

## **EFFECT OF IFRS ADOPTION ON AUDIT FEES OF LISTED DEPOSIT MONEY BANKS IN NIGERIA**

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**ABSTRACT:** *We ascertain the effects of International Financial Reporting Standards (IFRS) adoption on the audit fees payable by listed Deposit Money Banks (DMB) in Nigeria. Data for the study was collected from the annual reports of the 15 listed DMBs in Nigeria. The study period spanned two accounting standard regimes: the Nigerian Statements of Accounting Standards (SAS) (2009- 2011) and the IFRS (2012-2014). We analysed the effect of IFRS adoption on audit fees in Nigeria in two ways: first we compared audit fees and the known determinants (audit task complexity and reporting quality) under the two standards regimes using a paired-sample t-test. Second, we employed multivariate analysis to examine and explain the combined effect of audit task complexity, financial reporting quality and IFRS in explaining the change in audit fee following IFRS adoption. We found that audit fees are significantly higher under the IFRS than under the SAS; we also found that IFRS adoption has significantly increased audit complexity and improved financial reporting quality. We conclude that less than 50% of the significant increase in audit fees following IFRS adoption is explained by IFRS task complexities. We recommend further research to ascertain the other factors that could have led to the significant increase in audit fees of DMBs. Lastly, given that the quality of financial reporting increased with IFRS adoption recommend that accountants, regulatory authorities, professional bodies and all other parties in financial reporting chain should deepen their knowledge of IFRS.*

**KEYWORDS:** Audit fees, IFRS adoption costs, Money Deposit Banking, Nigeria

JEL classification: M41, M42, M48

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### **INTRODUCTION**

With the globalization of international financial markets, the idea of adopting a common accounting language for financial reporting to develop international comparability became widespread. Of all the possible ways of implementing a single financial reporting language, adoption of International Financial Reporting Standards (IFRS), issued by the International Accounting Standards Board (IASB), is the approach selected by most countries, including Nigeria where they have been compulsorily adopted by all listed firms since January 2012.

The fundamental objective of the IASB is to develop IFRS that bring **transparency**, **accountability** and **efficiency** to financial/capital markets around the world. Consistent with its fundamental objective, the stated vision of the IASB is:-

*To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and*

*comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users to make economic decisions<sup>i</sup>*

Adoption of the IFRS increases transparency (Barth & Schipper, 2008); the quality of information (Taylor, Tower & Neilson, 2010; Choi, Peasnell & Toniato, 2013; McAnally, McGuire & Weaver, 2010; Aharony, Barniv & Falk, 2010) and comparability of financial statements (Barth, Landsman, Lang & Williams, 2012; Yip & Young, 2012). IFRS adoption also makes reported financial statements useful for economic decisions (Chen, Young & Zhuang, 2013). The consequent increased usefulness of information has a positive impact on financial predictions by potential investors and analysts who follow companies in the capital and/or credit markets (Armstrong, Barth, Jagolinzer & Riedl 2010; Joos & Leung, 2013; Florou & Pope, 2012). Furthermore, IFRS adoption has a positive effect on information use, to the extent that the accounting information prepared according to IFRS is seen as having higher quality and, as a consequence, more frequently used in executive pay (Ozkan, Singer & You, 2012) and in investment decision making (Chen, Young, & Zhuang, 2013). Thus, IFRS adoption leads to improved investors' ability to make informed financial decisions, improved investment and/or funding conditions, and an effective allocation of financial resources worldwide. However, IFRS adoption attracts “new” costs relating to preparation, compliance and certification requirements of the “new” accounting regime, such as increased/additional auditing costs (ICAEW, 2007). For example, as noted in an Australian study, firms subjected to IFRS raised concerns over the significant preparation, compliance and certification costs by the change in reporting regime (Jermakowicz & Gornik-Tomaszewski 2006).

