Holding Cities Accountable: The Impact of Municipal Governance on Cities' Audit Results & Report Timeliness

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Version: August 2012

Abstract:

This study examines the effects of governance policies on cities' A-133 audit results and audit report timeliness. The A-133 audit is required by the Federal government to determine if non-Federal entities are using Federal funds in compliance with requirements and with appropriate internal controls. Any noncompliance or internal control deficiencies are disclosed in the report as audit exceptions, and these results are publicly available.

The specific governance institutions studied here are: city governance structure, City Council election policies, use of an audit committee and internal audit function, and Finance Department leadership. The results of this research indicate that governance impacts both the prevalence of audit findings in the audit report and timeliness of the report issuance. Specifically, cities that elect their Finance official are less likely to have audit findings, cities that enforce term limits on City Council members are more likely to have audit findings, and cities that implement a city manager structure are shown to issue timelier audit reports.

Results found here serve to broaden existing theory in the public sector as this study is the first in a municipal setting to explore the relationship between governance and audit exceptions and the relationship between governance and audit report delay. This research seeks to encourage discussion about potential policy changes that may improve the quality and timeliness of municipal reporting. Furthermore, this research may lead to future discoveries regarding the impact of governance as the audit report can be used to assess a city's effectiveness and efficiency in managing public resources by a number of stakeholders, including the Federal government, the municipal bond market and local voters. In turn, these stakeholders may reward or punish the city and its officers for the audit results disclosed.

I. INTRODUCTION

Each year, the Federal government provides over $400 billion in grants to non-Federal entities, including state, local and tribal governments, colleges, universities and other non-profit organizations (OMB 2011). City governments use these funds to provide programs and services for local citizens. In order to hold these entities accountable for the proper use of these funds, an A-133 audit (or single audit) is required by the Federal government for any non-Federal entity that spends more than $500,000 of Federal funds. In this audit, an independent auditor determines whether the entity is in compliance with Federal requirements regarding the funds distributed and whether the entity has appropriate internal controls in place to ensure this compliance. Upon completion of this audit, the A-133 audit report, containing any problematic audit findings related to noncompliance or internal control weaknesses, is submitted to the Federal government and disclosed publicly.

According to the Governmental Accounting Standards Board (GASB), the motivation for governmental financial reporting is accountability – accountability to taxpayers, regulatory bodies and government bondholders. Audited financial statements act as a measure of fiscal and operational accountability for a municipality. Fiscal accountability is the responsibility of the government to justify that actions in the short-term comply with public policy decisions regarding raising and spending public funds (GASB 1987). Operational accountability is defined by the GASB as "the government's responsibility to report the extent to which they have met their operating objectives efficiently and effectively" and whether they can continue to meet these objectives in the future (GASB 1987).

The financial statements provide information to stakeholders regarding a municipality's fiscal and operational accountability. The auditor reviews these statements and determines whether the financial information is fairly presented, controls are operating effectively and the municipality complies with laws, grants, contract agreements and Federal program requirements. The audit report is issued with the financial statements, describing any audit findings, and the stakeholders use these audited financial statements as a portrait of the city's fiscal and operational accountability. Because the audit report acts as an accountability tool for public officials, municipalities benefit from understanding the impact of governance on their audit results.

Beyond the results contained within the report, the timeliness of the audit report issuance also affects the city's stakeholders. Relevance of information decreases when information is not timely; therefore, more timely reports are more useful. In 1985, the Governmental Accounting Standards Board (GASB) published a study finding that approximately 90% of users of governmental financial reports considered timeliness to be an important quality of government financial reporting (GASB 1987). Following this study, the GASB released Concept Statement No. 1 and established timeliness as one of the key characteristics of governmental financial reports. In 1998, the National Federation of Municipal Analysts (NFMA) recommended the SEC become involved in encouraging timelier reporting by municipalities (NFMA 1998). The NFMA revealed that practices in governmental reporting resulted in financial information not being available until it is irrelevant and therefore not useful, which results in uncertainty in the municipal securities market (NFMA 1998). For these reasons, understanding governance policies of municipalities and their effects on audit report timeliness is essential and has potentially far-reaching effects.

The primary contribution of this study is to identify governance policies that influence audit report results and timeliness of reporting. While governance has been examined in the commercial and nonprofit sectors, many governance policies are unexamined at the municipal level, especially as they relate to audit report results and report timeliness. This study broadens the existing theory in the public sector by demonstrating that governance impacts both the quality and timeliness of reporting within a municipality. Furthermore, this research not only seeks to understand the effect of municipal governance on audit results and report timeliness, but also to encourage discussion about potential policy changes that may improve the quality and timeliness of financial reporting. The policies and practices examined in this study are adaptable; therefore, the results have important implications for future policymaking.

Results of this study indicate that previously unexplored governance policies reduce audit findings, namely the type of leadership in the Finance Department and the election policies of City Council. In regards to audit report timeliness, cities that use a city manager are shown to issue more timely reports.

II. THEORETICAL FRAMEWORK AND BACKGROUND

i. PRINCIPAL-AGENT THEORY

Principal-agent theory underlies the relationship between the voting public and the elected officials that are chosen to represent the voters. In the public sector, public officials act as agents over citizens' resources and have differing interests from the citizens they represent. These officials carry the responsibility of making decisions on the citizens' behalf with regard to the availability of public goods and services and the management of public funds. Incentives are used to align the interests of the principal and the agent, and monitoring and oversight help to ensure that the agents act in the interests of the principals.

