Journal of Accounting and Public Policy xxx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

Journal of Accounting and Public Policy

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

Full length article

Differences in internal control weaknesses among varying municipal election policies

Amanda N. Peterson

East Carolina University, College of Business, Greenville, NC 27858, United States

A R T I C L E I N F O

Keywords:
Internal control weaknesses
Municipal governance
Electoral control
Municipal fraud
Municipal audit
Material weakness

A B S T R A C T

In a time when regulators and constituents are growing increasingly concerned with municipal fraud, abuse, waste and inefficiencies, developing a well-designed, effective internal control system is key for municipalities to curb these issues. In this study, the relationship between municipal elections and internal control weaknesses is examined. As elections have been shown to improve public officials' performance via accountability, appropriate use of elections is expected to have a pivotal effect on a municipality, ultimately impacting the operating effectiveness of the internal control system. Two election variables – election of the Finance official and use of term limits for City Council and the mayor – are evaluated to determine if a relationship with the prevalence of internal control weaknesses reported exists. The contribution of this study is the finding that both the use of term limits and election of the Finance official are associated with fewer instances of internal control weaknesses, implying that these election policies have a meaningful effect on governance quality, impacting the effectiveness of internal controls.

1. Introduction

In recent years in the public sector, measures have increased to curb municipal waste, misuse of funds, abuse of power and fraud. Regulators are increasingly concerned with the quality of financial reporting and disclosure in the public sector, largely in part due to recent instances of municipal securities fraud. In 2014, the Securities and Exchange Commission (SEC) created the Municipalities Continuing Disclosure Cooperation (MCDC) Initiative, which was an initiative to encourage municipal securities issuers to self-report violations of securities laws in exchange for reduced sanctions (SEC, 2014). In 2016, under this initiative, the SEC charged 71 municipal bond issuers with violations, finding that from 2011 to 2014 these issuers sold bonds with offering statements containing falsified statements or omissions about their compliance with continuing disclosure obligations (SEC, 2016). Also in 2016, federal prosecutors indicted the town supervisor of Ramapo, NY on 22 counts of securities fraud, wire fraud and conspiracy, which involved falsified accounting entries and misappropriation of funds (DOJ, 2016). These charges are believed to be the first criminal municipal securities charges brought against public officials.

In addition to the regulatory spotlight recently shone on municipal securities fraud, taxpayers are growing increasingly concerned with reducing fraud, abuse and waste of taxpayer funds, along with improving efficiency of city resources. In 2012, the largest municipal fraud in U.S. history came to light, which involved the comptroller/treasurer of Dixon, IL, Rita Crudwell, embezzling $53.7 million over her 29 years in office by diverting funds from Illinois tax-sharing programs to her personal bank accounts (Pope, 2013). This fraud was discovered because of a city employee whistle-blower. A simple internet search for "city misuse of funds" brings up more than a dozen instances over the last year alone currently being investigated across the country.

A well-designed, effective internal control system should mitigate some of these aforementioned issues. While internal controls

E-mail address: petersonam@ecu.edu.

https://doi.org/10.1016/j.jaccpubpol.2018.04.001

alone cannot ensure fraud will not occur, a well-designed system will make these occurrences much more difficult to achieve. The internal control system also helps to safeguard assets and promote efficient operations, accuracy and reliability of financial reporting, and compliance with applicable laws and regulations (Thomson, 2015). The internal controls should be designed for these purposes and operating effectively in order to meet these objectives. A poorly designed or ineffective internal control system creates an environment with greater potential for inefficiencies, waste, misuse of funds, abuse of power and even fraud, in the worst case scenarios. Internal control weaknesses can signal instances of these issues within a city government.