In this study, we focus on compliance costs; specifically, we focus on audit costs consequent upon the mandatory adoption of the IFRS. Our study is situated in the Nigerian banking industry. Auditing in the banks is very important because financial instruments constitute a significant component of the assets of banks but it is hard to monitor financial instruments from the outside; consequently, auditing plays a particularly important role in mitigating information asymmetries in the banking industry (Cameran & Perotti, 2014). Previous research on audit fees determination (e.g., Simunic, 1980; Francis & Stokes, 1986; Carson & Fargher, 2007; Defond, Francis & Wong, 2000) exclude financial institutions because a number of the empirical proxies typically included in audit fee models— e.g., financial leverage, current or quick ratio, inventory and receivables as a percentage of total assets— are not meaningful for banks. In consideration of this, we incorporate only variables applicable and perhaps unique to the banking industry in our study.

We investigate to ascertain the effects of IFRS adoption on the audit fees payable by Nigerian Deposit Money Banks (DMBs) for the period 2009-2014. Two accounting regulation regimes were in operation during this six-year study period; financial statements were prepared under the Nigerian Statements of Accounting Standards (SAS) for the first three years (2009 – 2012) and under IFRS for the remainder of the study period (2012 – 2014)<sup>ii</sup>.

The rest of the paper is as follows: Relevant literature and methodology adopted to achieve research objectives are highlighted in sections 2 and 3; the study results are presented in section 4, while section 5 concludes the paper.

## LITERATURE REVIEW

From literature, three main factors drive the amounts of audit fees payable: increased investment in audit resources, audit task complexity, and financial statement quality (Craswell, Francis, & Taylor, 1995, Simunic & Stein, 1996)<sup>iii</sup>. Upon the mandatory adoption of IFRS, auditors incur additional training and other costs to become familiar and knowledgeable about the new standards in order to be able to assess their proper implementation. In addition, as reported by the Public Company Accounting Oversight Board (PCAOB), some global audit networks have created global offices to consult on IFRS issues and its implementation with affiliated firms (PCAOB, 2008). This creates greater overhead costs for audit firms. Therefore, auditors are likely to increase audit fees resulting from IFRS adoption to recoup their increased investment in IFRS audit resources.

Apart from increased overhead costs as noted above, adoption of IFRS increases auditor effort. The IFRS are principles-based and fair-value-oriented standards that require auditors to make more complex estimates and to use greater professional judgement (KPMG, 2007; Deloitte, 2008; Kim, Liu & Zheng, 2012). In many cases, the IFRS are more detailed and involve increased disclosures, requiring the auditor to certify financial information of a differing nature than that reported previously (Webb 2006; Ernst & Young 2005). This implies that more audit effort is required to manage the risk in terms of the chances of financial statements being materially misstated arising out of IFRS' emphasis on fair value. Reliance on fair value measurements require more professional judgment, discretion and subjectivity in the financial reporting process and increases the chances of reporting errors which ultimately result in audit failure (Love & Eickemeyer 2009; Lin & Yen 2009). To protect their reputation capital, auditors increase audit effort and/or client risk assessments (Clarkson, Ferguson, & Hall 2003) which are likely to result in an increase in audit fees. On the bases of these two factors, we expect to observe increased audit fees associated with the adoption of IFRS attributable to increased audit effort, increased investment in audit resources, and an increased audit risk premium.

On the other hand, IFRS-based financial statements are assumed to be of higher quality which reduces auditors' risk of misstatement or misinterpretation. In other words, higher quality financial statements reduce expected liability costs which may lead to lower fees charged by auditors. This argument was formalised in the model by Kim *et al.* (2012) supporting the view that financial reporting quality is negatively associated with audit fees (Gul, Chen & Tsui, 2003; Bedard & Johnstone, 2004; Blankley, Hurtt & MacGregor, 2012; Frankel, Johnson & Nelson, 2002). Hence, since IFRS imply higher quality financial reporting, we expect to observe a decrease in audit fees.

Prior studies have identified these two opposing effects on the relationship between IFRS adoption and auditing fees. First, IFRS adoption increases the audit task complexity (the complicatedness of an audit assignment) which is likely to be reflected by higher fees. Second, IFRS adoption improves the quality of financial reporting, which should reduce the costs of auditing. These studies conclude that the audit fee premium associated with IFRS adoption increases with the increase in audit task complexity arising from IFRS adoption and decreases with the improvement in financial reporting quality brought about by IFRS adoption. (Griffin, Lont & Sun, 2009; DeGeorge, Ferguson & Spear, 2013) Kim, Liu, & Zheng, 2012; Camerans & Perotti, 2014).

