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Regulation S-X Updates and the Pro Forma EBITDA Add-back

On May 21, 2020, the Securities and Exchange Commission (the "SEC") adopted amendments to the financial disclosure requirements in Regulation S-X (the SEC's accounting rules for the form and content of financial statements included in SEC filings related to pro forma reporting for acquisitions and dispositions). The amendments were intended to streamline certain reporting requirements and facilitate timely access to capital, reduce the complexity and cost associated with compliance, and ensure investors have a more meaningful financial picture of the impact that significant acquisitions and/or dispositions have on a reporting company. These amendments became effective January 1, 2021.

APPLICABILITY TO CREDIT AGREEMENTS

While the updated regulations have been widely discussed in the context of securities offerings and disclosure requirements, certain changes with respect to pro forma financial reporting may have a broader impact on credit facilities for reporting and non-reporting companies alike. In most credit agreements, a borrower's "Adjusted EBITDA" is used in the calculation of financial maintenance covenants and leverage ratios, which in turn often affect a number of highly-negotiated credit agreement provisions, including pricing and basket capacity for incurrence tests and restricted payments. Adjusted EBITDA takes the standard EBITDA metric, but is revised to add-back (and eliminate the impact of) certain items that borrowers believe are unusual, non-recurring or not indicative of the borrower's actual operating profitability. One such add-back, the pro forma cost-savings add-back, permits borrowers to adjust EBITDA to take into account specific events or actions that may reduce expenses (or create synergies) on a recurring basis, including those that are projected to materialize following an acquisition or disposition (e.g., elimination of employee redundancies).

How these cost-savings and synergies are verified, and the guardrails around what can and cannot be added back in the calculation of Adjusted EBITDA are often heavily negotiated between borrowers and lenders. One such guardrail used in many credit agreements is to allow pro forma adjustments for acquisitions and dispositions consistent with Regulation S-

X given the limitations on such adjustments prior to the recent amendments. In many credit facilities, shared caps on add-backs for restructuring charges and pro forma cost-savings do not apply to pro forma adjustments that comply with Regulation S-X. In either case, it's important for lenders to understand exactly what adjustments are permitted under Regulation S-X in order to accurately forecast financial covenants and basket capacity.

Under the prior formulation, Rule 11-02(b)(6) of Regulation S-X required that pro forma adjustments to financial statements included only those events that were (a) directly attributable to the transaction in question, (b) factually supportable and (c) expected to have a continuing impact on the registrant (i.e., the borrower and its subsidiaries). The Division of Corporation Finance further clarified that under the previous rules, pro forma adjustments that accounted for actions of management or that were expected to occur after an acquisition or disposition, including termination of employees and closure of facilities, should not be included as the timing and effect of these items are generally too uncertain.[1] As such, limiting pro forma adjustments for acquisitions and dispositions by reference to adjustments consistent with Regulation S-X based on the prior formulation greatly reduced the scope of adjustments a borrower could make to EBITDA and protected lenders from broad management discretion that might otherwise be permitted to increase the Adjusted EBITDA calculation.

EFFECT OF RECENT AMENDMENTS

As part of the recent amendments, the prior restrictive pro forma information requirements of Regulation S-X have been replaced with simplified adjustment criteria that are broken down into three parts: (1) "Transaction Accounting Adjustments" which link the effects of the acquired business to a company's historical financial statements through application of required GAAP / IFRS accounting, (2) "Autonomous Entity Adjustments" which reflect the operations of a company as an autonomous entity when it was previously part of another entity, and (3) "Management's Adjustments" which provide the flexibility to reflect anticipated synergies and other projected effects of the acquisition or disposition in question and post-acquisition plans that company management intends to implement. In adopting the Management's Adjustments concept, the SEC intended to broaden the scope of permitted pro forma adjustments that previously precluded adjustments for the potential effects of post-acquisition actions expected to be taken by management.[2] Note that unlike the Transaction Accounting Adjustments and Autonomous Entity Adjustments, Management's Adjustments are not required and are completely optional at the discretion of the company.

