DEBT COVENANTS AND POTENTIAL FINANCIAL REPORTING IMPACTS

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TOPICS

01 UNDERSTANDING DEBT COVENANTS

02 COMMON FINANCIAL RATIOS IN DEBT COVENANTS OF HEALTHCARE ENTITIES

03 BEST PRACTICES RELATED TO EXISTING DEBT COVENANTS

04 STEPS TO TAKE IN THE EVENT OF NONCOMPLIANCE

05 NONCOMPLIANCE EFFECTS ON FINANCIAL REPORTING

06 DEBT COVENANTS WHEN OBTAINING NEW DEBT

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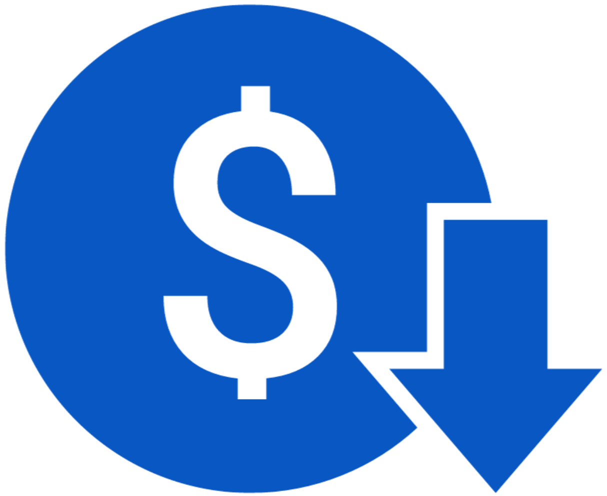
UNDERSTANDING DEBT COVENANTS

DEBT COVENANTS

Legally binding agreements or conditions that are included in a loan contract in order to protect the lender's interests and reduce the risk of borrower default.



DEBT COVENANTS

Common covenants can include financial ratios, limitations on additional borrowing, material adverse change clauses, and requirements for reporting financial information to the lender.

It is very important to read covenants within debt agreements **very carefully** and **pay attention to the details.**

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DEBT COVENANTS

Covenants can significantly impact providers' financial flexibility.

- Restricted Capital Use - Potentially restricting large capital expenditures and/or significant investments.
- Borrowing Limitations – Often cap how much additional debt a company can take on, limiting future financing options.
- Operational Constraints – Can result in management needing to manage operations more conservatively to ensure financial ratios are met.

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MOST COMMON FINANCIAL RATIOS IN DEBT COVENANTS OF HEALTHCARE ENTITIES

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DEBT SERVICE COVERAGE RATIO

Assess the ability to generate sufficient cash flow to cover principal and interest payments.

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DEBT SERVICE COVERAGE RATIO

Example: The borrower shall maintain a minimum Debt Service Coverage Ratio of X, as calculated (quarterly, bi-annually, or annually), in accordance with GAAP.

DEBT SERVICE COVERAGE RATIO =

$$\left(\frac{\text{Net Operating Income } \underline{\text{as defined by the debt agreement}}}{\text{Total Debt service } \underline{\text{as defined by the debt agreement}}} \right)$$

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DEBT SERVICE COVERAGE RATIO

DEFINITIONS MATTER

Example:

1. Does Net Operating Income include impact of Interest Expense?
2. What is Debt Service? The next 12 months or the 12 highest future months (maximum annual debt service)?

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DAYS CASH ON HAND

Measures the number of days a healthcare organization can cover its operating expenses with its available cash and liquid assets.

DAYS CASH ON HAND

Example: The borrower shall maintain a minimum Days Cash on Hand of X days, as calculated at the end of each fiscal (quarter, year), in accordance with GAAP.

DAYS CASH ON HAND =

$$\frac{\left(\dfrac{\text{Cash and Cash Equivalents + Short-Term Investments}}{\text{Operating Expenses as defined in the debt agreement}}\right)}{\text{365 days}}$$

BEST PRACTICES RELATED TO EXISTING DEBT COVENANTS

BEST PRACTICES RELATED TO EXISTING DEBT COVENANTS

Identify and assign an individual team member to monitor and perform periodic covenant testing and forecasting in order to identify potential issues well in advance.

