THE TRANSPARENCY AND RELIABILITY OF MUNICIPAL GOVERNMENTS' FINANCIAL STATEMENTS

Terry Elliott
Morehead State University

Bruce K. Grace
Morehead State University

Scott Meisel
Morehead State University

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Abstract

Governmental Accounting Standings Board (GASB) Statement No. 34 requires financial reporting for state and local governments. The motivation behind GASB 34 was to make governmental financial reports more comprehensive and transparent. Until its implementation, data on state and local governments was not reported consistently from entity to entity. This paper extends the earnings management literature to include municipalities and funds management. We use a version of the Jones model (Meisel, 2007) and find that municipalities manage funds.

INTRODUCTION

The purpose of this study is to ascertain the quality of financial data as reported by city governments and if municipal governments

engage in the same type of manipulations that for-profit entities do. For-profit institutions have been heavily criticized recently because of reports of opaque and unreliable data as reported on their financial statements. The problems resulting from their stakeholders relying on such data have been reported elsewhere. We believe that such potential problems in the financial statements of municipal governments could also affect those bodies and their stakeholders. Transparent, reliable statements would enhance the progress, performance, and accountability of their economies. We examine whether city governments manage their financial data to achieve certain benchmarks to look better for constituents and other parties with an interest in the statements. As such, we develop a model to detect problem areas.

Governmental Accounting Standings Board (GASB) Statement No. 34 defines financial reporting requirements for state and local governments. The motivation behind GASB 34 was to make governmental financial reports more comprehensive and transparent. Although adopted in 1999, governments whose total annual revenues exceeded $100 million were not required to implement GASB 34 until June 15, 2001. For those with revenues between $10 million and $100 million, the implementation date was June 15, 2002. Others had until June 15, 2003 to apply the new rules. One key component is the fund financial statements. GASB 34 requires that state and local government agencies change from cash to accrual basis accounting.

The enactment of GASB 34 has already spawned new research. One of the first studies to make use of the data generated from the implementation of GASB 34, Wang and Liou (2009) analyze changes in states' financial conditions. Using data obtained from Comprehensive Annual Financial Reports constructed according to GASB 34, they find that there was a significant difference in financial conditions from fiscal years 2003 to 2004. Patrick (2010) looks at the adoption rates of GASB 34 by local governmental bodies where the state does not require adoption. She finds that smaller, more rural, governments have a slower rate of adoption than larger, more metropolitan areas. Vermeer, Patton, and Styles (2011) find that it is still difficult to gather comparable

information across governmental bodies for infrastructure assets under GASB 34. Differences in depreciation choices, for example, still make comparisons complicated. Taking advantage of the implementation of GASB 34 and the uniformity it provided, Aikins (2011) looks at the auditor's role in local governments. He finds, by comparing a survey sent out in 2008 to auditors with Comprehensive Annual Financial Reports, that auditors have a significant influence over the operations of local governments. Also, Kioko (2013) is able to benefit from the operation of GASB 34 to study state financial conditions before, during, and after the recent recession. The principal finding is that smaller state governments were able to weather the recession and become healthier, while larger state governments emerged from the recession weaker.

The following, also, benefited, from GASB 34. Palumbo and Zaporowski (2012) test the factors that determine the credit rating process. A conclusion is that an understanding of the factors that determine the credit rating process can help institutions and individuals on both sides of the bond market evaluate the potential impacts on credit ratings of changes in economic, fiscal, financial, and political conditions. Malanga (2013) discusses different examples of states that have been found to be manipulating their financials by omitting information, providing false information, or using questionable accounting practices. Lynnette (2017) discusses state and local governments' disclosure requirements as it relates to bond issues. 45 states settled cases related to materially false or misleading statements about past compliance with continuing disclosure requirements. Ketz (2014) discusses a specific case brought by the SEC. The SEC's investigation found that the 2009 budget and mid-year fiscal report misstated the city's financial condition.

The General Fund is used to account for all financial resources not restricted to specific purposes or otherwise accounted for in another fund. The financial resources of the General Fund are expended primarily for current operating purposes. The accounting principles for the General Fund are based on the "flows and balances of financial resources" concept rather than the income determination approach for accounting; therefore, the General Fund is a working

capital entity. The accounting equation for such an entity is current assets - current liabilities equals fund balance. The General Fund account is prepared on the modified accrual basis.

