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United States Accounting Standards: Do the SEC Requirements regarding U.S. GAAP Violate GATS?

Introduction

Trade is an important part of the world economy. Multilateral trade agreements have been established to facilitate free trade. Tariffs and non-tariff barriers to trade are generally not allowed between contracting parties. However, "[t]he real question is not the actual existence of the barrier, but the willingness to dismantle it, which is affected by the degree to which the barrier is embedded in the non-trade public policy or economic system of the country raising the barrier." In the United States, the Securities and Exchange Commission (SEC) requires all companies wishing to register with them to provide financial statements that use U.S. Generally Accepted Accounting Principles (U.S. GAAP) or to reconcile any differences in the accounting standards used with U.S. GAAP. Does this requirement constitute a non-tariff barrier to trade in the stock market? To answer this question, this article will look at the background trade agreements including the General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services (GATS). After looking at these trade agreements, this article will look at the SEC requirements regarding accounting

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1 See infra notes 9–59 and accompanying text.


5 GATT, supra note 2.

standards for foreign issuers. Finally this article will examine whether the SEC rules constitute a non-tariff trade barrier and the effect the rules have on foreign issuers.

I. Trade Agreements

In order to further international trade goals, several countries have participated in a series of negotiating rounds and established a multilateral trade system. The first set of negotiations resulted in the General Agreement on Tariffs and Trade (GATT), which took effect on January 1, 1948. The primary goal of the GATT is to reduce tariff and non-tariff barriers to trade and to “open markets.” The GATT anticipated the establishment of the International Trade Organization to oversee the implementation of the agreements. The establishment of this organization required the ratification of the Havana Charter by the contracting countries. The U.S. Congress did not approve the Charter and, thus, the contracting countries were forced to “cobbl[e] together an institutional structure to govern the multilateral trade system for nearly a half century.” This lack of a central governing body was one of the many concerns addressed at the Uruguay Round. The Uruguay Round of negotiations started on September 20, 1986 and

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7 See infra notes 60–65 and accompanying text.
8 See infra notes 66–101 and accompanying text.
10 Kennedy, supra note 9, at 421.
12 Id. at 12.
13 Leebron, supra note 11, at 13.
14 Id. at 12.
lasted over seven years. The Final Act of the Uruguay Round, signed on April 15, 1994, included an agreement establishing the World Trade Organization (WTO).

The original GATT applied only to trade in goods. In 1947, when the GATT was first signed, trade in services “were not a significant component of world trade.” In addition, “[s]ervices in general, and heavily regulated services like financial services in particular, are not completely amenable to some of the traditional trade disciplines found in GATT, such as reduction of tariffs, prohibition of quantitative restrictions, most favored nation treatment, and national treatment.” However, the world economic landscape changed significantly in the years following the enactment of GATT. The issue of trade in services became an important issue for the United States in the 1970s. Congress enacted legislation addressing trade and included trade in goods and services in its definition of “international trade.” “The service sector of the United States’[s] economy encompasses ‘all economic activity other than agriculture, mining, and manufacturing.’” It is the largest component of the United States’[s] economy, accounting for approximately 80% of the United States’[s] gross domestic product and private non-farm employment.” Services were first officially considered an international trade issue when trade in services was added to the table in the Uruguay negotiation rounds through the Punta del Este Ministerial Declaration. The Declaration indicated that GATT


18 Id. at 12.

19 Trachtman, supra note 3, at 51 (quoting Office of the USTR, GATT Uruguay Round: Progress Report 6 (Dec. 14, 1988)).

20 Trachtman, supra note 3, at 41.

21 Jarreau, supra note 15, at 11–12.


23 Jarreau, supra note 15, at 11.

24 Id. at 7.

25 Trachtman, supra note 3, at 44.
principles would apply to trade in services, but trade in services would not actually be included within the legal framework of GATT. One of the reasons that agreements on financial services were not included within the framework of GATT is because of the nature of the different agreements.

In GATT, there has been an effort to "tariffy"—convert to tariff form—non-tariff barriers, in order to quantify them and to make them more amenable to reduction, as well as to provide a less economically objectionable form of trade barrier. Traditionally, services have not been subjected to tariffs, possibly because of their "invisible" nature: it is difficult to identify the point at which they cross a border. Even where the service is easily identified, it is normally not subject to tariff.