One monitoring mechanism used is the external audit performed by an independent third party. An external audit involves an extensive evaluation of the financial reports, internal controls and processes in place within the entity. The audit acts a tool used by citizens to evaluate the performance of the government and to hold public officials accountable. The audit provides an objective assessment of whether municipal agents effectively manage public resources.

Within this principal-agent relationship, information asymmetry exists because the officials are privy to private information that the voters do not have, which gives the officials an information advantage. The result of the external audit is an audit report, which gives an overall opinion as to the presentation of the financial statements, the internal control system design and operating effectiveness, and compliance with laws and regulations. This audit report gives voters information that otherwise would not be available to them, therefore reducing the information asymmetry problem.

In the municipal government setting, transaction costs (i.e., costs of relocating to a different city) are high compared to those of the capital market (Zimmerman 1977). Because of this, voters cannot easily dispose of their investments in the municipality, i.e., their real estate investments, and are less able to protect themselves from opportunistic behavior by the public officials acting as their agents. Due to these high transaction costs, monitoring and oversight are of the utmost importance (Baber et al. 2011).

ii. ACCOUNTABILITY, TRANSPARENCY AND OVERSIGHT

The aim of this study is to determine whether policies that place greater emphasis on municipal accountability, transparency and oversight have a beneficial impact on audit results and audit report timeliness. The elements of accountability, transparency and oversight are integral components of a city government because they enhance citizens' trust in the government and its officials.

Accountability generally has three characteristics: scrutiny by others, accounting for actions and the risk of negative consequences when performance is unsatisfactory. Accountability refers to the obligation of an entity to account for its activities, accept responsibility for its actions and disclose the results of these activities and actions. In the context of a city, this includes the responsibility for taxpayers' resources. When functioning properly, accountability mechanisms align the objectives of the citizens and the public officials, ensuring that public resources are effectively and efficiently managed. Greater emphasis on accountability ensures that public officials and workers are held responsible for their actions and allows the public to monitor and discipline public officials (Maskin and Tirole 2004).

Transparency implies open and full disclosure of information. Increased transparency leads to improved oversight as it reduces information asymmetry and improves accountability (Hermalin and Weisbach 2007). Measures that emphasize accountability tend to also highlight transparency - information disclosure, or improved transparency, is required in order for an entity to be held accountable for its actions. Lack of transparency also creates opportunity for corruption and reduced efficiency (UN 2007).

Public oversight fights corruption, builds confidence and trust in the city government and encourages accountability and transparency. Oversight within a local government involves monitoring the fiscal and operational accountability of the city, including compliance and financial reporting. An ideal municipal governance structure incorporates practices that implement oversight, accountability and transparency.

Policies that promote accountability, transparency and oversight instill confidence and trust in the government. Some policies also improve fiscal responsibility, financial reporting quality and compliance with laws, regulations, contracts and grant agreements. External audits indicate a city's financial reporting quality and compliance with laws, regulations and federal grant requirements. Because the goals of these policies are aligned with the measures evaluated through external audits, cities that emphasize these policies are expected to have better audit results and timely reporting.

iii. The Single Audit Act

U.S. non-Federal entities receive over $400 billion annually from the Federal government in order to fund various programs, including social welfare, education, healthcare, public safety, and public works programs (OMB 2011). Prior to the Single Audit Act of 1984, no cohesive, organized method for auditing these programs existed. With implementation of the Single Audit Act, the Federal government outlined which entities are required to obtain audits of these programs, known as single audits or A-133 audits, and detailed mandatory audit requirements and steps. Furthermore, this Act required public disclosure of the single audit report.

The single audit is a thorough, organization-wide audit performed by an independent third-party auditor, usually annually, and is required for any non-Federal entity receiving $500,000 or more in Federal assistance. The audit entails an extensive review of the entity's compliance with the Federal government's requirements. For each federally funded program, the Federal government details the compliance requirements, published annually in the Office of Management and Budget (OMB) A-133 Compliance Supplement. The areas audited include allowable activities and costs, cash management, program eligibility, budgeting (such as matching, earmarking, etc.), procurement, reporting (both financial and programmatic), and subrecipient monitoring, among other areas. For each area, specific audit steps are outlined.

This detailed outline is used by the auditor to examine both the entity's compliance with grant requirements and the internal control system in place to ensure compliance. Compliance tests, or audit tests to ensure compliance requirements are met, test areas such as: eligibility tests for entitlement program recipients are properly administered; program funds are spent according to earmarking requirements; quarterly financial reports are accurately prepared and submitted timely to the oversight agency; etc. The internal control system over each of the processes is examined to determine that appropriate controls are in place to ensure that compliance is met.

The single audit (SA) opinion is issued by the independent auditor, and this audit opinion report is submitted to the Federal government and published publicly on the OMB's website. In this report, any significant internal control or compliance issues are noted as well as the expected corrective action to be taken by the entity in the following reporting periods. These problematic audit findings are disclosed in the SA report as audit exceptions.

As the SA is an organization-wide audit, the audit exceptions identified in the audit report identify operational deficiencies that underlie various departments of an entity, rather than just those responsible for financial reporting. Many areas of a municipality are examined when a single audit is performed as compliance is tested in relation to both financial and programmatic components. As such, this audit gives a comprehensive view of how a municipality is functioning and has the ability to highlight pervasive issues.

