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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.

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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[1] The research described in this article was funded by a GASB Gil Crain Grant. The policy recommendations in this article were not included in the report provided to the GASB.

[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 follow an "A + B = C" format (where both A and B cease to exist as separate entities), whereas mergers follow an "A + B = B" format (where B assumes A and continues). To dissolve "without replacement" is, in essence, to "disappear" – to dissolve into unorganized territory, or be swallowed by a nearby government by default but with no plans in place to transfer the government's operations to another entity. Of the three categories, dissolution without replacement is most akin to a government "going out of business". All three types of dissolution involve a government ceasing to exist independently, and may require a GCD.

Based on their analyses, the authors offer Fig. 1 as an illustration of the public perception of how government financial distress, dissolution, and disclosure are related. Financial distress is the root cause of dissolution (path A), sometimes leading to bankruptcy first (path B). Paths A and B closely mirror dissolution paths taken by private entities. A GCD should precede dissolution, but, as the figure indicates, there is concern that preparers will fail to make the disclosure since current guidance does not incorporate measures of fiscal distress applicable to the public sector. Further, guidance does not provide an "early warning" of financial distress or service insolvency (i.e., inability to provide services) that does not eventually culminate in dissolution (path C). Such disclosures may be of greater concern to citizens.

Fig. 1 presents bankruptcy as precursory to dissolution (and, possibly, a GCD). However, bankruptcy courts cannot legally force municipalities to dissolve (see Anderson, 2012). Although highly publicized when they occur (causing many to overestimate their frequency), municipal bankruptcies are extremely uncommon and, in some states, forbidden or only allowed under restrictive conditions. From 2010 to 2015, only nine local governments filed for bankruptcy protection (Maciag, 2013; PBS, 2014). Three of these filings were dismissed; all entities continue to operate as going concerns. It therefore seems doubtful that bankruptcy considerations provide useful indication of the likelihood of dissolution, or for that matter, a valid justification for making a GCD.

Anderson's articles (Anderson, 2012, 2014) provide a comprehensive description of the legal and practical issues surrounding municipal dissolution. In summary, state laws govern municipalities' ability to incorporate, dissolve, and reorganize and vary greatly. Some states require every inch of territory to be incorporated, others allow dissolution with a petition and vote, and a few allow dissolution without petition under certain conditions. Three states require dissolving municipalities to be debt-free. Supreme Court precedent dictates that dissolving municipalities must have a mechanism in place to repay outstanding debts (e.g., tax levies in the geographical region of the former municipality, as is mandated by Virginia) (Anderson, 2012).

A GCD is clearly inappropriate for a government without the foreseeable ability to legally dissolve in the near future. In contrast, some states (e.g., Minnesota, Ohio) have the power to mandate dissolution under certain circumstances.[3] Recent developments in state policy raise the question of whether the need for GCDs, or disclosures regarding changes to governmental entity structure in general, will soon grow. Based on recent activity in state legislatures, combining governments is a topic of interest to many elected and appointed officials. Table 1 outlines existing known legislative initiatives, proposals, or political activism related to combining or dissolving local governments.[4] One reporter quips, "Marrying political sovereigns is hard, but no consolidated government has ever divorced" (Funkhouser, 2012).

Methodology and findings

Sample description

Anderson (2012) identifies a sample of municipal dissolutions occurring between 1857 and 2010 by comparing the Census of Governments (COG) listings, obtaining official state records, and searching for news articles. The authors followed Anderson's methodology to extend the time frame to the time of the study (2016). Because COG data are published for years ending in "2" and "7", the identification of post-2012 dissolutions depended on data from state records, news articles[5] and correspondence with state officials. The final sample consists of 133 dissolutions. The authors were unable to confirm whether approximately 80 additional municipalities that were dropped from the COG listing between 2007 and 2012 dissolved, and thus did not include them in the sample.