At least for the United States, the primary goal of establishing this multilateral system for dealing with trade in services was to set up a more rigorous approach to national barriers to trade in the service sector. The negotiations ended with inclusion of the General Agreement on Trade in Services (GATS) as part of the Final Act of the Uruguay Round. There are eight annexes, in addition to the main text of GATS, that are considered integral parts of the agreement. While not officially part of the text of GATS, the annexes are essentially additional agreements reached by the parties. "Trade in services includes cross-border services, services provided in one country to consumers from another country, services provided by an establishment of a person from one country in another country, or services provided by natural persons from one country in the territory of another country." Included under the broad umbrella of services is the subsection of financial services. Financial services is a broad category that contains insurance, securities, and banking services.

26 Id.
27 Id. at 45.
28 Id. at 52.
29 Id. at 44.
30 Jarreau, supra note 15, at 34.
31 Id.
32 Trachtman, supra note 3, at 44.
33 Jarreau, supra note 15, at 6.
34 Id. at 8.
GATS is the first multilateral agreement providing disciplines on barriers to trade and investment in the services sector. GATS provides a limited scope of discipline, addressing geographic regulatory restrictions (those that are more explicitly protectionist), but avoiding immediate action on the far more difficult problem of generally applicable regulation that has collateral restrictive effects on trade in services.\(^{35}\)

Getting an agreement on financial services proved to be a difficult task.\(^{36}\) During the Uruguay Round, the negotiations regarding financial services ended in a deadlock between the United States and the European Union (E.U.).\(^{37}\) "[T]he [United States] severely limited the application of GATS to financial services, as GATS had not achieved sufficient market liberalization in other countries for the [United States] to be willing to lock in its own liberal policies regarding national treatment."\(^{38}\) The United States's main concern was the lack of sufficient market-opening commitments in the areas of banking and securities that were guaranteed by many of the contracting parties.\(^{39}\) Time was important in the negotiation process because the U.S. Congress gave authorization to enter into the Uruguay Round agreement under fast track procedures.\(^{40}\) The importance of the fast track procedures is that the agreement would be accepted in its entirety, without Congress having the opportunity to make changes to the agreement. If an agreement could not be reached on the financial services issue before the December 15, 1993 deadline, Congress would have been able to amend the agreements reached during the negotiations.\(^{41}\) Allowing the U.S. Congress to amend the agreements would have guaranteed the demise of

\(^{35}\) Trachtman, supra note 3, at 56.

\(^{36}\) Jarreau, supra note 15, at 10.

\(^{37}\) Trachtman, supra note 3, at 25.

\(^{38}\) Id. at 54.

\(^{39}\) Id. Those countries that attempt to benefit from the market liberalization granted by other nations without granting increase access to their markets are known as "free riders." Id.

\(^{40}\) Id. For a discussion of the “fast track” procedure see David A. Gantz, A Post-Uruguay Round Introduction to International Trade Law in the United States, 12 ARIZ. J. INT'L & COMP. L. 7, 22 (1995).

\(^{41}\) Jarreau, supra note 15, at 25.
GATS.\textsuperscript{42} In order to save the negotiated agreements, the contracting countries decided to extend the negotiation period for financial services in the Decision on Financial Services.\textsuperscript{43}

Following the Uruguay Round the negotiations on financial services continued. The Decision on Financial Services authorized negotiations to last until June 30, 1995.\textsuperscript{44} As the negotiations continued, "it became apparent that the United States would not sign a broad financial services agreement."\textsuperscript{45} On June 30, 1995, the United States indicated that it would no longer participate in the negotiations.\textsuperscript{46} The negotiations were extended for one month and an "interim" agreement was reached without the participation of the United States.\textsuperscript{47} Seventy-seven WTO members made financial services commitments in this agreement.\textsuperscript{48}

In December 1996, the WTO decided it would resume negotiations on financial services in April 1997. The agreement to resume the negotiations was made in the Singapore Ministerial Declaration.\textsuperscript{49} The participating countries hoped to attain better market access commitments with more countries allowing this improved access.\textsuperscript{50} The result of these negotiations was the Fifth Protocol to the GATS, known as the Financial Services Agreement.\textsuperscript{51} The Financial Services Agreement was signed on December 13, 1997 by 102 WTO members.\textsuperscript{52} The Financial Services Agreement became effective on March 1, 1999.\textsuperscript{53} The agreements reached are subject to the schedules of commitments

