only a matter of convenience or only accounted for a limited part of its business activity, and/or (ii) no single economic environment was dominant to its operations or shareholder base. In these circumstances, the SEC noted that foreign issuers often desired to select a non-reporting currency chiefly on the basis of its familiarity to and acceptance by the international markets, and that some multi-national companies stated amounts in their financial statements in different currencies in different trading markets, either by choice or by mandate of the various jurisdictions.¹⁵⁹ To address these difficulties, the SEC proposed to revise Rule 3-20 of Regulation S-X.¹⁶⁰ The proposed amendments enabled a foreign issuer to state the amounts in its primary financial statements in which it reported to a majority of its shareholders.¹⁶¹ The proposal also required a foreign issuer that changes its reporting currency to comprehensively recast its financial statements as if the new reporting currency had been used since at least the earlier period presented in the filing.¹⁶² Moreover, the proposal sought comment on whether transactions of the foreign issuer and its subsidiaries that were located in the same country as the issuer should be measured in the reporting currency, or whether they should be measured in the currency of their primary economic environment and translated to the reporting currency.¹⁶³

As a result, the adopted amendments permit a foreign issuer to use any currency it

155. Securities Act Release No. 7054, *supra* note 154, at 21, 810.

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.*

160. See Regulation S-X, 17 CFR §210.3-20 (1994).

161. Securities Act Release No. 7054, *supra* note 154, at 21, 810.

162. *Id.* at 21, 811-12.

163. *Id.*

deems appropriate in its primary financial statements.¹⁶⁴ The proposed requirement that the reporting currency also be used to report to a majority of the issuers' non-affiliated shareholders was deleted in response to the comments.¹⁶⁵ The amended rules also require specific disclosure in a note to the financial statements if the currency in which the foreign issuer expects to declare dividends is different from the reporting currency, where there are material exchange restrictions affecting the reporting currency or the currency in which dividends are paid.¹⁶⁶ The adopted rules apply to financial statements of the foreign registrant. Financial statements furnished with respect to equity investees or acquired businesses may, however, be prepared using the same reporting currency as the foreign issuers' primary financial statements or the currency in which that entity normally prepares its financial statements.¹⁶⁷ Furthermore, regarding the SEC's proposal for comment on two alternative approaches for measuring actions that would then be translated into the reporting currency,¹⁶⁸ the SEC adopted the approach that requires the foreign issuer to separately measure its own transactions, and those of each of its material operations (for instance, branch, division, subsidiary, or joint venture), that are included in the issuer's consolidated financial statements and located in a non-hyper-inflationary environment. Such measure is to be made using the particular currency of the primary economic environment in which the issuer or the operation conducts its business.¹⁶⁹ The amendments also provide that changes in the reporting currency require the financial statements of periods prior to the change to be comprehensively recast as if the new reporting currency had been used.¹⁷⁰ To compre-

164. See *Selection of Reporting Currency for Financial Statements of Foreign Private Issuers and Reconciliation to U.S. GAAP for Foreign Private Issuers with Operations in a Hyper-Inflationary Economy*, Securities Act Release No. 7117, 59 Fed. Reg. 65, 628 (Dec. 20, 1994).

165. Securities Act Release No. 7117, *supra* note 164, at 65, 628.

166. *Id.* The depicted trends and reported results that are afflicted by exchange rate fluctuations should be provided in explanatory disclosure in filings with the SEC as part of the explanation of the material changes from year-to-year required by the MD&A Section of Regulation S-K, 17 CFR §229.303 (1994), as well as the comparable sections in Item 9 of Form 20-F, 17 CFR §249.220f (1994). *Id.* at 65, 629.

167. *Id.* at 65, 629 n. 9.

168. *Id.* at 65, 629.

169. *Id.* at 65, 629 n. 10. Financial statement amounts so determined would be translated to the reporting currency using the methodology that is prescribed by SFAS-52 for translation of financial statements from a functional currency to a reporting currency. *Id.* Under that method, (a) all assets and liabilities are translated into the reporting currency at the exchange rate at the balance sheet date, (b) all revenues, expenses, gains, and losses are translated at the exchange rate existing at the time of the transaction or, if appropriate, a weighted average of the exchange rates during the period or year, and (c) all the translation effects of exchange rate changes are included as a separate component ("cumulative translation adjustment") of shareholders' equity. *Id.*

170. *Id.* at 65, 629-30.

