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Fair Value Accounting and Loan Loss Provisioning- Early Evidence from Nigerian Banking Industry

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Abstract
The purpose of this study is to investigate the Loan Loss Provisioning under International Financial Reporting Standards (IFRS) and Nigerian Prudential Guidelines. The audited first time annual reports of four Nigerian banks were analysed. Simple percentages and tables were used to determine the relationships between the figures thrown out by the two provisioning models. We found that prudential guidelines provisions were more aggressive and higher in all cases than IFRS provisions. In other words, the profit figures under prudential guideline model were more conservative than the corresponding figures under the IFRS model. The result of the study was based on 1 year 2012 audited first time IFRS accounts of 4 Nigerian banks and therefore cannot be generalised but regarded as rather indicative of the differences between the two models. The paper has practical implications for Nigerian regulatory authorities and in particular the CBN who may wish to retain its Loan Loss Provisioning Model or transmute to the IFRS model. This is about the first study on Nigerian banks on this subject matter post mandatory adoption of IFRS in 2012 and, has added to our knowledge of IFRS Loan Loss Provisioning compared to the Nigerian Prudential guideline model.
Key Words: IFRS, Fair value, Prudential Guidelines, Loan Loss, Early Evidence.

Introduction

Nigeria mandated reporting under the International Financial Reporting Standards (IFRS) with effect from 1st January 2012 with significant public interest entities leading the way. IFRS is very much affected by fair value accounting (also called "mark to market" accounting). Some of the IFRS that rely heavily on fair value measurements include:

i) IAS 16 which provides a fair value option for property, plant and equipment
ii) IAS 36 which requires asset impairments (impairment reversals) to fair value
iii) IAS 38 requires intangible assets impairments to fair value
iv) IAS 39 require fair value for financial instruments other than loans and receivables that are not held for trading, securities held to maturity, and qualifying hedges.

IFRS buoyed by fair value reporting has attracted wide debate on its effect on the ability of an investor to forecast earnings. One school of thought believes that better accounting standards make reported earnings less noisy and more accurate given that all other things remain equal. In such a regime, earnings will be easier to forecast. The other school of thought, however, believes that managers in a low quality reporting regime are capable of smoothening reported earnings to meet objectives which include; reducing the volatility of their own compensation; reducing the volatility of payments to other stakeholders (e.g. employee bonuses and dividends); reducing corporate taxes and avoiding recognition of losses. This contrasts with high quality regimes where earnings will be expected to be more informative, more volatile and also more difficult to predict (Ball, 2005). What is the early evidence of the effect of fair value accounting on accounting numbers in Nigeria's banking industry? This is the question that will guide the rest of this study which will proceed further as follows; review of related literature; followed by chronicling the methodology of study; results of the study will be stated; followed by the discussion of the results; we then conclude.

Literature Review

Fair value 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- exit price. Fair value measurement assumes that a transaction takes place in the principal market for the asset or liability or , in the absence of a principal market, in the most advantageous market for the asset or liability (KPMG, 2012). Fair value has also been described in the context of IFRS as the amount for which an asset can be exchanged (or a liability be settled) between knowledgeable, willing parties in an arm's length transaction (Editor, 2011). Banks have long had major issues with asset and liability recognition issues. The issue of IAS 32 dictating disclosure rules and IAS 39 dictating measurement rules for financial assets and liabilities was thus mired in controversy, a revised IFRS 9 has now been issued to better meet user needs (Baskerville & F 2011).The dust on whether fair value accounting made worse the global financial crisis (otherwise referred to as economic meltdown) is yet to settle down. While proponents of fair value accounting argue with gusto that fair value is not to blame, others forcefully argue that the option helped bank management to under provide for non- performing loans resulting in overstatement of profits and payment of undeserved dividends. The main challenge under IFRS is lack of active markets in emerging economies where market prices can be obtained in order to comply with IFRS fair value accounting rules. Under IFRS, fair value accounting focuses on the price at which an asset can be sold. For exchange traded products such as stocks, bonds, and derivatives, prices are usually liquidation values unless they are loans and receivables or held to maturity assets. There is need to clear conceptual issues on fair value accounting. Practical issues relating to the concept need also to be addressed (Okaro, 2011)

