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Accounting and financial reporting during a pandemic

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Abstract

In this paper, I discuss how a pandemic affects the nature of financial reporting especially for financial and non-financial institutions that were deeply affected by the 2020 coronavirus (COVID-19) pandemic. I show that accounting practices or techniques such as fair value accounting, big bath earnings management, loss avoidance and income smoothing techniques can help to dampen the effect of a pandemic on firm performance. Some implications about the merits and risks of accounting during a pandemic are highlighted and discussed.

Keywords: coronavirus, COVID-19, accounting, earnings management, financial reporting, earnings quality, reported earnings, bailout, accounting techniques, loss avoidance, fair value accounting, stimulus package, big-bath accounting, income smoothing.

JEL Code: M41, M42, M48, M49.

1. Introduction

In this paper, I discuss some accounting practices and financial reporting options for firms during a pandemic such as the 2020 coronavirus (COVID-19) pandemic. A pandemic is a disease that is prevalent over a country or the world.

The coronavirus (COVID-19) pandemic was first reported in Wuhan China on December 31, 2019. The coronavirus (COVID-19) pandemic created a lot of uncertainty among firms in the real and financial sectors. It negatively affected the performance of firms around the world through demand and supply shocks partly caused by governments' imposed lockdown in many countries (Ozili and Arun, 2020), and subsequently gave rise to cash flow problems for many firms which worsened the balance sheet of many firms around the world.

I show that managers have incentives to use accounting techniques to improve the balance sheet and financial performance of firms during a pandemic such as the coronavirus (COVID-19) pandemic. Compared to other topics in the accounting literature, there is a small accounting literature that focus on how accounting contributes to a crisis. Laux and Leuz (2010), Arnold (2009) and Bezemer (2010) show that certain accounting techniques in financial reporting contributed to worsen the 2008 global financial crisis (Laux and Leuz, 2010; Arnold, 2009; Bezemer, 2010), but such evidence does not exist for pandemics. There are no studies that focus on accounting during a pandemic which is the subject of this paper.

The interest in studying accounting during a pandemic is explained by the importance of managerial discretion in firms' financial reporting in bad times. Managers may exercise discretion over certain accounting numbers and techniques to improve their deteriorating balance sheet and income statement in bad times such as during a pandemic. The discussion in this paper contributes to the recent debate on the role of accounting in crises.

The rest of the paper is organized as follows. Section 2 presents the literature review. Section 3 discuss some possible accounting practices during a pandemic. Section 4 concludes.

2. Literature review

In the management accounting literature, Roslender (1995) show that there is a need for management accounting to reposition itself for increased relevance during a crisis. Pavlatos and Kostakis (2015) show that economic crisis affects management accounting practices within organizations. They investigate the impact of the economic crisis on management accounting practices in Greece. They find that managers used activity-based costing (ABC) systems and strategic management accounting techniques during the economic crisis, while the use of traditional cost accounting techniques decreased.

In the financial accounting literature, Huizinga and Laeven (2012) show that the balance sheet reported by banks during the global financial crisis was a distorted representation of the financial health of banks. They observe that banks overstated the value of distressed assets and their regulatory capital ratios during the US mortgage crisis. Also, real estate-related assets were overvalued in banks' balance sheet especially those of bigger banks while banks with large exposure to mortgage-backed securities kept fewer loan loss provisions, and distressed banks used accounting discretion over the classification of mortgage-backed securities to inflate their books. Pozen (2009) show that during the 2007-2008 global financial crisis many analysts blamed the ‵fair value′ or ‵mark to market′ accounting rules because it required banks to write down their troubled assets to the prices they were sold on the open market at the time which was almost zero, and valuing the troubled assets at the fair value at the time drove financial institutions toward insolvency. Arnold (2009) show that accounting practices were deeply implicated in the global financial crisis and in proposals for recapitalizing financial institutions and in restoring stability to the global financial system. Ozili and Arun (2018) show that systemic banks manipulated loan loss provisions estimates to smooth profits during recessions. They also observe that global systemic banks in Europe also engage in income smoothing practices in the post-crisis era while income smoothing was common among non-systemic banks in the pre-crisis era.

3. Accounting practices during a pandemic

During a pandemic, economic agents will reduce their participation in economic activities that require person-to-person interaction especially if the pandemic is linked to some contagious disease. Due to fear and uncertainty, financial markets will become volatile as investors become risk-averse, preferring safer investments. Equity will become scarce for firms, private equity investment will decline, supply will be affected as production falls, operating costs will increase and profit will fall, leading to poor performance of firms. In these circumstances, firms can use accounting techniques in financial reporting to mitigate the negative impact of a pandemic on firm performance.

3.1. Fair value accounting

Managers can rely on fair value accounting techniques to reduce their liability. Fair value accounting is the practice of reporting assets and liabilities on the balance sheet at a fair value and recognizing changes in fair value as gains and losses in the income statement (Laux and Leuz, 2010), and when the current market price or a close substitute is used as the basis for fair value, it is called mark-to-market accounting. During a pandemic, firms that have large liabilities or a significant amount of securitized obligations may have incentives to revalue their obligations at fair value using the current market price or a close substitute which can reduce the amount to be paid and the total liability of leveraged firms. This applies if liability contracts include a fair value measurement option.

In the past, fair value accounting has been linked to financial crisis. Prior studies show that fair value accounting contributed to the 2008 financial crisis although it was not a direct cause. For instance, Pozen (2009) show that many analysts blamed 'fair value' or 'mark to market' accounting rules because it required banks to write down their troubled assets at the fair value price which was almost zero during the financial crisis, and valuing the troubled assets at the fair value at the time drove financial institutions toward insolvency. Some scholars admit that fair value accounting contributed to the financial crisis (e.g. Laux and Leuz, 2010; Magnan, 2009), while others argue that fair value accounting was the scape goat of the financial crisis (e.g. Veron, 2008; Badertscher et al, 2012). Although the effect of fair value accounting on a pandemic is unknown at least empirically, a possible prediction is that debtors

will become winners and creditors will become losers during a pandemic when the value of assets and liabilities are marked-to-market.

