



KAPITEL 3 / CHAPTER 3 CORONAVIRUS PANDEMIC IMPACT ON ACCOUNTING AND FINANCIAL REPORTING

ВПЛИВ ПАНДЕМІЇ КОРОНАВІРУСУ НА ОБЛІК ТА ФІНАНСОВУ ЗВІТІСТЬ

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Introduction

The coronavirus pandemic changed world economy and has a strong impact on different types of business, financial activity, and touched all countries, industries, professional areas that are facing challenges associated with the economic conditions resulting from efforts to address it. For example, many business entities and individuals in the travel, hospitality, leisure, education, food industry have felt sharp declines in revenues due to regulatory and organizational limitations (e.g. “shelter in place” mandates, school closures) and voluntary changes in consumer behavior (e.g. “social distancing”). As the coronavirus pandemic increases in both scale and duration, business entities are experiencing conditions often associated with a general economic downturn. According to Deloitte’s (2020) research, this condition includes: financial market volatility and erosion, deteriorating credit, liquidity concerns, further increases in government intervention, increasing unemployment, broad declines in consumer discretionary spending, increasing inventory levels, reductions in production because of decreased demand, layoffs and furloughs, and other restructuring activities. The continuation of these circumstances could result in an even broader economic downturn, which could have a prolonged damaging effect on the financial results of business entities.

The goal of this research is to summarize certain key accounting changes related to the results of the COVID 19 pandemic impact.

3.1. The Impact of COVID-19 on Businesses: what changed?

The coronavirus pandemic had a strong impact on businesses in 2020 and moving into 2021. Efforts, taken to control and prevent the COVID-19 affected different economic activities, which in turn has implications for accounting and financial reporting. As mentioned in the PWC’s report (PWC, 2020a), the implications include not only the measurement of assets and liabilities but also disclosure and possibly an entity’s ability to continue as a going concern.

The World Bank Group (Apedo-Amah et al., 2020) has developed a brief survey instrument for gathering data to measure the COVID-19 impact on the businesses. The questionnaire checks the pulse of measuring the impact on some critical dimensions: operations of the business, sales, liquidity and insolvency, labor adjustments, firms' responses, expectations and uncertainty about the future, and preferred mechanisms of public support. The COVID-19 outbreak led many firms to close or reduce operations, with a large drop in sales, and significant adjustments in employment, but with large heterogeneity in effects across firms. The results from the business pulse surveys draw a sobering picture of the impact of the shock, according



to which companies have been severely affected by the COVID-19 pandemic, often through multiple shocks at the same time. Not only do firms report a substantial drop in sales, but the financial situation is declining by smaller access to finance, and companies face significant uncertainties about the future. A lot of firms indicate that they are on the brink of insolvency, potentially leading to more employment losses, and uncertainty is exceptionally high which also is likely to lead to lower investments and more job losses.

The research of the Swiss School of Business Research (n.d.) found that the 2020 global pandemic was by far one of the greatest challenges that most businesses had to tackle. Its long-term effect on the economy has yet to be measured but unfortunately, some companies have collapsed due to the unexpected pressures endured. Nevertheless, amongst the destructions that the global economy faced, grew creativity, innovation, and adaptability by many industries and enterprises in a variety of sectors. Food platforms mostly diversified and offices became digital, virtual, and streamlined. The research results summarize 6 ways that Covid 19 has had a positive impact on businesses: 1. It pushed the fast-moving of digital access. 2. Provided companies with the perfect opportunity to innovate. 3. It highlighted the importance of training and upskilling. 4. It's seen a rise in productivity levels. 5. It's allowed businesses to save money. 6. It encouraged a stronger sense of community.

According to the latest McKinsey Global Survey (2021), which took part of more than 350 senior executives, business building is one of the leading strategic priorities for companies – double more than in recent years. That's because business leaders expect half of their companies' revenues five years from now to come from products, services, or businesses that do not yet exist, on the new-business building. This year's survey provides insights to move organizations up the learning curve faster. McKinsey's (2021) survey indicated that companies plan to transform sales, general, and administrative activities according to pandemic impact. Of the executives surveyed, 91 percent are planning to maintain or increase investment in digital technology in the coming years, more than half of respondents stated that remote working has increased productivity compared with pre-COVID-19 levels. This boost is leading organizations to aspire to an average of 20 percent savings through optimizing real-estate portfolios.

