

# ***Federal & Municipal Financial Reporting are Rigged!: Is the SEC's Acquiescence the Lynchpin?***

**“A Nation cannot plunder its own treasury without putting its Constitution and its survival in peril.”** *Justice Anthony M. Kennedy*

## **Memorandum to:**

*Federal Accounting Standards Advisory Board,  
Legislative Branch*

*Speaker of the House of Representatives Paul Ryan,  
House Minority Leader Nancy Pelosi,  
Senate Majority Leader Mitch McConnell,  
Senate Minority Leader Charles Schumer,  
Senator Elizabeth Warren,  
All Other Members of Congress,  
Comptroller General Gene Dodaro,*

*Executive Branch Officers including the President-elect and Vice President-elect and Selected Officials of Agencies of the Federal Government*

*President-elect Donald Trump  
Vice President-elect Michael Pence  
Secretary of the Treasury Nominee, Steven Mnuchin,  
Secretary of Commerce Nominee, Wilbur Ross, Jr.,  
Secretary of Defense Nominee, retired Marine General James Mattis  
Director of the Office of Management and Budget Nominee Congressman Mick Mulvaney,  
Commissioner of the Securities and Exchange Commission, Michael Piwowar  
Commissioner of the Securities and Exchange Commission, Kara Stein  
Chief Accountant of the Securities and Exchange Commission Wesley R. Bricker,  
Chair of the Board of Governors of the Federal Reserve System, Janet Yellen  
All Other Governors of the Federal Reserve System  
U.S. Attorney for the Southern District Preet Bharara,  
Office of Legal Counsel Principal Deputy Assistant Attorney General Karl Thompson,  
Director of the Federal Bureau of Investigation James Comey,*

*Judicial Branch*

*Chief Justice and Associate Justices of the Supreme Court of the United States,  
All Judges of the United States Court of Appeals  
All Judges of the United States District Courts  
All Judges of the United States Court of Federal Claims  
Chief Judge of the U.S. District Court for the Southern District of New York Loretta Preska,*

*State Courts*

*Judges of the Highest Courts of All Fifty States*

*State Governments*

*Governors of All Fifty States, Puerto Rico and Other U.S. Possessions,  
Legislatures of All Fifty States, Puerto Rico and Other U.S. Possessions,  
Attorneys General of All Fifty States, Puerto Rico and Other U.S. Possessions*

*Accounting Profession*

*Board of Trustees of the Financial Accounting Foundation,  
Board of Directors of the American Institute of Certified Public Accountants,  
Governmental Accounting Standards Board,  
General Counsel and Outside Counsel of All Accounting Firms,*

*Media and the Ratings Agencies*

*The New York Times, Wall Street Journal, Washington Post and All Other Media  
General Counsel and Outside Counsel of All Ratings Agencies*

**Joseph H. Marren, J.D., MBA, CPA (Inactive),  
Concerned Citizen  
January 6, 2017**

Notes: The views expressed by Mr. Marren do not represent the views of KStone Partners LLC or any of its other Members. The approach and discussion in this memorandum supersedes all prior publications by the author. End notes for this "working draft" document have not been completed.



*This memorandum is dedicated*

*To my brother David Stack Marren*

*In 2007 Dave was diagnosed with a rare neurological disease*

*Primary Lateral Sclerosis (“PLS”)*

*Readers that find this memorandum helpful or informative are urged to make a tax-deductible donation to fund PLS research at Columbia University Medical Center. Please make checks payable to “The Trustees of Columbia University” and indicate “David S. Marren PLS Research Fund” in the check’s memo line and mail to:*

*Columbia University Medical Center*

*Office of Development – attn: Matt Reals*

*100 Haven Avenue, Suite 29D*

*New York, NY 10032*

*And*

*To the memory of my father*

*Bernard Dominic Marren, JD, CPA,*

*a former Special Agent of the Federal Bureau of Investigation,*

*a graduate of Fordham University and*

*Fordham University School of Law*



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## A. Appeals to:

### a. **Commissioners of the Securities and Exchange Commission: It is Time for a Different Approach in the Municipal Securities Market**

The SEC Chair boasts in two recent speeches about the substantial strides made in enforcement in the municipal securities market since she took office. Based on the facts the author must acknowledge that Chair White has apparently done more to enforce the securities laws in the municipal securities market than all of her predecessors combined. Yet the SEC's efforts have come up woefully short of having the SEC achieve its stated mission in the municipal securities market.

In football there is an old saying that "You are what your record says you are!" The author is introducing a new metric for the SEC to evaluate its performance relative to its stated mission. It is the SEC's won/loss record with respect to whether or not the fifty states have published financial statements that can pass antifraud provision review. Based on this metric and Chair Mary Jo White's approximate four-year term her won/loss record is 0 Wins and 200 losses (50 states x 4 years). The next Chair of the SEC has to improve on that record.

