INTERNATIONAL JOURNAL OF ACADEMIC RESEARCH IN BUSINESS & SOCIAL SCIENCES
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To Link this Article: http://dx.doi.org/10.6007/IJARBSS/v13-i3/16600 DOI:10.6007/IJARBSS/v13-i3/16600

Received: *07* January 2023*,* ***Revised:*** *10* February 2023*,* ***Accepted:*** *26* February 2023

Published Online: *18* March 2023

In-Text Citation: (Isahak et al., 2023)

To Cite this Article: Isahak, M. S., Johari, A. S., Rahmatullah, D. A. M., Zainal, N. A., Tajuddin, N. A., & Kamaruddin, N. B. (2023). Impact of Covid-19 on Earnings Management in Financial Reporting - Concept Paper. *International Journal of Academic Research in Business and Social Sciences*, *13*(3), 1719 – 1729.

Vol. 13, No. 3, 2023, Pg. 1719 – 1729

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Impact of Covid-19 on Earnings Management in Financial Reporting - Concept Paper

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Abstract

The outbreak of the COVID-19 pandemic in 2020 brought severe impacts on economies around the world. The market situation worsened and became uncertain due to the shock of the sudden virus outbreak. This has created issues for almost all industries globally as they must cater to the sudden changes in economies to stay competitive. Companies have taken the initiative by undertaking earnings management strategies in their accounting functions to present a strong performance in their financial reports. Due to this, the reliability and quality of financial reporting have been questioned. This paper explains the impacts of COVID-19 on earnings management in financial reporting. Three impacts are discussed: the enormous financial pressure on enterprises, the uncertainty due to the pandemic impacts on firm financial policies, and the increased information asymmetry between corporate outsiders and insiders. With these insights, suggestions are proposed on the control companies can implement to ensure the reliability and quality of the financial report.

Keywords: COVID-19, Earnings Management, Financial Pressure, Financial Policies, Information Asymmetry

Introduction

The global COVID-19 outbreak is regarded as the twenty-first century's most significant social, economic, and health problem. The COVID-19 pandemic has delayed economic activity worldwide, causing human deaths and perpetuating the sickness itself. This has been its unusual effects and the steps governments took to stop it from spreading. Unprecedented levels of joblessness, a decline in economic activity, and fluctuating price swings across numerous financial markets have all been driven due to the pandemic. COVID-19 has already impacted the company's activities (Barai & Dhar, 2021). Indeed, the COVID-19 outbreak has impacted most firms' production and profitability since they cannot operate their business due to suspensions made by governments. The lockdown announcement affected the demand as all flights could not operate, consequently impacting all activities inside and outside the country.

In this regard, KPMG believes that "COVID-19 creates existential concerns on a business's ability to continue, which has substantial financial reporting effects, ranging from going concerned and liquidity to the recoverability and asset valuation." Earnings are one of the primary elements of a financial report and are frequently used to assess a company's operations and managerial choices. Stakeholders frequently use it to assess a company's progress over time (Wroblewski, 2016). Therefore, the dependability of earnings becomes controversial because managers are involved in creating financial reports and have incentives to control earnings (Healy & Wahlen, 1999). The manipulation of earnings is thus one of the primary concerns for financial experts.

Technically, some businesses manipulate their earnings at a difficult time to maintain their competitiveness and the earnings target (Simon et al., 2022). However, there is still debate today over the manner of earnings manipulation and the actions taken by financial management to ensure the goal of earnings manipulation may be achieved. In an organisation, accrual-based earnings management (AEM) and real-activity-based earnings management (REM) are the two most prevalent methods of managing earnings (Graham et al., 2005; Kim & An, 2018). AEM refers to the manipulation of the accrual component of profits. In contrast, REM happens when actual activities, such as a reduction in spending on research and development or any other expenses directly affect a firm's cash flows that the manager controls to boost the company's revenue (Cimini, 2015).

According to Ozili (2021), managers are encouraged to use their managerial discretion when preparing financial reports during a pandemic by using specific accounting rules and techniques like fair value accounting, big-bath accounting, income smoothing, and loss avoidance in order to improve the balance sheet and financial performance. Johnson (2019) also discovered a connection between the quality of accounting results and business cycles, specifically that there is a stronger correlation between stock returns and earnings during expansion years than during two periods of contraction. Filip and Raffournier's study (2014), "Financial Crisis and Earnings Management: European Evidence," indicated that, in contrast to Johnson (2019); Ozili (2021), the amount of earnings management decreased during the 2008–2009 crisis years in comparison to the years before the outbreak happened.

