

EFFECT OF FAIR VALUE ACCOUNTING ON EARNINGS QUALITY OF NIGERIA DEPOSIT MONEY BANKS.

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ABSTRACT

The effect of fair values on the earnings quality of selected banks in Nigeria is the main thrust of this work. To achieve this, the relationship between fair values and earnings quality was examined to determine its nature, and the effect of fair value adoption on earnings quality. Ten banks were purposively selected for the study using the data on their annual financial statements for period, 2012- 2016, for analyses. The dependent variable is earnings quality (EQ), proxied by predictability (PRED) of earnings; while the independent variables are fair value through other comprehensive income (FVTOCI), log of total asset values (SIZE) and leverage (LEV). Employing ex-post facto research design using the panel data regression and correlation tests for analyses. The results showed that all the independent variables (FVTOCI, SIZE and LEV) have significant relationship with the dependent variable (EQ). The F-statistic, 0.000070 is significant at 5% level of significance. The adjusted R² indicated that about 49.61% variation in the EQ is as a result of FVTOCI, SIZE and LEV. The remaining 50.39% variation is due to variables not reflected in this model. It is recommend that management of banks should consider the state of the stock market and the economic climate while adopting fair value., Financial Statement regulators need to be forthcoming on conditions that favour the application of fair values in order not to impair earnings quality of banks.

Keywords: Fair values. Earnings quality, Predictability, Size, leverage

INTRODUCTION

The approach by which firms measure and report, on continuous basis, certain assets or liabilities (most importantly financial instruments) at the current amount they would

receive if the assets were to be sold or amount to be paid if they were to be relieved of the liabilities is described as Fair Value Accounting (FVA) (Ryan, 2008; Ijeoma, 2013). Generally Accepted Accounting Principles (GAAP) defined fair value as the amount at which an asset can be purchased or sold in the most recent trading activities between buyers and sellers other than what such assets would have earned in liquidation and such amount as could be incurred or settled in current transaction between willing parties, for liability other than liquidation. It is considered the most useful market feature used in judging the quality of financial reporting (Prochazka, 2011). Power (2013) asserts that adopting fair value for accounting measurement will definitely show better economic changes (in terms of net assets and earnings) than historical cost convention.

Francis, LaFond, Olsson and Schipper (2004) point out that earning provides useful information to various stakeholders and it is an important ingredient for decision-making to investors (Ebirien & Nwanyanwu, 2017). Schipper and Vincent (2003) and Dechow, Ge, and Schrand (2010) averred that high quality reported earnings should reflect the firm's present operating profitability, future performance and its inherent value. Earnings quality has gained the attention of scholars, standard setters, professionals and other stakeholders for multiple reasons. It is a prominent parameter for assessing the financial performance of an economic entity.

High earnings quality is used to predict the future performance of the entity and forecast cash flows (Ronen & Yaari, 2008). The significance of earnings quality to the banking sector was underscored by Gadhia (2015), who stated that the banking sector's sustainability, competitiveness and healthy growth could be determined through earnings quality. It is to this end that Soludo as governor of Nigeria's Central Bank stated that any failure in the banking sector can be disastrous to the economy considering their intermediary role as principal depositories of financial savings and avenue for the implementation of monetary and credit policies (Okpara & Ihenacho, 2014).

Banking and accounting regulators around the world and indeed the U.S. Congress, the European Commission are concerned about the contributions of FVA to recent global financial meltdown (American Bankers Association, 2009). Critics argue that FVA, often also called mark-to-market accounting (MTM), has significantly contributed to the financial crisis and exacerbated its severity for financial institutions in the U.S. and around the world. This may be so because fair value measurement is ridden with inconsistency of measurement within financial statements and could bring about volatility of earnings due to mismatch (Barth, 2004). The mixture of measurement bases used hinder the users from making judgement on what happened with their money in the area of stewardship function of accounting and what management will be able to do with their money in taking meaningful decision (Abdel-Khalik, 2008; Chea, 2011).

Again, earnings reported under fair value will be distorted when errors and manipulations are included in the estimates fair value earnings will be biased when fair values are estimated with an error or are manipulated (Landsman, 2007; Danbolt and Rees, 2008; Ijeoma, 2013). The reliability of fair value measurement is impeded in inactive and illiquid markets, under mass sale out of a particular asset; when market prices are rapidly falling or when markets suffer from lack of liquidity. On the other extreme, proponents of FVA argue that it merely played the role of the proverbial messenger that is now being shot (Turner, 2008; Veron, 2008).