The Ghanaian experience with fair value is that "there appears to be a struggle in determining fair value especially in government securities"(Zori, 2011). In the case of Zambia their implementation of fair value, had challenges in respect of valuation rules and loan loss provisioning as the subjectivity of assumptions inherent in the standard can easily be manipulated by a bank to inflate its earnings. In Zambia also, other than foreign exchange market which is very active Zambia's markets are still inactive due to lack of secondary trading for many financial instruments (Mwape, 2010). Elsewhere, IFRS has been assailed for not being fit for purpose because it allowed banks to pay dividends and bonuses out of unrealized profits that were not certain (Wyman, 2011). In Nigeria, the regulatory authorities have been called upon to adopt a dynamic loan loss provisioning model based on the expected loss model irrespective of the loan loss provisioning model adopted by IFRS. Caution should be exercised in using the IFRS Loan loss provisioning model for internal decision making (Blaauw, 2009).

Under the IFRS model, credit impairment is measured using the provisions in IAS39 which is based on an incurred loss frame work. IFRS 9 which is an attempt to douse some of the criticisms of the credit measurement provisions of IAS 39 is based on an expected loss model. Nigerian Banks are, however, yet to migrate to this model. In Nigeria, providing for credit impairment is guided by the Central Bank of Nigeria (CBN) revised prudential guidelines of 2010.

In addressing the challenges faced by the Nigerian Banking industry which was at the brink of a crisis as a result of spiral effects of the global financial meltdown, the CBN undertook a review of the prudential guidelines. In the revised guidelines, which became effective 1st of July, 2010, the CBN provided for the adaptation of the prudential guidelines to IFRS after it has been adopted in Nigeria. Paragraph 12.4 of the revised Prudential Guidelines for Deposit Money Banks in Nigeria stipulates that Banks would be required to make provisions for loans as prescribed in the relevant IFRS Standards when IFRS is adopted. However, Banks would be required to comply with the following: (a) Provisions for loans recognized in the profit and loss account should be determined based on the requirements of IFRS. However, the IFRS provisions should be compared with provisions determined under prudential guidelines and the expected impact/changes in general reserve should be treated as follows: (i) Prudential Provisions is greater than IFRS provisions; transfer the difference from the general reserve to a non-distributable regulatory reserve. (ii) Prudential Provisions is less than IFRS provisions; the excess charges resulting should be transferred from the regulatory reserve account to the general reserve to the extent of the non-distributable reserve previously recognized. (b) The non-distributable reserve should be classified under Tier 1 as part of core capital (Omotola, 2012).

In the past, credit management in Nigeria's banking sector, has been fraught with abuses Table 1 below shows insider related credits attributable to bank directors that went awry in the wake of the liquidation of the banks.

Table1: Credit Facilities Granted Owners and Directors of Some Liquidated Banks in the 1990's

S/N	Banks (in Liquidation)	No of Directors involved	Amount as at Closure(N)	% of Total Risk Assets	Remarks
1	Alpha Merchant Bank Plc	11	1,314,418,700.43	33%	
2	United Commercial Bank Ltd	5	741,755,808.86	30%	
3	Financial Merchant Bank Ltd	1	383,061,096	100%	The entire Portfolio
4	High Land Bank of Nig.Plc	12	33,197,157.58	38%	
5	Commercial Trust Bank Ltd	1	247,749,719.10	38%	
6	ABC Merchant Bank Ltd.	8	272,981,634.00	49%	
7	Royal Merchant Bank Ltd.	7	646,940,182.23	69%	
8	North- South Bank of Nig. Ltd	13	240,668,637.62	32%	
9	Abacus Merchant Bank Ltd.	14	56888,254.11	47%	
10	Credit Bank Nig. Ltd.	6	379,934,611.47	76%	
11	Prime Merchant Bank Ltd.	1	539,292,310.00	64%	
12	Amicable Bank of Nig. Ltd.	7	149,854,896.00	56%	
13	Century Merchant Bank Ltd.	5	272,072,261.00	32%	
14	Group Merchant Bank Ltd.	13	595,836,077.20	80%	
15	Commerce Bank Plc.	4	1,294,851,665.64	52%	
16	Pinnacle Commercial Bank Ltd.	10	298,766,751.76	20%	
17	Republic Bank Ltd	1	161,375,466.00	38%	