III. LITERATURE REVIEW

Governance policies are institutional conventions a municipality adopts to affect the quality and level of oversight and accountability of the municipal officials. The policies examined in this study are audit committee existence, use of internal audit, City Council election policies, Finance Department leadership and use of a council-manager government structure.

i. Audit Committee

The audit committee is a voluntary mechanism in U.S. municipalities. Audit committee effectiveness is examined in the corporate sector, but little focus has been placed on this element in the public sector. The intent of this study is to extend findings from the corporate sector to the public sector.

In response to several financial reporting scandals, the Sarbanes-Oxley Act (SOX) was passed in 2002 to regulate publicly traded companies. The aim of this legislation is to improve accountability, transparency and oversight of publicly traded corporations. While this Act only applies to publicly held corporations, evidence suggests benefits to applying SOX-related practices to other entities: Ostrower (2007) finds that, in nonprofit agencies, the adoption of SOX-related practices has a positive relationship with agency performance.

A provision of SOX that potentially benefits governmental entities is the requirement to have an audit committee in place. In the corporate sector, audit committees have been studied at length and found to be effective in improving financial reporting quality (Kang et al. 2011; Baxter and Cotter 2009; Pucheta-Martinez et al. 2007; Vafeas 2005). Goodwin-Stewart and Kent (2006) examined the relation between the existence of an audit committee and audit quality using a sample of Australian firms, in which audit quality is measured using a proxy variable: audit fees. The underlying assumption to this research is that higher audit fees indicate a higher quality audit. They find higher audit quality among the sample of firms that voluntarily adopted an audit committee than the firms that did not.

After the implementation of SOX, the GAO focused on governance in the public sector. In 2002, the GAO recommended that public sector entities use an audit committee, and in 2003, the GAO required each government entity to designate an audit committee or a similar body to fulfill the financial oversight role (GAO 1999). Even so, some municipalities do not use an audit committee but instead have designated the City Council as a whole to act as the audit oversight body.

ii. INTERNAL AUDIT

Internal audit is a division of an entity dedicated to improving operational accountability, fiscal operations and internal control systems. An internal audit department works to achieve effectiveness, efficiency and accountability by providing an independent assessment of a city's policies and practices. The department acts as a fiscal monitoring operation and is responsible for providing management with information related to the city's programs, activities and functions. The department also recommends improvements to policies and procedures in order to enhance the internal control structure of the city. Overall, the internal audit function "provides assurance that internal controls in place are adequate to mitigate the risks, governance processes are effective and efficient, and organizational goals and objectives are met (IIA 2006)."

Little research has been performed over the internal audit department in the public sector, while research does exist in the corporate sector. Goodwin-Stewart and Kent (2006) evaluate the relationship between the existence of an internal audit department and audit quality and find that the use of internal audit varies directly with audit quality. Goodwin-Stewart and Kent explain that entities use internal audit as an additional monitoring mechanism to improve overall governance. Singh and Newby (2010) replicate these findings and find an even stronger positive relationship between internal audit and audit quality.

iii. Election Policies

Many studies in both the commercial and nonprofit sector evaluate the Board of Directors and election policies, while the election policies of City Council have been rather untouched in research with regards to accounting implications. City Council is the comparable body in a municipality to the Board of Directors in a nonprofit entity or publicly traded corporation. Both are intended to act as an independent oversight body and as the stakeholders' representative, whether stakeholders are citizens, in the case of a municipality, donors, in the case of a nonprofit organization, or investors, in the case of a publicly traded company.

The City Council acts as an oversight body for the city as a whole, and as with any oversight body, the potential for management entrenchment exists. Managerial entrenchment in the context of public governance occurs when council members gain so much power they are able to use the government to further their own interests rather than the interests of the citizens they represent. Entrenchment introduces inefficiency, lays the grounds for corruption and hinders the government's ability to serve the needs of the citizens. With increased entrenchment, government agents also increase their ability to secure resources for corrupt purposes and to block investigations.

Free and regular elections provide accountability by allowing citizens to discipline public officials. Additionally, the threat of removal encourages officials to avoid shirking and to act in the public's best interest, rather than in their own self-interest (Adsera et. al. 2003). Municipalities may hold unitary elections or staggering elections. In a unitary Council, all members stand for election each term; in a staggering Council, elections are held in different terms for different groupings of members (for example, by odd-numbered districts). Staggering elections prevent citizens from replacing a majority of the Council without at least two elections passing. The ease with which Council members can be removed is reduced when elections are staggered, so the use of staggered elections creates greater potential for entrenchment.

Prior research related to the election of corporate Boards of Directors shows that weaker shareholder rights (determined by an index of factors, including staggering elections) are associated with lower firm performance (Gompers et al. 2003). Furthermore, Bebchuk and Cohen (2005) extend this study and find that the main factor driving these results is the use of staggering elections. Baber et al. (2007) finds that measures of manager entrenchment (including staggering elections) are important indicators of internal control problems. Additionally, boards using staggering elections have been shown to be resistant to takeover and to reduce firm value (Bebchuk 2002; Faleye 2007).

