

Municipal Restatements and Governance

Abstract

We investigate whether monitoring by auditors, citizen voters, and councils are associated with the frequency of municipal reporting restatements. We find that municipalities with Big four auditors are significantly less likely to restate, while those that recently switched auditors are significantly more likely to restate. We also find that higher levels of council political competition are positively associated, and a measure of citizen participation is weakly negatively associated with the probability of restatement. Finally, we explore the relation between restatements and a variety of council governance characteristics, including the presence of audit committees, finance committees, council independence, staggered council elections, and the council-manager form of government, and find none are significantly associated with municipal restatements.

1. Introduction

The General Accounting Office (GAO) recently announced that 11 of 23 federal agencies sampled restated their financial statements to correct material errors (GAO, 2005). These restatements can be significant, with one agency reporting a misstatement of over \$5 billion dollars. Similarly, the City of San Diego announced a restatement of fiscal year 2002 capital assets of \$640 million, or approximately 10% of total net assets, which is larger than the \$580 million restatement reported by Enron in 2002 (Greenblatt, 2005).

Governmental restatements are problematic, as "frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties."¹ The issue of restatements is particularly relevant in the context of local governments because municipalities use financial statement information to make decisions that have an economic impact on citizens, such as determining budgets and setting tax rates and fees. If the numbers used in making these important decisions are suspect, then it is questionable whether governments are fulfilling their stewardship responsibility, one of the primary objectives of standardized reporting under governmental GAAP (GASB 2006).

The primary focus of our study is on the relation between municipal restatements and governance mechanisms designed to ensure that municipal officials act in the best interest of citizens. More specifically, we evaluate whether external monitoring by auditors and citizen voters, and/or internal board (council) monitoring, are associated with the frequency of financial reporting restatements.

With respect to audit firm characteristics, and in contrast to prior literature (i.e., Abbott, Parker, and Peters, 2004; DeFond and Jiambalvo, 1991), we find that municipalities with Big

¹ See "Fiscal year 2004 U.S. government financial statements - sustained improvement in federal financial management is crucial to addressing our nation's future fiscal challenges," David M. Walker, in testimony before the committee on government reform, U.S. House of Representatives, February 9, 2005.

four auditors are significantly less likely to restate. While we find no relation between non Big four municipal audit specialists and restatements, we do find limited results that state auditors are positively associated with restatements.

We also find that municipalities who recently switched auditors are more likely to restate, consistent with results in Lazer, Livnat, and Tan (2004). Interestingly, we further find that new auditors are more likely to restate regardless of whether the prior auditor was a Big four audit firm. The latter finding contrasts with those of Lazer et al. (2004), who find that switching to a small auditor from a big auditor results in significantly *fewer* restatements. In addition, we find no association between auditor turnover and restatements when the switch is between non Big four firms. Thus, overall, our finding of a negative relation between Big four auditors and restatements is consistent with higher-quality auditors being associated with better quality reporting. However, our finding that Big four auditors are equally likely to have their financial statements subsequently restated after switching to a non Big four firm is inconsistent with Big four firms reflecting relatively higher quality reporting.

In contrast to their corporate sector counterparts, municipal officials are subject to competitive elections, which can potentially affect the likelihood of reporting accounting restatements. We use a measure of the level of council seat competition as a proxy for the degree of citizen influence and find that more council competition is associated with an increased probability of restatement. Furthermore, municipalities often compete with each other for limited resources in terms of managerial talent and external financing, deemed jurisdictional competition (Tiebout, 1956; Dilorenzo, 1883). We find limited evidence suggesting that municipalities facing higher levels of jurisdictional competition are less likely to restate results.

Finally, we examine the relation between council governance characteristics and the probability of restatements. Similar to Baber, Kang, and Liang (2005), with the exception of a measure of manager entrenchment, we find no significant relation between a variety of council governance characteristics and the probability of restatements. Our measures include council size, and indicator variables to represent the city manager form of government, and the presence of financial monitors such as audit committees. In further tests, we find no significant relation between restatements and either audit committee independence or audit committee financial expertise, in contrast to corporate-sector findings in Abbott et al. (2004).

Our paper extends prior literature in several ways. First, we comprehensively examine restatements in the public sector context. In so doing, we extend the GAO's preliminary analysis of federal agencies to the local government setting to document the prevalence and determinants of municipal restatements. Such research is important to help ascertain whether municipal governments are fulfilling their stewardship responsibility. Second, we extend prior research that examines the relation between auditor attributes and restatements. Prior corporate sector research has been somewhat limited in exploring auditors' role in restatements because measures of auditor quality lack sufficient variation. In contrast, the public sector contains a high degree of variation in auditor size and quality. Third, we study how election cycles drive specific financial reporting decisions. This is of interest to citizens making voting decisions based on prior financial performance. Finally, our paper adds to public sector research by investigating the role that council governance plays in financial reporting quality. Prior governance-related research in the municipal sector is limited, and the influence of council characteristics such as entrenchment and audit committees on financial reporting quality is unknown. The latter findings are likely to be of interest to regulators, who are currently discussing the efficacy of

implementing portions of the Sarbanes-Oxley Act to governmental entities, particularly those provisions regarding audit committees.

Our paper proceeds as follows. Section 2 discusses the relevant literature and presents specific hypotheses, while Section 3 contains data collection procedures. Section 4 explains the methodology of our multivariate analysis and summarizes results, and concluding remarks are in Section 5.

2. Background and hypothesis development

The incidence of accounting restatements is a well-researched topic in the corporate sector (Abbott et al., 2004; Agrawal and Chadha, 2005; Baber et al., 2005; Srinivasan 2005). These studies often use an agency cost framework to evaluate how manager incentives influence reporting decisions. In contrast with the corporate environment, municipal restatements are often the result of errors rather than deliberate actions intended to deceive citizens. Appendix A provides some example restatements for municipalities in our sample.

Prior studies assign weak corporate governance as a principle factor responsible for the financial reporting misstatements that lead to accounting restatements. That is, restatements are construed as evidence of internal control failure. Given this context, investigating the extent to which municipal characteristics correlate with accounting restatements sheds light on the effectiveness of control procedures designed to promote the use of municipal resources consistent with voter preferences.

The objective of this study is to compare and contrast associations between accounting restatements and control mechanisms considered in terms of restrictions on managerial behavior by auditors, citizen voters, and/or municipal council characteristics. We illustrate examples of

specific associations between accounting restatements and governance mechanisms using the following hypotheses (stated as the null).

2.1 Municipal restatements and external governance

2.1.1 Auditor characteristics

Theoretical relations between restatements and audit firm characteristics such as auditor quality are not straightforward, particularly because restatements imply auditor error if the municipality employs the same auditor each year. If high quality auditors are more likely to discover and correct material errors during the normal course of the audit, then there will be a reduced likelihood of subsequent restatements. This is consistent with arguments in DeFond and Jiambalvo (1991), although empirical studies (DeFond and Jiamalvo, 1991; Lazer et al., 2004) find no significant relation between accounting errors (restatements) and the presence of Big eight (six) auditors.

