



Research Brief:

**State and Local Government Use of
Generally Accepted Accounting Principles for
General Purpose External Financial Reporting**

Governmental Accounting Standards Board

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March 2008

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How many state and local governments in the United States follow generally accepted accounting principles (GAAP) when preparing their audited financial reports? That may be one of the most commonly asked questions about governmental accounting and financial reporting standards. It also has been among the most difficult to answer. Apart from rough guesses based on anecdotal evidence, there previously was no reasonable estimate of how many of the 87,575 nonfederal governmental entities in the United States apply GAAP.

In its strategic plan for 2004–2009, the Governmental Accounting Standards Board (GASB) committed itself to finding an answer. In 2006, the GASB contracted with researchers from the University of Houston’s C.T. Bauer College of Business—Dr. Saleha B. Khumawala, Associate Professor of Accounting, and doctoral candidate Daniel G. Neely—to conduct a study in conjunction with GASB staff of the application of GAAP by state and local governments.

The study had two parts. The first part involved a review of the laws and regulations of the 50 states to determine which states require some or all of their political subdivisions to prepare annual financial reports in conformity with GAAP. Using the U.S. Census Bureau’s Census of Governments, the review of GAAP laws and regulations allowed for a determination of the number of governmental entities that are *required* to follow GAAP by their states.

The second part of the study was a survey of governments that are not required by their states to follow GAAP. The survey was intended to establish an estimate of governments that prepare financial reports in conformity with GAAP even though they are not required to by state law or regulation. The combined results of the survey and the review of state laws and regulations form the basis of an estimate of the proportion of all state and local governments that follow GAAP. Secondly, the survey was intended to ascertain why governments that are not required to follow GAAP do so, and why other governments choose not to.

Ultimately, the survey did not include all governments not required to follow GAAP by state law or regulation, due to difficulties in surveying very small governments. The survey was limited to a population of 17,577 medium to large entities. Overall, including the governments

required to follow GAAP, the study encompassed 31,221 governments that together represent over 98 percent of all state and local government revenue.

This research brief describes the methodology employed to make the estimate of GAAP compliance and summarizes the results. *Based on the research findings, we estimate that 67 to 72 percent of state and local governmental entities included in the study follow GAAP.*

Methodology

The review of state laws and regulations was conducted in the latter part of 2006 and early in 2007. It was a combination of archival research and interviews by the GASB staff and the external researchers. The archival research encompassed both print documents and state government legislative websites. The interviews were conducted by telephone and email with knowledgeable persons in states for which relevant laws or regulations were not readily identifiable. The tables in the appendix to this research brief present the findings of the review by state and type of governmental entity—counties, local governments (cities and townships), and independent school districts.

It became apparent during the review that unlike general purpose entities and school districts, special districts could be governed not by a single law or regulation, but by multiple individual laws and regulations for specific types of special district—water, fire, transportation, and mosquito abatement, for instance—as well as for single entities. Therefore, it was deemed too difficult to produce a comprehensive catalog of financial-reporting-related laws and regulations governing special districts in all 50 states. Consequently, all special districts were candidates to be included in the population to be surveyed, along with county, local, and school district entities not required to follow GAAP by state laws or regulations.

Due to concerns regarding the likelihood of being able to deliver the survey invitation email to the appropriate person in the smallest governmental entities, the survey was limited to medium to large governments, based on population, enrollment, or annual revenue. The survey excluded:

- Counties with populations below 21,127 residents (the bottom 2 quartiles)
- Local governments with populations below 5,000

- Independent school districts with enrollments of less than 731 students (the bottom quartile)
- Special districts with less than \$1 million in expenditures.

A total of 56,354 entities were excluded, 95 percent of which were either local governments or special districts. Although the majority of governmental entities were not included in either the review or the survey, they account for only a fraction of financial activity. The state governments, plus the governments the states require to follow GAAP and the population covered by the survey—a combined 31,221 entities—represent more than 98 percent of total state and local government revenue.

The survey was intended to be administered to all 869 of the included counties (21,127 or more residents) and a random sample of the included localities, school districts, and special districts, a total of 8,670 entities. Respondents were invited to participate by an email containing a link to an Internet-based survey and two follow-up reminders were distributed subsequently. Email addresses came primarily from the Census of Governments database; GASB staff directly obtained the email addresses that were missing. The survey was administered to a total of 6,354 entities (2,316 emails were undeliverable), from which 650 responses were received, for an overall response rate of 10.2 percent. Individual response rates by type of entity ranged from 7.0 percent for special districts to almost 14.1 percent for counties.

