International Journal of Research Publication and Reviews

Journal homepage: www.ijrpr.com ISSN 2582-7421

Borrowing Costs and Financial Reporting Quality of Small and Medium Scales Enterprises in South-East, Nigeria

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DOI: https://doi.org/10.55248/gengpi.2022.3.11.25

ABSTRACT

This study hinges on the effect of borrowing cost (IAS 23) on the financial reporting quality of Small and Medium Scales Enterprises (SMEs) in South East Nigeria. This is because the measurement of borrowing cost in the financial reports of most SMEs operators in Nigeria is highly incomprehensible even after IFRS implementation in Nigeria. This unsatisfactory disposition reveals that SMEswith high-debt-ratio are prone to manipulate earningsin order to increase their reported earnings and avoid the debt covenant default which all togetherundermine the financial reporting quality of these firms.Most SMEs still subscribe to indiscriminate treatment of borrowing cost while the effect of borrowing cost on financial reporting quality is equally not known with certainty. To this end, the study evaluates the effect of borrowing cost on value relevance, faithful representation, comparability and understandability of the financial reporting of SMEs in South East Nigeria. To this end, primary data were elicited from 284 respondents. Hypotheses were tested using the Analysis of Variance and it was discovered that appropriate measurement of borrowing cost enhances the recognition of interest and other expenses incurred by an entity connected with borrowing cost. It also engenders the predictive and confirmatory value of the accounting numbers and helps SMEs to avoid all forms of misrepresentation and biasin their financial reports.

KEYWORDS: Borrowing costs, value relevance, faithful representation, understandability & comparability

1.Introduction

The operationalization of borrowing cost (IAS 23)in the financial reports of SMEs in Nigeria has been interwoven with implementation exposures in many quarters even after IFRS implementation in Nigeria. There have been hues and cries among stakeholders regarding how the treatments of borrowing costs in the financial statements breed diminution of profit which was not the case in the pre-IFRS implementation era.It is common spectrum that borrowing cost arises when businesses embark on debt financing.

Nida (2016) opined that borrowing cost broadly refers to the cost involved in accessing credit. Borrowing cost occurs both on the lender's side and the borrower's side. On the lender's side, the borrowing cost is mostly called interest income which usually includes: costs of information gathering, loan administration, enforcement and others. On the borrower’s side the borrowing cost include: high interest rate, membership requirements, high service fees to mention but a few (Sharbati, Aslani&Barandagh, 2014). All of which ordinarily impinges on the borrowing capacity of businesses that leveraged on debt financing.

Accounting for borrowing costis of less concern to businesses that have little or nothing to do with debt financing. However, in the wake of the present economic reality that was orchestrated by the hydra-headed coronavirus saga, unfavorable economic policies and economic mismanagement by the political class in Nigeria; the present economic atmosphere has witnessed high inflationary rate, high cost of production, low purchasing power, high cost of diesel and fuel as well as rising cost of consumables etc. These havecompelled businesses to resort to debt financing with very high borrowing costswhich are presently unsustainableand highly inimical to the success of businesses in Nigeria.

Besides the highborrowing costs,several business owners and shareholders on the other hand are apprehensiveon the measurement of borrowing cost in the financial statement which to them is unwholesome and incomprehensible.This exposure stems from the fact that appropriate accounting for borrowing cost could lead to recognition of high expenses in most cases which leads to reduced performance;whereas, SMEs are accustomed to indiscriminate treatments of borrowing costs even after the advocacy for the implementation of borrowing cost as contained the IAS 23.Nida (2016) also added that businesses with high-debt-ratio are prone to manipulating earnings in order to increase their reported earnings and avoid the debt covenant default. These by extension inversely affect the financial reporting quality of firms.

Although, the International Financial Reporting Standards (IFRSs) were fully implemented in Nigeria in 2012 and businesses were expected to abide to the guidelines of the standards (Beredugo, Igbeng&Eze, 2013). However, despite this landmark, the full implementation of borrowing cost-IAS23 has not been duly observed by some of these businesses, thereby making their financial statements unreliable.These actions have continued to breed misrepresentation in the financial statement of SME operators.