On the other hand, it is also possible that audit quality and restatements vary directly, because high-quality auditors, especially those with industry specialization, are more likely to detect and report restatements subsequent to the date of the original audit. Hammersley (2006) provides experimental evidence that industry specialist auditors are more likely to detect complex accounting errors, especially in industries such as the municipal sector where accounting practices are industry-specific. To investigate these explanations, we propose the following null hypothesis:

H_{1A} Restatements and auditor quality are unrelated.

In addition to auditor quality, restatements can also be affected by auditor turnover. For example, auditors can reduce the potential risk of new clients by forcing them to restate the financial statements audited by the previous auditor. Consistent with this hypothesis, Lazer et al.

(2004) find that the presence of a new auditor is positively associated with restatements. Despite lower levels of litigation risk in the municipal sector, reputation concerns could prompt replacement auditors to limit the exposure associated with new clients by performing an exhaustive audit in the first year. Therefore, restatements will be higher in the year of an auditor change. We propose the following null hypothesis:

H_{1B} Restatements and auditor turnover are unrelated.

2.1.2 Political and jurisdictional competition

In contrast to their private sector counterparts, municipal officials face competitive elections at regular intervals. However, competitive elections can serve as control mechanisms only to the extent that voters have viable alternatives at the ballot box. For example, incumbents facing little competition have fewer incentives to consider voter preferences. In this light, closely contested elections can have two possible consequences with respect to restatements. First, competitive elections can improve municipality talent levels by removing poor performers from office. In addition, close elections can encourage incumbents to withhold or delay restatement disclosures to prevent a public backlash, leading to a negative relation.

Municipal elections take place at both the mayoral and council levels. Following Evans and Patton (1987), we focus on council elections because many cities do not have a separate mayoral election and many local elections are nonpartisan. To investigate these potential effects we propose the following general hypothesis:

H_{2A} Restatements and council political competition are unrelated.

In addition to municipal characteristics, prior studies suggest inter-jurisdictional concerns also create demand for monitoring. Similar to non-profit organizations, municipalities compete for scarce resources in terms of managerial talent or external financing (Glaeser, 2002).

Furthermore, Tiebout (1956) suggests that competition among jurisdictions for residents encourages bureaucrats to act in line with taxpayer preferences, and Dilorenzo (1983) provides evidence suggesting that competition among jurisdictions leads to better monitoring of public services. Therefore, municipalities facing strong jurisdictional competition will develop high quality accounting systems to assist in the monitoring function. This leads to the following null hypothesis:

H_{2B} Restatements and jurisdictional competition are unrelated.

2.2 Municipal restatements and council governance

Council governance characteristics may also be associated with the probability of restatements. Two studies examine the relation between audit committees and accounting errors or restatements using pre-Sarbanes Oxley data. In a sample of 41 corporations with accounting errors, DeFond and Jiambalvo (1991) find the presence of audit committees is associated with fewer errors. Abbott et al. (2004) find that restatements are inversely associated with audit committee independence and financial expertise. More recent studies examine the association between board characteristics and restatements using post-Sarbanes Oxley samples, with sometimes contrasting results. Baber et al. (2005) find that board characteristics such as board and audit committee independence, and audit committee financial expertise are not associated with corporate restatements. Similarly, Agrawal and Chadha (2005) find that restatements are unrelated to board and audit committee independence, and like Abbot et al. (2004), find restatements are less likely in the presence of independent board members with financial expertise.

The results of prior research may be confounded by regulation, however. The corporate sector is subject to rules and regulations such as exchange listing requirements (NYSE) or

legislation (SOX) over board and audit committees that potentially impact the relation between governance and financial reporting. In contrast, the municipal sector is not subject to such rules, and the presence of audit committees is currently voluntary. Regulators have taken notice of this issue, as organizations such as the National Association of State Auditors, Comptrollers and Treasurers (NASACT) are currently discussing the possibility of implementing provisions of the Sarbanes-Oxley Act to governmental entities with publicly traded debt, while others propose mandating the presence of financial monitors such as audit committees and financial experts.² In order to examine whether voluntary council monitoring attributes such as the presence of audit committees is associated with financial reporting quality, we propose the following null hypothesis:

H_{3A} Restatements and the presence of council financial monitoring are unrelated.

Recent research proposes that manager entrenchment can be associated with accounting restatements. Baber et al. (2005) find that the probability of restatement is higher for firms with more entrenched management (or alternatively, more limited shareholder rights). In other words, managers with the ability to create governance structures that preserve their influence are more likely to restate their results. A similar conflict exists in the municipal sector, where elected officials have incentives to construct governance systems that restrict citizen participation. To investigate this phenomenon, we propose the following hypothesis:

H_{3B} Restatements and council entrenchment are unrelated.

Finally, prior municipal research finds that the form of government, or whether the municipality is run by a strong-mayor or a city manager, is associated with disclosure quality (Evans and Patton, 1987). Evans and Patton (1987) provide evidence that city manager form of government is positively associated with disclosure quality as measured by the GFOA certificate

² See KPMG Flashpoint, "State and Local Government Audit Committees Broaden their Focus," 2003.

of achievement. To study the association between form of government and restatements we present the following hypothesis:

H_{3C} Restatements and the presence of the city manager form of government are unrelated.

3. Sample and data

Our population is the 4,244 municipalities (cities and towns) who responded to a 2001 survey conducted by the International City/County Management Association (ICMA). Council financial monitoring and governance measures are constructed in part through the use of the ICMA data. We draw our sample from the 365 municipalities with a population over 50,000, similar to prior research such as Copley, Gaver, and Gaver (1995), to increase the comparability and availability of financial reports. Restatement and auditor quality data are obtained from within the financial reports, which are collected through a combination of online searches and requests sent to the municipalities. Auditor turnover data are obtained from both the financial reports as well as from the Single Audit Database provided by the U.S. Census. Audit committee data is gathered through a survey to the 365 municipalities and direct contact with municipalities with an available financial report. Of the 254 municipalities in our sample, 27% indicate that they have an audit committee.

Council seat competition data are from the ICMA, while details on jurisdictional competition are from the 2000 U.S. Census. Data to compute control variables are obtained from the Census Bureau's Annual Survey of Governments. Table 2, Panel A outlines our sample selection procedures. Our sample consists of 740 observations for 254 municipalities for fiscal years 2001 – 2004. Variable descriptions are provided in Table 1.

Consistent with Palmrose, Richardson, and Scholz (2004), we identify restatements when a municipality refers to a restatement or prior period adjustment within their financial report,

through either footnote disclosure or reference within the financial statements. We exclude restatements due to the implementation of GASB standards such as GASB 34, as well as reclassifications between funds. Thus, restatements are caused primarily by errors, such as those due to erroneous application of GAAP, etc.

Table 2, Panel B highlights observations by year, and reveals that financial reports from 2003 and 2004 are included in the sample more frequently, which is likely due to more readily available reports on the Internet. The restatement rate is fairly constant throughout the period, ranging from a low of 25% in 2001 to a high of 34% in 2003. Overall, 31% of city-year observations have a restatement disclosed in the financial reports. Table 2, Panel C summarizes restatement frequency by municipality, and notes that a majority of cities in the sample (55%) have a restatement in at least one year, and that 23% of municipalities had restatements in multiple years during the sample window.

