

1995

## Bridging the GAAP: Accounting Standards for Foreign SEC Restraints

Eric M. Sherbet

---

### Recommended Citation

Eric M. Sherbet, *Bridging the GAAP: Accounting Standards for Foreign SEC Restraints*, 29 INT'L L. 875 (1995)

<https://scholar.smu.edu/til/vol29/iss4/8>

This Symposium is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in International Lawyer by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

## Bridging the GAAP: Accounting Standards for Foreign SEC Registrants

Over the past several years, an increasing number of foreign firms have sought access to U.S. capital markets.<sup>1</sup> The U.S. capital markets attract these firms for several reasons. First, the United States has the largest, most efficient capital markets in the world.<sup>2</sup> Second, institutional investors in the United States have shown an increasing demand for foreign securities.<sup>3</sup> Third, listing shares on an American exchange can be an effective foothold for marketing products in the United States. Whatever the reasons for coming to market, foreign firms cannot reap the benefits of the American capital markets without complying with the United States' complex system of securities regulation. Specifically, the federal securities laws require foreign firms who wish to offer securities publicly in the United States to present financial statements in accordance with U.S. generally accepted accounting principles (GAAP).<sup>4</sup>

---

**Note:** The American Bar Association grants permission to reproduce this article, or a part thereof, in any not-for-profit publication or handout provided such material acknowledges original publication in this issue of *The International Lawyer* and includes the title of the article and the name of the author.

\*B.S., University of Virginia, 1986; J.D., New York University School of Law, 1995; Certified Public Accountant, New Jersey, 1989.

1. Richard C. Breeden, *Foreign Companies and U.S. Securities Markets in a Time of Economic Transformation*, 17 *FORDHAM INT'L L.J.* S81 (1994); Richard Kosnik, *The Role of the SEC in Evaluating Foreign Issuers Coming to U.S. Markets*, 17 *FORDHAM INT'L L.J.* S100 (1994).

2. Breeden, *supra* note 1, at S81.

3. James L. Cochrane, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?*, 17 *FORDHAM INT'L L.J.* S59 (1994).

4. Form 20-F, item 18, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,724, 29,765 (Jan. 1, 1995). The United States has many sources of GAAP, although the pronouncements of professional bodies such as the Financial Accounting Standards Board, Accounting Principles Board, and other groups affiliated with the American Institute of Certified Public Accountants constitute the most significant portion of GAAP. Although the SEC has primarily incorporated GAAP into its requirements, it does supplement the body of GAAP through Accounting Series Releases and Regulation S-X. MARTIN A. MILLER

Some firms have avoided the U.S. capital markets because of the perception that the costs of compliance with U.S. GAAP will be significant.<sup>5</sup> Perhaps because the differences between U.S. GAAP and German GAAP<sup>6</sup> are so significant, German firms have been especially reluctant to present U.S. GAAP financial statements.<sup>7</sup> Several leading German companies, including Hoechst, Siemens and Volkswagen, have tried unsuccessfully to convince the U.S. Securities and Exchange Commission (SEC or Commission) to relax the accounting requirements for foreign registrants.<sup>8</sup> In 1993 Daimler Benz AG broke ranks with the German blue chips. The parent company of Mercedes Benz presented U.S. GAAP financial statements in its registration statement as part of a listing of its shares on the New York Stock Exchange (NYSE or Exchange).<sup>9</sup> The financial statements included in Daimler's 1993 Form 20-F converted 1993 \$354 million German GAAP income to a \$1.057 billion U.S. GAAP loss.<sup>10</sup>

Because Daimler was the most significant German firm to comply with U.S. accounting principles, its November 1993 listing received a great deal of publicity.<sup>11</sup> Much of the publicity focused on the issue of accounting requirements for foreign registrants. Many in the financial community fear that the U.S. GAAP requirements will cost the U.S. capital markets their preeminence in the global financial community.<sup>12</sup> The NYSE has joined some foreign firms in calling for an exemption for certain firms from the U.S. GAAP requirements.<sup>13</sup> The SEC, however, maintains that the U.S. GAAP requirements protect investors by ensuring efficient and honest markets.<sup>14</sup>

Foreign firms should be required to comply with U.S. GAAP for several reasons. First, the NYSE's concerns about the incentive effects of the requirements may be unfounded. Second, evidence supports the contention that U.S.

---

& LARRY BAILEY, GAAS GUIDE 1993, § 4.13 (1991). For purposes of this article, the term GAAP is given its broadest definition to include the professional and SEC pronouncements as well as practices widely recognized throughout the profession.

5. Although Part III.A.1 argues that the U.S. disclosure rules are not a disincentive to enter American markets, some firms perceive the costs of compliance to be high. See discussion *infra* part IV.A.1. Generally, however, registration of foreign firms in the United States has been robust.

6. German GAAP are a function of European Union law, national statute, and professional pronouncements. See discussion *infra* part II.

7. Anita 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.

8. *Id.*

9. *Id.*

10. Daimler Benz Aktiengesellschaft, 1993 Form 20-F, F-12 (1994) [hereinafter Daimler Benz].

11. William C. Freund, *That Trade Obstacle, the SEC*, WALL ST. J., Aug. 27, 1993, at A6; Raghavan & Sesit, *supra* note 7, at A1; Anita Raghavan & Christi Harlan, *Daimler's SEC Pact to List Stock in U.S. May Spur Other Foreign Firms to Follow*, WALL ST. J., Mar. 31, 1993, at B12; Mary Shapiro, *The SEC's Open Door Policy*, WALL ST. J., Sept. 23, 1993, at A17; Glenn Whitney & Terence Roth, *Daimler May Be Sign of Change for Equities*, WALL ST. J., Mar. 29, 1993, at B6C.

12. Cochrane, *supra* note 4, at S59; Freund, *supra* note 11, at A6.

13. Cochrane, *supra* note 3, at S63; Freund, *supra* note 11, at A6.

14. Breeden, *supra* note 1, at S79.

investors value U.S. GAAP reporting. Third, and most important, the U.S. GAAP requirements are an integral part of the framework of U.S. securities regulation. Any exemption from these requirements must provide a vision of how home country financial statements would fit with the auditing requirements and civil liability provisions of U.S. federal securities laws.

