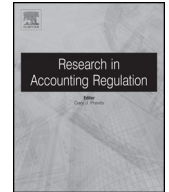




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Why municipalities fail: Implications for uncertainty disclosures

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ABSTRACT

Why Nations Fail (Acemoglu and Robinson 2012), a book widely and favorably reviewed by the business press (MacLeod 2013), identifies political and economic factors that allow some jurisdictions to prosper while other, often geographically and culturally similar, jurisdictions languish. The book's propositions are based on detailed case studies of countries across time and continents. The study summarized here follows a similar approach by relying on hand-collected evidence of municipalities that failed in the sense they ceased to exist as separate legal entities.¹ This evidence is used as a basis for identifying misconceptions about governments as going concerns, redefining what it means for a government to be a going concern, suggesting ways to improve disclosures related to going concern uncertainty (as redefined), and identifying questions for future policy-relevant research.

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Introduction

In April 2015, the Governmental Accounting Standards Board (GASB) initiated research on going concern disclosures based on feedback from stakeholders, who suggested that the GASB should examine the relevance of the “going concern” concept as it applies to governments and government organizations (GASB, 2015). Early in the research process, the GASB research staff realized they did not know how, when or why government entities cease to exist. There were no data. The authors of this article received a grant from the GASB to provide evidence useful in assessing the relevance of the “going concern” concept to government entities.

Although not initially apparent to the authors, their approach to identifying the reasons why governments cease to exist was similar to that of Acemoglu and Robinson (2012)

in their study: *Why Nations Fail*.² A government that ceases to exist has failed in the sense that it no longer provides citizens with the sense of community that comes from having a shared history, attachment to local schools, parks, and other institutions, and locally provided public services. Identifying and understanding those failures required a case-by-case examination of municipalities that disappeared from the Census of Governments database. Some of these municipalities were going concerns that had failed to respond to the most recent census survey. Others were no longer going concerns; they had legally dissolved. Like Acemoglu and Robinson (2012), the authors of this study found that institutions (municipalities) most frequently fail (dissolve) when they are unable to adapt to changing economic conditions, the taxpayers lose trust in the government to provide services at a reasonable price and/or are unwilling to participate in local government. Unlike Acemoglu and Robinson (2012), who were concerned with economic and political policy, the focus of the current paper is on using

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² *Why Nations Fail* was on the short list for the 2012 Financial Times and Goldman Sachs Business Book of the Year Prize (MacLeod, 2013).

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the evidence collected in the GASB study to identify shortcomings in the existing going concern guidance for municipalities, suggest ways to improve that guidance, and identify research questions that could be addressed to provide evidence useful to the GASB in its deliberations.

Going concern guidance for governments

Existing GASB guidance, which was taken directly from the AICPA auditing standards, assigns financial statement preparers “a responsibility to evaluate whether there is substantial doubt about a government’s ability to continue as a going concern twelve months beyond the financial statement date” (GASB, 2009). The premise that a reporting entity will continue to exist into the foreseeable future is an assumption underlying the accrual basis of accounting. The GASB’s current deliberations focus on “whether there is a gap between what financial statement users discern from going concern disclosures (for example, a conclusion that the government will cease to exist as a legal entity) and the actual information needed by those users (that is, for the disclosures to identify severe financial distress)” (GASB, 2016).

The GASB’s reliance on going concern disclosure (GCD) guidance that was not written specifically for governments is unusual given the much-publicized statement that governmental and private sector accounting “is – and should be – different” (GASB, 2013). One justification given for maintaining differences is, “Financial statements of business enterprises generally are prepared using a ‘going-concern’ assumption [. . .]; however, this is not equivalent to a presumption of extended longevity. Users of business enterprises’ financial statements may use those statements to assess longevity. [. . .] In contrast, the ability of governments to exist in the future generally is not in doubt (even in the extreme case of municipal bankruptcy), but rather the issues are the sustainability of the level of services provided and the ability to meet future levels of demand for services” (GASB, 2013, p. 5).

As this study documents, governments do sometimes “fail”, but often not for the reasons one might expect. The study sheds light on several shortcomings of the current GCD guidance for governments. For the GASB to address these shortcomings effectively, it must identify the governmental equivalent to a “going concern” and the stakeholders affected, and address two aspects of governmental viability: (1) continuation as an independent entity, and (2) financial condition. By providing evidence on the frequency and motivation for local governments ceasing to exist as independent entities (i.e., dissolving) and identifying several misconceptions about the relationships between municipal dissolution, financial condition, and disclosure, the study offers useful background for researchers seeking to provide policy-relevant insights to the GASB.

Motivation

The definition of “going concern” is to continue as a separate, legal entity. Headlines such as “In Maine, Local Control is a Luxury Fewer Towns Can Afford” (Bidgood, 2016) suggest that fiscal distress may be driving local governments to dissolve at an increasing rate. However, this characterization

of the relationship between fiscal stress and the likelihood of dissolution is oversimplified.

There are two aspects to the question of whether – and how – the GCD guidance for governments should be altered. The first aspect is related to government dissolution. Despite commonly held beliefs that governments exist in perpetuity, they do occasionally dissolve. Implications of government dissolution for financial disclosure under current GCD guidance are unclear. To what extent do stakeholders need to be warned of pending dissolution? Is it possible for financial statement preparers to assess the likelihood of dissolution, and how? And, from a technical standpoint, what is the necessity of GCDs given the implications of dissolution (or other changes to reporting entity structure) for the assumptions underlying financial reporting?

Academic research examining the dissolution of governmental entities is scarce, particularly as it pertains to accounting and disclosure issues. Anderson (2012) contributes several articles to the legal literature, noting:

“. . . [S]cholars have cared so little about municipal dissolution, a subject that has occupied fewer scholarly pages than the number of years in a century – and most of those pages were written a century ago. Yet dissolutions happen, and if ever there has been a wave of them, we are in one now. More than half of the dissolutions ever recorded took place in the past fifteen years” (p. 1366).

Since current governmental GCD guidance is based on private sector guidance, it is necessary to examine how the dissolution process differs from that of corporations to identify changes that need to be made. Given the positive effect of policy changes on governmental disclosure quality (Gore, 2004) and audit quality (Johnson, Freeman, & Davies, 2009) that has been documented by prior research, it is plausible that enhanced GCD guidance for preparers and auditors could result in similar improvements.

The second aspect the GASB must address is related to financial condition. As defined by Berne (1992), governmental financial condition is “the probability that a government will be able to meet both (1) its financial obligation to creditors, consumers, employees, taxpayers, suppliers, constituents, and others as they become due and (2) the service obligations to constituents, both currently and in the future.” The first component resembles the concept of financial condition for private entities, but the second is decidedly unique.

Statements made by the GASB (cited in the Introduction) suggest the desire for disclosures to warn stakeholders of looming “severe financial distress” (GASB, 2016). However, as with dissolution, the practical implications of “severe financial distress” for disclosure guidance are unclear. How does one define, assess, or consistently report on the “severity” of fiscal distress? What minimum level of services are governments “obligated” to provide? And, as it pertains to the current study, how does financial distress fit into the framework of going concern considerations?

Misconceptions about government dissolutions

Municipalities dissolve by one of three mechanisms: consolidation, merger, or “without replacement”. Consolidations

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