Interest on short-term debt, accrued payroll, and amounts recorded as encumbrances that have become expenditures at year-end are expenditures that might be accrued. Revenues, expenditures and transfers are closed into fund balance. These closing entries summarize the actual change in total fund balance during the year. The management of financial data can take place in three of the traditional areas associated with earnings management in for-profit financial reporting entities: 1) accrued revenues, 2) accrued expenditures, and 3) transfers.

Other governmental funds include the Special Revenue Fund, Capital Projects Fund, and Debt Service Fund. These funds are presented on the modified accrual basis and are accumulated and converted to accrual basis in the government-wide Statement of Net Assets and Statement of Activities. The conversion to accrual basis should allow earnings management models that are used to detect earnings management in for-profit financial reporting entities to be used on government-wide statements.

This conversion should allow a test of whether city governments manage their financial data such as debt to achieve certain benchmarks. Other financial data such as the net assets to expenses ratio, a measure of financial position, can also be incorporated into a model that examines management of financial data.

PREVIOUS LITERATURE

There is a scarcity of previous literature on the management of financial data by city governmental entities. However, there is a plethora of literature on earnings management in for-profit financial reporting entities. For instance, see Cahan (1997), Moyer (1990), Warfield and Linsmeier (1992), and Young (1999).

Frank, Gianakis, and McCue (2005) find that governments under forecast revenues to a considerable extent and that the

requirements of GASB 34 might serve to mitigate that. An article in *Miller Governmental GAAP Update Service* (2004) finds that statement preparers and auditors might have to be from different accounting firms. This would tend to reduce any potential misstatements. Walker, Dean, and Edwards (2004) find that accountants and engineers who are involved in the preparation of the statements are divided as to how much weight decision makers place on them. They also report that there is a less than optimal amount of information sharing among relevant insiders. Jacob (2004) asserts that, although no such actions had taken place, implementation of GASB 34 could result in credit downgrades. This would make borrowing more expensive and affect the electability of politicians; as such, there would be an incentive to manage funds. Chase and Phillips (2004) show how GASB 34 makes analysis of government finances easier and more transparent, leading to increased monitoring and fewer expected acts of manipulation.

Seung-Woog and Stephens (2010) look at whether the level of earnings management influences market mispricing. They find, using the level of discretionary current accruals to representation for earnings quality, that investors misprice securities in the short-run given their perception of the direction of earnings management. Elshafie, Ai-Ru, and Yu (2010) examine the relationship between reported pro forma earnings and the manipulation of discretionary accruals. They find that the difference between pro forma earnings and reported earnings is less for firms with lower levels of discretionary accruals. Imen and Seboui (2011) look at diversified firms for earnings management. Using the modified Jones model and accruals, they find that diversified firms have more of an earnings management problem than non-diversified firms. They also, find that geographical diversification tends to enhance the occurrence of earning management. Habib, Borhan, and Islam (2013) study whether financially distressed firms manage earnings using accruals using Dechow, Sloan, and Sweeny's (1995) model. They discover that financially distressed firms tend to manage their earnings and understate them more than overstate them. Alsharairi,

Gleason, and Kannan (2014) investigate earnings management in takeover scenarios. They ascertain that acquirers who make non-cash bids may engage in earnings management and pay higher premiums. They do not find earnings management of cash bidders. Lin and Yung (2014) look at potential earnings management of corporate spinoffs. They find earnings management among parent firms using accruals and the Jones (1991) model.

Mindak, Sen, and Stephan (2016) try to determine if companies attempt to manipulate with respect to analysts' estimates, the prior year's estimates, and zero earnings. They observe that companies that manage their earnings upward are looked at positively by the market. Those that manage their earnings downward are not favored by the market. Alhadab and Nguyen (2018) search for evidence that diversified firms manage earnings. They find that earnings are managed in an upward direction. They use several models, including the modified Jones model of Dechow, Sloan, and Sweeny (1995). Sakaki, Jackson, and Jory (2017) try to ascertain whether the stability of institutional ownership affects earnings management. They find that stable institutional owners provide a monitoring role that reduces the incidence of earnings management. Ozili (2017) looks at European banks manage earnings by using fee income or commissions to smooth or increase earnings. He finds that non-too-big-to-fail banks use fee and commission income to smooth earnings to a greater degree than too-big-to-fail banks. He also discovers that large European banks manage their earnings in the post-crisis period.