Table 3, Panel A presents descriptive statistics, and Panel B presents correlations between restatements and various auditor, election, and council characteristics. The auditor variables suggest significant auditor quality variation, with only 23% of the city-year observations using a Big four auditor. This result is significantly lower than the 52% of cities in 1985 audited by Big eight firms reported in Copley, Gaver, and Gaver (1995), and the corporate sector rates exceeding 85% (Krishnan and Zhang, 2005; Raghunandan and Rama, 2006) in recent years. Furthermore, 13% of city-year observations occur in the year after an auditor switch, which is consistent with the 9% documented by Baber, Brooks, and Ricks (1987) in the municipal sector, and the 7% documented by Lazer et al. (2004) in the corporate sector. Untabulated results further strengthen the finding that the Big four market share is declining in the municipal sector, with 93% of municipalities with Big four auditors switching to a smaller firm.

The political competition variables suggest that large regime changes are not common in a single election cycle, given that incumbents retained 45% of open seats on the city council, and 79% of municipalities have staggered council elections. In addition, the cities in our sample constitute an average of 77% of the population in their respective counties, suggesting they possess high levels of jurisdictional influence relative to nearby cities.

The council characteristics suggest that financial oversight bodies have not been universally adopted, with approximately 45% of municipalities having a formal finance or audit committee, with individual rates of 30% and 27%, respectively. Furthermore, citizen participation measures allowing for recall provisions, citizen initiatives and popular referendums appear at rates of 28%, 18%, and 44%, respectively, with 49% of municipalities having at least one of the preceding control mechanisms available to citizens. Finally, 75% of the municipalities use the council-manger form of government, which is consistent with results from Evans and Patton (1987).

Table 4 provides additional detail about the restatements. Panel A highlights that the average city restating results adjusted their accounts by an absolute value of over \$8 million.³ Furthermore, 62% of the 232 restatements corrected more than one account, with a total of 635 individual account restatements.

Panel B subdivides each individual restatement into one of twelve categories based on the underlying account affected. We note in column (1) that approximately 27% of the restatements involved a capital asset account, while 16% of the restatements failed to provide enough documentation to identify the accounts affected (See Figure 1). The latter indicates that, consistent with GAO findings for federal agency restatements, municipal restatements are often

³ In comparison, consider that Hammersley's (2006) experimental instrument sets the city's materiality at \$125,000, with general fund revenues of \$25,211,000.

not transparent.⁴ Columns (3) and (4) report restatement magnitude, and indicate that the largest restatements are made to pensions and capital assets (see Figure 2). Finally, column (5) provides information on the effect on net assets, with revenue restatements increasing net assets 71% of the time. In additional untabulated results, we identify restatements by fund type, and find that enterprise fund restatements are the most prevalent (27%), followed by government-wide restatements (17%), general fund restatements (10%), and unidentified fund restatements (9%), respectively.

4. Multivariate Specifications

4.1 Tests of auditor quality and turnover

We use the following logit specification to investigate associations between restatements, auditor quality, and auditor turnover (H_{1A} and H_{1B}):

$$RESTATE_i = \alpha_0 + \alpha_1 AUDITOR + \alpha_0 + \alpha_2 SWITCH + \sum \alpha_j CONTROL_{i,j} + \varepsilon_{i,j} \quad (1)$$

where the dependent variable $RESTATE_i$ is a measure of 2001-2004 municipal i 's restatement, and $CONTROL_{i,j}$ represents a series of control variables.

The restatement variable ($RESTATE$) is defined as a dummy variable equal to one if a municipality has a restatement in year i , and zero otherwise. Auditor quality ($AUDITOR$), which represents our test of H_{1A} , is defined alternately as whether the municipality uses a Big four auditor, a municipal audit specialist as defined by the Governmental Audit Quality Center that is not a member of the Big four, or a state auditor – that is, when the state government auditor's

⁴ The GAO findings for federal agency restatements show that governmental restatement disclosure transparency is a problem. For example, the GAO indicates that in some instances, federal agency restatements were insufficient for a reader of the financial statements to clearly understand the error that occurred and its financial statement impact. Similarly, our findings that 16% of restatements fail to identify the accounts restated, and 9% fail to identify the funds affected, indicate that municipal restatement disclosures are often not readily transparent.

staff conducts the municipal audit.⁵ $SWITCH_i$, an indicator variable defined as one if the municipality has a new auditor in the current year, represents our test of H_{1B} .

We control for municipal size and debt outstanding in all of our regressions. Municipal size is the log of population, and debt outstanding is the total debt per capita, both of which are Winsorized at the 1% level to remove the effect of outliers. We also include year and state fixed effects to control for other unobserved differences across observations.

Results are presented in Table 5. The evidence in column (1) regarding H_{1A} finds that municipalities employing a Big four auditor are significantly less likely to restate their results, suggesting that high quality audits reduce the need for subsequent restatements. This finding contrasts with prior corporate sector literature (i.e. Abbott et al. 2004; DeFond and Jiambalvo, 1991), which finds no relation between audit firm size and the probability of restatement. Interestingly, in column (2) we find no relation between non Big four municipal audit specialists and restatements, which appears to conflict with experimental evidence in Hammersley (2006). Results in column (3) indicate a weakly positive association between state auditors and restatements. One explanation for this result is that state auditors do not have the same reputation and legal concerns as other firms, and are therefore more independent.

The results in column (4) regarding H_{1B} indicate that municipalities who recently switched auditors are more likely to restate the results, which is consistent with results in Lazer et al. (2004). However, in contrast with Lazer et al. (2004), the results in column (5) suggest a positive association between restatements and switches to a non Big four firm. This result is inconsistent with our previous finding that Big four auditors are associated with better quality

⁵ The AICPA's Government Audit Quality Center identifies audit firms that satisfy membership requirements available at www.gaqc.aicpa.org/memberships. In further tests (not reported), we substitute an alternate municipal audit specialist variable using firms with market share greater than the state median based on the number of municipal audits and total population, and find results consistent with those reported.

reporting. Furthermore, results in column (6) suggest that switches between small firms are weakly associated with the likelihood of restatements, suggesting that there are other factors besides reporting quality that drive the decision to change auditors. We find no significant association between restatements and either of our control variables, population and debt per capita. Column (7) presents results for the combined model, and shows results consistent with those presented in columns (1) – (6), with the exception of the state auditor variable, which is no longer significant.

4.2 Tests of political and jurisdictional competition

We use the following logit specification to investigate associations between restatements and political or jurisdictional competition (H_{2A} and H_{2B}):

$$RESTATE_i = \alpha_0 + \alpha_1 COUNCIL_COMP_i + \alpha_2 JURIS_COMP_i + \sum \alpha_j CONTROL_{i,j} + \varepsilon_{i,j} \quad (2)$$

where the dependent variable $RESTATE_i$ is a measure of 2001-2004 municipal i restatement, and $CONTROL_{j,i}$ represents a series of control variables, as defined previously.