Findings of the Estimation Effort

Review of State Requirements

Almost three-quarters of the states (36) have laws or regulations that require at least some of their political subdivisions to follow GAAP. Some or all school districts are required to follow GAAP in 34 states. At least some local governments in 27 states are required to follow GAAP. Some or all counties in 28 states must comply with GAAP due to state laws or regulations.

Twelve states have established thresholds below which compliance is not required. The thresholds are generally based on population, revenues, or expenditures, as well as on enrollment for school districts. Although these thresholds are generally identifiable, in some states the cutoff points were not clear. In addition, in some states certain governments are required to conform to GAAP but do not do so, and either no enforcement mechanism is available or it is not employed.

In most of these states it is uncertain how many governments are actually complying. We have chosen to exclude the following entities from the estimate of governments that are required to follow GAAP by their states—entities that have unenforced requirements, and governments within states that could not provide precise numbers of the entities that comply and do not comply.

We estimate that 13,594 sub-state governmental entities in the United States are required by state law or regulation to prepare GAAP financial statements (not including special districts, due to reasons explained in the methodology section), or 25.9 percent of all counties, localities, and independent school districts. (See Table 1.) GAAP requirements are most common for independent school districts, 55.8 percent of which are required to follow GAAP by state law or regulation. Approximately 43.4 percent of county governments are required to follow GAAP. The proportion for cities and towns is considerably lower—13.2 percent.

Survey of Governments Not Required by States to Follow GAAP

Governments included in the survey were asked if they follow GAAP when preparing their annual financial statements. The positive responses were surprisingly high, ranging from 80.4 percent of independent school districts to 92.8 percent of special districts. Overall, the respondents from all types of entities responded positively 87.4 percent of the time.

Anticipating that some respondents may not understand what it means to “follow GAAP” when preparing financial statements, the survey included two follow-up questions intended to filter out respondents that stated they follow GAAP but, in fact, may not. The first question asked respondents to identify the accounting they use to prepare their financial statements. Respondents were given a choice of cash basis, modified accrual, full accrual, modified and full accrual, and other basis of accounting, and were asked to check all that applied. It was assumed that respondents may not be following GAAP if they did not select at least full accrual (either on its own or with modified accrual).

Table 1
Estimations of GAAP Compliance

	<u>States</u>	<u>Counties</u>	<u>Localities</u>	<u>Independent School Districts</u>	<u>Special Districts</u> ¹	<u>Total Entities</u>
A GAAP Required		1,316	4,748	7,530	¹	13,594
B Total Entities	50	3,034	35,933	13,506	35,052	87,575
Percentage (A ÷ B)		43.38%	13.21%	55.75%	¹	¹
C Entities Included in the Population for the Survey		869	4,979	3,972	7,757	17,577
D Entities Included in the Survey Sample		869	2,380	1,748	3,673	8,670
Deliverable Emails		782	1,716	1,085	2,771	6,354
E Entities Responding to the Survey		110	234	112	194	650
Response Rate		14.07%	13.64%	10.32%	7.00%	10.23%
F Respondents Stating They Follow GAAP		93	205	90	180	568
G Percentage Stating They Follow GAAP (F ÷ E)		84.55%	87.61%	80.36%	92.78%	87.38%
I Respondents Stating They Use Full Accrual		58	131	22	112	323
J Percentage Stating They Use Full Accrual (I ÷ E)		52.73%	55.98%	19.64%	57.73%	49.69%
K Percentage Applied to Population for the Survey (maximum) (J × C)		458	2,787	780	4,478	8,734
L Respondents Stating They Present the Required Components		53	117	20	84	274
M Percentage Stating They Present the Required Components (L ÷ E)		48.18%	50.00%	17.86%	43.30%	42.15%
N Percentage Applied to Population for the Survey (minimum) (M × C)		419	2,490	709	3,359	7,409
O Minimum Number of Entities Following GAAP (A + N)	49	1,735	7,238	8,239	3,359	21,003
P Percentage of Entities Included in Study (O ÷ [A + C]) ²		79.39%	74.41%	71.63%	43.30%	67.27%
Q Maximum Number of Entities Following GAAP (A + K)	49	1,774	7,535	8,310	4,478	22,328
Percentage of Entities Included in Study (Q ÷ [A + C]) ²		81.20%	77.47%	72.25%	57.73%	71.52%

Notes:

¹ Special districts were not included in the review of state GAAP requirements.

