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Accounting for the Coronavirus

This article examines challenges facing accountants due to economic and financial stress increasing at the same time that oversight may be relaxing, provides insight into the question of whether we should expect a rise in accounting manipulations, and concludes with comments on mitigating hindsight bias.

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The economic shutdown resulting from the responses to the global coronavirus pandemic has disrupted all manner of business relationships governed by contracts. This has brought into sharp focus the critical governance role that accounting numbers play in many business transactions. In particular, they constitute a kind of "scorecard" for compliance with the terms of numerous types of contracts and agreements, such as debt contracts, supplier agreements, operating agreements, incentive compensation agreements, merger earnouts, and sales commission agreements.

Even in the best of times, accounting and financial reporting — which are often erroneously thought of as objective, straightforward exercises in number crunching — involve a considerable amount of subjectivity and judgment. In fact, they are subject to judgmental estimates that go far beyond simply recording the numbers, as well as beyond either voluntary or mandatory changes in the way the accounting numbers are derived.

The economic fallout from the coronavirus pandemic seems likely only to heighten the subjectivity, complexity and risk associated with such judgments while simultaneously creating more challenges for oversight. The business challenges created by the pandemic are largely unprecedented, and in many cases managers will need to make highly subjective judgments without the benefit of past experience. Simultaneously, unique financial and business pressures are likely to exacerbate incentives to strategically employ accounting changes.

Because of the unprecedented nature of the pandemic and its impact on businesses, many good-faith accounting judgments may turn out to be incorrect in hindsight, and they may be misinterpreted in hindsight as manipulative. Thus, it is even more important that retrospective evaluations of judgments made in these uncertain times are based on facts known and knowable at the time the judgment was made, focusing on the processes followed by the accountant making those judgments. Whether or not the judgment turns out to be a correct prediction is, in fact, inconsequential in investigating allegations of manipulation.

This article examines challenges facing accountants due to economic and financial stress increasing at the same time that oversight may be relaxing. We provide an overview of some academic research that may be helpful in evaluating the question of whether we should expect a rise in accounting manipulations, particularly those designed to avoid debt covenant violations. We then conclude with some comments on mitigating hindsight bias in investigating disputed technical defaults or alleged accounting manipulations.

Accounting Judgments Are Necessarily Subjective

Even as standard setters continue to adapt accounting standards in response to the increasing variety and complexity of transactions in which companies engage, the reality remains that no set of accounting standards can (or should) eliminate the role of judgment and subjectivity in accounting. As stated simply by the Financial Accounting Standards Board's (FASB's) Conceptual Framework, "To a large extent, financial reports are based on estimates, judgments, and models rather than exact depictions." *(Statement of Financial Accounting Concepts No. 8*, August 2018, "Chapter 1: The Objective of General Purpose Financial Reporting," OB11).

This point was highlighted by an advisory report commissioned in 2008 by the Securities and Exchange Commission Chairman Christopher Cox:

Judgments could differ between knowledgeable, experienced, and objective persons. Such differences between reasonable judgments *do not, in themselves, suggest that one judgment is wrong and the other is correct*. [emphasis added]

(*Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission*, August 1, 2008 "CIFR Report")

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Thus, companies are often faced with questions to which several reasonable and informed accountants could come up with as many reasonable and informed answers. Sometimes these differences in judgment arise from a number that cannot be directly measured: What is the fair value of this asset that is not traded on an open market? What percentage of my loan receivables should I expect to not collect, and how large of a corresponding provision for bad debt should I recognize?

Other times, these questions are even more qualitative in nature: Am I presenting this number with enough prominence on the financial statements? Does this piece of bad news constitute an indication of impairment? Does a modification to a lease constitute canceling an old agreement? Not infrequently, these types of questions underlie litigation that arises from disagreements over whether one party has been honest and forthcoming in their financial reporting.

To get a sense of the type of subjectivity that will be tested in the economic pressure cooker of a global pandemic, we highlight a few of the types of subjective estimates that may prove to be especially troublesome. Importantly, both tangible net worth and net income — two measures commonly used in debt covenants — are heavily influenced by the types of subjective accounting choices described here:

- **Unusual and infrequent events:** Entities are required to report transactions or events that are unusual in nature and infrequent in occurrence (or both) as a separate component of income from continuing operations. With the unprecedented nature of the social and economic disruptions caused by the coronavirus pandemic, it may be challenging for many firms to identify which transactions and events can, or should, be considered unusual and infrequent. The FASB's definitions of unusual and infrequent require companies to consider "the environment in which the entity operates." Given the uncertainty caused by the novel coronavirus, it may be difficult now to define a normal environment. (*FASB Accounting Standards Codification* (ASC) Master Glossary and ASC 220-10-45-1.)
- **Asset impairments**: When the value of an asset on a firm's balance sheet exceeds that asset's fair value, firms are required to write down the value of the asset on the balance sheet and recognize a loss. Impairment evaluations are often described as a two-step process. First, entities must determine whether events or circumstances indicate that the asset may be impaired. Second, if an indication of impairment exists, entities must measure the impairment (if any) based on estimates of the asset's fair value. Estimates of the fair value of an asset depend on predictions about the future productivity of that asset — estimates that may prove difficult to develop or support given the uncertainty introduced by the pandemic. For example, whether and the extent to which an asset is impaired may depend on management's outlook on pandemic-related disruptions. Expectations for a swift return to normalcy could justify little-to-no

impairment, while expectations for prolonged disruptions would likely lead a company to record significant impairments.

- **Allowance for loan losses:** Entities adopting the FASB's new loan loss standard (including most large banks) to estimate the amount of expected credit losses must consider relevant information about "past events, current conditions, and reasonable and supportable forecasts." (ASC 326-20-30-7) Past events may not hold much predictive power in the face of unprecedented economic disruptions. Any evaluations of current conditions are bound to be highly subjective and increasingly difficult with the current degree of economic uncertainty. Finally, given the lack of predictive power of past events and the unprecedented nature of current events, any forecasts — even those supported by reasoned assumptions — are likely to deviate from actual future outcomes.
- **Revenue recognition:** Firms recognize revenue only to the extent that the amounts are expected to be collected from the customer. In the current environment, collectability of revenues may be highly uncertain. For example, credit card companies may have robust models and extensive historical data that can help predict what portion of fees and interest will be uncollectible. However, these data may not be meaningful in an environment with unemployment levels not seen since the Great Depression.

Do Debt Agreements Constrain Borrowers?

Given the room for judgment to influence compliance with debt covenants, one might expect debt contracts to contain provisions that constrain the borrowers' potential opportunistic application of accounting standards. Allowing greater discretion has the potential to be costly for lenders when legitimate covenant violations are prevented or delayed. Analyses of publicly available debt agreements, however, reveal that many debt agreements have little, if anything, to say about the way in which accounting standards are applied by the borrower.

For example, Drum et al. (2018) examined a sample of 89 indentures filed with the SEC between 2014 and 2016 by the top 20 public companies (by market capitalization) for each market sector identified in the S&P 500. Only eight of the indentures included language that provided guidance on addressing the scenario in which accounting rules changes might affect the calculation of covenant ratios.

In addition, Beaty et. al. (2002) examined 206 debt contracts and identified 114 that mandated that covenant ratios to be based on the principles used at the date of the agreement, while the other 92 allowed voluntary changes, mandatory changes, or both. Beaty et al. (2002) found evidence that lenders charge higher interest rates for debt contracts that allow accounting changes to impact covenant calculations. This is evidence that lenders seek compensation for taking on the risk associated with companies being able to opportunistically change their accounting practices in order to reduce the likelihood of a covenant violation.

There are good reasons for contracts to allow for accounting discretion. First, changes to methods or approaches to making accounting estimates may be necessary to appropriately reflect changing circumstances. For example, it may be reasonable and expected that estimation methods will change to reflect the coronavirus pandemic.

Second, most borrowers follow a set of accounting standards such as U.S. GAAP or IFRS that require application of significant judgment. Constraining that judgment for purposes of calculating debt covenant ratios would impose great cost on the part of borrowers to maintain two sets of books. Thus, it is unlikely that a given debt agreement will contain language that eliminates the prospect of a company applying discretion in the accounting that feeds in to covenant ratios.

The Classic Fraud Triangle and the Coronavirus Pandemic

While judgments made in good faith are a central and important part of accounting and financial reporting, judgment can also be employed (or appear to have been employed) in an effort to manipulate a company's financial results. A framework commonly used by auditors to evaluate the risk of fraud is referred to as the fraud triangle. In short, it posits that management is more likely to commit fraud when three components are present: 1) incentive — such as pressure to avoid violating a debt covenant or meet earnings targets; 2) opportunity — such as weak or malfunctioning internal controls or inadequate accounting policies; and 3) rationalization — such as believing that upper management would behave in a similar way or encourage the behavior.

It is not hard to imagine how each of these components may come into play in the midst and wake of the coronavirus pandemic (and/or be re-evaluated in hindsight through this lens). A manager or executive may rationalize and see incentive for an aggressive accounting judgment during this challenging time. They may view it as their only choice to avoid a variety of bad outcomes: losing a bonus, missing an earnings target, violating a debt covenant.

