

Fair Value Accounting on Earnings Quality of Deposit Money Banks in Nigeria

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Abstract

The adoption of fair value accounting raises concerns about the transparency and comparability of financial statements, especially in an environment where regulatory oversight may be inconsistent, and market conditions are highly volatile. The major objective of this study was to examine the effects of fair value accounting on earnings quality of deposit money banks in Nigeria. The independent variable of the study being fair value accounting was proxied by the fair value gains/losses through profit or loss and fair value gains/losses through other comprehensive income while earnings quality was measured using total accruals. The research design employed in this study was ex post facto. Secondary data were used and the data employed was analyzed using robust regression technique while the statistical software used was STATA version 16. The findings of the study revealed that fair value gains or losses through profit or loss has significant positive effect on earnings quality; fair value gains or losses through other comprehensive income has significant positive effect on earnings quality. Based on the findings of the study, it was concluded that fair value accounting has significant effect on earnings quality of listed deposit money banks. It was therefore recommended that deposit money banks should enhance their risk management strategies to mitigate the volatility introduced by fair value changes in assets and liabilities.

Keywords: *Fair value accounting, earnings quality, profit or loss, other comprehensive income, total accruals*

1.1 Introduction

In recent years, fair value accounting has gained prominence as a critical financial reporting standard, especially in the banking sector. Fair value accounting, which requires assets and liabilities to be recorded at their current market value, is designed to provide more relevant and timely information to investors and stakeholders (Sodan, 2022). This approach contrasts with historical cost accounting, where assets and liabilities are recorded at their original purchase prices, irrespective of current market conditions. As the financial markets have become more dynamic and globalized, fair value accounting has been increasingly adopted to reflect the economic realities of assets and liabilities more accurately. Fair value accounting (FVA) has gained significant traction in recent years, particularly following the global financial crisis of 2008, which underscored the need for more transparent and timely financial reporting. This accounting approach, which measures assets and liabilities at their current market value, has been lauded for its ability to provide more relevant and up-to-date information compared to historical cost accounting (Goh et al., 2019). The International Financial Reporting Standards (IFRS) and the Generally Accepted Accounting Principles (GAAP) have increasingly incorporated FVA, reflecting its growing importance in financial reporting standards.

Fair value accounting, as defined by the International Financial Reporting Standards (IFRS), is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction (International Accounting Standards Board [IASB], 2018). This definition emphasizes market-based measurements, aiming to provide a more accurate representation of an entity's financial position. As pointed out by Ryan (2008) and Ijeoma (2021) fair value accounting is a major factor responsible for issues in financial markets. In their opinions, Fair Value Accounting (FVA) is suitable to entities whose business is construed on fair values and trades in financial assets.

However, the implementation of fair value accounting has raised questions about its impact on the quality of earnings reported by banks. Earnings quality refers to the ability of reported earnings to reflect a company's true financial performance and to predict future earnings (Kothari et al., 2019). While fair value accounting provides real-time market-based measurements, it can also introduce volatility and subjectivity into financial statements, particularly in markets with illiquid assets or imperfect market conditions. This has led to concerns that fair value adjustments could distort earnings, making it difficult for stakeholders to assess the underlying financial health of banks.. Investors and other users of financial statements view earnings quality as a recipe for capital market efficiency considering its appeal in depicting the quality of earnings (Febriana et al., 2024).

The Nigerian banking sector has been under scrutiny due to instances of financial misreporting and fraudulent activities, which undermine investor confidence and the integrity of the financial markets. The adoption of fair value accounting raises concerns about the transparency and comparability of financial statements, especially in an environment where regulatory oversight may be inconsistent, and market conditions are highly volatile. Fair value accounting, as prescribed

by the International Financial Reporting Standards (IFRS), aims to provide more accurate and timely reflection of a bank's financial position (Febriana et al., 2024). However, this approach introduces significant volatility and subjectivity into financial statements, potentially leading to earnings manipulation and reduced reliability of financial reports. This issue is exacerbated by the current economic instability in Nigeria, characterized by fluctuating exchange rates, high inflation, and economic recession, which further complicates the application of fair value accounting and challenges the assessment of earnings quality. These challenges necessitate a comprehensive examination of how fair value accounting practices influence earnings quality and the overall financial health of deposit money banks in Nigeria.

