

DISCLOSURES OF FOREIGN COMPANIES
REGISTERED IN THE U.S.

by

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Introduction

An increasing number of foreign companies seek capital by trading their securities in the U.S. As a result, many financial and accounting consultants find opportunities in working with foreign companies and therefore must know about their disclosure requirements. In the protection of investors' interest, the Securities and Exchange Commission (SEC) is a U.S. government agency that has the authority to mandate disclosure practices for companies under its jurisdiction. When foreign companies are traded through formal registration on an organized exchange in the U.S., these companies fall under the SEC's jurisdiction and must follow the required disclosure mandates.

This paper discusses business, financial, and accounting disclosures of foreign companies as required by the SEC. The paper's discussion covers the disclosures of different types of American Depositary Receipt (ADR), an investment instrument that is gaining much popularity. This paper should be useful to an increasing number of accounting and financial consultants working with foreign companies that are trading or seeking to trade in the U.S.

Disclosures of Foreign Companies Registered in the U.S.

Foreign securities registered in the U.S. are governed by the Securities Act of 1933 (Securities Act) and the Securities Act of 1934 (Exchange Act). SEC Regulations S-X contain special provisions for foreign registrants. The application of the registration and disclosure requirements of the Federal securities laws to foreign registrants is documented in SEC Memo dated September 1994. Foreign companies registered in the U.S. are required to file disclosure reports with the SEC.

Companies' filings with the SEC are accessible to analysts and the investing public. Many foreign companies volunteer to file disclosures electronically. Their filings can be retrieved electronically from EDGAR, the online database of corporate filings available from the SEC's web site. Disclosures of those companies that do not file electronically are available through the SEC's Public Reference Library, or via information contractors such as Disclosure Incorporated.

The current disclosure system for foreign companies was adopted in 1982. The system consists of registration forms (forms F-1, F-2, F-3, F-4) under the Securities Act. The first three forms are all used to register regular securities, except that these forms differ in length depending on the level of incorporation of other filings. Registration form F-4 is used in connection with mergers and exchange offers. The required registration disclosures include the company's business, management's discussion, financial statements reconciled to U.S. accounting standards, principal risk factors, principal physical properties of the company, pending legal proceedings,

foreign taxes to U.S. holders, exchange controls, and other ownership restrictions. The company is also required to disclose about its directors and officers, their compensation and insider interests, the use of the offering proceeds, the names of the underwriters and the nature of the underwriting obligation.

The disclosure system for foreign companies also consists of form 20-F under the Exchange Act. An important component of form 20-F is the reconciliation from the foreign company's domestic accounting standards to U.S. accounting standards. Form 20-F is allowed for both registration and annual reports. The required registration disclosures are similar to the ones required in Securities Act forms. Annual reports on form 20-F must be filed within six months of the end of the fiscal year. Interim reports by foreign registrants must be filed as required pursuant to the law of its domicile country (usually semiannual) using form 6-K. Interim reports on form 6-K are due 45 days after the interim period.

A main feature of form 20-F is the alternative use of Items 17 and 18. The more stringent Item 18 requires full disclosure of all information required by U.S. accounting standards relating to segment information and pension information. On the other hand, Item 17 requires only reconciliation of the difference in the income statement and balance sheet amounts. Statements using Item 17 are permitted for registration and limited offerings, such as non-convertible investment grade securities and offerings to shareholders and employees. All other offerings must use Item 18 statements to provide more extensive disclosures.

A foreign company may make disclosures at a higher level than the required level. For example, a foreign company that is required to file form 20-F Item 18 to reconcile to U.S. accounting standards may use form 10-K to report directly in U.S. accounting standards. Similarly, one that is required to file form 20-F Item 17 may file form 20-F Item 18 or form 10-K.

Corporate news and press releases are filed using form 6-K. Foreign companies are required to file this form to furnish current information required in their domestic countries, information filed with a foreign stock exchange, and information distributed to securities holders. Reports of current events on forms 6-K are due within 15 days of confirmation of the events. These forms are the source of current information about foreign companies. They are also their only reports between annual reports.

Accommodations and Exemptions

The SEC has attempted to facilitate access by foreign companies to the U.S. public markets. The accommodations for foreign companies include allowing interim reports on the basis on home country regulation. While U.S. companies must file quarterly, interim reports by foreign companies must be filed as pursuant to the law of its domicile country (typically semiannual) using form 6-K. Another accommodation for foreign companies is to allow them a longer report lag. Foreign companies' annual reports on form 20-F must be filed within six

months (versus three months for U.S. companies) of the end of the fiscal year.

Accommodations for foreign companies are also in the form of exemption from disclosure rules. Foreign companies are exempted from the proxy rule and the insider stock trading and short-swing profit recovery provisions. Furthermore, they are allowed to disclose executive compensation on an aggregate basis. Under current SEC annual reporting rules, a foreign company that does not wish to make a public offering of securities in the U.S. may omit disclosures about income taxes, leases, pensions, nonconsolidated affiliates, related parties, and complete industry and geographic segment information. All these items are required of U.S. companies. The SEC exempts some grandfathered companies and those that make private placement under rule 144A from required disclosures. Concerted efforts to relax registration rules have resulted in a surge of foreign listings on the New York Stock Exchange (Ogden 1996).

