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EFFECT OF IAS23 COMPLIANCE ON SOLVENCY OF DEPOSIT MONEY BANKS IN NIGERIA

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ABSTRACT

The general knowledge from the understanding of IAS 23 is that borrowing costs incurred in financing qualifying assets be capitalized with the accompanying capitalization rate duly disclosed in the financial statement, but the implication of such treatment on entity's solvency is seldomly discussed. This study presented the relationship between IAS 23 compliance and the solvency performance of deposit money banks in Nigeria. Borrowing costs capitalized and IAS 23 disclosure were used to predict the observed dependent variable (Debt-to-assets ratio). Seventy-five financial statements from fifteen sampled banks over a period of five years (2016-2021) were analyzed using Statistical Product and Service Solutions (SPSS) version 23. The findings revealed significant inverse relationship between Capitalized borrowing costs and the value of debt-to-assets ratio meaning that as the capitalization of banks' qualifying borrowing costs increases, the debt-to-assets ratios decreases.IAS 23 disclosure has a positive significant relationship with Debt-to-assets ratio. This study rejected the null hypothesis and concluded that the relationship between IAS 23 compliance and the solvency performance of commercial banks in Nigeria is statistically significant. While IAS 23 has succeeded in improving comparability by eliminating some of the divergences with the US GAAP, this study recommended reduction in judgmental interpretations through further amendments to specifically define some terms such as 'substantial period of time', cessation of capitalization of borrowing costs when activities necessary to prepare the qualifying asset have been 'substantially' completed.

KEYWORDS: Borrowing Costs, IAS, IFRS, Qualifying Assets, Solvency.

INTRODUCTION

The desire to ensure a set of financial statements that is credible enough to show the true and fair view of the entity's financial position has resulted in the establishment of many standards over the years (Bodle, Cybinski, & Monem, 2016). The need for common accounting language and treatments of accounting transactions further led to the harmonization and convergence of standards across the globe (Ali & Flayyih, 2021; Bassemir & Novotny-Farkas, 2018). Many authors have concluded based on the outcome of their research, that the adoption of IFRS and the harmonization of the required standards for accounting treatment of business transactions have increased comparability of financial reports and the quality of the financial statements available to users(Habib, Bhuiyan, & Hasan, 2019; LI & Yang, 2016; Mensah, 2020; Osasere & Ilaboya, 2018). Very specific to the treatment of borrowing cost is the introduction of IAS 23. In determining the initial measurement of an asset, the general concern has always been whether to capitalize the finance costs accrue from the acquisition, production, or construction of qualifying assets or to expense the finance cost through the income statement (Muthupandian , 2009). Some accounting practitioners opined that capitalizing the attributable finance costs of qualifying asset will better present a more realistic market value of the asset thereby helping to present a true and fair financial position to users of financial information than to write off the qualifying finance costs through the profit or loss account.

In 1982, precisely November, the International Accounting Standards Committee (IASC) published its first exposure draft (E24) to address the concerns around the capitalization of borrowing costs. This became a reference point for accounting treatment of borrowing costs until March 1984 when International Accounting Standards (IAS) 23 was launched and fully took effect on the 1st of January 1985. The application of IAS 23 witnessed several comparability challenges which led to the release of the revised IAS 23 in 1993 to address the issue of financial statements comparability with effective date of implementation being 1st January 1995.

Specific consideration was given to the capitalization of borrowing costs of qualifying assets to achieve a convergence with the US GAAP. Between May 2006 to 1st January 2009, IAS 23 was amended to recognize borrowing costs components and the amendment to IFRS annual improvement took place between 2015 to 2017(Manea , 2018).While series of studies have been conducted in trying to explain the applicability, adoption, and convergence of IFRS to promote better understanding and comparability of financial statements, very few scholarly articles exist that discuss IAS23. This study is therefore sought to consider the relationship between IAS 23 compliance and solvency performance of deposit money banks in Nigeria. Audited financial statements from fifteen commercial banks for a period of five years have been used to establish a relationship model between IAS 23 compliance and solvency performance.

