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# SECURITIES REGISTRATION

## A Financial Statement Guide Through the Season

*Registering and offering securities of U.S public companies at different times of the fiscal year can pose challenges due to financial statement considerations. For calendar year companies, it is especially difficult between mid-February and the filing of the company's Form 10-K.*

**By Harald Halbhuber**

Financial statement considerations can pose challenges for registering or offering securities at certain times of the company's fiscal year. Companies often observe quarterly earnings blackouts starting around the end of a fiscal quarter until the next earnings release or 10-Q or 10-K. A company's ability to file a registration statement after February 14 (in the case of calendar year filers) but before the Form 10-K depends on its profitability. Offerings after February 11 and before the 10-K may not be eligible for negative assurance auditor comfort. Offerings after year-end but before the 10-K may also face so-called "white paper" auditor comfort issues. Offerings between the earnings release and the 10-Q or 10-K have their own challenges.

### Timeline

Accompanying this article is a simplified timeline highlighting certain financial statement considerations for a calendar year filer, discussed in more detail below. This article focuses on US public companies that have timely filed all required SEC reports. Additional considerations

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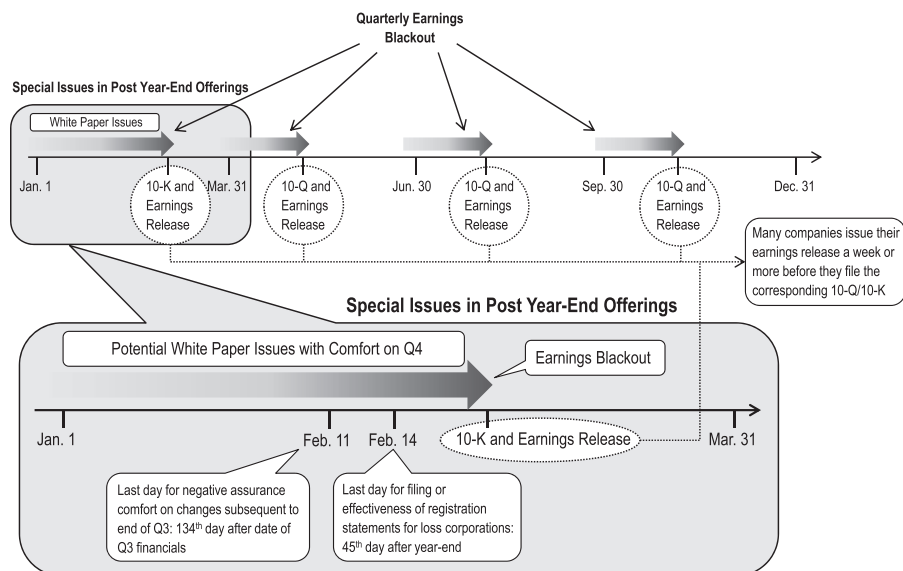
apply to foreign companies, companies that are going public or went public only recently, and companies that are not current in their filings.

### Earnings Blackouts: What You Know and When You Know It

Many public companies have so-called quarterly blackout periods during which they restrict their executive officers, directors and other insiders from trading in the company's securities. These blackouts are imposed as a precaution. Although the company has not yet announced its financial results for the quarter, these individuals could be perceived as having material information about the company's financial performance during the quarter. Start and end dates of these periods vary company by company, but they usually begin sometime around the end of the quarter or a bit before that and end a day or two after the company has announced its results in an earnings release or filed the corresponding 10-Q or 10-K. Due to similar concerns about being perceived to possess material non-public information, companies themselves also tend to stay out of the market during or around these periods.

When a company's quarterly blackout period begins is not set by a hard-and-fast rule. It is based on a judgment about when management has enough information to give it a relatively clear view on how the company performed financially during the quarter. Selling securities during a blackout period therefore remains legally possible if the company and the underwriting banks can get sufficiently comfortable that, based on the information available to management at the time, the offering document does not contain a material misstatement or omission.