## DATA AND METHODS

The study adopts an *ex-post facto* descriptive design. Most of the sampled banks are audited by Big 4 accounting firms and audit fees payable are mandatorily reported in the DMBs' annual financial statements. Data were collected from the Annual reports of the respective DMBs sampled in the study. We adopted the following procedure to achieve our research objectives. First, we compared audit fees under the two sets of standards (i.e., SAS and IFRS) using a paired-sample t-test to ascertain whether IFRS adoption resulted into significantly increased audit fees paid by Deposit Money Banks in Nigeria. Then, we performed multiple regression analyses to measure the extent to which the variation in audit fees (the dependent variable), is explained by the four independent variables: (i) audit task complexity, (ii) earnings quality; (iii) the effect of the audit task complexity occasioned by IFRS adoption on the audit fee, and (iv) the improvement in earnings reporting brought about by IFRS adoption. We controlled our regressions with bank (client) size. The multiple regressions are based on the following model:

$$\text{AUDFEE} = \alpha + \beta_1 \text{AUDCOM} + \beta_2 \text{QUALITY} + \beta_3 \text{IFRS} * \text{COM} + \beta_4 \text{IFRS} * \text{QUALITY} + \beta_5 \text{SIZE} + \varepsilon$$

Where:

AUDFEE	= Natural log of the audit fees in millions of naira
IFRS	= IFRS has the values of 1 for IFRS or 0 for SAS
AUDCOM	= The average of the number of pages of the annual reports and the ratio of financial instruments to total assets.
QUALITY	= Earnings quality reporting measured by the ratio of Loan Loss Provision to Gross Loan for each sampled bank
SIZE	= Number of branches of each sampled bank.
IFRS*AUDCOM	= interaction term connecting AUDCOM and IFRS
IFRS*QUALITY	= interaction term connecting QUALITY and IFRS
$\varepsilon$	= the error term

These variables are discussed below:

### The Dependent Variable: Audit fees

This is the dependent variable for the study. The audit fees paid (in millions of naira) by Nigerian deposit money banks for a statutory audit of their financial statements for six (6) years (2009-2014).

### The Independent Variables are four:

(i) **AUDCOM** measures audit task complexity. Complexity is the difficulty of an audit assignment. It is measured in the study by the average number of pages of annual reports and the ratio of financial instruments to total assets for each sampled bank. A bulky annual report is an indication that a great deal of effort has been expended in the audit process.

(ii) **QUALITY** is measured by the ratio of loan loss provisions (LLP) to gross loans of the bank. LLP refers to the sum of the general and specific loan loss provisions. Banks use LLPs to reduce the volatility of their reported earnings. A high LLP ratio is indicative of a high probability that the bank managed its earnings. Similarly, a low LLP ratio indicates a lower probability of earnings management. "Unmanaged" earnings are assumed to be of higher quality than "managed" earnings.

(iii) **IFRS\*AUDCOM** creates an interaction or a linkage between AUDCOM (Audit task complexity) and IFRS adoption thereby capturing the effect of the audit task complexity occasioned by IFRS adoption on audit fees. One of the components of AUDCOM is the size of

the annual reports certified by the audit process in any given year. IFRS-compliant annual reports are bulkier than the annual reports prepared under local standards (KPMG 2007; Deloitte 2008). IFRS requires more detailed disclosures than the now discarded Nigerian standards (SAS). Moreover, under the IFRS, auditors certify more financial information that includes management's (subjective) forecasts and assessments of assets and liabilities. For example, the reporting requirements for hedge accounting calls for companies to undertake and document detailed tests of hedge effectiveness, and provide significantly more disclosures on the assumptions underlying these analyses. Also, the IFRS provisions relating to share-based payments require substantial disclosures as to the nature and method of executive compensation plans, along with detailed information on inputs of fair value calculations. It has been reported that first-time IFRS-compliant annual reports are up to 60 percent longer than previous annual reports (Webb, 2006; Ernst & Young 2005). This study expects audit task to become more complex consequent upon IFRS adoption, increasing the amount of chargeable audit fees. Hence, a positive relationship between audit task complexity (i.e. the larger the number of pages of the annual report), a higher level of audit fees is expected.