² To calculate the percentage for total entities, the denominator in the equation is [A + C + 50] to include the state governments.

Of the 93 county respondents stating they follow GAAP, 58 selected at least full accrual, 131 of the 205 local governments, 22 of the 90 independent school districts, and 112 of the 180 special districts. This response—52.7 percent of counties, 56.0 percent of localities, 19.6 percent of school districts, and 57.7 percent of special districts—is treated as the maximum estimate of GAAP compliance among the governments surveyed. Overall, 49.7 percent of all respondents selected at least full accrual, a significant decline from the 87.4 percent stating they follow GAAP.

The second follow-up question asked if the respondents' financial reports included fund financial statements, government-wide financial statements, management's discussion and analysis (MD&A), and required supplementary information (RSI). Respondents were asked to check all items that applied. For entities other than special districts, it was assumed that only those respondents that selected at least the fund and government-wide financial statements and MD&A were actually following GAAP (some governments are not required to present any RSI). All three items were selected by 53 county respondents (48.2 percent), 117 localities (50.0 percent), and 20 independent school districts (17.9 percent).

Some special districts present both government-wide and fund financial statements like general purpose governments. However, those operating as business-type activities (a housing authority, for example) present just a single set of financial statements. Therefore, it was assumed that special district respondents that selected at least the government-wide financial statements and MD&A were actually following GAAP.¹ Those two items were selected by 84 respondents or 43.3 percent.

The filtering process had a major impact on the results. Across the board, the decline from the respondents stating they follow GAAP to those stating they use full accrual and include all required items in their financial reports is sizeable. The drop is particularly steep among school districts. The proportion of school districts fell from 80.4 to 17.9 percent. Overall, the proportions dropped from 87.4 to 42.2 percent. The lower proportions are treated as the minimum estimate of GAAP compliance among the governments surveyed.

¹ In retrospect, the wording of this question's answers in the special district survey should have been changed to reflect the terminology employed by special district entities, business-type activities in particular. This issue and its potential impact on the results are discussed further in the Discussion of the Results section below.

Combining the Estimates

All but one state produce a CAFR prepared in conformity with GAAP. (The lone exception prepares a CAFR that does not encompass its entire financial reporting entity.) Combining actual state compliance with the estimates of governments required by state law or regulation to comply and other governments that comply provides an overall proportion of the governments included in this study. This proportion should become the foundation of an overall estimate of GAAP compliance among all state and local governments with further research focusing on the relatively smaller governments not addressed here.

We estimate that 67.3 to 71.5 percent of the 31,221 state and local governments included in this study follow GAAP when preparing their annual financial statements. Based on the large proportion of each type of entity that are required by states to follow GAAP, the counties and independent school districts included in the study have high estimated GAAP compliance—79.4 to 81.2 percent of counties and 71.6 to 72.3 percent of school districts. Despite the small percentage of local governments required by states to follow GAAP, the estimate of compliance for cities and towns included in the study is 74.4 to 77.5 percent. The lowest proportion is estimated for special districts—43.3 to 57.7 percent. The level and breadth of the range for special districts may be the result of relying solely on survey results without a complementary estimate of special districts required by states to follow GAAP, as well as other factors discussed below.

Discussion of the Results

The estimation of GAAP compliance ranging from 67.3 to 71.5 percent relates only to the state and local governments included in the study and should not be construed as the proportion of *all* such entities in the United States. The estimated range—21,003 to 22,328 entities—relates to the largest 31,221 governments. These proportions should not be portrayed as the overall proportion of GAAP compliance in the United States.

They can, however, be considered a foundation for building an overall estimate with additional research. Since the estimation process did not encompass the 56,354 smallest governmental entities, any compliance at all among those governments would increase the total

number of entities that comply with GAAP . There may be reasons to believe that the addition to the estimate could be noticeable.

First, there are approximately 50,500 governments with outstanding municipal debt.² Even if one were to assume that all 31,221 governments covered in this study have outstanding debt, there would be approximately 19,329 debt issuers among the 56,354 smaller governments. Because GAAP financial statements are preferred by the bond rating agencies and municipal analysts in general,³ one may posit that a notable percentage of these smaller debt issuers follow GAAP. If the estimated range of GAAP compliance among the governments in the study were applied to the 19,329 smaller debt issuers, then the result would be an additional 13,003 to 13,824 GAAP-compliant governments. Again, any compliance at all among the 37,025 small, non-debt-issuing governments would increase the total number of compliant governments.