hensively recast prior financial statements, a methodology consistent with SFAS-52 Should be applied.¹⁷¹

B. ACCOUNTING FOR OPERATIONS IN HYPER-INFLATIONARY ECONOMIES

The SEC also proposed amendments to Item 17 and Item 18 of Form 20-F that would permit a foreign issuer that accounts for its operations in hyper-inflationary economies in accordance with IAS-21, "The Effects in Changes in Foreign Exchange Rates," to omit quantification of any differences that would have resulted from the application of the U.S. standard in SFAS-52.¹⁷² IAS-21 requires that amounts in the financial statements of the hyper-inflationary operation be restated for the effects of changing prices in accordance with IAS-29, Financial Reporting in Hyper-Inflationary Economies, and then translated into the reporting currency.¹⁷³

As adopted, the amendments eliminate the requirement that a foreign issuer quantify the effects of a translation methodology for operations in a hyper-inflationary environment which differs from SFAS-52, so long as the method used in the financial statements conforms with IAS-21, provided that the method is used consistently for all periods.¹⁷⁴ The adopted rule differs, however, from the proposal in that it limits the permissible method for restating the effects of changing prices to the historical costs/constant dollar method.¹⁷⁵ The SEC asserted that the historical cost/constant currency method is the preferable choice because it is more likely to facilitate comparison between similarly situated companies: under the historical costs/constant currency method, amounts in the financial statements of the hyperinflationary operation are restated for the effects of changing prices, and then translating into the reporting currency.¹⁷⁶ Moreover, a hyper-inflationary environment is defined in the adopted rules as one experiencing cumulative inflation of approximately 100% or more over the most recent three-year period, as measured using an appropriate inflation index which measures the general price levels in that country.¹⁷⁷ Accordingly, for-

171. *Id.* at 65, 629. That is, the income statement and statement of cash flows should be translated into the new reporting currency using an appropriately weighted average exchange rate for the applicable period, and assets and liabilities should be translated using the exchange rate at the end of the applicable period. *Id.* Foreign registrants that encounter unusual or complex problems in the implementation of a change in reporting are encouraged to discuss those issues with the SEC staff prior to filing. *Id.*

172. Securities Act Release No. 7054, *supra* note 154, at 21, 812.

173. See Wayne E. Carnall, *Current Accounting Issues and Related Developments Affecting the Division of Corporation Finance (As of May 2, 1994)*, PLI, Annual Institute on Securities Regulation, 868 PLI/Corp. 487 (1994), available on Westlaw. Issuers may elect either of two methods described by LAS-29, (a) restatement of historical costs amounts into units of currency that have the same general purchasing power (historical costs/constant currency), or (b) measurement at current cost, with amounts for prior periods were stated, for changes in the general level of prices (current cost method). *Id.*

174. Securities Act Release No. 7117, *supra* note 164, at 65, 630.

175. *Id.* at 65, 630.

176. *Id.*

177. *Id.* This definition is consistent with that used to define a hyper-inflationary entity under SFAS-52. *Id.*

eign issuers may omit reconciliation of accounting differences arising from the use of IAS-21 for hyper-inflationary operations only when they would have been required to comply with the comparable provisions of SFAS-52.¹⁷⁸ Finally, the SEC stated that the adopted rules apply equally to subsidiaries of and the parent company operating in a hyper-inflationary environment; hence, the legal structure of an entity should not affect the financial statements.¹⁷⁹

D. ACCOUNTING FOR BUSINESS COMBINATIONS AND GOODWILL

The SEC also proposed to amend Form 20-F to eliminate the requirement that foreign issuers reconcile certain differences attributable to accounting methods for a business combination or for the amortization period for goodwill or negative goodwill, if the method used regarding these items conforms with IAS-22, "Business Combinations."¹⁸⁰

1. Accounting for Business Combinations

Under the proposed rules, a business combination which would be deemed a uniting of interests under IAS-22 and which was accounted for using that basic method in the primary financial statements would be deemed, for purposes of reconciliation to U.S. GAAP, a "pooling of interests," with quantification required only to the extent that the procedures used in the primary financial statements differ from the procedures required under U.S. GAAP for a pooling of interest.¹⁸¹ Similarly, a business combination that would be deemed an acquisition under IAS-22 and which was accounted for using that basic method in the primary financial statements would be deemed, for purposes of the reconciliation, a purchase, with quantification required only to the extent that the procedures used in the primary financial statements differed from the procedures required under U.S. GAAP for a purchase.¹⁸²