Table 1

History of IAS 23	
November 1982	Exposure Draft E24 Capitalisation of Borrowing Costs
March 1984	IAS 23 Capitalisation of Borrowing Costs
1 January 1986	Effective date of IAS 23 for 1984 IAS 23
August 1991	Exposure Draft E39 Capitalisation of Borrowing Costs
December 1993	IAS 23 (1993) Borrowing Costs (revised as part of the 'Comparability of Financial Statements' project)
1 January 1995	Effective date of IAS 23 (1993) Borrowing Costs
25 May 2006	Exposure Draft of proposed amendments to IAS 23
29 March 2007	IASB amends IAS 23 to require capitalisation of borrowing costs.
22 May 2008	IAS 23 amended for 'Annual Improvements to IFRSs 2007 for components of borrowing costs
1 January 2009	Effective date of March 2007 and May 2008 amendments to IAS 23
12 December 2017	IAS 23 amended for 'Annual Improvements to IFRS Standards 2015–2017

Source: https://www.iasplus.com/en/standards/ias/ias23

LITERATURE REVIEW/THEORETICAL REVIEW

- **Conceptual Review**

IAS 23 defined borrowing costs as the interests and other costs that an entity incurs in relation to borrowing of funds. Ordinarily, borrowing cost and the related interest expense incurred in the process of obtaining and utilizing borrowed funds are expected to be expensed into the profit or loss account. However, IAS 23 gave exception to borrowing costs of qualifying assets to be capitalized. An asset is said to be a qualifying asset when such asset takes substantial period of time to be completed for the intended use or sale. Controversy remains as to what constitute a substantial period, but individual entity's professional judgment has continued to apply especially when such asset requires more than twelve months or more to be ready for its intended use.