The 133 dissolutions were concentrated in 27 states, with over half occurring in just six states: Nebraska (28), Missouri (14), New York (11), Minnesota (10), Indiana (6), and Iowa (6). With the exception of New York, these states all rank in the top ten states in number of governments per capita. A t-test (untabulated) indicates that dissolution without replacement (as opposed to consolidation or merger) is

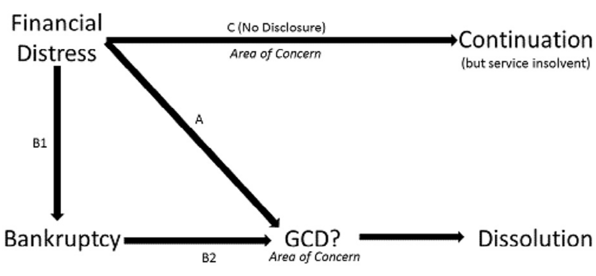

Fig. 1. Illustration of the common perception regarding dissolution and fiscal distress.

[3] Minnesota identifies a town's tax delinquency exceeding 70% per year as a basis for dissolution. Ohio statute lists six conditions for mandated dissolution, including having been "declared during an audit to be unauditable in at least two consecutive audits."

[4] A Pearson correlation analysis suggests a 26% correlation ($p = 0.07$) between state proposals encouraging consolidation (those tabulated on Table 1) and having at least one confirmed dissolution during the sample period. There is no significant correlation between such proposals and the number of local governments per capita.

[5] LexisNexis Academic was used to find news articles in newspapers, magazines, press releases, and industry publications. The search terms for recent dissolutions were "[State name]" followed by: "municipal dissolution" and "municipal disincorporation". The search terms for events leading up to specific dissolutions were "[Municipality name], [State name]" followed by "dissolution" and "disincorporation".

Table 1
State initiatives pertaining to municipal dissolution, consolidation, and/or merger.

State	Proposed or enacted initiative
Illinois	A task force appointed by the governor of Illinois reports that "narrowly crafted Illinois laws have made it difficult . . . for local governments to consolidate" (Civic Federation, 2016), and recommends a four-year moratorium on creating new local governments, statutes to allow consolidation or dissolution by referendum, and other measures to encourage dissolution.
Indiana	Then-Governor Mitch Daniels created the Commission on Local Government Reform in 2007 to "develop recommendations to reform and restructure local government in Indiana in order to increase the efficiency and effectiveness of its operations and reduce its costs to Hoosier taxpayers". The commission encouraged local governments to explore consolidation options and increase citizens' power to initiate consolidation, and the state to incentivize local government consolidation (Indiana Commission on Local Government Reform, 2007). A recent House Bill, which had not yet been passed as of the time of writing, proposes the dissolution of all township governments by 2019.
Iowa	Since the early 2000s, some citizens and elected officials have proposed legislation to encourage consolidation of city and county governments (e.g., Greenblatt, 2007; Grove, 2016). In February 2016, a joint resolution was proposed which would consolidate several counties. Proponents believe consolidating the counties would result in cost savings.
Kansas	A legislative committee is examining the possibility of "modernizing" the dissolution process, particularly after one Kansas city was unable to dissolve after zero candidates ran for office, zero votes were cast, there is no city council to initiate dissolution, and the state is also prohibited from stepping in (Carpenter, 2015).
Minnesota	State auditor recently issued a report endorsing a grant program to support the study and implementation of local government consolidations. Perhaps highlighting the importance of these small governments to the local culture, the Minnesota auditor's report emphasizes that local governments should retain control over the consolidation process (Minnesota, 2012).
Missouri	The media has recently raised concern about "waste" and corruption in a large number of local governments (e.g., Bose, 2015, Miller, 2014). Legislators have discussed whether – and how – local governments should be forced to dissolve (Rosenbaum, 2013) and have proposed lowering the obstacles to state-mandated or citizen-elected dissolution (Rosenbaum, 2015).
New Jersey	Concern over high property taxes prompted a recent legislative proposal that, if passed into law, would simplify the municipal consolidation process and provide mechanisms to apportion debt among property owners in affected municipalities (Reitmeyer, 2016).
New York	Began an initiative in 2009 to lower property taxes through greater governmental efficiency, which offers a $20 million award for the local government that achieves the greatest permanent reduction in property taxes through consolidation (New York State, 2016).
South Carolina	The State Senate advanced a bill in February 2016 that would require towns that drop below 300 residents to undergo an audit of services that are financed by tax revenues. Under the bill, the Secretary of State's Office reviews the audit, determines whether the findings of the audit are satisfactory or indicate the town is mismanaged and provides recommendations to the Joint Commission on Municipal Incorporation. Towns that fail audits are given the chance to submit a correction plan before the town is dissolved (South Carolina Radio, 2016).
Washington	A bipartisan effort to amend the state Constitution to merge Washington counties with populations less than 25,000 is expected to be introduced to the state legislature in 2017 (Thomas, 2016).

most common in states with more governments per capita ($p < .01$).

