

SYSTEMATIC ACCOUNTING ISSUES

ACCOUNTING RULES SET BY GASB SEEM BIAS TOWARD GOVERNMENTS

The development of accounting standards for state governments is the responsibility of the Governmental Accounting Standards Board. These standards make up the Generally Accepted Accounting Principles used by state and local governments to prepare their annual reports. For the reasons set forth here, we believe the GASB has lacked the independent board members and adequate funding to set standards that are not biased toward governmental officials. Compromise on the part of this standards setting body has hampered the development of accounting doctrine that would foster truthful state accounting.

The National Council on Governmental Accounting (NCGA) was the first national organization to address government accounting and financial reporting issues.^{xiv} The NCGA did not have the resources and staff needed to address the number of governmental issues as they arose. To remedy this problem the Financial Accounting Foundation accepted responsibility for establishing state and local government accounting standards in 1979.

Initially the FAF wanted state and local government accounting standards to be set by the FASB but government organizations argued that government accounting and business accounting are fundamentally different. These organizations threatened to continue to rely on the NCGA's standards and not assist the FAF financially or to recognize the FASB standards. As a compromise, in 1984 the GASB was established by the FAF, the American Institute of Certified Public Accountants; the Government Finance Officers Association; the National Association of State Auditors, Comptrollers and Treasurers; and the seven other organizations representing state and local government officials.^{xv} These organizations still have a great influence over the GASB because they dominate the GASB funding and board member selection process.

Numerous examples raise doubts about the independent nature of the GASB. For instance, in the early 1990's the GASB issued Statement 11 which would have required a full accrual system similar to systems used by business. Some of the governmental organizations that were involved in the formation of the GASB were adamantly against switching from the traditional cash basis fund accounting. To give time for this debate to be resolved, the GASB chose to not give Statement 11 an implementation date, effectively ending this important improvement.

Another suspicious example occurred in 1994 when some of the original GASB members' terms ended. Possibly because governmental organizations dominate the GASB board member selection process, the incoming members were accountants who strongly favored the traditional cash basis fund accounting system.^{xvi} In 1999 the new board issued Statement 34, "Basic Financial Statements---and Management's Discussion and Analysis---for State and Local Governments". The board resolved the debate between those who wanted to use a full accrual accounting system and those who wanted to continue to use the traditional cash basis fund system by requiring that **both** systems be used. As discussed later in this document, using both systems has resulted in annual reports that are too complicated and cumbersome.

Another instance where the GASB's governmental constituency appears to have impacted the independent standard setting process involves the reporting of post-employment benefits. As detailed in this Study, the GASB lags far behind the FASB when it comes to reporting on retirement

costs. The GASB allows an extended period of time for governments to amortize the prior underfunding of post-employment benefits. The standards for pension and other post-employment benefits, including health care costs, enable governments to leave significant liabilities *off-balance sheet*. GASB standards are also lax on the evaluation of pension fund assets. GASB GAAP allows actuaries to value assets on an average of their market price over five years. This “smoothing” of the assets’ value obscures the plan’s risk profile. The GASB also permits each state to choose the way the pension plan actuaries will calculate pension expenses and liabilities, including the actuarial cost methods, assumptions and amortization periods.^{xvii} This makes it difficult, if not impossible, to compare pension plans from state to state.

Because GASB 34 states that financial reports should provide information that is useful in evaluating efficiency and effectiveness, the GASB is proceeding toward the establishment of a formal project on governmental performance measurement reporting. Eight major state and local public interest groups have strenuously objected to this project, because they believe it will create more complicated financial reporting than is necessary to provide additional information of real value to decision makers. Some of these government constituencies have threatening to stop funding the GASB and have proposed the disbanding of the board, if the project on performance measurement reporting proceeds. That these threats are credible highlights the dependency of the GASB on the governments it is supposed to regulate.

These examples serve to illustrate some of the ways the independent standard setting process of the GASB seems to be compromised by bias toward its governmental constituency. The funding and management mechanism that evolved from this history is inadequate to ensure an ongoing program of high-quality governmental accounting standards and has raised questions about its ability to remain independent (from) its donors.^{xviii} On October 30, 2007 Arthur Levitt, former SEC chairman, urged the entire accounting standards setting process be reconstituted to serve the investing public rather than corporate and government constituent groups. He advocated that GASB members be chosen based on who is “best qualified” to serve, rather than based on recommendations from constituent groups.^{xix} Levitt and others have also called for an independent source of funding for the GASB.

Like Arthur Levitt, the Institute is concerned about the GASB’s lack of independence from its governmental constituency. The independence issues may have caused some GASB members to lose sight of the desire to present information that could assess government accountability and sustainability. While we can’t read the minds of GASB members, we can suspect that the GASB’s lack of independence has directly led to major deficiencies in state and local government accounting standards.

