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EXPERT ANALYSIS

Falling Municipal Dominoes: How Accounting Has Abetted Irresponsible Official Behavior

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In an opinion piece published May 16, 2014, in The Wall Street Journal, titled "More Detroits Are on the Way," former New York Lt. Gov. Richard Ravitch contrasted New York City's fiscal probity following its mid-1970s financial crisis with Detroit's bankrupt condition. He credited the different outcomes to the balanced budget requirement imposed on New York's municipalities.

He briefly mentioned the discussion at the time regarding the accounting for deferred payments contractually due city employees, and he might have alluded to the then-recent settlement of the New York City teachers' union contract. The contract provided retroactive pay increases covering the five years during which negotiations had sporadically been conducted. The increases were to be paid over a number of years, thereby spreading the impact on the city's budgets and financial reports over an extended period of time.

Ravitch's commentary did not explore municipal accounting, but its role in creating the conditions that have contributed to fiscal mismanagement in hundreds, if not thousands, of state and local government units across the country deserves further examination.

Accounting rules govern financial reporting by private enterprises and governmental units. The rules are intended to ensure accurate, unbiased and timely reporting of financial position and performance. They are further intended to support appropriate decision-making by creditors and owners — and in the case of cities and states, by taxpayers and voters.

It is neither the province nor the purpose of financial reporting to alter or influence public policy or investor behavior. None-theless, it is well understood that such behavior is affected by reported results — especially quarterly earnings announcements measured against consensus expectations.

Notwithstanding this unwanted but uncontrollable effect, it is accepted that accounting should not be crafted to trigger behavioral reactions, even if those responses might strike some observers as being socially beneficial. In other words, accounting should present information in a neutral manner, permitting consumers to process it in accordance with their own interests and value systems.

By now, many of our fellow citizens — in Chicago and Illinois especially,[1] but more generally in many of the nation's over 90,000 local governmental units — have realized that many municipalities have for decades been financially mismanaged. Municipal workers have become alarmed by the sudden recognition that their beloved pension and other post-retirement benefit promises might not be kept — because they cannot be kept.

And many investors in the municipal debt instruments that have allowed most governmental units to remain afloat have taken notice of the ratings downgrades already announced, with others being possible as unfunded obligations have to be satisfied.[2]

In 2013, Detroit was permitted to move forward with a Chapter 9 bankruptcy filing. The action was facilitated by a court ruling that said its workers' pension obligations (of which $3.5 billion were

unfunded), together with its other debt commitments, including health care obligations — $18 billion all told — were contracts and thus were subject to restructuring notwithstanding a state law ban on benefits reductions. *In re City of Detroit*, 504 B.R. 97 (Bankr. E.D. Mich. 2013).

This was, by far, the largest municipal bankruptcy in U.S. history. But other states and some cities have unmanageable debt obligations of far greater size, and they are likely to face similar crises.

Detroit was not the first city to experience a municipal bankruptcy, and it surely will not be the last. Among the states, Illinois now has the dubious distinction of having the nation's largest unfunded pension obligation — some $111 billion as of December 2015. The governor and the Senate and House leaderships (which for years prior to 2015 were of the same political party) had long been unwilling to address the shortfall despite innumerable deadlines, ultimatums, special legislative sessions and public displays of hand-wringing.

Political leaders claimed that an accord reached late in 2013 would have ended the crisis based on projected savings of $155 billion over the next 30 years. But even this measure would have trimmed the unfunded liability by only about $20 billion.

In mid-May 2014, however, an Illinois state court judge put this putative solution — which a Dec. 3, 2013, Wall Street Journal editorial scathingly critiqued as one that merely "tinkers around the edges" — on hold.

The ruling came in response to public employee unions' suits asserting that pension reductions would violate an Illinois constitutional provision that says pensions are a "contractual relationship" having benefits that cannot be "diminished or impaired."

A number of other states have similar provisions, and this issue — whether contractual obligations such as pensions can be revised without a bankruptcy filing — may ultimately require U.S. Supreme Court resolution.

Warren Buffett, in a prescient 1975 letter to Katharine Graham, publisher of The Washington Post, on whose board he served at the time, observed that "[t]here probably is more managerial ignorance on pension costs than any other cost item of remotely similar magnitude. And, as will become so expensively clear to citizens in future decades, there has been even greater electorate ignorance of governmental pension costs."

Many municipalities find themselves in deep fiscal holes that, even apart from the effects of the 2008 recession and the weak recovery since then, cannot be filled with even the most draconian of tax increases.

Deferred funding of far-distant monetary obligations in favor of more immediate, politically expedient needs, abetted by securities market booms that temporarily alleviate apparent pension funding shortfalls, have become endemic. Now many municipalities find themselves in deep fiscal holes that, even apart from the effects of the 2008 recession and the weak recovery since then, cannot be filled with even the most draconian of tax increases.

The all-too-human inclination of public officials, like corporate managers, is to conceal or delay recognition of financial problems. Unfortunately, this tendency has been aided and abetted by accounting rule-makers in both private and public sectors, most dramatically regarding obligations for post-retirement benefits such as pensions and health care.

