SHEARMAN & STERLING LLP

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Financial Statement Triggers

Requirements for New or Updated Financial Statements Can Affect Access to Capital Markets and M&A

Financial statement requirements can surprise US public companies seeking to access the capital markets or to register shares in connection with acquisitions. Fully compliant 10-K, 10-Q and 8-K reporting can be inadequate. Before the company can register or offer securities, it may have to file new or updated financial statements. The relevant rules and market conventions are quite technical and not always intuitive, but understanding them is critical for successfully planning and executing transactions. We explore some of these triggers in a series of brief publications. In this first installment, we provide an overview.

Overview

SEC financial statement requirements can create periods when a company, despite being completely up to date with its 10-K, 10-Q and 8-K filings, is effectively blocked from accessing the capital markets or registering shares issued to target shareholders in an acquisition. This is true even for large public companies that qualify as so-called "well-known seasoned issuers," or WKSIs, and therefore do not require SEC review for their shelf registration statements. Market conventions in securities offerings can have similar effects. As discussed below, key factors that can trigger financial statement issues include: (1) the time of the fiscal year when the transaction takes place, (2) pending or completed acquisitions, (3) pending or completed dispositions, (4) changes in reporting segments or accounting principles, (5) changes in guarantors, and (6) significant equity investees that are not subsidiaries.

Registration vs. Offering

As a practical matter, in an offering of securities under an existing shelf registration statement, market participants generally apply the same financial statement rules that would apply to the filing of a new registration statement. Also offering documents for Rule 144A placements, although unregistered, typically include the same financial information that would be required in a registration statement. This market practice reflects the view that the financial statements required in a registration statement provide a benchmark for the financial information that investors will expect or that should be provided to them to avoid claims that the offering document omitted material information. This practice exists even though most of the SEC's financial statement requirements technically apply only when a registration statement is filed or becomes effective. In most cases, compliance does not need to be tested again at the time of a subsequent offering, and updates are only required to reflect a "fundamental change."

This distinction between registration and offering can become critical for planning and executing transactions. The rule of thumb is that the prospectus supplement for an offering should contain the same financial information that would be required in a newly filed registration statement. However, it may sometimes be possible for the company

and the underwriting banks to conclude that certain financial information that would be required if the company were filing a new registration statement is not, in fact, material to investors, and can therefore be omitted.

Market practice accords different weights to the various SEC requirements. For example, it is fairly well established in Rule 144A bond offerings that the detailed consolidating guarantor financial information required by Rule 3-10 of Regulation S-X is not material to investors. Instead, investors receive information about the percentage of the consolidated group represented by the guarantors under certain financial metrics, and the amount of debt and other liabilities at the non-guarantor group. For other purposes, such as separate target and pro forma financial statements in connection with significant acquisitions, which are discussed below, the market tends to follow the SEC's requirements more closely, and in certain respects goes beyond them. The convention for significant acquisitions is to include target and pro forma financial statements even if those would not yet be required under SEC rules because the acquisition has not yet closed, or closed only recently. Getting comfortable with deviation from market convention is a judgment call that is based on the facts and circumstances of the particular situation.

In registered offerings, there is only room for such flexibility and judgment calls, however, if the company already has an effective registration statement on file at the time of the offering. Without an existing effective registration statement, the company must strictly comply with all applicable SEC financial statement requirements because it needs to file a new registration statement for the offering—or issue securities in the Rule 144A or private placement market instead. The same is generally true when the registration statement has to be amended for purposes of the offering, for example, in order to add a new class of securities. That is because for financial statement purposes the amendment of a registration statement is treated like a new filing if it amends the prospectus.

Financial Statement Triggers

Many different factors can trigger a requirement for new or updated financial statements or limit available auditor comfort in connection with the registration or offering of securities, including the following:

- ***Time of Year.*** Registering or offering securities can be more difficult at certain times of the company's fiscal year. Public companies often observe quarterly blackout periods during which they will not issue securities. Sometimes these blackouts can be overcome through appropriate diligence or disclosure. However, there may also be issues of a more technical nature that are less susceptible to creative solutions. For example, a company will not be able to file a registration statement after February 14 (in the case of calendar-year filers) but before the filing of its 10-K if the company expects to report a loss for its just completed fiscal year or reported a loss for its previous two fiscal years. Offerings after February 11 and before the filing of the 10-K may not be eligible for full "negative assurance" level auditor comfort. More generally, offerings at any time after the end of the fiscal year but before the filing of the 10-K may face so-called "white paper" issues that limit the auditors' ability to provide comfort with respect to fourth quarter results. Offering securities after the earnings release but before the corresponding 10-Q or 10-K can also be challenging for comfort and other reasons.

- ***Significant Acquisitions.*** The SEC has specific rules that govern when a company is required to file separate target financial statements and pro forma financial statements in connection with a significant acquisition. An acquisition is deemed "significant" if it exceeds 20% on any one of three specified significance tests based on the target's assets and pre-tax income and on the purchase price being paid in the acquisition. Target financial

statements need to cover one to three years, depending on significance. Pro forma financial statements giving effect to the acquisition need to cover the most recent year. Both must also cover the most recent interim period.

