

GLOBAL ACCOUNTING ■

# WHAT Foreign Filers Need to KNOW

**From SEC scrutiny to investor expectations to a lawsuit-happy securities bar, all kinds of challenges and pitfalls face foreign companies seeking to list on U.S. exchanges.**

The internationalization of securities markets is a reality. Numerous companies trade on exchanges and in markets as geographically diverse as the world itself. A major reflection of this phenomenon is the influx of foreign private issuers (FPIs) into U.S. capital markets. There are many reasons for this trend, including: increased access to capital at potentially lower cost, the ability to establish stock option plans for American employees, increased public awareness of the company and its products, and the ability to use their shares to make acquisitions in the U.S.

According to the Securities and Exchange Commission, the number of FPIs has increased from 434 in 1990 to approximately 1,200 today. These entities must comply with SEC requirements to reconcile their financial statements to a U.S. GAAP basis or to convert the presentation of their financial statements to U.S. principles. There is a noticeable trend for foreign entities to convert

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their primary financial statements to a U.S. GAAP basis, with examples including Siemens AG, Alliance AG and Honda Motors.

There are a number of significant reasons for a foreign entity to consider adopting U.S. GAAP. Currently, in order to raise capital in the U.S., the SEC generally requires compliance with Item 18 of Form 20-F. This item mandates that the company prepare a comprehensive reconciliation of its financial statements to U.S. GAAP recognition and measurements, and provide complete U.S. GAAP disclosures (e.g., derivatives and segment reporting).

Another factor motivating foreign entities to consider this conversion is the sense that the financial analyst and the investment communities are more comfortable with financial statements prepared in accordance with U.S. principles. Further, most observers would probably agree that U.S. GAAP is the most demanding

and comprehensive in the world. FPIs perceive that direct and indirect benefits may accrue from utilization of a rigorous accounting model that more closely reflects the economic performance of a business. One should note, however, that some research suggests that analysts can effectively interpret non-U.S. GAAP-based financial statements.

## **U.S. Regulatory Environment**

As a registrant in the U.S., a foreign company is subject to virtually every aspect of federal securities laws, regulations adopted and actions taken by the SEC. Recently, in several Staff Accounting Bulletins, the SEC has aggressively addressed the issues of materiality, restructuring charges and enterprise-wide goodwill, and revenue recognition. In addition, the staff has commented on such thorny issues as its expectations regarding implementation and disclosures involving derivative financial instruments under the Financial Accounting Standards Board's (FASB) Statement No. 133.

The "culture shock" to a foreign company seeking to comply with the U.S. regulatory structure can be enormous. The SEC has virtually absolute authority to question the propriety of the application of U.S. GAAP in a filing, and can and does force companies to restate financial statements and will initiate enforcement proceedings when it believes such are warranted. In egregious situations, cases are referred by the SEC to the U.S. Department of Justice for possible criminal prosecution. Foreign companies must assure that they, their auditors and legal counsel have sufficient expertise to minimize compliance problems with U.S. laws and regulations.

## **Litigious Environment, Dealing With the Investment Community**

It is common knowledge that the United States is one of the most litigious countries in the world. As a result, an FPI's senior management must be aware that public statements regarding the company's per-

formance or strategy must be carefully considered. Foreign companies may have great difficulty accepting this and then behaving in a manner that minimizes litigation risk.

For example, the senior management must be aware of the aggressive nature of shareholders and the likelihood of litigation if reported results are disappointing or an announcement leads to a significant decrease in the stock price.

Another difference in the U.S. market is the focus of analysts and the investment community at large on quarterly performance. In many countries, public companies report only every six months. Although the SEC permits such an approach for foreign companies reporting here, pressure from the investment community has led many such entities to release quarterly numbers. Those applying U.S. GAAP must assure that their interim numbers are of the same general quality as the year-end amounts.

An FPI must establish or enhance its investor relations department to interact effectively and implement the necessary policies to minimize the risk of ill-advised or inaccurate communications. The company must also assure that all public communications are consistent with information filed with the SEC, such as the annual report on Form 20-F. Inconsistent messages not only can cause problems with the investment community and hurt share prices, but could expose the company to shareholder lawsuits.

In October 2000, the SEC's Regulation FD (Fair Disclosure) took effect. A major thrust of this regulation is to eliminate selective disclosure to particular investors. Although this regulation does not currently apply to foreign companies, it could in the future

### **Illustrative Accounting Issues**

As suggested earlier, a number of features of U.S. GAAP may pose difficulties for complying with U.S. securities regulations. Among the most common:

**1. Revenue recognition.** Whether the company is a large construction contractor required to apply percentage-of-completion accounting, a consumer products company or a software provider applying AICPA Statement of Position (SOP) 97-2, "Software Revenue Recognition," every company adopting U.S. GAAP must closely review its current revenue recognition policies. For some companies, the difference in revenue recognition under U.S. principles can create dramatically different results. Companies concerned with revenue recognition may have to modify existing business practices in order to recognize revenue at the time they desire.

**2. Hedge Accounting.** Application of FAS 133 is a challenge for most companies, but may raise enormous issues for companies adopting U.S. GAAP and accounting for certain derivatives as hedges. The rules and documentation requirements surrounding hedge accounting may force many companies to value derivative instruments at fair value and report changes in those values in earnings, notwithstanding management's view that such instruments represent economic hedges. The inability to apply hedge accounting potentially subjects the company's earnings to substantial volatility.