\textsuperscript{42} Id.
\textsuperscript{43} Id.
\textsuperscript{44} Id.
\textsuperscript{45} Jarreau, supra note 15, at 27.
\textsuperscript{46} Id.
\textsuperscript{47} Id.
\textsuperscript{48} Id.
\textsuperscript{49} Singapore Ministerial Declaration, 36 I.L.M. 218 (1997).
\textsuperscript{50} Jarreau, supra note 15, at 27.
\textsuperscript{52} Id.
\textsuperscript{53} Id.
and exemptions enacted by each country. "Each WTO Member’s Schedule of Specific Commitments and List of Article II Exemptions, if any, are unique. The current and effective Schedule and List of each Member must be read carefully to determine precisely those opportunities afforded to foreign services and service suppliers."55

The agreements have provisions providing for most-favored-nation treatment,56 transparency,57 market access,58 and national treatment.59

II. Accounting Standards

The SEC regulates the disclosures required of public companies under the Securities Act of 1933.60 "The federal securities laws apply to issuers who offer, sell[,] or trade securities between the United States and any foreign country."61 In order to trade in the United States, companies generally must register with the SEC.62 Foreign companies wishing to register and trade stocks in the United States securities market must use U.S. GAAP in their financial statements or must reconcile their financial statements to U.S. GAAP.63 Proponents of this requirement argue that this is necessary to protect U.S. investors and the U.S. economy.64 Proponents of the accounting standards also justify the


55 Jarreau, supra note 15, at 42.

56 See infra notes 66–72 and accompanying text.

57 See infra notes 73–76 and accompanying text.

58 See infra notes 77–81 and accompanying text.

59 See infra notes 82–89 and accompanying text.


62 Id.


requirement because:

[A] distinction is made between foreign issuers that voluntarily enter the United States securities markets and those companies whose securities are traded in the United States without any significant voluntary acts of encouragement by the issuer. Currently, this distinction is accomplished by deeming all foreign companies having either securities listed on a United States exchange or having made a public offering of securities registered under the Securities Act as having voluntarily entered the United States market. Other foreign companies whose securities are traded in the United States through no direct acts of the issuers are deemed not to have taken any voluntary acts to enter the United States market.65

III. Discussion

The issue to consider is whether the requirement that foreign investors use U.S. GAAP in their disclosure statements violates GATS and the Financial Services Agreement. There are several factors to consider in determining whether a particular regulation constitutes a non-tariff barrier to trade. These include most-favored-nation treatment, transparency, market access, and national treatment.

The most-favored-nation (MFN) provisions require that “each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country.”66 MFN treatment was a highly

66 GATS, supra note 6, art. II para. 1. The MFN issues are three-fold, subsequent to a review of the Member’s Article II exemptions. The issues are: (1) is the Member at issue extending any treatment of the service in question to the services or service suppliers of any other country?; (2) is the service or service supplier at issue like the service or service supplier that has been accorded treatment of any nature by the desired host Member?; and (3) are the services or service suppliers of any other country, whether a WTO Member or not, accorded more favorable treatment?

Jarreau, supra note 15, at 62.
debated issue during the rounds of negotiations. Countries, particularly the United States, were concerned about granting MFN treatment when other countries would not do so. Each country’s MFN treatment obligation is subject to the country’s Annex on Article II Exemptions. The Article II Exemptions are viewed as an integral part of GATS, and allow a country to “maintain measures that are inconsistent with the obligation to accord immediate and unconditional treatment that is ‘no less favourable’ to the services and service suppliers of other Members than the treatment extended to the services and service suppliers of any other country.” These exemptions allow the contracting members to have greater flexibility and protection to withhold commitments to other countries that do not allow access to their markets.

The SEC rules require all companies wishing to register with it to either use U.S. GAAP or, in certain circumstances, reconcile different treatment with U.S. GAAP. Because the requirement is uniformly applied, it appears that the SEC’s rules regarding U.S. GAAP met the requirements of MFN treatment.

In addition to MFN treatment, countries must meet the transparency requirements. The transparency provision provides that “[e]ach Member shall publish promptly and, except in emergency situations, at the latest by the time of their entry into force, all relevant measures of general application which pertain to or affect the operation of this Agreement.” This provision is important to provide notice to the contracting countries about requirements that might affect trade in services. It is important to note that the Agreement does not provide where the requirements

67 Trachtman, supra note 3, at 54.
68 Id.
69 Jarreau, supra note 15, at 35.
70 Id.
71 Id.
73 Jarreau, supra note 15, at 63.
74 GATS, supra note 6, art. III para. 1.
must be published or how long they must be published. The SEC publishes the requirements for registering and listing in U.S. stock exchanges. Thus, it appears that the requirement of transparency is met.

