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EFFECT OF FAIR VALUE ACCOUNTING ON EARNINGS PREDICTABILITY OF LISTED COMMERCIAL BANKS IN NIGERIA

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Abstract

This study examined the effect of fair value accounting on earnings predictability of listed Commercial banks in Nigeria. It aimed to evaluate the effect of fair value intensity as well as fair value measurement hierarchy level two on the earnings predictability of listed Commercial banks in Nigeria. Correlational research design was used to assess the effect of fair value accounting on earnings predictability of listed Commercial banks in Nigeria. The population and sample of the study consist of all 16 listed Commercial banks in Nigeria as at 2022. Panel data regression was adopted for the study and the random effect model was selected as the Hausman specification test showed a non-significant result. The study specifically found that fair value intensity has a significant positive association with earnings predictability of listed banks in Nigeria, indicating that the higher the proportion of assets at fair valued, the higher the predictive power of earnings of listed banks in Nigeria. Fair value level two has significant negative relationship with earnings predictability of listed commercial banks indicating that high use of fair value level two measurement input lowers the predictive ability of earnings of listed commercial banks in Nigeria. From the findings it is recommended that Security and Exchange Commission and Central Bank of Nigeria should create enabling environment for active corporate debt instruments market to improve the reliability of fair value measurements. Financial Reporting Council of Nigeria should develop and impose stiff penalties against entities that abuse fair value measurement levels to serve as a deterrent. Auditors and regulatory staff of CBN should be adequately trained to detect sharp practices involving fair value measurement. CBN should put in place robust supervisory and regulatory policies that ensure reliable measurement of fair values of financial instruments.

Key words: Fair value, earnings, predictability, commercial banks

Introduction

Financial reporting among others aims to provide information that are relevant to current and prospective creditors, investors and other stakeholders in investment and other reporting to provide information regarding operating performance that enables providers of capital to predict the timing, risk and amount of an entity's future earnings. This means that earnings predictability is a very important attribute of earnings reported in the financial statements of

entities. IASB (2012) believes that fair value accounting result in financial statements that are more informative and of higher quality. Higher quality means less income smoothening, timely recognition of losses and more relevant accounting figures (Barth, Landsman & Lang, 2008). There is an on-going debate about the usefulness of fair value in predicting accounting earnings numbers of organisation. Promoters of fair value including Dechow, Mayers & Shakespeare (2010); Karaoglu (2005); Evans, Hodder, & Hopkins, (2014) among others assert that fair value is appropriate for financial assessment and provide three main arguments connecting fair values to future earnings: firstly, fair values sum up the present value of likely future cash flows and provide information about the riskiness and timing of its realisation and therefore are likely to be foretelling of future performance (CFA Institute 2005). Secondly, the fair value changes on certain financial instruments (such as, debt securities classified as available-for-sale securities), can be converted to realized gains and losses through the timing of asset sales thereby establishing a linkage between the fair values of financial instruments and measures of future performance (Evans, Hodder, & Hopkins, 2014). Thirdly, fair value accounting leads to earnings persistence and in formativeness for future performance measures (Dechow, Mayers & Shakespeare 2010; Karaoglu 2005). Therefore, earnings that result from accounting system with more fair value orientation may better foretell future earnings. Fair value intensity is a variable that measures the level of entity's financial statement's exposure to fair value based estimates. Daifei et al. (2015) document that the more exposed the financial statement of a bank is to fair value estimates the more predictable its future earnings will be from its current earnings. This study examines the effect of fair value accounting on earnings predictability of listed commercial banks in Nigeria. The effect of fair value accounting of financial instruments on the predictive ability of accounting earning numbers is the focus of this research. This is because financial instruments is the core assets of commercial banks and users of financial statement are in need of information that is useful in predicting the future performance of the entity in a bid to making appropriate decisions.

Literature review and hypotheses development

Theoretical framework

This study's theoretical framework anchored on a number of theories. Specifically, agency theory and signaling theory are the main theories underpinning this study.

The **Agency theory** explains the association that exists where the principal delegates work to the agent to carry out a given assignment. This association is described by Jensen and Meckling (1976) as a treaty where the owners engage managers to run the firms operations efficiently and effectively. Information asymmetry may result between the contracting parties as managers may be in possession of superior information about the present and expected future performance of the entity than the owners. Debatably, bank managers could have incentive to manipulate fair value estimates that promote their interest leading to biases in the information presented in the entity's financial statement (Ehalaiye et al. 2017). Aboody, Barth and Kasznik, (2006) assert that when accounting information is subjective and managers discretion allowed, intentional biases in the accounting aggregate estimates is very likely.