Whether the offering documents meets this disclosure standard will be assessed in hindsight,



after the company has actually reported its financial results for the quarter. If those results fall short of market expectations, the price for the company's securities will decline, and there is a risk that plaintiffs' lawyers could allege that, given the timing, the company must have been aware of this disappointing performance at the time of the offering. Even if there is no legal liability, selling securities shortly before reporting disappointing results can be a reputational embarrassment for both the company and the underwriting banks. The practical question is: Does management believe that the market will be disappointed in a material way by the results for the quarter?

- **What does management know?** This is perhaps the most difficult and fact-specific part of the analysis. As the quarter progresses and draws to a close, management will tend to have more and more information about how things went, but the different data points that are coming in from business units and subsidiaries may not be "hard" enough to provide a definitive view. How soon that stream of information gels into a clearer picture of the company's quarterly performance depends on the nature and complexity of the company's business,

the structure of its financial reporting systems, the number of different business units that may need to be consolidated, and many other factors.

- **What does the market expect?** The other part of the analysis focuses on the expectations the market has for the company's performance in the quarter. These expectations can be based on analysts' reports, the company's own financial guidance, general economic trends that affect the company's business, and other factors. Debt markets, especially investment grade debt markets, generally are perceived to be somewhat less sensitive to unexpected changes in the company's financial results than equity markets. It is therefore possible that a certain deviation from market expectations would not be considered material for a debt offering, although it likely would be material for an equity offering.

If management believes that the company's results will be in line with, or better than, market expectations, then it may be possible to proceed with an offering without updating the market on the quarter. Management's belief will need to be stress-tested in this case, including by reviewing the internal information that management is

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using for this purpose as well as the company's track record in accurately anticipating its financial performance in similar situations or in connection with its published financial guidance. The company's auditors may not be able to provide much assistance in this regard because the internal information that management is using for this assessment often does not meet the standards that auditors require for their procedures. As a result, doing a deal under these circumstances, even after appropriate due diligence, is not without risk.

If management is less confident about not disappointing investors, the company may want to postpone the offering until after it reports financial results for the quarter in its next earnings release or 10-Q/10-K. As an alternative, the company could decide to reset market expectations by releasing information about its anticipated performance for the quarter. Potential approaches range from qualitative trend disclosure about factors that may lead the quarterly results to fall short of market expectations, through disclosure of a range of expected financial results, all the way to an early release of the company's estimated quarterly earnings. If the company has a practice of giving annual earnings guidance, the company may want to update the market on how this guidance will be affected by the anticipated quarterly performance. Any such disclosure will be subject to careful due diligence, which may include certification from the company's chief financial officer as to any numbers included in the offering document, since auditor comfort is not likely to be available for this information. Again, some risk will remain.

### **Loss Corporations: No Registration Statement after February 14 (45th Day after Year-End)**

Most public companies that are current with their regular SEC reporting and have timely filed their 10-Ks, 10-Qs, 8-Ks and any other required reports or statements are permitted to file or go

effective on a registration statement at any time of the fiscal year. The only exception to this rule relates to a company that wants to file a registration statement in the period between the 45th day after its fiscal year-end and the filing of its 10-K and that either<sup>1</sup>:

- has reported a net loss for both of its two most recent fiscal years covered by its last 10-K; or
- expects to report a net loss for its just completed fiscal year for which it has not yet filed a 10-K.

Such a company is sometimes referred to as a "loss corporation." The test is based on the financial metric "income attributable to the registrant, after taxes but before extraordinary items and cumulative effect of change in accounting principle."