Part I of this article highlights current SEC reporting requirements for foreign issuers, including recent steps taken by the SEC to ease the burden of foreign registrants. Part II reviews the application of these requirements by examining the 1993 Daimler Benz Form 20-F. Part III describes some of the NYSE's objections to the current SEC requirements and details the Exchange's world-class proposal to exempt certain foreign firms from the U.S. GAAP reporting requirements.<sup>15</sup> Part IV addresses the NYSE's concerns and discusses the problem of integrating the world-class proposal with the auditing requirements and civil liability provisions.<sup>16</sup>

## I. Current SEC Requirements for Foreign Issuers

### A. POLICY OF U.S. SECURITIES LAWS

Two fundamental policies of U.S. securities regulation are full disclosure and registration.<sup>17</sup> Prior to the enactment of the Securities Act of 1933 (the 1933 Act), many states required that all securities offerings be reviewed on their merits by a state body.<sup>18</sup> Because this approach was ineffective in combating securities fraud, Congress based the 1933 Act on a system of disclosure rather than merits review.<sup>19</sup> The policy of disclosure embraces the idea that investors are best protected if all relevant information about a security is fully and fairly disclosed.<sup>20</sup> In addition, many believe that a disclosure system is a more efficient use of SEC resources than a time-consuming merit analysis.<sup>21</sup> The 1933 Act requires the registrant to disclose a vast amount of qualitative and quantitative information about both the issue and the issuer. A prospectus provides the investor with this

15. Clearly the SEC and the NYSE are not the sole participants in this debate. Foreign and domestic firms, foreign and U.S. government agencies, attorneys, accountants, and investment bankers, and others in the financial community all have an interest in the outcome. In the interest of simplicity, however, and because the NYSE and the SEC are the primary regulatory bodies in this debate, the NYSE will serve as a surrogate for those who support acceptance of home country financial statements while the SEC will represent those who support the U.S. GAAP requirement.

16. Although this article specifically addresses the world-class proposal, these arguments equally apply to any general proposal to accept accounting standards other than U.S. GAAP.

17. Frode Jensen III, *The Attractions of the U.S. Securities Markets to Foreign Issuers and the Alternative Methods of Accessing the U.S. Markets: From a Legal Perspective*, 17 FORDHAM INT'L L.J. S27 (1994).

18. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 1.2 (2d ed. 1990).

19. *Id.*

20. *Id.*

21. *Id.*

information.<sup>22</sup> Accounting principles play a vital role in this disclosure system by communicating to the investor a wealth of information about the issuer's past performance and current financial status.

In order to help ensure the adequacy of disclosure, the securities laws require all sales of securities to be registered with the SEC unless specifically exempt.<sup>23</sup> Statutes provide many categories of available exemptions based on the nature of the offering<sup>24</sup> or the issuer.<sup>25</sup> For nonexempt issuers, the registration process begins with the filing of a registration statement with the SEC.<sup>26</sup> This document contains essentially the same information as the prospectus.<sup>27</sup> A registration statement that conforms to the SEC requirements will become effective no later than twenty days after filing.<sup>28</sup> The waiting period enables the SEC to review the adequacy of the registration statement. After the effective date, issuers and investors are free to consummate sales of the security.<sup>29</sup>

## B. REGULATION OF FOREIGN ISSUERS IN THE UNITED STATES

Foreign issuers may offer securities in the United States primarily under one of three regimes.<sup>30</sup> Private placements and Rule 144A offerings are exempt transactions, while public offerings by foreign issuers must comply with section 5 registration requirements.<sup>31</sup>

### 1. *Private Placements*

Section 4(2) of the 1933 Act exempts from registration "transactions by an issuer not involving any public offering."<sup>32</sup> Whether a transaction is a public offering is a factual matter, although the U.S. Supreme Court has cited several factors relevant to the inquiry. An offering is more likely to be public if there are a considerable number of investors, the issuer has solicited offers, and the investors are relatively unsophisticated and lack sufficient access to relevant information.<sup>33</sup> In order to prevent an issuer from converting a private placement to a public offering by means of a conduit, securities regulations place major restrictions on the resale of privately placed securities.<sup>34</sup>

---

22. 15 U.S.C. § 77e (1988).

23. *Id.*

24. *Id.* § 77d.

25. *Id.* § 77c.

26. *Id.* § 77e.

27. Jensen, *supra* note 17, at S30.

28. 15 U.S.C. § 77h(a).

29. *Id.* § 77e.

30. This article does not address the registration and reporting requirements for offerings of American Depositary Receipts (ADRs). On that subject, see in this issue Guy P. Lander, *American Depositary Receipts* at 897.

31. *Id.*

32. 15 U.S.C. § 77d(2).

33. SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

34. Jensen, *supra* note 17, at S34.

Foreign firms may prefer a private placement because it avoids the substantial registration costs of a public offering. Due to the limitations on resale and the resulting lack of liquidity, however, private placements have not been a fully satisfactory vehicle for the offering of securities by foreign issuers in the United States.<sup>35</sup>

## 2. Rule 144A Offerings

In order to ease the restrictions on resale of certain privately placed securities, in 1990 the SEC enacted Rule 144A.<sup>36</sup> Rule 144A is a safe-harbor rule that has been called a "quasi-public offering, quasi-private placement."<sup>37</sup> Securities offered pursuant to Rule 144A are exempt from registration because the SEC deems that the transaction does not involve a public offering by an issuer.<sup>38</sup> Accordingly, the transaction falls within the section 4(2) exemption. Resales of the offering are exempt since they are not deemed a distribution for purposes of section 4(1).<sup>39</sup>

Rule 144A transactions are not considered a distribution because the securities can only be bought and sold by a limited group of investors known as Qualified Institutional Buyers (QIBs).<sup>40</sup> Generally, QIBs are institutional investors who meet certain financial requirements.<sup>41</sup> The securities are traded separately on the National Association of Securities Dealers (NASD) sponsored PORTAL spreadsheet system and remain exempt on this secondary market only if they are sold to another QIB.<sup>42</sup> Although Rule 144A offerors do not need to meet the full prospectus requirements of a public offering, the rule does require the issuer to provide some information to the investor.<sup>43</sup>

Rule 144A is controversial because it establishes a separate unregulated secondary market for institutional investors.<sup>44</sup> Some believe that Rule 144A departs from the fundamental policy of disclosure. Instead of requiring full disclosure by Rule 144A issuers, the SEC has engaged in an unusual merits review of investors by limiting access to the PORTAL market to QIBs. Investors must meet the QIB criteria in order to trade on this market. Nonetheless, the PORTAL

35. *Id.* at S35.

36. 17 C.F.R. § 230.144A (1993).

37. Jensen, *supra* note 17, at S35.

38. *Id.*

39. *Id.* at S36.