While Management's Adjustments under the new rules require explanatory notes regarding material assumptions, calculation methods and estimates for when synergies will be realized, these notes only provide the basis for such adjustments rather than limit the scope of permitted adjustments. Under the amended rules the following conditions are required to be satisfied prior to including Management's Adjustments in financial statements:

- Each adjustment must be reasonable;
- The effects of adjustments are limited by the underlying historical financial statements (e.g., if the adjustment reduces overhead costs, the adjustment can't exceed historical overhead costs); and
- The pro forma financials must include all such "Management's Adjustments that are, in the opinion of management, necessary to a fair statement of the pro forma financial information" taken as a whole and include a statement to that effect.[3]

There is little guidance, however, as to which types of adjustments are considered "reasonable" or "necessary to a fair statement." Moreover, there is no requirement that synergies be anticipated to materialize within a specified period and no outside date on which they are required to have been achieved.[4] Consistent with the intent behind the inclusion of Management's Adjustments, the drafting of the revised rules is broad so as to account for varying confidence levels underlying projected transaction-related synergies and provides management the flexibility to depict full run-rate synergies as they deem appropriate so long as the bases for such adjustments are fully disclosed. Accordingly, the Regulation S-X

amendments, and particularly the ability of borrowers to reflect synergies through Management's Adjustments in pro forma financial statements, greatly reduce the impact of limiting the pro forma adjustments in credit agreements to those consistent with Regulation S-X.

The amended rules specify that Management's Adjustments, if included, must be presented in explanatory footnotes as reconciliations of pro forma net income to such amounts after giving effect to any Management's Adjustments.[5] The initial amendment proposal contemplated that Management's Adjustments would be required adjustments and should be presented in line-item format in a separate column of the pro forma financial statements. However, recognizing that synergies aren't always tracked at the line-item level required in pro forma financial information and might burden registrants with creating additional books and record related to synergies, the SEC opted to require such adjustments be reflected in footnotes. Moreover, the SEC's final announcement on the Regulation S-X amendments includes a footnote clarifying that the amended rules generally preclude "presentation of pro forma amounts that reflect Management's Adjustments elsewhere in a filing without also presenting with equal or greater prominence the amounts to which they are required to be reconciled and a cross-reference to that reconciliation."[6] This would suggest that Management's Adjustments may indeed be presented elsewhere in a filing, so long as the reconciliatory footnotes are also included. The fact that Management's Adjustments are optional and aren't presented on the face of pro forma financial statements does not necessarily alleviate any additional considerations or limitations that lenders should take in allowing pro forma adjustments in the calculation of Adjusted EBITDA consistent with Regulation S-X.

Management's Adjustments are a key part of the amended 3-prong approach to pro forma adjustments that was clearly intended to provide greater discretion to management in depicting run-rate synergies and associated cost-savings in connection with acquisitions and dispositions. As such, while not required, Management's Adjustments are a permissive adjustment under Regulation S-X going forward and any add-back restrictions in the calculation of Adjusted EBITDA that hinge on Regulation S-X should be closely scrutinized. Where other guardrails exist in the credit agreement related to pro forma adjustments for synergies and cost-savings, such as express cutoff dates for realization of synergies, aggregate caps or officer certification requirements, the impact of such guardrails may be effectively nullified if the company is permitted to include Management's Adjustments consistent with Regulation S-X without further limitation. Lenders may consider a variety of approaches to limit the effect of the recent changes to Regulation S-X in new facilities or amendments to existing credit agreements, including: (1) requiring that any Management's Adjustments be subject to shared caps and other limitations on run-rate synergies as noted above, (2) permitting Regulation S-X adjustments only to the extent consistent with the rules prior to the recent amendments, (3) limiting Regulation S-X adjustments to "required" (rather than permissive) adjustments, or (4) carving out Management's Adjustments under Rule 11-02 entirely from the Regulation S-X references in Adjusted EBITDA add-backs.

CONCLUSION

In light of the recent amendments to Regulation S-X, many existing credit agreements that limit pro forma add-backs by reference to items consistent with or as permitted under Regulation S-X may provide uncontemplated capacity allowing borrowers to increase Adjusted EBITDA calculations in connection with acquisitions and dispositions. Whether any add-back is permitted will depend on the specific drafting in the credit agreement, but add-backs for adjustments consistent with Regulation S-X may very well include an significant add-back for pro forma cost-savings and synergies pursuant to the Management's Adjustments prong of the amended rules under Regulation S-X.

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[1] Financial Reporting Manual (3310.4 and 3250.1) https://www.sec.gov/corpfin/cf-manual/topic-3
[2] *See* Amendments to Financial Disclosures about Acquired and Disposed Businesses; Release No. 33-10786; 34-88914; IC-33872; File No. S7-05-19; Pg. 104.
[3] 17 CFR §210.11-02(a)(7)(i)(C).
[4] A one-year time horizon included in the initial amendment proposal was rejected on the rationale that such a time constraint is not always consistent with the way synergy estimates are made.
[5] 17 CFR §210.11-02(a)(7)(ii)(A).
[6] *See* Amendments to Financial Disclosures about Acquired and Disposed Businesses; Release No. 33-10786; 34-88914; IC-33872; File No. S7-05-19; Pg. 118, fn 328.