Many works have been carried out on fair value measurement and financial service sector: Ryan(2008), Magnan (2009) and Prochazka (2011) worked on the role of fair value measurement and financial crunch; Gadhia (2015) and Ebirien and Nwanyawu (2017), assessed earning quality of financial sector; Barth (2004), Bachert and Kajuter (2010) and Ijeoma (2013), worked on fair value accounting and financial statement reporting;; Paoloni, Paolucci and Menicucci (2017), worked on fair value accounting and earnings quality with evidence from Europe. It is remarkable to note that considerable research attention has not been given to the extent to which fair values influenced earnings quality in Nigeria Deposit Money Banks. Most of the studies previous on this subject have been of foreign context. There exist an apparent need to domesticate the concept and its application, thus providing the impetus to carry out this study. The objective of this study therefore, is to examine the effect of fair values on earnings quality of selected Deposit Money Banks in Nigeria.

LITERATURE REVIEW

Fair Value Accounting

Fair value is the price agreed by a willing buyer and a willing seller in an arm's length transaction. Fair value is market-based measurement, which is not entity-specific. As observed by Ijeoma (2014), fair values exhibit "the most current and complete" value estimates of financial assets and liabilities reflecting the amounts, timing, and riskiness of the future cash flows attributable to such assets or obligations (IFRS 13, IFRS 9 and IAS 39). It is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Measurement is a key factor in determining the reliability and relevance of reported details in financial statements, especially with respect to its assets, liabilities and equity.

Some authorities have pointed to FVA as a major factor responsible for issues in financial markets. In their opinion, FVA is suitable to entities whose business is construed on fair values and trades in financial assets. It was held that it can be misleading and improper to apply fair values for commercial banks portfolio of financial assets during crisis and when

there is liquidity problems in the markets (American Bankers Association, 2009; Ijeoma, 2013). However, estimation of fair value (marking-to-model) creates opportunities for the exercise of management judgment and intentional bias which can decrease the quality of financial reporting (Nissim, 2003; Ryan, 2008).

Fair Values and the International Financial Reporting Standard (IFRS).

Recently, there is a global trend towards adopting International Financial Reporting Standards (IFRS) in the banking industry using FVA (IFRS 13), this has been supported by international organisations like World Bank, International Monetary Fund and Financial Stability Board (Jayasekara, Perera & Ajward, 2018). This will enhance single high-quality global accounting standards (World Bank 2017; FSB 2015). Fair value concept in the banking industry emerged as a result of introducing accounting standards for financial instruments measurement (IFRS 9 and IFRS 7) in 2010 to replace IAS 39 (Jayasekara at al 2018).

Nigeria being one of the 126 countries out of profiled 150 countries that have adopted IFRS (IFRS foundation, 2017) incorporated fair value in the financial statements of banking industry since 2012 which replaces the local Generally Accepted Accounting Standards (GAAP) to enhance comparability and enable them raise fund (debt and equity) within and outside their shore (Umoru & Ismal 2013; Uwuigbe & Abuwa 2014). Adoption of IFRS 13 brings quality to financial statement of banking sector in terms of globalization but challenged with inactive market, skill shortage, government control and weak regulatory environments among others.

Earnings Quality

Earnings quality reflects how much reported earnings are pointers to corporate profits in future. (Jim, Mark, Tomassini & David 2012). Investors and other users of financial statements view earnings quality as a recipe for capital market efficiency considering its appeal in depicting the quality of earnings. (Ewert & Wagenhofer, 2010). Thus, EQ refers to how much earnings depict actual performance of the company (Dechow & Schrand, 2004).

The characteristics of high earnings quality are relevance, faithful representation, comparability, verifiability, timeliness and understandability, as formulated in conceptual framework for high earnings quality by Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB 2008). Earnings predictability points to the ability of earnings to occur as planned. Following previous research of Lipe (1990) and Kousenidis, Ladas, & Negakis (2013), earnings predictability (PRED) is identified with the adjustment of earnings shocks, where higher variance indicates lower predictability. Thus, large values of PRED entails less predictable earnings and lower earnings quality (EQ) while

small values of predictability PRED indicates more predictable earnings and higher EQ. More predictable earnings are assumed higher quality earnings.

