

Fiscal Year 2019-20 Audited Financial Statements Deadline Extended Under Senate Bill 98

Typically, school districts in California (the “State”) are required to file their audited financial statements for the preceding fiscal year with the State Controller’s Office, the State Superintendent of Public Instruction, and the county superintendent of schools by December 15 of each year. In response to the Coronavirus 2019 (“COVID-19”) pandemic and the challenges it presents for school district operations, Senate Bill 98 (Chapter 24, enacted on June 29, 2020, as an urgency bill) provides, among other things, that a school district’s audited financial statements for fiscal year 2019-20 (the “2020 Audit”) are not due until March 31, 2021.

Delaying the 2020 Audit & Continuing Disclosure Compliance

While the extension of the 2020 Audit under Senate Bill 98 may be much needed and welcome from an operational standpoint, it creates a dilemma for California school district bond issuers with existing continuing disclosure obligations (referred to as “continuing disclosure undertakings”) with annual report deadlines prior to March 31, 2021. Moreover, the problem created has complexities which, without a deeper understanding of the issues raised, could result in a violation of federal securities disclosure laws.

A. The COVID-19 Pandemic and Senate Bill 98’s Extension on Filing the 2020 Audit Does Not Alter Annual Report Deadlines for Purposes of Continuing Disclosure Compliance.

Continuing disclosure undertakings generally require that an annual report be filed within a certain number of days or months following the close of a fiscal year. Annual reports are generally required to contain audited financial statements as well as updates to certain financial and operating information. Senate Bill 98’s extension of the 2020 Audit filing deadline to State and local educational agencies does not alter annual report deadlines for continuing disclosure purposes.

B. Most Continuing Disclosure Undertakings Include Provisions For When Audited Financial Statements Are Not Available, But Filing Financial Statements Other Than the Audited Financial Statements May Be Risky.

In general, continuing disclosure undertakings provide that if audited financial statements are not available by the annual report filing deadline, then such annual report must contain unaudited financial statements in a format similar to the financial statements contained in the final Official Statement¹, and the audited financial information must be provided in the same manner as such annual report when available.² While providing unaudited financial statements, often referred to by school districts as “unaudited actuals,” may seem easy enough, the challenge is preparing them “in a format similar to the financial statements contained in the final Official Statement.” California school district unaudited actuals are generally not in the same format as their audited financial statements. Unaudited actuals are not often prepared in accordance with the rules promulgated by the governmental account standards board (“GASB”) whereas audited financial statements are. For example, as a result of GASB rules, audited financial statements aggregate certain minor fund activity with the general fund, whereas unaudited actuals often do not follow such rules and do not include such fund aggregation. There may be other differences in accounting formats, principles and/or methodologies.

¹ Each school district issuer needs to review the specific language contained in its continuing disclosure undertakings. While it is typical to see language requiring the unaudited financial statements to be in a format similar to the financial statements contained in the final Official Statement, each school district issuer may have slightly different requirements for its unaudited financial statements. For the reasons discussed herein, to the extent that the unaudited financial statements are prepared using different accounting formats, principles and/or methodologies than the audited financial statements, it creates a risk of violating SEC Rule 10b-5 (as defined herein).

² In its June 23, 1995 letter, the Securities and Exchange Commission stated that “[t]he same financial statements that are included in the final official statement must be provided as part of the annual financial information. If audited financial statements are not available by the time the annual financial information must be provided, unaudited financial statements must be provided as part of the annual financial information, and, as required by the [SEC] rule [15c2-12], audited financial statements, when and if available, must be provided...” (see response to question 6).

Whenever a school district bond issuer makes a public filing of its annual report, it is speaking to the public debt market and such statement is subject to Securities and Exchange Commission Rule 10b-5 (“SEC Rule 10b-5”). SEC Rule 10b-5 states in relevant part: “It shall be unlawful for any person, directly or indirectly ... to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.” SEC Rule 10b-5 sets a high bar for public filings; there can be no errors or omissions of material facts. If the audited financial statements are not yet available, the risk of filing the unaudited actuals is not only preparing them in a format similar to the audited financial statements, but also in drafting the necessary disclosure to explain any differences between the accounting formats, principles and methodology of the unaudited actuals and the audited financial statements.³ Failure to do so could expose a school district issuer to securities disclosure liability if it turns out there are material differences between the unaudited actuals and audited financial statements that are not properly disclosed.

Options for Fiscal Year 2019-20 Annual Report Filings

Below is a discussion of various options available to California school district bond issuers with existing continuing disclosure undertakings having annual report deadlines prior to March 31, 2021.