To summarize the coronavirus impact, we can use the KPMG (2020a) report, according to which COVID-19 shows the greatest danger to the global economy since the financial crisis. Therefore, most companies may be affected, i.e. every company should make its own assessment considering the individual facts and circumstances and receive relevant answers on the questions: Does the company directly or indirectly depend on supplies from affected regions? What is the impact on the sales side? What happens to the company's procedures if employees are infected? How weak is the company to market price fluctuations? What is the impact on the company's cash flows? What will be the future direction of investments? The answers to such questions will give a first indication of how severe and in which areas the impact on accounting and financial reporting could occur.



3.2. The Impact of COVID-19 on Accounting and Financial Reporting

Companies' management should carefully evaluate the impact of coronavirus on accounting and internal, interim, and annual financial statements because the effect could be significant for many businesses.

As mentioned by Peterson et al. (2021) during a pandemic, stockholders will reduce their involvement 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 turn out to be more volatile as investors become risk-averse, choosing safer investments. Owners' equity will become scarce for companies, private investment will decline, supply will be affected as production falls, operating costs will increase and income will fall, leading to poor performance of firms. In such conditions, companies can use accounting techniques in financial reporting to mitigate the negative impact of a pandemic on firm performance.

The implications for financial statements include the measurement of assets and liabilities, the disclosure and possibly to continue the entity's activities on the basis of going concern. The changes, including the indirect effects from lower economic activity, should be considered by all businesses, not just from the territories which the most significantly affected. As mentioned in the PWC report (2020b), the impact of the new coronavirus on entities' accounting and financial statements includes such aspects: non-financial assets; financial instruments; leases; cash and cash equivalents; revenue recognition; non-financial obligations; going concern principle; disclosures; interim financial statements. In addition, Deloitte explore more key accounting questions according to COVID-19: material judgements and uncertainties; events after the end of the reporting period; alternative performance measures (APMs); restructuring plans; onerous contracts provisions; insurance recoveries; consolidation; acquisitions and disposals; defined benefit plans; government assistance; capitalization of borrowing costs etc. Some of these problems can have a huge impact on the accounting, financial results, financial and non-financial statements of the companies.

Accounting practices during a pandemic will have some features, which are playing tremendous role for companies' management and financial reporting.

Managers can use fair value accounting techniques to reduce their liability: during a pandemic, companies that have large liabilities may reevaluate their obligations at fair value on the base of current market price or a close substitute which can decrease the total amount of payment and the total liability of leveraged firms. This applies only if contract includes a fair value measurement option (Peterson et al., 2021).

“Big-bath” accounting, bailout funds, and stimulus packages from government: managers can engage in “big bath” behavior as a form of earnings management where excessively large nonrecurring charges are recognized in one period to enable the reporting of artificially higher earnings in future periods (Cheng, 2019). “Big-bath” accounting is an earnings management method whereby a large accounting write-off is taken in contradiction of income in the current period in order to reduce assets (Hope and Wang, 2018), which results in lower expenses in the future. Even



though tax authorities or auditors are able to detect such practice in businesses, the firm can explain such decision by arguing that the write-off of large expenses in the pandemic year were 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 companies from the government (Peterson et al., 2021).

Greater revenue smoothing and loss avoidance accounting: without stimulus packages or bailout funds during a pandemic, companies will strive to remain competitive during a pandemic by using accounting techniques that enable the firm to report moderate profits to signal that the company 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. Such methods were described by Amat and Gowthorpe (2004) as a part of creative accounting practices and summarized the range of reasons for a company's managers to engage in creative accounting. Revenue smoothing involves reducing, or smoothing out, the fluctuation in the size of earnings over time so that reported profits are never too high or too low. Firms may smooth income by delaying research and development (R&D) expense or by reducing labor costs in the pandemic year. On the other hand, companies can engage in loss avoidance practices by deferring large expenses to future years or by recognizing future income in the pandemic year to avoid reporting a loss in the pandemic year (Peterson et al., 2021).

Avoiding income-increasing earnings management: Commonly, during a pandemic, companies will perform poorly because suppliers will decrease production, consumer demand will fall and workers may become unable to work safely in the firm. Revenue's prediction will fall and shareholders will expect lower profit and deferred dividends in the crisis year which means there is no anticipation of high profits in the pandemic year and there will be little motivation to engage in income-increasing earnings management. At the same time, companies which receive stimulus packages or bailout funds from the government, are unlikely to engage in income-increasing earnings management to avoid control of the firm's large profit in the pandemic year. As mentioned by Peterson et al. (2021), since the goal of the bailout is to support distressed companies, businesses that report large profits during the pandemic year even after receiving stimulus funds may face criticism as to whether they should have been a beneficiary of the stimulus packages or bailout funds.