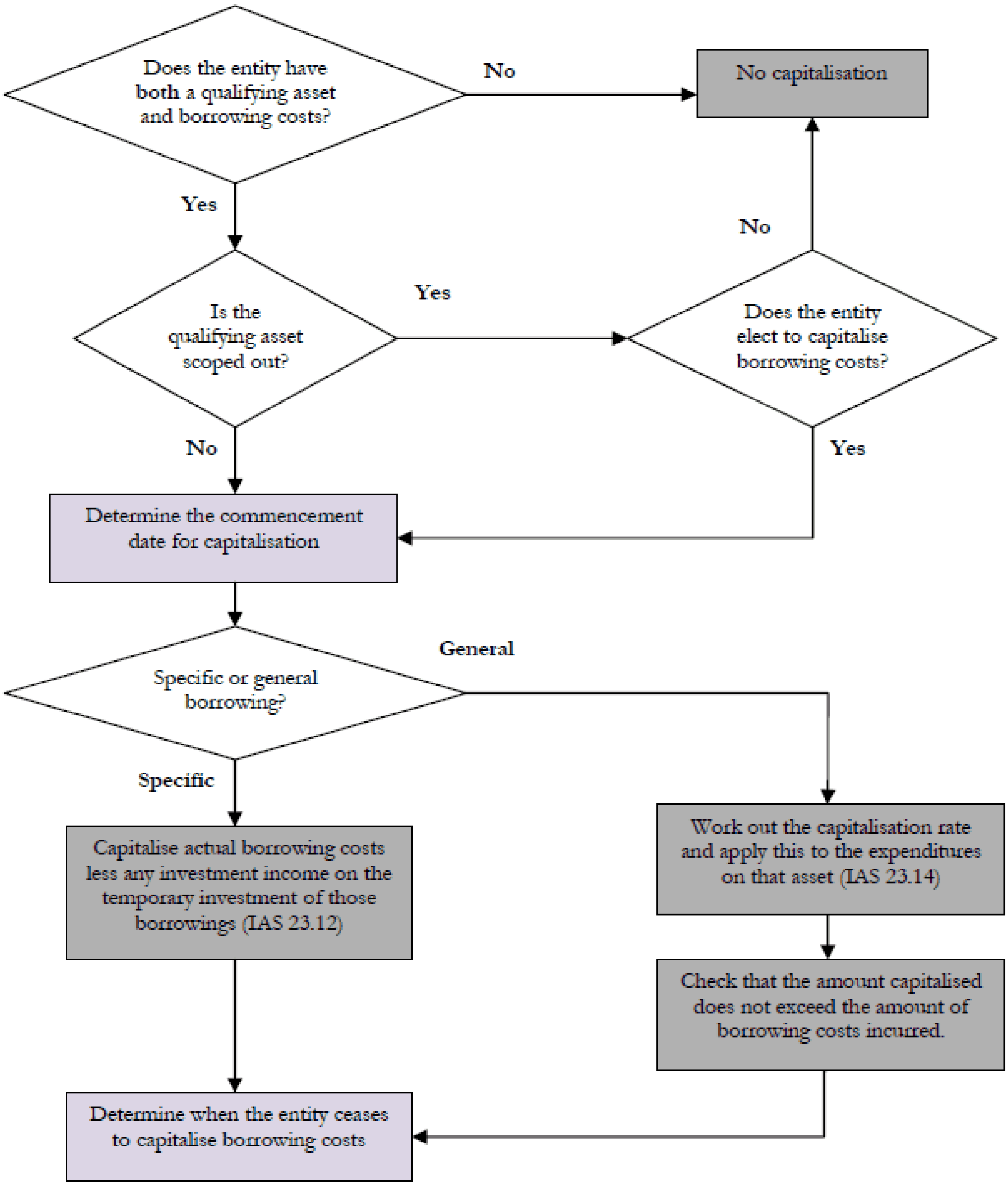
The standard further provides that where funds are taken from multiple sources at different interest rate, the capitalized interest rate shall be the weighted average of all the interest rates. The eligible borrowing costs represent costs that are directly attributable to borrowing funds for the qualifying asset, costs from funds borrowed specifically for obtaining a qualifying asset and general borrowings used in part to obtain a qualifying asset. Two key disclosures are required of an entity: the amount of capitalized borrowing cost during the financial year and the capitalization rate used in determining the eligible capitalized amount of borrowing cost (Tudor & Dragu, 2011).IAS23gavespecific requirements to commencement, suspension, and cessation of capitalization of borrowing costs for qualifying assets.

The standard recommends commencement of capitalization of borrowing costs for qualifying assets only to the extent that the expenditure and borrowing costs incurred are attributable to activities that are necessary to deliver the asset for its intended use or sale. In other words, Interests to be capitalized is limited to interests during active activities necessary for the construction of such qualifying assets. However, during a disruption to the period of active activities, capitalization of borrowing costs is expected to be suspended. That is, where there is a halt or stoppage in activities, borrowing costs during these periods are expected to be expensed except where the halt or stoppage is necessary for the quality of the item of asset. The cessation of capitalization of borrowing costs begins when an organization substantially realizes the completion of activities required for the attainment of the purpose for which the asset is constructed.

IAS 23 Specific Measurements

i. Funds borrowed specifically for the construction of qualifying assets; the borrowing costs eligible to be capitalized is the actual costs incurred less any income earned from temporal investment of such borrowed funds.
ii. In cases where the borrowed funds are part of general pool i.e. multiple borrowing not directly related to specific project; capitalization rate shall be applied on the expenditure for the asset in determining the eligible borrowed amount where capitalization rate is defined as the weighted average of the borrowing costs for the general pool.
iii. Capitalization can only commence when expenditures and borrowing costs are being incurred on qualifying assets with activities that are necessary to complete the asset for its intended use or sale are in progress.
iv. Capitalization should be suspended when active activities are interrupted except where such interruptions are necessary for the completion of the assets for instance, interrupting building construction works to allow concrete to dry and solidify.
v. Capitalization should cease when the activities necessary to deliver a qualifying asset for its intended use or sale have been substantially completed irrespective of whether such asset is being used, occupied or sold. An asset is professional adjudged to have been substantially completed when activities required to complete such asset can be regarded as minor.
vi. The construction of qualifying assets that can be split into milestones, components, or stages capable of being utilized while the construction of other components is ongoing, capitalization of attributable borrowing costs should cease when activities for each successive component are substantially completed.