40. 17 C.F.R. § 230.144A(a) (1993).

41. Generally, QIBs are insurance companies, investment companies, employee benefit plans, or financial institutions with a securities portfolio of at least \$100 million. *Id.*

42. Jensen, *supra* note 17, at S37.

43. 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, S18 (1994). The document delivered to the investor is known as an offering circular and contains much of the same information provided in a prospectus.

44. HAZEN, *supra* note 18, § 4.26.

market has enabled many foreign firms to access the U.S. capital markets without the need for U.S. GAAP disclosure.

### 3. *Public Offering*

Foreign firms may issue securities to the general public by way of a public offering. In order to publicly offer securities, a foreign firm must file a registration statement on Form F-1 with the SEC.<sup>45</sup> Form F-1 mirrors the requirements of Form S-1 for domestic registrants.<sup>46</sup> Foreign issuers may file a short form registration statement under Forms F-2<sup>47</sup> or F-3<sup>48</sup> if they meet certain criteria. After the initial registration of securities, the foreign issuer must comply with the periodic reporting requirements of the Securities Exchange Act of 1934 (1934 Act).<sup>49</sup>

Registrants must disclose on Form F-1 information required by both Regulations S-K and S-X. Pursuant to Regulation S-K, an issuer must disclose a variety of quantitative information, including descriptions of the business, legal matters, executive compensation, risk factors, and management's discussion and analysis.<sup>50</sup> Regulation S-X prescribes the accounting requirements for both Forms F-1 and 20-F.<sup>51</sup> Pursuant to Regulation S-X, foreign firms must present income statements and statements of cash flows for three years<sup>52</sup> and balance sheets for two years.<sup>53</sup> In addition, the financial statements must be audited in accordance with U.S. generally accepted auditing standards (GAAS).<sup>54</sup>

### C. ACCOUNTING REQUIREMENTS FOR FOREIGN ISSUERS

Foreign issuers may present financial statements in conformity with either item 17<sup>55</sup> or item 18<sup>56</sup> of Form 20-F. Registrants that file Form F-1 must conform to item 18, while other foreign issuers may file under item 17.<sup>57</sup> Items 17 and 18 are identical except that item 18 requires full U.S. GAAP and SEC footnote disclosure.<sup>58</sup> Because Daimler Benz filed a registration statement on Form F-1, the financial statements included in the 1993 Form 20-F conformed to item 18. Item 18 requires that financial statements on Form 20-F must disclose information

45. Jensen, *supra* note 17, at S30.

46. *Id.*

47. Form F-2, 2 Fed. Sec. L. Rep. (CCH) ¶ 6962 (May 11, 1994).

48. Form F-3, 2 Fed. Sec. L. Rep. (CCH) ¶ 6972 (June 22, 1994).

49. 15 U.S.C. § 78a-11 (1988). Foreign issuers must file Form 20-F annually (analogue to the Form 10-K requirement for domestic issuers). Form 20-F, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,701 (Jan. 1, 1995).

50. Regulation S-K, 17 C.F.R. § 229 (1993).

51. Regulation S-X, 17 C.F.R. § 210 (1993).

52. Regulation S-X, 17 C.F.R. § 210.3-19(a)(2) (1993).

53. Regulation S-X, 17 C.F.R. § 210.3-19(a)(1) (1993).

54. Regulation S-X, 17 C.F.R. § 210-2.02(b) (1989).

55. Form 20-F, item 17, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,724, at 21,763 (Jan. 4, 1995).

56. Form 20-F, item 18, 5 Fed. Sec. L. Rep. (CCH) ¶ 29,724, at 21,765 (Jan. 4, 1995).

57. *Id.*

58. *Id.*

substantially similar to U.S. GAAP and Regulation S-X. Registrants may satisfy this requirement by presenting financial statements in accordance with U.S. GAAP.<sup>59</sup> In the alternative, the registrant may present financial statements in accordance with another comprehensive body of accounting if the registrant meets the following requirements: (1) the accountant's report indicates the comprehensive body of accounting principles applied; (2) the financial statements include a narrative discussion of material variations from U.S. GAAP; (3) the financial statements include a reconciliation of net income and stockholders' equity per home country accounting principles to U.S. GAAP; and (4) the financial statements present all U.S. GAAP and SEC footnotes and disclosures.<sup>60</sup>

#### D. SEC EFFORTS TO EASE REGISTRATION AND DISCLOSURE REQUIREMENTS FOR FOREIGN ISSUERS

The SEC has tried to facilitate the registration process for foreign firms through a recent Securities and Exchange Act release.<sup>61</sup> Specifically, the SEC has expanded the availability of short form filing on Form F-3 and shelf registration. The release also provides a safe harbor for public announcements of unregistered offerings and broker-dealer research requirements. Most significantly, the SEC has undertaken to streamline the process of reconciling home country financial statements to U.S. GAAP principles. This streamlining has been accomplished by the following steps: (1) accepting a statement of cash flows in accordance with International Accounting Standard Number 7; (2) limiting reconciliation of U.S. GAAP net income and stockholders' equity to two years for first-time registrants; (3) eliminating the need for reconciliation of certain acquired businesses and equity investees; (4) permitting pro rata consolidation for certain joint ventures that would be treated under the equity method for U.S. GAAP purposes; and (5) eliminating the need for schedules for marketable securities, related party receivables, related party indebtedness, fixed assets, accumulated depreciation, and guarantees of securities of other issuers.<sup>62</sup>

## II. Highlights of Daimler Benz 1993 Form 20-F

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. Consequently, the financial statements are in accordance with German GAAP, but they also

59. *Id.*

60. *Id.* at 21,766.

61. Simplification of Registration and Reporting Requirements for Foreign Companies; Safe Harbors for Public Announcements of Unregistered Offerings and Broker-Dealer Research Reports, 59 Fed. Reg. 21,644 (Apr. 26, 1994) (to be codified at 17 C.F.R. pts. 229, 230, 239, 249).

62. *Id.* at 21,464-48.

include a narrative discussion of the differences between U.S. GAAP 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, the financial statements include all footnote disclosures required under U.S. GAAP.

