



## **NIGERIAN JOURNAL OF ACCOUNTING RESEARCH**

**A Publication of The Department of Accounting,**

**Ahmadu Bello University, Zaria-Nigeria**

**Vol. 2, Number 1 , June, 2015**

<https://njar.org.ng/>

### **INTERNAL GOVERNANCE MECHANISMS AND INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) COMPLIANCE IN NIGERIA**

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#### **Abstract**

*The study examined the impact of internal governance mechanisms on compliance with IFRS disclosure in Nigeria in the year of IFRS mandatory adoption. The study used multiple regression in a sample of 154 listed companies in Nigeria to determine how internal governance mechanisms affect IFRS compliance. The result shows that internal governance mechanisms through board independence, audit committee accounting expertise, and audit committee size have a positive impact on IFRS compliance in Nigeria. The study recommends the use of large proportion of non-executive directors in the composition of board of directors as recommended in the corporate governance codes in Nigeria to ensure proper monitoring and compliance with regulation. Due to the limitation of the study in terms of period of study and the variables examined, the study recommends further research on how other internal governance variables, such as internal audit function, affect IFRS*

*compliance and the period of the study should be extended to more than one year.*

**Keywords:** Corporate governance; compliance; International Financial Reporting Standard (IFRS).

## **1. Introduction**

Nigeria joined the leagues of countries that mandatorily adopted International Financial Reporting Standards (IFRS) in 2012. All listed companies are to use IFRS from January 1, 2012. The Financial Reporting Council of Nigeria (FRCN) revealed widespread non-compliance with IFRS among companies in Nigeria from the readiness test conducted in 2013. The FRCN disclosed that only 72 out of 190 listed companies examined submitted IFRS documents required by the Council. They further revealed that the non-compliance is more pronounced in the financial sector (Nwopoku, 2014).

Adoption of IFRS in 2012 represents a substantial shift in financial reporting in Nigeria. This regulatory change provides motivation for this research. First, the revelation of widespread non-compliance across firms in Nigeria provides the need to study how the internal governance mechanisms affects the level of compliance with IFRS as the primary responsibility for monitoring compliance with accounting regulation rest with the board of directors (SEC, 2011). Second, little academic research has studied compliance with IFRS in Nigeria, in particular, and Africa, in general.

The prior literature on jurisdictions, like Nigeria, that have mandatorily adopted IFRS, reports low-compliance with IFRS disclosure in the early period of IFRS adoption (Mısırlıoğlu, Tucker, & Yükseltürk, 2013; Tsalavoutas & Dionysiou, 2014; Tsalavoutas, Evans, & Smith, 2010; Tsalavoutas, 2011; Verriest, Gaeremynck, & Thornton, 2013). Prior literature has also argued that compliance with IFRS is affected by institutional factors, such as the governance and enforcement mechanisms (Al-Akra, Eddie, & Ali, 2010; Al-Shammari, Brown, & Tarca, 2008) and corporate characteristics (Al-Shammari et al., 2008; Bova & Pereira, 2012; Popova, Georgakopoulos, Sotiropoulos, & Vasileiou, 2013).

Many studies have examined corporate characteristics and IFRS compliance (Al-Shammari et al., 2008; Bova & Pereira, 2012; Hodgdon, Tondkar, Adhikari, & Harless, 2009; Mısırlıoğlu et al., 2013; Tsalavoutas, 2011), but very few studies have examined how governance mechanisms affect the level of compliance with IFRS (Hla, Hassan, & Shaikh, 2013; Kent & Stewart, 2008; Verriest et al., 2013). The area of IFRS compliance and internal governance mechanisms is not well explored, especially in developing countries, like Nigeria, where IFRS adoption is at the early stage. Hence, the objective of this study is to examine how internal governance mechanisms are associated with IFRS disclosures in the year of IFRS adoption in Nigeria.

The remaining part of the paper is divided into four Sections. Section Two reviews the literature and the development of hypotheses. Section Three presents the methodology used in addressing the research objectives. Section Four presents the data used in this study and analysis while Section Five concludes the paper.