MAJOR ACCOUNTING DEFICIENCIES REMAIN UNRESOLVED

While disclosure improvements have been made to GASB GAAP since the early 1990’s, comments made by James Antonio and Martin Ives, GASB chairman and vice chairman in 1993, are still true today. They said; “. . . (We) believe that the current accounting model is flawed because it fails to recognize in the operating statement significant unpaid expenditures that result from current period transactions and events. These include items such as claims, wages deferrals, unfunded pension and other employee benefits, and similar items related to the current period but not requiring cash outflow until future periods. The accounting model also results in reporting long-term debt issued to finance current operating expenditures as operating inflow rather than as a fund liability. In these instances, instead of producing a straightforward statement of operating

results, the accounting model produces operating statements likely to confound all but the most sophisticated users.”^{xx} Based on the findings of this Study, the Institute could not agree more with this statement.

THE BUDGETING MODEL CREATES SYSTEMATIC RISKS

The budget process is where seeds of fiscal irresponsibility can be planted. The cash basis system used to calculate state budgets is the soil in which these seeds can flourish. This short sighted accounting method creates at least two systematic risks, a morale hazard and a moral hazard.

A morale hazard occurs when a body acts without malice, but differently than it otherwise would because it is insulated from the effects of their behavior. This notion is usually applied to insured events because insurance “makes good” on uncertain future casualties. This knowledge may unconsciously induce the insured to take on riskier behavior than they would if they were not insured.

In a similar way, legislators and governors are subject to a budgeting **morale** hazard as a consequence of the cash basis budgeting method. Because this accounting method insulates politicians from the very real hazards of future obligations that are accumulating, they make decisions that they might not otherwise make, or that they may be legally prohibited from making. Incurring costs **now** is a much greater incentive if the costs do not need to be paid or **budgeted for** until a future point in time. This is particularly true if the reckoning will occur after the politician leaves office. This “not in my term of office” attitude is enabled by cash basis budgeting, because it creates spending capacity today and shifts the political pain into the future.

This is a phenomenon that may occur without malice. The Institute has interviewed a number of legislators who simply do not understand the budgeting process and the implications of ignoring accrued costs that will need to be paid in the future. Moreover, the nearly unlimited demand for services for which only a limited supply of resources exists creates such an immediate pressure even the most able and upright legislator might be unable to resist.

Cash basis budgeting also creates a **moral** hazard. A moral hazard occurs when a body acts **unethically** because they are insulated from the effects of their decisions. Legislators who use cash budgeting to avoid their state balanced budget requirements exemplify a moral hazard.

Unfortunately, state and local government officials determined long ago that if they paid their employees more salaries there would be an impact on their current budgets and financial statements. The cash basis method used to calculate state budgets allows governmental officials to use deferred compensation gimmicks to avoid such negative impacts and keep their workforces happy. So, during labor negotiations, governmental officials just keep promising employees more pension and retiree health care benefits. None of these deferred costs appeared on the budget so politicians do not have to cut other programs to provide for these benefits, nor do they have to raise taxes to fund these future promises.

Unscrupulous legislators may understand that they are incurring future costs but use the budget processes deficiencies to avoid the necessity of recognizing and providing for those expenses. At least some officials must understand the situation well and yet use it to their political advantage. To put employees’ current service cost obligations on the backs of future taxpayers is to create a fundamentally unbalanced budget. Unbalanced budgets are inequitable to future taxpayers who

have no voice in today's spending decisions. According to the GASB, this is contrary to the intent of balanced budget requirements, which is to provide accountability and to ensure that current costs are not passed on to future taxpayers.^{xxi}

The shortsightedness of cash basis budgeting is starting to catch up to governmental entities, especially when the governments' true financial positions, including the pension and OPEB liabilities, are calculated. New Jersey Governor Jon Corzine highlighted in one of his budget addresses, "The constant focus on short-term priorities without consideration of long-term costs has led to financial decisions that hang over the state today, tomorrow, and far into the future."^{xxii}

THE EFFECTS OF STRUCTURAL ACCOUNTING ISSUES

Our study of GASB standards found major accounting deficiencies in four areas:

- Annual reports which are too complicated and cumbersome;
- Budgets amounts do not agree to actual;
- Accounting for pension expenses and liabilities; and
- Accounting for the expenses and liabilities related to other post-employment benefits.

ANNUAL REPORTS ARE TOO COMPLICATED AND CUMBERSOME

Because GASB 34 requires state and local governments to use both the traditional cash basis fund accounting system and the more economic based accrual accounting system, annual reports are cumbersome, confusing and unnecessarily long. For example, Alabama's 2007 CAFR is 298 pages, and Illinois' is 498 pages. As a matter of comparison, the 2007 Consolidated Financial Report of the U.S. Government was 198 pages. General Electric's annual report for that year was only 104 pages.^{xxiii}

One particularly complicating factor is that GASB 34 requires the inclusion of complete financial statements for eleven funds. During our study we were continually frustrated with digging through the many fund statements included in the annual reports to find important disclosures. For example critical pension plan data is included in the CAFR footnotes and Required Supplemental Information, which is buried after the numerous fund statements.