These so-called defined benefit plans — those for which the companies or public entities (and thus, the shareholders and taxpayers, respectively) remain obligated regardless of their financial circumstances or of the success or failure of the underlying investments — have caused enormous hidden harm to many enterprises. The wisdom of granting such benefits is a governance issue, but the accounting for long-term obligations is an accounting concern that has not been responsibly addressed to date.

Companies in some of America's largest and most iconic industries, including steel and automobiles, long maintained the illusion of labor peace by making promises that could not be kept. Most of them ultimately sought bankruptcy protection, wiping out shareholders' investments and in most instances also harming creditors. In some cases, they received taxpayer-funded bailouts (including handing over pension obligations to the Pension Benefit Guaranty Corp.[3]), thus transferring the cost of their private misfeasance to the public.

Since 1973 the accounting rules have been set by the Financial Accounting Standards Board,[4] a private-sector organization. The board has moved at a snail's pace to address the venerable but absurd practice of "smoothing" recognition of defined benefit plan obligations and expenses. This practice has resulted in overstating the respective sponsors' financial performance, over-rewarding current management and encouraging the granting of exaggerated future benefits to (largely unionized) workforces to buy near-term labor peace.

By acquiescing to the seemingly well-intentioned strategy of smoothing recognition of costs associated with long-horizon defined benefit and other post-retirement benefit plans, accounting standard-setters have encouraged foolish behavior. Firms granted benefit increases that were economically nonviable, saddling later generations of managers with obligations that bankrupted companies and left former employees without the annuities many had planned to rely on in retirement.

In the public sector, the situation is even worse. This is because the relevant accounting principles differ from those in the private sector. The responsible rule-setter, the Governmental Accounting Standards Board, or GASB, has carried forward the time-enshrined practice of so-called "fund accounting."

This approach employs the "current financial resources measurement focus" that reports in the statement of operations only the municipalities' currently collected or collectible revenues and the currently paid or payable obligations using those current resources.[5]

The financial consequences of fund accounting have been similar to — and arguably even worse than — those in the private sector: The largely unionized governmental workforces have been able to extract promises of generous future benefits that become due long after current officeholders could be expected to have departed the scene.

Under the fund-accounting philosophy of financial reporting, current taxpaying voters are expected not to become agitated over those promises because the actual funding will, to the maximum extent possible, be postponed until later years — burdening later generations of taxpayers.

Thanks to fund accounting, those longer-term obligations are not included in the current fund-accounting reports as liabilities and corresponding expenditures. Thus, they are not affected by current budget constraints, including balanced budget requirements set by most states.

In its Statement No. 34, the GASB implicitly acknowledged the fragility of this approach, which ignores longer-term commitments. But the board's tepid response was to maintain the primacy of fund accounting while adding a new mandate for limited full accrual financial reporting.

Consequently, over the past 15 years state and local governments have been required to report their true, full-accrual financial position and results of operations, set forth in newly prescribed entity-wide financial statements. This incremental quantum of information is now a compulsory part of the comprehensive annual financial reports prepared by most governmental bodies.

Despite this requirement, the content of these annual reports (typically exceeding 100 pages, and often much longer) is overwhelmingly reserved for fund-accounting information, with as few as four pages dedicated to the more meaningful full-accrual representations. Thus, even those taxpayers who try to understand municipalities' financial circumstances are often thwarted in doing so.

It is safe to say that most users of municipal financial reports have great difficulty grasping the relationship between the full-accrual and the modified-accrual financial statements, even though limited reconciliations between them are also mandatory.

Users in jurisdictions having balanced budget requirements, such as New York City, are probably comforted by the fact that such mandates relate to the fund-accounting-based tabulations. They show vastly lower deficits or even report budget surpluses — a far different picture from that displayed by the full-accrual statements.[6]

Companies in some of America's largest and most iconic industries, including steel and automobiles, long maintained the illusion of labor peace by making promises that could not be kept.

The narratives accompanying the reports inevitably stress the municipalities' compliance with those mandates and say little or nothing about the real economic long-term obligations they face.

The GASB has adamantly defended the near-total reliance on fund reporting that ignores longer-term obligations and the expenses associated with them — most recently, in a 2013 special report — by arguing that the voters care only about how well the stewards of the public purse have matched current revenues with current expenditures.

The board seems to be saying that the future can be trusted to take care of itself.[7] Experience, as in Detroit, shows that this assumption is not correct. Instead, the future is now.

All states except Vermont have balanced budget requirements, although the stringency of such mandates varies and enforcement has historically been lax. Workarounds — such as burying operating expenses in off-budget capital programs — are common.

In many instances, these requirements also apply to jurisdictions within states — cities, counties, towns, water districts and school districts — but enforcement is often lax or requirements are worded in ways that provide too many "outs" for public officials. For example, in many cases the budget plan submitted for approval by the legislature must be balanced but it is acceptable for actual performance to fail to achieve this.

