Research in Accounting Regulation 26 (2014) 67–74

Contents lists available at ScienceDirect

Research in Accounting Regulation

journal homepage: www.elsevier.com/locate/racreg

Research Report

Voluntary formation of audit committees by large municipal governments

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ARTICLE INFO

Article history:
Available online 1 March 2014

Keywords:
Audit committee
Governmental accounting
Local government
Municipal governance

ABSTRACT

The Sarbanes–Oxley Act of 2002 requires that publicly-traded U.S. corporations have an audit committee in their internal control structure. In contrast to publicly-traded commercial firms, municipal governments are not required to form audit committees. Given that regulators believe it is a crucial aspect of internal control, we examine the extent to which city governments feature audit committees in the internal control structure. Based on a survey of financial managers from cities with populations greater than 100,000, we find that approximately 58% of the municipalities have such committees. Results indicate that larger and more financially viable cities are more likely to have audit committees. However, the form of municipal government and the quality of the local government's financial reporting and audit processes are not significant determinants of the presence of an audit committee.

Introduction

Feeling the effect of the financial crisis and changes in the local economy, many local governments are facing decreased tax revenue and substantial budget shortfalls (Lowenstein, 2011). In 2012, the cities of Stockton and San Bernardino, California, filed for bankruptcy. Many cities have reacted by reducing police, fire, and sanitation services. On November 18, 2010, New York City announced plans to eliminate ten thousand jobs by June 30, 2012 (Moynihan, 2010). With $1.5 trillion invested in municipal bonds (U.S. Census Bureau, 2008), investors have begun to question the security of their investments (Reilly, 2010). In response to similar concerns over the value of corporate investments, the Sarbanes Oxley Act of 2002 and Dodd–Frank Wall Street Reform and Consumer Protection Act include provisions to increase the monitoring of financial reporting by U.S. commercial firms. The results of Giroux and Cassell (2011) indicate that audit risk goes down when regulatory oversight increases, which suggests that similar requirements may improve the quality of municipal financial reporting. We examine the use of one important monitoring mechanism, the audit committee, by large cities.

Charged with overseeing financial reporting and the internal control environment, audit committees are an integral part of corporate governance (Rezaee, 2004). The Sarbanes–Oxley Act of 2002 (SOX) requires that every publicly-traded U.S. corporation has an audit committee. SOX requires that audit committee members are independent and have sufficient financial statement expertise (Asare, Cunningham, & Wright, 2007). A recent survey confirms that mandated characteristics have been effectively implemented in public-company audit committees (Rupley, Almer, & Philbrick, 2011). In addition, the Public Company Accounting Oversight Board (PCAOB) recently issued Auditing Standard (AS) No. 16, *Communications with Audit Committees*, which highlights that active information exchange between an auditor and the client's audit

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http://dx.doi.org/10.1016/j.racreg.2014.02.006
1052-0457/

committee is important to ensuring the quality of financial reporting (Tysiac, 2012). Recent communication from the PCAOB also indicates that effective audit committee oversight, including reviewing audit firm inspection reports, also improves the quality of the audit process (Cohn, 2012). Despite the importance of audit committees to for-profit governance, there is no statutory requirement mandating the formation of audit committees for municipal governments. Instead, each government must determine whether an audit committee is needed. The purpose of our study is to identify characteristics of municipalities that voluntarily form audit committees.

Similar to corporations, local governments are responsible to various stakeholders, including bondholders, regulatory bodies, taxpayers, and the general public. West and Berman (2002, 2003) note that the bankruptcies of Orange County, California, and Miami, Florida, prompted government and professional regulators to examine whether sufficient programs are in place to ensure financial accountability amongst those charged with municipal governance. The Government Finance Officers Association (GFOA) has issued a best practices statement on audit committees (GFOA, 2008) that recommends many initiatives required by SOX for public companies.

Matkin (2010) finds that 36.8% of local governments have audit committees. From a series of 136 interviews, he concludes that audit committees are formed by municipalities to improve financial oversight. Approximately half of those surveyed who did not have audit committees indicated that an audit committee was unnecessary for their governments citing strong internal controls currently in place to prevent or detect material misstatement caused by error or fraud. Though prior research provides insight into why managers chose whether or not to form audit committees, no prior research examines what municipal characteristics are associated with cities that chose to form audit committees.

We hypothesize that the presence of an audit committee will be associated with the size and financial health of a city, the form of municipal government, and the quality of the local government's financial reporting and audit processes. We predict that larger cities are more likely to have audit committees since the complexity and fiduciary responsibility of city management increases as the size of the city grows (Giroux & Shields, 1993). In addition, we expect that more financially viable cities are more likely to have audit committees since those cities benefit from the increased oversight provided by audit committees. Following Evans and Patton (1983), we hypothesize that the presence of audit committees will be positively associated with the council-manager form of government since prior research has shown that city-managers, who are hired by the city councils as chief executive officers for the municipalities, signal competence through strong financial performance. We also expect the attainment of the GFOA's Certificate of Achievement for Excellence in Financial Reporting and the appointment of a Big Four or Second Tier auditor is positively associated with the presence of audit committees (Evans & Patton, 1983; Giroux & McLelland, 2003).

To test our predictions, we surveyed financial executives of cities with populations over 100,000 to determine whether they have an audit committee, or equivalent governing body responsible for overseeing financial reporting and the internal control environment. Approximately 58.3% of the 199 responses indicated that their local governments have such committees. Our reported incidence of audit committee formation is significantly higher than in Matkin (2010) because we focus on larger municipalities. We believe this is appropriate due to the greater complexity of these cities and greater fiduciary responsibility placed on their management.

Combining the survey responses with publicly available information from the U.S. Census Bureau and each municipality's Comprehensive Annual Financial Report (CAFR), we develop a logistic model predicting the likelihood of whether or not a municipality will chose to form an audit committee. Our model indicates that larger and more financially viable cities are more likely to have audit committees. However, we find no statistically significant relationship between governance structure, financial reporting quality or audit quality and the likelihood that a given municipality has an audit committee. This lack of relationship is consistent the observations of those surveyed in Matkin (2010) who indicated that the creation of audit committees was unnecessary for their cities given their already strong internal control environments.

Our research design extends the research on municipal use of audit committees by creating a model to predict characteristics associated with voluntary audit committee formation. Our results highlight the financial benefits observed in large municipalities that chose to voluntarily adopt such a monitoring mechanism. Improved financial performance is important since the $1.6 trillion spent by local governments in 2008 represents approximately 12% of the United States' gross domestic product (U.S. Census Bureau, 2008; U.S. Department of Commerce, 2008). Such findings may be of increasing importance to regulators given the recent focus on the cost/benefit analysis of proposed legislation, such as required by the Jumpstart Our Business Startup Act (JOBS Act) (U.S. SEC, 2012). Our research also contributes to the governmental accounting research by providing financial metrics summarizing the financial performance and governance characteristics of large cities in the second half of the first decade of the 21st century.

The remainder of the paper is organized as follows: "Municipal use of audit committees" provides background information on the use of audit committees by local governments. "Model development" presents our model development. "Sample and empirical model" provides additional detail on our sample and empirical model. "Results" presents our results. "Conclusion" concludes our study.

Municipal use of audit committees

Based on public choice theory, Giroux (1989) presents a model of the political environment in which voters, the city council/mayor, bureaucrats, and municipal employees, jointly determine the level of municipal disclosure based on the incentives of each group. In addition, municipal