

**EARNINGS QUALITY AND MANDATORY ADOPTION
OF INTERNATIONAL FINANCIAL REPORTING
STANDARDS: THE CASE OF NIGERIA**

BY

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ABSTRACT

The world has transformed into a unified basis of financial reporting as a result of the continuous rise in the application of international financial reporting standards (IFRS). This transformation has changed accounting standards from rules-based to principles-based. However, the consequence of IFRS implementation remains unclear, especially from high level pre-adoption divergent environments. Thus, this study investigates the general and differential effects of IFRS adoption on earnings quality of listed firms in Nigeria over SAS period (2007-2011) and IFRS period (2012-2016) moderated by both audit committee effectiveness and expertise. Employing quantitative data analysis, the study utilises secondary data obtained from annual reports and accounts of 77 listed companies. Several hypotheses were advanced based on institutional and agency theories. The hypotheses were tested through panel regression analyses and majority of the findings are consistent with the theoretical expectations. Regarding the general effects on the one hand, the findings reveal that earnings quality of listed firms in Nigeria decreases subsequent to IFRS adoption. Likewise, regarding the differential effects on the other hand, the analyses reveal that the magnitude of the deterioration varies across adopting firms as some firms' attributes like Big 4 audit firms and profit, play significant roles in curtailing the magnitudes of earnings quality deterioration during IFRS period. Finally, the study found that both audit committee effectiveness and expertise moderate the association between IFRS adoption and earnings quality. After conducting several sensitivity analyses, the findings from these analyses are consistent with the main findings of the study. All these findings have some policy and theoretical implications. The outcome from this study will enable regulators, especially the Nigerian SEC and Financial Reporting Council (FRC) of Nigeria to put appropriate measures in place for the realization of all the benefits associated with IFRS implementation and the need to take some proactive measures with regards to the composition of the audit committee. With regards to theoretical implications, the study contributes to the extant literature by supporting the agency theory as audit committee characteristics strengthen the association between IFRS implementation and earnings quality on the one hand and by lengthening the discussions on IFRS implementation on the other hand.

خلاصة البحث

تحول العالم إلى أساس موحد للتقارير المالية نتيجة للارتفاع المستمر في تطبيق معايير التقارير المالية الدولية (IFRS). لقد غير هذا التحول المعايير المحاسبية من القواعد إلى المبادئ. ومع ذلك، لا تزال نتيجة تطبيق المعايير الدولية للإبلاغ المالي غير واضحة، خاصة من البيئات المتباينة عالية المستوى قبل التبني. وبالتالي، تبحث هذه الدراسة في الآثار العامة والتفاضلية لاعتماد المعايير الدولية لإعداد التقارير المالية على جودة أرباح الشركات المدرجة في نيجيريا خلال فترة SAS (2007-2011) وفترة إعداد التقارير المالية الدولية (2012-2016) بإشراف كل من فعالية لجنة التدقيق وخبرتها. باستخدام تحليل البيانات الكمية، تستخدم الدراسة البيانات الثانوية التي تم الحصول عليها من التقارير السنوية وحسابات 77 شركة مدرجة. تم تطوير العديد من الفرضيات بناءً على النظريات المؤسسية والوكالات. تم اختبار الفرضيات من خلال تحليل المنحدر لوحدة ومعظم النتائج تتفق مع التوقعات النظرية. فيما يتعلق بالتأثيرات العامة من ناحية، تكشف النتائج أن جودة أرباح الشركات المدرجة في نيجيريا تتناقص بعد اعتماد المعايير الدولية لإعداد التقارير المالية. وبالمثل، فيما يتعلق بالآثار التفاضلية من ناحية أخرى، تكشف التحليلات أن حجم التدهور يختلف باختلاف الشركات التي تبني، حيث تلعب سمات بعض الشركات مثل شركات التدقيق الكبرى الأربعة والربح دورًا مهمًا في الحد من تدهور جودة الأرباح خلال المعايير الدولية للإبلاغ المالي. فترة. وأخيراً، وجدت الدراسة أن كلاً من فعالية لجنة التدقيق وخبرتها يخففان من الارتباط بين تبني المعايير الدولية لإعداد التقارير المالية وجودة الأرباح. بعد إجراء العديد من تحليلات الحساسية، تتوافق نتائج هذه التحليلات مع النتائج الرئيسية للدراسة. كل هذه النتائج لها بعض الآثار السياسية والنظرية. ستمكّن نتائج هذه الدراسة الجهات التنظيمية، وخاصة مجلس SEC النيجيري وإعداد التقارير المالية (FRC) في نيجيريا من وضع التدابير المناسبة لتحقيق جميع الفوائد المرتبطة بتنفيذ المعايير الدولية للإبلاغ المالي والحاجة إلى اتخاذ بعض التدابير الاستباقية فيما يتعلق ب تكوين لجنة التدقيق. فيما يتعلق بالآثار النظرية، تساهم الدراسة في الأدبيات الموجودة من خلال دعم نظرية الوكالة حيث أن خصائص لجنة التدقيق تقوي العلاقة بين تنفيذ المعايير الدولية لإعداد التقارير المالية وجودة الأرباح من ناحية وإطالة المناقشات حول تنفيذ المعايير الدولية للإبلاغ المالي من ناحية أخرى.