Second, the proportions of compliance for the special districts are surprisingly low. The estimates may suffer because special districts were not included in the review of state GAAP requirements. Presumably, special districts required to comply with GAAP should be reflected in the survey results. Another reason the results may be low relates to the terminology used in the filtering questions in the survey. Respondents from special districts that operate as business-type activities might not be familiar with the “government-wide” and “fund” financial statement terminology. The resulting confusion could have led them to select incorrect answers and therefore not be counted as following GAAP. The truth of the matter is uncertain and bears further investigation. Overall estimates of compliance could increase as a result.

Third, the GASB is aware that in several states that do not require GAAP, many governments actually do follow GAAP. For instance, more than half of the localities in California received the Government Finance Officers Association’s Certificate of Achievement for Excellence in Financial Reporting in 2005, which cannot be awarded without GAAP compliance.

² U.S. Securities and Exchange Commission, “Report on Transactions in Municipal Securities,” July 1, 2004, Table A-10, accessed on March 19, 2008, at <http://www.sec.gov/news/studies/munireport2004.pdf>.

³ Standard & Poor’s, for instance, states that, “GAAP reporting is considered a credit strength...Lack of an audited financial report prepared according to GAAP could have a negative impact on an issuer’s rating, since questions about reporting will be raised.” (*Standard & Poor’s Public Finance Criteria 2005*. NY: The McGraw-Hill Companies, Inc., 2005, p. 55.)

Limitations of the Data

In addition to the issue of the wording of the special district survey, there may be two notable sources of error in the results of the survey. First, respondents may have inaccurately claimed to follow GAAP and thereby inflated the estimates. However, the two follow-up questions should sufficiently deal with that possibility. Of course, it is possible that some respondents may have answered the first question accurately but the second or third question inaccurately. Although it may be possible that filtering using the two follow-up questions removed respondents that actually do follow GAAP, the possible consequence of underestimation was deemed less of a concern than the overestimation that might have resulted without the filtering.

The second potential source of error—nonresponse bias—could be more of a concern. One may plausibly hypothesize that the GAAP compliers among the survey sample would be more likely to respond to the survey than those that do not follow GAAP. The result may be greater-than-expected reporting of compliance.

On the other hand, perhaps expectations are too low. The survey covered relatively larger governments. One may assert directly that larger governments are more likely to follow GAAP than smaller governments. Indirectly, one may point out that larger governments are more likely than smaller governments to issue debt, and in proportionately greater amounts, which could result in the preparation of GAAP-based financial statements for the capital markets.

It should be noted in closing that we have generally chosen to follow the more conservative path when interpreting the results of this study. Although the result may be to artificially depress the estimates, that outcome is deemed preferable to promulgating unsupportably high estimates of GAAP compliance.

Future Directions for Research

This study is but a beginning of the process of establishing a comprehensive estimate of GAAP compliance among state and local governments. As noted, more than 56,000 entities were not included. Studies of those governments would help to close the circle, building incrementally on the foundational estimates presented here. Of specific interest would be the 35,052 special districts, particularly whether state laws and regulations exist that require GAAP compliance

among special districts. Little is known at this point about what types of special districts tend to be required by states to follow GAAP or what thresholds, if any, have been established.

Correspondence

Communication regarding this study should be directed to Dean Michael Mead, GASB research manager and author of this research brief, at dmmead@gasb.org.

**Appendix Table A
County Governments Required by States to Follow GAAP**

Counties									
State	GAAP Required	Falls Below Threshold	GAAP Not Required	Total	State	GAAP Required	Falls Below Threshold	GAAP Not Required	Total
AL			67	67	MT ²			54	54
AK			12	12	NE			93	93
AZ	15			15	NV	16			16
AR			75	75	NH ³			10	10
CA	57			57	NJ			21	21
CO	62			62	NM	33			33
CT				0	NY			57	57
DE			3	3	NC	100			100
FL	66			66	ND	53			53
GA	156			156	OH ⁴	61		27	88
HI	3			3	OK			77	77
ID	44			44	OR			36	36
IL			102	102	PA	66			66
IN			91	91	RI				0
IA	99			99	SC			46	46
KS			104	104	SD			66	66
KY			119	119	TN			92	92
LA	60			60	TX	21	233		254
ME	16			16	UT	29			29
MD	23			23	VT			14	14
MA	5			5	VA	94	1		95
MI ¹			83	83	WA			39	39
MN	87			87	WV			55	55
MS	82			82	WI	45	27		72
MO			114	114	WY	23			23
Total						1,316	261	1,457	3,034

Notes: Connecticut and Rhode Island do not have county governments.

