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FINANCIAL ACCOUNTING REPORTING: COVID - 19 EFFECTS

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ABSTRACT

This paper reviews the impact of Covid-19 on selected 2020 financial accounting reports and the quality of information contained in the reports. Selected disclosures are addressed with issues that speak to full disclosure to the stockholders. A discussion of the advantages and disadvantages of the disclosures is presented together with those disclosures required for stockholders to retain confidence in their investments.

Keywords: note disclosures, accounting information, COVID impact

INTRODUCTION

In January 2020, the World Health Organization declared COVID-19 a global health emergency and pandemic. The Spread of COVID-19 had severe damaging effects on world-wide business operations and financial reporting. This research highlights the effects on financial reporting resulting from the pandemic. It is important for investors and the public to receive high quality financial information provided by audited financial reports (SEC, 2020; PCAOB, 2020a; PCAOB, 2020b). Although Certificated Public Accounting (CPA) firms express the importance of disclosing the effects of COVID-19, there are various disclosures affected by the pandemic that should be a part of the annual financial report including the following.

- Going concern
- Subsequent events
- Asset valuation
- Revenue and expense recognition
- Lease modifications
- Hedging
- Income taxes

A scenario of each disclosure will be addressed as they should appear in the financial report note disclosures. A major issue is how to display a subsequent event related to Covid-19. The discussion also will address concerns regarding the increased risk in financial reporting caused by the pandemic as well as the pros and cons of the changes to financial reporting.

COVID-19 AFFECTED DISCLOSURES

Going Concern Disclosures

COVID-19 affected economic activity significantly and companies must determine if these implications affect their going concern assumption. Many companies will include a disclosure on the effect of COVID-19 whether it is a small impact or a severely damaging effect on the company's ability to continue as a business. PriceWaterhouseCoopers (PWC) (2020) provides examples of different scenario disclosures to help entities disclose this event. PWC advises companies with a fiscal year after December 31, 2019, to reassess disclosures affected by COVID-19 like assets and liabilities, gains and losses, and going concern as a subsequent event. If a company's financial statements have not been prepared (i.e. December 31, 2019 reporting date) the going concern and disclosures should be reflected in the 2020 year-end financial statements (PWC, 2020). There are a variety of circumstances with different outcomes affected by COVID-19. The events caused by COVID -19 could cause significant doubt on the entity's ability to continue as a going concern thereby creating a material uncertainty. Management could determine that the impact of COVID-19 had not created material uncertainty and the entity is able to continue as a going concern (Lynch, Lynch and Cullinan, 2020). Management could also determine that COVID-19 had an immaterial impact that does not cast doubt on the entity's ability to continue as a going concern but could affect the entity's future performance or alter asset valuations. Another scenario would be if entity could no longer continue as a going concern (PWC, 2020). Suppose management finds there is a material uncertainty but determines that the going concern is still applicable. In that case, it should disclose the material uncertainty, express the plans set in place to correct this uncertainty, and disclose that the material uncertainty might induce significant doubt on the entity's ability to continue as a going concern. However, this could result in an inability to realize assets and pay debts in the normal course of business. Suppose there is significant doubt on the entity's ability to continue as a going concern. In that case, the disclosure should be as specific as reasonably possible about the effect the pandemic had on the entity (PWC, 2020). If the entity had issues unrelated to COVID-19, these issues should be disclosed and made clear that the issues would still be present without COVID-19. Entities should also disclose that the pandemic is an uncertain situation and expects further changes to affect the entity. Disclosing the entity's plans to reverse the negative outcomes caused by COVID-19 is suggested as well.

The entity's disclosures need to include a management statement declaring the use of a going concern statement is acceptable. If management determines that the material uncertainty creates significant doubt that the entity cannot continue as a going concern and finds no alternative solution, the entity cannot prepare financial statements using the going concern assumption (PWC, 2020). Material uncertainty disclosures may differ depending on the entity's different circumstances. Entities should still include disclosures even if they have determined that COVID-19 has not created significant uncertainties. Financial statements in this case should include a statement about how the COVID-19 pandemic affects the entity's liquidity.

Material Uncertainty Creating Doubt

To keep entity's disclosures uniform, PWC suggest guidelines on what to include in the disclosures across different scenarios (PWC, 2020). The following is an outline of what to include in the note disclosures in the event a material uncertainty is present, and it creates doubt that the entity can continue as a going concern is the following.

a. An introduction that describes the situation reporting the entity's financial position and the effects caused by the pandemic.

b. Measures being taken to ensure the going concern is appropriate. Examples of the measures could include the following.