There have also been apprehensions among some stakeholders as to the implementation of borrowing cost. This is because it mostly leads to the reduction in the company's financial position. In other instances, most firms are shying away from the implementation because they lack the technological know-how on the subject matter (Beredugo, 2020).

In addition, the effect of borrowing cost is not known with certainty. The lapse in the financial reporting system could also be traceable to the unspecified effect of borrowing cost on financial reporting by SMEs. This is because the treatment of some aspect of borrowing cost (IAS 21) is regarded as an expense, whereas they were usually capitalized before the mandatory requirement of IAS. It is against this background that this study evaluates the effect of borrowing costs on financialreporting quality of SMEs in South East States in Nigeria. To this end the following question was answered: to what extent does accounting for borrowing cost affects the financial reporting quality of SMEs in South East States in Nigeria?

2. Literature review and theoretical framework

2.1 Borrowing costs

Borrowing costs that are specifically incurred for the acquisition, construction or production of a qualifying asset may be included in the cost of that asset. Such borrowing costs may be capitalized as part of the cost of the asset, when it is probable that they will result in future economic benefits or service potential to the entity and the costs can be measured reliably. Borrowing costs can also be recognized as an expense in the period in which they are incurred. The effect of the application of the standard on the quality of financial report can be better explained using the agency theory.

This theoretical underpinning is concerned with resolving the problems that can occur in agency relationships. Its efficacy is discussed under the agency cost which is the summation of the monitoring costs, bonding costs and residual loss. By these, the owners limit the abnormal activities of the managers, by incurring monitoring costs. The management compensates the owners in return, by incurring "bonding costs" to assure the owners' that their actions will not be injurious (e.g.using the appropriate measurement of borrowing cost in the company's financial report). Residual loss could be unavoidable loss company experiences as result of observing generally acceptable principle which is a reflection of the encumbrances associated with the implementation IAS 23. Agency costs can therefore be reduced by educating owners and by disclosing more information in the financial statements which enable the owners to have access to appropriate, relevant and reliable information.

In view of the above IAS 23 - borrowing cost advocates that when an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity recognizes an expense for the borrowing costs in the period in which they are incurred. When an entity applies "Financial Reporting in Hyperinflationary Economies," it recognizes as an expense the part of borrowing costs that compensates for inflation during the same period in accordance with IFRS 13.

When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified. Funds sourced from general borrowings of the entity are not specifically incurred and costs related to such borrowings are not eligible for capitalization. Funds that have been borrowed centrally may be transferred to other entities within the economic entity as a loan, a grant or a capital injection. Some loans may be interest-free or require that only a portion of the actual interest cost be recovered and grants or capital injections do not normally incur interest (Okoroafor, 2016). This is accounted for in relation to qualifying assets of organizations.

2.1.1 Qualifying Assets of an organization

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale (ICAN, 2019). Qualifying assets are usually self-constructed non-current assets. Any of the following may be qualifying assets depending on circumstances: inventories, items of property, plant and equipment; intangible assets; office buildings; Power generation facilities and Investment properties. While the following are regarded not qualifying assets: inventories that are manufactured or otherwise produced, over a short period of time; and assets that is ready for their intended use or sale when acquired (ICAN, 2019).

2.1.2 Borrowing costs eligible for capitalisation

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset must be capitalized as part of the cost of that asset. All other borrowing costs are recognized as an expense in the period in which they are incurred. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those that would have been avoided if the expenditure on the qualifying asset had not been made. This includes the costs associated with specific loans taken to fund the production or purchase of an asset and general borrowings. General borrowings are included because if an asset were not being constructed it stands to reason that there would have been a lower need for cash (ICAN, 2019).

The cost of borrowing money is affected by five major factors that restrict borrowing capacity at a particular time: this is Risk level, Inflation, Interest Rate, Market and Economic conditions and Collateral Security.
This standard specifies that borrowing costs should be recognized from the date when the entity:

a. Incurs borrowing costs;
b. Incurs expenditure on the qualifying asset; and
c. Commences activities that are necessary to get the asset ready for its intended use or sale (Cîrstea, 2014).