The result of this study contributes to the finding of literature according to three impacts. This study provides insight into the impact of earnings management during a pandemic, which brought enormous financial pressure to enterprises; uncertainty significantly impacts firm financial policies and increases information asymmetry between corporate outsiders and insiders. It is essential to understand the practice of earnings management and whether it affects stakeholders. The preparation of the financial reporting must be accurate and fair since the decision is made according to the data they received.

Problem Statement

The sudden outbreak of COVID-19 in early 2020 has caused severe impacts on economies around the world. The COVID-19 shock has caused significant economic losses in practically all industries globally in terms of output, consumption, imports, and exports. Additionally, the prevention and control measures, such as traffic restrictions and regional lockdowns, have worsened the situation by hindering the growth of numerous industries. The COVID-19 effect has created issues for countries all over the world in terms of increasing inflation and rising debt risks. Due to this pandemic, the global market has significant risks and uncertainties (Yan et al., 2022). According to Zamri et al (2022), these effects caused harm to numerous industries, and to make matters worse, some of them have been seriously impacted, forcing them to shut down.

Some managers would likely present a strong performance of their firms despite the company being confronted with difficult situations as the firms must file a financial report at the end of the fiscal year (Azizah, 2017). However, some people are still surviving and creating opportunities to manage the firm's earnings to stay competitive (Zamri et al., 2022). Companies worldwide were strongly motivated to undertake earnings management because of the economies' rapid changes, which also impacted their financial reporting. According to a study that has already been done on earnings management, implementing earnings management strategies is a common method for companies to handle the shock of exogenous events (Yan et al., 2022).

The two most common methods are real and accrual-based earnings management (Cohen & Zarowin, 2010). Comparatively, accrual-based earnings management selects accounting methods to alter accrual items so it does not affect the total corporate profits. However, it has higher litigation risks (Gunny, 2010). In contrast, real earnings management manipulates related businesses' daily operations to control earnings. Although this strategy is more subtle, it affects the company's long-term profitability and future expansion (Graham et al., 2005). Thus, if earnings management practice is not conducted in the right way, it could lead to lots of possible risks either in terms of law or even in the growth of the company itself in the future as people would question the truth and fairness of the financial reports presented by the company.

In this paper, we study the impacts of COVID-19 on earnings management in financial reporting. We also offer a few suggestions on what control can be implemented by companies to ensure the reliability and quality of the financial report.

Gap in Research

Some research and studies related to the impact of COVID-19 on earnings management have been conducted. Yan et al (2022) found that COVID-19 intensifies earnings management behaviour in China enterprises. Another study found that firms in the USA used income-decreasing discretionary accruals during the pandemic to inflate earnings as there was a decline in discretionary accruals and a considerable increase in the absolute value of discretionary accruals from 2019 to 2020 (Liu & Sun, 2022). There is also a study focusing on the impact of the COVID-19 pandemic on European firms. The study found that EU firms tend to present lower-quality financial reports during the pandemic by managing earnings upward (Lassoued & Khanchel, 2021). Therefore, this paper intends to study the impact COVID-19 has on earnings management in financial reporting.

Significance of Study

The worldwide spread of the COVID-19 virus is currently being regarded as the most significant global public health, economic, and social disasters of this century. The COVID-19 pandemic has severely impacted several industries; to make it worse, some were forced to shut down. The pandemic has resulted in historically high levels of unemployment, a slowdown in economic activity, and volatile price changes across various financial sectors (Lassoued & Khanchel, 2021). In fact, the COVID-19 outbreak affected the output and profitability of most businesses because most of their operations were halted during the nationwide lockdown enforced by several governments, which resulted in the cancellation of flights and a decline in demand (Lassoued & Khanchel, 2021).

Significant uncertainties exist for businesses regarding their continued existence and future development. The COVID-19 shock has produced a sudden interruption in supply chain operations and a decrease in demand for most businesses. More specifically, when looking at the situation from the point of view of supply, the unexpected outbreak of public health incidents makes it impossible to maintain the usual flow of production elements such as labour and raw materials (Yan et al., 2022).