Many sources shape German accounting principles. Unlike U.S. GAAP, statutes heavily influence German GAAP. 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.<sup>63</sup> The profession does, however, influence the standard-setting process through pronouncements of the Institute of Auditors (*Institute der Wirtschaftsprüfer* or IdW).<sup>64</sup> 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.<sup>65</sup>

Consistent with the Fourth Directive, the Commercial Code requires the audit report to state that "[t]he annual [financial statements] shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss."<sup>66</sup> By contrast, the KPMG *Deutsche Trehaund Gesellschaft* audit report included with the Daimler filing conforms to U.S. GAAS. The first paragraph indicates that the audits were conducted in accordance with both U.S. and German GAAS.<sup>67</sup> The opinion paragraph states that "the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Daimler Benz as of December 31, 1993 and 1992, and the results of their operations and cash flows for each of the years in the three-year period ended December 31, 1993, in conformity with generally accepted accounting principles in Germany."<sup>68</sup> Lastly, an explanatory paragraph indicates that a footnote reconciles German GAAP to U.S. GAAP.<sup>69</sup>

Neither the Fourth Directive nor German GAAP require a statement of cash flows.<sup>70</sup> In order to satisfy the SEC reporting requirements, the Daimler filing includes U.S. statements of cash flows.<sup>71</sup> Additionally, the filing appends U.S.

63. LARRY L. ORSINI ET AL., WORLD ACCOUNTING § GER.01[1] (1994).

64. *Id.* § GER.01[2].

65. *Id.* § GER.01[2]. Effective January 1, 1993, with the signing of the Treaty of European Union, but subsequent to the passage of the Fourth and Seventh Directives, the European Economic Community became known as the European Union. GEORGE A. BERMAN ET AL., CASES AND MATERIALS ON EUROPEAN COMMUNITY LAW 16 (1993).

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

67. Daimler Benz, *supra* note 10, at F-1.

68. *Id.*

69. *Id.*

70. COOPERS & LYBRAND, INTERNATIONAL ACCOUNTING SUMMARIES: A GUIDE FOR INTERPRETATION AND COMPARISON G-2 (2d ed. 1993).

71. Daimler Benz, *supra* note 10, at F-4.

GAAP footnote disclosure to the corresponding German GAAP footnotes. Specifically, the filing discloses U.S. GAAP footnote information with respect to retirement plans,<sup>72</sup> income taxes,<sup>73</sup> financial instruments,<sup>74</sup> extraordinary items,<sup>75</sup> and segment reporting.<sup>76</sup>

The heart of the accounting standards debate, however, is captured in note 2 to the consolidated financial statements.<sup>77</sup> The footnote describes, in narrative form, the following differences between U.S. and German GAAP that affect the net income and stockholders' equity of Daimler Benz.

*Long-term contracts.* German GAAP generally require revenue and costs on long-term contracts to be recognized in accordance with the completed contract method.<sup>78</sup> U.S. GAAP account for long-term contracts under either the completed contract or the percentage of completion method.<sup>79</sup>

*Goodwill.* German GAAP permit goodwill to be charged directly to stockholders' equity or capitalized and amortized over its useful life,<sup>80</sup> while U.S. GAAP require goodwill to be capitalized and amortized over its useful life.<sup>81</sup>

*Pensions.* Actuarial calculations in Germany are usually based on tax regulations that do not permit the consideration of expected salary increases as a factor in the calculation of pension cost.<sup>82</sup> U.S. GAAP require calculation of the projected benefit obligation based on future compensation if the plan's pension benefit formula so provides.<sup>83</sup> In addition, U.S. GAAP require recognition of liability for postretirement benefits other than pensions.<sup>84</sup> Germany has no such requirement.<sup>85</sup>

*Foreign Currency Translation.* German accounting standards contain no specific references to foreign currency translation.<sup>86</sup> 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

72. *Id.* at F-16.

73. *Id.* at F-21.

74. *Id.* at F-34.

75. *Id.* at F-20.

76. *Id.* at F-35.

77. *Id.* at F-9.

78. COOPERS & LYBRAND, *supra* note 70, at G-15.

79. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, LONG TERM CONSTRUCTION-TYPE CONTRACTS, ACCOUNTING RESEARCH BULLETIN No. 45, § 15 (1955).

80. COOPERS & LYBRAND, *supra* note 70, at G-4.

81. ACCOUNTING PRINCIPLES BD., AMERICAN INST. OF CERTIFIED PUB. ACCOUNTANTS, APB OPINION No. 17: INTANGIBLE ASSETS §§ 24-27 (1970).

82. COOPERS & LYBRAND, *supra* note 70, at G-18.

83. FINANCIAL ACCOUNTING BD., EMPLOYER'S ACCOUNTING FOR PENSIONS, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 87, § 17 (1985).

84. FINANCIAL ACCOUNTING BD., EMPLOYER'S ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 106 (1990).

85. COOPERS & LYBRAND, *supra* note 70, at G-18.

86. *Id.* at G-6.

balance.<sup>87</sup> Daimler generally translates the balance sheet of foreign subsidiaries on the basis of period end rates.<sup>88</sup> U.S. GAAP require foreign currency transactions and the balance sheet of foreign entities to be translated at the period end rate.<sup>89</sup>

*Financial Instruments.* German GAAP require establishment of a reserve for unrealized losses for financial instruments that hedge against currency risk.<sup>90</sup> Unrealized gains, however, are not recognized until they become realized.<sup>91</sup> U.S. GAAP require, under certain circumstances, the recognition of both unrealized gains and losses on hedge contracts.<sup>92</sup>

*Deferred taxes.* Deferred taxes are less common in Germany than in the United States because the German GAAP more frequently conform to the tax regulations.<sup>93</sup> If accounting income exceeds taxable income, the liability method recognizes deferred tax liabilities.<sup>94</sup> Recognition of deferred tax assets is optional.<sup>95</sup> U.S. GAAP recognize deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the financial statements or tax returns.<sup>96</sup> If it is more likely than not that some portion or all of a deferred tax asset will not be realized, U.S. GAAP recognize a valuation allowance.<sup>97</sup> In addition, deferred tax effects of the U.S. GAAP adjustments must be recognized.<sup>98</sup>

*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.<sup>99</sup> German firms, however, have historically recorded higher accrual balances and asset reserves than would be allowable under U.S. GAAP.

*Other Differences.* Other differences in accounting principles include adjustments for LIFO inventory, treasury stock, and the minority stockholders' interest in the U.S. GAAP adjustments.<sup>100</sup>

87. Daimler Benz, *supra* note 10, at F-7.

88. *Id.*

89. FINANCIAL ACCOUNTING STANDARDS BD., FOREIGN CURRENCY TRANSLATION, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 52, § 27 (1981).