The adopted amendments eliminated the requirement that foreign private issuers quantify the effective differences arising solely from the different criteria applied to the selection of the basic method of accounting for a business combination, if the criteria used in the primary financial statements for determining the method are consistently applied

178. *Id.* Consistent with the rule prior to amendment, foreign issuers that prepare their financial statements in a reporting currency that comprehensively includes the effects of price level changes are not required to eliminate such effects in the reconciliation to U.S. GAAP. *Id.* Item 17(c)(2)(iv)(A) and Item 18(c)(2)(iv)(A) of Form 20-F does not require that the entity operate in a hyper-inflationary environment. *Id.*

179. *Id.*

180. *See Reconciliation of the Accounting By Foreign Private Issuers for Business Combinations*, Securities Act Release No. 7056, 59 Fed. Reg. 21, 821 (Apr. 19, 1994).

181. Securities Act Release No. 7056, *supra* note 180, at 21, 821.

182. *Id.* Relief under this rule would be available only if the criteria used in the primary financial statements for determining the method (purchase or pooling) are consistently applied and are consistent with IAS-22. *Id.*

and are consistent with IAS-22.¹⁸³ However, in accordance with the suggestions of many commentators, the new provisions will not be available with respect to business combinations that are promoter transactions, leveraged buyouts, mergers of entities under common control, or reverse acquisitions.¹⁸⁴ The final rule indicates that those types of transactions would continue to be required to be reconciled in full to U.S. GAAP.¹⁸⁵

2. Accounting for Goodwill and Negative Goodwill

In addition, the SEC initially proposed to eliminate the requirement to reconcile to U.S. GAAP amounts arising from differences in the periods used to amortize goodwill and negative goodwill in the primary financial statements if the method used is consistently applied and consistent with IAS-22.¹⁸⁶ Under IAS-22, goodwill and negative goodwill is amortized over a period not exceeding five years unless a longer period, not exceeding twenty years, can be justified.¹⁸⁷

These rules were generally adopted as proposed.¹⁸⁸ In adopting the amendments, the SEC noted that the accounting differences between IAS-22 and APB-17 "are not so opaque as to result in the loss of material information to investors."¹⁸⁹ However, the SEC qualified relief under the amendments, asserting that relief from reconciliation permitted under the adopted rules is applicable only to differences in the amortization period as it applies to the aggregate amount of goodwill or negative goodwill that would be determined under U.S. GAAP.¹⁹⁰

183. See *Reconciliation of the Accounting by a Foreign Private Issuers for Business Combinations*, Securities Act Release No. 7119, 59 Fed. Reg. 65, 637 (Dec. 13, 1994). The two basic methods of accounting described above can be summarized as either "pooling of interests" or "purchase" as determined under U.S. GAAP primarily pursuant to Accounting Principles Board Opinion No. 16, "Accounting for Business Combination" ("APB-16"), or "Uniting of Interests" and "Acquisition" under IAS-22. For a comparison of the principle similarities and differences between these methods, see *Id.* at 65, 638.

184. Securities Act Release No. 7119, *supra* note 183, at 65, 638.

185. *Id.* at 65, 639.

186. Securities Act Release No. 7056, *supra* note 180, at 21, 822.

187. *Id.* Cf. Accounting Principles Board Opinion No. 17, "Accounting for Intangibles," ("APB-17"), which requires the amortization of goodwill or negative goodwill over its useful life, except the period cannot exceed forty years. *Id.*

188. Securities Act Release No. 7119, *supra* note 183, at 65, 639.

189. *Id.* at 65, 639. If the useful life of goodwill or amortization period of negative goodwill exceeds five years, justification of the longer period is required by 172 of IAS-22 to be shed in a note to the primary financial statements. *Id.* Foreign registrants will continue to be required under both Item 17 and 18 of Form 20-F to describe the accounting differences, even where relief from quantification of differences is granted by the amendments. *Id.*

190. *Id.* For example, negative goodwill under IAS-22 (the amount by which the fair value of acquired net assets exceeds the purchase price) must be reconciled to negative goodwill determined under U.S. GAAP (the amount remaining after the excess over the purchase price has been applied to reduce the carrying value of non-monetary, non-current assets. *Id.* In response to a commentator's suggestion, Items 17 and 18 of Form 20-F have been modified to clarify that point. *Id.*