The second component of AUDCOM in prior research is the ratio of financial instruments to total assets (Griffin *et al.*, 2009; Cameran & Perotti, 2014). The adoption of IFRS by banks in Nigeria has huge audit implications because there are substantial recognition, measurement, and classification differences between Nigerian SAS and IFRS (OR&C, 2011). Under the local standards, only one standard (SAS 13) dealt with financial instruments, requiring classification of financial instruments into short term and long term investments and requiring entities to measure long term investment at cost or re-valued amounts and short term investments at the lower of cost and net realizable value. Under the IFRS several recognition, classification, presentation, measurement and disclosure requirements are mandated by the four standards (IFRS 7, IFRS 9, IAS 32 & IAS 39) on financial instruments which banks are now required to comply with but which were not required under the SAS. For example, Nigerian banks did not apply hedge accounting; there was neither provision nor guidance for it in the SAS. Given that financial instruments constitute a significant component of the assets of the banks, the numerous requirements of IFRS on financial instruments will increase audit complexity of banks compared to what was tenable under the SAS regime. We expect an increase in audit complexity arising from this source to increase the level of audit fees.

**(iv) IFRS\*QUALITY** refers to the improvement in earnings reporting brought about by IFRS adoption. This variable creates an interaction or a linkage between earnings reporting quality and IFRS adoption. It measures the effect of the improved earnings reporting quality brought about by IFRS adoption on audit fees. This proxy tests how difficult it is for banks to carry out income smoothing or earnings management under IFRS compared to SAS. It is expected that the stringent impairment requirements and the restriction on provision for incurred losses under IFRS would significantly reduce the ability of banks to engage in earnings management; the quality of financial reporting for listed deposit money banks in Nigeria is expected to improve with the adoption of IFRS in 2012. A low ratio is a sign of quality while a high ratio indicates higher opportunity for earnings management. We expect a negative relationship between increased earnings quality brought about by IFRS adoption and the level of audit fees charged.

### **Control Variable**

**SIZE**, the control variable in the study, is measured by the number of branches of the banks; audit fees can be influenced by the size of the firm being audited. The number of branches of

each sampled bank is used to measure the banks' sizes. In order to test the relative relationship between the dependent variable (Audit fees) and the Independent variables (AUDCOM, QUALITY, IFRS\*AUDCOM and IFRS\*QUALITY) the control variable, SIZE is held constant. To control for this influence, the model controls for SIZE in order to test the relative relationship of the dependent and independent variables.

#### 1V: Results

Table 1 displays the descriptive statistics for the study variables' under both groups. Across all 15 DMBs, audit fees, audit task complexity and financial reporting quality increased following IFRS adoption. According to the statistics, the mean value of Audit fees in the IFRS era is ₦231.44 million compared to ₦154.46 million under SAS, this represents an increase of 49.8% [ $(\text{₦}231.44 - \text{₦}154.46) / \text{₦}154.46$ ]. Increases are also noticed from the analysis in respect to audit task complexities and financial reporting quality<sup>iv</sup> about 36% and 45% respectively following IFRS adoption. The standard deviations for pre- and post-IFRS measurements reveal that audit fees and audit tax complexity were more variable during the era of IFRS.

**Table 1:** Descriptive Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	IFRS AUDIT FEE (₦)	231,440,355	15	126,148,430	32,571384
	SAS AUDIT FEE (₦)	154,458,900	15	61,447,592	15,865,700
Pair 2	AUDCOM IFRS	96.468	15	26.8206838	6.9250708
	AUDCOMM SAS	70.841	15	14.9212982	3.853
Pair 3	QUALITY IFRS	.044	15	.029	.007
	QUALITY SAS	.116	15	.0966218	.025

#### Univariate Analysis

Tables 2 and 3 summarise and explain the impact of IFRS adoption on audit fees of DMBs in Nigeria using univariate means. First, Table 2 reports that at 0.827, the correlation between the audit fees under SAS and under IFRS is statistically significant. Audit fees were higher overall, and the increases are consistent across 82.7% of the DMBs. Only 17.3% have either reduction or no increase in audit fees following IFRS adoption. On the other hand Pearson's correlation between the audit task complexity and financial reporting quality is 0.437 and 0.558 respectively, just around 50% correlation. Unlike the audit fees, audit complexity and reporting quality increased less consistently following IFRS adoption.