- Using resources provided by the government in response to the pandemic
- Ideas for raising capital
- Planning with lenders for extensions
- Negotiate with lenders the terms of breach covenants, request a waiver due to extreme circumstances
- Arrange payment holidays from lenders allowing the entity to miss certain monthly payments for a period of time
- Request rent relief
- Temporarily change business plan to cater to services that are in demand for the period

c. Closing statement should reiterate the going concern assumption is appropriate (PWC, 2020).

Significant Uncertainty Exists but is not Material

Other circumstances due to COVID-19 could create significant uncertainties but may not be material or the issues caused by COVID-19 may not be significant. In this case, the disclosure would have a different heading when the uncertainties caused by COVID-19 are not significant. The heading would introduce the implications of COVID-19 on the business or liquidity risk section.

The introduction to the section would disclose the condition of the entity due to COVID-10 and state management plans to maintain any unforeseen circumstances. The narrative would include a discussion of the effects of COVID-19 on the entity's financial position and the effects of the pandemic on its operation.

Following the introduction section, a note narrative would present the plans in place to ensure a going concern is appropriate by discussing what steps management has taken to maintain events due to COVID-19. The basis for management decision regarding the appropriateness of the going concern assumption when a material uncertainty is not present but cast significant doubt should be included in this section.

Subsequent Events

Circumstances due to COVID-19 should change over time. In some cases, the situation could improve as time passes, or the pandemic could create further issues. Although the events will have various consequences on different entities, all entities will be at risk of uncertainties related to the pandemic. Due to these uncertainties, entities should consider circumstances due to COVID-I 9 after fiscal year-end. Some events may not require additional adjustments to the financial statements but create the need to be disclosed as a subsequent event if determined to be material (PWC, 2020).

ASC 855 describes two types of subsequent events. Type I subsequent event provides information about a condition that existed at the date of the financial statements but was not considered as of that date (Dauberman and Sibleman, 2020). These subsequent events require disclosure and adjustment to the financial statements. A Type II subsequent event is one that affects information that is properly_reported and disclosed on the financial statements but, due to the subsequent event, the information is no longer valid as of the date of the public entity's financial statement or a nonpublic entity's statement is available to be issued. The financial statements will not be adjusted since the information was accurate as of that date. However, disclosure is required to inform financial statement users that the information on the financial statements is no longer accurate (Dauberman and Sibleman, 2020).

COVID-19 would be classified as a Type II subsequent event. The disclosure should be concise describing the subsequent event and its effect on the financial position. If an estimate cannot be determined, the disclosure should provide a statement explaining the fact. The events that create significant doubt should be disclosed if the going concern is no longer valid. Subsequent event requirements pertain to events that occur after the end of the reporting period but before the issuance of the financial statements (Dauberman and Sibleman, 2020).

Asset Valuation

Financial projections are significantly affected by cash flow shortages, delayed receivables, changes in market value, or trading conditions. As a result, financial estimate revisions can result in impairment (Coetzee, 2020). According to the Wall Street Journal $261 billion of assets were impaired mid-year 2020 in U.S.-based companies (Littan, 2020). Property, plant, and equipment could be impaired because it is uncertain that the asset's carrying value can be recovered] (Dauberman and Sibleman, 2020).

NEW REQUIRED DISCLOSURES

Revenue and Expense Recognition

GASB issued a technical bulletin clarify guidance for existing revenue recognition and expense outflows procedures in light of COVID-19 (GASB, 2020). Included in the bulletin, GASB states that resources provided by the CARES Act should be recorded as a liability until eligibility requirements are met. Once the eligibility requirements are met, the liability amounts are recognized as revenue. The U.S. Treasury classifies the CARES Act program resources as other financial assistance. Paycheck Protection Program resources should be recognized as a liability until the entity is legally forgiven of the debt (GASB, 2020). Many entities would qualify for forgiveness when the funds were used for their intended purpose. GASB also stated that expense outflows related to COVID-19 should not be treated as extraordinary items because the disease is expected to reoccur in the future making the expense not infrequent (GASB, 2020). Guidelines state that extraordinary items are transactions or other events that are both unusual in nature and infrequent in occurrence (GASB, 2020).

Lease Modifications

Due to the decrease in business revenue, lessees are requesting relief on lease obligations. Many lessors have questioned how to handle lease modifications resulting from COVID-19. Should lease modifications have an accounting impact from the change that needs to be considered along with the business implications of the change in payments (Bober, 2020)? The issue is whether or not the change in timing and/or amount was permitted in the initial contract. ASC 842 defines lease modifications, in part, as a change in consideration or the term of a lease (Bober, 2020). If the lease modification met that definition, the lessor would have to rerun the lease classification tests and then flow a lease classification change through an accounting decision tree (Bober, 2020). Because this process is not easily done, FASB allows companies to elect if they wanted to treat the change as an accounting modification or not. If an entity elects not to treat the change as a modification, lease classifications do not need to be reviewed or treated as a new lease (FASB, 2019). To be eligible for relief, the lease modification has to be related to COVID-19 and the total rent payment should either be the same as stated in the original contract or less. Granting a lease modification creates risk for the lessor. Before granting a lease modification, lessors should evaluate if their systems and process can handle the change and how the change would flow through the lease management system. Management should discuss the risk of loss due to the change and properly record the change documentation. Documentation will be vital if the entity decides to elect not to treat the change as a_modification because disclosure of the election will be required. The lessor's decision to grant a lease modification depends on many factors. Factors include quality of credit, future prospects, customer relationships, payment history, and the current status of payments.

