

Financial Disclosure and Municipal Market Dynamics: What the Research Tells Us

Justin Marlowe

Endowed Professor of Public Finance and Civic Engagement
Daniel J. Evans School of Public Policy and Governance
University of Washington

jmarlowe@u.washington.edu

Municipal Finance Conference Webinar

January 24, 2017



EVANS SCHOOL OF PUBLIC POLICY & GOVERNANCE
UNIVERSITY of WASHINGTON

Today's Presentation

Our question: How does the municipal bond market respond to state/local financial disclosures?

The "question behind the question": What might happen if the federal government regulates state/local financial disclosures?

Today's focus: What does research tell us about three potential "policy interventions"?

1. Require compliance with generally accepted accounting principles (GAAP)
2. Reduce disclosure delay
3. Prescribe the content/format of financial reports

Our key take-away is a conundrum: The market responds, but do the benefits to issuers of that response pass the "cost-benefit" test?



Today's Disclosure Landscape

State and local government financial reporting is "unregulated"

- Per the Tower Amendment (1975), Securities and Exchange Commission (SEC) does not directly regulate government financial reports
- However, SEC has broad "indirect" authority:
 - Tower Amendment created the Municipal Securities Rulemaking Board (MSRB) to regulate municipal bond brokers/dealers; SEC approves all MSRB rules; FINRA enforces
 - Broker-dealers must ensure appropriate "continuing disclosure" of financial information to prevent securities fraud
 - SEC has pursued actions against financial institutions and state/local governments that have not complied with MSRB continuing disclosure rules



Today's Disclosure Landscape

SEC has been active in the municipal bond market:

- Report (2012) on the municipal securities market highlighted concerns about timeliness and informativeness of state and local government financial reports
- High profile enforcement actions against broker/dealers - Municipalities Continuing Disclosure Cooperation (MCDC) Initiative;
- High profile enforcement actions against governments - City of Miami, FL convictions; major fine levied on PANYNJ; others

Congresswoman Gwen Moore (D-WI) introduced a bill that would hold governments responsible for disclosure, and mandate national accounting standards



Today's Disclosure Landscape

The argument for unregulated disclosure:

- No single regulatory regime can treat every state/local government fairly
- Compliance costs of regulated disclosure are enormous, especially for smaller jurisdictions
- Market forces ensure investors get the information they need

The argument for regulated disclosure:

- New technology - namely "eXtensible business reporting language" (XBRL) - makes disclosure cheaper and easier than ever
- Silicon Valley's "democratization of public finance" - OpenGov, Neighborly, Socrata, BondLink, others - demands comparable financial reports
- Without default insurance, municipal bonds are no longer "commoditized"



Policy Intervention: Require GAAP Compliance

State/local governments comply with GAAP to varying degrees:

- By 1996, virtually all 50 state governments had adopted GAAP
- In 15 states, state law requires local governments to comply with GAAP created by the Governmental Accounting Standards Board (GASB)
- In 10 states, local government compliance is “unregulated”
- In the other 25, local governments follow a state-wide “chart of accounts” that may or may not correspond to GASB standards

Potential advantages of required GAAP compliance: Better comparability across governments; (potentially) less emphasis on cash-basis budgeting and financial reporting

Potential disadvantage: implementation/maintenance costs for issuers



Required GAAP Compliance: What the Research Tells Us

- Borrowing costs in GAAP-regulated states are, on average, 15-25 basis points less than in non GAAP-regulated states (Baber and Gore 2008).
- Governments substitute between disclosure and bond insurance (Gore, et. al. 2004).
- GAAP regulation induces additional disclosures for low-debt governments, but not for high-debt governments (Gore 2004).
- Ratings respond to accrual measures like net assets (Plummer, et. al. 2008; Kioko, et. al. 2012).
- However, buy side analysts still rely mostly on traditional fund-based measures like fund balance (Bloch 2016).



Policy Intervention: Improve Disclosure Timeliness

State/local governments typically release their financial statements 180 days after fiscal year close (Merritt Financial; GASB)

Potential policy interventions:

- Mandate audit reports by some “date certain”
- Encourage or require periodic unaudited reports
- Streamline the content of financial reports

Potential advantages of faster disclosure: Less uncertainty on pricing decisions; Better visibility into recent government policy

Potential disadvantages: Feasibility and costs of compliance for state/local governments



Improve Disclosure Timeliness: What the Research Tells Us

- Buy side analysts discount the value of “stale” financial information (Robbins and Simonsen 2010)
- Buy side analysts see disclosure delay as a sign of potential internal control weakness, management problems (Bloch 2016)
- Municipal borrowing costs increase by 6 basis points (\$319,800 for a typical issue) for every 100 days of audit delay (Edmonds, et. al. 2016)
- Non-profit hospitals that produce quarterly, unaudited financial reports borrow at 10-12 basis points less than those that don't (Marlowe 2016)



Policy Intervention: Prescribe Disclosure Content/Format

A key question: Do investors care about specific pieces of price-relevant information that are, or could be, included in government financial reports?