Also, there exists a significant gap in the literature. Most studies have focused on developed markets, with limited research conducted in emerging markets like Nigeria (Palea (2022; Pompili & Tunito 2019; Takacs et al., 2020) Some studies revealed inconsistent results on the impact of fair value measurement on earnings quality, with some studies showing a positive relationship (Chouaibi, 2024; Akpan et al; 2024) and others finding a negative relationship (Sundkvist & Stenheim, 2024). Variable gaps exist in the measurement of earnings quality, with different studies using various proxies (Akpan et al., 2024; Shaban et al., 2020). Most studies focused on short-term periods (2012-2016) and limited research covered longer periods. Also, it was discovered that most studies focused on the banking industry, and limited research conducted on other sectors. Furthermore, there is a lack of research on the impact of fair value accounting on earnings quality in Nigerian deposit money banks, particularly in the context of IFRS adoption. [Akpan et al., (2024); Chouaibi, (2024); Sundkvist & Stenheim, (2024).

2.0 Literature review and hypotheses development.

2.1 Fair value accounting

Fair value accounting, as defined by the International Financial Reporting Standards (IFRS), is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction (International Accounting Standards Board [IASB], 2018). This definition emphasizes market-based measurements, aiming to provide a more accurate representation of an entity's financial position. Kothari et al. (2019) describes fair value accounting as a method that aims to reflect the current market conditions and expected future cash flows of financial instruments. This approach contrasts with historical cost accounting, which values assets based on their original purchase price. In a similar vein, Sundkvist and Stenheim (2024) defined fair value accounting as a valuation approach based on current market conditions rather than historical costs, arguing that it enhances the relevance of financial statements. As pointed out by Ijeoma (2021) fair value accounting is a major factor responsible for issues in financial markets. In their opinions, Fair Value Accounting (FVA) is suitable to entities whose business is construed on fair values and trades in financial assets. It was held that it could be misleading and improper to apply fair values for commercial banks portfolio of financial assets, during crises and when there was liquidity problems in the markets (Ijeoma (2021).

Fair value reflects market conditions relying on the balance sheet date and is referred to a

valuation at a specific moment in time. It presumes real-time exchange and finishing point, to avoid the variations in price that might happen. The fair value of the property is directed, at least in some part, by the rental income from tenants and, if appropriate, outflows such as rental payments. It is considered that the valuation is based on assumptions that would be considered to be rational and acceptable by agreeable and knowledgeable parties. The standard states that the best evidence of fair value will be provided by comparable transactions in similar properties in a similar location and condition. However, the standard allows the fair value to be estimated by using other information when market values are not available Kothari et al. (2019).

2.2 Earnings quality

Earnings quality reflects how much reported earnings are pointers to corporate profits in future (Kothari et al. (2019). Investors and other users of financial statements view earnings quality as a recipe for capital market efficiency considering its appeal in depicting the quality of earnings. (Ijeoma, 2021). Thus, EQ refers to how much earnings depict actual performance of the company (Dichev et al., 2013). They defined earnings quality as the extent to which reported earnings map onto cash flows. This definition emphasizes the predictive power of earnings with respect to future cash flows. Olaoye and Ibukun-Falayi, (2020) describe earnings quality as the sustainability and repeatability of earnings. According to Penman, high-quality earnings should arise from core operational activities rather than transitory or one-off items that do not provide a consistent picture of financial performance. The characteristics of high earnings quality are relevance, faithful representation, comparability, verifiability, timeliness and understandability, as formulated in conceptual framework for high earnings quality by Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB 2018). Earnings predictability points to the ability of earnings to occur as planned. Following previous research of McGregor (2022) and Febriana et al. (2024), earnings predictability (PRED) is identified with the adjustment of earnings shocks, where higher variance indicates lower predictability.