BEST PRACTICES RELATED TO EXISTING DEBT COVENANTS

Integrate debt covenant compliance requirements into financial planning and forecasting processes to ensure proactive management of covenant compliance.

BEST PRACTICES RELATED TO EXISTING DEBT COVENANTS

Regularly communicate with the lenders and update them on the Entity's financial performance and any potential upcoming challenges or changes in business conditions that could negatively affect compliance with the covenant.

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BEST PRACTICES RELATED TO EXISTING DEBT COVENANTS

INTEGRITY of communications and interim financial reporting is critical.

Big variations in estimates to actual or subsequent year adjustments erode relationships.

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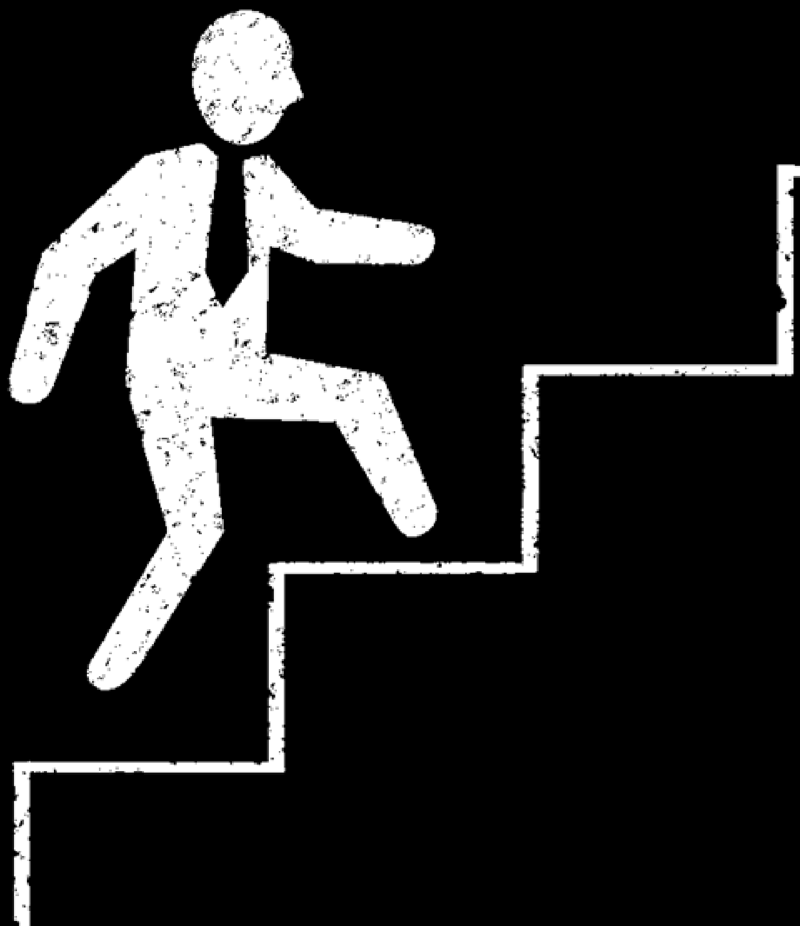

STEPS TO TAKE IN THE EVENT OF NONCOMPLIANCE

EARLY COMMUNICATION WITH LENDERS

- Maintain open lines of communication with lenders, especially if it becomes clear that a covenant breach is imminent.
  - Cure Provision
    - Included in a loan agreement that allows a borrower to rectify a covenant violation within a specified period of time without taking immediate default or penalty consequences, allowing the borrower a period of time to "cure" or fix the violation.
  - Amendments
    - Changes or modifications to the terms of a loan agreement, including its covenants, agreed upon by the borrower and lender.
    - Typically sought after when a borrower anticipates or is already in breach of its covenants.
  - Waiver
    - Temporary or permanent relaxation of a specific debt covenant requirement by the lender, that may be needed when an entity is in violation of a covenant but believes it can return to compliance within a reasonable amount of time.