Many foreign companies fall short of their disclosure requirements. Although the differences in disclosures are related to filing status, disclosure levels may vary among foreign companies nominally facing the same minimum disclosure requirements. Furthermore, within each filing status category, a substantial number of companies do not comply with disclosure requirements of their category (Frost and Kinney 1996).

Overall, foreign companies registered in the U.S. are required to reconcile to U.S. accounting standards. However, due to several exemptions allowed by the SEC, and also due to non-compliance by the foreign companies, the level of disclosure by foreign companies is

generally less extensive than that of U.S. companies. Direct observations of foreign and U.S. filings indicate that foreign companies file fewer interim reports, their reports are filed later, and they announce earnings later than U.S. companies (Frost and Kinney 1996).

Foreign companies may trade their securities in the U.S. not only by registering on an exchange but also on the over-the-counter (OTC) Pink Sheets market. Over-the-counter securities can obtain section 12g3-2(b) exemption from 1934 Exchange Act registration and reporting requirements. As a result, these companies are not mandated to report in or reconcile to U.S. accounting standards. However, they must report to the SEC their primary statements, such as annual reports, circulars, or prospectus that are required in their domestic jurisdictions. Analysts who research these firms need to be conversant with foreign disclosure standards.

American Depositary Receipts and their Disclosure Requirements

Foreign companies can trade their securities in the form of their original shares. In this case, U.S. investors may have to pay for the shares and receive dividends in foreign currencies. More conveniently, foreign companies can be traded in the U.S. in the form of American Depositary Receipts (ADR). Foreign companies participate in an ADR program to be traded more easily to American investors. These companies deposit their shares with a U.S. depository bank. The bank holds these American Depositary Shares (ADSs) and issues American Depositary Receipts (ADRs). ADRs are priced and dividends are paid in U.S. dollars. The

deposit agreement between a foreign company and a U.S. depository bank creates a sponsored ADR program. This deposit agreement is filed with the SEC using form F-6. Un-sponsored ADRs are created by a depository bank alone without an agreement with the underlying foreign company.

ADRs increasingly gain popularity in the U.S. Trading volume of ADRs reached over \$500 billion dollars in 1997 (Sherwood 1998). ADR indexes have been developed by financial service firms such as Merrill Lynch and Bank of New York. There are about 800 foreign companies registered in the U.S, of which 300 are ADRs, according to Standard & Poor's Compustat database. Registered ADRs are mainly on the New York Stock Exchange. The majority of these ADRs are from the U.K., Australia, Japan, and Hong Kong. Major ADR sponsors are Bank of New York, Bankers Trust Company, and Citibank, according to Bankers Trust Company's ADR database. Over 1,000 ADRs are traded on the OTC "Pink Sheets". The richest ADR offerings seem to be from the privatization of state-controlled enterprises, particularly telephone companies.

ADR programs are grouped into four categories. The first two categories, un-sponsored and sponsored level-I ADRs, are traded in the OTC "Pink Sheets" market and cannot be registered. In this case, companies usually obtain section 12g3-2(b) exemption from disclosure rules. As a result, these companies are not required to report in or reconcile to U.S. accounting standards. However, they are required to file their primary statements to the SEC.

The third category, sponsored level-II ADRs, may register their shares on a U.S. exchange but do not make public offerings in the U.S. Companies in the fourth category, sponsored level-III ADRs, may register their shares on a U.S. exchange and have a public offering in the U.S. Companies in the two latter categories are required to use U.S. accounting standards (file SEC form 10-K annually and 10-Q quarterly), or retain their domestic accounting standards and reconcile to U.S. accounting standards (file primary statements, form 20-F annually and form 6-K semi-annually).

The following table summarizes the discussion in this paper by presenting the minimum disclosure requirements of foreign companies.

TABLE: SEC DISCLOSURE REQUIREMENTS OF FOREIGN COMPANIES

| Categories | Exchange | Minimum Required Disclosure |
|------------------------------------------------------------------|-------------------------------------------------|----------------------------------------------|
| Foreign securities, Unsponsored ADRs, and Sponsored Level-I ADRs | N/A (OTC) | Domestic Jurisdiction of the Foreign Company |
| Foreign securities and Sponsored Level-II ADRs | U.S. exchanges (Register only) | 20-F Item 17 and 6-K |
| Foreign securities and Sponsored Level-III ADRs | U.S. exchanges (Register and Public offerings) | 20-F Item 18 and 6-K |

Summary

Foreign companies registered in the U.S. are regulated at minimum to reconcile from their domestic accounting standards to U.S. standards. However, due to accommodations and exemptions allowed by the SEC, the disclosure level required of foreign firms remains less extensive than that of U.S. firms. This paper has discussed the public disclosures and filings of foreign companies registered in the U.S. as mandated by the SEC. The discussion has also covered different ADR programs, their disclosure requirements, and their SEC filings. The discussion in this paper should be useful to accountants and financial consultants who work with foreign companies that are trading or seeking to trade in the U.S.

References

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