The structure of the statements confuses readers. For example, to calculate the amounts reported for the consolidated financial statements of corporations, it would be logical to combine the amounts that appear on the parent company financial statements and the amounts that appear on its subsidiaries financial statements. To calculate the amounts reported on the federal government consolidated financial statements, a person would combine the amounts that appear on federal agencies' financial statements. Contrary to reason, the amounts reported on consolidated (government-wide) financial statements of state and local governments are not the sum of the amounts reported on all of the funds financial statements. This is because some of the funds are accounted for using the accrual accounting method that is used to calculate the consolidated (government-wide) financial statements, while other funds are calculated on the cash basis.

BUDGETS DO NOT AGREE WITH ACTUALS

GASB 34 states that governments have a duty to provide financial information that is useful in comparing actual financial results with the legally adopted budget. This comparison was a major

component of this Study. We found that there was little comparison between the actual amounts reported on state financial statements (GAAP Basis) and Budgetary Basis amounts. The divergence between budget and actual was predicted when GASB Statement 34 was implemented. This divergence exist because the legally adopted budgets are prepared using cash basis fund accounting, while GASB 34 requires governments to prepare their government-wide financial statements on GASB's version of accrual accounting.^{xxiv} This creates a fundamental schism between the two reports, i.e. an “apples and oranges” scenario, which makes it very difficult for legislators to track the actual results of their budget decisions. The comparisons for California, Arizona and Arkansas are even more difficult because their budgets do not include revenues. In these states only expenditures are presented in their budgets.

BILLIONS OF DOLLARS IN PENSION LIABILITIES ARE NOT ON STATE BALANCE SHEETS

As previously mentioned, GASB GAAP did not require states to report any of their unfunded pension liability until 1997. Instead of having governmental entities report all of their unfunded pension liabilities at one time, the GASB allows these obligations to be amortized over 40 years. For example, prior to the implementation of GASB 27, Illinois had underfunded its pension plans by \$13.7 billion. Each year \$34 million of the pre-1997 under-funding is included in Illinois' Annual Pension Cost. Therefore, as of June 30, 2007, more than \$10 billion of pension liabilities for which Illinois became liable for before 1997 are still not reported on its Statement of Net Assets.

The GASB allows state and local governments to amortize benefit increases over 30 years. For example, in fiscal year 2003 the Illinois legislature approved an early retirement option for teachers. While this action increased Illinois' actuarially calculated unfunded liability by more than \$2.37 billion,^{xxv} the Net Pension Obligation on the Statement of Net Assets as of June 30, 2003 showed no increase due to this policy decision. The full \$2.37 billion became an off-balance sheet liability. The state's FY2003 financial statements also recorded no expense related to this benefit enhancement. Illinois chose to amortize this pension enhancement over 10 years. Therefore the Annual Pension Cost reported on the state FY2005-2007 financial statements was only one tenth of the \$2.37 billion. As of June 30, 2007 more than one and half billion dollars of the cost related to this 2003 decision remains off-balance sheet.

Because the GASB allows for a 40 year amortization of pre-GASB 27 underfunding and a 30 year amortization of benefit enhancements, the amount included as the Annual Pension Costs on the financial statements is usually considerably less than the amount the actuaries calculate is needed to adequately fund the pension systems. We are fortunate that the GASB does require the actuarial unfunded pension liability to be disclosed in the Required Supplementary Information. This may allow sophisticated users of the financial reports to approximate the true pension liability owed by some state.

For example, as of June 30, 2007 the Illinois Statement of Net Assets includes a Net Pension Obligation of \$14 billion. Information about the state true pension liability is found on page 135 of the Illinois CAFR within the Required Supplemental Information on the Schedule of Funding Progress. This schedule shows three years of actuarial information for each of the five pension plans. To calculate the total pension liability, the Institute had to add together the actuarial unfunded liability for each of the pension plans. The total liability was \$40 billion. This means GASB 27 allows \$26 billion of Illinois' true pension liability to be kept off-balance sheet.

The calculation of some states' true pension liability is made difficult, if not impossible, because the state is involved in a multi-employer pension system. Under such systems the municipalities and the state have created one system that combines their pension assets and liabilities. Information about the multi-employer pension system is included in the Required Supplemental Information of the state's CAFR. But the state's portion, including its actuarially accrued pension liability, may not separate.

