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Does timeliness of financial information matter in the governmental sector?

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ABSTRACT

The purpose of our study is to investigate whether the timeliness of annual financial statements included in an official registration statement impacts the initial yield and the initial rating of general obligation municipal bonds. Using hand-collected data from 1058 official registration statements, we find that total information delay, comprised of two component time periods (i.e., audit delay and post audit delay), is significantly associated with higher municipal debt costs and lower bond ratings. Our findings also support the prediction that municipal investors charge a larger risk premium for untimely information when default risk is high. Overall, our results suggest that future municipal bond studies should consider total information delay, rather than solely audit delay, when examining/controlling for the timeliness of governmental financial statements. Our findings also provide important empirical evidence supporting recent SEC and GASB initiatives to improve municipal reporting and disclosure, especially the need to develop interim financial reporting standards.

1. Introduction

One of the greatest concerns in the municipal sector is the timeliness of governmental financial reporting. In 2011, the Governmental Accounting Standards Board (GASB) stated that the "timeliness of financial reporting is perhaps the most frequent and common concern expressed to the GASB by users of state and local government financial reports" (GASB, 2011, p. 2).[1] In 2012, the U.S. Securities and Exchange Commission (SEC) echoed the views of the GASB, noting that municipal bond investors are often not afforded access to the same timely financial information as investors in other U.S. capital markets (SEC, 2012). The SEC further noted that the sheer size of the municipal bond sector, the prevalence of individual investors holding municipal securities, the severity of recent municipal defaults and bankruptcies, and the significant decrease in credit enhancements all amplify the need for timely disclosure.[2]

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[1] Although the Municipal Securities Rulemaking Board (MSRB) suggests that municipalities issue their annual financial statements within 120 days of their fiscal year-end, a 2010 study by Merritt Research Services found that it took states and local governments approximately six months or more after the end of the fiscal year to issue annual financial statements (Nolan, 2010). A 2011 GASB study found that only 46% of smaller governments issued their annual financial statements within six months (GASB, 2011).

[2] In 2011, there were over one million different municipal bonds outstanding totaling $3.7 trillion, which is significant in size relative to the corporate and foreign bond markets, which have about 10,000 issuers totaling $11.5 trillion in bond debt. Approximately 50% of municipal bonds are held directly by individual investors while only 17% of corporate and foreign bonds are held directly by individual investors (SEC, 2012). Newkirk (2015) also notes that state and local governments are expected to sell $358 billion of bonds in 2015, an increase of nearly $10 billion over 2014.

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Several high profile bankruptcies, including the cities of Harrisburg, Pennsylvania in 2011; Stockton, California in 2012; and Detroit, Michigan in 2013, as well as the 2008 default of 162 issuers on over $8.2 billion of municipal bond debt (Preston, 2010), have added public tension to the issue of timely municipal financial reporting. With increased perceptions of instability and risk in the municipal bond sector, taxpayers and investors are asking for better transparency. In 2012, the SEC proposed measures to Congress in efforts to improve municipal reporting and disclosure, including requiring the timely filing of financial information.[3] Thus, the purpose of our study is to examine the importance of timeliness by investigating the association between the timeliness of financial disclosures and the cost of debt capital within the municipal sector.

The municipal bond market provides a unique setting to understand timeliness because municipalities generally do not issue quarterly financial statements and there are no minimum required standards for the timely filing of annual financial statements (SEC, 2012).[4] These minimal reporting requirements lead to information delays in the municipal sector that are routinely more than ten months and that vary significantly across municipalities. For example, on July 30, 2014, the City of Live Oak, Texas issued $19,515,000 of general obligation bonds. The audited financial statements in Live Oak's official registration statement were for the year ended September 30, 2013 and were issued on January 22, 2014. Thus, the total information delay between Live Oak's year-end and bond issue date was ten months (303 days).