Another important requirement of the GATS agreement is allowing market access to contracting countries. This provision requires that contracting countries afford companies from other contracting countries MFN treatment with respect to market access. What constitutes MFN treatment for market access is not entirely clear:

"Market access" is more relative and flexible than "national treatment," and modern requirements for market access are often found in conjunction with requirements for national treatment... market access requirements may go further and require a degree of harmonization downward, or negative harmonization, sufficient to allow foreigners access. In this way, a requirement for market access may constitute a requirement for better-than-national treatment.

In order for a company to fully participate in securities markets, it may be necessary for that company to be afforded membership on the stock exchanges. Because access to the securities market is required under GATS, it is important to look at how accessible the exchange markets are to foreign issuers. Many commentators suggest that the SEC requirement regarding U.S. GAAP is the main reason that foreign companies choose not to enter the U.S. securities markets. Because of the deterrent effect that the SEC rules have on foreign companies, it is arguable that

75 Jarreau, supra note 15, at 63.
76 See e.g., 15 U.S.C.S. § 78m (2003) (providing that "Each financial report that contains financial statements, and that is required to be prepared in accordance with (or reconciled to) generally accepted accounting principles under this title and filed with the Commission shall reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles and the rules and regulations of the Commission.").
77 Trachtman, supra note 3, at 75.
78 GATS, supra note 6, art. XVI para. 1.
79 Trachtman, supra note 3, at 76.
80 Id. at 50.
the requirements violate the market access requirement of GATS.

Perhaps the most relevant requirement for this discussion is the requirement of national treatment. The national treatment provision requires:

In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords its own like services and service suppliers.\(^2\)

To satisfy this requirement, the Member nation may adopt "either formally identical treatment or formally different treatment than it accords to its own like services and service suppliers."\(^3\) If the treatment, either formally identical or formally different, that is afforded to contracting countries makes the market more favorable to the home country, then that treatment will violate the national treatment requirement.\(^4\) Like other provisions of the Agreement, this provision applies only to those sectors to which a country has scheduled it to apply.\(^5\) It is not clear how much is required of a home country to satisfy the national treatment requirement. It is clear that a country can have some protective measures to ensure the welfare of its economy. This right is provided for in one of the eight annexes to GATS, the Annex on Financial Services, which "authorizes each WTO Member to establish 'prudential' regulatory measures to protect purchasers and beneficiaries of financial services, as well as its domestic financial system."\(^6\) While countries have the right to take some measures to protect their interests, that right is not absolute:

"[N]ational treatment" clearly prohibits blatant protectionism or geographic regulation, such as prohibitions or restrictions on entry by foreigners, or more stringent rules applicable to foreign persons than to local persons. On the other hand, it is possible

\(^2\) GATS, supra note 6, art. XVII para. 1.
\(^3\) Id. art. XVII para. 2.
\(^4\) Id. art. XVII para. 3.
\(^5\) Trachtman, supra note 3, at 68.
that differential treatment may be justified from a regulatory standpoint, as opposed to a protectionist standpoint, simply because of the foreignness of the person regulated.\textsuperscript{87}

In some situations, simple national treatment may not be sufficient. "Better-than-national treatment may be necessary to allow free trade where the application of domestic regulation would inappropriately deter or prohibit foreign entry or operations."\textsuperscript{88} In addition, "better-than-national treatment might be appropriate in order to take account of differences in foreign economic and business systems, and foreign regulation that permits differing business structures and practices."\textsuperscript{89}

To satisfy the national treatment requirement the treatment need not be identical on its face, but it must be functionally equivalent. In fact, treatment that is identical on its face may not be functionally equivalent and may then violate the national treatment requirement. The accounting standards requirement creates a situation which gives rise to this distinction. Requiring that all companies, whether foreign or domestic, use U.S. GAAP in their financial statements or reconcile their statements to U.S. GAAP, on its face, is identical treatment of foreign and domestic companies. However, the effect of the requirement might create functionally different treatment of foreign companies.

Perhaps the easiest way to address whether the SEC requirements violate GATS is to look at the effects the requirements have on foreign issuers. There is some dispute as to whether the accounting standards requirements are actual deterrents to foreign issuers listing on the U.S. stock exchanges. Many commentators argue that the SEC’s requirements put up a significant barrier to foreign companies wishing to list securities on the U.S. stock exchanges.\textsuperscript{90} In fact, this view is considered the "accepted wisdom" in the financial field.\textsuperscript{91} Lawyers indicate that foreign clients claim that the accounting standards requirements are so onerous that the companies decide not to list directly in U.S.