90. COOPERS & LYBRAND, *supra* note 70, at G-6.

91. *Id.*

92. FINANCIAL ACCOUNTING STANDARDS BD., DISCLOSURE OF INFORMATION ABOUT FINANCIAL INSTRUMENTS WITH CONCENTRATIONS OF CREDIT RISK, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 105 (1990).

93. ORSINI ET AL., *supra* note 63, § GER.26[1].

94. *Id.*

95. *Id.*

96. FINANCIAL ACCOUNTING STANDARDS BD., ACCOUNTING FOR INCOME TAXES, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 109, § 6 (1990).

97. *Id.* § 17.

98. Daimler Benz, *supra* note 10, at F-11.

99. *Id.* at F-9.

100. COOPERS & LYBRAND, *supra* note 70, at G-12; FINANCIAL ACCOUNTING STANDARDS BD., ACCOUNTING FOR CONTINGENCIES, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 5, § 8 (1975).

Note 2 to the Daimler Benz 1993 consolidated financial statements quantifies the above differences:

|                                       | For the Year Ended<br>December 31, 1993<br>(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   |
| Accruals and Reserves                 | (2,450)   |
| Other                                 | 160   |
| Net loss in accordance with U.S. GAAP | <u><u>\$(1,057)</u></u>   |

Not surprisingly, the debate over the treatment of accruals and reserves has dwarfed that concerning all the other differences.<sup>101</sup> 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 calculation 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.<sup>102</sup> With this method of calculation, firms more evenly distribute operating results over the course of several years.<sup>103</sup> Accordingly, Daimler Benz adjusted excess liabilities downward and recorded \$2.45 billion in income in 1993.<sup>104</sup> Germans view this adjustment as a desirable practice designed to protect investors and creditors against short-term

101. Raghavan & Sesit, *supra* note 7, 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 adjustment is largely attributable to the tax effect of the accruals and reserves adjustment.

102. Freund, *supra* note 11, at A6.

103. *Id.*

104. This practice can be explained through a simple hypothetical using Daimler's reconciliation. Assume that in 1990 Daimler anticipates payment on environmental clean-up costs to be made in 1993. Because the contamination that requires clean up occurred in 1990, Daimler records an accrual

earnings fluctuations.<sup>105</sup> In the United States, the practice is discouraged as a means of managing income or income-smoothing. Accordingly, U.S. accounting principles require the recording of accruals and reserves to more closely reflect the actual estimate of future costs.

### III. The NYSE's Objections to the SEC's Requirement that Foreign Issuers Conform to U.S. GAAP

The NYSE's primary concern is that the U.S. GAAP requirements will cost the U.S. capital markets their preeminent position in the global financial community. Specifically, the Exchange contends that the stringent U.S. GAAP requirements discourage foreign firms from entering the U.S. capital markets.<sup>106</sup> Further, the Exchange contends that requiring foreign firms to present U.S. GAAP financial statements is unnecessary since U.S. investors have access to these foreign stocks in other markets without the benefit of U.S. GAAP reporting.<sup>107</sup> Lastly, if foreign capital markets are adequately served by their prevailing accounting standards, why should the United States insist that only U.S. accounting standards can adequately protect American investors?<sup>108</sup> The NYSE maintains that the SEC's unwillingness to accept any standards other than U.S. GAAP incorrectly assumes that U.S. GAAP are the world's best accounting principles.<sup>109</sup> For these reasons, the NYSE supports acceptance of home country financial statements and proposes an exemption from U.S. accounting requirements for world-class foreign firms.<sup>110</sup>

#### A. THE STRINGENT U.S. ACCOUNTING RULES WILL JEOPARDIZE THE POSITION OF THE U.S. CAPITAL MARKETS IN THE GLOBAL FINANCIAL COMMUNITY

The rise of the global economy and the emergence of the mutual fund have led to greater diversity in American investment portfolios.<sup>111</sup> As a result, the U.S. investment community has displayed an increased demand for foreign stocks.<sup>112</sup> U.S. investors seeking a position in the auto industry will no longer

---

in that year of \$5 billion. Either knowingly or unknowingly, Daimler has overaccrued. When the costs are paid out in 1993 and the liability is fully settled, Daimler finds that it need only pay out \$2.55 billion to clean up the site. As a result, it has \$2.45 billion excess accrual on its books which it reverses and records as income in 1993. However, Daimler need not wait until the liability is settled to reverse the reserve. Even if Daimler had not paid out any clean-up costs in 1993, it could still take the excess accrual into income if revised cost estimates indicated that there was an overaccrual.

105. Freund, *supra* note 11, at A6.

106. Cochrane, *supra* note 3, at S59; Freund, *supra* note 11, at A6.

107. Cochrane, *supra* note 3, at S62; Freund, *supra* note 11, at A6.

108. Cochrane, *supra* note 3, at S62; Freund, *supra* note 11.

109. Freund, *supra* note 11, at A6.

110. *Id.*

111. Cochrane, *supra* note 3, at S58.

112. *Id.*

limit their investment options to Ford, Chrysler, and General Motors. These investors also want access to shares of Daimler, Toyota, and BMW. The increase in purchases and sales of foreign stocks in the United States from \$142 billion in 1988 to \$347 billion in 1992 evidences the U.S. investor's appetite for foreign stocks.<sup>113</sup> In addition, the percentage of foreign stocks held by U.S. pension funds has jumped from approximately 2 percent in 1988 to an expected 7.5 percent in 1995.<sup>114</sup>

Many in the financial community view this investment trend as a "sea change" toward truly international trading.<sup>115</sup> The NYSE argues that the SEC's unwillingness to relax its reporting and disclosure requirements will discourage blue-chip foreign firms, like Nestlé and Siemens, from entering the U.S. capital markets.<sup>116</sup> In a recent *Wall Street Journal* editorial, a former chief economist of the Exchange called the SEC "a trade obstacle."<sup>117</sup> Because U.S. investors' desire for these stocks is increasing, they will look to other markets if they cannot find these issues on the NYSE, the American Stock Exchange (AMEX), or the National Association of Securities Dealers Automated Quotation System (NASDAQ). As a result, the U.S. markets will lose their preeminence among world capital markets.