Borrowing costs may include:
(a) Interest on bank overdrafts and short-term and long-term borrowings;
(b) Amortization of discounts or premiums relating to borrowings;
(c) Amortization of ancillary costs incurred in connection with the arrangement of borrowings;
(d) Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (Botzem& Sigrid, 2009).

2.2 Financial Reporting Quality

The IFRS/IASs are basically developed to ensure that firms engage in activities that are directed towards observing the principles of transparency, financial presentation and accountability. Its entail financial responsiveness and a show of stewardship in good faith regarding the management of the resources entrusted to management. IFRS/IAS in their Conceptual framework posited that high quality is attained by obeying the objectives and the qualitative characteristics of financial reporting information. The objective of the IASB is to serve the public interest by setting high-quality accounting standards, thereby enhancing the quality and consistency of practice throughout the world and strengthening the transparency and accountability of Firms. The qualitative characteristics as stated in IASB conceptual framework are relevance, faithful representation; comparability, verifiability, timeliness and understandability. These qualitative characteristics are integral to, and work with, the other characteristics to provide information useful for achieving the objectives of financial reporting.

Relevance

Relevance is referred to as the capability of making a difference in the decisions made by users and their capital providers. Financial and non-financial information is capable of making a difference when it meets the objectives of financial reporting, has confirmatory value and predictive value (IFAC 2014). It provokes high reliance on the accounting numbers(Greuning, Scott &Terblanche, 2011; PricewaterhouseCoopers, 2012).

Faithful representation

Faithful representation is the second fundamental qualitative characteristic. This is attained when the depiction of the phenomenon is complete, neutral, and free from material error. Information that faithfully represents an economic or other phenomenon depicts the substance of the underlying transaction, other event, activity or circumstance—which is not necessarily always the same as its legal form (Udeh&Sopekan, 2015). An omission of some information can cause the representation of an economic or other phenomenon to be false or misleading, and thus not useful to users of Financial Reports. All relevance information must be measured and appropriately disclosed.

Comparability

This comparability of financial reports places a greater demand for transparency and accountability on public officers who manage the activities and transactions of the public corporations. This may further enhance public-private partnership. Comparability is the quality of information that enables users to identify similarities in, and differences between, two sets of phenomena. Comparability is not a quality of an individual item of information, but rather a quality of the relationship between two or more items of information (Sloan, 2001).

Information about the entity's financial position, financial performance, cash flows, compliance with approved budgets and relevant legislation or other authority governing the raising and use of resources, service delivery achievements, and its future plans is necessary for accountability purposes and useful as input for decision-making purposes. The usefulness of such information is enhanced if it can be compared with, for example:

- Prospective financial and non-financial information previously presented for that reporting period or reporting date;
- Similar information about the same entity for some other period or some other point in time; and
- Similar information about other entities (for example, public sector entities providing similar services in different jurisdictions) for the same reporting period (Greuning, *et. al*,, 2011).

Understandability

Understandability shows the quality of information that enables users to comprehend its meaning. Firms are expected to present information in a manner that responds to the needs and knowledge base of users, and to the nature of the information presented. It is also believed that information on the financial reports should be verifiable in order to support the quality of the financial report (IFAC, 2016). Explanations of financial and non-financial information and commentary on service delivery and other achievements during the reporting period and expectations for future periods should be written in plain language, and presented in a manner that is readily understandable by users. Understandability is enhanced when information is classified, characterized, and presented clearly and concisely in line with the generally accepted principles and accounting standards (Beretha&Bozzolan, 2004).

2.3 Borrowing costs and Financial Reporting Quality

Benson (2014) carried out a study on "the effect of cost of credit on the financial performance of commercial diary small and medium enterprisesin Kenya. He found out that there is a significant relationship between financial performance of SMEs and the cost of credit offered by financial service providers. This study focused more of the financial performance rather than the financial reporting quality that is required to make informed decisions on the accounting numbers.

Nida (2016) in his study titled effects of borrowing costs, firm size, and characteristics of board of directors on earnings management types in Borsa Istanbul shows that managers are more likely to move the following period's reported earnings to the current period, considering the company is closer to a credit agreement since the debt covenant default is costly because it increases the cost of debt capital and reduces useful investments. Omid, Khalili, and Mohammadi (2012) also suggested a positive relation between Earnings Management and borrowing costs. These have gone to show that the application of borrowing cost could affect the predictive or confirmatory value of the financial report in terms of value relevance and faithful representation of the financial reports.