APPROVAL PAGE

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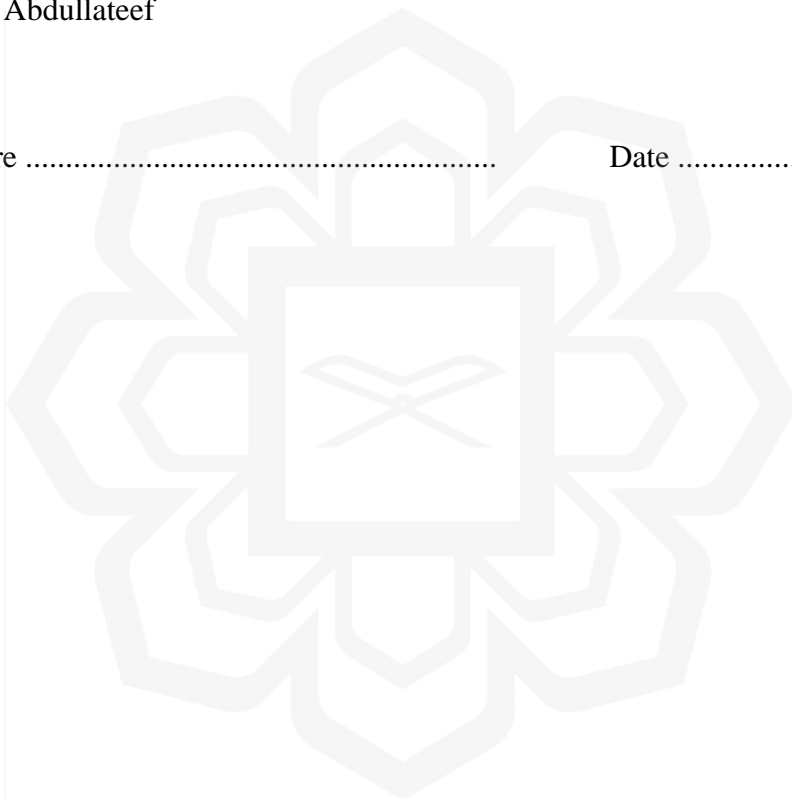
DECLARATION