The surviving firms during the pandemic create a chance for them to manage earnings in order to remain competitive in the industries. Since the firms are required to prepare financial reports, some managers intend to whitewash their financial performance despite the company currently facing challenging conditions (Azizah, 2017). However, this behaviour motive appears controversial (Lassoued & Khanchel, 2021).

Companies facing financial distress tend to use earnings management strategies to ensure they remain competitive in the industries. Therefore, this study focuses on the impact of COVID-19 on earnings management in financial reporting. This study will also provide the necessary details on how earnings management can help companies indicate better performance through financial reporting despite difficulties during the pandemic.

Literature Review

Enormous Financial Pressure

The COVID-19 pandemic has unquestionably had a significant impact on the country and the individual company in terms of finances (Jakobsson & Ljubisavljević, 2022). This pandemic has brought tremendous financial pressure to companies that urgently need to acquire funds from the capital market in order to survive the economic crises (Yan et al., 2022). Companies that are struggling financially have strong incentives to inflate their profits to achieve specific goals. As a result, they may deceive stakeholders about their company's financial performance (Campa & Miriano, 2015; Zang, 2012). They may use earnings management strategies to manipulate earnings to meet the financing demand.

Companies saw a decline in profitability due to the suspension of production and the drop in consumer demand caused by the COVID-19 pandemic. Additionally, some economic activities were halted during general lockdowns, social distancing, the suspension of flights, and a drop in demand in general (Lassoued & Khanchel, 2021). Consequently, they face difficulties in surviving and managing a wide variety of limitations, such as a precipitous drop in consumption, the pressure of rising prices, and an increase in the raw materials' worth as a direct result of the significant reduction in supply.

Due to the COVID-19 pandemic, companies are in a challenging and depressed position, which puts pressure on management for debt contracts, bonus incentives, and sales targets (Ulfah et al., 2022). Therefore, managers may be compelled to aggressively use accrual policies while preparing financial statements to boost the discretionary value. As a result, an increasing number of board directors contribute to more effective earnings management throughout the COVID-19 pandemic (Ulfah et al., 2022). This scenario should be a wake-up call for the board of directors to step up their effective management monitoring (Ulfah et al., 2022).

According to the study conducted by Yan et al (2022), companies that face severe financial distress experience more shock effects due to COVID-19, and they tend to choose accrual-based earnings management rather than real earnings management. This argument is supported by Bisogno and De Luca (2015), who stated that small and private enterprises in Italy suffer financial difficulties, which have a significant positive correlation with accrual earnings management designed to cover actual performance and retain loan financing from banks. In contrast, Kjærland et al (2020) stated that managers may employ income-decreasing accruals strategies when performance is below par because the poor results are unavoidable, enabling them to benefit from the crisis period by declaring greater than necessary losses.

In order to avoid displaying catastrophic results, managers could manage earnings upward and report an acceptable level of losses. This would help restore confidence among investors and stakeholders and signal that the company's position is better than that of its competitors (Ozili, 2021). This seemed to reflect actual financial performance through the profit statement. In such a case, the investors may not be interested in investing in these companies, hence it will be difficult for them to obtain funds.

Uncertainty Due to the Pandemic has a Significant Impact on Firm Financial Policies
The uncertainty due to the COVID-19 pandemic significantly impacts firm financial policies. Enterprises' actual operational conditions become more unpredictable due to COVID-19 (Ramelli & Wagner, 2020), which quickly increases the uncertainty they encounter. Executives are more likely to engage in upward earnings management when business operations are uncertain about retaining their compensation and reputations while appearing that the company is doing well. Managers have certain flexibility when preparing financial statements. However, this flexibility could be exploited to trick those who read financial accounts. Managers can influence earnings to a target level that satisfies a particular aim through subjective intervention and applying professional judgement while preparing accounts (Healy & Wahlen, 1999; Schipper, 1989).

Due to the widespread impact of COVID-19, investment opportunities in the capital market became uncertain. Firms have incentives to attract potential investors with rising incomes. In this regard, standard-setters are aware that such behaviour makes a set of stand-alone accounting standards insufficient to prevent financial information from being misrepresented due to earnings management. Therefore, under the COVID-19 shock, businesses with uncertain investment opportunities are likelier to engage in more earnings management to show external investors that they are doing well; draw in investors' money and foster foreign investment opportunities. These behaviours are also useful for standards setters and regulators to learn how pandemic crises affect the quality of financial reporting.