Another element of election policies examined here is the enforcement of term limits. Term limits require officials to rotate out of office after a set limit of time. Alt et al. (2011) perform a study using term limits at the gubernatorial level across states and time to evaluate the effects of term limits on elected officials' accountability. Alt et al. examine whether there is an "accountability effect," as indicated by variation in certain government measures between governors eligible for reelection compared to those ineligible for reelection. They find that governors who are eligible for re-election perform better in their role when compared to those who are ineligible for re-election. They explain this as the "accountability effect" and conjecture that reelection-eligible officials have more incentive to exert efforts on behalf of voters.

iv. FINANCE DEPARTMENT LEADERSHIP

Little research has examined the Finance Department leadership so this is an unexplored variable. Leadership of the Finance Department, the division of a municipality responsible for financial reporting, is an important element related to audit findings and audit report timeliness. The Finance Department manages the financial processes and prepares the financial statements. Within a city, the overseeing member of this department is the primary individual responsible for the financial statements. One of the main responsibilities of this official is the certification of the financial statements. After preparation and certification of these statements, the auditor provides the audit report, which details any audit findings discovered. For the public, this audit report acts as a measure of the Finance official's job performance as these statements are one of this individual's primary responsibilities.

The head of the Finance Department may be a political leader that is elected by the people (i.e., a comptroller) or a civil servant that is hired or appointed by the organization (i.e., a director of finance or certified financial officer). Political leaders are reappointed through public election, while civil service leaders do not undergo the election process. The "politician versus professional" debate has been analyzed from different perspectives and for various government positions (Federal judges, School Board officials, Public Utility Commissioners, etc.) with varying findings regarding the effectiveness of political leaders compared with the effectiveness of appointed officials.

V. Government Structure

Within a city, various political and administrative positions exist, but the specific role each position plays differs greatly. The majority of cities incorporate a City Council and Mayor or City Manager into the governance hierarchy; however, these positions assume different functions and responsibilities based on the structure of the government.

Which form of government is superior – a mayor-council system or a council-manager system – is unresolved. Under a mayor-council government, the executive branch is governed by an elected mayor who holds the majority of the executive authority, and the legislative branch is comprised of a City Council, over which the Mayor has veto power. The Mayor may appoint a chief administrative officer (CAO) to assist with the executive functions, but the CAO only reports to the Mayor. Conversely, a council-manager government resembles that of a private business in that voters act as stakeholders, City Council plays the role of the Board of Directors and the city manager acts as a hired chief executive officer and reports to the Council. All governmental authority lies in the hands of the Council but the Council assigns certain responsibilities to the manager. The mayor in a council-manager government is elected by voters or appointed by Council and has less authority, acting as more of a ceremonial figure (Hayes and Chang 1990).

Analyses of government structure have been performed to compare the two systems and their focus on public interest, as well as accountability and transparency (Svara 2002; Svara and Nelson 2008; O'Neill and Nalbandian 2009). O'Neill and Nalbandian (2009) show that the council-manager system encourages a greater focus on the public interest. Svara (2002) performs an in-depth study of government structure and determines that a council-manager form of government brings a broader view to the Council along with independent judgment and a focus on citizen representation. Svara and Nelson (2008) find that a city whose executive power is spread amongst a Council and manager (i.e., in a council-manager system) may have greater focus on public interest rather than the interests of a single elected official, as well as a stronger focus on promoting accountability and transparency (Svara and Nelson 2008).

The council-manager system was designed to fight corruption and unethical activity by promoting effective government through transparency, responsiveness and accountability. Some experts in the public administration field feel that the council-manager system is superior because the structure allows a partnership between the administrative and political functions that cannot be achieved through the mayor-council structure (O'Neill and Nalbandian 2009).

IV. Hypothesis Development

i. Audit Committee

Although the GAO recommends implementation of an audit committee, some municipalities do not use an audit committee but instead have designated the City Council as a whole to act as the audit oversight body. Cities that emphasize the importance of this level of oversight by establishing a designated audit committee are expected to have less audit exceptions. This prediction is introduced as a hypothesis in its alternative form:

Hypothesis 1: The likelihood of audit exceptions is inversely related to the existence of an audit committee.

In regards to report timeliness, there are competing expectations for the audit committee. On one hand, the audit committee emphasizes the importance of reporting and acts as a monitoring mechanism, therefore encouraging timely reporting. However, because the audit committee emphasizes better reporting, the report may take more time to prepare and submit. For this reason, no direction is hypothesized.

Hypothesis 2: Audit report delay varies with the existence of an audit committee.

ii. Internal Audit

The internal audit function aims to improve fiscal operations and reduce internal control weaknesses. Because an internal audit function promotes effectiveness, efficiency and accountability, while also providing additional monitoring, the following hypotheses are introduced:

Hypothesis 3: The likelihood of audit exceptions is inversely related to the existence of an internal audit function.

Hypothesis 4: Audit report delay is inversely related to the existence of an internal audit function.

iii. Election Policies

Staggering elections limit voters' ability to hold officials accountable, as the entire Council cannot be replaced at the same time. Therefore, it is nearly impossible for elections to actually create a policy change. Because staggering elections limit voters' ability to replace the Council, this policy reduces the effectiveness of oversight by allowing management entrenchment. Therefore, the following hypotheses are introduced:

Hypothesis 5: The likelihood of audit exceptions is directly related to the use of staggering elections.

Hypothesis 6: Audit report delay is directly related to the use of staggering elections.

Another element of election policies examined here is the enforcement of term limits. Term limits require Council members to rotate out of office on a regular basis, and competing expectations around this variable exist. Term limits create "lame duck" circumstances where elected officials lack incentives to pursue actions that benefit citizens. With term limits, citizens lose the ability to hold officials accountable because they are no longer up for election.