## **2. Literature Review and Hypotheses Development**

Adoption of IFRS in Nigeria became mandatory in 2012 by regulation and therefore, companies are expected to mandatorily comply with the disclosure requirements of IFRS. However, prior literature argues that the existence of regulation does not guarantee compliance because some companies would comply while others would not (Alanezi & Albuloushi, 2011). Prior literature identifies good corporate governance as a means of achieving successful IFRS implementation (Mısırlıoğlu et al., 2013) and is expected to make companies comply with IFRS (Verriest et al., 2013). The study considers the characteristics of the board of directors and the audit committees as proxies of agency cost that could limit opportunistic behaviour and may induce management to provide more information in the annual report.

### **2.1 The Board of Directors**

The board of directors undertakes the monitoring role in companies, including compliance with accounting regulations. Prior literature has argued that effective monitoring of the management depends on board composition, independence, size (John & Senbet, 1998); and the ability of the board to meet frequently to review the activities of the company ((Lipton & Lorsch, 1992). In line with the arguments in the literature, the study considers three important attributes of the board of directors in ensuring compliance with IFRS.

#### **(a) Board Independence**

Prior literature argue that a board with a higher proportion of non-executive directors mitigates agency conflict (Cerbioni & Parbonetti, 2007). Literature also argue that the monitoring capacity of the board of directors depends on the directors' independence (Kent & Stewart, 2008). Additionally, literature finds board effectiveness in which board independence is also a proxy, to have helped firms align with IFRS disclosure and high-quality financial information (Chen & Rezaee, 2012). Other literature also finds out that the greater the board independence, the higher the compliance with IFRS (Verriest et al., 2013). Based on these arguments, the first hypothesis is raised in a positive direction. Thus:

**H<sub>1</sub>:** The higher the proportion of non-executive directors in the board of directors, the greater the extent of compliance with the disclosure requirements of IFRS.

**(b) Board Size**

Prior literature argues that a large board in terms of size, has higher capacity to monitor the activities of the management than a small board, but the size is limited to a certain point when the benefit of any increase in size is offset by incremental cost associated with large groups because of poor communication (John & Senbet, 1998). Thus, the ability of the board to monitor a company's operations depends on its size, but the size should not be too large to diminish the board's monitoring capabilities. Literature finds effective internal governance, in which board size is a component of board effectiveness, helps companies align with mandatory disclosure of IFRS (Chen & Rezaee, 2012). Most of the prior literature has supported large board size to have a positive effect on board effectiveness (Gisbert & Navallas, 2013; Jizi, Salama, Dixon, & Stratling, 2013; Laksmana, 2008). Thus the hypothesis is stated in positive form.

**H<sub>2</sub>:** The larger the size of the board of directors, the greater the extent of compliance with the disclosure requirements of IFRS.

**(c) Board Meetings**

Literature argue that for a board to fulfil its supervision function effectively, it must be active in monitoring management by meeting regularly to ensure reliable and credible financial statements (Chen & Rezaee, 2012). Literature also finds boards that meet regularly to have improved the mandatory disclosure requirements of IFRS in Australia (Kent & Stewart, 2008). Thus, the study develops the hypothesis in a positive direction.

**H<sub>3</sub>:** The higher the frequency of meetings by the board of directors, the greater the extent of compliance with the disclosure requirements of IFRS.

## **2.2 Audit Committee**

The responsibility of the board of directors for monitoring compliance with accounting regulation is normally delegated to audit committee. The study considers four characteristics of audit committee in ensuring compliance with the disclosure requirements of IFRS.

**(a) Audit Committee Independence**

Prior literature argued that members of the audit committee who are independent of the management, monitor financial accounting processes better than those members who are non-independent of the management (Klein, 2002). Many prior studies have found audit committee independence to have a positive impact on

disclosure (Liu, 2006; Nelson, Gallery, & Percy, 2010; Verriest et al., 2013). Thus, the hypothesis is stated in positive form

**H4:** The higher the proportion of non-executive directors in the audit committee, the greater the extent of compliance with the disclosure requirements of IFRS.