The **Signalling Theory** defined a signal is an observable action, sign or structure that is meant to convey an otherwise imperceptible virtue of something or environment. Signals basically are pointers to unobservable signaler's quality at a given point in time (Davila, Foster & Gupta, 2003). Signalling theory is primarily concerned with dipping information asymmetry between parties (Spence, 1973). For instance, Spence's (1973) work on labour markets established how an applicant might portray himself or herself to decrease information unevenness that hampers the choice of prospective employers. Spence

hypothesised how first-rate prospective employees differentiate themselves from low-grade prospects via the expensive signal of painstaking higher education. Management scholars have also used signalling theory to explain the power of information asymmetry in differing research contexts. The use of signalling theory in management literature has gained acceptance in recent years as scholars have lengthened the range of probable signals and the contexts in which signalling occurs. Financial instrument's fair value is a signal of the expected future cash flow and the difference thereon signals potential earnings. Signalling theory therefore provides a good explanation of fair value intensity, available for sales and total comprehensive income ability to predict future earnings

Conceptual framework

Concept of earnings predictability

This concept which holds that earnings is said to be more predictive if it provides additional information about an entity's future financial performance that is relevant for decision making. Two attributes to be noted about this definition of earnings predictability includes: Firstly, reported earnings' predictive ability depends on information it provides about the entity's future financial performance. Secondly, predictability is jointly determined by the ability of accounting system to accurately measure performance and the relevance of the reported financial performance to decision makers. Earnings predictability is therefore a good measure of higher earnings quality as measure by the ability of current earnings numbers to predict the entity's earnings one or more years ahead (Barth 2000).

Concept of fair value accounting

Fair value accounting is a financial reporting technique in which entities are required or allowed to measure and report certain assets and liabilities on an ongoing basis at estimates of the prices they would receive to sell the assets or would pay to transfer the liabilities in an orderly transaction between knowledgeable and willing market participants at the measurement date (IFRS 13). IASB (2010) defines fair value as "the amount at which an asset could be exchanged between knowledgeable and willing parties in an arm's length transaction at the measurement date". Fair value usually means the market value, if there is a deep and liquid market for the asset or liability; an estimate for which the asset can be realised (liability discharged) if active market value is not available. This estimation (mark to model) creates opportunities for the exercise of management discretion which may present a good opportunity to reduce information asymmetry by sending signal of the present value of the assets to the stakeholders. IFRS 13 identified fair value measurement which stipulates that a firm should determine the exact asset or liability that is being measured, (in case the assets are not a financial asset), the appropriate valuation basis for the measurement (depicting its best and highest use). The principal (or most advantageous) market for the asset or liability, the appropriate measurement technique(s) for the valuation, considering data availability for inputs development that best represent market participants assumptions in pricing of the asset or liability and the fair value hierarchy level in which the inputs are belongs.

The concept of fair value (exposure) intensity

This was conceptualized **by** Bratten et al. (2016) as fair value intensity is the proportion of an entity's assets that are fair valued (total fair valued assets/total assets) and included or disclosed in the financial statement. It is the extent to which the financial statement of an entity is exposed to fair value estimates. Ehalaiye et al. (2017) defined fair value intensity as the value of financial assets and liability that are measured and reported at fair value on the balance sheet of the entities. Ayres, Huang and Myring. (2017) defined fair value intensity as

the total summed monetary value of assets that are fair valued scaled by the book value of the entity's total assets at a particular time.

Ho_1 Fair value intensity has no significant effect on earnings predictability of listed commercial banks in Nigeria.

The concept of fair Value Hierarchy Levels Two

This include inputs that are not market quoted prices used within Level one with regards to such asset or liability, both clearly or implicitly. (IFRS 13:81). These inputs include: prices quoted for similar assets or liabilities traded in active markets, identical assets or liabilities quoted prices in markets that are not active, observable interest rates and yield curves commonly quoted at intervals, implied upheavals, credit spreads. Operationally this study views fair value measurement hierarchy levels two as the sum of the indirectly observable inputs based fair valued financial instruments.

Ho_2 Fair value measurement hierarchy levels two have no significant effect on earnings predictability of listed commercial banks in Nigeria.