Hedge Accounting

Hedge activities may be affected by COVID-19. Brian Goetsch, CPA, Director, Accounting Advisory Services for KPMG, warns that some entities may want to reevaluate whether hedge accounting is the most profitable option during the pandemic (Murphy, 2020). Entities cannot easily predict future outcomes because of the pandemic's unpredictable circumstances. It will be difficult to prove favorable profits incurring based on past events (Murphy, 2020). FASB ASC Topic 815 (FASB, 2019) that addresses derivatives and hedging in detail is another item for review regarding specific changes and possible results of the pandemic. Current accounting consequences include gains and losses from accumulated other comprehensive income that needs to be reclassified if transaction occurrence is not probable. Future accounting can be impacted by having mark-to-market volatility in profit and loss because derivatives are not possible for hedge accounting (Murphy, 2020). Although the pandemic presents more risks for hedge accounting, the economic downturn could prove beneficial. It could provide the opportunity to set low costs for future transactions based on current spot rates and forward rates. Interest rates are lower than they have been in the past years providing advantages for current and forward debt issuances. Entities should weigh their options and decide if derivatives are the right move (Murphy, 2020).

Income Taxes

In the 2017 Tax Act, net operating loss deductions were limited to 80% of taxable income and eliminated loss carrybacks for most purposes. Before the 2017 Tax Act, 100% of corporate net operating losses could be carried back two years and carried forward 20 years. The 2020 Act reversed the 2017 Tax Act changes to net operating losses. Entities can carryback 2018-2020 net operating losses to five years. Net operating losses are not limited for tax years prior to 2018 and limited to 80% of modified taxable income from tax years after 2017 for tax years beginning after 2021 (Rizzi, 2020). This significant tax law reversal is meant to stimulate the economy and relieve pressure caused by COVID-19 (Rizzi, 2020).

Increased Risks Attributed to COVID-19

In addition to the impact on financial disclosures, various accounting areas become exposed to additional risks. Given the many risks involved with this pandemic, it is imperative that proper documentation is recognized and judgments have adequate reasoning to support them. Entities are at higher risks of material misstatements for their financial statements. Entities should be equipped to prove judgements with proper documentation. In addition to making well-thought-out judgments, assessments and evaluations of financial position should be ongoing. The need for repetition is important because events caused by COVID-19 are unpredictable. Although there are many audit risks have come to light due to COVID-19, there are four key audit risks including accounting estimates, fraud, internal control, and noncompliance with laws and regulations (Dohrer and Mayes, 2020)

Accounting Estimates

Clients and vendors may not be able to make timely payments, or in some cases unable to pay the debt at all. Former deputy chief accountant in the Enforcement Division, Jason Flemmons, advised that under GAAP, the criterion is not whether a debt is paid on schedule, but whether or not it is probable that the recorded balance is paid in full (Maine, 2020). Even though GAAP requirements state that market condition and volatility should be considered the new revenue recognition component, variable consideration, holds another potential risk. Entities should reconsider estimates of variable consideration because earnings projections may be impacted. Thus, entities should determine if assets are impaired. In addition to testing for impairment, it should be determined if the impairment is temporary or permanent. Allowance for doubtful accounts, goodwill, and intangible assets are examples of what might be impaired. In the past, auditors have used historical estimate to measure validity. In 2020, valuation specialists may be more appropriate.

For an accounting estimate to be acceptable as reasonable by an auditor, it must be supported by sufficient objective evidence to enable a conclusion that it is based on the best information available at the time the financial statements are issued and is free from management bias (Levy, 2020). In uncertain times, management has the tendency to be extra conservative when reporting loss contingencies auditors should maintain professional skepticism and be mindful of these biases. AS 2501 that guides auditors when evaluating estimates was amended and will be effective for the fiscal year ending on or after December 15, 2020 (Levy, 2020).