We consider three measures of political or jurisdictional competition. The first two measure council competition ($COUNCIL_COMP$), and are alternatively defined as the amount of council open seat competition, calculated as [1 - the ratio of incumbents elected to the city council divided by the estimated number of open seats], or the term length of the city council, both calculated using ICMA data. Note that higher values for the open seat competition measure indicate higher competition. We measure jurisdictional competition ($JURIS_COMP$) as [1 - the ratio of municipal population divided by the total population of the respective metropolitan statistical area] as measured by the U.S. Census. For this measure, higher values represent more competition.

Results are presented in Table 6. Column (1) results find that councils with more open seat competition are associated with a higher probability of restatement. We find no association between the length of the council term and restatements, as illustrated by the results in column (2). The results in column (3) suggest that municipalities facing more jurisdictional competition are less likely to restate their results. One explanation for this result is that reduced levels of competitive forces for labor and external financing are associated with accounting systems that are less reliable. Column (4) presents results for the combined model, and shows results consistent with those presented in columns (1) – (3), with the exception of the jurisdictional competition variable, which is no longer significant.

4.3 Tests of council characteristics

We use the following logit specification to investigate associations between restatements and council governance characteristics (H_{3A} , H_{3B} , and H_{3C}):

$$RESTATE_i = \alpha_0 + \alpha_1 FIN_i + \alpha_2 ENTRENCH_i + \alpha_3 MGR_i + \sum \alpha_j CONTROL_{i,j} + \varepsilon_{i,j} \quad (3)$$

Our first two governance measures focus on the relation between council financial monitoring (FIN) and restatements, and constitute our tests of H_{3A} . The first is at the board (council) level, and is a dummy variable equal to one if the city council has a finance committee, and zero otherwise, using ICMA survey data. Callen, Klein and Tinkleman (2003) find that nonprofit finance committees perform a monitoring role by overseeing budgets and administrative expenses. Second, we consider whether the municipalities provide for an audit committee and include a dummy variable equal to one if the municipality has an audit committee. Audit committee data is gathered through a survey, following Baber, Gore, Rich, and Zhang (2006).

Our second governance measures focus on the relation between manager entrenchment (*ENTRENCH*) and restatements, and serve as our test of H_{3B}. Prior studies find that measures of manager entrenchment are generally the most important indicators of poor performance (Bebchuk and Cohen, 2005) and internal control issues such as accounting restatements (Baber et al. 2005). While examining all measures of manager entrenchment is beyond the scope of this study, we instead focus on three provisions designed to capture the level of citizen rights vis-à-vis elected officials. We first use the ICMA survey data to construct a composite “citizen participation” index which is similar to measures used in the private sector (Gompers, Ishii, and Metrick 2003; Bebchuk et al. 2005; Baber et al. 2005). The three provisions represent citizen involvement in municipal legislation that should provide managers with incentives to provide high quality reporting. We include count variables for municipalities with provisions for 1) recall of poorly performing officials, 2) citizen-driven legislation directly on the ballot, and 3) voter ability to pre-empt a legislative action by requiring a popular referendum before the measure can take effect. The citizen participation index is therefore a count variable ranging from zero to three that reflects the number of the above provisions in place for a given municipality, with larger values indicating higher levels of citizen participation.

We also use ICMA data to consider the effects of staggered councils and board independence, two other measures used in prior literature⁶ (Gompers et al. 2003; Bebchuk et al. 2005; Baber et al. 2005). *Staggered council* is an indicator variable equal to one for cities with staggered election cycles. Finally, in an examination of nonprofit boards, O’Regan and Oster (2005) indicate nonprofit boards are typically comprised 100% of members that are outside the organization – that is, nonprofit managers are not on the board. Following O’Regan and Oster

⁶ Factor analysis performed on the combined set of citizen participation and entrenchment variables (not reported) identifies two principal factors, providing additional support for separate analysis of the two variable classes.

(2005) and Gore (2006), we include *Council independence* as an indicator variable equal to one for cities in which the chief executive can vote on the city council. Each of these two provisions indicates a relatively higher level of elected official entrenchment when present.

Finally, we include a dummy variable equal to one if the municipality is a city manager form of government, and zero otherwise, as our test of H_{3C} . Control variables are the same as those presented previously.

Table 7 presents the results. Columns (1) and (2) suggest no association between council financial monitoring, defined as the presence of finance or audit committees, and the likelihood of restatement. However, consistent with Baber et al. (2005), column (3) finds a weakly negative association between citizen participation and restatements. One interpretation of this result is that greater citizen participation provides municipal officials with incentives to provide high quality financial reporting because of greater accountability. Columns (4) and (5) suggest no association between the other measures of managerial entrenchment and restatements. Column (6) finds that the form of government is not associated with the likelihood of accounting restatements. Finally, column (7) presents results for the combined model, and shows results consistent with those presented in columns (1) – (6).

4.3 Robustness Checks

4.3.1 Audit committee composition

Abbott et al. (2004) document an inverse association between restatements and both audit committee independence and financial expertise. This suggests that audit committee composition may be more relevant than the audit committee existence indicator variable included in our primary regressions in Table 7. We therefore substitute measures of audit committee financial expertise and independence in place of our audit committee existence indicator (not

reported), and find no evidence of an association between restatements and audit committee composition. One explanation for our finding of no relation between restatements and either the existence or composition of audit committees is the voluntary nature of the audit committee formation in the municipal sector. We control for this self-selection by performing a Heckman (1979) analysis, and including the inverse Mills ratio in regressions with audit committee characteristics (not reported). We find similar results to those presented in Table 7.

4.3.2 Restatement Accounts Affected

One key aspect of GASB 34 is that it required documentation of all property, plant, and equipment on the balance sheet. To consider the possibility that carryover effects from this rule change are driving our results, we exclude restatements related to capital assets and re-perform regressions of equations (1) – (3). The results (not reported) are generally consistent with those presented in Tables 5 through 7. However, one difference is that the results highlight a weakly positive association ($t = 1.76$) between restatements and the presence of a non-Big four audit specialist when capital asset restatements are excluded.

4.3.3 Restatement Magnitude

We test our results for sensitivity to small restatements by re-performing our regressions of equations (1) – (3) excluding restatements in the bottom quartile of dollar restated per capita. With the exception of jurisdictional competition, which is no longer significant when small restatements are excluded, our untabulated results are generally consistent with those presented in Tables 5 through 7.

4.3.4 Complex Operations

Recent studies (Ashbaugh-Skaife et al., 2006; Doyle, Ge, and McVay, 2006) suggest that firms with more complex operations are more likely to encounter internal control problems. We

therefore control for municipal complexity by including a count variable calculated as the number of enterprise funds for a given city-year, available from the U.S. Census. We find our results, except for the association between jurisdictional competition and restatements, are robust to the inclusion of the complexity measure. In addition, we find that complexity is not significantly associated with the probability of restatement.

5. Conclusion

We investigate whether monitoring by auditors, citizen voters, and councils are associated with the frequency of municipal reporting restatements. Such an investigation is important in light of recent GAO findings with respect to federal agencies, which highlights that governmental restatements can undermine public trust and confidence in both the government involved, and other related parties such as the auditors. Further, governmental restatement research is important to explore whether governments are fulfilling their stewardship responsibility, one of the primary objectives of standardized reporting under governmental GAAP (GASB 2006).