Fair Values and Earnings Quality - A Conceptual Approach

Exposure to Fair Values is computed by income statement approach (Hodder, Hopkins, & Wahlen, 2006). Large amount of financial instruments (assets and liabilities) are reported by banks and these are recognized at fair value in accordance to IAS 39 and IFRS 9. Hence, reported net gains (losses) at Fair Value Through Other Comprehensive Income (FVTOCI) is applied to measure the extent of fair values recognized in banks' income statements.

Some debt instrument assets must be classified by FVTOCI where fair value is not adopted. Net income from profit and loss statement is added to other comprehensive income (mostly fair value adjustments not allowed in profit and loss statement) and shown in the statement of comprehensive income. So, comprehensive income is the sum of net income and other comprehensive income, which includes items that are not recognized in income statement because they have not been realized. Two control variables (size and leverage) are adopted fixed in examining the influence of unrealized fair value gains (losses) on EQ.

Conceptual Framework

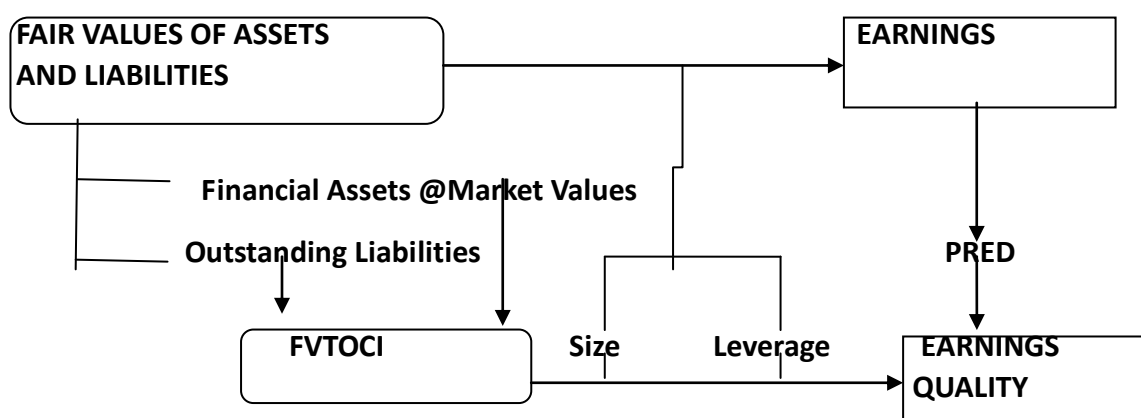


Fig. 1 Conceptual Framework

Theoretical Framework: Agency Theory

Agency theory was propounded by Jensen and Meckling in 1976. They explained that agency relationship arises when the business owner(s) employ another person and saddled such with the responsibility of managing their business or performing a service on their behalf. This entails delegation of some decision-making authority to the agent, it usually results into division of labour and might be advantageous in the advancement of resourceful and productive economy (Hoitash, Hoitash & Bedard, 2008). The agents according to Pauloni (2017) are expected to act in the best interests of the principals. In this study, management is the agent with the responsibility of delivering high quality earnings that can positively

predict future earnings of Deposit Money Banks in Nigeria to the principals (stakeholders), which may include the shareholders, creditors, new investors and others. Furthermore, agency relationship exist in order to utilize the special skills and private information possessed by the agent and also to relax constraints on the principal's time but due to rationality in human reasoning, agents tend to pursue a personal goal which may contradict the goal of the principal or that of the business as a whole. In such situation, there is need for cross examination and proper monitoring of the agents by the principal thus requiring the attention of experts in harmonizing the discrepancies of interests between the principal and the agents (Herbohn, Ragunathan & Gardsden, 2007).

This paper is developed on Agency theory and its hypotheses derive from it. The agency framework requires that the quality of financial reports should reflect in the ability of earnings to guide the principal in the use of his resources and in ascertaining to what extent, the management is maximizing shareholders wealth.

Empirical Review

Various studies have been conducted on fair values and earnings quality across the globe although with divergent findings as to the relationship between them. Paoloni, Paolucci and Menicucci (2017), covered a period of ten years (2007-2016) of data on European banking sector. The authors depended on cross-sectional and time series data for panel data OLS regression analysis. They measured EQ using attributes like "persistence, predictability, variability and smoothing". Results of the study portray European banks with large fair values in their reports as having higher aggregate EQ, providing better tools for investors' decisions, reducing the risk in capital allocation decisions and enhancing management decisions in banks.