As per Okoye and Adediran (2013) the presentation and appropriation of IFRS/IAS in Nigeria will make and support open doors for bigger money change for firm and upturn the centralization of economies of scale. Taiwo and Adejare (2014) recommended from their investigation that IFRS/IAS will upgrade money related execution. It will likewise upgrade business proficiency.

A study conducted by Samuel (2017) on the Reluctance of capitalizing the Borrowing Cost carried out at the residence development in the province of Jawa Barat, Indonesia. The study showed that there was a positive and significant impact of borrowing cost as the representation of capitalized interest cost towards EPS. This aspect of the study did not look into the understandability, completeness or neutrality posture of borrowing cost.

Furthermore, Waweru and Riro (2013) find evidence that managers in highly leveraged firms in Kenya practice more earnings management (EM) than unleveraged ones.In contrast, Zamri, Rahman, and Isa (2013) reveal that managers in slightly leverage firms in Malaysia practice more EM than leveraged ones. This demonstrates some level of bias in the presentation of the financial reporting which could undermines the financial reporting quality of an organization.

3. Methodology

The survey research design was used to assess the effect of borrowing cost on financial reporting quality of SMEs in South East Nigeria. This is undertaken by administering questionnaires to Accountants and auditors of the selected SMEs in the Zone. The questionnaire is designed to facilitate responses that would confirm the extent to which the borrowing cost affect the financial reporting quality of SMEs in South East Nigeria.

A total of 393 firms were selected from the Agricultural, Consumer Goods, Healthcare, Oil & Gas, and Utility/Service industries in the South East geopolitical zone. This selection was based on firms with well-structured accounting department. The respondents' population of the study comprises of 983 accounting staff from the 393SMEs in the Zone.

A sample size of 284 respondents from 257 SMEs was considered adequate following computation using Yamane sample size determination. The stratified sampling technique was applied to determine the population quota of each of the industries and simple random sampling for choosing the actual respondents in each industry.

Table 1: SAMPLING DISTRIBUTION OF SMEs IN THE SOUTH EAST GEOPOLITICAL ZONE

SECTOR	ANAMBRA	ENUGU	IMO	ABIA	EBONYI	Total
Agriculture	10	10	11	11	11	53
Consumer Goods	`	11	10	10	10	51
Healthcare	9	10	10	10	10	49
Oil & Gas	9	10	9	9	9	46
Utility	10	10	10	10	9	49
Total	48	51	50	50	49	248

Source: Researcher's Computation, (2022)

The targeted respondents all have good understanding of Borrowing Cost and financial reporting quality. The study focused majorly on the primary sources of data through the questionnaire which was administered to sampled respondents. The questionnaire designed for the independent variables contain closed-ended items designed on a 5-point Likert scale. The respondents were expected to indicate their choices by ticking one of these options. The measures used for financial reporting quality include constructs relating to: relevance, faithful representation, understandability, and comparability of financial reporting quality.

The instrument was tested for reliability and the result shows a high correlation of 0.89 indicating that the instrument was able to measure the construct reliably.The full specification of the regression equations are as presented below, where, $\boldsymbol{\beta}_{0,}$ =regression intercept; $\boldsymbol{\beta}_{i,}$ =parameters to be estimated=1....., 284 (number of samples) and ε_j = the error term.

$FRQ_i = \boldsymbol{\beta_0} + \boldsymbol{\beta}_1 BC_i + \varepsilon_i$ ……………… equation 1.1

Where:

FRQ = Financial Reporting Quality (relevance, faithful representation, understandability and comparability)

BC = Borrowing cost.

i = respondents (1…284)

The 'a priori expectations are:

$\boldsymbol{\beta}_1 > 0$; implying that the higher the BC, the higher the financial reporting quality.

In relation to the analysis of data, the Objective was examined using the Analysis of Variance. Appropriate testing of the estimates of the regression results was employed. Statistical significance of the result was determined using t-statistics at 5% levels of significance.