With respect to auditor characteristics, we find that municipalities with Big four auditors are significantly less likely to restate, while those that recently switched auditors are significantly more likely to restate. In contrast to prior literature (i.e., Lazer et al. 2004), we find that new auditors are significantly more likely to restate regardless of whether the prior auditor was a Big four audit firm. In other words, Big four auditors are equally likely to have financial statements for which they were responsible restated after an auditor switch.

In contrast to corporate sector entities, municipal officials are subject to competitive elections that can potentially affect financial reporting quality. Using two measures of competition, one representing council seat competition, and the other jurisdictional competition,

we find that higher levels of council competition are positively associated with the probability of restatement, and limited results with respect to jurisdictional competition.

Finally, we explore the relation between restatements and a variety of council governance characteristics, including the presence of audit committees, finance committees, council independence, staggered council elections, the council-manager form of government, and a composite measure of citizen participation. With the exception of our measure of citizen participation, which is weakly negatively associated with the probability of restatement, all remaining governance characteristics are not significantly associated with restatement.

Overall, our results support the contention that external governance measures in the form of both auditor characteristics and council competition are significant determinants in the likelihood of municipal accounting restatements. Future research can investigate the consequences of accounting restatements and their impact on citizens.

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Table 1
Variable descriptions

| | |
|-------------------------------------|---|
| <i>Restatement_t</i> | Indicator variable equal to 1 if the municipality has a restatement |
| <i>Auditor Variables</i> | |
| <i>Big 4 auditor</i> | Indicator variable equal to 1 for years in which a municipality's financial statements are audited by a member of the Big 4 |
| <i>Small GAQC auditor</i> | Indicator variable equal to 1 for years in which a municipality's financial statements are audited by a member of the governmental audit quality center that is not a member of the Big 4 |
| <i>State auditor</i> | Indicator variable equal to 1 for years in which a municipality's financial statements are audited by a state-run auditor |
| <i>Auditor switch</i> | Indicator variable equal to 1 for years with an auditor switch |
| <i>Big 4 to Non-Big 4</i> | Indicator variable equal to 1 for years with an auditor switch, whereby the previous auditor was a member of the Big 4, and the current auditor is not a member of the Big 4 |
| <i>Non-Big 4 to Non-Big 4</i> | Indicator variable equal to 1 for years with an auditor switch, whereby the previous auditor was not a member of the Big 4, and the current auditor is not a member of the Big 4 |
| <i>Competition Variables</i> | |
| <i>Council seat competition</i> | 1 – [Ratio of number of incumbents elected to number of open seats on council] |
| <i>Council term length</i> | Natural log of council term length] |
| <i>Jurisdictional competition</i> | 1 – [Ratio of municipal population to total metropolitan statistical area (MSA) population] |
| <i>Board Variables</i> | |
| <i>Finance committee</i> | Indicator variable equal to 1 if the municipality has a finance committee in place |
| <i>Audit committee</i> | Indicator variable equal to 1 if the municipality has an audit committee in place |
| <i>Financial oversight</i> | Indicator variable equal to 1 if the municipality has either a finance or an audit committee in place |
| <i>Recall provision</i> | Indicator variable equal to 1 if the municipality allows citizens to place a question on the ballot of whether an elected official should be removed |
| <i>Initiative</i> | Indicator variable equal to 1 if the municipality allows citizens to place charter, ordinance or home rule changes on the ballot by collecting petition signatures |
| <i>Popular referendum</i> | Indicator variable equal to one if the municipality allows citizens to require charter, ordinance, or home rule changes made by the council to be placed on the ballot for voter approval |
| <i>Citizen participation</i> | Index calculated as the sum of the following indicator variables: recall provision, initiative, and popular referendum. |
| <i>Staggered council</i> | Indicator variable equal to one if the council terms of office are staggered |
| <i>Council independence</i> | Indicator variable equal to one if the CEO has a vote on the council |
| <i>Council-manager form</i> | Indicator variable equal to 1 for a council-manager form of government |
| <i>Control Variables</i> | |
| <i>Size (population)</i> | Natural log of year 2000 population |
| <i>Per capita debt</i> | Total debt outstanding divided by total population |

Table 2
Summary of sampling procedures

Panel A: Data collection

| | <u># municipalities</u> | <u># observations</u> |
|--|-------------------------|-----------------------|
| Total cities and towns in ICMA database | 4,244 | 16,976 |
| Less governments with population < 50,000 | 3,879 | 15,516 |
| Total cities and townships with populations > 50,000 | 365 | 1,460 |
| Less those with financial reports unavailable | | |
| Final sample: | | |
| Financial reports collected online | 228 | 529 |
| Financial reports collected from municipalities | | 211 |
| Total financial reports | 254 | 740 |

Panel B: Observations by year

| | <u># restatements</u> | <u># observations</u> | <u>restatement rate</u> |
|-------|-----------------------|-----------------------|-------------------------|
| 2001 | 33 | 132 | 25% |
| 2002 | 54 | 162 | 33% |
| 2003 | 70 | 208 | 34% |
| 2004 | 75 | 238 | 32% |
| Total | 232 | 740 | 31% |

Panel C: Descriptive statistics for restatements

| | <u># municipalities</u> | <u># observations</u> |
|--|-------------------------|-----------------------|
| Municipalities with restatements in at least one year | 140 (55%) | 232 (31%) |
| Percentage of municipalities with restatements that restated in more than one year | 59 (23%) | n/a |

Table 3
Descriptive statistics

Panel A: Summary Statistics

| <i>Variable</i> | <i>n</i> | <i>Mean</i> | <i>Median</i> | <i>Standard deviation</i> | <i>25th percentile</i> | <i>75th percentile</i> |
|----------------------------------|----------|-------------|---------------|---------------------------|-----------------------------------|-----------------------------------|
| Restatement | 740 | 0.315 | 0.000 | 0.465 | 0.000 | 1.000 |
| <i>Auditor Variables</i> | | | | | | |
| Big 4 auditor | 740 | 0.226 | 0.000 | 0.418 | 0.000 | 0.000 |
| Small GAQC ₁ auditor | 740 | 0.400 | 0.000 | 0.490 | 0.000 | 1.000 |
| State auditor | 740 | 0.053 | 0.000 | 0.224 | 0.000 | 0.000 |
| Auditor switch | 740 | 0.131 | 0.000 | 0.338 | 0.000 | 0.000 |
| <i>Election Variables</i> | | | | | | |
| Council seat competition | 691 | 0.447 | 0.400 | 0.279 | 0.250 | 0.667 |
| Council term length | 733 | 3.587 | 4.000 | 0.789 | 3.000 | 4.000 |
| Jurisdictional competition | 740 | 0.772 | 0.866 | 0.223 | 0.609 | 0.964 |
| <i>Council Variables</i> | | | | | | |
| Finance committee | 740 | 0.304 | 0.000 | 0.460 | 0.000 | 1.000 |
| Audit committee | 740 | 0.266 | 0.000 | 0.442 | 0.000 | 1.000 |
| Financial oversight | 740 | 0.446 | 0.000 | 0.497 | 0.000 | 1.000 |
| Recall provision | 740 | 0.277 | 0.000 | 0.448 | 0.000 | 1.000 |
| Initiative | 740 | 0.176 | 0.000 | 0.381 | 0.000 | 0.000 |
| Popular referendum | 740 | 0.445 | 0.000 | 0.497 | 0.000 | 1.000 |
| Citizen participation | 740 | 0.493 | 0.000 | 0.500 | 0.000 | 1.000 |
| Staggered council | 740 | 0.788 | 1.000 | 0.409 | 1.000 | 1.000 |
| Council independence | 740 | 0.685 | 1.000 | 0.468 | 0.000 | 1.000 |
| Council-manager form | 740 | 0.750 | 1.000 | 0.433 | 0.500 | 1.000 |
| <i>Control Variables</i> | | | | | | |
| Size (population) | 740 | 172781.30 | 9303 | 316405 | 68390 | 165687 |
| Per capita debt | 740 | 1980.30 | 1531.67 | 2297.93 | 936.34 | 2395.93 |