**B. U.S. GAAP REQUIREMENTS FOR FOREIGN ISSUERS ARE  
UNNECESSARY SINCE U.S. INVESTORS HAVE ACCESS TO  
THESE STOCKS ON OTHER MARKETS**

Although foreign stocks cannot be traded on a U.S. exchange without U.S. GAAP financial statements, some U.S. investors are already availing themselves of these stocks on the foreign markets and on the Rule 144A PORTAL system without the benefit of U.S. GAAP disclosure.<sup>118</sup> Despite the SEC's attempts to protect U.S. investors' interests by enforcing its disclosure rules, these investors are buying Siemens stock in Frankfurt and Nestlé shares in Zurich based on German and Swiss GAAP financial statements, respectively. These stocks are also available within the United States to U.S. investors. The Rule 144A PORTAL system allows institutional investors to access foreign stocks without requiring U.S. GAAP financial statements.<sup>119</sup> Therefore, a U.S. GAAP requirement is unlikely to protect U.S. investors when they can obtain these stocks without a U.S. GAAP requirement anyway.

113. *Id.* at S59.

114. *Id.* at S60.

115. *Id.* at S59.

116. *Id.*

117. Freund, *supra* note 11, at A6.

118. Cochrane, *supra* note 3, at S62.

119. *Id.*

### C. FOREIGN CAPITAL MARKETS HAVE BEEN ADEQUATELY SERVED BY THEIR LOCAL ACCOUNTING STANDARDS

The NYSE notes that investors in foreign markets are adequately protected by their local standards.<sup>120</sup> If German GAAP adequately serve the German investor or the U.S. investor buying shares in Frankfurt, why are those standards insufficient to protect investors in the U.S. capital markets? The Exchange maintains that the SEC roots its insistence on requiring U.S. GAAP disclosure in a narrow-minded belief that other bodies of accounting principles are deficient and that U.S. GAAP are superior to all other bodies of accounting principles.<sup>121</sup> The notion that different disclosure standards leave investors unprotected is "a mirage in the modern world of low-cost, high-speed communications."<sup>122</sup>

### D. THE NYSE'S WORLD-CLASS PROPOSAL

The NYSE has proposed a resolution of the foreign listing standards issue. The NYSE proposal is a compromise in which world-class foreign companies would be exempt from the current SEC U.S. GAAP reporting requirements.<sup>123</sup> Home country financial statements would highlight material differences between home country and U.S. GAAP in a narrative, but would not be required to present quantitative U.S. GAAP information or any U.S. GAAP footnote disclosure.<sup>124</sup> The proposal defines world-class companies as those with annual revenues of \$5 billion and market capitalization of \$2 billion, or average weekly trading volume outside the United States of at least \$1 million or 200,000 shares.<sup>125</sup> Currently, about 200 non-U.S. companies meet these criteria.<sup>126</sup> Under this proposal, the NYSE hopes that Daimler, Glaxo, and Siemens will be more likely to trade side by side on U.S. exchanges with Ford, Merck, and General Electric.

## IV. Reasons for Requiring Foreign Registrants to Comply with U.S. GAAP

### A. RESPONSE TO THE NYSE'S OBJECTIONS

Contrary to the NYSE's claims, a U.S. GAAP requirement does not necessarily discourage foreign investors from entering U.S. capital markets. In addition, the availability of foreign stocks on other markets does not render the U.S. GAAP

---

120. *Id.*

121. Freund, *supra* note 11, at A6.

122. *Id.*

123. Cochrane, *supra* note 3, at S63.

124. *Id.*

125. *Id.*

126. Michael A. Schneider, *Foreign Listings and the Preeminence of U.S. Securities Exchanges: Should the SEC Recognize Foreign Accounting Standards?*, 3 MINN. J. GLOBAL TRADE 301, 305 n.20 (1994).

requirement meaningless. Lastly, requiring U.S. GAAP reporting does not imply a value judgment about other bodies of accounting principles, but rather expresses a judgment about which principles best serve the needs of the U.S. capital markets.

1. *A U.S. GAAP Requirement Does Not Necessarily Discourage Foreign Participation in U.S. Capital Markets*

The NYSE is concerned that strict enforcement of the U.S. GAAP requirements will discourage foreign firms from entering the U.S. capital markets. However, U.S. capital markets are not necessarily failing to attract foreign issuers. While evidence cannot conclusively show that the SEC requirements have no effect on foreign firms' decisions to enter U.S. markets, enough raw statistical and anecdotal evidence exists to cast doubt on the NYSE's contention that the U.S. GAAP requirements are a significant roadblock to foreign participation in U.S. markets. Currently, more than 550 foreign firms trade on the U.S. exchanges.<sup>127</sup> Both Germany and the United Kingdom have roughly the same number of foreign firms trading on their markets.<sup>128</sup> No other country has close to as many foreign firms trading on its exchanges.<sup>129</sup> Admittedly, the United States has by far the largest markets and, as such, should reflect the largest number of firms, but the absolute number should provide some basis for assuming that, at a minimum, foreign firms are not being driven away by U.S. accounting principles. The disincentive theory is also questioned by examining trends of foreign listings. Between 1989 and 1993 approximately 250 foreign firms raised \$100 billion in the U.S. public markets.<sup>130</sup> During this same period, the number of foreign listings in London, Tokyo, Paris, and Frankfurt all declined.<sup>131</sup>

These statistics evidence the SEC's recent efforts to allay the fears of potential foreign registrants by easing some of the registration requirements and working closely with issuers to facilitate the registration process. At a recent symposium at Fordham Law School, Richard Breeden<sup>132</sup> and Richard Kosnik<sup>133</sup> stressed the Commission's willingness to work with foreign issuers on an individual basis. This sense of cooperation was noted by several practitioners<sup>134</sup> and, more importantly, by a recent foreign registrant.<sup>135</sup> Certainly, drawing conclusions from

127. James R. Silkenat, *Overview of U.S. Securities Markets and Foreign Issuers*, 17 FORDHAM INT'L L.J. S4, S5 (1994).

128. Cochrane, *supra* note 3, at S58.

129. *Id.*

130. Kosnick, *supra* note 1, at S100.

131. Breeden, *supra* note 1, at S83.

132. Chairman of the U.S. Securities and Exchange Commission (1989-93). *Id.* at S77.

133. Former Associate Director, Division of Corporation Finance, U.S. Securities and Exchange Commission. Kosnik, *supra* note 1, at S97.

134. Decker, *supra* note 43, at S22; Jensen, *supra* note 17, at S37; M. Elizabeth Rader, *Accounting Issues in Cross-Border Securities Offerings*, 17 FORDHAM INT'L L.J. S129 (1994).

135. 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, S118 (1994).

the above raw data and the testimony of a few individuals would be premature. Nonetheless, this evidence suggests that the NYSE will have to make a more convincing case in order to show that the current requirements are having the effect the NYSE contends.