A loss corporation cannot file a new registration statement or an amendment that amends the prospectus, or go effective on a registration statement, after the 45th day after the end of its fiscal year, unless the filing includes audited financial statements for the just completed fiscal year. For a company with a calendar year fiscal year, the 45th day is February 14.<sup>2</sup> This rule effectively prevents loss corporations from filing, amending or going effective on a registration statement after that date until they have filed their 10-K for the just completed fiscal year. However, a loss corporation can use an already effective shelf registration statement to conduct an offering during this period.

Among the companies that can easily be caught by this rule are companies that have no or very little revenue, such as companies in the biotech sector. Companies that have significant revenues and EBITDA can be affected if they are more leveraged or have significant depreciation or amortization expense. It also can catch companies that are generally profitable on a net income basis, but expect to report a net loss for their most recently completed fiscal year due to an impairment or other

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one-time event, even if it was already reported in one of the first three quarters.

### **No Negative Assurance Comfort after February 11 (134th Day after End of Q3)**

In an offering of securities, the underwriting banks require a comfort letter from the company's auditors. Among other things, the comfort letter comments on changes in certain financial statement items subsequent to the date of the most recent financial statements included in the offering document. If those are for the nine months ended September 30 and the offering takes place in January of the following year, the comfort letter would comment on changes since September 30. These comments are phrased as "negative assurance." This refers to a statement from the auditors that, based on their procedures, "nothing came to their attention" that caused them to believe that there were any such subsequent changes, other than changes that they disclose in the comfort letter. This enables the underwriting banks to decide whether the changes need to be brought to the attention of investors.

The applicable professional standard for the accounting profession permits auditors to provide negative assurance on such subsequent changes only as of a date less than 135 days from the end of the most recent period for which the auditors have performed an audit or review.<sup>3</sup> For subsequent changes as of a later date, auditors may not use the negative assurance formulation described above, but are limited to reporting the procedures performed and findings obtained.<sup>4</sup> Rather than stating that, based on their review of the company's internal monthly financial statements or inquiries from management, no changes or only certain specified changes came to their attention, the comfort letter would merely report the content of those internal statements or the responses from management.

For US public companies that file their reports on time, the 135-day rule tends to become an

issue only for offerings that occur after the end of the fiscal year but prior to the filing of the 10-K. The 10-K is not due<sup>5</sup> until 60 days (large accelerated filers)<sup>6</sup>, 75 days (accelerated filers)<sup>7</sup> or 90 days (non-accelerated filers) after year-end. For a company with a calendar fiscal year, the last day as of which the auditors can provide negative assurance on subsequent changes from the third quarter financial statements is February 11, but the company's 10-K is not due until March 1, March 16 or March 31, depending on filer status, although some companies file it sooner. Leap years, weekends and holidays can cause these filing deadlines to shift. During most other times, the company's next 10-Q will be filed before the 135th day after the end of the prior quarter, because it is due 40 days (large accelerated filers and accelerated filers) or 45 days (non-accelerated filers) after quarter-end.<sup>8</sup>

The 135-day rule and its implications for auditor comfort make it more difficult for companies to access the capital markets after February 11 (or the corresponding date for non-calendar year filers) until the 10-K is filed. However, as discussed above in relation to blackouts, it may be possible to overcome the absence of full auditor comfort through additional due diligence, officer's certificates, and other measures. This requires discussion among the company and the underwriting banks and their respective legal advisers.

### **White Paper: No Comfort on Q4 Numbers until Audit Fieldwork Is Substantially Complete**

Limitations on the ability of the company's auditors to provide comfort on changes in financial statement items subsequent to the date of the third quarter financial statements also come out of a "white paper" of the accounting profession.<sup>9</sup> It cautions auditors against providing negative assurance comfort on such changes as of year-end or a subsequent date until the field work for the year-end audit is substantially complete. Although the white paper contemplates that

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the auditor may decide to provide non-negative assurance comfort in this case, or cover partial periods within the fourth quarter, the accounting firm's internal policies may not allow that either. The white paper also cautions auditors against agreeing fourth quarter capsule financial information in the offering document to the company's accounting records through tick marks until the audit field work is substantially complete. The rationale is that auditors should not provide comfort when the audit fieldwork is still in process and the relevant numbers could change.