At the same time that the incentives to commit accounting fraud are becoming larger, the opportunities are increasing, and the urge to rationalize is becoming stronger, we also are entering uncharted waters with respect to the role of oversight in the financial reporting process. For example, social distancing translates into increased distance between company management and their auditors. In a literal and physical sense, many auditors may now be unable to conduct standard procedures that require an in-person presence, such as unannounced inventory counts or observing an employee's implementation of the company's internal controls.

Manipulative Accounting

Commonly, concerns about the use of judgmental estimates in accounting focus on managers' ability to massage their earnings upward. For example, firms at the cusp of violating debt covenants may have flexibility to avoid a technical default by making small adjustments to judgmental accruals. A small adjustment to an estimate of future pension forfeitures could decrease the liability enough for a firm to meet a debt-to-tangible net worth covenant. A change in assumption about expected rates of return could increase revenue to help meet an interest coverage ratio covenant.

It isn't hard to understand why managers may be incentivized to massage their earnings numbers upward, but accounting manipulations can also happen in the other direction. Accounting literature and historical examples demonstrate that firms respond to incentives to decrease earnings in certain settings. An overstated impairment charge, for example, sets up a company for a more favorable return on assets in future periods.

Note that "reserves" established for losses are often misinterpreted by the financial press, which often describes establishing a reserve as "setting aside" money. It is important to understand that the establishment of a reserve simply recognizes a loss with a corresponding liability (or asset reduction). Firms that are properly establishing reserves are not segregating cash or saving for future negative events.

Investors and creditors may be forgiving to companies reporting poor results during the current economic crisis, particularly poor results that the company attributes to the pandemic (*i.e.*, by identifying unusual and infrequent events). One implication of reporting large impairments now, in a forgiving time, is that they will allow the company to report better metrics (such as returns on assets or return on equity) as the economy recovers in the future.

This may be particularly advantageous for companies that have secured concessions on financial covenants from a lender. For example, in March 2020, *Covenant Review* reported that a loan backing a private equity deal included provisions that would allow losses from non-recurring events — such as, say, a pandemic — to be added back to earnings for purposes of calculating covenant ratios. (Idzelis, Christine, "'Novel' Loan May Let Private Equity Firm Add Coronavirus Losses Back to Earnings." *Institutional Investor*, March 6, 2020)

Similarly, a deceitful manager with no immediate disincentive to report poor results may overstate expenses in the current period — when earnings are being released among a flood of bad news, for example — to save some in a "cookie jar" for future periods. Such manipulations can occur even in more sanguine times; for example, in 2010, Dell, Inc., paid $100 million to settle SEC allegations that Dell maintained so-called "cookie jar" reserves and released them strategically in order to meet consensus EPS.

Because of the great uncertainty in the current economic climate, establishing appropriate and defensible reserve estimates will be particularly challenging. Thus, reserve estimates established in Q1 and Q2 of 2020 will need to be carefully evaluated in future quarters and reversed promptly if/when the reserve is no longer justified. The fact that a reserve recognized in Q1 2020 is released at a later date does not necessarily indicate that the reserve was established in bad faith.

Similarly, firms that are almost certain to violate their covenant thresholds, or firms otherwise seeking to restructure debt, may be incentivized to report lower earnings to elicit concessions from lenders. Granting concessions — such as waiving covenants, delaying payments, or reducing the interest rate — is, of course, optional for the lenders. However, granting concessions likely would be preferable over a liquidation in a poor economic environment, when the pool of eager buyers is likely to have dried up. Thus, borrowers may have incentive to take larger losses earlier to elicit more favorable concessions from lenders. (*See*, Filip and Raffournier (2014))

The prospect of securing or maximizing government assistance in the wake of the coronavirus may create even more incentives to report lower earnings. The controversies surrounding public firms (*e.g.*, Shake Shack, AutoNation) or other large organizations (*e.g.*, LA Lakers) receiving Paycheck Protection Program (PPP) loans illustrate the problems with attempting to identify appropriate beneficiaries for government assistance based on accounting figures.

For example, the recent guidance from the Small Business Administration (SBA) indicates that a business can qualify for the PPP if it has a tangible net worth less than $15 million and has earnings before taxes for the last two years of less than $5 million. Even without any accounting manipulations, these two criteria do a poor job of identifying "small businesses" because companies that invest heavily in intangible assets (*e.g.*, GE, Allergan) and billion-dollar startups (*e.g.*, Wayfair Inc.) would meet these conditions.

Does Academic Research suggest that We Should Expect a Rise in Manipulative Accounting?

No one can predict the future, and the unprecedented nature of the current economic environment created by the pandemic makes attempting to do so even more challenging. But we can look to past research to see how similar situations have unfolded as a predictor of whether we should expect a wave in accounting manipulations in the midst or wake of the coronavirus pandemic.

Accordingly, we examined and have summarized some examples of research that address: 1) whether evidence suggests firms make accounting choices in response to incentives in contracts; and 2) whether earnings management increases during financial crises.