¹ Michigan's law requiring GAAP compliance was not fully enforced at the time of the study.

² In practice some small counties do not comply, but a precise number was not available.

³ Counties are required to follow GAAP but are not required to obtain an audit.

⁴ 27 counties produce cash-basis financial statements despite the GAAP requirement.

**Appendix Table B
Local Governments Required by States to Follow GAAP**

Local Governments									
State	GAAP Required	Falls Below Threshold	GAAP Not Required	Total	State	GAAP Required	Falls Below Threshold	GAAP Not Required	Total
AL			451	451	MT ³			129	129
AK			149	149	NE			977	977
AZ	87			87	NV	19			19
AR			499	499	NH ⁴			234	234
CA			475	475	NJ			566	566
CO ¹	178	92		270	NM	101			101
CT	179			179	NY			1,545	1,545
DE			57	57	NC	541			541
DC			1	1	ND			1,692	1,692
FL	374	30		404	OH ⁵	268	1,944	38	2,250
GA	379	152		531	OK			590	590
HI	1			1	OR			240	240
ID			200	200	PA			2,564	2,564
IL			2,722	2,722	RI	39			39
IN			1,575	1,575	SC			269	269
IA			948	948	SD			1,248	1,248
KS			1,926	1,926	TN	349			349
KY	345	79		424	TX ⁶			1,196	1,196
LA	242	60		302	UT	220	16		236
ME	489			489	VT			284	284
MD	157			157	VA	72	157		229
MA	351			351	WA			279	279
MI ²			1,775	1,775	WV			234	234
MN	250	2,397		2,647	WI	26	1,824		1,850
MS	81	215		296	WY ⁷			98	98
MO			1,258	1,258					
						<u>4,748</u>	<u>6,966</u>	<u>24,219</u>	<u>35,933</u>

Notes:

- ¹ Governments below threshold may apply for exemption, though it is unclear how many of the 92 have done so.
- ² Michigan's law requiring GAAP compliance was not fully enforced at the time of the study.
- ³ In practice some small localities do not comply, but a precise number was not available.
- ⁴ Local governments are required to follow GAAP but are not required to obtain an audit.
- ⁵ Only cities are required to follow GAAP, 38 of which produce cash-basis financial statements despite the GAAP requirement.
- ⁶ Some cities are not required to follow GAAP, but the threshold for compliance was unclear.
- ⁷ GAAP is required for larger cities unless they have a mayoral form of government, but the specific threshold is unclear.

**Appendix Table C
Independent School Districts Required by States to Follow GAAP**

Independent School Districts									
State	GAAP Required	Falls Below Threshold	GAAP Not Required	Total	State	GAAP Required	Falls Below Threshold	GAAP Not Required	Total
AL			128	128	MT	352			352
AK			0	0	NE			575	575
AZ	231			231	NV	17			17
AR	310			310	NH	167			167
CA	1,047			1,047	NJ	549			549
CO	182			182	NM	96			96
CT	17			17	NY			683	683
DE	19			19	NC	0			0
FL	95			95	ND			226	226
GA	180			180	OH ¹	574		93	667
HI	0			0	OK			571	571
ID			116	116	OR			236	236
IL			934	934	PA	516			516
IN			294	294	RI	4			4
IA	386			386	SC	85			85
KS			324	324	SD	176			176
KY	176			176	TN ²			14	14
LA	66			66	TX	1,089			1,089
ME	99			99	UT	8	32		40
MD	0			0	VT			283	283
MA	82			82	VA	1			1
MI			580	580	WA			296	296
MN	345			345	WV			55	55
MS	164			164	WI	442			442
MO			536	536	WY	55			55
						<u>7,530</u>	<u>32</u>	<u>5,944</u>	<u>13,506</u>

Notes: Alaska, Hawaii, Maryland, and North Carolina do not have independent school districts. Hawaii, Maryland, and North Carolina require their dependent school districts to follow GAAP.

¹ 93 districts produce cash-basis financial statements despite the GAAP requirement.

² Districts are required to comply, but some do not. An exact count was not available.