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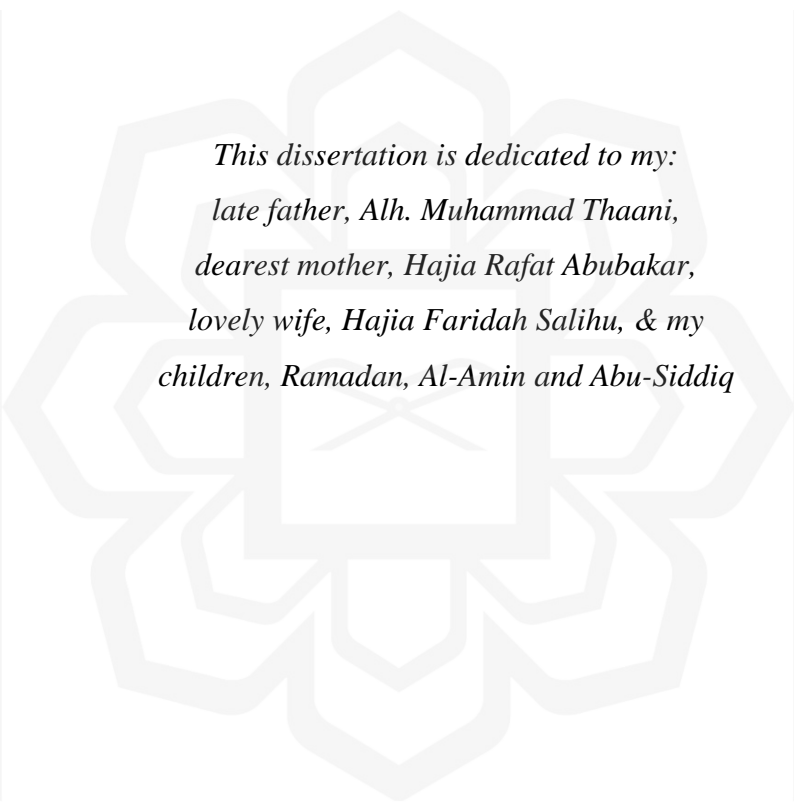
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*This dissertation is dedicated to my:
late father, Alh. Muhammad Thaani,
dearest mother, Hajia Rafat Abubakar,
lovely wife, Hajia Faridah Salihu, & my
children, Ramadan, Al-Amin and Abu-Siddiq*

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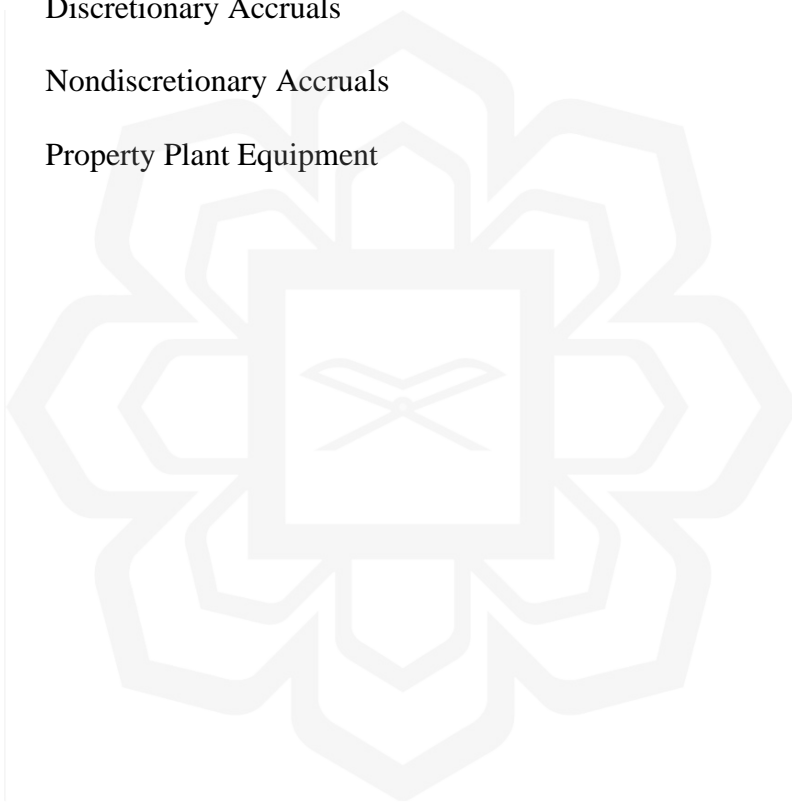
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LIST OF ABBREVIATIONS

AAN	Association of Accountants of Nigeria
BOFIA	Banks and Other Financial Institutions Act
CBN	Central Bank of Nigeria
EU	European Union
FASB	Financial Accounting Standards Board
FRC	Financial Reporting Council
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
GLS	Generalized least square
IAS	International Accounting Standards
IASB	International Accounting Standard Board
IASC	International Accounting Standard Committee
ICAN	Institute of Chartered Accountants of Nigeria
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
LM	Lagrange Multiplier
NAICOM	Nigerian Insurance Commission
NASB	Nigerian accounting standard board
NSE	Nigerian stock exchange
OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary least square

SAS	Statement of Accounting Standards
SEC	Securities and Exchange Commission
UN	United Nations
VIF	Variance inflation factor
WB	World Bank
NBS	Nigerian Bureau of Statistics
SFAC	Statement of Financial Accounting Concepts
DA	Discretionary Accruals
NDA	Nondiscretionary Accruals
PPE	Property Plant Equipment



CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

The continuous rise in the implementation of International Financial Reporting Standards (hereafter IFRS) has transited the world towards a new accounting paradigm (O'Connell, 2007; Horton, Serafeim, & Serafeim, 2013; Barth, 2015). The transition according to extant literature is propelled by the need to harmonize accounting standards and have a common basis for financial reporting in order to guarantee inter-border comparability and high level of transparency (Daske & Gebhardt, 2006). What further pushes this transition is the integration of markets across jurisdictions.

Nowadays, firms look beyond national borders for investments and subsequently, companies compete for customers across continents. Currently, both local individuals and institutional investors hold shares and securities of international companies, thus, making the cost of international investment more costly due to differences in standards guiding the preparation of the general-purpose financial information. Therefore, to facilitate proper comparison and ease of doing business, it is necessary to have unified accounting standards applicable across nations. The uniform standards will ensure adequate decision making, leading to proper capital allocation in any country of the world.

In recognition of the above need, International Accounting Standards Board (IASB) was formed and saddled with the obligation of issuing high quality standards acceptable to all nations and capable of promoting transparency in corporate reporting

(Chebaane & Othma, 2014). To this end, the board which was created in 2001 has continued to pursue and promote this course of global acceptance and adoption to the extent that IFRS has become a global financial reporting benchmark. The standards which are principles-based set of standards with established rules and some dictates to particular treatments, represent basis of corporate reporting for most nations in the globe. In other words, 166 countries across continents require or allowed the adoption of IFRS, including emerging economies in Africa since 2002 when it was first launched. And a good number of remaining countries are on the verge of adoption (IFRS, 2018).

The benefits of adopting IFRS is of great significance to regulators (Chen, Jiang, & Skerratt, 2015) as well as reporting entities. Prior studies have documented that companies disclosing IFRS-based financial statements exhibit greater accounting quality compared to companies disclosing based on domestic standards (Ali, Akbar, & Ormrod, 2016; Chiha, Trabelsi & Hamza 2013). Similarly, IFRS has resulted to greater comparability of corporate financial statements (Landsman, Maydew, & Thornock, 2012). Additionally, extant studies have documented positive effects of IFRS adoption on capital markets such as, increased investment opportunities (Amiram, 2010; Yu, 2010; Covrig et al., 2007), liquidity and capital market improvement and cost of capital reduction (Daske et al., 2008; Jeanjean & Stolowy 2008; Li, 2010; Schleicher et al., 2010), and more accurate predictions (Horton et al., 2013; Byard et al., 2011; Tan et al., 2011). In all, Landsman (2007) suggests that IFRS promotes and enhances more accurate financial disclosure than local GAAP.

In order to confirm the above benefits linked with IFRS adoption, numerous literature have examine the consequence of IFRS adoption ranging from countrywide studies (Paananen & Lin, 2009; Doukakis, 2010; Iatridis & Rouvolis, 2010; Pascan & Turcas, 2012; Chiha, Trabelsi & Hamza, 2013; Liu & Sun, 2015; Ali, Akbar, &

Ormrod, 2016), continent specific studies (Daske & Gebhardt, 2006; Chen, Tang, Jiang, & Lin, 2010; Aubert & Grudnitski 2012; Doukakis, 2014) to cross continents studies (Cai et al., 2014; Jeanjean & Stolowy, 2008).

One striking revelation from the above studies is evidence of contrasting results on the impact of adopting IFRS even in nations where it was first launched (like the UK) and countries whose local GAAP appearing grossly similar to IFRS (such as the UK, Canada and Australia). For instance, in a study of 15 EU nations Chen et al., (2010) find that accruals quality is higher after IFRS. This finding was further supported by the findings of Chiha, Trabelsi and Hamza (2013) who posit that post-IFRS's earnings quality is higher compared to pre-IFRS's earnings quality. In contrast, the findings of Paananen and Lin (2009); Kabir, Laswad and Islam (2010); Callao and Jarne (2010) reveal a decline in earnings quality as earnings management were significantly higher during IFRS period.