Economic theory suggests that, as total information delay increases, estimation risk and information asymmetry among investors grows, leading to a rise in the cost of capital (Lambert et al., 2012; Francis et al., 2005; Verrecchia, 2001). Although total information delay captures the full delay experienced by bond investors, prior research (Payne and Jensen, 2002; Wilson and Howard, 1984) and policy makers (SEC, 2012; GASB, 2011) have primarily focused on only a portion of this delay (i.e., audit delay, defined as the time period between the fiscal year-end date and audit report date of the annual financial statements). In our example, the City of Live Oak, Texas had an audit delay of 114 days. However, this period is not representative of the total information delay experienced by bond investors because the City of Live Oak did not issue its bonds for another 189 days beyond the audit report date. Thus, for the City of Live Oak, the total staleness (i.e., total information delay) of the financial information available to investors at the bond issue date was 303 days. As a result, we posit that total information delay may be an important indicator of timeliness and, as such, will be significantly valued by investors. To investigate this, we examine total information delay by breaking it into two component time periods: (1) audit delay, defined in the prior literature as the time period between the fiscal year-end date and audit report date of the annual financial statements, and (2) post audit delay, which we define as the time period between the audit report date of the annual financial statements and the bond issue date.[5]

A failure to recognize post audit delay can lead to inaccurate inferences regarding whether municipal investors and rating agencies are receiving timely financial information. In our example, the City of Live Oak, Texas issued their financial statements in 114 days, well within the Municipal Securities Rulemaking Board's (MSRB) 120 day suggestion and also within the six month filing requirement to obtain the Government Finance Officers Association's (GFOA) Certificate of Achievement for Excellence in Financial Reporting. However, meeting the standards of the MSRB and GFOA did not ensure that investors who purchased these bonds in July 2014 received timely information.

Using hand-collected data from 1058 official registration statements, we find that both audit delay and post audit delay are positively associated with investors demanding higher bond yields. We also find this association to be stronger when default risk is high. Further, we find evidence that rating agencies penalize governments with lengthy audit delays and post audit delays. Overall, our findings are consistent with economic theory and support the assertion that both audit delay and post audit delay incrementally impact the cost of debt capital.

On average, our findings suggest that for every 100 days that information is delayed, municipal borrowing costs increase by 12 basis points. These significant costs suggest that prudent governments may time their bond issuances near the audit report date to lower borrowing cost. However, to implement this strategy, government officials must be aware that information delay increases borrowing costs.[6] Even if they are aware, there are countervailing forces, such as needing the funds for a specific project, or investor preferences to purchase bonds in January and February and sell bonds around April 15, which may prevent government officials from timing a bond issuance.

Our study contributes to the academic literature by finding that municipal investors value both audit and post audit delay. While prior research (Wilson and Howard, 1984) solely examines the impact of audit delay on municipal borrowing costs, our results suggest that audit delay and post audit delay have an equivalent impact on borrowing costs (i.e., the coefficients on audit delay and post audit delay are not statistically different). This finding suggests that municipal investors consider total information delay (i.e. fiscal year-end date to bond issue date) rather than solely the delay between the fiscal year-end date and the audit report date (i.e., audit delay). In sum, future municipal bond research should consider total information delay (i.e., both audit and post audit delay) when examining/controlling for the timeliness of governmental financial statements.

Our findings have important policy implications for both the GASB and SEC. In its 2011 report on the timeliness of governmental financial information (GASB, 2011), the GASB focuses solely on the timely filing of annual financial statements

[3] Congress has to provide the SEC with additional authority to initiate changes to improve municipal securities disclosure.

[4] Of the 258,162 disclosure documents filed with EMMA between July 2009 and June 2011, approximately 5.7% were voluntary quarterly or monthly financial information (MSRB, 2011).

[5] See Fig. A for an illustration of total information delay, audit delay, and post audit delay. These delays are measured relative to the fiscal year-end date for the annual financial statements.

[6] Our conversations with government officials and municipal financial advisors suggest that government officials are generally unaware of the impact of information delay on borrowing costs.