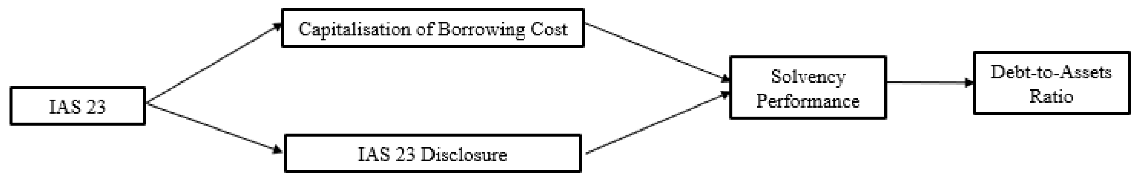
Figure **1: IAS 23 DECISION FLOW**



Source: https://annualreporting.info/borrowing-costs/

Figure 1 depicts the objective of this study by evaluating the effects of two requirements of IAS23 (capitalization of borrowing costs and IAS23 disclosure) on organization's solvency using the debt-to-assets ratio.

Figure 2: Conceptual Model



Source: Authors' own Construct 2022

- **Theoretical Review**

The common knowledge from capital structure theory highlights the fact that entity may not be able to finance its operations wholly from internally generated revenue from time to time. Three sources of funds in preferential order would be to either finance investments from internal revenue, through debt or through equity (Al-Ghazzawi & Qisi, 2017). The choice of accounting policy has direct impact on the credibility of the financial statement available to users. Since the focus of IAS 23 is on the debt financing and how to treat the costs that accrue from borrowed funds, signaling theory underpins this study.

Signaling theory describes the possible behavior when two investors, users of financial reports or entities have access to different information such that one party is more empowered to make a rational decision than the other party. The extent to which common accounting language is achieved through financial reports available to users will likely determine the level of information asymmetry that is prevalent. Additionally, the choice of accounting treatment for borrowed funds and the relative accompanying costs can either enhance or reduce the credibility of financial information (Desalegn, 2020) especially the grey areas that are subjected to interpretations and professional judgments. To maintain common language, amendment to IAS23 has to focus on resolving subjective terminologies in the standard.

- **Empirical Review**

While professional accountants and global accounting bodies have striven to set directions, scholarly discussions around the treatment and impact of borrowing costs have suffered severe shortage (Van Staden & van der, 2012). Available literature, however, pointed to the fact that entity's borrowing costs and investment decisions are correlated. Drawing from the knowledge of capital structure theory, companies ordinarily tend to optimize their debt-equity financing mix in such a way that minimizes the average cost of capital and maximizes value to shareholders. The work of Al-Ghazzawi and Qisi (2017) considered the impact of corporations borrowing costs on firms' pricing decisions under IAS23 and revealed a significant relationship between capitalization of borrowing costs and firm's pricing decisions using cost-plus price and contribution margin price.

Having studied ninety-two companies across ten European countries, Tudor and Dragu (2011) came up with a statistical model that showed a positive correlation between IAS23 compliance and some key parameters for evaluating companies' solvency.

The standards setters believe that the adoption of IAS23 by companies will enhance comparability by providing common ground for capitalizing borrowing costs (Turegun, 2016). Contrary to this view, studies have pointed out some of the judgmental areas of IAS23 which call for the attention. Van Staden and van der (2012) identified some technical uncertainties relating to IAS23 to include terminologies such as 'Extended period', 'Substantial period of time' and 'A common but avoidable event'.