The policy question: Can regulators calibrate the content of financial reports to best meet investors' needs?

Advantage: responding directly to key stakeholders' financial needs;

Disadvantage: Adds complexity and cost to government financial reporting



Expand Disclosure Content: What the Research Tells Us

- Unfunded pension liabilities and unfunded OPEB liabilities are strongly reflected in credit ratings (Benson, et. al. 2015; Martell, et. al. 2013; Marlowe 2010)
- Governments with sizeable unfunded ARC borrow at two or three basis points higher than those with fully funded pensions (around , but strongly related to credit ratings (Benson and Marks 2016; Burson, et. al. 2016)
- The “modified approach” to infrastructure reporting reduces secondary market price dispersion by up to 15% (Bloch, et. al. forthcoming)
- Governments with material weaknesses to internal controls borrow at 10-18 basis points higher than those without those weaknesses (Park, et. al. 2016)



Where We Need to Learn More

- Where disclosure does not matter - bias against "non-findings"
- Implementation costs for issuers of complying with new GASB standards
- Role and implications of state-level oversight bodies
- What about budgeting institutions and transparency?
- Benefits, costs, and implementation challenges of XBRL, other technology advances to expedite and drive down the cost of reporting
- What's the value of disclosure as a "democratic principle" or accountability as a democratic value?
- How, if at all, does the market respond to "road shows" and state and local governments' other enhanced investor outreach?



Papers Cited

- Baber, William R. and Gore, Angela K. (2008). "Consequences of GAAP Disclosure Regulation: Evidence from Municipal Debt Issues." *The Accounting Review* 83(3): 565-592.
- Benson Earl and Marks, Barry (2014). "The Influence of Accounting Information Disclosed Under GASB Statement No. 34 on Municipal Bond Insurance Premiums and Credit Ratings." *Public Budgeting & Finance* 34(2): 63-83.
- Benson, et. al. (2016). "Does the Funding Level of City Government Pension Liabilities Affect Tax-Exempt Bond Insurance Premiums and Credit Ratings?" *Municipal Finance Journal* 37(1): 25-49.
- Bloch, Rebecca (2016). "Assessing the Impact of GASB Statement Number 34: The Perceptions of Municipal Bond Analysts." *Municipal Finance Journal* 23(1): 51-71.
- Bloch, Rebecca, Justin Marlowe, and Dean Michael Mead (forthcoming). "Infrastructure Asset Reporting and Pricing Uncertainty in the Municipal Bond Market." *Journal of Government and Non-Profit Accounting*.
- Burson, Jean, John Carlson, O. Emre Ergungor, and Patricia Waiwood (2014). "Do Public Pension Obligations Affect State Funding Costs?" *Municipal Finance Journal* 35(2): 17-51.
- Carpenter, Vivian, Rita H. Cheng, and Ehsan Feroz (2007). "Toward an Empirical Institutional Governance Theory: Analyses of the Decisions by the 50 US State Governments to Adopt Generally Accepted Accounting Principles." *Corporate Ownership & Control* 4(4): 30-46.
- Edmonds, Christopher T., Jennifer E. Edmonds, Beth Y. Vermeer and Thomas E. Vermeer (2016). "Does Timeliness of Financial Information Matter in the Governmental Sector?" Working Paper, University of Alabama-Birmingham.
- Gore, Angela K. (2004). "The Effects of GAAP Regulation and Bond Market Interaction on Local Government Disclosure." *Journal of Accounting and Public Policy* 23(1): 23-52.



Papers Cited (continued)

Gore, Angela K., Kevin Sachs, and Charles Trzcinka (2004). "Financial Disclosure and Bond Insurance." *Journal of Law and Economics* 47(1): 275-306.

Johnson, Craig L., Sharon N. Kioko, and W. Bartley Hildreth (2012). "Government-wide Financial Statements and Credit Risk." *Public Budgeting & Finance* 32(1): 80-104.

Marlowe, Justin (2016). "Disclosure Timeliness and Municipal Bond Market Pricing." Working Paper, University of Washington.

Park, Young Joo, David S.T. Matkin, and Justin Marlowe (2016). "Internal Control Deficiencies and Municipal Borrowing Costs." *Public Budgeting & Finance*

Plummer, Elizabeth, Hutchison, P. and Patton, Terry. (2007). "GASB No. 34's Governmental Financial Reporting Model: Evidence on its Information Relevance." *The Accounting Review* 82(1): 205-240.

Pridgen, Annette K. and Wilder, W. Mark (2013). "Relevance of GASB No. 34 to Financial Reporting by Municipal Governments." *Accounting Horizons* 27(2): 175-204.

Reck, Jacqueline and Wilson, Earl (2014). "The Relative Influence of Fund-Based and Government-Wide Financial Information on Municipal Bond Borrowing Costs." *Journal of Governmental & Nonprofit Accounting* 3(1): 35-57.

Robbins, Mark and Simonsen, Bill (2010). "The Quality and Relevance of Municipal Bond Disclosure: What Bond Analysts Think." *Municipal Finance Journal* 31(1): 1-20.