Table 2 summarizes the types of dissolutions that occur, basic demographic statistics about each type, and reasons given for dissolution.

Thirty of the 133 dissolutions identified are mergers, and ten are consolidations. Dissolutions without replacement are most common (93 of 133) despite the previously discussed recent interest in combining governments, which has prompted political activism in several states (see Table 1). Dissolutions without replacement have doubled in frequency since the early 2000s. Over six dissolutions without replacement occurred per year, on average, between 2012 and 2015,[6] compared with around five from 2007 to 2011 and just three from 2002 to 2006.

The subsample of dissolved municipalities for which demographic data were obtainable[7] suggests that dissolutions without replacement affect smaller communities on average (a mean [median] population of 759 [181]) compared with merged or consolidated communities (2640 [870]).[8] Dissolved cities had incomes per capita averaging $18,072, compared with the median income per capita in the US in 2010 of $26,558. The statistic ranges from $26,001, to $20,243, to $17,219 for consolidations, mergers, and dissolutions without replacement respectively. Citizens of dissolved municipalities are, on average, 39.2 years of age (but just 35.6 for consolidations), compared with the 2010 national average of 37.2. Median unemployment in dissolving municipalities ranges from 3.0% to 3.8%, much lower than the 2010 national unemployment rate of 10.8%.[9]

An examination of the industrial makeup of the dissolved cities (untabulated) reveals that manufacturing is listed as the top industry, employing the largest percentage

[6] This statistic does not include the dissolution of 26 Nebraska municipalities with one vote in 2015. Including those, there were on average 14.7 dissolutions per year from 2012 to 2015.

[7] Demographic records for some of the dissolved entities were unavailable in the Census datasets. Possible reasons for this include that municipality was so small before dissolution that the Census did not receive adequate responses from its citizens or because the records were eliminated from the Census.

[8] Excludes Louisville, Kentucky, an outlier with a much larger population than the others on the list. Louisville consolidated with the surrounding county following years of population loss to suburbs. An untabulated logistical regression analysis reveals that the dissolutions without replacement in the sample are associated with lower populations than mergers or consolidations. Consolidations are associated, on average, with higher population, median income, and median age than mergers and dissolutions without replacement.

[9] Note that unemployment statistics ranged dramatically in recent years, from 3.7% in 2000, to 6.9% in 2005, and back to 6.3% in 2015 (according to Census data).

Table 2
Demographic characteristics and reasons for dissolution by dissolution method.

Type	Dissolutions	Reason	#	Statistic	Population	Median income ($)	Unemployed (%)	Age
Consolidation	10 (7.5%)	Efficiency	9	*Min*	332	21,827	0.90	22.3
		Disinterest	0	*Median*	1,332	26,001	3.80	35.6
		Population	1	*Mean*	3,092	34,217	4.93	35.5
		Financial	0	*Max*	12,342	69,731	11.10	47.8
		Forced	0	*Std. Dev*	4,621	18,536	4.31	9.1
		Other	0					
		*N**	10		6	6	6	6
Merger	30 (22.5%)	Efficiency	16	*Min*	14	11,477	1.00	28.6
		Disinterest	2	*Median*	815	20,243	3.00	39.4
		Population	3	*Mean*	2,187	21,288	3.81	39.4
		Financial	1	*Max*	13,995	45,012	11.70	59.0
		Forced	0	*Std. Dev*	3,504	7,464	2.76	6.0
		Other	4					
		*N**	21		25	25	21	25
No replacement	93 (70%)	Efficiency	46	*Min*	5	3,800	0.50	20.5
		Disinterest	46	*Median*	181	17,219	3.80	39.5
		Population	15	*Mean*	759	19,125	6.52	41.9
		Financial	12	*Max*	20,013	58,578	57.10	67.5
		Forced	7	*Std. Dev*	2,435	9,289	8.78	10.3
		Other	19					
		*N**	84		74	70	47	72
Total	133 (100%)	Efficiency	71	*Min*	5	3,800	0.50	20.5
		Disinterest	48	*Median*	302	18,072	3.55	39.4
		Population	19	*Mean*	1,233	20,557	5.62	40.9
		Financial	13	*Max*	20,013	69,731	57.10	67.5
		Forced	7	*Std. Dev*	2,932	10,141	7.31	9.5
		Other	23					
		*N**	115		105	101	74	103