First, the literature on debt covenants suggests that firms close to violating a covenant can and do use discretion to avoid a technical default. For example, Dichev and Skinner (2002) examined 8,804 loans and found that an anomalously low number of firms report metrics that barely violate covenant thresholds. It is hard to avoid the suspicion that the temptation to manipulate numbers to your company's advantage is greater when the degree or magnitude of the manipulation required is smaller.

Other studies have examined firms that did violate debt covenants and documented patterns consistent with firms employing income-increasing discretionary accounting in the periods prior to technical default. For example, DeFond and Jiambalvo (1992) document significantly positive abnormal working capital accruals in the year prior to technical default, suggesting that firms positively manipulate income in the year prior to violation. Sweeney (1993) showed that the managers of violating firms made a greater number of income-increasing accounting changes relative to managers of control firms.

Finally, Graham, Harvey, and Rajgopal (2005) surveyed over 400 financial executives about the factors that motivate their accounting and disclosure decisions. The respondents generally ranked avoiding technical default low on the list of motivating factors, but the survey found (perhaps unsurprisingly) that private companies and firms closer to violating covenants consider the avoidance of violating debt covenants to be relatively more important in reporting their earnings.

Second, research on how the quality of financial reporting changes in times of financial crisis provides decidedly more mixed results. (Dong, Doukakis, and Ryan (2016)) examined discretionary gains and losses recognized by banks that are attributable to the changes in the firms' own credit risk. Their results suggest that less creditworthy firms generated more earnings-increasing adjustments, and that banks exercised discretion over those adjustments to smooth earnings during the 2008 financial crisis than they did afterwards.

On the other hand, two studies (Filip and Raffournier (2014), and Arthur, Tang, and Lin (2015)) examined the quality of earnings of European firms during the 2008 financial crisis. Their examinations found evidence of less earnings management and higher-quality earnings during the financial crisis than before the financial crisis. That is, these authors found that the 2008 financial crisis coincided with more truthful financial reporting.

We can speculate on why this might be the case. There may be less incentive to manipulate earnings during a crisis due to a higher market tolerance for poor performance; perceived risk of litigation may increase during crises; auditor and regulatory scrutiny may increase; or investors may make deeper or more frequent inquiries into discretionary accruals during a financial crisis. In a post-pandemic economic recovery, these and other factors all enter into the mix when examining the individual decisions made by a company, an accounting function, or a manager.

Conclusion: What Lies Ahead?

As the SEC-mandated disclosure states, past performance is no guarantee of future results. Given the unique social and market conditions of the coronavirus pandemic, past performance may provide even less predictive power now than in other periods. While a bold prediction about the coronavirus-induced economic crisis causing a sharp rise or fall in dishonest financial reporting may be eye-catching, at least two factors preclude such a prediction in either direction.

First, evidence from the last financial crisis is inconclusive. We can safely assume that, during this unprecedented time, the accounting functions at many firms will be challenged to make highly judgmental estimates, and that some of those judgments may impact borrowers' compliance with debt covenants. We know that some evidence suggests that firms respond to incentives in debt contracts by managing earnings. However, we have also seen that research into accounting manipulations during the 2008 financial crisis shows mixed results.

Second, an economic lockdown such as that resulting from the pandemic is truly unprecedented, and the characteristics of a health-induced crisis are likely to be much different from those of a purely financial crisis such as the one we saw in 2008. While the 2008 financial crisis was endogenous to the economy itself, the current crisis reflects an exogenous and swift shock (*i.e.*, shift in demand due to lockdown measures, and disruptions to supply chains). Like the initial shock, the speed of recovery may be largely dependent on external forces, such as when and how lockdown measures will ease and when adequate testing will become widely available.

Thus, accounting judgments based on predictions about these exogenous factors may be even less reliable this time around than they were in 2008. Even if the evidence about earnings management during the 2008 financial crisis was strong, the predictive value of that evidence to understand how the current crisis will unfold is unclear.

In the end, the facts and circumstances surrounding each disputed technical default or alleged accounting manipulation will need to be investigated individually. Any evaluation of accounting judgments must be based on the process accountants followed and the facts the accountant had access to at the time, and not whether the judgment turned out to be a correct prediction. In such investigations, eliminating the use of hindsight can be difficult, but is likely to be even more critical to a balanced examination.

For this reason, any retrospective evaluation of judgment will be heavily influenced by the quality and availability of contemporaneous documentation supporting well-reasoned judgments. Lack of sufficient documentation of judgmental estimates will make any retrospective evaluation of those judgments much more contentious. Investing in documentation of the assumptions and judgments that influenced accounting decisions now will pay dividends for companies and auditors down the road.