ASSESS THE VIOLATION

Conduct thorough assessment of the breach to understand the root causes of the breach and extent of the violation

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DEVELOP A REMEDIATION PLAN TO RETURN TO COMPLIANCE

Work with management, a CPA firm, and/or legal advisors to develop a comprehensive plan to remedy the breach. The plan should include specific actions to achieve compliance with the covenant and include a timeline for implementation.

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NEGOTIATE WITH THE LENDER

Present the remediation plan to the lender and provide detailed information about the causes of the breach, the steps being taken to address it, and how compliance will be restored and request an amendment or waiver.

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NONCOMPLIANCE EFFECTS ON FINANCIAL REPORTING

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NONCOMPLIANCE EFFECTS ON FINANCIAL REPORTING

- Debt Reclassification
- Disclosure Requirements
- Going Concern Assessment

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DEBT RECLASSIFICATION

In the event of a debt covenant violation, debt that was previously classified as long-term may be reclassified as **short-term on the balance sheet** for financial reporting. This reclassification reflects the lender's right to demand repayment upon default within the next 12 months due to noncompliance.

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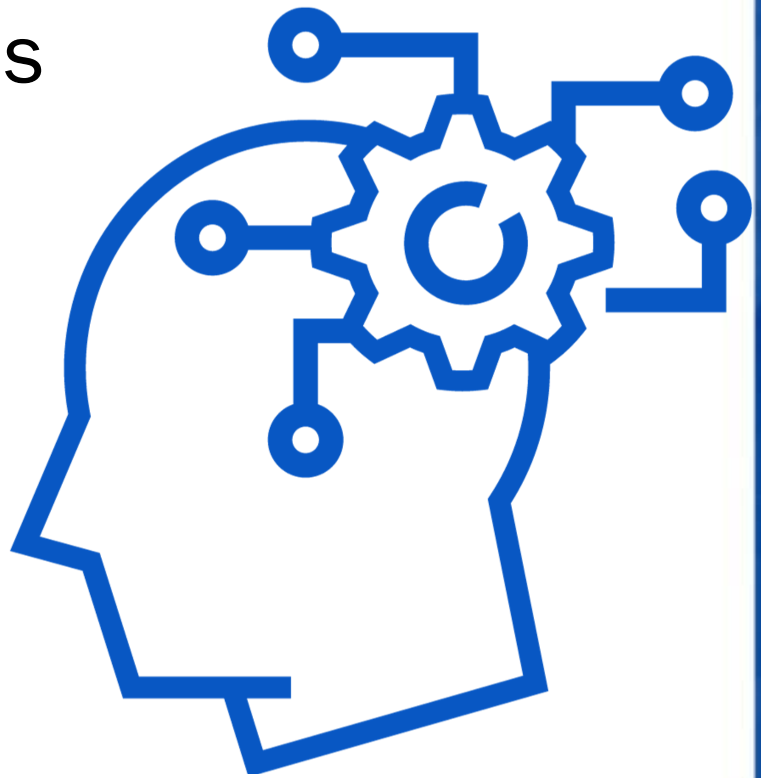
DISCLOSURE REQUIREMENTS

In the event of a debt covenant violation, disclosure of the existing violation in the footnotes may be **necessary for adequate disclosure** in order to ensure transparency and compliance with reporting standards.

GOING CONCERN ASSESSMENT

Covenant violations need to be considered as part of management's assessment of going concern (i.e., an indicator). This assessment is a **critical part of financial reporting** and can lead to an Emphasis of Matter paragraph in the audit opinion and additional disclosures in the audit report.



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GAAP REPORTING BASIS

Under U.S. GAAP, continuation of a reporting entity as a **going concern** is presumed as the *basis for preparing financial statements* unless and until the entity's liquidation becomes imminent. Preparation of financial statements under this presumption is commonly referred to as the going concern basis of accounting.

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MANAGEMENT RESPONSIBILITY

In connection with preparing financial statements for each annual and interim reporting period, an entity's management should evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued.

