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The effects of GAAP regulation and bond market interaction on local government disclosure

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Abstract

This study examines the effects of disclosure regulation on municipal managers' incentives to disclose financial report information to the bond market. I compare disclosure levels of municipal governments in Michigan, which requires GAAP, with those in Pennsylvania, which has unregulated disclosure. In the absence of disclosure regulation I find that managers have bond market-induced incentives to disclose information. Controlling for other incentives to disclose, the evidence implies that regulation induces additional disclosures for low-debt governments, and is not binding for high-debt governments.

Keywords: Regulation; Disclosure; Bond market; Local governments

1. Introduction

Although financial reporting and disclosure have been regulated for over 60 years, relatively few studies have evaluated the effects of these regulations. The lack of research critically evaluating the effects of disclosure regulation is surprising given the impact that this regulation has had on the accounting

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profession (Healy and Palepu, 2001). Disclosure regulation research is especially critical in light of recent calls for increased regulation due to the corporate accounting scandals. Regulation proponents assert that market failures necessitate mandatory disclosure, and that in the absence of regulation, organizations lack incentives to voluntarily disclose adequate levels of information. Critics argue that market forces produce optimal levels of disclosure, and provide arguments against the efficacy of market failures. [1] Empirical evidence on disclosure regulation is extremely limited, however, primarily due to data constraints (Healy and Palepu, 2001).

The purpose of my paper is to provide further empirical evidence about the effects of disclosure regulation on information production. I do so in the context of the municipal bond market, for two reasons. First, governmental GAAP is being made mandatory in many states at substantial cost. Second, because not all states require GAAP, municipalities allow an examination of disclosure regulation in a relatively controlled experiment.

I first examine disclosure in an unregulated case, and hypothesize that bond market incentives are sufficient to induce disclosure. I next examine the influence of regulation on disclosure and hypothesize that for any given level of regulation, mandated disclosure induces information production for low-debt municipalities, and is non-binding for the rest. My empirical tests compare municipal disclosure levels in a state that requires GAAP (Michigan) with those in a state with unregulated disclosure (Pennsylvania). [2]

My analysis indicates two main results. First, in the unregulated state, I find a significant positive association between disclosure levels and proxies for bond market interaction. This evidence suggests that in the absence of regulation, municipal managers disclose financial information in response to bond market incentives. This result is interesting because prior studies have had conflicting results about the relation between disclosure and proxies for debt. For example, studies such as Robbins and Austin (1986) and Evans and Patton (1987) find positive relations, while others such as Evans and Patton (1983), Ingram and DeJong (1987) and Copley (1991) find either no statistically significant relation or report mixed results. It is also interesting because it shows municipal managers act rationally in response to capital market incentives, opening an avenue to future disclosure regulation research with implications that extend beyond the municipal sector.

[1] For summaries of the arguments for and against disclosure regulation, see Easterbrook and Fischel (1991), Watts and Zimmerman (1986), and Leftwich (1980).

[2] I define "regulated" disclosure as requiring GAAP regulations, and "unregulated" disclosure as requiring neither GAAP nor other, state-mandated disclosure regulations.