3. Implementation and Transition of the Amendments

Under the adopted rules, the SEC will permit foreign issuers to elect to apply the provisions of IAS-22 in the determination of the method of accounting for business combinations but not adopt its provisions for amortization of goodwill and negative goodwill.¹⁹¹ The SEC further stated that the new provisions would be implemented in financial statements beginning on or after January 1, 1995, with *retroactive encouraged but not required*.¹⁹² For a foreign issuer that does not retroactively implement IAS-22, full reconciliation to U.S. GAAP would be required with respect to business combinations consummated prior to January 1, 1995.¹⁹³

As requested by several commentors, the adopted rules clarify how foreign issuers and their auditors should describe the balance sheet and income statement amounts which do not reflect full reconciliation to U.S. GAAP.¹⁹⁴ Amounts reported in the reconciliation should be referred to as determined in accordance with U.S. GAAP except for the specific items for which there is a deviation; exceptions should be stated to be in accordance with Item 17 or 18 of Form 20-F, as applicable, and different than that required by U.S. GAAP.¹⁹⁵ 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 on the financial statements taken as a whole.¹⁹⁶

E. ELIMINATION OF SUPPLEMENTAL FINANCIAL SCHEDULES

In a separate release, applicable to both domestic and foreign issuers, the SEC proposed to eliminate the requirement to provide two supplemental financial schedules—Short Term Borrowings and Supplementary Income Statement Information.¹⁹⁷

191. *Id.*

192. *Id.*

193. *Id.*

194. *Id.*

195. *Id.* The accommodation provided under the adopted rules is an exception to the requirement to reconcile to U.S. GAAP that is similar to the accommodation that was provided to foreign private issuers that prepare price-level adjusted financial statements. See Securities Act Release No. 7119, *supra* note 183. *Id.* at 65, 639 n. 5.

196. *Id.* at 65, 639. The auditor's report is required to comply with Rule 2-02 of Regulation S-X, 17 CFR §210.2-02 (1994), 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 U.S. GAAP or the quantification of the effects of accounting differences is materially misstated, or, where applicable, is incorrectly stated to be determined pursuant to the special provisions afforded under Item 17 or 18 by the rules adopted under the Release, the financial statements would be presumed to be materially misleading and an exception should be cited in the auditor's report. *Id.*

197. See *Financial Statements of Significant Foreign Equity Investees and Acquired Foreign Businesses of Domestic Issuers and Financial Schedules*, Securities Act Release No. 7055, 59 Fed. Reg. 21, 814 (Apr. 19, 1994) (proposing release); *Financial Statements of Significant Foreign Equity Investees and Acquired Foreign Business of Domestic Issuers and Financial Schedules*, Securities Act Release No. 7118, 59 Fed. Reg. 65, 632 (Dec. 20, 1994) (adopting release).

1. Short Term Borrowings

Although the adopted amendments eliminate this schedule; however, as proposed, weighted average interest rate on borrowings outstanding as of each of the dates for which balance sheets are presented will be required to be disclosed in footnotes to the financial statements.¹⁹⁸

2. Supplementary Income Statement Information

The SEC also eliminated this schedule under the amendments.¹⁹⁹ While the amounts of the items formally referenced by this schedule (maintenance and repairs; depreciation and amortization of the costs of intangible assets, pre-operating costs and similar deferred costs; taxes other than payroll; royalties; and advertising costs) need not be disclosed by foreign registrants on an on-going basis, discussion of discretionary expenses and other items in this schedule, quantified to the extent practicable, will be required in the company's MD&A section of the registration statement to explain, if necessary, material trends and uncertainties that affected operating results, liquidity or financial condition of the foreign registrant, or that may be reasonably likely to affect future results, liquidity or financial condition.²⁰⁰

V. Conclusion

In conclusion, it is clear that dealing with the SEC's financial disclosure requirements in lieu of a public offering is not an easy process, and that it often takes longer than most foreign issuers would like or anticipate when they first begin to contemplate issuing their securities in the U.S.²⁰¹ This proposition is in almost all certainty a primary reason why many Mexican and South American companies which currently list their securities on the U.S. national exchanges have generally opted to "test the waters" before registering their securities with the SEC by undertaking either a Regulation D Rule 506 or Regulation S/Rule 144A exempt placement to reach U.S. investors. However, the hurdles involved in SEC registration are far from overwhelming, and the recent initiatives undertaken by the SEC to streamline the registration and disclosure processes indicate that the SEC will be even more flexible and accommodating to foreign issuers in the future. Thus, Mexican and South American issuers alike should consider the inclusion of public offerings of securities in the U.S. as part of their overall strategies in raising capital outside of the U.S. private placement markets.