**3. Allowances and Accruals.** The SEC's focus on all types of accruals requires that a company review its policies to ensure that its policies and methodologies are consistent with U.S. GAAP. Normal allowances for items such as obsolete inventory, sales returns, contractual losses, receivables and warranties must be reviewed thoroughly. Special accruals for litigation, restructurings or environmental matters should be reviewed for compliance.

**4. Consolidation.** Many companies use numerous special-purpose vehicles for various financing transactions. Under U.S. GAAP, many of these entities could require consolidation. Furthermore, some companies may be consolidating entities that should not be consolidated

under U.S. principles or applying the cost or equity method to entities that should be consolidated.

**5. Stock options.** Companies need to evaluate existing and future plans to understand whether they have variable plans that boost earning volatility, or fixed plans. Reconciling various local laws and cultural views toward stock-based compensation and the results of applying U.S. GAAP to such programs can present challenges.

**6. Pensions and other employee benefits.** Accounting for pensions and other retirement plans poses challenges for companies, as special valuation reports must be obtained to adhere to prescribed accounting standards. Additionally, the results can differ significantly from other methods of accounting, such as pay-as-you-go (i.e., cash basis) accounting.

**7. Deferred income taxes.** Accounting for income taxes under U.S. GAAP requires that taxes are provided for the effects of temporary differences between an asset's or liability's balance sheet carrying amount and the tax basis in the local jurisdiction. Such accounting is complex and typically requires systems and technology support.

These are but a few of the challenges confronting foreign companies entering U.S. capital markets. The application of U.S. accounting principles to primary consolidated financial statements is not simply an accounting exercise. The process involves use of a fundamentally different set of accounting principles and affects the entire organization, requiring a change in mindset, business practices and information systems.

### **A Different Paradigm**

It is not only the accountants who must be cognizant of the implications of integrating a new set of accounting principles. The company's operating management must be educated about how the business will be depicted under U.S. GAAP — often in a much different and perhaps less desirable manner. Account-

ing policy issues such as those mentioned above need to be analyzed and the differences understood.

For example, in some countries the completed-contract method is used for accounting for a long-term contract, while U.S. GAAP generally requires the percentage-of-completion method. U.S. principles may also require consolidation of entities that previously had not been consolidated or had been accounted for under the cost or equity method. Such issues can have a dramatic impact on financial statements and can trigger different operational decisions. Indeed, the manner in which transactions are reported in financial statements may influence their terms and conditions.

Adopting U.S. GAAP will require the FPI to undertake a significant training effort. Accounting and finance personnel will need to be immersed in the comprehensive application of U.S. accounting principles. Senior management will need to be educated on the fundamental principles and manner in which various transactions and events will be reported here. The sales staff will need training on revenue recognition implications for different sales contracts, the information technology staff will need training on the implications of required capitalization of internally developed software and treasury personnel will need to be aware of the accounting implications of investing and hedging transactions.

Preparers of budgets and forecasts must be aware of the ways in which implementing U.S. GAAP will impact the development and potential accuracy of their work. The specific challenges will vary depending on the industries in which a company operates. Companies involved in the software business will need to forecast estimated revenues by applying SOP 97-2 to software revenue recognition. Forecasters must also factor in how one-time transactions such as the sale or acquisition of a business will be reported in accordance with U.S. principles.

Additionally, accounting for mat-

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ters such as restructurings, pensions and loss accruals can differ significantly. For example, a restructuring charge taken in 2001 for local accounting purposes may not qualify as such under U.S. GAAP; charges reported in fiscal 2001 may be included in fiscal 2002 results of operations. Because investors must be informed about trends in the business, a company's forecasting system must be sufficiently robust to allow the timely identification of material developments that need to be disclosed in filings with the SEC and to the investment community.

### **IT and Accounting Systems**

Companies adopting U.S. GAAP should expect to implement changes to existing systems — and in some cases, implement entirely new systems. For example, meeting the requirements for percentage-of-completion accounting can be a daunting managerial, as well as systems, task. The requirement to update estimated cost-to-complete figures and anticipated margins on a quarterly basis may require changes in current processes and systems. Further, if a company wants to apply hedge accounting to its portfolio of derivative instruments, systems must be in place to track the required information and ensure compliance with documentation and disclosure requirements.

Implementing SOP 98-1, "Accounting for the Cost of Internal Use Software," has been a challenge to Amer-

ican companies and has typically required a technology support solution. Accounting for income taxes under U.S. GAAP is complex, and requires systems to accumulate the information related to the computation and disclosure of deferred taxes.

**I**n summary, companies planning to enter the U.S. capital markets should develop a comprehensive plan to support that effort. Among the important features of such an effort are assurances that senior management is fully committed and understands the attendant issues and challenges. Secondly, companies should establish a committed, multidisciplinary project team of full-time individuals made up of outside advisors and individuals in the company with skills in accounting, information technology, tax law and, most importantly, operating management.

Furthermore, a bottom-up approach to converting to U.S. GAAP is recommended. Typically, centrally managed conversions become more of an accounting exercise, meaning that the company will be able only to prepare a reconciliation to U.S. principles and thus lose out on any benefits obtainable from adopting U.S. GAAP as its primary accounting principles.

Companies should take the necessary time to educate senior management and the board on the issues associated with adopting U.S. protocols and becoming a U.S. registrant. The company should review its accounting and reporting practices carefully to ensure that all significant U.S. GAAP-related issues are identified. Lastly, it is usually better to discuss major accounting and reporting issues with the SEC via a pre-filing conference than to wait until issues are identified by the staff during their review of the document.

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