Variable descriptions are defined in Table 1.

Panel B: Pair-wise correlations (obs = 740)

| | <i>Restate</i> | <i>Big 4 auditor</i> | <i>Small GAQC auditor</i> | <i>State auditor</i> | <i>Auditor switch</i> | <i>Council seat comp</i> | <i>Council term length</i> | <i>Juris comp</i> | <i>Fin comm</i> | <i>Audit comm</i> | <i>Citizen part</i> | <i>Staggered council</i> | <i>Council indep</i> | <i>Council manager form</i> | <i>Size</i> |
|-----------------------|----------------|----------------------|---------------------------|----------------------|-----------------------|--------------------------|----------------------------|-------------------|-----------------|-------------------|---------------------|--------------------------|----------------------|-----------------------------|-------------|
| Restatement | 1.00 | | | | | | | | | | | | | | |
| Big 4 auditor | -0.25* | 1.00 | | | | | | | | | | | | | |
| Small GAQC auditor | 0.03 | -0.44* | 1.00 | | | | | | | | | | | | |
| State auditor | 0.17* | -0.13* | -0.19* | 1.00 | | | | | | | | | | | |
| Auditor switch | 0.13* | -0.09* | 0.12* | -0.06 | 1.00 | | | | | | | | | | |
| Council seat comp | 0.05 | -0.07 | -0.01 | -0.05 | 0.00 | 1.00 | | | | | | | | | |
| Council term length | 0.07 | -0.11* | -0.04 | 0.09* | 0.05 | -0.03 | 1.00 | | | | | | | | |
| Jurisdictional comp | -0.06 | -0.05 | -0.05 | 0.03 | 0.04 | 0.05 | 0.06 | 1.00 | | | | | | | |
| Finance committee | -0.03 | 0.14* | -0.14* | -0.04 | 0.01 | -0.01 | 0.01 | -0.05 | 1.00 | | | | | | |
| Audit committee | -0.01 | 0.24* | -0.19* | -0.06 | -0.01 | 0.03 | -0.01 | -0.15* | 0.21* | 1.00 | | | | | |
| Citizen participation | -0.02 | 0.00 | 0.04 | -0.04 | 0.02 | -0.23* | -0.01 | 0.09* | -0.07 | -0.19* | 1.00 | | | | |
| Staggered council | 0.04 | -0.22* | 0.13* | -0.08* | -0.02 | 0.28* | 0.35* | 0.08* | 0.09* | 0.13* | -0.18* | 1.00 | | | |
| Council independence | -0.01 | -0.10* | 0.01 | -0.19* | -0.01 | 0.10* | 0.03 | 0.29* | 0.08* | 0.05 | -0.12* | 0.32* | 1.00 | | |
| Council-manager form | -0.05 | -0.08* | 0.03 | -0.24* | -0.03 | 0.16* | 0.02 | 0.23* | 0.06 | 0.09* | -0.01 | 0.36* | 0.66* | 1.00 | |
| Population | -0.06 | 0.47* | -0.15* | 0.03 | 0.04 | -0.11* | 0.10* | -0.25* | 0.02 | 0.10* | -0.05 | -0.26* | -0.28* | -0.29* | 1.00 |
| Per capita debt | 0.03 | 0.10* | 0.02 | -0.01 | 0.05 | -0.04 | 0.00 | -0.12* | -0.01 | 0.07 | 0.08* | -0.04 | -0.04 | -0.05 | 0.22* |

* Indicates significance at the 5% level.

Variable descriptions are defined in Table 1.

Table 4
Restatement summary

Panel A: Number of restated accounts

| <i>Number of accounts affected</i> | <i>Count</i> | <i>Average Total Amount Restated (absolute value)</i> |
|--|--------------|---|
| 1 | 88 | 4,100.15 |
| 2 | 66 | 4,596.57 |
| 3 | 23 | 12,045.19 |
| 4 | 17 | 5,960.10 |
| 5 | 9 | 33,334.10 |
| 6 | 11 | 8,793.70 |
| 7 or more | 18 | 29,098.19 |
| Total | 232 | 8,045.55 |

Panel B: Restatement summary by account type, in \$000 (n=635)

| <i>Restatement Type</i> | <i>% of total</i> | <i>Mean</i> | <i>Median</i> | <i>Standard Deviation</i> | <i>25th percentile</i> | <i>75th percentile</i> | <i>% Increase Net Assets</i> |
|-------------------------|-----------------------|-------------|---------------|-------------------------------|---------------------------------------|---------------------------------------|--------------------------------------|
| Capital Assets | 0.27 | 5,315.96 | 1,325.92 | 13,229.38 | 325.06 | 4,311.00 | 0.57 |
| Deferred Revenue | 0.04 | 2,019.99 | 508.38 | 5,225.39 | 287.93 | 1,876.79 | 0.36 |
| Revenue | 0.10 | 1,383.24 | 347.11 | 3,918.46 | 79.90 | 826.00 | 0.71 |
| Liabilities | 0.14 | 1,872.24 | 339.64 | 4,949.89 | 92.44 | 1,119.65 | 0.56 |
| Compensated Absences | 0.03 | 1,903.80 | 449.45 | 3,035.39 | 97.20 | 2,688.22 | 0.45 |
| Pension | 0.04 | 8,585.05 | 434.93 | 19,767.08 | 214.51 | 4,021.21 | 0.70 |
| Expenditures | 0.03 | 1,186.58 | 180.45 | 2,443.10 | 93.88 | 626.11 | 0.40 |
| Receivables | 0.13 | 1,180.91 | 470.24 | 2,126.44 | 137.50 | 887.99 | 0.70 |
| Cash and Investments | 0.02 | 1,858.79 | 924.00 | 2,610.46 | 60.16 | 2,872.05 | 0.36 |
| No Detail Provided | 0.15 | 2,689.59 | 223.59 | 13,967.58 | 83.31 | 685.00 | 0.54 |
| Other | 0.06 | 713.63 | 339.31 | 1,149.39 | 72.28 | 704.07 | 0.43 |

Restatement type is identified based on the underlying account affected as denoted within a given municipality's restatement footnote disclosure.