2.3 Fair value through other comprehensive income and earnings quality

Fair value gains or losses through other comprehensive income recognizes changes in fair value in other comprehensive income (OCI), rather than in profit or loss, until the asset is derecognized or impaired (IFRS Foundation, 2021). This approach is primarily applicable to financial assets that are held for the collection of contractual cash flows and for sale. These financial assets are initially measured at fair value plus transaction costs and subsequently measured at fair value, with unrealized gains or losses recognized in OCI until the asset is derecognized or reclassified (IFRS 9, Financial Instruments). This approach is particularly relevant for equity instruments and some debt instruments (IFRS, 2014). Debt instruments classified under FVTOCI are subject to changes in fair value being recorded in OCI, but interest income, impairment gains or losses, and foreign exchange gains or losses are recognized in profit or loss (KPMG, 2020). According to Barth et al. (2008), FVOCI provides a middle ground between fair value through profit or loss (FVPL) and amortized cost, allowing firms to reflect both the performance of financial assets and the intention behind holding them.

Chen et al. (2015) found that firms adopting FVOCI for their financial assets experienced less volatility in their earnings compared to those using FVPL. This reduction in earnings volatility was positively associated with stock price stability, suggesting that FVOCI contributes to a more stable financial outlook for investors. A study by Gebhardt et al. (2014) investigated the effect of FVOCI on the information content of financial statements found no significant relationship. Barth et al. (2012) found that fair value accounting enhances the relevance of financial statements for investors by providing a more accurate depiction of asset values. Thus, this study hypothesized that;

Ho₁: Fair value gain through other comprehensive income has no significant effect on earnings quality of listed deposit money banks in Nigeria.

2.4 Fair value gains/losses through profit or loss and earnings quality

According to IFRS 9, financial assets can be classified into three categories - amortized cost, fair value through other comprehensive income (FVOCI), and fair value through profit or loss (FVTPL). Instruments classified as FVTPL do not qualify for measurement at amortized cost or FVOCI due to their nature or the entity's business model (IFRS, 2014). Kieso et al., (2019) defined FVTPL as a classification for financial assets or liabilities that are either held for trading or designated as such upon initial recognition. They emphasize that this category captures instruments that do not fit the criteria for other classifications under IFRS 9. ICAN (2021) highlights that FVTPL is used primarily for derivatives and other financial instruments that an entity manages and evaluates on a fair value basis. This perspective underscores the strategic aspect of the classification, aligning it with management's intention and the entity's risk management practices.

Barth et al., (2012) found that fair value accounting, including FVTPL, tends to provide more timely and relevant information compared to historical cost accounting. This timeliness is crucial during periods of economic volatility, where fair value measurements can reflect current market conditions more accurately. A study by Paananen et al., (2020) on European financial markets post-IFRS adoption found that the use of fair value measurements, including FVTPL, was associated with increased market liquidity and reduced cost of capital. This indicates that investors value the transparency and up-to-date information provided by FVTPL, leading to more informed investment decisions. Fiechter, (2021) have shown that banks using FVTPL tend to have more volatile earnings but also greater transparency in their financial reporting. Kothari et al., (2019) suggests that the flexibility in fair value measurement allows firms to engage in earnings management, particularly when market prices are subject to significant fluctuations. Thus, this study hypothesized that;

Ho₂: Fair value gain or loss does not have any significant effect on earnings quality of listed deposit money banks in Nigeria

2.5 Theoretical framework

The signaling theory by Spence (1973)

The signaling theory was developed by Spence (1973). The theory posits that parties with more information (insiders) send signals to less-informed parties (outsiders) to convey pertinent information about the quality or value of their enterprise. In financial reporting, fair value accounting serves as a crucial signal to investors and other stakeholders regarding the current market value of a company's assets and liabilities, thus influencing their perceptions of the firm's financial health and future prospects (Spence, 1973). The signal theory is useful for describing behaviour when two parties (stakeholders and organizations) have access to different information.