Another complication in calculating a state's true pension liability is that the actuarial valuation date is not in sync with the fiscal year end of the state annual report. The California CAFR for year ended June 30, 2007 is a good example of this problem. The actuarial valuation date for the pension plans is June 30, 2006. This means that the actuarial unfunded liability included in the required supplemental information of the CAFR is outdated.

We also found it disturbing that it is possible for state and local governments to report a Net Pension Asset on its Statement of Net Assets even though they have actuarially determined pension liabilities in millions, if not billions of dollars. This occurs if the government's annual contributions to its pension plan are higher than the annual pension costs, as calculated according the GASB 27 rules. An example of this phenomenon can be found in the 191-page CAFR of the city of Lakeland, Florida for September 30, 2007.^{xxvi} The Lakeland Statement of Net Assets reported a Net Pension Asset of \$7.9 million for its employee pension and retirement systems. Within the Required Supplementary Information, on page 100 of the CAFR, the true liability can be found. The Unfunded Actuarial Accrued Liability as of October 1, 2006, the last actuarial valuation date, was \$62.4 million.

Another example of the confusion created by pension accounting standards can be found in Texas. On the 2007 Texas Statement of Net Assets there is both a \$7.3 million Net Pension Asset and a \$421 million Net Pension Obligation. The Net Pension Asset was reported because the state contributions to its Judicial Retirement System Plan II (JRS2) have been greater than the cumulative Net Pension Costs, calculated according to GASB 27, that were reported on the Texas Statements of Net Activities. A review of the state Schedule of Funding Progress finds that the JRS2 pension system had an unfunded actuarial accrued liability, the truer liability, that was actually almost \$9 million. The Net Pension Obligation was the result of the state funding other pension plans in amounts less than the Net Pension Costs as calculated under GASB 27. We could not calculate the truer pension liability for Texas, because one of the state's six pension plans, Teacher Retirement System of Texas, is a multi-employer plan and the amount included on the Schedule of Funding Progress appears to be the plan's total liability for which the state is only partially responsible.

OTHER POST-EMPLOYMENT BENEFITS ARE NOT REPORTED AT ALL

State and local governments have not been required to report any OPEB liabilities or related expenses beyond the benefits paid to current retirees. GASB 45 will change that starting in 2009. Unfortunately and similar to pension liabilities, very significant amounts of OPEB liabilities will not be reported on each state's *balance sheet*. The amount each state has under-funded its OPEB liability before GASB 45 implementation date in 2007 will not be immediately reported on each state's CAFR. Instead the pre-GASB 45 under-funding will be amortized over 30 years. This means that some states issuing their CAFR for FYE June 30, 2008 will report a little more than one thirtieth of their true OPEB liabilities. Therefore approximately ninety seven percent of these liabilities will be left off -balance sheet.

Some state and local governments have begun using actuaries to calculate their OPEB liabilities. In the 2007 Illinois CAFR, which was issued on June 25, 2008, State Comptroller Daniel Hynes noted, “On April 21, 2008 the State performed an actuarial valuation of the health, dental, vision, and life insurance benefits promised to retirees. The valuation reported a \$24.2 billion actuarial liability with no assets currently set aside to fund the liability as the State uses a ‘pay-as-you-go’ method to make payments to retirees.”

Because state and local governments have promised these retirement benefits without setting aside money to fund future payments, OPEB liabilities are enormous. Studies have estimated that state and local governments OPEB liabilities are between \$600 billion and \$1.6 trillion.^{xxvii} The new accounting standard did not create this under-funding, but fortunately the disclosures required under GASB 45 will reveal them for the first time and make these funding gaps more apparent.

Because so many factors are involved, managing the costs of these health care and other OPEB programs is difficult. State and municipal laws and collective bargaining agreements may make it impossible for public sector employers to act unilaterally. It is also not easy to change employee expectations. Difficulties may be encountered when by trying to get citizens to agree to additional taxes to fund governmental employees’ benefits especially during a period when taxpayers are losing these types of benefits from their own private sector employers.^{xxviii}

Since corporations have been required to move from reporting for their OPEB on the pay-as-you-go basis to the accrual basis, many companies have cut back on these benefits.^{xxix} We can only assume this result is due to the change in OPEB reporting requirements, but this certainly brings home the old adage that you can’t manage something until you measure it.

Already there is evidence that governments are starting to consider managing their newly calculated OPEB liability. In his CAFR transmittal letter dated March 28, 2008 California’s State Controller John Chiang noted that in 2007 he commissioned the state’s first actuarial report on OPEB. The report disclosed that the state faces a \$47.9 billion unfunded liability. Controller Chiang went on to say, “In January 2008, the California Public Employee Post-employment Benefits Commission, appointed by the Legislature and Governor, unanimously recommended that the state and local governments ‘prefund’ retiree health benefits by setting aside and investing funds as employees earn OPEB benefits.”^{xxx}