Source: Ogunleye (2005)

Allied to the issue of insider related credits is under provisioning for non- performing credits often from insider related borrowers. Table 2 shows some of the banks that failed the CBN stress test and their auditors who apparently were culpable for not qualifying their reports just before the banks found themselves in dire straits.

Table 2: Banks that Failed the CBN Stress Test

Bank	Year End	Auditor	Date of Last Audit Report	Audit Opinion	Date Problem Surfaced	Remarks
Intercontinental	29/2/2008	PWC	May 2008	Unqualified	2009	Loan loss provision as per CBN is 278.2Billion Naira and not 36 Billion per audited accounts
Oceanic	31/12/2008	PWC	May 2009	Unqualified	2009	Loan loss provision per CBN is 210.9 Billion Naira and not 16.6Billion Naira as per audited accounts

Source: Adapted from Otusanya (2010)

Such was the magnitude of the under provisioning for loan losses. Credit management and loan loss provisioning has thus been the Achilles hill of many Nigerian Banks.

Methodolgy

This study relied mainly on secondary data represented by the annual reports of four banks for the year ended 31st December 2012. The choice of the four banks stems from the fact that they were the early birds in terms of publishing the First mandatory IFRS accounts in Nigeria with sufficient details for analysis. The banks are Zenith bank, First bank, Guaranty trust bank and Access bank. These banks together control about 64% of the profits of all banks in Nigeria(Prudential 2013). Meanwhile many of the banks are blaming the Central Bank of Nigeria (CBN), the apex regulator of the banking industry for their failure to release their financial reports in time. CBN has, however, denied the charge.(Komolafe & Nnorom 2013). The four banks are ranked among the five top banks in the country along side UBA Plc. Absolute figures and simple percentages will be used to analyse the effect of the prudential guideline provisions on the financials of the banks.

Results and Discussions

Table 3 shows the comparison for loan loss provisioning as per IFRS and Prudential Guideline Requirements for First Bank Nigeria(PLC) for the year ended 31st December, 2012.

Table 3: Loan Loss Provisioning for First Bank (Nig) Plc under Prudential Guidelines and IFRS

Prudential Guideline Loan Loss Provision(1) ₦'Million	IFRS Credit Impairment Charge (2) ₦'Million	Difference (1-2) ₦'Million	Difference as Percentage of Profit for the Year*
16,202	9,847	6,355	8.9%

*Profit for the year ended 31st December 2013 from continuing operations = ₦'Million 71,144

Table 4 compares Loan loss provision under Prudential Guidelines with IFRS Impairment charge for Guaranty Trust Bank Plc. for the year ended 31st December, 2012

Table 4: Loan Loss Provisioning for Guaranty Trust Bank under Prudential Guideline and IFRS

Prudential Guideline Loan Loss Provision(1) ₦'Million	IFRS Credit Impairment Charge (2) ₦'Million	Difference (1-2) ₦'Million	Difference as Percentage of Profit for the Year*
28,133.141	16,820.339	11,312.802	13.3%

* Profit for the Year ended 31st December, 2012 from continuing operations = ₦'Million 85,263.826

Table 5 compares Loan Loss provisioning under Prudential Guidelines with IFRS impairment Charge for Access Bank Plc for the Year ended 31st December, 2012.