DATA

Sample and Data

A sample of 50 city governments was selected from the Metropolitan Statistical Area (MSA). The GASB 34 implemented around 1999 required cities to prepare Comprehensive Annual Financial Reports. The main requirement in GASB 34 was to convert funds using modified accrual accounting to accrual accounting. This conversion was to be included in a Comprehensive Annual Financial Report (CAFR). Thus, data was collected from the

CAFR through the internet by Googling the city financial statements. Data was collected from the CAFR's from the date of implementation of GASB 34 to the latest information available.

Papers using the Modified Jones Model to search for earnings management, including Meisel (2007) and Key (1997), used an aggregate of 12 years or more in their study; therefore, we use 12 years or more of data in this study. Of the 50 cities, 35 had 12 years or more presented in the CAFR's. This study used 35 cities to determine whether city governments managed their numbers.

Other studies (Key 1997; Cahan et al. 1997) used various time periods in their research design. Key (1997) used 12 years to test earnings management in the Cable Television industry. Cahan et al (1997) used 14 years to test a sample of chemical firms. The number of years of data in this study is methodology papers (Jeter and Shivakumar 1999; Dechow et al. 1995) on earnings management acknowledge reliable parameter estimates using periods of this length.

METHODOLOGY

Hypotheses

City managers can be motivated to manage financial numbers in either direction. As stated in the introduction, the higher the financial numbers of a city unit, the better the financial ratios used to assess financial data. In addition, to the possibility of receiving better borrowing rates, inflating financial numbers will make the financial statements look better for constituents. Inflating financial numbers might be evidenced by positive t-statistics and positive discretionary accruals. Another possible explanation for financial data manipulation in city units is the adjustment of assets and liabilities to influence the capital adequacy requirement for securing loans. City managers may be motivated to apply increasing financial numbers to manage financial data.

Alternatively, a greater reduction of capital increases financial numbers due to a reduction of the estimated uncollectible taxes. This implies that an increase in the estimated uncollectible taxes reduces earnings and increases a city's regulatory capital.

Managers of city governments with low regulatory capital have incentives to increase the estimated uncollectible taxes lowering financial numbers. Also, lower numbers can be used by managers to justify a call for higher tax rates. Since earnings can be manipulated in either direction, a two-tailed test was used to test the hypotheses. Therefore, we test the following hypothesis stated in the null form:

H_1: Managers of city governments do not manipulate financial data in the second year after implementation of GASB 34

The Modified Jones model has been used in a plethora of studies to detect earnings management in the private sector. The samples in most of those studies have been various manufacturing industries. One other study used a service industry, cable television firms.

Studies such as Dechow et al. (1995), Guay et al. (1996), and Young (1999) evaluated the ability of discretionary models to detect earnings management including the Healy, DeAngelo, and Industry models along with the Jones and Modified Jones models. All three studies confirmed that existing models of discretionary accruals generate relatively poor measures of managerial accounting choice. However, evidence indicates that the Modified Jones model is still the best model available for detecting earnings management. Therefore, this study uses the Modified Jones model to determine whether city governments manipulate financial data to achieve financial goals. The Modified Jones model is used to specify non-discretionary accruals (NDA). The model separates total accruals into nondiscretionary and discretionary accrual components:

$$TA = NDA + DA$$

where:

TA = Total accruals
NDA = Nondiscretionary accruals
DA = Discretionary accruals

There are various methods used to manipulate earnings including the use of accruals, changes in accounting methods, and changes in capital structure. This study uses total accruals in its test to determine whether city governments manipulate financial data. Therefore, the following computation (Jones, 1991, p. 211, footnote #29) measured total accruals (TA):

$$TA_{it} = [\Delta CA_{it} - \Delta CASH_{it}] - \Delta CL_{it} - DEP_{it}$$

where:

TA_{it} = total accruals for city government
ΔCA_{it} = the change in current assets for city government
$\Delta CASH_{it}$ = the change in cash for city government
ΔCL_{t} = the change in current liabilities for city government
DEP_{it} = depreciation expense for city government

