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The Association between State Reporting Requirements and Municipal Bond Interest Costs

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Abstract

For information to be relevant it must be timely information is one of the important principles of accounting. In the large U.S. municipal bond market, timely information is always an issue. The state of Illinois mandated that municipalities in the state must provide financial information to a central repository where the information is made available to the public. The purpose of this study is to see if requiring information provides useful information to the municipal bond market.

Keywords: municipal bond market, timeliness of information, financial reporting

THE ASSOCIATION BETWEEN STATE REPORTING REQUIREMENTS AND IMUNICIPAL BOND INTERST COSTS

The municipal bond market is a large, important part of the U.S. economy with $3.9 trillion of debt outstanding (http://www.msrb.org/msrb1/pdfs/MSRB-Muni-Facts.pdf). The SEC has oversite over the corporate bond market and requires audited annual reports to be filed within 60-90 days of fiscal year end but there is no comparable oversite or reporting requirements for municipal bonds. The importance of timely information has long been acknowledged but, despite the importance of timely information, the amount of time governments take to provide information has increased over time[1]. To improve timeliness of reporting, the State of Illinois requires all municipal entities in the state to file digital, audited financial reports within 180 days to the Illinois Comptroller's Office where the information is placed in a central, online repository available to the public[2]. The purpose of this study is to determine whether state reporting requirements improve the timing of financial statements and reduce information asymmetry in the municipal bond market by providing useful information to investors.

"The issue of timeliness centers on the amount of time that elapses between the end of the fiscal year being reported on and the date the financial report becomes available to the public" (GASB 2011 p.3). However, most studies have lacked information on when the information is publicly available. For example, GASB (2011) measures timeliness of information as the time period between FYE and audit report date while acknowledging that there is a difference between when an auditor completes his work and when the information is publicly available.

The importance of providing timely, relevant information in the municipal bond market has increased in importance. According to Dugan (2011), 56% of issuers of municipal bonds had at least one missing financial statement between 2005 and 2009 and 40% of the borrowers had missing financial statements for 3 or more years. Additionally, prior to 2008, over 50% of new municipal bond issues were insured but by 2010 that percentage had dropped to less than 9% (Sherrill and Yerkes 2018). Municipal bonds do not have the number of bond analysts following them the way corporations do. Fewer sources of information and the decrease in the safety net that bond insurance provides make information provided more important to municipal bond investors, a vast majority of which are individual investors (Cuny 2016).

Timeliness is an important quality for information to be relevant. Previous research has found that providing timely information is beneficial in lowering bond costs in the municipal bond market (Sherrill and Yerkes 2018; Edmonds et al 2017; Henke and Maher 2016; Ingram, Raman and Wilson 1989; Dwyer and Wilson 1989). Henke and Maher (2016) examine a sample of over 7000 original bond issues and find municipalities with longer delays in issuing financial statements have higher bond yields and/or lower the bond ratings both of which increase bond costs. Going a step further, Sherrill and Yerkes (2018), using a sample off 1000 bond issues find the association between timing and bond costs hold in the secondary municipal bond market as well. Additionally, they find longer time lags are associated with a decrease in bond liquidity (longer delays making it more difficult to sell), make bonds less likely to trade, and make municipalities less likely to issue new bonds. Furthermore, Ingram, Raman and Wilson (1989) examine whether the municipal bond market reacts to the release of financial information. They find that the price of new issues is higher with longer delays. These studies indicate that providing timely information lowers bond costs; thus, municipalities have incentives to provide timely information while incurring real costs by delaying the release of information. If the information contained on the Illinois website is useful, the market will impound the information into the price of bonds issued in the state. If a central repository for financial information reduces bond costs, other states have the incentive to require municipalities to use a central repository to make information available to the public.

In order to investigate whether posting information onto a central, publicly available repository supplies additional information to the municipal bond market, we examine the information on the Illinois Comptroller's website to determine whether the municipal bond market pays attention to when the information is posted. Information is relevant to investors only if they have access to it. Neither audit delay nor reporting delay measure when information is publicly available. This study examines posting delay – the period of time between FYE and the date financial information was received by Illinois for inclusion on the comptroller's website. This measure eliminates factors out of management's control (auditor competency and municipal complexity to name a few)

[1] Dwyer and Wilson (1989) found 100 days, on average, between fiscal year end and the publication of audited financial reports in the 1980's while the Municipal Securities Rulemaking Board (2017) found 188 days to be the average in their sample from 2010-2016 and Cuny, Kim and Mehta (2020) found 259 days for the audit to be completed after fiscal year end.

[2] Illinois requires an audit for any municipality in the state with a population of 800 or more, that has bonded debt, or owns or operates a public utility (65 ILCS 5/8-8-3)

and measures how long it takes management to send a completed audit report to the state for posting. If posting data provides useful information, it should affect bond prices.

There are reasons why this study may not get significant results. According to Ingram et al (1989), there is little evidence individual investors review annual reports and other financial information. This may be because the information is difficult to obtain. Illinois, by providing information on a central website, eliminates the costs of disclosing information for municipalities and makes it easier for investors to access the information. The Illinois requirement may not provide useful information if investors use private information. Additionally, Peters and Romi (2013) argue that even if reporting is mandatory, entities may withhold negative information especially if the cost and/or risk of detection is low. They also point out that reporting requirements with no significant penalties do not lead to compliance (Peters and Romi 2013)[3]. This is supported by Cuny (2016) who finds that political incentives not to disclose information outweigh the benefits of transparency.

When examining timing issues, previous research has examine the period of time between FYE and audit report date as a measure of timing (Payne and Jensen 2002). Edmonds et al expanded this research to include the period of time from the audit report date until bond issue date. This study, by examining Illinois refines the previous research by measuring timing as the period of time between audit date and the date the financial information was sent to the Illinois for posting. Specifically, GASB (2011) notes that a limitation of their study is they don't know when the information is publicly available. This measure reduces many of the factors found in previous research as affecting timing such as the complexity of the government and the difficulty of finishing an audit and is a better measure of management's efficiency and effectiveness. Our measure neutralizes all the variances in complexity of governments by examining the period of time from audit to posting date.

This paper examines 86 bonds issued by municipalities in Illinois for the years 2010-2017 using regression analysis. The results of this study suggest that requiring a central repository for the audited financial statements by municipalities in Illinois reduces bond interest costs. The results contribute to the literature by providing an exact date of when information is publicly available. Our results indicate that it is beneficial for state regulators to require municipalities to provide audited financial statements to a central repository and to incur the costs of the repository in order to provide information to investors and lower interest costs for the municipalities.

[3] According to Illinois regulations (65 ILCS 5/8-8-4) municipalities may request an extension of the 180-day rule. Failure to comply may result in fines of $5-$20 per day.

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