Table5: Loss Provisioning for Access Bank under Prudential Guidelines and IFRS

Prudential Guideline Loan Loss Provision(1) ₦'Million	IFRS Credit Impairment Charge (2) ₦'Million	Difference (1-2) ₦'Million	Difference as Percentage of Profit for the Year*
36,122.378	33,314.034	2,808.344	7.7%

*Profit for the year ended 31st December 2012 from continuing operations = ₦' million 36,353.643

Table 6 compares loan loss provisioning under prudential guideline and IFRS Impairment Charge for Zenith Bank of (Nig.)Plc. for the year ended 31st December 2012

Table 6: Loan loss Provisioning for Zenith Bank (Nig) Plc. Under Prudential Guidelines and IFRS

Prudential Guideline Loan Loss Provision(1) ₦'Million	IFRS Credit Impairment Charge (2) ₦'Million	Difference (1-2) ₦'Million	Difference as Percentage of Profit for the Year*
21,437	15,768	5,669	5.9%

*Profit for the year ended 31st December 2012 from continuing operations = ₦'Million 95,803

Discussions

For all the banks, the prudential guidelines provisions were higher than the corresponding IFRS impairment charge. The differences were of course taken to the credit of regulatory risk reserve which is part of Tier 1capital as enjoined by the provisions of prudential guidelines. Zenith bank had lowest percentage of the difference between the two provisions over the profit from continuing operations for the year to 31st December 2012 at 5.9%. This is followed by Access bank at 7.7%. For First bank, the figure is 8.9% while Guaranty Trust bank figure is as high as 13.3%. The figures show that the prudential guidelines provisions result in more conservative profit figures as a result of higher loan loss provisions. There is a lot to commend the prudential guidelines aggresive approach to loan loss provisioning given the welter of abuses that have characterised loan loss provisioning in the history of banking in Nigeria. Already some of the banks are announcing enhanced dividend payout ratio with attendant salutary effect on their share prices. Zenith bank, for example, is paying a dividend of one Naira and sixty kobo only, up from ninety five kobo or 68%. In the same vein, GT bank grew its dividend from one Naira and ten kobo only to one naira and thirty kobo only or 18.18%. Banks are expected to migrate to incurred loss model with the implementation of IFRS 9 on or after 1st January, 2015.

Conclusion

This study set out to investigate empirically the loan loss provisioning model under IFRS and the Prudential Guideline of Central Bank of Nigeria (CBN). To achieve the objective, the maiden IFRS annual accounts for the year ended 31st December 2012 of First bank, GT bank, Zenith bank and Access bank were analysed to reveal the differences between the loan loss Provisioning under IFRS and the Prudential guideline. The differences were expressed as % of their respective after tax profits for the year on continuing operations. GT bank led the pack with the difference between the loan loss provision as per prudential guideline and IFRS as a % of after tax profit on continuing operation put at 13.3%. This was followed by First bank at 8.9%. Next on the line was Access bank at 7.7%. Zenith bank brought the rear at 5.9%. Overall, the result is consistent with expectation. The CBN revised prudential guideline of 2010 was a reaction to the abuses in the banking sector in respect of loan loss provisioning and was bound to produce more aggressive figures as loan loss provisions. The provision that such differences be credited to a regulatory risk reserve not available for distribution has ensured that profits made by possible under provision of loan losses are not available for distribution as dividends. As noted many Nigerian Banks are already growing their dividends as a result of the profits reported in their first year IFRS audited accounts. In doing this, they are pandering to the desire of the average Nigerian shareholder to see annual increases in his/her dividends. For IFRS itself, flexibility allowed for various jurisdictions to determine how IFRS profits made by companies within its purview are legally appropriated has come to its rescue as a standard that will gain international acceptance. The argument that fair value allow banks to increase their leverage in periods of boom is upheld in this Nigerian study.

Our findings should be interpreted in the light of the limitations of this study. First our study covered only four banks (although controlling over 60% of the profit of the industry) leaving out about ten other banks. Second the data covered only one period of 12 months being the only available data as a result of the newness of the IFRS regime in Nigeria. Despite these limitations, we believe that this study has thrown light on the implication of loan loss provisioning under both IFRS model and the prudential guidelines. This result should inform the regulators in deciding whether or not to retain the provisions of the prudential guidelines alongside the IFRS fair value model for loan loss provisioning as at present or even when the IFRS transmutes to the expected loss model under IFRS 9 in 2015.

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