## 2. *U.S. GAAP Reporting Is Still Meaningful Despite the Availability of Foreign Stocks on Other Markets*

U.S. investors can purchase foreign stocks on foreign exchanges. In addition, institutional investors can trade in foreign stocks on the Rule 144A PORTAL system. Firms that issue shares on either foreign exchanges or the Rule 144A market are not required to provide U.S. GAAP financial statements to investors. The NYSE maintains that the availability of these stocks without U.S. GAAP financial statements renders the U.S. GAAP requirements for foreign firms irrelevant.<sup>136</sup> For example, regardless of whether the SEC requires Daimler to present U.S. GAAP financial statements in order to trade in New York, an investor can buy Daimler shares in Frankfurt based on German GAAP financial statements.<sup>137</sup> As a result, a U.S. GAAP requirement for foreign stocks merely increases the cost of capital in the United States without adding value to the flow of information in the market.<sup>138</sup> This argument fails to consider an important point: the availability of foreign shares in other markets without the benefit of U.S. GAAP disclosure does not inevitably lead to the conclusion that U.S. accounting standards are irrelevant. To say that investors are buying shares based on non-U.S. accounting standards is not to say that those investors do not value the information provided by U.S. GAAP. Some evidence supports the notion that U.S. GAAP adds value to the investment decision. Although Rule 144A does not require U.S. GAAP reporting, frequently in these transactions investment bankers require disclosure in the offering circular of the differences between home country accounting principles and U.S. GAAP.<sup>139</sup> Investment bankers will also request quantification of those differences, although these calculations may not always be included in the document.<sup>140</sup> If investors did not value U.S. GAAP information, they would not likely request U.S. GAAP disclosure as part of a transaction that does not require such information. In addition, two statistical studies in the 1993 *Journal of Accounting Research* have shown that U.S. GAAP add value to the investor's decision. The first study compared annual earnings and corresponding stock prices based on a sample of several thousand annual reports from seventeen countries

---

136. Freund, *supra* note 11, at A6.

137. Similarly, there is no GAAP requirement for the Rule 144A market, although one should recall that this market is limited to QIBs.

138. Freund, *supra* note 11, at A6.

139. Decker, *supra* note 43, at S15.

140. *Id.*

over the period 1983-1990.<sup>141</sup> The study concluded that the value-relevance (the degree of association between accounting measures and price or return) and timeliness (how quickly information is impounded into stock price) of accounting information varies greatly among countries.<sup>142</sup> At least four countries had more value-relevant information than the United States, while five countries, including Germany, had less value-relevant information than the United States.<sup>143</sup> The relative scores of the various countries are less important than the conclusion that the body of accounting principles applied is relevant to the investment decision. This conclusion seems to contradict the NYSE's assumption that the body of accounting principles applied in the United States is irrelevant due to the availability of foreign stocks on other markets. The second study makes an even stronger case for U.S. GAAP reporting for foreign firms.<sup>144</sup> This study analyzed the relationship between stock price and the information provided in the Form 20-F reconciliation of home country to U.S. GAAP net income and stockholders' equity. It concluded that the Form 20-F reconciliation is value relevant (the reconciliation increases the association between the accounting information and stock price).<sup>145</sup> The anecdotal evidence and statistical studies are admittedly a first cut at the question of the value of U.S. accounting standards. While this evidence does not conclusively decide the issue, it tends to rebut the Exchange's contention that the accounting standards are irrelevant due to the availability of foreign stock on other markets.<sup>146</sup>

### 3. Home Country GAAP and Protection of Investors

The NYSE argues that home country GAAP could adequately protect the interests of American investors on U.S. exchanges and that the SEC's insistence on U.S. GAAP represents a belief that U.S. principles are superior to all others.<sup>147</sup> This argument may misunderstand the role of accounting principles in the capital markets as well as the difference in markets throughout the world. Capital markets around the world can differ in many ways, including size, complexity, and efficiency. Composition of market participants also distinguishes between different markets. In some countries, many firms offer securities in a capital market that

141. Andrew Alford et al., *The Relative Informativeness of Accounting Disclosures in Different Countries*, 31 J. ACCT. RES. 183 (Supp. 1993).

142. *Id.* at 213.

143. *Id.*

144. Eli Amir et al., *A Comparison of the Value-Relevance of U.S. versus Non-U.S. GAAP Accounting Measures Using Form 20-F Reconciliations*, 31 J. ACCT. RES. (Supp. 1993).

145. *Id.* at 262. The authors of the study warn against using the results to draw conclusions about the usefulness of 20-F reconciliations because of the ability of a careful investor to extract the value-relevant information from home country financial statements. *Id.* However, one might question whether it is not more efficient to enhance the accessibility of the information by providing it in a reconciliation.

146. Freund, *supra* note 11, at A6.

147. *Id.*

has a large percentage of the population as potential investors. In other countries, where few firms offer securities publicly, trading in those securities by individual investors is the exception rather than the rule. The German and U.S. markets exemplify this difference. First, the German stock market is dominated by large investors, such as banks, who commonly sit on the board of outside directors.<sup>148</sup> Second, German individuals tend to rely on state pensions for retirement income and are less likely to participate in the stock market than their U.S. counterparts. Third, because the banks are members of the board, they invest with an eye towards long-term performance.<sup>149</sup> Fourth, speculation is far less common in Germany than the United States. Given these differences, variances between the accounting principles of the two countries are not surprising. Because Germany focuses on long-term performance, it prefers the use of reserves to protect against short-term fluctuation in stock price. Because short-term performance is not as important in Germany, the earnings per share concept is unknown there.<sup>150</sup> In the United States, the focus is on short-term performance, and investors want financial information to reflect current conditions. Contrary to the German approach, the use of reserves to protect against fluctuations in price is known as income-smoothing and is considered an undesirable interference with pricing accuracy. Accounting principles, like the capital markets they serve, are not alike. The principles reflect the nature of the markets and the corresponding interests of investors in those markets. Rather than debate which principles are theoretically superior, the focus should be on which set of standards will best serve the interests of the U.S. investor.