**(b) *Audit Committee Members' Accounting Expertise***

The prior literature argued that the effectiveness of the audit committee depends on the members' accounting and financial expertise (Cohen et al., 2002). Similarly, literature argued that the competence of the audit committee members is perceived to be high if the members are knowledgeable in finance and accounting (Kent & Stewart, 2008). Thus, the study hypothesise that

**H5:** The higher the proportion of members of the audit committee with accounting expertise, the greater the extent of compliance with the disclosure requirements of IFRS.

**(c) *Audit Committee Meetings***

It has been argued in the literature that that audit committee members who meet regularly can reduce financial reporting problems (Farber, 2005). The literature also finds a positive relationship between audit committee meeting and the level of disclosure with IFRS (Kent & Stewart, 2008). Based on these arguments, the following hypothesis is suggested:

**H6:** The higher the frequency of the audit committee meeting, the greater the extent of compliance with the disclosure requirements of IFRS.

**(d) *Audit Committee Size***

Prior literature argued that the effectiveness of the audit committee, in terms of size, has a positive impact on the internal control system and in reducing agency cost (Ho & Wong, 2001). Literature also argued that a larger audit committee has more knowledge to undertake its responsibilities, but they also caution having too many members because it will affect the audit committee's effectiveness (Karamanou & Vafeas, 2005). Literature also finds large audit committees to have a positive effect on disclosure (Li, Pike, & Haniffa, 2008). Based on these arguments, the hypothesis is raised in a positive direction. Thus:

**H7:** The larger the size of the audit committee, the greater the extent of compliance with the disclosure requirements of IFRS.

### 2.3 Control Variables

The study considers four corporate characteristics, which have been used by the prior literature as control variables. The first variable is company size as the adoption of IFRS would require an overhaul of the existing accounting system as well as additional cost in terms of training, external technical advice, software upgrade and additional external audit fees (Institute of Chartered Accountants in England and Wales (ICAEW)., 2007). Company size could therefore be used as a proxy for information cost.

The second variable is earnings, which could be used as a proxy for political, and agency costs. A profitable company may provide a high-level disclosure to avoid government scrutiny since adoption is mandatory in Nigeria or it may provide less disclosure not to attract much attention from other public interests (Wallace et al., 1994).

The third variable is audit quality, which could also be used as a proxy for agency cost. Prior literature has found audit quality to have positive impacts on compliance with IFRS (Mısırlıoğlu et al., 2013). The fourth variable is industry to differentiate between financial and non-financial firms in the sample.

### 3. Methodology and Model Specification

The study used cross-sectional data and the period of study is 2012. The study also employs a positivist approach in which a quantitative design is employed to test the hypotheses. Secondary data is used from the annual reports of the selected firms. A multivariate regression is used to examine how internal governance mechanisms affect IFRS compliance. The population of the study consists of all listed companies (198) in Nigeria as at 31 December 2012, which is the year of IFRS mandatory adoption. Forty-four companies did not provide full sets of information in the annual reports to examined compliance with IFRS and therefore, are removed from the sample. The finale sample is 154 companies.

The model used in this study is given as follows:

$$CINDEX_i = \alpha_0 + \alpha_1 BDIND_i + \alpha_2 BDSIZ_i + \alpha_4 BDMTG_i + \alpha_5 ACIND_i + \alpha_6 ACMTG_i + \alpha_7 ACSIZ_i + \alpha_8 AQLTY_i + \alpha_9 SIZE_i + \alpha_{10} EARN_i + \alpha_{11} IND_i + \varepsilon_i$$

Where:

CINDEX is the compliance index for IFRS mandatory disclosures, measured as the ratio of compliance with the applicable disclosure requirement of IFRS by company i divided by number of applicable IFRS disclosures for company i.

$BDIND_i$  is the ratio of non-executive directors to the number of directors on the board for company  $i$ .

$BDSIZ_i$  is the numbers of directors on the board of a company  $i$ .

$BDMTG_i$  is the number of board meetings per year for company  $i$ .

$ACIND_i$  is the ratio of audit committee members who are non-executive directors to the size of audit committee for company  $i$ .

$ACEXP_i$  is the ratios of members of audit committee with accounting expertise for company  $i$ .

