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Account Management and Financial Recording During the Coronavirus Pandemic

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***Abstract*: This research aims to explore how the pandemic impacted the accounting practices of Banking Institutions and Non-Banking Financial Institutions (NFIAs). It also assesses the consequences of using accounting principles such as Loss Avoidance, Big Bath Accounting, or Income Smoothing for the reporting of financial information. Such practices can perhaps lead to misreporting, therefore engendering misinterpretation.**

***Keywords*: Accounting, Banks, Coronavirus, COVID-19, Finance, Government, Management, NFIA, Pandemic.**

1. Introduction

This study will explore the financial recording practices adopted by businesses and companies during the Coronavirus pandemic, and those practices that were also prevalent during other financially unstable periods, such as the Market Crash of 2007-08, or the Dot-Com Bubble in the early 2000s.

This virus outbreak has led to a consequential level of uncertainty across all sectors and industries, especially the financial market, which is amidst the worst affected sectors. The supply and demand shocks engendered by the lockdown across the globe have induced liquidity issues and have downsized balance sheets for every company.

Via assessing such financial recording techniques, this paper will manifest how accounting techniques lead to an apparent improvement in cash flow statements, income statements and balance sheets. Shareholder confidence, and company reputation are, among other factors, the motivation to alter the financial information via the techniques that are explored in this paper.

A bad quarter is recoverable; however, a prolonged period of illiquidity may inflict permanent damage to the reputation and trustworthiness of a business. Such damage can be hidden from the financial statements of a business via the use of various accounting techniques. Since such techniques are capable of concealing information, and potentially misleading shareholders, it is important to study their usage and impact during such extraordinary circumstances.

2. Research Methodology

Past studies have shown that economic disasters lead firms to alter their financial reporting to dampen the impact on their financial statements. A study on the Greek crisis concluded that the economic downturn engendered a spike in the usage of ABC (activity based costing) systems, and unconventional methods of recording. The study also asserted that conventional accounting, as it did in the Greek Financial Crisis, witnesses a sudden drop in employment during hard times. Thus, it can be expected that uncommon accounting would again rise in popularity following the pandemic.

As presented by Huizinga and Laeven in their study of the Housing Market Crash, financial institutions used unconventional financial methods to misrepresent their liquidity position. It was discovered that banks, and NBFIs exaggerated the value of their assets, and their liquidity measures during and after the crash. Weak assets in the housing market were embellished by higher prices, and institutions with a significant proportion of capital backed by mortgage securities excessively utilized accrual-based reporting to conceal their bad investments. Such financial tampering could also be seen in the statements of banks with lower collateral provisions for bad debts.

Assessing other studies on accounting practices during the 2007 Market Crash, it can be argued that principles such a ‘fair value’ and ‘matching principle’ lead banks towards bankruptcy as they force these institutions to report the true value of their assets, i.e., the value at which their assets would be sold in a market. At the time, due to the unparalleled uncertainty, the value of real-estate assets had practically gone down to nothing. This was the reason behind the adoption of concealing practices that could help maintain shareholder confidence, and value. Furthermore, past researches have manifested that, during crises, financial practices start to get further complex, and firms start to further utilize footmarks of financial statements to embed information, which may not be easily understandable to the average shareholder.

Such online, and in-print studies, research-papers and journals have been capitalized for the construction of this research. By using studies of past financial crises, this study will try to understand, and to some extent, forecast the usage of unconventional accounting in the current global financial downturn.

3. Research and Analysis

As public movement comes to a halt, and people’s participation in markets gets restrained, their ability to spend would be considerably impacted. Amidst such circumstances, the uncertainty would render financial securities highly volatile, and would leave investors highly aversive to volatile securities, making them prefer bonds, deposits over equity investments. This would lead to a profound impact on the performance of firms. The contemporary circumstances were also ubiquitous during other financial disasters, and these lead firms to use financial concealment. The below mentioned financial techniques have been witnessed during the 2007 Market Crash, and are expected to be seen again this year.

A. Fair Value Financial Reporting

In the context of reported liabilities on the balance sheet, fair value financial reporting refers to the convention of recording the value assets and liabilities at the price at which a transaction took place between market participants. Changes in the fair value of are recorded in the incomes statement in the form of incomes and expenses. Another valuation method is the market value, which relies on valuing assets and liabilities with respect to their contemporary market value.

Firms that have historically utilized the Fair Value Methodology generally perform worse than those firms that use Market Valuation methods during economic hardships. If under a fair value measurement option, the market valuation method would allow firms to reduce the size of their liabilities, revalue them at a lower amount. Companies and institutions with huge debt obligations, or other forms of liabilities are, therefore, incentivized to switch to the market prices, allowing themselves to pay a lower amount. However, this may force the firm to revalue their assets as well, resulting in a smaller asset base. Although this may result in a reduction in market value of the company, such an asset downsize would not be idiosyncratic, but rather would be witnessed by other leveraged institutions as well.

