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ACCOUNTING MATTERS

The role of a municipality's financial health in a firm's siting decision

Emanuele Padovani [a], David W. Young [b,*], Eric Scorsone [c]

[a] Associate Professor of Business Administration, University of Bologna, Forlì FC 47121, Italy
[b] Professor Emeritus, Questrom School of Business, Boston University, Boston, MA 02215, U.S.A.
[c] Associate Professor and Director, Center for Local Government Finance & Policy, Michigan State University, East Lansing, MI 48824-1039, U.S.A.

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Abstract When deciding where to locate a new facility, a firm needs to consider the financial health of the municipality where its activities will take place. Unless it sites its facility in a financially viable community, a firm is putting a substantial investment at risk. Despite the importance of this issue, many firms pay insufficient attention to a municipality's financial condition. Instead, they focus on matters such as the tax rate, the quality of the school system, or the absence of regulatory constraints. All of these features are important, but unless a municipality is financially healthy, they can evaporate before a company has attained its expected return on investment. There are 5 financial statements and 10 financial ratios that can be used to create a financial health template, which can help a firm to assess a municipality's financial strength, or its counterpart financial weakness. The template goes beyond the debt-repayment focus of credit rating agencies to matters such as financial autonomy, cash flows, and borrowing capacity. We use data from three cities—Barcelona, Dublin, and Detroit (pre- and post-bankruptcy)—to demonstrate the template's ability to facilitate comparisons among cities that are in different countries and that use different accounting systems.

1. Where should you settle?

One of the many considerations a company makes when deciding where to locate a new facility or relocate an existing one is the financial health of the city or town where its activities will take place. Indeed, even such factors as quality of life or availability of well-qualified employees can be linked indirectly to the financial health of the local government. Unless it locates its offices or manufacturing plants in a financially viable community, a firm is putting a substantial investment at risk.

Despite the importance of this issue, many firms pay insufficient attention to a local government's financial health. Instead, they focus on matters such as the tax rate, the quality of the school

* Corresponding author
E-mail addresses: emanuele.padovani@unibo.it (E. Padovani), david@davidyoung.org (D.W. Young), scorsone@anr.msu.edu (E. Scorsone)

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system, or the absence of regulatory constraints. All of these features are important, but unless a municipality's financial condition is healthy, they can evaporate before a company has attained its expected return on investment.

In its Best Places for Business ranking, *Forbes* identified 12 metrics including job growth, cost of doing business, living costs, income growth, educational attainment, and projected economic growth (Badenhausen, 2015). None of these measures relates directly to the financial health of the city or town, however, and only a few of them—such as projected economic growth and the cost of doing business—are even indirectly related to the municipality's financial health. In the European context, Mercer's (2016) ranking of a city's quality used 10 factors, but only a few of these—such as schools and public services—are related to the city itself, and none focuses directly on the city's financial health. Indeed, Luger and Bae (2006) conclude that typical cost-of-doing-business studies are flawed and incomplete, and therefore provide potentially misleading results.

In response to this uncertainty, some firms have responded by playing off one city against another in an effort to obtain the best deal (Levy, 1990). But the deals frequently are short-term in nature, such as tax relief or business-friendly regulations. According to Reese and Rosenfeld (2001), this is a mistaken focus; instead, they suggest an assessment of the financial strength of the local government or its counterpart: financial weakness.

Some may argue that bond-rating agencies such as Moody's perform an adequate assessment. However, rating agencies focus mainly on the ability of a municipality to repay its debt and not necessarily on its overall financial health. Indeed, rating agencies often consider lack of international standardization of accounts as a justification to lower their assessment (Carroll & Marlowe, 2009). As a result, deviation from International Public Sector Accounting Standards (IPSAS) becomes a surrogate for a more careful assessment of a municipality's financial condition.

A firm considering siting a facility in a given municipality needs to use a much broader perspective. In particular, it needs information about the municipality's ability to provide public services, which can help to attract and retain a high-quality workforce, as well as to maintain and/or upgrade its infrastructure (which can help to reduce the cost of doing business relative to other locations). A less important question is whether the municipality abides by the tenets of IPSAS.

Clearly, this broadened perspective is very different from that of a credit rating agency. Furthermore, as companies' siting decisions become increasingly global, their ability to undertake cross-border comparisons is central to the decision-making process. Few rating agencies are equipped to make international comparisons of the financial health of municipalities that use different accounting systems.

The purpose of this article is to address these broader concerns and to present a framework that a firm can use to assess the financial health of a city or town under consideration for a new facility. The framework can assist a firm to assess the financial health of a single municipality or to make comparisons among the municipalities in several different countries where different accounting systems are in use.

2. Complicating factors

Two factors can complicate an assessment of a city's financial health. First, despite efforts by the Government Accounting Standards Board (GASB) and the International Public Sector Accounting Standards Board (IPSASB) to encourage the use of accrual accounting, many cities continue to prepare their financial statements on a cash or modified-cash/modified-accrual basis. This, in itself, is a warning signal. If a city has not adopted accrual accounting, its financial health can be measured only partially. Factors such as the economic life of infrastructure assets (roads, bridges, tunnels) will be obscured, and it is likely that there will be significant unfunded (and likely unreported) liabilities for pensions and other post-retirement benefits.

Second, the literature on financial health of cities and towns includes a wide array of definitions and options, leading to a diversity of approaches used by auditors to assess the accuracy of a city's financial statements (Padovani & Scorsone, 2011). As a result, to rely on a set of audited financial statements to assess a city's financial health may be risky. Moreover, audited financial statements only verify that the city has followed appropriate accounting standards. Unanalyzed, they say nothing about the quality of a city's financial health.

3. Methodology

The CEOs and CFOs of six cities in six countries (each of which used a different accounting system) were asked to reach a consensus on how best to report on and analyze a municipality's financial health. A hybridization approach was used to build a framework that represents the commonalities among the