$ACSIZ_i$  is the number of audit committee members for company  $i$ .

$ACMTG_i$  is the number of meetings held by audit committee members per year for company  $i$ .

$AQLTY_i$  is a dummy variable that equals 1 for Big-4 auditors (PwC, KPMG, Ernst & Young, and Deloitte) , 0, otherwise for company  $i$ .

$SIZE_i$  is the logarithm of the total assets for company  $i$ .

$EARN_i$  is measured as net profit after tax divided by outstanding ordinary shares for company  $i$ .

$IND_i$  is a dummy variable that equals 1 if the firm belongs to financial firms, 0, otherwise.

#### 4. Results and Discussions

This section presents descriptive statistics, correlation matrix and then inferential statistics. Table 1 presents the descriptive statistics of the dependent variable and continuous independent variables.

**Table 1: Descriptive Statistics**

Variable	Mean	SD	Min	Max.	Skewness	Kurtosis
IFRS Compliance Index (CINDEX)	0.69	0.14	0.40	0.90	-0.10	1.81
Board Independence (bndind)	0.70	0.12	0.40	0.92	-0.22	2.31
Board size (bdsiz)	9.03	2.82	5.00	20.00	1.16	4.56
Board Meetings (bdmtg)	4.66	1.54	2.00	12.00	1.95	7.62
Audit Committee Independence (acind)	0.85	0.21	0.00	1.00	-1.18	3.99
Audit Committee expertise (acaexp)	0.24	0.22	0.00	1.00	0.43	2.80
Audit Committee meetings (acmtg)	3.56	1.00	1.00	8.00	0.22	4.93
Audit Committee Size (acsiz)	5.58	0.81	4.00	6.00	-1.44	3.07
Size	7.21	0.88	5.06	9.50	0.62	3.36
Earnings (earn)	1.10	3.24	-9.86	26.67	4.19	30.55

**Source: STATA Output**

The statistics show an average compliance with IFRS disclosure of 69% with minimum compliance of 40% and maximum compliance of 90%. Additionally,

the result shows that the board of directors has an average size of nine with minimum of five and maximum of twenty members. The result also indicates that on average 70% of members of board of directors are non-executive directors. The average board meeting is five with minimum number of meetings of two and maximum of twelve. The average of audit committee members is five with minimum members of five and maximum of six. On average, 85% of members of audit committee are non-executive directors and 24% possesses accounting expertise. The average number of audit committee meetings is four with minimum number of meetings of one and maximum of eight.

#### 4.2 Univariate and Multivariate Analysis

The univariate analysis in Table 4.2 shows that board size is positively and statistically associated with IFRS compliance in Nigeria at 1%. In addition, the audit committee accounting expertise and size are positively and statistically associated with IFRS compliance at 1% while an audit committee meeting is positively associated with IFRS compliance at 10%.

**Table 4.2: Correlation and Regression result**

Univariate Analysis		DV=CINDEX				Multivariate Analysis	
Variables	CINDEX	Variables	coefficient	t-statistics	P> t	Model summary	
CINDEX	1.000	Intercept	0.267**	2.88	0.005	Number of observation	154
bdind	0.089	bdind	.136**	2.16	0.033	R-square	67.84%
bdsiz	0.337***	bdsiz	-0.022	-0.77	0.441	Adjusted R-square	65.35%
bdmtg	0.100	bdmtg	-0.054**	-2.17	0.032	F-Statistics	27.23
acind	0.005	acind	-0.018	-0.75	0.453	p-value (F-Statistics)	0.000
acaexp	0.539***	acaexp	0.105***	2.78	0.006	Mean VIF	1.48
acmtg	0.141*	acmtg	-0.001	-0.11	0.909	hettest <sup>a</sup> Prob > chi <sup>2</sup> =	0.5495
acsiz	0.284***	acsiz	.017*	1.89	0.061	ovtest <sup>b</sup> Prob > F =	0.5664
aqly	0.747***	aqly	.139***	8.17	0.00	Swilktest <sup>c</sup> Prob>z =	0.1012
size	0.611***	size	.039***	3.17	0.002		
earn	0.358***	earn	0.005**	2.15	0.033		
ind	0.177**	ind	0.012	0.76	0.446		

<sup>a</sup> Breusch-Pagan / Cook-Weisberg test for heteroskedasticity. <sup>b</sup> Ramsey RESET test using powers of the fitted values of CINDEX. <sup>c</sup> Shapiro-Wilk test for normality of the residuals. \*\*\*significant at 1%, \*\*significant at 5%, \*significant at 10%.