\textsuperscript{87} Trachtman, \textit{supra} note 3, at 64–65.
\textsuperscript{88} \textit{Id.} at 65–66.
\textsuperscript{89} \textit{Id.}
\textsuperscript{90} Karmel & Head, \textit{supra} note 81, at 1208–1210.
markets. Not all scholars are convinced that the SEC requirement that foreign companies comply with U.S. GAAP is the principal reason that foreign companies choose not to list in the U.S. securities markets:

[Research suggests that companies decide for or against listing in the [United States] for many reasons. Disclosure requirements, particularly accounting reconciliation, are only one, and not always the most important of the various factors that influence a company's decision. Other reasons include a specific U.S. business purpose for the listing (e.g., U.S. acquisition), the benefits of U.S. capital markets (e.g., their liquidity and "cheapness" or their ability to supply large amounts of equity capital), and industry-specific reasons (e.g., companies in a similar industry all list in the [United States]).]

Commentators are also equally divided as to whether the SEC requirements should remain in place. There are many arguments in favor of maintaining the U.S. GAAP requirements. One argument is that the SEC requirements make the U.S. system better than other systems and represents the "the most 'transparent financial reporting and full and complete disclosure' system in the world, and this system should be followed whenever the U.S. public is given the opportunity to buy securities in a primary offering or in an organized secondary trading market." Others argue that for investors to make informed decisions, they must be able to compare domestic and foreign companies and that the most effective way of comparing the companies is to have the financial statements use a uniform system of accounting standards. This argument is supported by the first argument that U.S. GAAP represents the best system of accounting and, thus, should be the uniform system used. The last argument in favor of requiring foreign companies to use U.S. GAAP is that this requirement keeps domestic issuers from being disadvantaged in U.S. capital markets.

Some commentators disagree with the SEC requirements and

92 Id.
93 Id. at 52.
94 Greene, supra note 64, at 429–30.
95 Id.
96 Id. at 430.
argue that foreign issuers should not be required to use U.S. GAAP:

First, U.S. investors are needlessly disadvantaged under the current system in circumstances when the information about non-U.S. companies would be adequate for informed investment decision-making without requiring those companies to comply with U.S. GAAP and the other U.S. disclosure requirements. For such companies, U.S. investors, both retail and institutional, are merely driven to the less efficient and less transparent over-the-counter markets and non-U.S. markets. At the same time, U.S. retail investors who are not substantial or sophisticated enough to make arrangements to buy securities offshore are denied the benefits of attractively priced foreign privatizations and other primary offerings.\footnote{\textit{Id.} at 430–31.}

In addition, the accounting standards that a particular country, including the United States, chooses to adopt is the result of a political process and, thus, might not represent the best principles for assessing financial information.\footnote{\textit{Id.} at 431.} Also, doing away with the accounting standards requirements will not harm investors.\footnote{James L. Cochrane, \textit{Are U.S. Regulatory Requirements for Foreign Firms Appropriate?}, 17 \textit{Fordham Int’l L.J.} S58, S61 (1994).}

There is a growing consensus among experts that requiring foreign companies to file additional U.S. GAAP reconciliation after their home country documents are made public is of little value to investors. These filings have no material impact on the price of the stock, which is set by economic fundamentals in the home country. Even when foreign companies go through the work to reconcile with U.S. GAAP, U.S. investment analysts following the company typically rely more on financial statements based on home country accounting. If the stock is being priced in its home country using its own financials and it’s being priced here in the United States using home country financials, what have we accomplished by forcing the company through this particular kabuki?\footnote{\textit{Id.} at S62.}

The only thing that is clear in this debate is that there is not a clear consensus. There is evidence that the requirement that foreign issuers reconcile their financial statements to U.S. GAAP

\footnote{\textit{Id.} at S62.}
does affect their ability to have the same access to U.S. securities markets as U.S. issuers. This evidence suggests that the requirements could violate the GATS requirements of national treatment and market access. However, there is also evidence that the SEC requirements do not present a significant barrier to foreign companies. Also, the United States does have some flexibility in making regulations that protect the U.S. economy. Based on this evidence, the SEC requirements may not violate GATS.

Conclusion

It has been recognized that “[t]he GATS and the Fifth Protocol [the Financial Services Agreement]... constitute more of a beginning than an end of a process.” It is unclear whether the SEC requirement that foreign companies use U.S. GAAP accounting standards constitutes a violation of multilateral trade agreements. Because there is this uncertainty, and access to U.S. securities markets is important to both the U.S. and world economies, this issue should be discussed in further negotiation rounds.

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