METHODOLOGY

This study evaluates the impact of IAS 23-borrowing cost on the solvency performance of deposit money banks in Nigeria. The population for the study is the twenty-three (23) registered money deposit banks licensed with regional, national and international authorization as contained in the Central Bank of Nigeria (CBN) list of deposit money banks as at June 30th 2021.An ex post facto research design was used to examine a total sample of fifteen banks drawing the content analysis of seventy-five audited financial statements from 2016-2020.

Since compliance with IAS 23 is expected to impact entity's qualifying assets with the value of capitalized borrowing costs, Debt-to-Asset ratio was computed for all the banks considered within the five years period as a measure of solvency.

Solvency performance of the banks considered represents the dependent variable with debt-to-assets ratio as proxy while IAS 23 compliance is the independent variable with borrowing costs capitalized and IAS 23 disclosure as proxies. IAS 23 disclosure was computed using the two disclosure requirements i.e. disclosure of the amount of capitalized borrowing costs and the capitalization rate utilized.

$$\text{IAS 23 Disclosure Index} = \frac{\text{Total Score of Individual Banks}}{\text{Maximum possible score (Total disclosure required)}} \times 100$$

Statistical Product and Service Solutions (SPSS) version 23 was used to carry out inferential multiple regression statistics of the data obtained from the sampled banks. The model for this study is stated as:

$$Y = \beta_0 + \beta_{1\text{-}2x} + \varepsilon \text{--------------} \quad (i)$$

Where Y= the dependent variables (Solvency Performance)

β_0= the constant

$\beta_{1\text{-}2}$= the co-efficient of the explanatory variable

X= the explanatory variable (IAS 23 Compliance) and

ε = error or residual term.

Adopting the above model, the model below was formulated:

Debt-Assets Ratio = f (β_0+β_1(Borrowing Cost Capitalized) + β_2(IAS 23 Disclosure) + ε) --- (ii)

RESULTS, ANALYSIS AND DISCUSSION OF FINDINGS

In order to achieve the objective of this study which was to determine the relationship between IAS 23 compliance and the solvency performance of commercial banks in Nigeria, the null hypothesis below was formulated and tested:

H_0: The relationship between IAS 23 compliance and the solvency performance of commercial banks in Nigeria is not statistically significant.

To test the hypothesis, the result of the multiple regressions in table 1 was analyzed.

Table 2

Debt-Assets Ratio = f (a+β_1(Borrowing Cost Capitalized) + β_2(IAS 23 Disclosure) + ε)

		Unstandardized Coefficients		Standardized Coefficients			Collinearity Statistics	
Model		B	Std. Error	Beta	t	Sig.	Tolerance	VIF
1	(Constant)	.878	.121		7.257	.000		
	Borrowing Costs Capitalized	-.393	.204	-.350	-1.927	.041	.378	2.646
	IAS 23 Disclosure	.560	.198	.513	2.827	.006	.378	2.646

a. Dependent Variable: Debt_Assets Ratio

R	0.320
R Square	0.103
Adjusted R Square	0.078

Source: SPSS output using data extracted from annual reports of observed banks (2022)

Table 2 showed a negative significant relationship between Borrowing Costs Capitalized and our measure of solvency performance (Debt-to-Asset ratio)at t = -1.927 with a p-value of 0.041which is <0.05.

This implies a significant inverse relationship between Capitalized borrowing costs and the value of debt-to-assets ratio. That is, as the capitalization of banks' qualifying borrowing costs increase, the debt-to-assets ratios decrease

Since debt-to-Assets Ratio is taken as Total Liabilities / Total Assets, the model revealed that as more capitalization of qualifying borrowing costs directly increases the value of total assets, the computed debt-to-assets ratio will decrease.IAS 23 disclosure has a positive significant relationship with Debt-to-Assets ratio at t = 2.827 with a p-value of 0.06 which is < 0.05.