Flexible accounting rules during a pandemic: the flexibility of accounting rules in order to look beyond short-term uncertainty when accounting for expected losses, suggests an important countercyclical effect of flexibility in accounting for expected losses amidst an unprecedented crisis. While such flexibility backstopped unwelcome ballooning of loss provisions because of the unprecedented uncertainty, it is also important that these provisions accurately reflect expected losses after the pandemic crises end (Casanova, Hardy, Onen, 2021). Also 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. At the same time, flexible 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 (Peterson et al., 2021).

3.3. The impact of COVID-19 on going concern assumption in accounting and financial statements

Going concern is one of the central principles of accounting, on which financial statements are prepared. According to this principle a business entity will continue to operate in the predictable future without the need or purpose to liquidate or restrict its operational activities. In this case, the assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. It is the responsibility of a business entity to determine whether the going concern assumption is appropriate in the preparation of financial statements. Implementation of stringent measures to contain or delay the spread of COVID-19 has significantly disrupted business operations and economic activity. The unpredictability of the potential impact of the outbreak may result in material uncertainties that cast doubt on an entity's ability to operate as a going concern. It is therefore important for the management to understand and anticipate the effects of COVID-19 on their business while performing an assessment of going concern (KPMG, 2020b).

The uncertainties about the impact of the COVID-19 pandemic make the going concern assessment more difficult, owing to the extent and duration of social distancing measures in effect in many jurisdictions and the impact on the economy. Companies should consider the impact of these matters on the entity's specific circumstances. In particular, the current and potential cash resources, including access to existing and new financing facilities, and factoring and reverse factoring arrangements, need to be considered up to the date of the authorization of the financial statements (Deloitte, 2020).

An overall lower economic activity has created an unprecedented level of uncertainty of consequent future earnings of entities. In this highly uncertain environment, going concern assessments would be more difficult to be used by company's management, which, therefore, may consider to undertake following steps:

- identify the principal risks and uncertainties caused for business by the pandemic, this majorly includes the entity's liquidity and solvency risks;
- revise budgets as the budgets prepared for the previous financial year may be not relevant anymore;
- update forecasts of sales, gross margins, and changes in working capital taking into account risk factors determined and different possible results;
- reassess sources of finance e.g., from external or related parties;
- undertake a study of projected covenant compliance in different scenarios;
- review the feasibility of future management's plans such as refinancing of current debts and restructuring of different types of activities (operational, financial, investment) (KPMG, 2020b).

PWC (2020b) considers multiple scenarios of the impact of coronavirus on



disclosures relating to going concern and subsequent events in financial statements:

Scenario 1: Going concern with material uncertainties. There are material uncertainties related to events or conditions (the consequences of COVID-19) that may cast significant doubt upon the entity's ability to continue as a going concern. The consequences of COVID-19 might combine with other events or conditions to create a material uncertainty.

Scenario 2: Going concern without material uncertainties. The impact of COVID-19 on future performance and therefore on the measurement of some assets and liabilities or on liquidity might be significant and might therefore require disclosure in the financial statements, but management has determined that they do not create a material uncertainty that casts significant doubt upon the entity's ability to continue as a going concern.

Scenario 3: Going concern without material uncertainties. COVID-19 is not expected to have a significant impact on the entity. Management has determined that there is no material uncertainty that casts doubt on the entity's ability to continue as a going concern. It expects that COVID-19 might have some impact, though not significant, for example, in relation to expected future performance, or the effects on some future asset valuations.

Scenario 4: Non-going concern. The going concern basis of preparation is no longer appropriate. Management intends to liquidate the entity, cease trading or has no realistic alternative but to do so. IFRS 101 "Presentation of Financial Statements" permits an entity that is no longer a going concern to prepare financial statements on a different basis but still in accordance with IFRS.

Conclusions

The global coronavirus pandemic was by far one of the greatest challenges that most businesses had to tackle during the last couple of years. Its long-term effect on the economy has yet to be measured but unfortunately, some companies had to react to the unexpected economic situation. The reaction will give the indicators of how powerful and in which areas the impact of a pandemic on accounting and financial reporting could occur. Accounting practices during a pandemic will have some features, which are playing a tremendous role in companies' management and financial reporting. Companies' management needs to evaluate such impact on accounting and internal, interim, and annual financial and non-financial statements because the effect could be significant for many businesses. The implications for financial statements include the measurement of assets and liabilities, incomes and expenses, results of different types of activities, the disclosure, and possibly to continue the entity's activities on the basis of going concern.