Property plant and equipment (PPE) and change in revenues (ΔREV) variables are used in the NDA specification to control for changing conditions. PPE was included to capture the portion of total accruals related to nondiscretionary depreciation expense. The change in revenues in the non-discretionary accrual serves as a control variable for economic and business cycle effects, which, otherwise might have been included in the error term. The nondiscretionary accrual (NDA) can be specified as:

$$NDA = (\Delta REV - \Delta REC) + PPE$$

where:

ΔREV = the change in revenues
ΔREC = the change in receivables
PPE = property, plant and equipment

Based on the use of lagged assets as a scaler to reduce heteroscedasticity, the following version of the Modified Jones model (from Cahan, 1992) was used in Meisel (2007) to test earnings management in the banking industry:

$$TA_{it}/A_{it-1} = \beta_{0i}(1/A_{it-1}) + \beta_{1i}[(\Delta REV_{it} - \Delta REC_{it})/A_{it-1}] + \beta_{2i}(PPE_{it}/A_{it-1}) + \beta_{3i}PART_i + \in_{it}$$

where:

TA_{it} = total accruals for city government i.

A_{it-1} = assets for city government i at time t-1[7].

ΔREV_{it} = the change in revenues for city government i.[8]

ΔREC_{it} = the change in receivables for city government i.[9]

PPE_{it} = property, plant and equipment for city government i at time t. [10].

$PART_i$ = 1 if observation is from event year[11]

0 if observation is from the other years[12]

$\in_{it}$ = the error term for city government i.

A similar model will be used here. However, the models above used time series data. Due to the brief time in which GASB 34 has been in effect, this may not be practical for this study.

Partitioning Variable

The discretionary accruals are embedded in the error term. The error term or residuals contain all other factors not included in the NDA. A partitioning variable (PART) is used to separate the event period from the estimation period. PART is an indicator variable equal to 1 in the year in which financial numbers are hypothesized to occur in response to the stimulus identified by the researcher and 0 in the other years. The PART variable compares total accruals in the event year to total accruals in other years. Dechow et al. (1995) showed that total accruals measure discretionary accruals. Therefore, the PART variable measures discretionary accruals in the event year in comparison to discretionary accruals in the other years. Ordinary Least Squares regression is estimated on a city-specific basis producing a t-statistic on the dummy variable (PART). According to two studies (Dechow et al. 1995; Key 1997), earnings are managed when the estimated coefficient on PART from firm specific regressions is statistically significant.

Therefore, in testing the hypotheses, a statistically significant coefficient (β does not = 0) on PART indicates that a city used discretionary accruals more in the event year than in the estimation period to engage in financial data manipulation. The following Z-statistic (Dechow et al. 1995) was used to aggregate the t-statistics cross-sectionally:

$$Z = 1/ N^{1/2} \Sigma^{N}_{j=1} t_j/[k_j/(k_j-2)]^{1/2}$$

where

t_j = t-statistic for city j, and
k_j = degrees of freedom for t-statistic of city j, and
N = number of firms

Dechow et al. (1995) used a sample of 32 firms alleged by the Securities and Exchange Commission to have manipulated earnings over a period of 1982-1992. The 32 firms had varying event periods between 1982 and 1992. This study has 35 cities with varying event periods between 1999-2002. An aggregate Z-statistic was used to test the Modified Jones model over varying event periods. This was possible because the exact same 35 cities were being compared.

RESULTS

In general, the error term or residual contains all accrual items not included in the non-discretionary accrual specification. Therefore, the error term or residual indicates the sign of the discretionary accrual in each year tested. A negative sign would show that cities are using income-decreasing discretionary accruals in the event year. A positive sign would show that cities are using income-increasing discretionary accruals in the event year. The number of positive and negative dummy variable (PART) t-statistics indicates the number of cities using higher or lower discretionary accruals in the event year in comparison to the other years. The Z-statistic measures the significance of H_1 (no manipulation of financial information in event year).

Regressions of the 35 cities in the sample indicated 14 positive discretionary accruals and 12 negative discretionary accruals, thus indicating a slight majority of positive discretionary accruals. Interestingly, there were also nine cities that had no discretionary accruals. This seemed to indicate that there were nine cities in the sample that were not managing their financial data in the event year (2nd year of GASB 34 implementation). Therefore, there were 26 cities managing their financial data for some purpose (See Table 1).