When evaluating an entity's ability to meet its obligations, management must consider ***quantitative and qualitative information***.

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QUALITATIVE AND QUANTITATIVE INFORMATION

This should include:

1. The entity's current financial condition, including its liquidity sources at the date that the financial statements are issued.
2. The entity's conditional and unconditional obligations due or anticipated within one year after the date that the financial statements are issued.

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QUALITATIVE AND QUANTITATIVE INFORMATION

3. The funds necessary to maintain the entity's operations considering its current financial condition, obligations, and other expected cash flows within one year after the date that the financial statements are issued.

4. The other conditions and events, when considered in conjunction with 1, 2, and 3 above, that may adversely affect the entity's ability to meet its obligations within one year after the date that the financial statements are issued.

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OTHER ADVERSE CONDITIONS

Negative financial trends, for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, and other adverse key financial ratios.

Other indications of possible financial difficulties, for example, **default on loans or similar agreements**, a need to restructure debt to avoid default, noncompliance with statutory capital requirements, and a need to seek new sources or methods of financing or to dispose of substantial assets.

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OTHER ADVERSE CONDITIONS

Internal matters, for example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, costly long-term commitments, and a need to significantly revise operations.

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OTHER ADVERSE CONDITIONS

External matters, for example, legal proceedings, legislation, or similar matters that might jeopardize the entity's ability to operate; and **an uninsured or underinsured catastrophe such as a hurricane**, tornado, earthquake, or flood.

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AUDITOR RESPONSIBILITY

The auditor is responsible for the **evaluation of management's assessment** as to whether conditions or events, considered in the aggregate, raise substantial doubt about the entity's ability to continue as a going concern within one year after the date of the financials statements being issued.

When events or conditions have been identified that indicate substantial doubt may exist, the auditor must make a conclusion as to whether substantial doubt **has or has not been alleviated** by management's plans to mitigate the substantial doubt indicators.

WHEN SUBSTANTIAL DOUBT HAS NOT BEEN ALLEVIATED – SUBSTANTIAL DOUBT EXISTS

The entity is required to include a statement in the notes to the financial statements indicating that there is substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued.

The entity must also disclose the following:

- The conditions or events that led to substantial doubt about the entity's ability to continue as a going concern
- Management's evaluation of the significance of the conditions or events in relation to the entity's ability to meet its obligations
- Management's plans to mitigate the conditions or events

WHEN SUBSTANTIAL DOUBT HAS NOT BEEN ALLEVIATED – SUBSTANTIAL DOUBT EXISTS

Below is an illustrative example of the addition to the Independent Auditor’s Report:

Substantial Doubt About the Company’s Ability to Continue as a Going Concern
The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has stated that substantial doubt exists about the company’s ability to continue as a going concern. Management’s evaluation of the events and conditions and management’s plans regarding these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to this matter.

WHEN SUBSTANTIAL DOUBT HAS BEEN ALLEVIATED – NO SUBSTANTIAL DOUBT EXISTS

The entity shall disclose in a note to the financial statements information that enables users of the financial statements to understand all of the following:

- The conditions or events that raised substantial doubt about the entity's ability to continue as a going concern (before consideration of management's plans)
- Management's evaluation of the significance of the conditions or events in relation to the entity's ability to meet its obligations
- Management's plans that alleviated substantial doubt about the entity's ability to continue as a going concern

WHEN SUBSTANTIAL DOUBT HAS BEEN ALLEVIATED – NO SUBSTANTIAL DOUBT EXISTS

Below is an illustrative example of the addition to the Independent Auditor's Report:

Emphasis of Matter

As discussed in Note X to the financial statements, the Company suffered recurring losses from operations. Management's evaluation of the events and conditions and management's plans to mitigate these matters are also described in Note X. Our opinion is not modified with respect to this matter.

DEBT CLASSIFICATION CASE STUDY

A Medical Center is in violation of certain debt covenants at its fiscal year-end (December 31, 2024) and anticipates remaining in noncompliance through December 31, 2025, based on conservative estimates. The lender waived all events of default that have report dates to-date, however, stated that their policy was not to waive probable future defaults. They did communicate that it was their intent, once reported, to positively consider the waiver.