The existence of these mixed results on the consequence of IFRS adoption could possibly be as a result of three factors which earlier works have flouted. First, there is a high level of divergence between domestic standards of some countries prior to IFRS implementation. For instance, In Nigeria there are 15 remarkable differences between domestic standards and IFRS (Ikpefan & Akande, 2012). Sequel to this, findings from environments with a high level of pre-adoption divergence are expected to give new insight into the consequences of IFRS implementation. Second, firms differ in terms of their attributes, such as healthiness, choice of audit firms and degree of reliance on fair value measurement which invariably influence their approach to IFRS implementation. This is premised on the argument that adopting firms will not benefit equally from IFRS implementation (Chen, Jiang & Skerratt, 2013). Third, the strategy to IFRS implementation differs from country to country. For instance, after the

pronouncement of adoption in 2010 companies in Nigeria were immediately compelled to begin transition in the subsequent year without room for sufficient preparation despite absence of voluntary application. This is contrary to what was obtained in other nations like UK, New Zealand, Germany and Canada where they all started by allowing their companies to voluntarily apply IFRS before it was made mandatory (Cai, Rahman & Courtenay, 2014). Similarly, for a better implementation, the Canadian Accounting Standards Board made a pronouncement to adopt IFRS over five-year transition period (Burnett, et al., 2015) contrary to Nigeria that allowed three-year transition period despite the complex nature of IFRS. This adoption strategy presupposes that previous empirical findings dominants in UK, Canada, France, Australia and Germany will not be the same in the context of Nigeria.

Therefore, it becomes expedient to consider these three factors and examine the consequence of implementing IFRS from a pre-adoption divergent environment as it is expected that findings from this environment will not yield similar results with countries whose local GAAP is grossly similar to IFRS. Accordingly, in order to enrich the existing studies and as a way of contributing to extant literature, the current study considers these three factors and investigates the impacts of IFRS adoption in a pre-adoption divergent environment on earnings quality of firms. Testing adoption effects on earnings quality are necessary because earnings are the most reliable and utilise summary measure of accounting information than any other one. In addition, earnings are the general reflection of past, current and future state of affairs of firms. That is why both known and unknown investors use earning numbers not only to assess the performance of firms but also for firm valuation and resource allocation.

In specific terms, the study investigates the general and differential impact of IFRS adoption on earnings quality by concentrating on the areas capable of influencing

the impact of IFRS adoption on the quality of reported earnings. The differential examination is necessary especially from the Nigeria context where there is a high level of pre-adoption divergence between Nigerian standards (statement of accounting standards) and IFRS, absence of voluntary adoption and insufficient transition time lag. These three factors propelled adopting firms in Nigeria to approach IFRS differently. Accordingly, there would be disparities in the effects of IFRS implementation on earnings quality across these firms. As a further contribution to extant studies, the current study emphasises on the differential effect of IFRS adoption on earnings quality by including into the study's models some peculiar firms' attributes (such as profit, audit firms and level of fair value reliance) that are capable of yielding variation in earnings quality subsequent to IFRS adoption. Consequently, the study assesses the variation in the rate at which IFRS adoption affect the quality of reported earnings heterogeneously.

In addition, the importance of corporate governance in stimulating earnings quality through oversight functions in the reporting process cannot be overemphasised. In fact, the two cannot be dichotomized. On the basis of this, Sloan (2001) affirms that financial accounting and corporate governance are inevitably connected. Therefore, in order to ensure high quality financial reporting, several monitoring devices are put in place among which include board for audit committee. The role of audit committee is essential not only on the overall board performance but also on the quality of financial reporting. Therefore, audit committee is a significant mechanism in the corporate governance effectiveness (Anderson et al., 2004; Zhang et al., 2006; Salehi & Shirazi, 2016) for ensuring high quality financial statements (Carcello & Neal, 2000). To this end, the study expects audit committee to provoke earnings quality. Hence, this study

also examines the nexus between audit committee attributes and quality of reported earnings.