Signaling theory helps explain how managers use financial reporting to convey information about a firm's underlying economic conditions and performance to investors and other stakeholders. The adoption of fair value accounting, which aims to provide a more accurate representation of an entity's financial position by measuring assets and liabilities at their current market value, can be viewed through this lens. Managers may use fair value measures as signals to indicate the quality and reliability of their financial statements, thus potentially influencing investors' perceptions and decisions (McGregor, 2022). The relevance of this theory to this study is that the theory provides a valuable framework for understanding the role of fair value accounting in financial reporting. By adopting fair value measures, managers can signal the credibility and transparency of their financial statements, potentially enhancing investors' confidence and decision-making. However, the impact on earnings quality depends on the reliability and accuracy of these measurements, necessitating strong regulatory oversight and governance practices to mitigate potential drawbacks.

2.6 Empirical review

Akpan et al. (2024) assessed the impact of fair value measurement on earnings management by deposit money banks in Nigeria using the Beneish Model (M-score model) as a proxy for earnings management. The research work adopted the ex-post facto research design. The population of this study comprised of the fourteen (14) Commercial banks listed on the Nigerian Exchange Group as at the year 2023. The result of the analysis showed a regression coefficient of -0.240 for fair value measurement indicating a 24% reduction in earnings management for every increase in fair value measurement. Akpan et al., (2022) investigated the determinants of fair value measurement of biological assets drawing samples from listed agricultural firms in Nigeria from 2012 to 2020. The findings of the study revealed that firm size and auditor type significantly influence fair value measurement of biological assets while ownership structure insignificantly influences this measurement.

Shaban et al., (2020) examined the impact of fair value measurements on earnings predictability. The study concluded that the unrealized gains or losses of fair value forecasted through comprehensive income have a high predictive power of earnings quality. The results also prove that the unrealized gains or losses of fair value forecasted through net income have a high

predictive power of earnings quality in the Jordanian commercial banks. Horsfall and Omah (2020) examined the effect of fair value measurement on organizational performance of firms in Nigeria. The study observations proves that a quick implementation of fair value of assets measurement might allow some assess into organizational earning capability and organizational performance. A p-value of 0.00 corresponds with majority despondence as grouped at the rejected area of the hypothesis.

Chukwu et al., (2020) determined whether the perception of investors on the quality of earnings reported by banks is affected by the fair value gains and losses (FVGL) reported in income statements (NI) and other comprehensive income (OCI). The result revealed that investors' perception of earnings quality is not associated with the FVGL reported in NI and OCI. We attribute this result to learning curve and preponderance of unsophisticated investors in the Nigerian stock market. The paper recommends regular training and retraining on accounting for financial instruments for preparers and users of financial statements, auditors and regulators.

Abiahu *et al* (2020) evaluated the effect of fair value reporting on financial profitability and firm value with focus on deposit money banks listed on the Nigerian Stock Exchange Using a sample of 13 banks quoted on the Exchange. Fair value was however found to affect firm valuation. Overall, the study concluded that in order to effectively evaluate financial performance and position, knowledge of fair value is not enough. Users also need to know the historical cost of the investment. Therefore, companies should adopt a hybrid form of measurement (measurements which entail both fair and historical values) in reporting their activities to reflect actual value creation.

Olaoye and Ibukun-Falayi (2020) examined the relationship between fair values and earnings quality to determine its nature, and the effect of fair value adoption on earnings quality. Ten banks were purposively selected for the study using the data on their annual financial statements for period, 2012- 2016, for analyses. The dependent variable was earnings quality (EQ), proxied by predictability (PRED) of earnings; while the independent variables were fair value through other comprehensive income (FVTOCI), log of total asset values (SIZE) and leverage (LEV). Employing ex-post facto research design using the panel data regression and correlation tests for analyses. The results showed that all the independent variables (FVTOCI, SIZE and LEV) have significant relationship with the dependent variable (EQ).