According to Melnyk et al (2014), adjustments to the business environment or the firm financial policies may be necessary in today's dynamic and volatile world. There have been serious questions about whether the standard performance measurements accurately reflect the diverse environments and rapid changes. Current research agendas, therefore, encourage scholars to take a step back from focusing on specific areas of business performance and adopt a more thorough and innovative approach (Ferreira & Otley, 2009; Giovannoni & Pia Maraghini, 2013). However, because this crisis may create fresh uncertainty for businesses, it is difficult to determine which indicators and measurements best reflect their performance during the COVID-19 outbreak (Kraus et al., 2020).

Early studies have also revealed that organisations' financial policies and corporate performance are significantly impacted on the revenue side, raising concerns about their sustainability (Kells, 2020; Larcker et al., 2020). Companies that sustain their agility and aggressively adjust their production, sales, and financial practices in response to the COVID-19 pandemic will probably have a better chance of surviving in the new normal (Mather, 2020).

China's COVID-19 prevention and control policies, which to some extent limit the external stakeholders' oversight of enterprise, increase the asymmetry of internal and external information, and foster the conditions for enterprise speculation, are examples of how the uncertainty of the pandemic has a significant impact on firm financial policies (Yuan et al., 2022). As a result, fund providers and investors must exercise greater caution because firms during pandemics often conceal their actual financial condition. In order to evaluate a firm's creditworthiness, it is crucial to have deeper insights into the reliability of accounting data. Overall, this study reveals that the uncertainty of financially distressed firms due to the pandemic impacts firms' financial policies by manipulating earnings using the real earnings management approach during the COVID-19 pandemic.

Increase Information asymmetry between Corporate Outsiders and Insiders

The impact of COVID-19 on business is extremely unusual, and it also has exerted various impacts on the firm's financial performance. As companies perform poorly and uncertainty in the overall economy grows, so does information asymmetry between insiders and outsiders. This has resulted in the rapidly deteriorating business performance of nearly every business sector globally.

During a pandemic, management may be more tempted to reduce or conceal their company's deteriorating performance and financial stability. Due to the increased information asymmetry and relaxed monitoring, the economic benefits of upward earnings management increase while potential losses decrease. Therefore, companies are more strongly motivated to manage earnings in these circumstances, and they are more tempted to fail to report poor financial performance or delay the timing of their reports (Ryu & Chae, 2022).

In new research from Ryu and Chae (2022), they found that the amount of company information asymmetry was determined by company size. A large company was set to have low information, where the more stakeholders a company has, the more difficult it is for management to make decisions contrary to its stakeholders' interests. On the other hand, small companies were set to have a high information asymmetry. This means distribution and service industries with high information asymmetry significantly increased earnings management during the COVID-19 post. Thus, managers may have incentives to increase information asymmetry between corporate insiders and outsiders under these conditions.

Hence, according to the research from Ryu and Chae (2022), their study found that the practice of earnings management during the post-COVID-19 was more evident in companies with higher information asymmetry and with a smaller number of stakeholders and a lower level of monitoring activities. This is because when information asymmetry is high, stakeholders lack adequate resources, incentives, or access to relevant information to monitor managers' actions, giving rise to the practice of earnings management. At the same time, stakeholders may not have the information required to undo manipulated earnings (Lasdi, 2013).

