**CALIFORNIA BUDGET WOES AND CHIMERICAL PENSION BELIEFS: GASB COULD HELP IF IT HAD THE WILL**

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***Grumpy Old Accountants, July 2012***

California is getting a lot of press these days about its awful budget situation, most of which has been self-inflicted. Boskin and Cogan refer to California’s problems as “[Casino Budgeting](http://online.wsj.com/article/SB10001424052702304707604577428364256150418.html?KEYWORDS=california+pension).” They observe the reluctance of Governor Jerry Brown and other state politicians to impose real reforms, relying instead on increasing tax rates, accounting gimmicks, and gambling that Silicon Valley will generate lots more taxable income. Given the lack of political will to solve its problems, California has the lowest bond rating of any state, and is ranked the worst state for its business climate.

While there are many facets of this crisis, we shall focus on some fanciful notions that state leaders have about pensions. In a recent USC Dornsife/Los Angeles Times poll, [California voters said they do not blame workers for the pension woes](http://latimesblogs.latimes.com/california-politics/2012/03/la-times-poll-california-pension.html). We don’t either, but we do blame the so-called “leaders” of the state who either do not realize, or have not realized until recently, that the state’s economy cannot sustain all of the entitlement promises it has made. California simply does not have the resources to pay the pensions it has promised to workers.

An analogy might help. We Grumpy Old Accountants can promise our children an inheritance of at least one billion dollars each. If we did, what actions would our children take? Would they rush to purchase expensive cars, houses, jewelry, and travel to exotic places? Probably not as we doubt that they are so naïve to act on that rash promise because it would only redound to their hurt. They realize that their dads just aren’t that rich…after all, they are merely accounting professors! In a similar fashion, we would hope that California citizens would grasp the reality of the state’s economics, and act accordingly.

So where does accounting enter into all of this? The Governmental Accounting Standards Board (GASB), the source for state and local government GAAP, could actually make a positive contribution to solving this pension dilemma, if so inclined. While GASB Statement No. 50 requires a computation of the projected pension obligation incurred by a governmental unit, it only calls for *disclosure*. If the GASB required that the pension liability number be actually included in the balance sheet (as required for corporate entities), the impact on human behavior potentially could be significant. The media presumably would report the “real” balance sheets and pension liabilities, the voters might better understand the economic reality of the position they are really in, and politicians could no longer pretend that a problem does not exist since liabilities clearly would dwarf available assets.

This state of affairs reminds us of an interesting court case to which we helped draft two amicus letters, and were signatories. Unfortunately, the courts were zealously legalistic and economically blind.

In December 2001 the former Orange County Board of Supervisors, among other things, voted to increase the retirement benefits from 2% to 3% of annual compensation multiplied by the total years of service if the employee retired at age 50 or over. This pension benefit enhancement was applied to all years of service, both past and future. The cost was estimated to be $100 million, but this cost has grown to at least $187 million. The current Board of Supervisors for Orange County decided to sue the Board of Retirement of the Orange County Employees Retirement System and the Association of Orange County Deputy Sheriffs because they believed that the state constitution required taxpayer approval of the proposed retirement benefit increase.

This pension benefit enhancement was applied to all years of service, both past and present. The change that applies to future years of service will give rise to an accounting liability if and when the employee has earned that additional benefit by providing future years of service—a fact not contested in this case. On the other hand, the nature of the benefit enhancement as it applies to past years of service was contested.

The argument was straight-forward. The increase to pension benefits is a liability that must be paid for in future years. ***Incurring such liabilities may take place only if the taxpayers approve.*** Taxpayers were not given a chance to vote on this increase to liabilities brought about by the pension enhancement, so the pension increase should be nullified by the courts. The defendants argued that the increase to pension benefits is not a liability, and so there is no constitutional violation.

The court tossed out the case, accepting the arguments by the defendants. Orange County appealed the case, but the Second Appellate District Court of Appeal sided with the defense. Orange County then appealed to the California State Supreme Court, again claiming the pension benefit enhancement is a pension liability. The Supreme Court sided with the defense.

At both levels of appeals, a group of academics and practitioners wrote an amicus letter. The group also included a former member of the FASB and past SEC Chief Accountant. The argument was rather simple, saying that a promise to pay more in the future of course meets the definition of a liability. Both appellate courts tossed out this argument by focusing on the fact that GASB Statement No. 50 does not put this amount on the balance sheet, arguing that if the GASB does not require recognition on the government’s balance sheet, then it must not be a liability.

The Orange County case is surreal. On the one hand, the case is simple because the economics of pensions clearly demonstrate the creation of a liability that must be borne by the county. On the other hand, the court decisions are disturbing because they have tamped down economic reality by politicizing the issues and allowing irresponsible politicians to create huge liabilities that possess the potential to destroy state and county economies. Unfortunately, ignoring the economic reality of pension liabilities does not make them go away.

The lead attorney for the defense in the Orange County case was Jerry Brown. He ignored the economics when he claimed that the obligation was not a true liability. That historical fact may help explain his irrational pension decisions as California governor.

In the mean time, we hope that members of the GASB start thinking like the cowardly lion in *The Wizard of Oz*. They clearly need courage to stand up and require governmental entities to tell the truth in their financial reports.

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*