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***Auditors should not provide comfort when the audit fieldwork is still in process.***

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The white paper effectively creates a period when management already has internal financial information about the company's financial performance for all of the fourth quarter and the full fiscal year, but the auditors are unwilling or unable to provide comfort on that information. This is an example of a blackout situation, and similar principles apply. Companies and underwriting banks wishing to offer securities during this period would have to do so without such comfort, which may not be feasible.

- ***Without Q4 Information.*** If the company's internal financial information suggests that its results for the fourth quarter will meet or exceed market expectations, it may be possible to conduct the offering without including any information about the quarter in the offering document. This may prove difficult, however, because investors may not want to buy the securities from the company a month or more after year-end without an update on how the fourth quarter went. Investors may ask about this during a meeting or call that management holds as part of the offering. As a practical matter, the company will not be able to provide information about this unless it is also included in the offering document.

- ***With Q4 Information.*** If the company and the underwriting banks decide that it is necessary or advisable to include some capsule financial information about the fourth quarter in the offering document, they assume the risk that the information is still subject to change and that, when the audit is complete, the final numbers that will be reported in the 10-K are different from those that were disclosed at the time of the offering. The underwriting banks would have to perform some due diligence on the capsule financial information, and may require a certificate from the company's chief financial officer or other support for these numbers. However, some amount of risk would remain. Again, the feasibility of the transaction, and the necessary disclosure, diligence and back-up, will need to be discussed among the working group.

### **Between Earnings Release and 10-Q/10-K**

Many companies announce their quarterly financial results through an earnings release before they file their 10-Q or 10-K. For some companies, the time between the earnings release and the filing of the 10-Q or 10-K is only a few days, while for others it may be several weeks. In the latter case, companies may want to access the capital markets right after the earnings release, without waiting for the filing of the 10-Q or 10-K. In addition, significant shareholders that are looking to sell down their stake in an underwritten offering pursuant to a registration rights agreement may want to do so as soon as the quarterly results are out.

There is some logic to this approach. The earnings release and the accompanying earnings call often will include most of the financial metrics and other information, including an update on the company's financial guidance or outlook, that the market needs to adjust the price of the company's securities. In many cases, the price will react to the earnings release by rising or falling. The subsequent filing of the 10-Q or 10-K tends not to have an additional material effect on the price of the company's securities.



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Deals on the basis of the earnings release, before the 10-Q or 10-K, face several challenges, however, including the following:

- **Comfort issues.** Because the full financial statements have not been finalized and issued, the comfort that the auditors can provide on the numbers in the earnings release will be limited to agreeing those numbers to the company's accounting records. This is a lower level of comfort than the review (in the case of Q1 through Q3) or audit (in the case of Q4) of the full financial statements. That review or audit generally will be completed only when or shortly before the company files the full financial statements in the 10-Q or 10-K. As discussed above in relation to white paper issues with post year-end offerings, auditors may not be in a position to provide comfort for Q4 numbers until audit fieldwork is substantially complete. Similarly, auditors may not provide comfort on numbers in an earnings release for Q1, Q2 or Q3 unless they are already relatively advanced in their review. It is important to discuss with the auditors early on what level of comfort will be available and when.
- **Risk of changes.** When the full quarterly or annual financial statements have been finalized, reviewed or audited, and issued in the 10-Q or 10-K after the offering, there is a risk that they show financial results that differ from those in the earlier earnings release. Having sold securities on the basis of numbers that subsequently change can expose the company and the underwriting banks to liability or can simply be embarrassing. One of the factors in assessing this risk is the company's track record when it comes to differences between the numbers contained in the earnings release and those subsequently reported in the 10-Q or 10-K. Some high yield bond offerings provide for a longer settlement cycle (for example, T+10) to ensure that the offering does not close until after the filing of the 10-Q or 10-K. In those cases, the underwriting or purchase agreement includes as a condition to the underwriting banks'

obligation to close that the financial results reported in the 10-Q or 10-K are substantially consistent with those in the earnings release.