**Table2:** Paired samples correlations

	N	Correlation	Sig
Pair 1 Audit Fees (IFRS) & Audit Fees (Pre-IFRS)	15	.827	.000
Pair 2 Complexity (IFRS) & Complexity (Pre-IFRS)	15	.437	.104
Pair 3 Quality (IFRS) & Quality (Pre-IFRS)	15	.558	.031

Paired-samples t-test results in Table 3 indicate that audit fees are significantly higher in the

IFRS period (M = ₦231.44million, SD = ₦126.15million) than for the SAS period (M= ₦154.46million, SD= ₦61.45million):  $t(14) = 3.598$ ,  $p < 0.01$ . Audit complexity was significantly higher in the post IFRS adoption period (M = 96.47, SD = 26.82) than before (M = 70.84, SD = 14.92):  $t(14) = 4.078$ ,  $p < 0.01$ . Reporting quality improved significantly in the post-IFRS period (M = 0.044, SD = 0.029) is lower than in the pre-IFRS period (M = 0.116, SD = 0.097):  $t(14) = -3.315$ ,  $p < 0.01$ .

**Table 3: Paired samples test results**

	IFRS Mean	PRE-IFRS Mean	Differences		PAIRED SAMPLE TEST	
			Mean	Std Error	t-statistics	p- value
AUDIT FEES (₦millions)	231.44	154.46	76.98	21.40	3.598	0.003
AUDIT COMPLEXITY	96.47	70.84	25.63	6.28	4.078	0.001
REPORTING QUALITY	0.044	0.116	-0.072	.022	-3.315	0.005

The paired sample test results confirm that the amounts of audit fees paid, audit complexity and reporting quality are significantly different in the period following IFRS adoption compared to the period before. Increased audit complexity increased audit fees significantly as increased reporting quality reduced audit fees significantly.

### Multiple Regression Results

To examine and explain the combined effect of IFRS adoption, audit task complexity, financial reporting quality and firm size on audit fees of listed DMBs in Nigeria, we employ the multiple regression analysis.

Before the multiple regression analysis was performed, we tested the relationships between the predictor variables for multicollinearity. As presented in Table 4, no severe multicollinearity problems are observed.

**Table 4: Pearson correlation coefficients**

Control Variables	AUDCOMM	EARNINGS QUALITY	IFRS* AUDCOM	IFRS* QUALITY	SIZE
AUDCOM	1.000				
EARNINGS QUALITY	-.202	1.000			
IFRS*AUDCOM	.341**	-.371**	1.000		
IFRS*QUALITY	.199	-.021	.657**	1.000	
SIZE	-.031*	.085	.015	.105	1.000

\*  $p < 0.05$ ; \*\*  $p < 0.01$

The Model Summary signals that the combined effects of the four independent variables significantly explain the dependent variable ( $R^2 = 45.3\%$ ; Adjusted  $R^2 = 42.0\%$ ). Furthermore, the analyses of variances (ANOVA) signal that the model used in the study has significant explanatory power ( $F = 13.89$ ,  $p < 0.01$ ). The results of multiple regression analyses are shown in Table 5.