Table 5
The relation between municipal restatements, auditor quality, and auditor turnover

| Variable | <i>Model 1</i> (n=701) | <i>Model 2</i> (n=701) | <i>Model 3</i> (n=701) | <i>Model 4</i> (n=701) | <i>Model 5</i> (n=701) | <i>Model 6</i> (n=701) | <i>Model 7</i> (n=701) |
|------------------------|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
| Intercept | 2.16 (1.01) | 1.28 (0.64) | 2.07 (1.02) | 1.96 (0.95) | 1.73 (0.83) | 1.48 (0.72) | -1.62 (0.72) |
| Big 4 auditor | -1.88 (5.46)*** | | | | | | -1.94 (5.28)*** |
| Small GAQC auditor | | 0.30 (1.53) | | | | | -0.19 (0.86) |
| State auditor | | | 1.24 (1.78)* | | | | 0.61 (0.77) |
| Auditor switch | | | | 0.86 (3.48)*** | | | 0.81 (3.05)*** |
| Big 4 to Non-Big 4 | | | | | 1.44 (3.06)*** | | |
| Non-Big 4 to Non-Big 4 | | | | | | 0.54 (1.76)* | |
| Size | 0.24 (1.49) | -0.15 (1.07) | -0.20 (1.44) | -0.22 (1.55) | -0.20 (1.40) | -0.17 (1.25) | 0.18 (1.04) |
| Per capita debt | 0.04 (1.17) | 0.04 (1.33) | 0.05 (1.68)* | 0.05 (1.43) | 0.05 (1.74)* | 0.04 (1.41) | 0.05 (1.22) |
| Year dummies | Included ² | Included ² | Included ² | Included ² | Included ² | Included ² | Included ² |
| State dummies | Included ² | Included ² | Included ² | Included ² | Included ² | Included ² | Included ² |
| Pseudo R ² | 0.12 | 0.09 | 0.09 | 0.10 | 0.10 | 0.09 | 0.14 |

*, **, *** indicate significance at p < .10, .05, and .01; based on two-tailed tests.

¹z-statistics are reported in parentheses, using robust standard errors.

²For brevity, the year-specific and state-specific intercept terms are not reported.

This table presents estimates for a logit regression model, where the dependent variable is an indicator variable equal to one for city-years where the municipality reported a restatement and zero otherwise. Variable descriptions are included in Table 1.

Table 6
The relation between restatements and council competition

| <i>Variable</i> | <i>Model 1</i> <i>(n=659)</i> | <i>Model 2</i> <i>(n=694)</i> | <i>Model 3</i> <i>(n=701)</i> | <i>Model 4</i> <i>(n=659)</i> |
|----------------------------|----------------------------------|----------------------------------|----------------------------------|----------------------------------|
| Intercept | 0.09 (0.04) | 1.59 (0.76) | 3.95 (1.97)** | 2.21 (0.89) |
| Council seat competition | 1.08 (2.86)*** | | | 1.06 (2.79)*** |
| Council term length | | 0.01 (0.04) | | -0.00 (0.01) |
| Jurisdictional competition | | | -1.11 (2.17)** | -0.87 (1.60) |
| Size | -0.13 (0.91) | -0.19 (1.34) | -0.25 (1.71)* | -0.19 (1.24) |
| Per capita debt | 0.05 (1.75)* | 0.05 (1.52) | 0.04 (1.29) | 0.05 (1.57) |
| Year dummies | Included ² | Included ² | Included ² | Included ² |
| State dummies | Included ² | Included ² | Included ² | Included ² |
| Pseudo R ² | 0.10 | 0.08 | 0.09 | 0.10 |

*, **, *** indicate significance at $p < .10$, $.05$, and 01 ; based on two-tailed tests.

¹z statistics are reported in parentheses, using robust standard errors.

²For brevity, the year-specific and state-specific intercept terms are not reported.

This table presents estimates for a logit regression model, where the dependent variable is an indicator variable equal to one for city-years where the municipality reported a restatement and zero otherwise. Variable descriptions are included in Table 1.

Table 7
The relation between restatements and council governance characteristics

| <i>Variable</i> | <i>Model 1</i> <i>(n=701)</i> | <i>Model 2</i> <i>(n=701)</i> | <i>Model 3</i> <i>(n=701)</i> | <i>Model 4</i> <i>(n=701)</i> | <i>Model 5</i> <i>(n=701)</i> | <i>Model 6</i> <i>(n=701)</i> | <i>Model 7</i> <i>(n=701)</i> |
|-----------------------|----------------------------------|----------------------------------|----------------------------------|----------------------------------|----------------------------------|----------------------------------|----------------------------------|
| Intercept | 1.57 (0.80) | 1.53 (0.74) | 1.95 (0.99) | 1.45 (0.69) | 0.89 (0.41) | 2.55 (1.32) | 1.43 (0.62) |
| Finance committee | -0.04 (0.19) | | | | | | -0.09 (0.43) |
| Audit committee | | 0.11 (0.52) | | | | | 0.09 (0.41) |
| Citizen participation | | | -0.19 (1.79)* | | | | -0.18 (1.68)* |
| Staggered council | | | | 0.05 (0.16) | | | 0.02 (0.07) |
| Council independence | | | | | 0.19 (0.77) | | 0.17 (0.61) |
| Council-manager form | | | | | | 0.04 (0.14) | -0.03 (0.10) |
| Size (population) | -0.17 (1.25) | -0.18 (1.28) | -0.19 (1.39) | -0.17 (1.13) | -0.14 (0.95) | -0.17 (1.13) | -0.16 (1.00) |
| Per capita debt | 0.05 (1.55) | 0.05 (1.55) | 0.05 (1.75)* | 0.05 (1.54) | 0.05 (1.52) | 0.05 (1.54) | 0.05 (1.70)* |
| Year dummies | Included ² | Included ² | Included ² | Included ² | Included ² | Included ² | Included ² |
| State dummies | Included ² | Included ² | Included ² | Included ² | Included ² | Included ² | Included ² |
| Pseudo R ² | 0.09 | 0.09 | 0.09 | 0.09 | 0.09 | 0.09 | 0.09 |

*, **, *** indicate significance at $p < .10$, $.05$, and 01 ; based on two-tailed tests.

¹z statistics are reported in parentheses, using robust standard errors.

²For brevity, the year-specific and state-specific intercept terms are not reported.

This table presents estimates for a logit regression model, where the dependent variable is an indicator variable equal to one for city-years where the municipality reported a restatement and zero otherwise. Variable descriptions are included in Table 1.