In addition to the impact of this "accountability effect," regular rotation from office disrupts the continuity of knowledge and experience of City Council. This disruption may reduce the level of oversight and monitoring provided by the Council and may have a negative impact on the reporting process. Based on this expectation, the following hypotheses are introduced:

Hypothesis 7: The likelihood of audit exceptions is directly related to the use of term limits.

Hypothesis 8: Audit report delay is directly related to the use of term limits.

iv. FINANCE DEPARTMENT LEADERSHIP

The Finance Department is responsible for financial reporting, and the leader of this department reviews, approves and certifies the financial statements in order for the auditor to perform the audit and issue the audit report. The audit report acts as a measure of the Finance official's job performance as these statements are one of this individual's primary responsibilities.

The Finance leader may be a political leader that is elected by the voters or a civil servant that is hired or appointed by the organization. Political leaders are reappointed through public election, while civil service leaders are not subject to the election process. For Finance officials, elections act as an accountability mechanism for citizens to hold the officials responsible for the audited financial statements. Therefore, it is expected that elected officials produce better audit results and more timely reports. Based on the accountability element that elections establish, the following hypotheses are introduced:

Hypothesis 9: The likelihood of audit exceptions is inversely related to Finance leadership through an elected official.

Hypothesis 10: Audit report delay is inversely related to Finance leadership through an elected official.

v. Government Structure

Regarding oversight, most municipalities rely upon a City Council and Mayor or a City Council, Mayor and City Manager. The council-manager system, which relies upon the added position of the city manager, inherently has a stronger separation of power. The system was developed for the purpose of fighting corruption through greater transparency and accountability. Because of this, the following hypotheses are introduced:

Hypothesis 11: The likelihood of audit exceptions is inversely related to the use of a council-manager system.

Hypothesis 12: Audit report delay is inversely related to the use of a council-manager system.

V. Methodology

i. Sample Selection and Data

A sample of 125 cities was selected from the largest U.S cities in population per the U.S. Census Bureau. Any entity that spends more than $500,000 of federal funds is required to obtain a single audit, and all of these cities meet this requirement. The Office of Management and Budget (OMB) requires any entity receiving a single audit to submit a Data Collection Form (DCF), which is an electronic document that is completed and certified by the external auditor with detailed results of the single audit. The DCF is submitted electronically to the OMB through the Federal Audit Clearinghouse (FAC) and is maintained in the FAC Single Audit

Database, which is publicly available. Data related to audit results and audit report timeliness is obtained from this database. Data related to the governance policies is obtained from each city's Comprehensive Annual Financial Report (CAFR) and the city's website, both of which are publicly available.

ii. MODEL DEVELOPMENT AND VARIABLES

Municipalities are audited on several levels. A financial statement audit (FSA) is conducted to ensure that the basic financial statements - the government-wide financial statements (statement of net assets and statement of activities) and the fund financial statements (covering the governmental funds, proprietary funds, fiduciary funds and component units) - are prepared in accordance with generally accepted accounting principles (GAAP). The FSA audit opinion assesses whether a municipality has prepared its financial statements in accordance with GAAP and whether the statements are free of material misstatement. This FSA opinion is a financial reporting opinion and involves auditor testing of monetary balances included in the financial statements (i.e., cash balance, accounts receivable balance, etc.), as well as the internal controls over those balances (i.e., bank reconciliations, accounts receivable aging schedule, etc.).

Municipalities that expend $500,000 or more of Federal assistance, which includes grants, awards, etc. (direct from the Federal government or passed through another entity such as the state) are subject to a single audit (SA) in addition to the FSA. The SA is performed in order to provide assurance to the Federal government as to the management and use of Federal funds by recipients. Unlike the FSA, the SA opinion does not speak to the financial reporting of the entity, but instead to its compliance with Federal requirements. During the SA, the auditors test whether the entity complied with the government-mandated requirements (i.e., were eligibility tests for food stamps recipients properly administered, were quarterly financial reports properly submitted to the Medicare oversight agency, etc.). Internal controls over these processes are also tested. The A-133 audit opinion assesses whether a city is in compliance with Federal requirements and whether their controls over these compliance requirements are adequately designed and operating effectively.

An FSA opinion has several levels: unqualified, qualified, adverse or disclaimer. An unqualified opinion is considered to be the best opinion, meaning that there is no reason for the auditor to qualify it and there are no material issues to note. A qualified opinion has a reason for the auditor to add in a qualifying statement, meaning it is not "clean." This opinion usually occurs when there is an issue in one area that is material but not pervasive throughout the entity (for instance, the public works department had major accounting systems failures that created a material error, but it did not affect any other part of the city). Beneath the qualified opinion is an adverse opinion, which is considered a problematic opinion – the financial statements are considered to be materially misstated. Finally, a disclaimer occurs when the auditor cannot give an opinion because they do not have sufficient information to properly perform the audit.

The A-133 opinion has the same levels as the FSA opinion, defined in the same manner. However, the A-133 opinion also delves into more detail. Beyond the standard opinion, there may be "audit findings." Audit findings are disclosed when material noncompliance or control deficiencies are discovered.

Material noncompliance related to a single audit is defined as an inability to follow applicable compliance requirements that results in significant noncompliance. Control deficiencies related to federal programs exist when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance. Control deficiencies related to the SA that are significant enough to warrant reporting are significant deficiencies and material weaknesses. A significant deficiency is a control deficiency that adversely affects the entity's ability to administer a federal program, such that there is a reasonable possibility that noncompliance with a program requirement will occur. A material weakness is a significant deficiency that results in a reasonable possibility that material noncompliance with a program requirement will occur.