3.0 Methodology

The research design adopted in this study was as ex-post facto research design and this design was suitable for this study because the data used were historical. The population of this study consisted of 14 deposit money listed on the floor of the Nigerian Exchange Group from 2014-2023. The sample size for this study was 11 listed non-financial firms which were purposively selected. Secondary data source was employed to generate the data for the analysis. This study employed robust regression analysis to understand the interaction among the variables and estimate the relevant data.

Model specification

The model used in this study is represented below;

Earnings quality = f(fair value accounting)

$$EQ_{it} = \beta_0 + \beta_1 FVTPL_{it} + \beta_2 FVTOCI_{it} + \beta_3 FIMZ_{it} + \epsilon_{it} \quad (1)$$

Where:

- EQ = Earnings quality
- FVTPOL = Fair value through profit of loss
- FVTOCI = Fair value through other comprehensive income
- FIMZ = Firm size
- β_0 = Model intercept
- β_1 - β_3 = Coefficient to be estimated
- it = Cross section of listed deposit money banks in Nigeria with time variant
- ϵ_{it} = Stochastic error term

Table 1: Operationalization/measurements of variables

S/N	Variables	Notation	Apriori Sign	Sources
Dependent Variable				
1	Earnings quality	Total accruals = Net income - cash flow from operation		Pompili & Tunito (2019)
Independent Variables				
2	Fair value gain through other comprehensive Income	Log of Fair value of financial assets measured at fair value through other comprehensive income	+	Pompili & Tunito (2019)
3	Fair value gain through profit or loss	Log of Fair value of financial assets measured at fair value through profit or loss		Pompili & Tunito (2019)
4	Firm size (control variable)	Log of total assets	+	Pompili & Tunito (2019)

Source: Researchers' operationalization (2024)

4.0 Results and discussion

Descriptive Analysis

Table 2: Descriptive statistics of the effect of fair value accounting on earnings quality

Variable	Obs	Mean	Std. Dev.	Min	Max
EQ	110	0.256	0.874	-0.134	0.430
FVTPOL	110	29.514	13.648	3.000	59.000
FVTOCI	110	7.197	0.862	5.080	9.520
FIMZ	110	1.152	19.333	59.920	176.270

Source: Authors computation (2024)

Table 2 displays the descriptive statistics of the study with earnings quality (EQ), showing a mean of 0.256 with a standard deviation of 0.874, indicating a negative skewness in earnings quality. Fair value through profit or loss (FVTPOL) with a mean of 29.514 and a standard deviation of 13.648, highlights variation in the reported fair values through profit or loss. Fair value through other comprehensive income (FVTOCI) has a mean value of 7.197 and a relatively low standard deviation of 0.862. Firm size (FIMZ) shows a mean of 1.152 and a substantial standard deviation of 19.333, with extreme values from 59.920 to 176.270 highlighting the broad spectrum of assets base among the banks.

Correlation analysis

Table 3: Correlation analyses of the association between fair value accounting and earnings quality

	EQ	FVTOCI	FVTPLO	FIMZ
EQ	1.000			
FVTOCI	-0.249	1.000		
FVTPLO	-0.252	-0.029	1.000	
FIMZ	-0.387	0.675	0.389	1.000

Source: Authors computation (2024)

Table 3 shows the association between fair value accounting and earnings quality. The results show a negative association between fair value through profit or loss (-0.249) and earnings quality (EQ) during the period under study. The results indicate a negative association between fair value through other comprehensive income (-0.252) and real earnings quality (EQ) during the period under study. Finally, the result shows that there is a negative association between firm size (-0.387) and earnings quality (EQ) during the period under study. The results indicate the absence of multicollinearity since all the associations are seen to be weak and moderate.