This table shows descriptive statistics for the confirmed dissolutions in total, and by type. Column 1 lists the type of dissolution. Column 2 lists the number of dissolutions categorized in each type. Columns 3 and 4 list the reasons documented for dissolution and the number of dissolutions for which each reason is documented. Evidence supports multiple reasons for some dissolutions; no evidence is found to indicate the reasons for others. N^* gives the number of dissolutions for which *some* reason is documented. Since there are multiple reasons documented for some dissolutions, the sum of the # of reasons documented for each type of dissolution (column 4) may be greater than N^*. Since no evidence is found to indicate the reasons for other dissolutions, N^* may be less than the number of dissolutions listed in column 2. The remaining columns provide demographic data for the subsample of dissolved municipalities for which it was obtainable. In these columns, N^* gives the number of municipalities for which the data were available (and, thus, the subsample size on which the descriptive statistics are based). One outlier, Louisville, KY (a consolidation city), is excluded from the calculation of descriptive statistics.

of citizens, in 36.6% of dissolved municipalities, and as the second largest industry in another 20%. The 2014 Census data suggest that, since 2005, manufacturing employment has declined by 16%.

Current state of disclosure

Audited financial statements were available for only twenty sample municipalities. Half contained note disclosures referencing a pending dissolution, sometimes labeled as a "subsequent event". One quarter of the audit reports contained a reference in the form of an explanatory paragraph. Of all the audited municipal financial statements obtained, only one included a going concern opinion.

A search of the Federal Audit Clearinghouse database revealed that fourteen sample municipalities received sufficient federal funding since 1997[10] to require a single audit. None of 38 audits obtained for the fourteen municipalities contained a going concern opinion.

[10] The Federal Audit Clearinghouse database compiles audit data (but not financial data), including the opinion given, for governmental and non-profit entities that receive a minimum amount of grant support from the federal government, subjecting them to single audit requirements. The database goes back to 1997.

Paths to dissolution

Table 2 categorizes the reasons for dissolution into one or more of six groups: (1) seeking greater efficiency, (2) low participation in local government, (3) population exodus, (4) financial distress, (5) forced by state or county, and (6) other. Some dissolutions fall into multiple categories. Table 3 shows the number of dissolutions for which each reason appears to be the sole versus contributor. The support for categorization was obtained from state documents and correspondence with state officials where possible. However, news accounts often provided a richer (albeit, less

Table 3
Breakdown of reasons for dissolution by single versus contributing factor.

Reason	Sole reason	Contributing reason
Efficiency	33	39
Disinterest	4	43
Population	6	12
Financial	4	9
Forced	0	3
Other	9	14

This table displays the frequency with which each reason for dissolution (Column 1) is documented as the sole factor (Column 2) versus one of two or more factors (Column 3) leading to dissolution.

substantiated) context and were referred to extensively. Dissolutions for which no background was located are uncategorized.