Conceptual Framework

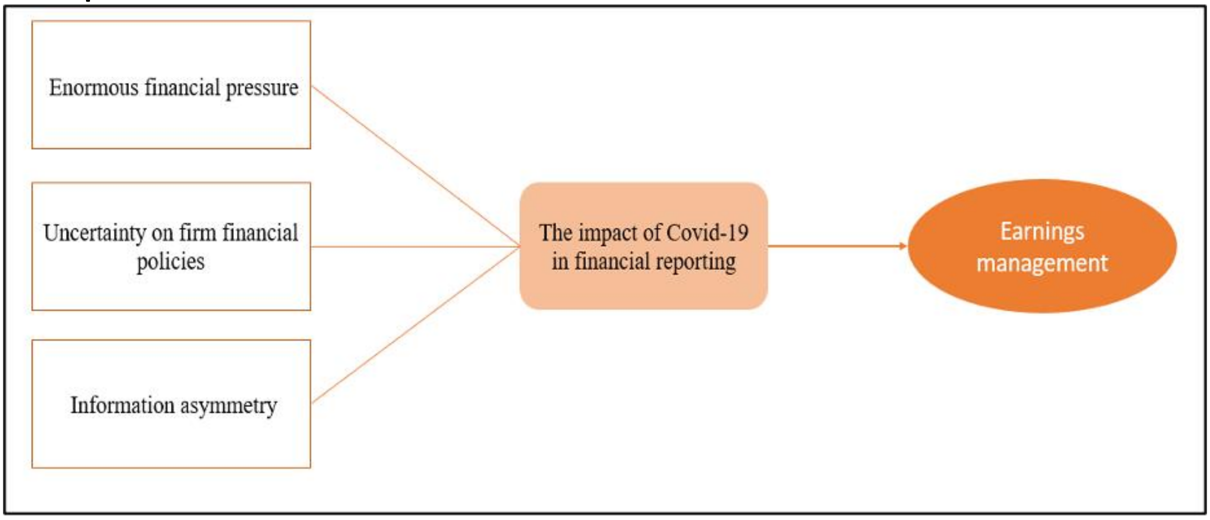

Figure 1: The Proposed Conceptual Framework for the Impact of COVID-19 on Earnings Management in Financial Reporting

The above conceptual framework is created to clearly understand the impacts of COVID-19 on earnings management which have brought enormous financial pressure, uncertainty on firm financial policies, and increased information asymmetry. All of these impacts of COVID-19 have brought an organisation to engage with earnings management in financial reporting. Figure 3 illustrates the impacts of COVID-19 on earnings management.

Conclusion

The COVID-19 outbreak has had a devastating impact on global health and economic systems. While most economic activities were halted during the general lockdown, the COVID-19 epidemic also resulted in a decline in firm profitability. Given the importance of accounting numbers for stakeholders during difficult times, this is a significant issue. As a result, this article looked into how the presence of a pandemic affected the majority of businesses and, ultimately, earnings management in financial reporting. This study discovered that as companies perform poorly and uncertainty in the overall economic growth, so does

information asymmetry between company insiders and outsiders in financial reporting. It also put enormous financial pressure on enterprises, and uncertainty has a significant impact on firm financial policies.
Nonetheless, even though earnings are managed, it would be naive to ignore cash flows. Earnings management is a fact of life in a world where managerial discretion can be abused and manipulated, which does not exclude all accounting. The current emphasis on financial accounting issues is encouraging, but it could be a passing fad related to people's morbid obsession with bad news. To avoid large-scale accounting fraud in the future, the challenge will be to maintain this momentum the next time the markets rise.

Recommendation

Most accounting fraud cases involving financial statement manipulation have included inadequate or non-existent internal controls, allowing organisation leaders to commit fraud. Internal controls are a company's first line of defense against financial data misreporting, whether caused by unintentional error or intentional fraud. It is critical to implement various internal controls in order to increase the system's accountability and transparency. Several checks and balances discourage employees from falsifying financial data, engaging in fraud, and using dishonest accounting practices. Additionally, a system of internal controls and audit trails, as well as stringent documentation, verification, and sign-off requirements, can improve fraud detection and prevention. This reduces the risk of fraud and protects the company (Reciprocity, 2022).

Next, critical internal control is a formal, systematic process for reconciling all major accounts. For example, deposits should be compared to all incoming check logs. The company must ensure that bank statements and check cancellations are reviewed on a regular basis to ensure that bills are not issued out of order. It is critical to examine cancelled checks in order to ensure that only authorised individuals sign checks.

Apart from that, one should confirm the legitimacy of all vendors as well as the appropriateness of all endorsements, reimbursements, and expenditures. In accordance with the segregation of duties, reconciliation should be handled by a separate individual who has no check-signing or bookkeeping responsibilities. This designated individual must sign and date the reconciliation report to certify that it was completed; when it was completed, and by whom (Reciprocity, 2022).

Finally, internal controls are also required for inventory, equipment, and other assets to be reviewed. Throughout the year, inventory counts should be performed at random by someone who is not financially motivated to underreport. At least once a month, general journal entries should be reviewed. Any unusually large or unusually small sums should be noted and investigated as red flags. Wire transfers are a common form of fraud, especially in offshore bank accounts. As a result, audit or compliance officers should conduct regular reviews of such transactions to ensure that they are legitimate, involve authorised parties, and are supported by adequate documentation (Reciprocity, 2022).

Acknowledgements

The authors would like to express their gratitude to the Faculty of Accountancy, Universiti Teknologi MARA, Malaysia, for funding and facilitating this research project.

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