Figure 1
Breakdown of sample by restatement type

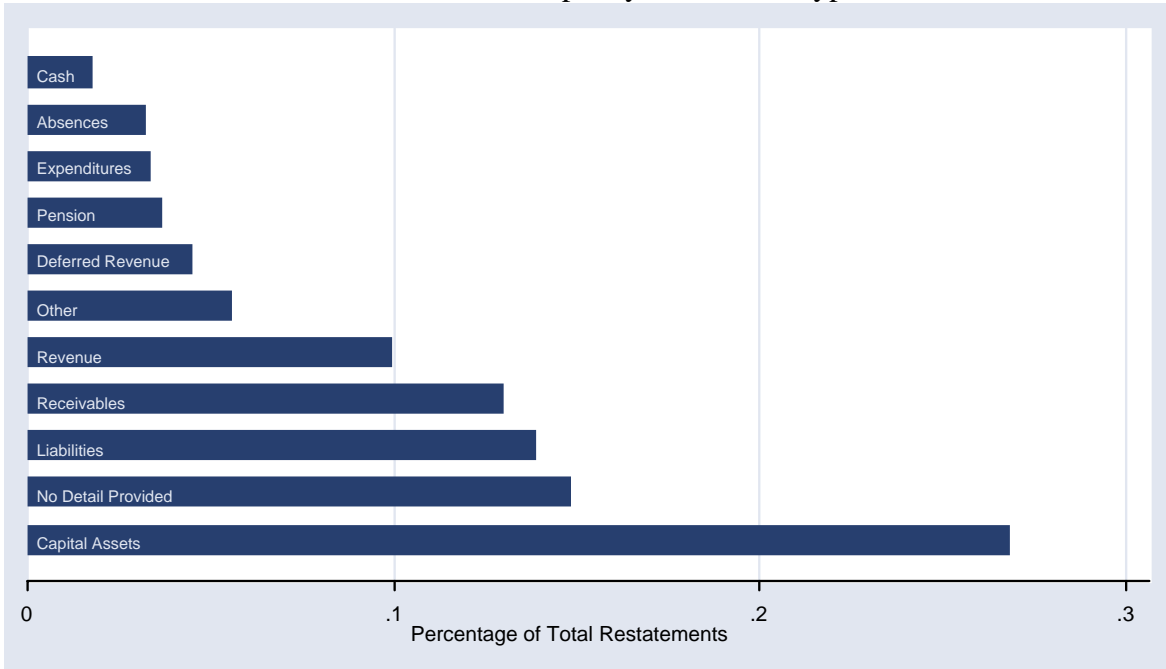
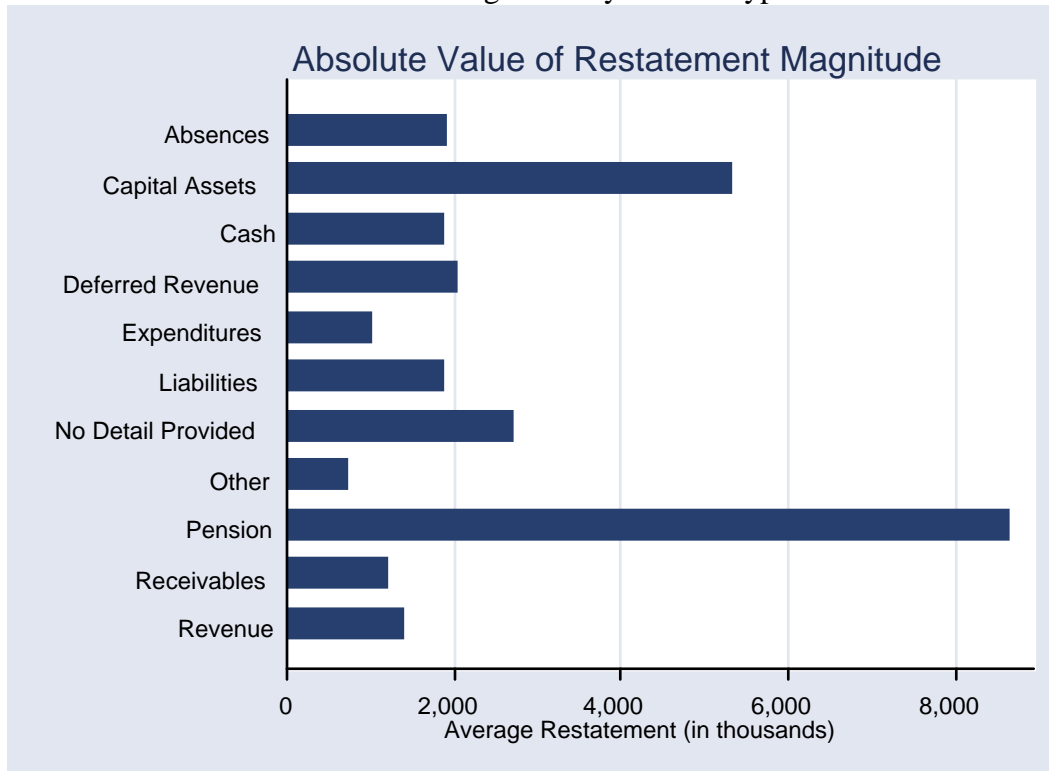


Figure 2
Restatement magnitude by account type



Appendix A
Examples of Municipal Restatement Disclosures

City of Fort Lauderdale, Florida, 2003

(H) Prior Period Adjustment

During the current year, it was determined that certain restricted revenues totaling \$1,427,033 as of September 30, 2002, were incorrectly recorded as deposits in the General Fund. To correct this error, the beginning fund balance of the General Fund of \$7,353,990, as originally reported, has been increased to \$8,781,023. In addition, beginning net assets for governmental activities of \$140,524,989, as originally reported, has been increased to \$141,952,022.

Victoria, Texas, 2002

NOTE 21: RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS

The Water and Wastewater, an Enterprise Fund, financial statements for the fiscal year September 30, 2001 have been restated to properly reflect the net accounts receivable balance for fiscal year ending September 30, 2001. The results of the restatement were to decrease the accounts receivable balance and the beginning retained earnings balance by \$360,878.

City of Saint Paul, Minnesota, 2003

C. RESTATEMENT OF FUND EQUITY

1. Prior Period Adjustment for Correction to Liability for Claims and Judgments Payable

The January 1, 2003 liability for Claims and Judgments Payable, as reported in the Governmental Activities Statement of Net Assets, was restated due to a change in calculation in the workers' compensation liability which was used to determine the 2001 liability. As a result of the correction, the January 1, 2003 Claims and Judgments Payable was restated as follows:

| | Amount |
|---|--------------|
| Balance, January 1, 2003, as previously reported | \$12,790,533 |
| Prior Period Adjustment for Correction to Workers' Compensation Liability | 6,272,474 |
| Balance, January 1, 2003, as restated | \$19,063,007 |

2. Prior Period Adjustment to the General Fund Materials and Supply Inventory

The City decided to eliminate the materials and supply inventory recorded in the General Fund.

Correction of Revenue Recognition

The General Fund overstated intergovernmental revenue in the prior period. Reimbursements from the Federal Emergency Management Agency (FEMA) Federal Disaster Assistance for costs associated with Disaster #1370, mainly for dredging done at the Harriet Island lower harbor, were disallowed.

| | Fund Balance |
|--|--------------|
| Balance, January 1, 2003, as previously reported | \$41,606,331 |
| Materials and Supply Inventory | (302,634) |
| Correction of Revenue Recognition | (314,230) |
| Balance, January 1, 2003, as restated | \$40,989,467 |