Fraud

Experts worry that the effects of COVID-19 would hide underling issues unrelated to the pandemic. SECs Enforcement Division chief accountant, Matthew Jacques, notes that previous economic downturns have revealed past errors or ongoing frauds (Maine, 2020). He warns that the Enforcement Division is observing entities more thoroughly to ensure they are not using the crisis to their advantage by reporting issues as events attributable to the pandemic that were not related. Ghandar (2020) claims the pandemic has been a perfect environment for the fraud triangle - incentives or pressure, opportunity, and rationalization. Given the economic strain COVID-19 has put on businesses, employees might feel the pressure to forge financial statements to show the company is having a better financial position to secure their job. As a result of shelter in place, rules many people have lost their jobs. Thus, employees could have the incentive to take from the company to replace their lost income. Shelter in place has also presented opportunities to override internal controls. Many companies do not have procedures to support their workforce working from home. Professional skepticism would help when reviewing overrides of internal controls. Hard times drive people to rationalize taking from the company by planning to pay it back later or forging documents to help the company. Although it is not the auditor’s responsibly to discover fraud, extra steps should be taken to spot potential fraud.

Internal Control

Internal control has increased risk as well. Combined with the fraud risks of material misstatement changes in management processes, systems and controls could increase error risk. Greater internal control risk is due to the workforce working remotely, increased layoffs, absences related to illness, and travel restrictions (Levy, 2020). Auditor accessibility has decreased as it is difficult to audit entities on location due to travel restrictions and in-office communication in many companies being switched to a digital mode. These internal control deficiencies over financial reporting could result in placement of inexperienced personnel placement to fill vacant position (Levy, 2020). The SEC has emphasized disclosure for operational challenges.

Noncompliance with Laws and Regulations (NOCLAR)

Many small businesses have participated in federal economic stimulus funding. The program reporting forms can be complex due to regulations that ensure the proper utilization of the resources. Dohrer and Meyes (2020) contend the complexity of these regulations, combined with the fact that applications for funding were hastily submitted by accounting staff working remotely for the first time, may have heightened the inadvertent noncompliance risk of regulations established by Treasury and the U.S. Small Business Administration. Thus, auditors should inspect the stimulus fund applications and reporting to ensure that no material effect on the financial statements exists.

Reporting Opportunities and Downsides

In this time of crisis, entities are turning to technology to support business practices. Virtual communication, the use of external platforms, and data gathering systems that are cloud-based have all increased (Littan, 2020) causing technology is advance at a rapid rate. Entities are being forced to update their systems to comply with shelter in place guidelines. Although the changes slow down processes for financial reporting initially and increase security risks, technology will eventually improve financial reporting processes. Technology creates the opportunity for real-time communication and reduces calculation errors. After entities revamp their processes and become accustomed to new procedures, the only downside to the increased reliance on technology is the loss of real contact with people.

The greatest downside for financial reporting in light of COVID-19 is the increased complexity of compliance guidelines. To ensure entities are not taking advantage of decreased security and economic stimulations, proper documentation is crucial. Many financial reporting processes use estimates for future projections, which require an extra level of complexity. Estimates that were relied on in the past will no longer be appropriate. Management has to determine new estimates and provide substantial documentation to support their estimates.

CONCLUSION

Disclosures are key in reporting financial statement element that has been impacted by COVID-19. Once thriving companies are now having to disclose the possibility of disconuing their business. Even companies that can still assume the going concern assumption need to disclose the effects caused by COVID-19 because the public needs to know if fluctuations in revenues were due to the pandemic. Thus, there are defiantly increased risks in financial reporting. One of the biggest concerns is that some entities will use this crisis to hide failings unrelated to COVID-19. Auditors should be mindful of declining historical trends and ensure COVID-19 disclosures are properly reflecting the economic downturn. In addition to being extra mindful of fraud, auditors have their work cut out to review financial statements. Estimates that were relied on in the past will no longer be accurate. All estimates from previous years must be reevaluated. The CARES Act provided a lot of financial assistance for companies this year. The applications are complex and require sufficient documentation to ensure the funds are used properly. Auditors must review these applications to ensure they are following federal laws and regulations. Although it is not required, it would be beneficial if auditors included an emphasis-of-matter paragraph to identify COVID 19 concerns in the accountant's report (Dauberman and Sibleman, 2020).

A Subsequent event needs to be disclosed depending on an entity's fiscal year. Assets need to be reevaluated and tested for impairment due to the economic downturn. Lessors will not have to recalculate lease classifications or apply changes through a decision tree when electing to modify leases to help lessees during these rough times. Hedging could be beneficial by taking advantage of low current spot rates but could prove hard to attain based on the uncertainty of probable future transactions. There are four key audit risks: accounting estimates, fraud, internal control, and noncompliance with laws and regulations. Increased reliance on technology could slow down productivity in the beginning implementation process for some companies but eventually improve financial reporting processes. Compliance guidelines are complex but necessary to keep entities honest. The COVID-19 pandemic has disrupted life worldwide, but business, in an altered fashion, goes on (Levy,2020).

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