**Table 5:** Results of multiple regression analyses

Independent Variables	Coefficients	t- statistics	p-value
Intercept	18.399	101.227	0.000
AUDCOM	0.005	2.947	0.004
QUALITY	-2.011	-2.251	0.027
IFRS*AUCOM	0.371	2.060	0.042
IFRS*QUALITY	-4.464	-2.531	0.013
SIZE	0.001	3.006	0.003
F = 13.888			
R <sup>2</sup> = 45.3%			
Adjusted R <sup>2</sup> = 42.0%			
DW statistics = 0.766			

The results indicate an increase of 49.8% in audit fees of Nigerian banks arising from the increased audit complexity brought about by IFRS adoption. The improved earnings reporting quality brought about by IFRS adoption “contributes” significantly to reducing audit fees of Nigerian deposit money banks. The significant increase in mean audit fees of 49.8 % documented in the post IFRS period makes us believe that since the fee increasing effect arising from the increased audit complexity caused by IFRS adoption is barely significant at 5 percent level, the significant increase in audit fees documented after IFRS adoption is not entirely explained by the variables used, but also by other confounding factors outside the scope of our study. These results are largely consistent with outcomes of prior studies in the sense that IFRS adoption improves accounting quality (Taylor, Tower & Neilson, 2010; Choi, Peasnell & Toniato, 2013; McAnally, McGuire & Weaver, 2010; Aharony, Barniv & Falk, 2010) and increases auditor effort and by extension, the level of audit fees charged (Kim *et al.*, 2012; Vieru & Schadetwitz, 2008; Cameran & Perotti, 2014; DeGeorge, Ferguson, & Spear, 2013; Crasswell, Francis & Taylor, 1995). However, the magnitude of the increase in audit fees consequent upon IFRS adoption is steep in Nigeria. For example, Kim *et al.* (2012) found that on average, the audit fee increased by 5.44% for IFRS adopter firms, compared to the non-adopter firms. Vieru and Schadetwitz, (2008) find evidence of IFRS implementation affecting audit and non-audit fees in the year of adoption, but do not go beyond that to see whether there is any continuing effect on costs. The mean audit fee increase between the pre-adoption and post- adoption periods in the Cameran and Perotti (2014) study was 19.29%.

## CONCLUSIONS AND RECOMMENDATIONS

The general conclusion of this study is that, audit fees have significantly increased following the adoption of IFRS by DMBs in Nigeria. We provide evidence that statutory audit fees increased by 49.8%; and concluded, based on analyses that the increase is not completely triggered by the increase in audit complexity occasioned by IFRS adoption but also due to other confounding factors not considered in this study. Furthermore, the improved financial reporting quality brought about by IFRS adoption constrains income smoothing activities of the Nigerian Deposit Money Banks; this reduces audit risk and ultimately audit fees. Given that the increase in audit fees documented after IFRS adoption in Nigeria is not entirely brought about by IFRS, it is recommended that Deposit Money Banks in Nigeria consider funding research to analyse their audit pricing with a view to establishing the other factors that also led to audit fee increase. Identifying these other factors would give the banks insights regarding what to do in order to save costs and improve their profitability. Lastly, given that the of quality



financial reporting associated with IFRS has increased, accountants, regulatory authorities, professional bodies and all other parties in the financial reporting chain should deepen their knowledge of IFRS. Continuous training and education of professionals is very important given that the IASB continually issues new standards and amends existing ones on an on-going basis.

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## Endnotes

<sup>i</sup> IASB Mission Statement: <http://www.iasb.org/about/index.asp>

<sup>ii</sup> Access Bank and Guarantee Trust Bank voluntarily adopted IFRS in 2011

<sup>iii</sup> We do not address potential legal liability or litigation risk, although this is a driver of audit fees mentioned by Fields, Fraser and Wilkens (2004), Palmrose (1988) and others. In Nigeria, auditors are neither prosecuted in connection with the audits they perform nor subjected to heavy penalties consequent upon the collapse of the firms with a “clean bill of health” issued by them. For example, no auditor was prosecuted or penalised following the massive bank failures of the 1990s and 2000s in Nigeria; similarly no auditor was held accountable for the fraud at Cadbury Nigeria Plc in 2006 despite “clean certification” issued by that company’s auditors in the periods the fraud persisted (Ajekwe & Ibiame, 2017).

<sup>iv</sup> Quality of financial reports in DMBs is measured by the ratio of loan loss provisions (LLP) to gross loans. A high LLP ratio is indicative of poor reporting quality. The decrease is therefore interpreted as increase in financial reporting quality.