198. Securities Act Release No. 7118, *supra* note 197, at 65, 635. In addition, for investment companies, although the schedule requirement has been eliminated, the information formally required by §210.12-10 of Regulation S-X, 17 CFR §210.12-10 (1994), will now be required to be provided in the body of the financial statements or in the footnotes. *Id.*

199. *Id.* at 65, 635.

200. *Id.*

201. Cf. Richard Koanik, *Panel U: The Role of the SEC in Evaluating Foreign Issuers Coming to U.S. Markets*, 17 Fordham Int'l L.J. S97-S99, S110-11 (1994) (addressing the flexibility of the SEC in evaluating and accommodating non-U.S. companies entering the U.S. capital markets).

ANNEX

Highlights of Daimler-Benz Form 20-F²⁰²

Prepared by: Eric M. Sherbet

A review of the Daimler-Benz 1993 Form 20-F crystallizes the issues at stake in the accounting standards debate. The financial statements included in the filing conform to the Item 18 requirements for presenting financial statements in accordance with another comprehensive body of accounting principles. Accordingly, the financial statements are in accordance with German GAAP but include a narrative discussion of the differences between U.S. and German GAAP as well as a quantitative reconciliation of net income and stockholders' equity under German GAAP to net income and stockholders' equity under U.S. GAAP. In addition, all footnote disclosures required under U.S. GAAP are included.

There are many sources of German accounting principles. Unlike U.S. GAAP, German GAAP is heavily influenced by statute. The Commercial Code (Handelsgesetzbuch or HGB), General Tax Law (Abgabenordnung or AO), Income Tax Law (Einkommensteuergesetz or EstG), German Stock Corporation Law (Aktiengesetz or AktG) and Limited Liability Company Law (GmbHGesetz or GmbHG) all govern accounting and financial reporting.²⁰³ The profession does, however, influence the standard-setting process through the pronouncements of the Institute of Auditors (Institute der Wirtschaftsprüfer or IdW).²⁰⁴ Lastly, because Germany is a member state of the European Union, it must comply with the Fourth (annual accounts) and Seventh (consolidation) Directives of the European Economic Community.²⁰⁵

Consistent with the Fourth Directive, the Commercial Code requires the audit report to state that "the annual financial statements give a *true and fair view* of the company's assets, liabilities, financial position and profit and loss."²⁰⁶ By contrast, the KPMG Deutsche Treuhand Gesellschaft audit report included with the Daimler filing conforms to U.S. GAAP. The first paragraph indicates that the audits were conducted in accordance with both U.S. and German GAAP.²⁰⁷ The opinion paragraph states that "the consolidated financial statements . . . present fairly, in all material respects, the financial position . . . of Daimler-Benz . . . and the results of their operations and cash flows . . . in conformity with generally

202. The ensuing analysis of the Daimler-Benz Form 20-F is contained in Eric M. Sherbet, *Bridging the GAAP: Accounting Standards For Foreign SEC Registrants*, at 7-10 (1994) (on file with Southern Methodist University School of Law).

203. Larry L. Orsini, John P. McAllister & Rajiv M. P., *World Accounting*, §GER.01[1](1994).

204. *Id.* at §GER.01[2].

205. *Id.*

206. Council Directive 78/660, art. 2 1978 O.J. (L 222) 12.

207. Daimler Benz Aktiengesellschaft, 1993 Form 20-F, at F-I (1994), available on LEXIS.

accepted accounting principles in Germany.²⁰⁸ Lastly, an explanatory paragraph indicates that a reconciliation of German to U.S. GAAP is provided in a footnote.²⁰⁹

Neither the Fourth Directive nor German GAAP require a statement of cash flows.²¹⁰ In order to satisfy the SEC reporting requirements, the Daimler filing includes U.S. statements of cash flows.²¹¹ Additionally, U.S. GAAP footnote disclosure is appended to the corresponding German GAAP footnotes. Specifically, U.S. GAAP footnote information is disclosed with respect to retirement plans,²¹² income taxes,²¹³ financial instruments,²¹⁴ extraordinary items²¹⁵ and segment reporting.²¹⁶