Table 3

ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.602	2	.301	4.115	.020[b]
	Residual	5.269	72	.073		
	Total	5.871	74			

a. Dependent Variable: Debt_Assets Ratio

b. Predictors: (Constant), IAS 23 Disclosure, Borrowing Costs Capitalized

Source: SPSS output using data extracted from annual reports of observed banks (2022)

The F-ratio in the ANOVATable3, $F (2, 72) = 4.115$, $p (0.020) < 0.05$also showed a good fit; meaning that our independent variables statistically significantly predict the dependent variable. The general model for this study is given as:

Predicted Debt-to-Assets Ratio = $0.878-0.393\beta_1+0.560\beta_2$

Decision:

The outcome of our analysis revealed significant relationship between our dependent and independent variables. We therefore reject the null hypothesis and conclude that the relationship between IAS 23 compliance and the solvency performance of commercial banks in Nigeria is statistically significant.

CONCLUSION AND RECOMMENDATIONS

The study expanded on the little available studies on IAS 23- borrowing costs. It briefly examined the challenges of accounting for borrowing costs prior to IAS23 and the various stages of amendments to IAS23. Relationship between IAS 23 compliance and solvency performance of commercial banks in Nigeria was established using borrowing costs capitalized and debt-to-asset ratio as proxies for our independent and dependent variables. The study tried to establish a relationship model which can serve as a means of predicting the effect of capitalized borrowing costs on the solvency performance of commercial banks in Nigeria.

Grey areas in IAS23 that are subjected to varying professional judgments which call for further amendments by the International Accounting Standards Board (IASB) were examined. The standard clearly stated that borrowing costs of inventories that meet the definition of qualifying assets are to be capitalized, inventories that are manufactured or produced in large quantities on a competitive bases are to be exempted; however, the term ‘large quantity’ is not quantitatively defined which is capable of being interpreted differently. IAS 23.4 did not clearly define the examples of inventories to be exempted which gives room for different interpretations. Likewise, the terms ‘substantially completed’ upon which the cessation of capitalization of borrowing costs of qualifying assets is based can be interpreted differently due to lack of clarity by the standard. This study therefore recommends further amendments to those grey areas for comparability and common accounting language to be achieved in the treatment of borrowing costs.

The concentration of this study to commercial banks in Nigeria and the use of debt-to-equity ratio to measure the impact of IAS23 compliance on solvency is a limitation to this study. Additional ratios can be employed to dive deep into further study which can also be extended to other sectors of the economy. However, the study has contributed to knowledge by establishing a model that links the relationship between borrowing costs capitalized, IAS 23 disclosure and debt-to-equity ratio.

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Appendix 1

Descriptive Statistics

	Mean	Std. Deviation	N
Debt_Assets Ratio	.9354	.28168	75
Borrowing Costs Capitalized	.9333	.25112	75
IAS 23 Disclosure	.7573	.25836	75

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.320[a]	.103	.078	.27052

a. Predictors: (Constant), IAS 23 Disclosure, Borrowing Costs Capitalized

ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.602	2	.301	4.115	.020[b]
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a. Dependent Variable: Debt_Assets Ratio

b. Predictors: (Constant), IAS 23 Disclosure, Borrowing Costs Capitalized

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
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	Borrowing Costs Capitalized	-.393	.204	-.350	-1.927	.041	.378	2.646
	IAS 23 Disclosure	.560	.198	.513	2.827	.006	.378	2.646

a. Dependent Variable: Debt_Assets Ratio

Collinearity Diagnostics[a]

Model	Dimension	Eigenvalue	Condition Index	Variance Proportions		
				(Constant)	Borrowing Costs Capitalized	IAS 23 Disclosure
1	1	2.929	1.000	.01	.00	.00
	2	.055	7.316	.74	.01	.26
	3	.016	13.450	.25	.98	.74

a. Dependent Variable: Debt_Assets Ratio