The December 31, 2024 audit is <u>substantially complete</u>.

How should the long-term debt be classified in the December 31, 2024 financial statements and does this result in an indicator of going concern?

VIOLATION OF DEBT COVENANTS

When a violation of a debt covenant gives the lender the right to call the debt as of the balance sheet date, such violation will typically result in the classification of the debt as current by the borrower unless the lender waives its right to call the debt **for a period of greater than one year.**

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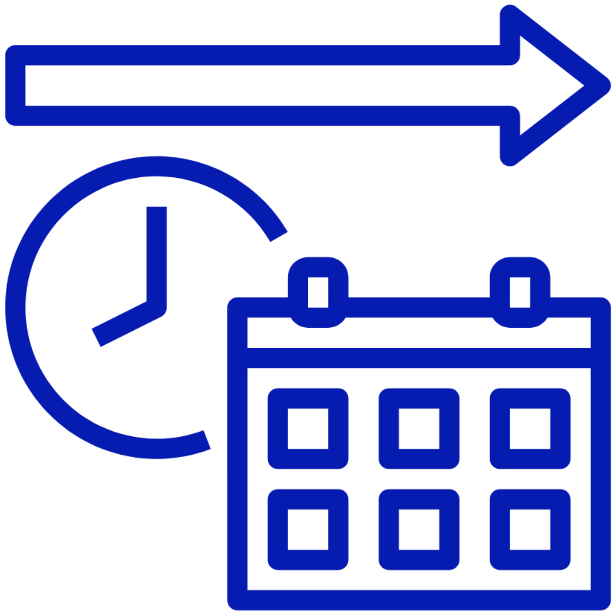
VIOLATION OF DEBT COVENANTS

Some long-term loans require compliance with certain covenants that must be met on an other-than-annual basis (e.g., monthly, quarterly or semiannual basis) and future covenant requirements are retained by the lender.



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VIOLATION OF COVENANTS

Unless all current and probable future violations of the covenant(s) are waived for a period of greater than one year, the debt should be classified as current if both of the following conditions exist:

a. A covenant violation that gives the lender the right to call the debt has occurred at the balance sheet date or would have occurred absent a loan modification.
b. It is probable that the borrower will not be able to cure the default (comply with the covenant) at measurement dates that are within the next 12 months.

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SUBSTANCE OF WAIVER

In considering whether a waiver should affect the classification of debt as current or noncurrent, the substance of the waiver should be evaluated (i.e., only substantive waivers should affect classification of debt as current or noncurrent).

For example, a substantive waiver should be in writing (i.e., **oral waivers are likely not substantive**).

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SUBSTANCE OF WAIVER

Waivers in the form of an email message may or may not be substantive. The borrower's legal counsel should be involved in that determination.

A substantive waiver has been approved by a loan officer with appropriate authority to grant the waiver and negotiate the terms of the waiver.

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DEBT COVENANTS WHEN OBTAINING NEW DEBT

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THOROUGHLY REVIEW AND UNDERSTAND ALL THE PROPOSED COVENANT TERMS AND REQUIREMENTS IN THE NEW LOAN AGREEMENT

Pay close attention to specific ratios, benchmarks, and other obligations that the entity will be required to meet.

Work with lenders to negotiate covenant terms that align with the entity's financial projections and seek flexibility to accommodate unexpected changes in the healthcare industry.

How will future accounting standards be considered?

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IN CONCLUSION – IS YOUR ORGANIZATION COVENANT-READY?

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COVENANT PREPAREDNESS CHECKLIST

1. Has our organization clearly assigned responsibility for covenant tracking and lender communication?
2. Do we understand the covenants within our debt agreements and how key terms are defined?
3. Are we monitoring and testing our key financial covenants regularly throughout the year?
4. Are we modeling covenant compliance under multiple budget scenarios?
5. Do we have a plan for how to engage the lender and request a waiver or amendment in the event that noncompliance becomes likely?

QUESTIONS?

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THANK YOU!

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