Historically, receipt of a qualified audit opinion by a governmental entity, whether FSA or SA, is rare, and there is little variation in the audit opinion variable. In this study's sample of 125 cities, only one received a qualified FSA opinion and 17 received qualified SA opinions, while 63 disclosed problematic audit findings in their SA report. In addition to having more variation, these SA findings also identify operational deficiencies that underlie various departments of an entity, rather than just those responsible for financial reporting. Many areas of a municipality are tested when a single audit is performed – compliance is tested in relation to allowable activities and costs, cash management, program eligibility, budgeting (such as matching, earmarking, etc.), procurement, reporting (both financial and programmatic), and subrecipient monitoring, among other areas. As such, this audit truly gives a broad view of how a municipality is functioning. For these reasons, A-133 audit findings are used to measure the audit report results in this study.

Two statistical models are employed to test the hypotheses in this study. The dependent variables examined are A-133 (i.e., Federal programs audit) reportable conditions and audit report delay (i.e., the number of days from the fiscal year end to the audit report date). The independent variables of interest in each model include governance policies related to reporting. The variables are defined in Table 1 of the Appendix and descriptive statistics can be found in Table 2 of the Appendix.

a. AUDIT REPORT RESULTS

The model in equation (1) below examines the determinants of external audit results:

$A133\_RC = B_1(\text{AUDIT COMM}) + B_2(\text{INT AUDIT}) + B_3(\text{STAGGER}) + B_4(\text{TERM LIMIT}) + B_5(\text{ELECT OFF}) + B_6(\text{GOV STRUC}) + B_7(\text{BIG 4}) + B_8(\text{STATE AUD}) + B_9(\text{LOW RISK}) + B_{10}(\text{FED EXPEND}) + \varepsilon.$

The dependent variable is measured using A-133 reportable conditions (A133_RC) in the single audit report. Reportable conditions consist of control and compliance deficiencies found in the audit of the municipality's federal programs. This variable is coded as a 1 if any reportable condition is included in the municipality's single audit report. The basis for the hypotheses related to this model is that certain governance policies will lead to improved operational accountability and internal controls, therefore reducing incidences of reportable audit exceptions.

The AUDIT COMM indicator variable is coded as 1 if the entity has a designated audit committee. INT AUDIT is coded as 1 if the municipality has an internal audit function within the organization. Both AUDIT COMM and INT AUDIT are expected to have negative associations with audit reportable conditions. STAGGER and TERM LIMITS are both expected to have a positive association with audit findings; STAGGER is coded as a 1 if staggering elections are used for Council members, and TERM LIMITS is coded as a 1 if TERM LIMITS are imposed on Council members. The ELECT OFF indicator variable is coded as a 1 if the Finance official is an elected official and is expected to have a negative association with audit reportable conditions. GOV STRUC represents the government structure and is coded as a 1 if the council-manager system is used; this variable is expected to have a negative association with audit findings.

Prior research shows that auditor characteristics and municipal characteristics may impact audit findings, so control variables are introduced to control for these differential effects. Jakubowski (2008) finds that state auditors discover more audit findings than private CPA firms, so the indicator variable STATE AUD is included and coded as a 1 if the auditor is a state auditor to control for differential effects due to auditor type. The BIG 4 indicator variable is included to control for differential effects due to auditor size and audit quality (Deangelo 1981; Dopuch and Simunic 1980; Laurence et al. 2011) and is coded as a 1 if the auditor is a Big 4 audit firm. To control for effects due to municipality size (McLelland and Giroux 2000), the log of federal expenditures (FED EXPEND) is included in the analysis. Finally, the LOW RISK indicator variable is included to control for differential effects due to differences in audit risk (entities are classified by the auditor as low-risk in accordance with the Office of Management and Budget A-133 guidelines, and this classification is listed on the municipality's DCF) – this variable is coded as a 1 if the municipality is classified as low-risk.

b. AUDIT REPORT TIMELINESS

The model in equation (2) below examines the determinants of audit report timeliness:

$$ARD = B_1(\text{AUDIT COMM}) + B_2(\text{INT AUDIT}) + B_3(\text{STAGGER}) + B_4(\text{TERM LIMIT}) + B_5(\text{ELECT OFF}) + B_6(\text{GOV STRUC}) + B_7(\text{A133\_RC}) + B_8(\text{BIG 4}) + B_9(\text{STATE AUD}) + B_{10}(\text{LOW RISK}) + B_{11}(\text{FED EXPEND}) + \varepsilon.$$

The dependent variable in the second model is audit report delay (ARD), measured as the number of days from the fiscal year end to the audit report release date. Similar to model 1, the basis for the hypotheses for this model is the expectation that governance policies encourage the municipality to report on a timelier basis.

The AUDIT COMM indicator variable is coded as a 1 if the entity has a designated audit committee. INT AUDIT is coded as a 1 if the municipality has an internal audit function within the organization. Both AUDIT COMM and INT AUDIT are expected to have negative associations with audit report delay. STAGGER and TERM LIMITS are both expected to have a positive association with audit report delay; STAGGER is coded as a 1 if staggering elections are used for Council members, and TERM LIMITS is coded as a 1if TERM LIMITS are enforced on Council members. The ELECT OFF indicator variable is coded as a 1 if the Finance official is an elected official and is expected to have a negative association with audit report delay. GOV STRUC represents the government structure and is coded as a 1 if the council-manager system is used; this variable is expected to have a negative association with audit report delay.