The heart of the accounting standards debate, however, is captured in Note 2 to the consolidated financial statements.²¹⁷ The footnote describes, in narrative form, the differences between U.S. and German GAAP that affect the net income and stockholders' equity of Daimler-Benz. The following summarizes some of these differences:²¹⁸

1) *Long-term contracts* —

German GAAP generally requires revenue and costs on long-term contracts to be recognized in accordance with the completed contract method.²¹⁹ U.S. GAAP accounts for long-term contracts under either the completed contract or percentage of completion method.²²⁰

2) *Goodwill* —

German GAAP permits goodwill to be charged directly to stockholders' equity or capitalized and amortized over its useful life,²²¹ while U.S. GAAP requires goodwill to be capitalized and amortized over its useful life.²²²

208. *Id.*

209. *Id.*

210. COOPERS & LYBRAND, *International Accounting Summaries: A Guide for Interpretation and Comparison*, G-2 (2d. ed. 1993).

211. Daimler-Benz, *supra* note 207, at F-4.

212. *Id.* at F-16.

213. *Id.* at F-21.

214. *Id.* at F-34.

215. *Id.* at F-20.

216. *Id.* at F-35.

217. *Id.* at F-9.

218. The author notes that the ensuing analysis represents only a cursory review of very detailed and complex accounting issues, any one of which could merit a separate paper of its own. The summary and corresponding table that follows are intended to highlight the nature and magnitude of the issues at stake.

219. COOPERS & LYBRAND, *supra* note 210, at G-15.

220. LONG-TERM CONSTRUCTION-TYPE CONTRACTS, Accounting Research Bulletin No. 45, at § 15 (American Institute of Certified Public Accountants 1955).

221. COOPERS & LYBRAND, *supra* note 210, at 0-4.

222. INTANGIBLE ASSETS, Opinion No. 17, at §§24-27 (Accounting Principles Board 1970).

3) Pensions —

Actuarial calculations in Germany are usually based on the tax regulations, which do not permit the consideration of expected increases as a factor in the calculation of pension cost.²²³ U.S. GAAP requires calculation of the projected benefit obligation based on future compensation if the plan's pension benefit formula so provides.²²⁴ In addition, U.S. GAAP requires recognition of liability for post retirement benefits other than pensions.²²⁵ Germany has no such requirement.²²⁶

4) Foreign Currency Translation —

There are no specific German accounting standards with respect to foreign currency translation.²²⁷ Daimler-Benz employs a conservative approach by stating receivables and payables at either the historical or period end rate, whichever would result in a lower receivable or higher payable balance.²²⁸ Daimler generally translates the balance sheet of foreign subsidiaries on the basis of period end rates.²²⁹ U.S. GAAP requires foreign currency transactions and the balance sheet of foreign entities to be translated at the period end rate.²³⁰

5) Financial Instruments —

Under German GAAP, a reserve for unrealized losses is established for financial instruments that hedge against currency risk.²³¹ Unrealized gains, however, are not recognized until realized.²³² U.S. GAAP requires the recognition of both unrealized gains and losses on hedge contracts under certain circumstances.²³³

6) Deferred Taxes —

Deferred taxes are less common in Germany than the United States because the German accounting principles conform to the tax regulations more frequently.²³⁴ If accounting

223. COOPERS & LYBRAND, *supra* note 210, at G-18.

224. EMPLOYERS ACCOUNTING FOR PENSIONS, Statement of Financial Accounting Standards No. 87, at §17 (Financial Accounting Standards Board 1985).

225. EMPLOYERS ACCOUNTING FOR POST-RETIREMENT BENEFITS OTHER THAN PENSIONS, Statement of Financial Accounting Standards No. 106 (Financial Accounting Standards Board 1990).

226. COOPERS & LYBRAND, *supra* note 210, at G-18.

227. *Id.* at G-6.

228. Daimler-Benz. *supra* note 207. at F-7.

229. *Id.*

230. FOREIGN CURRENCY TRANSLATION, Statement of Financial Accounting Standards No. 52, at §27 (Financial Accounting Standards Board 1981).

231. COOPERS & LYBRAND, *supra* note 210, at G-6.

232. *Id.*

233. DISCLOSURE OF INFORMATION ABOUT FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND FINANCIAL INSTRUMENTS WITH CONCENTRATIONS OF CREDIT RISKS, Statement of Financial Accounting Standards No. 105 (Financial Accounting Standards Board 1990).