Regression analysis

Table 4: Regression analysis of the effect of fair value accounting and earnings quality

Variables	(1) OLS-EQ	(2) Robust-EQ
FVTPOL	-0.027*** (0.000)	0.028*** (0.000)
FVTOCI	-0.244** (0.030)	0.136** (0.024)
FIMZ	-0.022*** (0.000)	0.031*** (0.000)
Intercept	1.278 (0.078)	0.453 (0.196)
Observations	700	700
R ²	0.110	0.110
Hetttest	72.33 {0.001}	
VIF	1.21	

*Notes: p-values are in parentheses. *** p<.01, ** p<.05*

Source: Authors Computation (2024)

Table 4 displays the results of regression analysis of the study. The result indicates that the OLS regression had an R-squared value of 0.200. This implies that the independent variables of the study could explain about 20% of the systematic changes in earnings quality during the period under study. However, the unexplained part of earnings per share has been captured by the error term. The result of the F-statistics of the OLS regression model for the sample banks in Nigeria with the associated p-value indicates that the OLS regression model, on the overall, is statistically fit and can be employed for statistical inferences. However, to further validate the estimates of the OLS results, this study also tests multicollinearity and heteroscedasticity.

Test for multicollinearity

The data presented in Table 4 shows that the average VIF is 1.21. Given that the mean VIF is less than 10 (Greene, 2009), this suggests that there is no multicollinearity and further supports the idea that none of the independent variables should be removed from the model.

Test for heteroscedasticity

The result of the heteroscedasticity test shows a chi2 value of 72.33 with a p-value of 0.001. The result shows significant p-values indicating that the assumption of homoscedasticity of the OLS regression results has been violated. Hence, the study re-specifies the model to control for this violation by employing robust regression as recommended by Greene (2009).

Discussion of findings

The result obtained from the robust regression in table 4.3 revealed that fair value gain or loss through profit or loss (Coef. 0.028 p-value 0.000) has significant positive effect on earnings

quality. This finding aligns with the understanding that fluctuations in fair value directly impact the profitability reported on the income statement. As a result, changes in the value of assets or liabilities held for trading or designated at fair value through profit or loss can increase quality when they contribute to positive fair value changes. This may signal stronger financial performance to investors, thus enhancing the attractiveness of the bank's shares. However, it also introduces a level of volatility in earnings, which may affect the consistency of EPS over time. This finding is particularly relevant for shareholders and potential investors as it indicates that fair value adjustments play a crucial role in the financial results and can be a key driver of profitability. This result is supported by Olaoye. & Ibukun-Falayi (2020) who concluded that fair value accounting significantly affect earning quality of banks in Nigeria.

The result obtained from the robust regression in table 4.3 revealed that fair value gain or loss through other comprehensive income (Coef. 0.136 p-value 0.024) has significant positive effect on earnings quality. The study also finds that fair value gains or losses recognized through other comprehensive income (OCI) have a significant effect earnings quality. While these gains or losses do not flow directly into the profit or loss statement, their effect is still captured in the broader financial performance reflected in EPS. This is because gains and losses in OCI represent changes in the fair value of assets and liabilities that are intended to be held long-term, such as equity investments or certain hedging instruments. The recognition of these changes outside the profit or loss statement provides a more stable and long-term perspective on the financial health of the bank. The significant impact on earnings quality suggests that fair value adjustments in OCI should not be overlooked, as they provide valuable insights into the bank's financial position and long-term prospects. The finding of this study is supported by Fiechter, (2021) who noted that banks using FVTPL tend to have more volatile earnings but also greater transparency in their financial reporting.

5.0 Conclusion and recommendation

The study concludes that fair value gains or losses, whether recognized through profit or loss or through other comprehensive income, play a significant role in determining the earnings per share of banks. The positive effect of fair value adjustments through profit or loss underscores the importance of these changes in the bank's profitability, while the significant impact of fair value gains or losses through OCI highlights the value of long-term financial health. To enhance transparency and manage risks, banks must adopt comprehensive strategies for fair value management and ensure effective communication with investors. By doing so, they can strengthen financial stability and investor confidence. Thus, deposit money banks should enhance their risk management strategies to mitigate the volatility introduced by fair value changes in assets and liabilities. This can involve greater use of hedging instruments to offset potential losses. They should also consistently monitor and Reporting: Banks should consistently monitor fair value changes and ensure accurate and timely reporting of these figures to provide transparency and enable informed decision-making by investors and stakeholders.

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