Furthermore, from the perspective of institutional theory, the decision for IFRS adoption in Nigeria to a greater extent was engendered by institutional isomorphism. This can be inferred from the IFRS adoption strategies employed, propelled by various donors and aids institutions. Thus, the anticipated benefits from the IFRS adoption may not be witnessed by listed firms in Nigeria in a similar manner. To overcome this, corporate governance of individual firms can ensure proper application and compliance with the provisions of IFRS so as to ensure that the associated benefits of implementing IFRS are achieved. Similarly, IFRS is a principles-based standard with inherent flexibility and judgement. These flexibility and judgement according to some commentators give managers reasonable discretion which can be used opportunistically thereby deteriorating the quality of reported figures. To overcome this pitfall, Krismiaji, Aryani, and Suhardjanto (2016) observe that certain monitoring mechanisms (through audit committee effectiveness and expertise) are needed to daunt managers from utilising the flexibilities entrenched in IFRS opportunistically, as the two characteristics will stimulate high quality and credibility of financial reporting because of their governance roles in improving the performance of adopting firms (Nelson & Devi, 2014). More so, due to the complex nature of IFRS and its susceptibility to frequent amendment, effective audit committee members with more expertise and knowledge are needed in ensuring that both higher quality and transparency associated with IFRS-based financial statement are achieved. Consequently, firms with audit committee devoid of effective and expertise members are susceptible to disclose dishonest financial statements (Farber, 2005) thereby curtailing the quality of reported earnings. Hence, this study further investigates the moderating roles of audit committee effectiveness and

expertise in the nexus between IFRS adoption and earnings quality which previous study also flouted.

Conclusively, the current study investigates the overall and differential effects of IFRS adoption on earnings quality together with the effects of audit committee effectiveness and expertise in the nexus between IFRS adoption and earnings quality from the context of Nigeria. Paucity of documented studies in this area of research in Nigeria is noticeable. Also, the peculiar nature of Nigeria makes it an interesting area for research, especially after the adoption of IFRS (Ayuba, 2012). The uniqueness of Nigeria, coupled with the caution of the IASB that adopting IFRS is not like an application that is easily downloaded and applied (IFRS, 2015), presupposes that previous empirical findings will not be the same in the context of Nigeria particularly that the Nigerian GAAP largely differs from IFRS and also that much criticism has been labelled against cross-country studies. Research in this area will obviously have theoretical, practical and policy significance as discussed under Section 1.6.

1.2 MOTIVATIONS FOR THE STUDY

The current study is inspired by numerous factors majorly discussed under the following headings: 1) IASB call and IFRS adoption strategy in Nigeria, 2) Issues associated with IFRS adoption and conflicting findings and 3) flexibilities in IFRS.

1.2.1 IASB Call and IFRS Adoption Strategy in Nigeria

This study is motivated by IASB's call on the need to understand how IFRS affects individual adopting country of the world especially developing or emerging economies like Nigeria. Responding to this call would enable the board to know the consequence of implementing IFRS especially from a pre-adoption divergent environment.

Nigeria followed a unique IFRS adoption strategy which differs from other countries. After the pronouncement of adoption in the dawn of 2010, companies were immediately compelled to adopt IFRS with only one year of transition notice. This approach did not give adopting firms sufficient time to prepare for the strange standards since there was absence of voluntary application in the country before this period. This strategy is at variance with other countries like Canada, UK, Germany and New Zealand where they all started by allowing their companies to voluntarily apply IFRS before it became mandatory. This strategy allows effective IFRS take-off. Similarly, the Canadian Accounting Standards Board made a pronouncement to adopt IFRS over a five-year transition period. By this, their adopting firms will have sufficient opportunity to understand the complex nature of the standards for appropriate application.

Therefore, understanding how IFRS adoption affects the individual country is necessary not only to IASB but to the respective country. Up to recent, there are no serious empirical discussions on whether the earnings of listed firms in Nigeria have improved or deteriorated subsequent to IFRS implementation. Evidence from this study is of particular importance to Financial Reporting Council (FRC) of Nigeria especially as they relate to future IFRS-related decisions.

The economy of Nigeria is a diverse economy with expanding finance, manufacturing communication and service sectors. Although the economy is still typical of an underdeveloped nation (Chete, Adeoti, Adeyinka, & Ogundele, 2014), it is ranked as the 27th-largest economy in the world in terms of nominal GDP, and the 22nd-largest in terms of purchasing power parity. Following the successful rebasing of the nation's Gross Domestic Product (GDP), Nigeria is now Africa's largest economy as of 2015. Consequent upon this revelation, findings from this study will not only benefit other underdeveloped economies but other neighbouring countries on the