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Accounting restatements, governance and municipal debt financing

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ABSTRACT

We find that mean municipal debt costs are greater following financial restatement disclosures. Comparisons of the relative use of municipal debt, and of the use of unsecured versus secured debt, corroborate that financial restatements increase the cost of municipal debt financing. Additional analyses indicate that adverse consequences of restatements are mitigated by strong audit oversight and by provisions that encourage direct voter participation in the governance process. The evidence supports the use of restatements as a summary measure of financial reporting quality in the municipal context and informs thinking about auditor and voter oversight in the municipal financial reporting process.

1. Introduction

This study investigates restatements of annual financial reports issued by U.S. municipalities. Similar to findings in the corporate setting (e.g. Hennes et al., 2008; Plumlee and Yohn, 2010), municipal restatements are frequent and non-trivial in magnitude during the 2001–2004 period encompassed by the study. For example, the City of San Diego announced a $640 million restatement – approximately 10% of total net assets – of fiscal year 2002 capital asset accounts. To appreciate the magnitude of the restatement, consider that the amount exceeds the $580 million restatement in 2001 by Enron (Greenblatt, 2005).

Evidence from the corporate sector suggests that restatements indicate substandard financial reporting (Abbott et al., 2004; Palmrose et al., 2004; Agrawal and Chadha, 2005; Srinivasan, 2005). In contrast with the corporate sector, however, the importance of financial restatements by municipalities as an indicator of financial reporting quality is unresolved. One perspective is that restatements indicate fiscal mismanagement or manipulation of financial information to advance political agendas. For example, Moody's cites concerns about financial management when twice downgrading San Diego's bonds following restatement disclosures (Moody's, 2004a, 2004b). This view suggests that restatements are potentially important events in the municipal context. On the other hand, some argue that financial reporting is unimportant in the governmental setting (Zimmerman, 1977), which suggests by extension that financial restatements by municipalities are inconsequential. Therefore, the objectives of this study are to document

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associations between municipal governance characteristics and the incidence of municipal financial restatements, and to investigate whether municipalities that disclose restatements are penalized in municipal debt markets.

We focus on three aspects of municipal restatements. First, we investigate associations between restatements and two potentially important municipal governance characteristics: audit and voter oversight. A distinguishing feature of the investigation is its consideration of municipal governance using combinations of, rather than individual, municipal characteristics. More specifically, we construct indices designed to capture cross-sectional differences in the intensity and efficacy of audit and voter oversight in the municipal context. Multivariate specifications indicate that the collective explanatory power of these audit and voter oversight measures substantially exceeds that of size, financial condition, debt financing, regulatory oversight, and organizational form measures used frequently in studies of reporting quality in the corporate sector.

Second, we investigate restatements in the market for municipal debt. We find that municipal debt interest costs for new issues are substantially higher following restatement disclosures. Additional analysis indicates that municipalities reduce their use of debt financing and are more likely to issue secured than unsecured debt following a financial restatement. Such evidence corroborates our interpretation of the primary result that restatements influence municipal financing costs adversely.

Finally, we investigate whether the consequences of municipal restatements in debt markets are affected by audit and voter oversight characteristics. Specifications of debt costs that consider restatements and governance characteristics interactively suggest that adverse consequences of restatements are mitigated by strong audit oversight and provisions that encourage direct voter participation in the governance process.

The study makes at least three contributions to the literature. First, our results support the use of municipal restatements as a summary measure of governmental financial reporting quality. More specifically, the evidence suggests that lenders use municipal accounting information and penalize municipalities with poor financial reporting quality. Second, we consider the role of governance as a determinant of the causes and consequences of financial restatements by municipal governments. While the role of governance as a determinant of financial reporting quality is researched extensively in the private sector, no prior study investigates governance and financial reporting in the municipal context. Third, we expand the notion of municipal governance to consider the role of voter-taxpayer oversight as a determinant of municipal financial reporting quality. Because transactions costs to voters of investing in municipalities are greater than to shareholders in capital markets, direct participation in the governance process by outsiders is more likely in the municipal, than in the corporate, context where we expect that the exit option more effectively disciplines managers (Zimmerman, 1977). Thus, municipalities provide a unique, and a particularly rich, setting for understanding the more general questions of how outsider participation in the governance process influences the behavior of insider-managers.

The remainder of the presentation is organized as follows. Hypotheses regarding the consequences of financial restatements are developed in Section 2. Section 3 describes the data and measures used in the study. Cross-sectional associations between restatements and audit and voter characteristics reported in Section 4 validate the oversight indices used in the primary investigation reported in Section 5. Multivariate specifications described in Section 5 consider the consequences of restatements in municipal debt markets and whether these consequences are influenced by audit and voter oversight characteristics. Concluding remarks are in Section 6.

2. Municipal restatements and municipal governance systems

We identify municipalities that restate prior year financial statements to consider the consequences of municipal financial reporting quality. Following studies in the corporate sector (Abbott et al., 2004; Palmrose et al., 2004; Agrawal and Chadha, 2005; Srinivasan, 2005; Baber et al., 2012), we characterize restatements as corrections of accounting misstatements made previously by negligent or, in the extreme, opportunistic managers. We presume further that substandard governance is at least partially responsible for financial reporting errors that manifest ultimately as accounting restatements. Given this perspective, investigating the extent to which municipal governance characteristics correlate with accounting restatements informs thinking about the effectiveness of municipal governance as a determinant of financial reporting quality.

To develop a framework for thinking about how municipal governance influences financial reporting quality, we view municipal officials as agents who act on behalf of voters, lenders, or other participants in the municipal enterprise. This characterization is well-developed in the for-profit context (e.g., Jensen and Meckling, 1976), and thus, it is instructive to compare the incentives of voters/taxpayers who finance municipalities with the incentives of shareholders who finance commercial enterprise.

An important distinguishing feature of political markets is that transaction costs – the costs of locating to a new municipality – are high relative to transaction costs in capital markets (Zimmerman, 1977). Thus, voters/taxpayers who finance municipalities and consume municipal services find it costly to avoid taxes or discipline elected officials by disinvesting, i.e., by selling their real estate investments. For this reason, voters/taxpayers, who cannot easily dispose of investments in the municipal enterprise, are less able than private sector investors to price-protect themselves from opportunistic behavior by governmental agents. These high transaction costs potentially elevate the importance of direct forms of oversight to protect voter/taxpayer investments relative to the use of exit to discipline municipal officials.

To investigate the role of oversight as a determinant of municipal financial reporting quality, we characterize municipal governance as a portfolio of institutionalized procedures, practices, and mechanisms that provides monitoring and oversight and that constrains actions in ways that align the incentives of municipal officials with those of voters. To simplify the analysis, we restrict the investigation to two forms of municipal governance, which we designate audit oversight and voter oversight. These governance forms are developed below, but it is important to acknowledge that our treatment of governance mechanisms