The result of the regression model in Table 4.2 indicates that the board characteristics and the audit committee characteristics jointly explain compliance with IFRS with an adjusted R-square of 65.35%. The model is significant at 1%. The result shows that the coefficient of board independence is positive and statistically significant at 5%. This indicates that more information could be made

available to investors when the board of directors are more independent. This finding support hypothesis one, which hypothesised a positive relationship between board independence and IFRS compliance. Prior literature has also supported a positive relationship between board independence and IFRS compliance (Chen & Rezaee, 2012; Verriest et al., 2013).

Similarly, the result shows that the coefficients of audit committee accounting expertise and audit committee size are positive and statistically significant at 1% and 5% respectively. The results support the argument that the accounting expertise of audit committee members increases their ability to ensure compliance or detect non-compliance with accounting regulations (Cohen et al., 2002). The result also supports the argument by prior literature that the effectiveness of audit committee is influenced by its size (Ho & Wong, 2001; Karamanou & Vafeas, 2005). Additionally, these finding support hypotheses five and seven and shows that audit committee expertise and audit committee size could be used as proxies for reducing agency cost in line with the agency theory's argument.

However, in contrast to the prediction of hypothesis three, the result in Table 4.2 indicates a significantly negative relationship between board meetings and IFRS disclosures. Prior literature has argued that regular meetings can enhance the supervisory functions of the board and ensure reliable and credible financial statements (Chen & Rezaee, 2012). However, this does not seem to be the case with listed companies in Nigeria concerning compliance with IFRS. This could be as a result of challenges experienced during the first year of IFRS adoption. This is evident in the extension of the deadline for the annual report submission to the authorities (Nnorom, 2013). The challenges could demand a high number of meetings to address the issues surrounding IFRS adoption. However, increase in the number of meetings without a corresponding increase in the knowledge of IFRS could negatively affect compliance. The finding also contradicts the result of Kent and Stewart (2008) who report a positive relationship between board meetings and IFRS disclosure in Australia.

The result also indicates that board size, audit committee independence, and audit committee meetings are not statistically significant in influencing IFRS compliance in Nigeria and therefore, hypotheses two, four, and six are rejected.

## **5. Summary and Conclusion**

The study examines how internal governance mechanisms affect compliance with IFRS disclosure in Nigeria 2012 being the year of IFRS mandatory adoption. The study finds board effectiveness through board independence to have positive

impact on IFRS compliance. Similarly, the accounting expertise of audit committee and their size are found to have positive impact on IFRS compliance in Nigeria. The findings highlight the importance of board independence in enhancing the monitoring capacity of the board of directors and the importance of accounting knowledge and adequate number in the composition of audit committee.

The study concludes that compliance with IFRS could be improved with large proportion of non-executive directors in the composition of the board of directors. The study also concludes that the effectiveness of audit committee in fulfilling their duty of ensuring compliance with accounting regulation depends on their accounting expertise and their size. The study is only limited to one year of IFRS adoption in Nigeria and how internal governance mechanisms affect IFRS compliance. Therefore, the interpretation should be made with caution as compliance is expected to rise and factors affecting IFRS compliance could also not be limited to internal governance variables examined in this study.

The study recommends the use of large proportion of non-executive directors in the composition of board of directors as recommended in the corporate governance codes in Nigeria to ensure proper monitoring and compliance with regulation. The study also recommends the use of accounting expertise as a major yardstick in the composition of audit committee as one of their major duty is to ensure compliance with accounting regulation. Similarly, the study recommends examination of how other internal governance variables such as internal audit function affect IFRS compliance which prior literature is yet to examine.

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