The study was focused on the European banks use and adoption of fair values in their financial statement and it identified and processed so many attributes of EQ which had not been prominent in Nigeria, except the estimation of predictability. The multidimensional aspect needs to be simplified to isolate the relative significance of the concepts. The study may need to be replicated in Africa to assess the comparability of findings and general application.

Ebirien & Nwanyanwu (2017) research into earnings quality of firms in the Nigeria financial services spanning from 2011 to 2015. Specifically, the study examines the differential earnings quality of Deposit Money Banks (DMBs) and insurance companies listed on the Nigeria Stock Market. The study employed panel technique to gain data efficiency after subjecting the data collected to normality test, multicollinearity test and Hausman test shows that random effect model is preferred to fixed effect model. Earnings quality is found to vary to various stakeholders and predicts that DMBs exhibit higher EQ than the insurance

companies. The work has successfully assessed earnings quality in isolation, it is therefore understandable that the conclusions were towards a comparative analysis of DMBs with Insurance firms. It would have been quite interesting to link this assessment to fair value adoption in Nigeria.

Ijeoma (2014), investigated the impact of fair value accounting on corporate financial reporting in Nigeria. The study employed field survey method of data collection which involved the use of questionnaire where 562 sample were used and was analysed using Kruskal – Wallis rank sum test statistic. The study established that adoption of fair values provided investors with more relevant information than conventional reporting. However, it was noted that the present structure of the Nigeria capital market may obstruct the implementation of fair values. Adoption of full fair value for financial instruments was found to fulfil the aims of performance reporting.

Ijeoma's study has concentrated on fair value accounting in isolation without a link to earnings quality but the discovery that the adoption of fair values is bedevilled by some challenges is remarkable especially in Nigerian context. Concluding that fair values fulfils the aims of performance reporting seem to be different from findings which highlight challenges. The link between the finding and the conclusion needs to be clarified. Above all, this study has not linked its findings to earnings quality which is more succinct than general outlook of financial reporting

METHODOLOGY

Variable Description and Model Specification

To measure the extent of fair values recognized in banks' income statements, FVOCI is divided by comprehensive income (CI) i.e. FVOCI/CI. Earning predictability was used as the proxy for EQ and this is the extent to which earnings can be predicted, i.e. the Square root of the error variance of Earnings. Thus, $PRED = \sqrt{\delta^2(V_{it})}$. We used log of Total assets as the size of the firm. The variable leverage (LEV) is calculated as the ratio of total liability (TL) to total assets (TA). Thus, $LEV = TL/TA$.

Model Specification

The model developed for this work is a regression model wherein:

$$Y = f(X)$$

Where $Y = \text{Earnings Quality}(EQ)$

$X = \text{Fair Values}$

And,

$$EQ = PRED.$$

$$X = X_1, X_2, X_3$$

Where,

$PRED = \sqrt{\delta^2(V_{it})}$. The Square root of the error variance of Earnings.

$$X_1 = FVTOCI_t$$

$$X_2 = Size$$

$$X_3 = LEV$$

μ is the error term

Thus, $PRED_t = \alpha_1 + \beta_1 FVTOCI_t + \beta_2 SIZE_t + \beta_3 LEV_t + \mu$

(Model developed by author, 2019)

Population and Sampling

Ten (10) MDBs for a period of 5 years (2012-2016). Purposive sampling method was used to select the sampled firms from the total population of 21 Banks. Selected MDBs include United Bank for Africa Plc (UBA), First Bank of Nigeria Plc (FBN), Zenith Bank Plc, Access Bank Plc, Guaranty Trust Bank Plc (GTB), Union Bank Plc, Citi Bank Nigeria, Fidelity Bank, Wema Bank and Diamond Bank.

Sources of Data

Secondary data were extracted from the annual reports and accounts of the sampled MDBs spanning from 2012 to 2016 which fall within the period of adoption of IFRS in Nigeria.

RESULTS AND DISCUSSIONS

Table 1 presents the descriptive statistics of the data. It presents the mean, median, maximum, minimum, Standard deviation, Sum and sum square dev. for all the variables used in the model.