As reduction of inefficiencies, waste, misuse of funds, abuse of power and fraud are of such importance in the municipal sector, understanding factors that strengthen the internal control system is key. This study examines determinants of internal control weaknesses related to municipal governance – specifically, the role of elections and the impact on internal control weaknesses. One of the most convincing mechanisms of good governance is increased electoral control through the use of regular elections (Adsera et al., 2003). Elections enable voters to hold public officials accountable for their actions by rewarding those who perform satisfactorily with reelection and removing from office those that do not perform adequately. As elections have been shown to improve public officials' performance via accountability, this study posits and finds that election policies have a meaningful effect on a municipality, ultimately impacting the operating effectiveness of the internal control system. This finding is important because a stronger internal control system will leave less opportunity for inefficiencies, abuse, waste and fraud.

This research study examines elections for the Finance Department, City Council and the mayor in relation to internal control weaknesses. These public officials are chosen because their job performance can impact the municipality's internal control system: first, the position responsible for financial reporting – the Finance official; second, those charged with general oversight of a municipality – City Council and the mayor. While the Finance official likely has a more direct impact on internal controls, especially those related to financial reporting, the oversight body may have a pervasive effect on the operations of a city that will have a trickle-down effect on the internal control system. Other studies in the public sector have analyzed effects of certain governance policies (for example, audit committee, staggered elections and use of a city manager) on internal control weaknesses, however this is the first study to evaluate these election components and their potential impact on internal controls.

The contribution of this study is the introduction of two new governance variables of interest in the municipal sector – term limits for City Council and the mayor and election of the Finance leader (versus appointing through other means) – in order to analyze whether these election policies impact the internal control weaknesses disclosed in the financial statement audit report. In order to examine these relationships, this study uses time-series data covering the time period of 2008–2015 to arrive at a sample of 1004 observations, as well as propensity score matching to address endogeneity concerns in studies of this kind. The evidence in this study suggests, after controlling for other determinants of internal control problems, that both the use of term limits and electing the Finance leader are associated with fewer instances of internal control weaknesses.

The remainder of this paper is organized as follows. In section two, background information related to municipal auditing and the theoretical framework for this study are presented. In section three, relevant literature is reviewed and hypotheses are developed. In section four, the research methods used are explained, including development of the models and variables, data and sample selection. Statistical results and analysis are described in section five, and finally concluding remarks are presented in section six.

2. Background and theoretical framework

This study examines the relationship between constituents of a municipality and the officials that represent them, like the elected Finance official or City Council members and the mayor, through the lens of the principal-agency framework. These public officials make decisions on citizens' behalf with regard to management of public funds and taxpayer resources, as well as availability of public goods and services. They are expected to act as agents of the people but may have divergent interests from the constituents they represent.

Municipal governance is a critical element to instill confidence in these public officials, as well as restore this confidence when damaged. Policies that emphasize accountability, transparency and oversight enhance citizens' trust in the government and its officials. In terms of election policies and their relationship with municipal governance, electing the Finance official grants constituents with electoral control, which increases accountability as officials can be voted out of office if they are not performing well. Term limits increase transparency by reducing the likelihood of Council entrenchment. Both of these policies are expected to improve the effectiveness of oversight. The governance institutions of a city set the "tone at the top" and present the attitude and expectations of the entity. A tone underscoring the importance of accountability, transparency and high quality oversight fosters an environment with less opportunity for misuse of funds, abuse of power or fraud. Policies that promote better governance may also improve fiscal responsibility, financial reporting quality and compliance with laws, regulations, contracts and grant agreements.

Within this principal-agent relationship, information asymmetry exists because public officials are privy to private information that voters do not have, which gives the officials an information advantage. Incentive plans are structured to align the interests of the principal and agent, and monitoring and oversight help to ensure that agents act in the interest of the principal. A common monitoring mechanism is the external audit report, which involves an extensive evaluation of financial reports, internal controls and processes in place within the entity. The audit report provides an objective assessment of whether these public agents effectively manage public resources and acts a tool for citizens to evaluate performance of public officials. The 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, gives voters information that otherwise would not be available to them, therefore reducing the information asymmetry problem.

In a municipal setting, transaction costs in the principal-agent relationship (i.e., costs of relocating to a different city) are high