In addition, certain municipal and auditor characteristics are included to control for the effects of these factors. The indicator variable for reportable conditions (A133_RC) is included in this model to control for any timing effects due to the disclosure of problematic audit findings. Audit report delay is expected to vary positively with this variable. Prior research has shown that audit report delay is greater when the auditor is a state auditor rather than an independent CPA (Dwyer and Wilson 1989; Carslaw et al. 2007), hence the STATE AUD indicator variable is included to control for differential effects due to auditor type (coded 1 if the auditor is a state auditor). Carslaw et al. (2007) find that audit report delay is greater for Big 4 audit firms when compared to non-Big 4 audit firms, so the BIG 4 indicator variable is included to control for these effects (coded 1 if the auditor is a Big 4 audit firm). Carslaw et al. (2007) also find that entities classified by the auditor as low-risk in accordance with the Office of Management and Budget A-133 guidelines issue timelier reports, so the LOW RISK indicator variable is included (coded 1 if the municipality is classified as a low-risk auditee) to control for differential effects due to audit risk. Lastly, Payne and Jensen (2002) find that audit delay has a positive relationship with municipality size, so FED EXPEND is included to control for differential effects due to municipality size and is measured as the log of federal expenditures.

VI. Results and Analysis

i. Audit Report Results

The results for the estimation of Model 1 are presented in Table 3 of the Appendix. In this model, it is hypothesized that governance policies impact the likelihood of disclosure of audit exceptions. Two hypotheses presented for Model 1 are supported by the statistical results. Hypothesis 7 states that the likelihood of audit findings will vary positively with the use of term limits for City Council members. The results for the TERM LIMITS variable support this hypothesis (.098, $p < 0.10$, one-tailed), indicating that enforcing term limits on the City Council reduces the continued knowledge and experience level of the Council, which leads to more reported audit findings.

Hypothesis 9 states that cities with elected Finance officials are less likely to have audit findings than those that do not elect their Finance official. The indicator variable ELECTED OFF (-.282, $p < 0.05$, one-tailed) provides support for this hypothesis, indicating that officials that are held accountable for their actions through elections perform better in their position and therefore have better audit results.

The results do not support Hypotheses 1, 3, 5 and 11, which relate to the following governance policies: use of an audit committee, internal audit, staggering elections and a city manager, respectively.

ii. AUDIT REPORT TIMELINESS

The results for estimation of Model 2 are presented in Table 4 of the Appendix. In this model, it is hypothesized that governance policies impact the audit report timeliness of municipalities. Two hypotheses presented for Model 2 are supported by the statistical results. Hypothesis 2 states that use of an audit committee will vary with audit report delay. The indicator variable AUDIT COMM (26.428, $p < 0.05$, two-tailed) supports this hypothesis, indicating that cities with audit committee oversight have longer audit report delay.

Hypothesis 12 states that cities that use a city manager will have a negative association with audit report delay. The indicator variable GOV STRUC (-27.687, $p < .05$, one-tailed) supports this hypothesis, suggesting that greater accountability, transparency and oversight in city manager governments improve the timeliness of reporting.

The governance policy hypotheses that are not statistically supported by the results from this model are Hypotheses 4, 6, 8 and 10, which relate to the use of internal audit, staggering elections, term limits and elected Finance officials, respectively.

Overall, these results help to explain factors that influence audit findings and audit report timeliness for municipalities. The Finance Department leadership is found to be a statistically significant variable in regards to the likelihood of having audit exceptions. This supports the argument that electing the Finance official allows citizens to hold the official accountable for his actions, which therefore encourages the official to perform better. The external audit report is one way that the Finance Department is evaluated publicly, and officials are aware that the public may use this report as a basis for future election decisions. Therefore, elected Finance officials have greater incentive to perform well and have fewer audit findings in the audit report.

The use of term limits is shown to have an association with the prevalence of audit findings. This finding is explained in two ways. First, term limits disrupt the continuity of knowledge and experience on the City Council, which impacts many aspects of the city and, in turn, negatively impacts the city's audit results. Second, Council members succumb to an "accountability effect," meaning that Council members subject to term limits that are in a later term are not held accountable for their actions as they do not stand election, so there is no incentive to perform better. This reduced oversight leads to poorer audit results. The use of term limits has been widely debated over the past twenty years – this result adds an interesting perspective to the argument against term limits.

An audit committee is found to be associated with a longer audit report delay. The audit committee encourages a more in-depth review by the city of the internal control systems and policies and procedures in place prior to submission of the financial statements and program information for an audit. This additional review requires more time. Furthermore, the audit committee reviews the audit report prior to release, and this additional time adds to the audit report delay.

The use of a council-manager system has a negative association with audit report delay. As shown in past research (Svara 2002; Svara and Nelson 2008; O'Neill and Nalbandian 2009), council-manager systems place a greater emphasis on accountability, transparency and oversight, and as such, these cities are expected to provide better and timelier reports. While the audit results hypothesis is not statistically significant, city managers (i.e., council-manager systems) are shown to provide more timely reports than mayor-council systems.