Companies normally have approximately 75 days from the closing of the acquisition to prepare and file those financial statements on an 8-K. Absent a registration statement or offering, no target financial statements or pro forma financial statements are required to be filed before an acquisition has closed, even if an acquisition agreement has already been signed. However, if the acquiring company wants to offer securities after a significant acquisition has become probable, it may have to provide both target financial statements and pro forma financial statements at the time of the offering, even if the 75-day period has not yet expired. Where SEC rules would not require this, market convention usually does.

Once the acquisition has closed and the acquiring company has filed all required target and pro forma financial statements on the 8-K, it will often assume that no further financial information about the completed acquisition will be required. However, if the acquiring company subsequently registers or offers securities, it may find itself having to update the target or pro forma financial statements. This can be the case even after the acquiring company has filed a post-acquisition 10-K or 10-Q that includes the more limited pro forma financial information required by GAAP in the notes to the financial statements.

- ***Dispositions.*** In relation to dispositions, there are two overlapping but separate regimes: GAAP standards for "discontinued operations" and the SEC's rules about pro forma financial statements for significant dispositions. Each regime has its own triggers and calls for different disclosure, so they need to be analyzed separately.

If a company has classified a business as "discontinued operations" under GAAP, it will start reporting that business separately in its financial statements for dates and periods subsequent to the classification. This classification can be triggered when management has committed to a plan for the sale of the business, an active program to locate a buyer has been initiated, it is probable that the sale will be completed within a year, and certain other criteria are met. The classification would only apply going forward and no revisions to prior years would be required until the next 10-K. But if the company then registers or offers securities, it first may have to recast its annual financial statements and MD&A to reflect this classification retroactively for all audited periods. This is the case even for discontinued operations that are not considered "significant" under the SEC's rules.

Once a disposition that is significant under the SEC's rules has closed, the company must file an 8-K with pro forma financial statements reflecting the disposition unless the disposed business has already been classified as discontinued operations in the company's most recent 10-K. If they are required, these pro forma financial statements should generally cover all three fiscal years included in the 10-K, rather than just the most recent year required in the case of significant acquisitions. They also need to cover the most recent interim period, unless the corresponding 10-Q already reflected the disposition. In contrast to the 20% threshold for acquisitions, dispositions are considered significant when the disposed business exceeds 10% on any one of the three tests. Also, once a significant disposition has closed, the company has only four business days to file the 8-K with the pro forma financial statements, not 75 days as in the case of a significant acquisition. As in the acquisition context, however, the registration or offering of securities can accelerate the timing for the required pro forma financial statements. They may then need to be filed before the significant disposition has closed, merely on the basis that it has become probable.

- ***Change in Reporting Segments or Accounting Principles.*** If a company changes its reporting segments during the first three quarters of the fiscal year, it will reflect the new segment structure in the first 10-Q that covers a period ended after the effectiveness of the change. The company would not be required to recast the segment reporting footnote in its annual financial statements or make corresponding changes to its annual MD&A until it files its next 10-K. However, similar to the effect that discontinued operations can have, a change in segment reporting may make it impossible for a company to register or offer securities until it has revised its annual financial statements and MD&A to reflect the new segment structure for all audited periods. The same applies to a change in accounting principles for which retrospective application is either required or elected.
- ***Change in Guarantors.*** A company that has registered guaranteed debt securities includes in its 10-K and 10-Qs the guarantor financial information required by Rule 3-10 of Regulation S-X. When the guarantor structure changes—for example, a subsidiary that did not previously guarantee the debt securities becomes a guarantor—this would simply be reflected in the next 10-Q or 10-K. However, if the company would like to offer new debt securities in a registered offering that rank effectively equally with the existing ones, it may first have to update its financial statements to reflect the new guarantor structure. In addition, if a subsidiary guarantor has been acquired only recently, the company may have to provide separate financial statements for that subsidiary if its net book value or purchase price, whichever is greater, is 20% or more of the principal amount of the securities being registered. As a result of all of these issues, companies often decide to sell the new guaranteed debt securities not in a registered offering, but in a Rule 144A placement. If the Rule 144A placement includes registration rights, these issues may become relevant for the subsequent exchange offer registration statement.
- ***Significant Equity Investees.*** Public companies are required to file separate annual financial statements for significant investments that are not consolidated as subsidiaries, but accounted for under the equity method. The relevant significance test is 20%, although more limited information may also be required for equity investees that are significant merely in excess of 10%. When separate investee financial statements are required in a 10-K, the reporting company has a grace period that permits it to file those financial statements later than the due date of its 10-K if the investee itself is a non-accelerated filer or a foreign business. These grace periods are not available if the separate financial statements are required in a registration statement.

As part of its broader “disclosure effectiveness” initiative, the SEC is currently in the process of reviewing the requirements for target and pro forma financial statements as well as those for guarantor and equity investee financial information. It is possible that some of the rules may change as a result.

Financial Statement Requirements Can Affect M&A Transactions

Financial statement requirements that are triggered by registering securities can also have implications for mergers and acquisitions. In addition to specific target and pro forma financial statement requirements for the acquisition itself, the filing, amendment or effectiveness of the S-4 registration statement for a stock merger or exchange offer can trigger a need to file new or updated financial statements for the acquiror. In addition, financial statement requirements can affect an acquiror’s ability to file a resale registration statement to register shares issued to owners of a private target company in a private placement. If the acquiring company is unable to file a registration statement and have it become effective at the closing of the acquisition or shortly thereafter due to the absence of required financial statements, this can affect its ability to use stock as an acquisition currency in the transaction.

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