4. Data Presentation and Analysis

The data presentation and analysis carried out under this sub-section is based on responses gathered from respondents through the administered questionnaire.

Table 2: Descriptive Statistics on Borrowing cost

IAS 23	N	Minimum	Maximum	Mean	Std. Deviation
1. Business discloses the accounting policy adopted for borrowing costs.	284	1.00	5.00	2.6408	1.24032
2. Borrowing costs that are specifically incurred for the acquisition, construction or production of a qualifying asset are included in the cost of that asset.	284	1.00	5.00	3.8521	1.06633
3. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.	284	1.00	5.00	3.9231	0.93233
4. Other borrowing costs are recognized as an expense in the period in which they are incurred.	284	1.00	5.00	2.9876	.91240
5. The borrowing costs capitalized during a period does not exceed the actual borrowing costs incurred during that period.	284	1.00	5.00	3.0282	1.18854
Valid N (listwise)	284				

Source: Researcher's Computation, (2022)

Table 2 entails the descriptive statistics on the components of borrowing cost as used in this study. The minimum and maximum values for responses on Business disclosure of accounting policy that were adopted for borrowing were between 1 and 5 respectively. The mean distribution and the standard deviation also stand at 2.64 and 1.24 respectively. In relations to response on borrowing costs that were specifically incurred for the acquisition, construction or production of a qualifying asset are included in the cost of that asset show that the minimum value is 1 and the maximum value is 5 while the mean distribution and the standard deviation is 3.8521 and 1.06633 respectively.

The minimum and maximum values for question relating to the readily identifiable qualifying assets when a business borrows fund specifically for the purpose of obtaining a qualifying assets are 1 and 5 respectively while the mean distribution and standard deviation are 3.90 and 2.9876 respectively. The maximum and minimum values on whether other borrowing costs are recognized as an expense in the period in which they are incurred are 1 and 5 respectively while the values for mean and standard deviation are 2.9876 and 0.912 respectively. Lastly the question on borrowing costs capitalized during a period does not exceed the actual borrowing costs incurred during that period shows that the minimum and maximum values on are 1 and 5 respectively while the values for mean and standard deviation are 3.0282 and 1.18854 respectively.

Table 3: Descriptive Statistics on the Characteristics of Financial Reporting Quality

QFR		Statistic	Std. Error	95% Confidence Interval Lower	95% Confidence Interval Upper
Relevance	Mean	2.52	.03	2.45	2.59
	Std. Deviation	.641	.022	.594	.682
	N	284	0	284	284
Faithful_Repre	Mean	2.50	.03	2.44	2.57
	Std. Deviation	.657	.024	.603	.701
	N	284	0	284	284
Understandability	Mean	2.48	.04	2.41	2.54
	Std. Deviation	.645	.024	.592	.687
	N	284	0	284	284
Comparability	Mean	2.48	.04	2.41	2.55
	Std. Deviation	.665	.025	.611	.710
	N	284	0	284	284

Source: Researcher's computation (2022)

Table 3presents the descriptive statistics on the characteristics of financial reporting quality which include relevance, faithful representation, understandability, comparability and timeliness. Relevance had a mean score of 2.52 with an accompanying standards deviation of 0.641, faithful representation had a mean score of 2.50 with a standard deviation of 0.657, understandability had a mean score of 2.48 with a standard deviation of 0.645, comparability had a mean of 2.48 and a standard deviation of 0.665 while timeliness had a mean score of 2.27 and standard deviation of 0.541.

TABLE 4: ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
Relevance	Regression	170.328	1	170.328	181.229	.000[b]
	Residual	265.038	282	.940		
	Total	435.366	283			
Faithful Representation	Regression	267.386	1	267.386	1386.009	.000[b]
	Residual	54.403	282	.193		
	Total	321.789	283			
Understandability	Regression	150.178	1	150.178	1.051	.734[b]
	Residual	177.611	282	.630		
	Total	327.789	283			
Comparability	Regression	68.766	1	68.766	116.241	.000[b]
	Residual	166.826	282	.592		
	Total	235.592	283			

a. Dependent Variable: Relevance, Faithful Representation , Understandability , Comparability

b. Predictors: (Constant), BC

Source: Researcher's computation (2022)

Table 4 shows the effect of borrowing cost on the attributes of financial reporting quality which ranges from value relevance, faithful representation, understandability and comparability of the financial reporting.