Review of empirical studies

Fair Value Accounting and Earnings Predictability: Increasingly, financial reporting globally is becoming fair value oriented as the IASB continues to issue more standards requiring its recognition and disclosure but academics, practitioners and regulators have continued to debate its merits and usefulness in predicting future earnings. Bratten et al. (2016) examined the usefulness of fair values in predicting future cash flow and earnings of Banks using samples of both public and private banks in the United States of America. Fair value intensity, fair value gain and fair value through other comprehensive income were used to measure fair value and analysed via multivariate regression, they found that exposure to fair values enhances the ability of earnings to predict future cash flow and earnings.

Fair value Intensity (exposure) and earnings predictability: Bratten et al. (2016) used two approaches to measure the level of banks' exposure to fair value accounting namely: balance sheet and income approach. They measured banks fair value accounting exposure as the summation of assets and liabilities recognized at fair values scaled by total assets from a sample of 3104 bank year observations between 1992 and 2006 in United States of America against pre-tax ROA one and two years horizon and document that information embedded in the fair value estimates of balance sheet measure of fair value exposure can help predict future interest revenue from trading securities, realized gains and losses on settlement of derivatives and realized income from available for sale securities thereby making earnings from more fair value accounting exposed banks to be better predictors of future earnings. Considering that the study cover a period to 2006, we argue that extending the study to 2016 may result in a different findings because of updates and adjustments in the relevant IFRSs. More so, replicating the study in a developing country like Nigeria where most financial instruments lack active market may result in different findings. Also, Evans et al. (2014) evaluated the predictive ability of fair values for future financial performance of commercial banks in United States of America between 1994 and 2008. The total sample size is 7,794 bank-year-observations analyzed using multivariate regression. They measure exposure to fair value as the difference between fair value of assets and the book value and arrived at a conclusion that fair value intensity enhances earnings predictive ability of banks. This study measures fair value intensity differently as total fair valued assets divided by total assets to see if the result will be same or not. Ayres et al. (2017) investigated the link between fair value accounting and analyst forecast accuracy using a sample 2,338 firm-year observations from USA based financial entities between 2007 and 2013. They documented that fair value

intensity does not affect analysts forecast accuracy implying that fair value intensity has no relationship with earnings predictability. Their findings may have been affected by the period of study which coincided with financial crises when the market prices of most assets may not truly reflect the real fair value as a result of fire sales. Thus, there is a need for such study to be carried out in the Nigerian environment. In Nigeria, active market prices for large proportion of financial instruments are not available, thus fair values are likely to be more mark-to-model based than market price based. Although managers could use such discretion opportunities to reduce information asymmetry and improve earnings predictive ability, they are more likely to act opportunistically in a weak shareholder protection environment Hung, (2000). Chen, Sommers and Taylor, (2006) argued that with the absence of intentional misrepresentation by managers, the unobservable nature of mark-to-model fair value estimates potentially leads to greater estimation error. Despite the above, this study predicts that higher fair value accounting intensity will positively relate to earnings predictability for banks in Nigeria. Daifei et al. (2015) assessed the usefulness of fair values in improving the predictive ability of earnings: Evidence from international banks; based on a sample of international (non-U.S.) banks from 24 countries during 2009-2012, they examined the usefulness of fair values in improving the predictive ability of earnings and provide evidence that the fair value measurement hierarchy classification levels affect earnings' ability to predict future cash flows and future earnings and that the discretionary fair value components. This study separates fair value level two and three to examine their individual effect on earnings predictability using data from listed commercial banks in Nigeria.

Research methodology

Research design, population and sample

This study will adopt correlation research design. Correlation research design is used to explain the statistical relationship between two or more variables. The population of the study consist of all the commercial banks in Nigeria listed on the Nigeria Stock Exchange between 2012 and 2022. The study is adopting a census approach; therefore, sample size of this study is the entire population of listed commercial banks in Nigeria.

Method of data collection and data sources

The data for this study were extracted from secondary source basically from the audited financial statement of listed commercial banks in Nigeria (for ten years) between 2012 and 2021. This study relied on audited financial statement for data because of the credibility audit adds to financial statements.

