<u>COVID-19 EIDL Loans: How much do I owe?</u>

We have been receiving calls from small businesses who are struggling to understand the Payoff Balance on their EIDL loans. You can find the SBA's calculation of this balance by logging into your account in the Capital Access Financial System (CAFS). For many of us, that will be enough. But your bookkeeper, or accountant may struggle with reconciling your outstanding balance for reporting purposes. For these people it helps to understand how the SBA is handling accrued interest and payments.

<u>How has the EIDL Loan Impacted my Balance Sheet?</u>

Let's start with an important point. The SBA has reemphasized that EIDL loans must be repaid in full and that there are no plans for forgiving the principal balance or accrued interest on these loans. The total Payoff Balance that you see in CAFS is the current amount that is owed and must be paid in full to remove the lien. This number will change as interest continues to accrue and payments are made. During the pandemic, EIDL loans were a necessary lifeline for many small businesses. The terms of the loan were favorable and with a payback period of 30 years the monthly payments were relatively modest. Many small business owners did not fully appreciate the impact of this loan on their balance sheet and equity in the business. While the loan can be repaid as scheduled over the 30-year term many small businesses do not have a plan to operate for 30 years. Small businesses owners may want to sell their business, or execute another exit strategy, well short of the completion of the 30-year loan term. The remaining balance of the loan must be paid off when the exit strategy is executed. This will mean that the amount of equity the owner will receive from the business will be reduced by the outstanding balance of the loan. Business owners must consider and plan for how this will impact their objectives.

We have emphasized the above point because business owners need to understand that interest will continue to accrue during any deferment periods. This included the initial 30-month deferment as well as any additional deferments obtained through the Hardship Accommodation Plan. The amount of the loan that will eventually have to be paid back is increasing during deferments. For most businesses, when the initial EIDL loan was originated the loan documents stated that payments would be deferred for 12 months. The loan agreement also set out the dollar amount of the scheduled monthly payment that the business would have to make. This payment amount was sufficient to pay off the entire principal balance of the loan plus the 12 months of accrued interest over the 29 years remaining in the loan term. The loan was fully self-amortizing.

When the SBA extended the deferment period (first to 24 months and then to 30 months) they did not have the ability to go back and change the scheduled payment amount set forth in the loan documents. This means that the scheduled payment will not be sufficient to fully pay off the loan over the remaining term. It will not be high enough to pay the additional interest that accrued during the extended deferment, and it will not make up for the lost repayment of principal from these payments. This will leave a balance due at the end of the term and the borrower will be required to pay this amount in a balloon payment (one lump sum). With the additional deferments the loan is no longer self-amortizing.

How is the SBA Calculating my Payoff Balance?

This is a point we have received recent calls about. Clients look at what the SBA is showing as the Payoff Balance and are struggling to reconcile this in a traditional loan amortization fashion. This can be particularly confusing after the business has started to make monthly payments. There are two factors needed to understand the calculation. First, the SBA is only accruing interest on the unpaid principal balance of the loan. Second, when you start making payments the SBA will apply those payments to accrued interest first, before making any reduction to the principal balance. Let's look at this using some numbers.

We will start by assuming our business, let's call it the Widget Company, received an EIDL loan for $150,000. According to the loan documents, Widget was scheduled to start making regular payments on this loan of $731 beginning in the 13th month after the loan's origination. (Please note that we will use round numbers in this article. If you want to fully understand why, see the *Note on Rounding* at the end of this article). During the first 12-month deferral, interest will accrue on the outstanding Principal Balance. This is the first factor that may cause some confusion. Some might assume that the SBA would charge interest on the accrued interest balance. They do not. Widget's loan will accrue interest of $5,625 during the first 12 months.

Now let's assume that Widget started making regular payments in month 13. If we were going to run a straight-line amortization of the Payoff Balance over the remaining 29 years of the term, we would expect that for each payment a portion would be applied to the principal balance and a portion towards interest. But the SBA's policy states that all payments will be applied to accrued interest first before any reduction in the principal balance. When Widget made its first payment of $731 in month 13, it would work like this. The payment would first be applied towards the current month's interest of $469 and then the balance of $262 ($731-$469) would go towards the $5,625 in interest that accrued during the first year. The Payoff Balance after the first payment would be the $150,000 principal balance plus the remaining accrued interest of $5,363 ($5,625-$262), or $155,363. If we run the calculations further, we will see that it will take roughly 21 months for Widget to pay off all the accrued interest and begin making reductions to the principal balance of the loan.

The same math needs to be applied to calculate the Payoff Balance for businesses that took advantage of the 30-month deferral (most of us) and for those that may take advantage of additional deferments under the Hardship Accommodation Plan. Interest will continue to accrue and the scheduled payment of $731 will no longer be sufficient to fully payoff the loan during the remaining term. There will be a balance due at the end. A precise calculation of this balance for reporting purposes, such as year end financials, can be time consuming. Our CPA's or bookkeepers may welcome this challenge, but most small businesses will rely on the numbers in CAFS.

Note on Rounding: Our math will not match precisely to the SBA's calculations. First, we have rounded to the nearest whole dollar amount. Second, the SBA accrues interest on a daily basis. We have used a monthly calculation of interest for our example. In the case of Widget, we have said that the monthly accrued interest would be $469, an even amount for each month in the year. The SBA would accrue this amount at a rate of $15.41 per day. In February the SBA would accrue $431.48 ($15.41 * 28 days) of interest while in December they would accrue $477.71 ($15.41 * 31 days) of interest. If you want to match their numbers exactly you would have to account for these differences.