The most commonly cited reason that municipalities initiate dissolution is the belief that the independent local government is unable to provide quality services at a reasonable cost. These dissolutions are placed in the “Efficiency” category. Citizens sometimes attest that another nearby municipality either already provides, or could begin providing services to the dissolved municipality more efficiently (i.e., at a lower cost and/or higher quality). Such cases represent almost all consolidations and mergers, and over half of dissolutions without replacement. A t-test (untabulated) reveals that, relative to the other categories, dissolutions in this category tend to affect municipalities with higher median incomes and populations, lower median age and unemployment, and in states with more governments per capita. News articles and correspondence with municipal officials include narrative such as,

> *Those who want the city dissolved say they receive limited services for their taxes.*
>
> (Bartleman 2008)

> *The primary justification for the consolidation was that it would save money by eliminating duplicate staff.*
>
> (Authors’ correspondence with municipal official)

Lack of citizen engagement, categorized as “Disinterest”, is the next most commonly cited reason to dissolve. This may include failure to fill elected or unelected positions. This condition is most common before a dissolution without replacement, affecting over half. Citizens may be too busy to engage in government service – the average unemployment rate for dissolutions in the “Disinterest” category is lower than in others. One news article stated,

> *Since nobody ran for office in the last election and not one vote was cast, the remaining four councilmen decided to dissolve the municipal government.*
>
> (Hunt 2012)

Population exodus (“Population”) – not to be confused with a small but stable population – is the third most commonly cited reason for dissolution, and is evident in nineteen of the dissolutions, most commonly resulting in dissolutions without replacement. Concerns related to population loss are not restricted to small communities. Population decline was a primary concern of decision makers in the case of Louisville, Kentucky, a city that continuously lost residents to the suburbs for 50 years prior to consolidating with the surrounding county (Watcher, 2013).

Fiscal distress (the “Financial” category) is difficult to identify as an isolated reason for dissolution, as it is endogenous with factors such as population decline, a shrinking tax base, and citizen demands for more service efficiency. For example, financial distress could cause service disruptions, leading to citizen discontent, and eventually, population decline, reduced tax revenues, and additional financial distress. The financial documents for most of the dissolved entities had been discarded or could not be located by state officials, which precluded independent investigation of financial condition. The category contains dissolutions undertaken following struggles to meet obligations. Such evidence is distinct from citizens’ desires to minimize property taxes, as this does not necessarily indicate that the municipality is financially distressed. For example, one state auditor’s report states: “The Village has a six-year history of unsound financial position and management has not developed a financial plan or taken corrective action. . .” The report goes on to “recommend . . . a petition for the surrender of corporate power.”

Table 3 highlights that in only four cases did financial distress appear to be the *sole* motivation for dissolution. Overall, there was distinct evidence in very few cases – 13 of 133 dissolutions – that financial distress was a primary contributor to the decision to dissolve. Twelve of the thirteen were without replacement. Interestingly, dissolutions stemming from financial distress tend to affect municipalities with larger populations and lower median incomes, relative to other categories, according to a t-test (untabulated).

Only seven dissolutions (all without replacement) were state- or county-mandated, falling into the “Forced” category. The “Other” category includes unique reasons such as voluntarily desertion due to natural disasters (e.g., flood) or public health concerns (e.g., lead contamination). All of the dissolutions in the “Forced” category, and several in the “Other” category, overlap with other contributing reasons.

Implications for disclosure regulation

The analyses suggest that the relationship between dissolution, distress, and disclosure actually follows a framework similar to that illustrated by Fig. 2 (bankruptcy, discussed previously, has been removed for simplicity). The perception that financial distress is the primary contributor to the likelihood of municipal dissolution is not necessarily true for local governments. Dissolution stems from other factors that may or may not be endogenously related to financial distress (path A). These factors are little researched and little understood, but have important implications for financial reporting as they affect the probability of a municipality continuing as a going concern, or experiencing financial distress.

Proposed changes to disclosure guidance for governments must consider two aspects of government viability. First, the likelihood that a governmental entity will cease

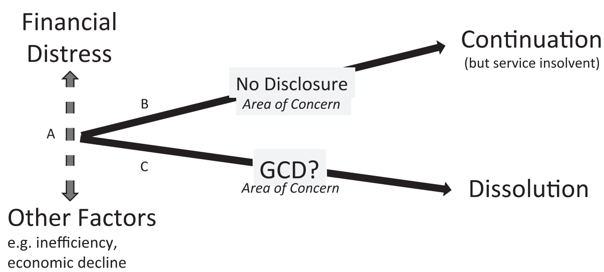

Fig. 2. Illustration of the actual relationship between dissolution and financial distress.