234. Orsini, McAllister & Parikh, *supra* note 203, at §GER.26[1].

income exceeds taxable income, deferred tax liabilities are recognized under the liability method.²³⁵ Recognition of deferred tax assets is optional.²³⁶ Under U.S. GAAP, deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been recognized in the financial statements or tax returns.²³⁷ If it is more likely than not that some portion or all of a deferred tax asset will not be realized, a valuation allowance is recognized.²³⁸ In addition, deferred tax effects of the U.S. GAAP adjustments must be recognized.

7) Other —

Other differences in accounting principles include adjustments for LIFO inventory, treasury stock and the minority stockholders' interest in the U.S. GAAP adjustments.²³⁹

8) Accruals and Reserves —

Both U.S. and German GAAP provide that loss contingencies are to be recorded when the loss is both probable and estimable.²⁴⁰ German firms, however, have historically recorded higher accrual balances and asset reserves than would be allowable under U.S. GAAP.²⁴¹

The above differences are quantified in Note 2 to the Daimler-Benz 1993 consolidated financial statements:²⁴²

	For the Year Ended December 31, 1993 (in millions of U.S. \$)
Net income under German GAAP	354
Long-term contracts	45
Goodwill	(165)
Pensions	(359)
Foreign currency translation	(23)
Financial instruments	(129)
Deferred taxes	1,510
Other	160
Accruals and Reserves	(2,450)
Net loss in accordance with U.S. GAAP	(1,057)

235. *Id.*

236. *Id.*

237. ACCOUNTING FOR INCOME TAXES, Statement of Financial Accounting Standards No. 109, at §6 (Financial Accounting Standards Board 1990).

238. *Id.* at § 17.

239. Daimler-Benz, *supra* note 207, at F-9.

240. COOPERS & LYBRAND, *supra* note 210, at G-12; ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5, at §8 (Financial Accounting Standards Board 1975).

241. Daimler-Benz, *supra* note 207, at F-9.

242. *Id.* at F-12.

Not surprisingly, the debate over the treatment of accruals and reserves has dwarfed that of all the other differences.²⁴³ At first glance, the accruals and reserves adjustment appears to contradict the description of the comparative accounting treatment noted above. Despite the fact that German GAAP yields larger accrual balances and more expense than would be permissible under U.S. GAAP, Daimler's 1993 adjustment of German accruals and reserves is a *reduction* of net income. This demonstrates an accounting practice that is acceptable in Germany but frowned upon in the United States. During profitable years, German firms will record larger accruals than they may truly need in the future. If subsequent years are less profitable, they will adjust for excess accruals by recording as income the excess of the liability provided in a previous profitable year over the actual settlement amount of the liability.²⁴⁴ In this way, operating results are more evenly distributed over the course of several years.²⁴⁵ Accordingly, Daimler-Benz adjusted excess liabilities downward and recorded \$2.45 billion in income in 1993 (footnote omitted). Germans view this as a desirable practice designed to protect investors and creditors against short-term earnings fluctuations.²⁴⁶ In the United States, the practice is discouraged as a means of managing income as "income smoothing." Accordingly, U.S. accounting principles require the recording of accruals and reserves to more closely reflect the actual estimate of future costs.

It is clear that the underlying components of Daimler-Benz's decision to access the U.S. markets were not only a fundamental long-term view that a truly global company must sell its products around the world, but also that it must develop a truly global ownership base in its securities. Daimler-Benz saw the existence of an informed international investor base with confidence in its understanding of the company's financial picture as a significant corporate asset.²⁴⁷ In short, what Daimler-Benz's management correctly perceived was that in today's world, both a strong global customer base and a strong global ownership base are critical corporate assets.²⁴⁸

243. Raghavan & Sesit, *supra* note 88, at A1; John Schmid, Daimler Benz Reports First-Ever Loss, *Reflecting New Accounting, Lower Sales*, Wall St. J., Sept. 20, 1993 at A10. Note that the magnitude of the deferred tax adjustments is largely attributable to the tax effect of the accruals and reserves adjustment.

244. William C. Freund, *That Trade Obstacle, the SEC*, Wall St. J., Aug. 27, 1993, at A6.

245. *Id.*

246. *Id.*

247. See Breeden, *supra* note 90, at S93.

248. *Id.* at S93.