Hypothetically it can be discovered that Accounting for borrowing cost significantly affect {$F_{\text{Statics}} = 181.229$, p-value $0.000 < 0.05$} the value relevance of financial reporting. The f-value of 181.229 with a p-value of 0.000 depict that the application of borrowing cost (IAS 23) in the financial reporting of organizations that uses debt financing in its operation enhances the value relevance of the financial report. It gives more meaning to the accounting number by making sure the financial statements are relevant for effective decision making as outlined by the specificity of qualitative financial reporting.

In relations to faithful representation; borrowing cost also significantly affect {$F_{\text{Statics}} = 181.229$, p-value $0.000 < 0.05$} the faithful representation of financial reporting. The F-statistics which indicate a higher f-value of 1386.009 with an accompanying p-value shows that were borrowing cost are adequate accounted for in the financial statement as specified by the generally acceptable standard, it is tantamount to ensuring that the financial report contains all information, not bias and it is free from material error that might influence the judgment of a reasonable person.

Our result on the effect of borrowing cost on the understandability of {$F_{\text{Statics}} = 1.051$, p-value $0.734 > 0.05$} financial reports shows that the application of borrowing cost does not significantly affect understandability of financial reporting. By implication most of the recipients of the financial reports are yet to fully comprehend the philosophy behind the capitalization of some borrowing cost on one hand and expensing of other borrowing cost on the other hand. To them given the Nigeria scenarios with an increasing cost of borrowing, these costs should have been capitalized to portray the financial position. This is because the borrowing cost is mostly added to the long term debt which must be repaid in the short or long run as the case may be. The requirement also did not conform to the present needs of most organization in Nigeria which persistently impinge on their understanding.

Lastly, our result on the effect of borrowing cost on comparability shows that the application of borrowing cost in the financial statement significantly affects the comparability of financial reporting. This is because; where a specific standard has been adopted for use by a firm and the sector it operates. It simply creates room for comparability of event within itself or among it peers or competitors. By implication the application of borrowing cost IAS 23 in a firm's financial statements enables users to identify similarities in, and differences between, two sets of phenomena. This comparison creates room for improvement.

5 Summary, Conclusion and Recommendations

The application of borrowing cost significantly affect the relevant, faithful representation and comparability of financial reporting quality, however this was not the case between the effect of borrowing cost on understandability of financial reporting among SMEs in south east states. All our results were in congruence with our a priori expectation except for the effect of borrowing cost on understandability of the financial reporting

Appropriate measurement of borrowing cost is to enhance the recognition of interest and other expenses incurred by an entity in connection with borrowing cost. This standard has proven its value relevance in the prompt recognition of borrowing cost as expense except for qualifying assets as a means of measuring assets and liabilities in their real values and enhancing the financial reporting of government. It application does not only bring about predictive value of organizations activities but also serve as a confirmatory value of the accounting numbers in the financial statements. By these, managers with or without highly leveraged firms would give appropriate treatment of borrowing cost in the financial reports as a means of avoiding misrepresentation and bias.

Appropriate accounting for borrowing cost could also engender neutrality, verifiability, consistency, free from material errors and completeness in the financial information. While in terms of understandability, most firms did not give a vividly presentation of accounting for borrowing cost in a well-organized manner and the notes to the statement of financial position and the income statement regarding borrowing cost were not sufficiently clear which create the room for the insignificant relationship between borrowing cost and understandability of financial reporting of firm.

Based on the findings of the study, the following recommendations were proposed:

i. For Borrowing cost policy to be properly understood and applied in practice, sensitization, general capacity building and training of all relevant partiesare essential.

ii. Regulators should also encourage greater compliance with Accounting for borrowing cost as a means of ensuring more comparability and transparency of financial accountability.

iii. Firms should as a matter of urgency take cognizance of appropriate recognition of borrowing costs that were incurred to obtain a particular qualifying asset as a means of enhancing the quality of financial reports.

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