to exist as a going concern. Despite the rarity of dissolution, this study documents that the political pressures to dissolve may be increasing and that dissolution without replacement has increased in recent years. However, GCDs are rare and, when present, inconsistent among the dissolutions sampled. Over 10% of the sample received enough support from the federal government to require a single audit, but none of the audit reports indicated the municipality might soon dissolve, raising questions about the adequacy of current GCD guidance. Did the government provide this support under the assumption of continued viability? Because dissolution is almost always initiated and approved by citizens, they are unlikely to be caught off guard. However, the prospect of dissolution undermines the principles of accrual accounting (which GAAP for governments requires), is material to financial reports, and may be unknown to some stakeholders (like the federal government).

The GASB makes a case that governmental accounting standards should be context-specific (GASB, 2013). Perhaps there is no better example than with municipal dissolution. The path to municipal dissolution is not identical to that leading to corporate dissolution. Many municipalities dissolve for reasons not directly attributable to financial distress. The GCD guidance focuses on an entity's inability to remain financially viable, but citizen satisfaction, state policies, and the local economy also influence the likelihood of dissolution. GCD guidance should focus on governmental performance measures other than just financial indicators.

Rather than taking a "kill two birds with one stone" approach, the authors recommend that standard setters treat the likelihood of severe financial distress as a second aspect of government viability. Such a disclosure could follow the framework of Fig. 2. In the government setting, financial distress often follows indicators of declining performance that are not strictly financial. For example, economic reliance on troubled industries, recent population decline, or citizen apathy could be visible before financial statement based indicators show signs of distress. Additional investigation of the typical profile of dissolving or distressed governments may also be warranted. Prior research documents that municipal governance and internal control mechanisms are positively associated with population and financial condition (e.g., Fitzgerald & Giroux, 2014), and that internal control quality is negatively associated with the issuance of a going concern opinion (Jiang, Rupley, & Wu, 2010). The extent to which demographic characteristics like education level, income, and population are related to citizen engagement could influence internal control quality and continued viability.

Of particular importance is citizen dissatisfaction with services, which could lead to population decline. Financial performance indicators should be developed to determine the extent to which a government has the financial flexibility to improve quality or efficiency of services. Given that service dissatisfaction is a top driver of dissolution, but also endogenous with financial condition, this could be an important place for financial statement preparers and auditors to look for signs of financial distress or possible dissolution.

Once preparers and auditors have identified indicators of financial distress – either directly, through financial performance measures, or indirectly by examining other factors described in this study – an assessment should be made of the likelihood that a government will either (a) dissolve (warranting a GCD), or (b) continue operating, but in a distressed condition (requiring a similar, but not identical disclosure about financial viability). The decision-maker should consider indicators listed in Table 4. Although beyond the scope of the current study, the authors note that a number of state monitoring programs,[11] academic studies (e.g., Trussel & Patrick, 2009; Kloha, Weissert, & Kleine, 2005), and the GASB (GASB, 2011) have suggested specific metrics for evaluating governmental financial condition.

Table 4
Indicators for assessing the likelihood of financial distress and dissolution.

Step 1: Assess environmental conditions
Declining population.*
Aging population.
Economic dependence on struggling/declining industry.
Declining property values, increasing foreclosure rates, and rising inventory of homes for sale.
Citizen initiatives to increase or improve services or lower property taxes.
Lack of interest in holding public office.
Step 2: Assess likelihood of continuation as going concern. Consider:
a. Environmental/Local conditions
Similarly positioned municipalities in the state have recently undertaken dissolution.
Service provisions could feasibly be assumed by municipality in near proximity.
b. Citizen initiatives
Petition for dissolution is circulating (or has circulated).
Vote on dissolution is set (or will likely be set) for near future.
Dissolution has been proposed at recent council/board meetings.
Application has been submitted to state grant program for merger/consolidation assistance.
Citizen demands for lower property taxes could be met through dissolution.
c. State initiatives
State audit/review reveals mismanagement/noncompliance with laws.*
State agency (e.g., auditor, monitoring program, etc.) recommends dissolution or dissolution assistance.
State agency has power to mandate municipal dissolution.*
Step 3: Assess likelihood of severe financial distress. Consider:
a. Short- and long-term performance
Financial ability to meet current and future obligations with current and future resources.
Recent trends or events that suggest future changes in financial condition.
b. Competence/Willingness/Ability of management to improve financial condition
Steps taken to acknowledge or improve financial condition.
Government structure, turnover, and balance of power, which might affect reactive abilities.