Data treatment techniques

This study adopted panel data multiple regression for data analysis. The technique was used to account for heterogeneity of samples in determining the impact of fair value accounting on the predictive ability of listed commercial banks in Nigeria. The data was subjected to skewness and kurtosis test to evaluate the normality of the data. Multicolinearity test was conducted to check for harmful associations among independent variables that are capable of invalidating the regression result using variance inflation factor (VIF). Hausman specification test was conducted to indicate the result to be interpreted between fixed effect and random effect. The Hausman specification test showed a non-significant result hence the random effect model was chosen for interpretation. Finally, Lagrangian multiplier test effect was conducted to determine the result to be interpreted between random effect and ordinary least square. The result of the Langrangian multiplier test was significant indicating that random effect model results were preferred for interpretation. The assumption underlying fair value

accounting is the provision of information that assists in predicting an entity's future cash flows' realizations. Therefore, its effect on earnings predictability can be directly evaluated by analyzing its ability to predict future earnings (Daifei et al., 2015). Since fair value estimates shows the present value of future expected cash flows, they are reliable measures of the values of asset and liabilities.

Model specification

Following the models of Ehalaiye et al. (2017), this study tests the effect of fair value on earnings predictability of listed DMBs in Nigeria as follows:

$EBT_{it+1} = \alpha + \beta_1 FVSITY_{it} + \beta_2 FVL2_{it} + \varepsilon_{it}$

Where:

EBT_{it+1}	=	Earnings before tax of the respective banks one year ahead.
α	=	Constant per bank year
$FVSITY_{it}$	=	Fair value intensity per bank year
$FVL2_{it}$	=	Fair value level two per bank year
ε_{it}	=	Error terms (omitted variables) per bank year

Result and discussion

Correlation matrix

Correlation matrix indicates the association between each pairs of variable in the model. The association between the dependent variable and each of the independent variables is expected to be strong whiles that among the independent variables themselves is expected to be low. A correlation coefficient of ±0.8 between two independent variables is considered excessive, indicating likely presence of multicollinearity (Gujarati, 2004).

Table 4.1
Correlation Matrix

Variables	EBT_{t+}	FVSITY	FVL2
EBT_{t+1}	1.0000		
FVSITY	0.3684	1.0000	
FVL2	-0.2534	-0.2973	1.0000

Source: STATA output (2022)

Table 4.1 revealed that the correlation matrix shows that the relationship between fair value intensity (FVSITY) and EBT_{t+1} is 0.37. This shows that there is a positive relationship between current fair value intensity and future performance of listed commercial banks in Nigeria. This is in line with the expectation of IASB that fair value accounting provides decision useful information to users of financial statement while the correlation matrix show that the coefficient of correlation between fair value measurement hierarchy levels two and EBT_{t+1} is -0.25 indicating a negative association between fair value level two and future performance.

Regression Result

This study carried out Hausman specification test to choose between fixed and random effect model. The result reveals a chi2 value of 3.42 and the prob>chi2 0.7550. This non-significant p-value indicates that Hausman favours random effect model for interpretation. Also the study carried out Lagrangian Multiplier test to determine the result to be interpreted between Random effect model and OLS. The LM test result favoured Random effect model

as the p-value was significant at 1 per cent (0.0007) where is the hausman test, LM test- please create a table for the results.

Table 4.2
Random-Effects Regression Result

ebtt1	Coef.	Std. Err.	z	P>|z|
TCI	0.49234	0.18466	2.67	0.008
FVSITY	0.27221	0.10985	2.48	0.013
FVL2	-0.07203	0.02413	-2.99	0.003
CONSTANT	-0.25498	0.15655	-1.63	0.103
R-Square: Overall	0.4414			
Wald chi2	39.30			
Prob > chi2	0.0000			

Source: Regression result output form STATA

The Wald chi2 value of 39.3 and P-value is 0.0000 shows that the model is fit. The R-square indicates the level at which the explanatory variables explains the dependent variable. From table 4.6, the R-square is 0.4414 meaning that all the explanatory variables in this study explain earnings predictability of listed commercial banks in Nigeria up to 44.14 per cent. This provides a reasonable evidence to conclude that fair value accounting variables used in this study are suitable for the study on the effect of fair value accounting on earnings predictability of listed commercial banks in Nigeria.

Findings from the regression result indicates that four of the explanatory variables (fair value intensity, fair value level two, fair value level three and available for sales have significant effect on earnings predictability of listed commercial banks in Nigeria, while fair value level one does not have a significant effect on earnings predictability. However, only fair value intensity and available for sales assets have significant and positive association with earnings predictability of listed commercial banks in Nigeria.