- **Risk of additional information in 10-Q or 10-K.** Although the earnings release contains most of the material headline financial information about the quarter, the full financial statements and MD&A in the subsequently filed 10-Q or 10-K contain additional and more detailed information. Although these details may not seem material at the time, investors may take a different view once they have had a chance to pore over the additional information. There is also a risk that plaintiffs' lawyers may try to construct a link between a subsequent decline in the price of the company's securities and information that is detailed somewhere in the 10-Q or 10-K. If the 10-Q or 10-K is filed only a short time after the offering, plaintiffs can allege that the company must have been aware of most of the information that would be included in the report. Underwriting banks therefore sometimes have a policy of not pricing a deal too close to the filing of the 10-Q or 10-K.

## Conclusion

Registering or offering securities can be more challenging from a financial statement perspective at certain times of the fiscal year than at others. However, if they are identified ahead of time, many of these challenges can be overcome with proper planning, diligence and disclosure. This article has given only an overview of some of the factors to be considered in this regard. Each transaction presents unique facts that will need to be reviewed and discussed before an offering can proceed.

## Notes

1. See Rule 3-01(c) of Regulation S-X, which provides that filings made more than 45 days after the end of the registrant's fiscal year need not include a balance sheet more current than as of the end of the third fiscal quarter of the most recently completed fiscal year if the following conditions are met: (1) the registrant files annual, quarterly and other

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reports pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 and all reports due have been filed; (2) for the most recent fiscal year for which audited financial statements are not yet available the registrant reasonably and in good faith expects to report income attributable to the registrant, after taxes but before extraordinary items and cumulative effect of a change in accounting principle; and (3) for at least one of the two fiscal years immediately preceding the most recent fiscal year the registrant reported income attributable to the registrant, after taxes but before extraordinary items and cumulative effect of a change in accounting principle. Rule 3-12(b) of Regulation S-X imposes the same requirements at the anticipated effective date of a registration statement or proposed mailing date of a proxy statement.

2. In years where February 14 (or the corresponding date for non-calendar year filers) is not a business day, Rule 417 of Regulation C under the Securities Act extends the last day on which a registration statement of a loss corporation can be filed without including audited financial statements for the just completed fiscal year to the first following business day.

3. See PCAOB Auditing Standards: AU Section 634 Letters for Underwriters and Certain Other Requesting Parties at paragraph. 46. Effective as of December 31, 2016 this will be renumbered as AS6101: Letters for Underwriters and Certain Other Requesting Parties.

4. *Id.* at paragraph. 47.

5. See General Instruction A(2) of Form 10-K.

6. See Exchange Act Rule 12b-2(2) which defines a “large accelerated filer” to mean a company that (1) has an aggregate market value held by non-affiliates of \$700 million or more, as of the last business day of the company’s most recently completed second fiscal quarter, (2) has been subject to reporting under the Exchange Act for a period of at least 12 calendar months, (3) has filed at least one annual report under the Exchange Act and (4) is not eligible to use the requirements for smaller reporting companies in Regulation S-K.

7. See Exchange Act Rule 12b-2(1) which defines an “accelerated filer” to mean a company that meets the other conditions specified in footnote 4 above for a large accelerated filer, but has an aggregate market value held by non-affiliates of \$75 million or more, but less than \$700 million, as of the last business day of the company’s most recently completed second fiscal quarter.

8. See General Instruction A of Form 10-Q.

9. See white paper entitled “Comfort Letter Procedures Relating to Capsule Information Presented in a Registration Statement Prior to the Issuance of the Year-End Financial Statements,” American Institute of Certified Public Accountants, Inc., 2005.