A. Prepare the 2020 Audit prior to the deadline for any annual reports required by existing continuing disclosure undertakings even if that means the 2020 Audit is prepared prior to the revised deadline under Senate Bill 98.

The Upside: This way there is no lengthy analysis of financial statement filing options under existing continuing disclosure obligations, no failure to timely file the 2020 Audit, and no errors or omissions relating to filing unaudited actuals. Senate Bill 98 provides an extension of the 2020 Audit filing deadline, but nothing prevents a school district issuer from completing and filing the 2020 Audit earlier in order to comply with its continuing disclosure undertakings.

The Downside: The school district may not be able to take full advantage of the State filing extension for the 2020 Audit, and it may cause operational challenges to shift limited resources to prepare for and participate in a time-consuming audit process.

B. If, as a result of COVID-19, the 2020 Audit will not be ready prior to the deadline for one or more annual reports required by existing continuing disclosure undertakings, file the 2020 Audit late and don't provide unaudited actuals in the initial annual report filing.

The Upside: By filing the annual report without any financial statements⁴ and filing the 2020 Audit when available, the school district issuer does not waste time, effort and cost spent trying to convert unaudited actuals into a format similar to audited financial statements. The school district issuer reduces the risk of violating SEC Rule 10b-5 by not filing any financial statements and related disclosure that could fail to describe differences between the accounting formats, principles and methodology of the unaudited actuals and the audited financial statements.

The Downside: By filing the annual report without any financial statements and filing the 2020 Audit when available, the school district issuer would violate one or more existing continuing disclosure undertakings by failing to provide unaudited financial information in a format similar to the audited financial statements. On or before the deadline for filing the annual report, the school district issuer would need to file a notice of failure to timely file the 2020 Audit. The school district issuer would be required to disclose in any official statement or other offering document this noncompliance with its continuing disclosure undertakings for five years following the lapse in compliance. While this may sound like a big downside, many underwriters and investors are indifferent to disclosures of noncompliance with continuing disclosure undertakings when there is good reason for it, and the school district issuer would be able to tell that story in its disclosure. After all, this would be a one-time circumstance, and not a reflection of the school district issuer's indifference to its continuing disclosure obligations.⁵

³ In its June 23, 1995 letter, the Securities and Exchange Commission stated that continuing disclosure undertakings must specify in reasonable detail what accounting principles are followed and material changes to accounting principles or requirements may warrant a narrative explanation in the annual report describing the impact of such changes (see responses to questions 10 and 11).

⁴ All other financial or operating data required to be included an annual report by a continuing disclosure undertaking must be filed in a timely manner.

C. *If, as a result of COVID-19, the 2020 Audit will not be ready prior to the deadline for one or more annual reports required by existing continuing disclosure undertakings, file the unaudited financial statements “in a format similar to the financial statements contained in the final Official Statement.”*

The Upside: Even though the 2020 Audit is not available, the school district issuer is still complying with its continuing disclosure undertaking by filing the unaudited financial statements. By taking this approach, the school district issuer would not be required to file a notice of failure to file or disclose the late filed 2020 Audit as an instance of continuing disclosure noncompliance in its official statement or other offering document for the next five years.

The Downside: Unaudited actuals are often not in a format similar to the audited financial statements and transforming them into that format and adequately explaining the process and any substantial differences may lead to material errors or omissions that could expose a school district issuer to securities disclosure liability under SEC Rule 10b-5.

Each school district issuer will need to analyze its unique existing continuing disclosure undertakings in consultation with its financial advisor, disclosure counsel, and other consultants who provide continuing disclosure services to determine which option works best for that school district issuer. Nothing contained in this article should be construed or relied upon as legal advice. Instead, this article is intended to provide an overview of considerations associated with Senate Bill 98’s 2020 Audit filing deadline extension and potential impacts on California school district bond issuers with existing continuing disclosure undertakings having annual report deadlines prior to March 31, 2021.

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⁵ It is important to remember that a continuing disclosure undertaking is only a contract between the school district issuer and bondholders. Failure to comply with one of the undertaking’s requirements is generally not a default under bond documents, and can only be “enforced” by a bondholder (or, in certain cases, bond trustee) lawsuit seeking to enforce compliance, which will occur within a few months of the annual report deadline anyway. Most importantly, the undertaking cannot be enforced by the Securities and Exchange Commission, but the school district issuer must make proper disclosure of the lapse in compliance in future official statements.