There is a fundamental problem with financial reporting standards that apply to state and local governmental units. Many or most balanced budget requirements define "balanced budget" in terms of "fund accounting" financial statements and practices. Thus, these governments can — and do — proudly announce the attainment of balanced budgets. But they also ignore long-term obligations such as post-retirement benefits and publicly issued debt that are scheduled to come due more than a year after the current reporting date.

Taxpayers (and their descendants) in countless municipal jurisdictions now face a choice between accepting higher taxes or abrogating pensions and other obligations to public employees.

The disparity between the nominally balanced (or even surplus-showing) current year results and true economic performance is enormous and continues to grow.

For example, the dire circumstances in Chicago and Illinois more generally are due not merely to politicians' cynical, self-serving, win-the-next-election-focused behavior. Such behavior is traditional; it is expected and generally tolerated by voters.

Accounting rule-setters have failed to impose standards that would unambiguously disclose the consequences of such behavior in time to educate the taxpayers and, if needed, force change to avert the looming disasters on many municipalities' fiscal horizons.

Many elected leaders won't disclose what might be career-ending truths to voters unless they are absolutely required to do so. The first step in changing their behavior is to end the myopic distortions wrought by slavish adherence to the principles of fund accounting.

A parallel necessity for private enterprise reporting is to completely eliminate any practices that attempt to "smooth" apparent entity performance.

A second step would be to lobby for changes to balanced budget requirements, where they exist, so that they explicitly relate to full-accrual GAAP-basis financial statements, and not just to budgetary promises or partial-accrual fund accounting financial statements.

A third step is to seek balanced budget mandates in jurisdictions that do not have them. This is largely a political question, and not one about which accounting can speak with any authority.

In an ideal world, public servants and political leaders would all act responsibly, serving the interests of taxpaying constituents in both the near term and over the longer horizon.

Experience shows that this is often not the case. Whether they know it or not, taxpayers (and their descendants) in countless municipal jurisdictions now face a choice between accepting higher taxes and the possibly unconstitutional, and certainly painful, abrogation of pension and other obligations to teachers and other public employees.[8]

These past failures will have to be paid for. It will be distressing, but future fiscal disasters should be averted by making necessary changes to both governmental and commercial GAAP to ensure that reports on entities' financial positions and results of operations reveal economic reality, so decision-makers can make wiser choices.

NOTES

[1] Most recently, in March, Chicago's credit rating was dropped to near-junk level by Fitch; it had already been set at junk level by Moody's. The city's $20 billion unfunded pension obligations were cited as a major cause for both actions. Meanwhile, Illinois continues its multi-year status as the state having the nation's lowest credit rating, becoming the first state earning a rating below single-A from Moody's, with unfunded pensions again being a major contributing reason.

[2] Although most municipalities now have stable rating outlooks thanks to the economic recovery post-2008, the aggregate of unfunded obligations exceeds $1 trillion. Most of this total has never been adequately acknowledged in municipal entities' financial statements, but it will have to somehow be financed from future taxes and borrowings.

[3] The Pension Benefit Guaranty Corp., created by the Employee Retirement Income Security Act of 1974, 29 U.S.C.A. § 1001, is required to assume defined benefit pension obligations of private sector plans when companies go bankrupt.

[4] FASB Statement No. 87, issued in 1985, and supplemented, revised and interpreted several times since then, sets the current rules on post-retirement benefit plan accounting by plan sponsors (employers). FASB Statement No. 112, issued in 1992, sets the requirements for post-retirement benefits other than pensions (mainly retiree health care plans) for employers.

[5] GASB Statement No. 34, issued in 1999, mandated "full GAAP" reporting (which reveals actual deficit financial positions) but also carried forward the decades-old predominant practice of "fund accounting" showing only current resources and uses of resources. Almost all state and local governmental officials cite "fund accounting" in their self-congratulatory pronouncements about their budget-balancing achievements.

[6] To illustrate, on a strict GAAP (full accrual, entity-wide financial reporting) basis, the city of New York ended fiscal 2015 with almost $181 billion of accumulated deficits. Nevertheless, using the more expansive definition of GAAP permitted under the implementation guidance for GASB Statement No. 34, the city could report an accumulated deficit of only $2.9 billion in its fund-basis financial statements. Much of this difference is explained by future obligations for pensions (almost $47 billion) and other post-employment benefits (over $89 billion), neither of which had been recognized as expenses in the statements of revenues, expenditures and fund balances — notwithstanding the fact that they pertained to past services provided by workers.

[7] Gov't Accounting Standards Bd., Why Governmental Accounting and Financial Reporting Is — and Should be — Different (2013). Note that GASB standards only govern state and local governmental accounting. The federal government uses other principles, which even many trained financial professionals find to be truly unfathomable — so much so that some federal agencies are denied "clean" audit opinions by the Government Accountability Office, which is required to examine their financial reports annually.

[8] In the final analysis, politicians will more likely offer their constituents the "Hobson's choice" of higher taxes, period — and, if possible, blame their predecessors in office and court-imposed restrictions on changes to employee benefit plans.

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