* Consideration should be given to whether the municipality meets conditions for mandated dissolution by the state, if relevant.

Conclusion

Acemoglu and Robinson's (2012) *Why Nations Fail* provides convincing evidence that resources are not the primary

[11] For example, preparers and auditors could look to states like Connecticut, Florida, Michigan, New York, North Carolina, Ohio, and Oregon, all states which the authors found prescribe specific indicators for assessing local government financial condition.

reason some nations fail while others prosper. In a similar vein, the authors of the current study find that although financial stress may be a contributing factor it is not the primary reason municipalities dissolve. More often, dissolution occurs because citizens view their municipality as a dysfunctional institution: one that failed to adapt to changing conditions and no longer provides the opportunities and services taxpayers expect.

Very few, if any, municipalities cease to be going concerns in the sense that they dissolve without arrangements being made by the state or another governmental entity to ensure that the needs of affected citizens continue to be met. Some stakeholders may disagree with the decision to dissolve, but few are likely to be surprised by a dissolution under existing laws, which often make dissolution a complicated and lengthy process. The current going concern disclosure guidance does not address a chief concern of most stakeholders: financial insolubility causing disruption of services. Disclosure guidance should reflect the importance of service efficiency to stakeholders, both in evaluating financial condition and in making decisions about dissolution.

The expression "going concern" comes from the auditing literature (AICPA AU Section 570) and is too narrowly focused to describe accounting and reporting guidance for governmental entities. More appropriate alternatives to the expression "going concern" might be "ability to continue as an independent entity" or "ability to continue providing generally expected levels of service." Further, the term "ability" should be understood broadly to include local citizens' commitment to the continuation of the entity as well as financial ability to continue operations. The study documents that some dissolutions occur because citizens are apathetic and unwilling to serve as elected or unelected officials, have lost faith in the quality and breadth of services provided by their municipality, or, consistent with Anderson's (2012) observations, that anti-tax sentiments, as well as gradual economic decline (often accompanied by population loss) motivate many dissolutions. These conditions may be accompanied by financial distress; however, even a financially distressed entity is unlikely to dissolve if the citizens are engaged and committed to continuation, particularly since most dissolution proceedings are initiated by citizens.

In summary, the research indicates that the likelihoods of governmental dissolution and financial distress are (1) related, but not identical concerns and (2) should be assessed in the context of the governmental entities' legal and operating environments. As discussions of governmental efficiency, and even consolidation, increase around the country, deliberations of how these issues should be disclosed to financial statement users will certainly continue. The study informs this debate and suggests the following questions for future research.

- What measures of financial distress are most useful in predicting outcomes such as service cuts and debt default? Would such measures be useful to preparers and auditors as leading indicators to assess the "severity" of financial distress?
- What traditional financial ratios are most useful for predicting severe financial distress?
- Are economic and/or socioeconomic indicators (e.g., plant closing, population decline, increased crime) more useful in assessing municipal financial condition than traditional financial statement ratios?
- What is the time series relationship between economic deterioration and negative changes in financial statement ratios?
- How can the supplemental and statistical information in government Comprehensive Annual Financial Reports (CAFRs) be used to assess the financial condition of municipalities?
- How successful have state initiatives encouraging mergers, consolidations and joint service agreements been in reducing costs and improving the quality of public service?
- Does the failure of single audits to identify governments that dissolve indicate a problem with audit guidance or inadequate auditor training?
- What is the causal relationship between certain demographic characteristics (e.g., average age, income, unemployment rate, etc.) and a municipality's vulnerability to dissolution?
- What are the short- and long-term financial implications of dissolving, merging, or consolidating local governments? Under what circumstances do these financial implications positively or negatively affect citizens?

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