VII. Conclusion

This study has uncovered previously unexplored areas of municipal governance as they relate to audit report results and timeliness, and the results have significant implications for future policymaking. Elected Finance officials are shown to positively impact audit results -

cities may consider this when determining the structure of the Finance Department and whether to appoint or elect the department head. As the debate for and against term limits rages on in the public sector, this research offers an additional argument against term limits, as the use of term limits is shown to have a positive association with the disclosure of audit findings in the single audit report. Furthermore, it is important for municipalities to understand the effect of implementing an audit committee on report timeliness so they can aim to be proactive and mitigate this negative effect.

The A-133 audit studied here is a measure of a city's controls and compliance with Federal program requirements. This audit report may be seen as a report card for the municipality and the municipal officials. Audit findings are indicative of problems within the organization that have hindered the municipality from performing as it should, either in terms of program compliance or internal controls related to these programs. These issues may be indicative of larger problems related to the city's fiscal and operational accountability.

Overall, this research offers a new perspective into municipal governance and shows significant effects of these policies on audit results and audit report timeliness. Cities can use the results of this research to assess their governance structure and determine if changes are necessary. Therefore, important policymaking decisions may arise based on this research. In future research, these results will be used to re-perform this study on a larger sample size to further study the association between municipal governance, audit report results and report timeliness. In addition, future research will examine other effects of this relationship between governance and audit exceptions, namely any political or economic consequences of the disclosure of these problematic findings.

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APPENDIX

TABLE 1
VARIABLE DEFINITIONS

Dependent Variables

A-133_RC	A-133 reportable condition (0, 1): 1 if a reportable condition (significant deficiency, material weakness or material noncompliance) is found in the A-133 audit
ARD	Audit report delay: number of days between fiscal year end and the audit report date

Independent Variables

Governance policies

AUDIT COMM	Audit committee (0, 1): 1 if the municipality has an audit committee
TERM LIMITS	Term limits (0, 1): 1 if City Council has limits on the number of consecutive terms served
STAGGER	Staggering elections (0, 1): 1 if City Council elections are staggered
INT AUDIT	Internal audit (0, 1): 1 if the municipality has an internal audit function
ELECT OFF	Finance Department oversight (0, 1): 1 if the head of the Finance division is an elected official
GOV STRUC	City Manager (0, 1): 1 if the government structure is a council-manager structure (versus a mayor-council structure)

Control Variables

Auditor characteristics

BIG 4	Big Four audit firm (0, 1): 1 if the audit firm is a Big Four auditor
STATE AUD	State auditor (0, 1): 1 if the auditor is a state auditor (versus a private CPA)

Municipal characteristics

LOW RISK	Low-risk entity (0, 1): 1 if the municipality is considered a low-risk entity as determined by the auditor according to the OMB guidelines
FED EXPEND	Federal expenditures: log of municipality's federal expenditures

TABLE 2

DESCRIPTIVE STATISTICS

Variable	*N*	*Minimum*	*Maximum*	*Mean*	*Std. Deviation*
A133_RC	125	0	1	.50	.502
ARD	125	95	589	181.70	62.357
AUDIT COMM	125	0	1	.42	.495
INT AUDIT	125	0	1	.79	.408
STAGGER	125	0	1	.64	.482
TERM LIMITS	125	0	1	.48	.502
ELECTED OFF	125	0	1	.08	.272
GOV STRUC	125	0	1	.52	.502
BIG4	125	0	1	.17	.375
STATE AUD	125	0	1	.07	.260
LOW RISK	125	0	1	.56	.498
FED EXPEND	125	13.471	23.695	17.447	1.339

TABLE 3
ANALYSIS OF GOVERNANCE POLICIES AND A-133 REPORTABLE CONDITIONS (MODEL 1)

Independent Variable	*Expected Sign*	*Coefficient*	*t*
Intercept		-.984	-1.594
AUDIT COMM	-	.049	.563 .
INT AUDIT	-	.173	1.711
STAGGER	+	.097	1.036
TERM LIMITS	+	.098	1.176 ^
ELECTED OFF	-	-.282	-1.798 *
GOV STRUC	-	-.052	-.589
BIG4	+	.219	1.899 *
STATE AUD	+	.047	.297
LOW RISK	-	-.335	-3.858 ***
FED EXPEND	+	.081	2.314 **

^ = significant at 0.10, * = significant at 0.05, ** = significant at 0.01, *** = significant at 0.001 (all two-tailed tests, except where sign of coefficient is consistent with expected sign, then one-tailed test is used)

n = 125
Adjusted R^2 *= 26.5%*

TABLE 4
ANALYSIS OF GOVERNANCE POLICIES AND AUDIT REPORT DELAY (MODEL 2)

Independent Variable	*Expected Sign*	*Coefficient*	*t*	
Intercept		273.592	3.222	
AUDIT COMM	+/-	26.428	2.324	*
INT AUDIT	-	.287	.021	
STAGGER	+	1.803	.141	
TERM LIMITS	+	-14.255	-1.251	
ELECTED OFF	-	-20.335	-.940	
GOV STRUC	-	-.27.687	-2.293	*
A133_RC	+	20.751	1.630	*
BIG4	+	18.843	1.184	
STATE AUD	+	18.563	.857	
LOW RISK	-	-7.904	-.629	
FED EXPEND	+	-5.270	-1.077	

^ = significant at 0.10, * = significant at 0.05, ** = significant at 0.01, *** = significant at 0.001 (all two-tailed tests, except where sign of coefficient is consistent with expected sign, then one-tailed test is used)

n = 125
Adjusted R^2 = 11.9%