## B. THE WORLD-CLASS PROPOSAL

The NYSE's compromise solution to the accounting standards issue is its world-class proposal. Under this proposal, foreign firms that meet certain criteria would be permitted to present financial statements based on their home country accounting principles.<sup>151</sup> Although not all foreign firms would fall within this exemption provision, it certainly would be available to blue chip firms like Daimler Benz. The proposal, however, has a fundamental flaw. The world-class proposal fails to recognize the integrated nature of the American system of securities regulation. The foundation of the federal securities law is the policy of disclosure. Investors can protect themselves as long as the SEC ensures that the investors have all the information they need to make informed decisions. The U.S. accounting principles are the means used to convey much of the information needed by investors. In order to ensure that the information has been accurately and properly communicated, the SEC requires the financial statements to be subject to an audit in

148. GERHARD WEGEN, *INTERNATIONAL SECURITIES LAW* 127 (1992).

149. Breeden, *supra* note 1, at S92 (noting participation of banks on boards of German companies).

150. COOPERS & LYBRAND, *supra* note 70, at G-19.

151. Cochrane, *supra* note 3, at S63.

accordance with U.S. GAAS.<sup>152</sup> If this process of communication fails because of inaccurate or inadequate disclosure, several remedies are available to correct the failure. A system of civil liability buttresses SEC enforcement. In this regulatory scheme the parts are interrelated. The world-class proposal is inadequate in addressing the effect a change of one aspect of the scheme will have on the other aspects. The NYSE has failed to integrate the proposal with other aspects of the American system of securities regulation. Specifically, the NYSE must explain how the proposal will integrate with the auditing requirements and civil liability provisions of the federal securities laws.

### 1. *Auditing Requirements*

All financial statements included in SEC filings must be audited in accordance with U.S. GAAS. The NYSE has not addressed how the auditing standards would apply to firms that qualify for the exemption under the world-class proposal. Home country financial statements would be audited either in accordance with U.S. GAAS or in accordance with home country GAAS. U.S. GAAS could theoretically be applied to home country financial statements, but since auditing standards are so intertwined with accounting principles, the audit would require a careful and complex integration of the two sets of standards. One can question whether this integration would be an effective or efficient approach.

In order to accept home country GAAS, the United States would have to address instances where the U.S. requirements are more stringent than home country rules. For example, some countries do not require observation of inventories or confirmation of receivables as in the United States.<sup>153</sup> Other countries, such as The Netherlands, are still developing detailed auditing standards and currently have no peer review requirement for firms performing audits.<sup>154</sup> In addition, the United States has some of the most stringent independence requirements in the world. While most countries prohibit financial interests in clients by auditors, U.S. GAAS have a complex set of rules addressing family relationships and indirect investments that are not as common worldwide.<sup>155</sup> Before exempting foreign firms from U.S. GAAS requirements, the NYSE should address how it would resolve these issues under the world-class proposal. If the more stringent requirements are waived, investor protection could be sacrificed. Compromise may be possible, but the Exchange must articulate some resolution of this problem.

### 2. *Civil Liability Provisions*

A complex set of civil liability provisions supplements the SEC's ability to enforce disclosure requirements. Because the accounting standards are part of

152. Regulation S-X, 17 C.F.R. § 210-2.2(b) (1989).

153. Rader, *supra* note 134, at S134-35.

154. ORSINI ET AL., *supra* note 63, § NTL.37[5].

155. *Id.*

the rules designed to protect investors, any change to those standards must address the ability of investors to seek relief from injury in a civil action.

The application of section 11 of the 1933 Act to the Daimler Benz filing demonstrates the difficulty of integrating foreign accounting standards into the civil liability provisions.<sup>156</sup> Section 11 imposes civil liability on a number of designated defendants for material misstatements or omissions in a registration statement.<sup>157</sup> Assume that Daimler Benz filed a registration statement with 1993 German GAAP financial statements under the world-class proposal. An investor purchases Daimler shares based on the \$354 million net income reported in the financial statements. The stock subsequently drops and the investor initiates a section 11 action. The investor claims that the failure to disclose the \$2.45 billion reversal of reserves constitutes a material omission in the registration statement. Under German GAAP the \$2.45 billion disclosure would be omitted. The investor could convincingly argue that the omission is material because of a substantial likelihood that a reasonable investor would attach importance to it in determining a course of action.<sup>158</sup> A court could reasonably find for such a plaintiff. If such an investor does not have a valid claim under the proposal, the NYSE would seem to be proposing a world-class exemption for section 11 as well.

Another issue is how accountants' section 11 due diligence defense would be interpreted under the world-class proposal. Accountants will have a defense to a section 11 action if after reasonable investigation, they have reasonable ground to believe, combined with an actual belief, that no material misstatement or omission existed.<sup>159</sup> The relevant standard of care is the common law standard of reasonableness.<sup>160</sup> For accountants, GAAP and GAAS are evidence, if not the definition, of the standard of care.<sup>161</sup> If financial statements are presented in accordance with home country GAAP and GAAS, does that mean that judges and juries will have to interpret accounting and auditing standards from around the world? Considering the difficulty the American judicial system has had in understanding and applying U.S. GAAS and GAAP,<sup>162</sup> applying home country principles in a civil action would seem to be an unworkable system.

The above arguments represent a preliminary review of the complex issues implicated by a change in accounting principles. Other securities law issues will possibly arise if the SEC adopts the world-class proposal. Until the NYSE can articulate a vision of how these issues would be addressed, the SEC should retain its current requirements.

156. Securities Act of 1933, § 11, 15 U.S.C. § 77k (1988).

157. 15 U.S.C. § 77k(a).

158. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988).

159. 15 U.S.C. § 77k(b).

160. HAZEN, *supra* note 18, at § 7.4.

161. GEORGE SPELLMIRE ET AL., ACCOUNTANT'S LEGAL LIABILITY: PREVENTION AND DEFENSE 12.01 (1993).

162. See Harris J. Amhowitz, *The Accounting Profession and the Law: The Misunderstood Victim*, J. ACCT., May 1987, at 356.

## V. Conclusion

The NYSE is concerned about the effects of a U.S. GAAP requirement on the future of the capital markets. As a solution, the NYSE proposes to exempt blue-chip foreign firms from the current SEC requirement that they present their financial statements in accordance with U.S. GAAP. Because the Exchange is proposing a change from the status quo, it must prove its claims about the effects of and the need for the U.S. GAAP requirement. At present, the evidence regarding the incentive effects of the requirement and investors' preferences for accounting information is inconclusive. Further, the NYSE has not considered the role of accounting information in the various capital markets or how well other bodies of accounting principles would serve the interests of investors in the U.S. capital markets. Finally, the Exchange must present an argument that its world-class proposal can fit snugly into the U.S. system of securities regulation. Specifically, the exemption must address the auditing requirements and civil liability provisions of the federal securities laws. Until these issues are addressed, the SEC should retain its current rules and require foreign firms to report financial information in accordance with U.S. GAAP.