The Z-statistic for this study is 2.02. It is higher than the critical value of 1.96 making the Z-statistic significant at 5%. The results show that cities are manipulating their financial numbers to achieve various financial goals, such as floating bond issues. The PART coefficient indicates whether cities are managing financial data higher or lower in the event year (2nd year of GASB 34 implementation) in comparison to other years. A review of the PART coefficient signs over all cities indicates that 17 cities show positive PART coefficients and 18 cities show negative PART coefficients. This indicates that 17 cities are managing financial data higher and 18 cities are managing financial data lower compared to other years reported by the city. Thus, it appears that motivation to manipulate financial numbers is equally prevalent in the sample.

The research suggests that roughly one-half of the sample (17) is manipulating the financial data higher. Specifically, these 17 cities in the sample appear to be trying to manipulate data higher to appear good for constituents, or they may be manipulating financial data higher to secure loans for various purposes depending on the fund.

On the other hand, the data suggests that one-half of the sample (18) is manipulating data lower to achieve certain outcomes. For example, cities would have an easier time securing grants when presenting lower financial data. Most grants are based on need, which motivates a city to manage financial data lower, and the lower data may lend authenticity to managers' claims that higher taxes are needed.

TABLE 1
MODIFIED JONES MODEL[a]
SUMMARY STATISTICS

z-STATISTIC	
2.02[f]	
t-STATISTICS (positive/negative)[d]	17/18
Discretionary Accruals (positive/negative/0)[e]	
14/12/9	

a. $TA_{it} = \beta_{0i} + \beta_{1i}(\Delta REV_{it} - \Delta REC_{it}) + \beta_{2i}PPE_{it} + \beta_{3i}PART_i + \varepsilon_{it}$
Where
TA = total accruals; ΔREV = revenue in time period t minus revenue in time period t-1
ΔREC = receivables in time period t minus receivables in period t-1; PPE = property, plant and equipment; PART = 1 If the year is the event year and 0 otherwise.
All variables except PART are scaled by lagged total assets.
b. 35 cities in sample
c. event year = 2nd year after implementation of GASB 34
d. t-statistics on dummy variable PART
e. Error term or residual
f Significantly different than 0 at the 5% level (2-tailed test)
g N=12

CONCLUSION

We extend earnings management research by empirically testing the Modified Jones Model's ability to detect the manipulation of financial data in a governmental environment, specifically city governments. Other studies examined the model in multi-industry manufacturing samples. Two studies (Key 1997; Cahan et al. 1997) examined variations of the Modified Jones model in specific industries such as Cable TV (a service industry) and Chemical industries, respectively. The specific industry models used in these studies detected earnings management in those industries. However, neither of these specific industry studies tested the exact Modified Jones specification on those industries. The exact Modified Jones Model was adapted to banks on its ability to detect earnings management in a financial environment, specifically merged banks (Meisel, 2007). Thus, we have also tested the exact

Modified Jones Model adapted to governmental units, specifically cities, on its ability to detect the manipulation of financial data.

The limitations may include a self-selection bias because the sample contains only cities. Since financial data manipulation is difficult to measure exactly using publicly available data, measurement error is unavoidable (Barton, 2001). Even though the Modified Jones model is considered a crude proxy for earnings management (Healy, 1996), the use of a one-industry sample, restricted to city governments, mitigates most of the deficiencies of the model.

Future research might test other models that adjust the nondiscretionary accruals with different combinations of variables. In addition, an entirely different model with variables related specifically to governmental financial statements could be tested. For example, the net assets to expenses, a measure of financial position, could be used in a model to test the management of financial data. It is also possible that governmental units such as cities might manipulate financial data to achieve certain benchmarks needed to float bond issues.

In summary, the results show that cities overall are either increasing certain financial information or decreasing financial information to achieve a financial goal. This is evident due to the equal number of positive discretionary accruals and negative discretionary accruals. Controls are not working. The manipulation of financial information can ultimately result in bankruptcy. Thus, we recommend that the Governmental Accounting Standards Board address the various forms of financial data manipulation such as the use of accruals, changes of accounting methods, and changes in capital structure with new GASB standards.

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