Fair value intensity and earnings predictability

Table 4.2 reveals that fair value intensity has a positive coefficient of 0.27, a z-value of 2.48 and p-value of 0.013. This indicate that as more assets of the banks are fair valued, the predictive power of the banks earning are enhanced by 27% at 5% level of significance. This result is in line with Ehalaiye et al. (2017); Daifei et al. (2015), who document that exposure of banks financial statements to fair value accounting enhances earnings predictability and provides information about the features of a firm's financial performance. It is also in line with signaling theory which is primarily concerned with dipping information asymmetry by providing better information about future performance. It also confirms the assertions of IASB that fair value accounting provides more relevant information.

Fair value level two and earnings predictability

Table 4.2 indicates that fair value measurement hierarchy level two (FVL2) has a coefficient of -0.07, z-value of –2.99 and a p-value of 0.003. This means that the use of indirect observable input in fair value estimates lowers earnings predictability of listed DMBs in Nigeria at 99 per cent confidence level. This result is at variance with Ehalaiye et al. (2017) who found a positive relationship between FVL2 and earnings predictability. The result is however in agreement with that of Xu, (2013) who found that fair value level two is used to manage earnings thereby reducing the predictive power of earnings. As earlier stated, fair

value level two inputs includes : prices quoted for similar assets or liabilities traded in active markets, identical assets or liabilities quoted prices in markets that are not active, observable interest rates and yield curves commonly quoted at intervals, implied upheavals, credit spreads. The use of most of these inputs requires management discretion which when used opportunistically may result in earnings management which is may reduce the quality of reported earnings and hinder earnings predictive power.

Hypothesis testing

Hypothesis one

Fair value intensity has no significant effect on earnings predictability of listed commercial banks in Nigeria.

The result shows that fair value intensity has a z-value of 2.67 and a p-value of 0.008, meaning that fair value intensity has significant effect on earnings predictability of listed commercial banks in Nigeria. This result implies that the study has found enough evidence to reject the null hypothesis one of this study. The implication of this finding is that fair value intensity has a strong association with earnings predictability of listed commercial banks in Nigeria.

Hypothesis two

Fair value level two has no significant effect on earnings predictability of listed DMBs in Nigeria.

The result indicates that fair value level two has a z-value of -2.99 and a p-value of 0.003. This significant p-value shows that fair value level two is related with earnings before tax one year ahead at 1% level of significance. This result indicates that this study has provided sufficient evidence to reject hypotheses three of this study. The implication of this finding is that fair value level two has a strong influence on earnings predictability of listed DMBs in Nigeria.

Discussion of findings

The findings of this study confirm the influence of fair value accounting on earnings predictability of listed commercial banks in Nigeria. With reference to fair value intensity, this study provides proof that fair value accounting is desired not only to enhance the predictive ability of current earnings but to improve the relevance of financial statement information. The implication of this finding is that fair value accounting is desirable even in developing financial market like Nigeria. Also the findings of this study have vital implications for regulators and standard setter (such as Financial Reporting Council of Nigeria, CBN and NSE) and contribute to the debate on usefulness of fair value accounting. It also supports IASB claims that fair value accounting satisfies the objectives of general purpose financial reporting through providing decision-relevant information. This study provides enough evidence that the measurement input levels have effects and that levels two and three may be used to manage earnings. Therefore regulators have been provided with a signal that levels two and three fair value measurement inputs may be subject to abuse and that the predictive ability of fair values is dependent on the reliability of their measurement.

Conclusion and recommendations

Arising from the above findings, it can concluded that, the result shows that fair value intensity affects the predictive power of earnings of listed commercial banks in Nigeria. Hence this study concludes that exposing the assets of listed commercial banks in Nigeria to higher fair value accounting will increase earnings predictability of listed bank in Nigeria. Secondly, the study confirms that earnings predictability of listed commercial banks in

Nigeria are reduced by fair value level two inputs. Hence, it is concluded that the application of indirect observable measurement inputs in the estimation of fair values affects earnings predictability of listed commercial banks in Nigeria. In line with the findings and conclusion of this study, the following recommendations were provided:

i. From the conclusions, the study recommends that Security and Exchange Commission and Central Bank of Nigeria should create enabling environment for active corporate debt instruments market to improve the reliability of fair value measurements.
ii. Financial Reporting Council of Nigeria should develop impose stiff penalties against entities that abuses fair value measurement levels to serve as a deterrent.
iii. Auditors and regulatory staff of CBN should be adequately trained to detect sharp practices involving fair value measurement.
iv. CBN should put in place robust supervisory and regulatory policies that ensure reliable measurement of fair values of financial instruments.

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