Table1: Description of Banks by Size, Leverage and Earnings Quality

	FVOCI	SIZE	LEV	EQ
Mean	0.075316	21.03887	0.773346	0.115003
Maximum	0.963510	22.17809	0.898680	0.140019
Minimum	-0.353990	19.31964	0.005200	0.073275
Std. Dev.	0.212488	0.775460	0.230744	0.011949
Probability	0.000000	0.116491	0.000000	0.000001
Sum	3.765820	1051.944	38.66731	5.750138
Sum Sq. Dev.	2.212407	29.46554	2.608892	0.006997
Observations	50	50	50	50

Source: Researchers' Summaries and Computation from Annual Reports of Selected Banks

Table2: Diagnostic Test

Correlated Random Effects - Hausman Test				
Equation: Untitled				
Test cross-section random effects				
Test Summary		Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random		11.131130	3	0.0110
Cross-section random effects test comparisons:				
Variable	Fixed	Random	Var (Diff.)	Prob.
FVOCI	-0.001996	-0.000247	0.000001	0.1469
LEV	-0.117014	-0.021556	0.004876	0.1716
SIZE	-0.009185	0.006118	0.000046	0.0236

Source: Field Survey

The correctness of model specified was validated through diagnostic tests. The Hausman test probability showed 0.0110 which is lower than 0.05 specified; thus, we ran fixed effect.

Table 3: Regression results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.398883	0.148939	2.678162	0.0110
FVOCI	-0.001996	0.006008	-0.332301	0.7415
LEV	-0.117014	0.070916	-1.650046	0.1074
SIZE	-0.009185	0.007609	-1.207135	0.2350
Effects Specification				
Cross-section fixed (dummy variables)				
R-squared	0.619478	Mean dependent var.		0.115003
Adjusted R-squared	0.496066	S.D. dependent var.		0.011949
S.E. of regression	0.008483	Akaike info criterion		-6.482670
Sum squared resid	0.002662	Schwarz criterion		-5.985544
Log likelihood	175.0667	Hannan-Quinn criter.		-6.293361

F-statistic	5.019574	Durbin-Watson stat	1.615232
Prob(F-statistic)	0.000070		

Source: Field Survey (2020)

INTERPRETATION OF RESULTS AND DISCUSSIONS

The dependent variable is earnings quality (EQ) while the independent variables are fair value Through Other Comprehensive Income (FVTOCI), Size of Asset (SIZE) and Leverage (LEV). The regression and correlation analyses results showed that all the independent variables (FVTOCI, SIZE and LEV) have significant but negative relationship with the dependent variable (EQ). The F-statistic of 0.000070 is significant at 5% level of significance. The R² adjusted indicated that about 49.61% variation in the EQ is as a result of FVTOCI, SIZE and LEV. The remaining 50.39% variation is due to other variables not in this model.

This implies that fair value has a negative effect on predictability of earnings and thus could be misleading if depended upon by investors for the purpose of investments. This contradicts the agency duties of directors who are expected to seek the best interests of the principals (shareholders) as explained by (Pauloni, et al., 2017). The significance of other variables not captured by the measurements in the model as well as the level of development of Nigeria's capital market had effects on the results as observed by Ijeoma (2014).

CONCLUSION AND RECOMMENDATIONS

The study concluded that that fair value has a significant to Earnings Quality. When the intervening variables, Size and Leverage of the Banks are considered, earnings quality shows a negative relationship thus may not be a dependable basis for predicting earnings, hence making investment decision. The impact of fair value accounting on earnings quality is quite significant but negative. With the adoption of Fair Values, Earnings predictability of Nigerian Deposit Money Banks became quite high due to the variability of income. This impairs the earnings quality and thus affects the choices that stakeholders can make.

It is recommended that the adoption of fair values in Nigerian Deposit Money Banks should be made to affect both the financial assets and the liabilities, especially the ones that connect to redemption of debt instruments issued by bank. Besides, the recent economic changes and shocks have told significantly on the earnings pattern of financial institutions in general and banks in particular, giving data on earnings with wide variation. Thus, adoption of fair value at such a period as this will distort the realities that accounting and financial reports are meant to portray. Financial statement regulators should be clear on

what to do under such circumstances as this when stock market is quite unstable is challenged by liquidity.

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