3.2. Big-bath accounting, bailout funds and stimulus packages

Big-bath accounting is an earnings management technique whereby a large accounting write-off is taken against income in the current period in order to reduce assets (Hope and Wang, 2018), which results in lower expenses in the future. In countries where stimulus packages or bailouts are given to financial and non-financial firms during a pandemic (Ozili and Arun, 2020), firms in such countries may have greater incentives to engage in big-bath earnings management to take advantage of government's assistance and to take advantage of the fact that the markets cannot punish firms for their poor performance during a pandemic.

Firms can engage in big-bath earning management by charging a one-time large expense against income in order to reduce expenses in the future. The one-time large expense charged against income in the pandemic year will result in lower profit in the pandemic year with the expectation of higher profit in future years. Even though auditors are able to detect big-bath practices in firms, the firm can defend such practice by claiming that the decision to write-off large expenses in the pandemic year was due to the negative effect of the pandemic on business activities and that the resulting decline in profit would be mitigated using the stimulus package received by the firm from the government. This argument is supported by prior studies which show that the incentives for big-bath behaviour are high for firms with poor pre-managed performance (e.g., Riedl, 2004; and Christensen et al., 2008). Such firms tend to recognize a larger than necessary loss in order to save for a better tomorrow (Degeorge et al., 1999) since the probability of meeting any financial goals in the current period is low (Fiechter and Meyer, 2010).

3.3. Greater income smoothing and loss avoidance accounting

In the absence of stimulus packages or bailout funds during a pandemic, a firm will strive to remain competitive during a pandemic by using accounting techniques that enable the firm to report moderate profits to signal that the firm is not doing badly compared to its competitors during the pandemic. Examples of accounting techniques that can be used for this purpose are the

income smoothing technique and loss avoidance accounting technique. Income smoothing involves reducing, or smoothing out, the fluctuation in the size of profit over time so that reported profits are never too high or too low (Dou et al, 2013; Ozili, 2017). Firms may smooth income by delaying research and development (R&D) expenditure or by reducing labour costs in the pandemic year. On the other hand, firms can engage in loss avoidance practices by deferring large expenses to a future year or by recognizing future profit in the pandemic year to avoid reporting a loss in the pandemic year. For example, firms can delay the purchase of machinery, equipment, software or technology hardware, making large purchases on credit, and the recognition of future cash flows in the pandemic year.

3.4. Avoiding income-increasing earnings management

Generally, during a pandemic, firms will perform poorly because suppliers will reduce production, consumer demand will fall and workers may become unable to work safely in the firm. Earnings forecast will fall and shareholders will expect low profit and deferred dividend in the pandemic year which means there is no expectation of high profits in the pandemic year and there will be little incentive to engage in income-increasing earnings management. More so, firms that receive stimulus packages or bailout funds are unlikely to engage in income-increasing earnings management to avoid political and regulatory scrutiny of the firm’s large profit in the pandemic year. Since the purpose of the bailout is to support distressed firms, firms that report large profits during the pandemic year even after receiving stimulus funds may face political scrutiny and criticism as to whether such firms should have been a beneficiary of the stimulus packages or bailout funds in the first place.

3.5. Relaxing accounting rules during a pandemic

Relaxing accounting rules, or giving managers more flexibility in financial reporting, may become necessary to avoid problems of corporate bankruptcy and poor performance during a pandemic. But relaxing accounting rules during a pandemic also leads to the manipulation of accounting numbers which can ultimately decrease the reliability of accounting information during a pandemic. Laux and Leuz (2010) show that relaxing accounting rules, such as fair value measurement rules, leads to manipulation and decreases the

reliability of accounting information due to lack of transparency about the value of assets.

While it is common for governments to pressure accounting standard setters to relax accounting rules during a pandemic that affects a large number of financial institutions, the counter-argument is that accounting rules should not be relaxed during a pandemic because firms can reasonably anticipate that accounting rules will be relaxed which diminishes their incentives to minimize risks in the first place (Laux and Leuz, 2010).

4. Conclusion

This paper discussed some accounting practices that can be used by firms during a pandemic. Overall, the discussion showed that several accounting techniques can be used to reduce the negative impact of a pandemic on the financial report of firms. Some techniques that can be used by firms during a pandemic include fair value accounting, income smoothing, loss avoidance, big-bath earnings management, amongst others.

The implication is that accounting can play a significant role in mitigating the impact of a pandemic on the performance of firms. The discussion in this paper contributes to the recent debate surrounding the relevance of accounting to society. Although accounting – both as a discipline and practice – cannot be blamed for the negative effects of a pandemic on firms, but as a social science, accounting can be blamed for failing to help in mitigating the negative effect of a pandemic on firms' financial performance when managers are not permitted to use significant accounting discretion to mitigate the negative effects of a pandemic on their balance sheet. As the pandemic deepens, more fundamental questions will be asked about the contribution of accounting to society particularly in mitigating the negative impact of a crisis or pandemic on firms.

Finally, the severity of the coronavirus (COVID-19) pandemic and its social impact calls for a reassessment of all areas of accounting research and their relevance to improving society in bad times. Future research can empirically investigate the effect of accounting behavior on firms during the coronavirus pandemic. Future research can also empirically investigate the impact of accounting on society in the context of a pandemic.

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