Nevertheless, past researches have also identified that before the market crash, the firms utilized Market Valuation to record financial information faced severe illiquidity, and some even went bankrupt. This is because when institutions record their assets at market value during a downturn, the value of assets practically goes down to nothing. Thus, the helpfulness of Market Value for a firm during a financial crisis is subject to debate, but it can be said that borrowers benefit the most when the value of their debt decreases with the fall in market value.

Some studies have even concluded that the Fair Valuation Method was, amidst other reasons, the cause of the 2007 Market Crash. As firms were not able to downsize their debt obligations, and had several billions in low-standard Collateralized Debt Obligations, the market value of their debt skyrocketed, while their liquidity plummeted to almost nothing. Such a gap in the ability to pay and the value of debt rendered banks and other NBFIs helpless.

B. Bailouts, Stimulus, and the Big-Bath

When firms use Big Bath accounting, it refers to the process of adjusting the expenses of following years into the current fiscal year. This would reduce assets and profits in the current year for the firm, but would allow them to make their future results look better. Governments that provide stimulus and bailout packages for distressed industries, are likely to witness a profound usage of Big Bath accounting as an attempt to hide a company's surplus assets and incomes; These assets and incomes may be deferred to following years, when the country has recovered from the situation.

Amidst a global pandemic, wherein the financial reports of companies are already poor, using Big Bath techniques may make the results of the company’s performance look worse than they are. This would create room for the deferral of income to the following financial years, allowing the company to reduce its costs, and raise its profits in the future.

Sometimes firms can write-in one-off capital expenditures as revenue expenditures, therefore, making their profits narrower. Such huge, un-deferred expenses allow firms to lower their expenses for future years, while worsening their current financial reports. Studies have been able to identify this accounting technique in the financial statements of companies, nevertheless companies argue that by writing all the payments in one year, they would be able to use the bailout and surplus while maintaining the business health for the following years. They also defend their actions by asserting that such one-time payments would diminish the impact of the financial crisis.

C. Profit-Levelling and Loss-Aversive Recording

If a firm is unable to receive funds from the government that are necessary for its survival, the firm may still choose to manifest a good quarter by employing unconventional accounting methods. Such methods enable the firm to record normal-to-high profits, despite the bad year.

These methods include Profit Levelling and Loss-Aversive Recording. Profit Levelling, or Income Smoothing, includes maintaining a certain level of profitability each year, which does not manifest the profits as highly volatile, and ensures that the profits do not plunge. This can be achieved by deferring payments, or by downsizing the workforce. Furthermore, Loss Aversive techniques also include delaying payments to creditors, or by reporting future earnings in the current fiscal year.

D. Worse than it is

By and large, in the COVID-19 outbreak, as producers and consumers lose confidence in their future earnings, employment and GDP may fall, which may further engender a poverty trap. Amid such circumstances, shareholders would receive lower dividends as the profit generated may not allow the firm to pay out huge dividends. Additionally, the firms that do receive support packages may choose not to employ those funds, or rather delay their usage, in order to steer clear of reporting an unusually large financial profit or loss. Unusually large financial profit or loss may induce excessive inspection of the firm’s reported financial statements, and would also engender a worse reputation for the firms as it would lead to the question of whether that company should have received financial aid. Therefore, irrespective of whether firms receive financial compensation, firms choose to under report their earnings in times of financial hardship.

E. Fiscal relief packages

Although liberalization of financial reporting may allow firms to have better financial reporting during a financial crisis, such liberalization would also engender a reduction in transparency as firms may employ the aforementioned tactics to conceal their poor performance, or manifest themselves as weaker than they actually are. It has also been proved that liberal accounting laws have, in fact, led to manipulative reporting. Therefore, governments should employ laws that allow firms to be flexible, while not giving them the freedom to mis-report.

In a financial crisis, it is common for firms to try to conceal their performance, and manifest a better version of their statements, therefore, accounting laws and practices should not be loosened or liberalized during this pandemic.

4. Conclusion

Via this research, I have examined the financial reporting practices that companies employ during an economic downturn. Fair Value Method, Market Valuation, Loss Aversive Recording, Profit Levelling, and Big Bath Accounting are merely some of the methods that help firms conceal a poor performance, or manifest a worse financial position than what is the actual case. We conclude that the accounting policies of a firm can profoundly affect the extent to which their business is impacted by a recession, and in extraordinary circumstances like that of 2020, accounting can either help a firm to survive, or be the cause of its downfall.

Recent studies have blamed the subjective accounting policies of firms as the reason for economic and financial disasters. This paper deems that accounting policies do, to a great extent, help a firm dampen the negative influence of an economic trough, but they do not, by themselves, can engender a financial catastrophe. Thus, in 2020, firms have employed unconventional accounting measures as a weapon against the coronavirus, but as of now, there is not enough evidence to deem such measures as illegitimate.

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