Albert Einstein said that "Insanity is doing the same thing over and over again and expecting different results." It is time for the SEC to take a hard look in the mirror and come to the conclusion that it has to take a different approach in the municipal securities market to have a chance to succeed at fulfilling its stated mission.

The way forward for the SEC is to abandon its strategy of hope. It needs to interpret the U.S. Constitution's Article I, section 9, clause 7. In addition, it must repudiate its relationship with the GASB, and institute enforcement actions against the fifty states for their fraudulent reporting with respect to the Medicaid program and one or more selected high profile targets that use non-consolidated off-balance sheet vehicles to hide massive spending and legal obligations. It should consider working with U.S. Attorneys and state AG's to prosecute people and entities involved with perpetrating the massive frauds on the American people in the municipal securities market. The SEC might be astonished at the grass roots support that taking these actions would engender. Not surprisingly, this strategy would be highly unpopular in Congress. Thus, the SEC has to decide whether it wants to accomplish its mission or keep Congress happy. If it decides to keep Congress happy then it had better stop claiming that it is an independent agency.

#### **Shining a Bright Light on the SEC**

Louis Brandeis, whose ideas were a major influence on disclosure philosophy of securities regulation, stated "publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."<sup>1</sup>

The SEC has always indicated that it seeks input from investors and others on ways to improve. This commentary may test the limits of the SEC's ability to take constructive criticism as the author points out the several serious mistakes have been made with respect to regulation of the municipal securities market. For example, on the SEC's website there is a page describing "What We Do" that contains a list of "The Laws That Govern the Securities Industry." Unfortunately and prophetically,

the SEC does not list the United States Constitution as one of those laws....so the SEC's problems start with the most basic of issues.

Some may ask the question: Why raise the issue now? The answer is simple. Several years ago the author discussed with a senior SEC attorney (name available to the SEC upon request) the issue of improper accounting by states for the Medicaid program. He said that the issue had been discussed at the highest levels and that it was clear that it would take a change in administration for the SEC to tackle the problem.

### **SEC's Stated Mission Must Include Enforcing the U.S. Constitution**

It is the author's contention that the SEC can and should interpret the antifraud provisions as being inherent in the Statement and Account Clause of the United States Constitution. A government "of the people, by the people and for the people" with an explicit provision in its constitution requiring the publication of a Statement and Account of the Receipts and Expenditures of all public Money does not need an antifraud amendment to that constitution requiring the federal government to publish truthful figures. To a certain extent Congress recognized the importance of the antifraud provisions by making the issuance of municipal securities subject to them.

The right to financial information described in the Statement and Account Clause is no different than other textually enumerated rights contained in the Bill of Rights. The SEC should interpret the Fourteenth Amendment as incorporating the right to financial information. If the SEC so interprets the Constitution all states, cities and local governments would have to comply with the Statement and Account Clause which requires proper reporting of total receipts, total expenditures and the resulting surplus or deficit in a single Statement and Account. These figures must include "all public money." The off-balance sheet vehicles that are extensively used by state, city and local governments to mislead their respective electorates would need to be consolidated into one set of financial statements at each level of government. Assuming that the Constitution is interpreted in this manner many of the GASB's accounting pronouncements would be unconstitutional. Several already violate the antifraud provisions.

### **Why is the SEC's Mission Failure So Important to the Nation?**

The failure of the SEC to take on Congress over fraudulent accounting in the municipal securities market has implications far beyond that market. Why? Because the financial statements issued by state, city and local governments serve the dual purpose of informing investors and citizens/voters about how politicians are spending taxpayers' money. The unintended consequence of the SEC's failure is that all federal and state financial reporting is rigged. The failures of federal and state governments to publish complete and truthful statements and accounts of the federal government's and the fifty states' finances has made our republic dysfunctional, plagued by successive budget-deficit and debt-ceiling crises and headed towards financial Armageddon.

The failure of the SEC to go after the illegal structure of accounting standard setting in the municipal securities market has led to Congress setting up the same corrupt structure for federal financial reporting. If the SEC did its job and actually accomplished its mission of protecting investors in the municipal securities market this would expose Congress' corrupt practices at the federal level. Due to the failure of the SEC to aggressively pursue its stated mission, the GASB and FASAB are increasingly coordinating their accounting principles and standards to the detriment of investors and citizens/voters/taxpayers.



In addition it can be argued that the SEC determined the outcome of two recent Supreme Court decisions relating to the Affordable Care Act due to its decision not to go after improper state accounting for Medicaid. SCOTUS' decisions in the Obamacare cases were effectively based on fraudulent state financial information that did not reveal the extent of expenditures or the net present value of future legal obligations related to the Medicaid program. The SEC's decision not to prosecute improper state accounting for Medicaid stands in stark contrast to its prosecution of the states of New Jersey, Illinois and Kansas for the publication of fraudulent financial information related to pension obligations.

Furthermore, the SEC's conscious decision not to enforce the antifraud provisions as they relate to financial reporting by state governments regarding their participation in the Medicaid program produces a perpetual fraud on the federal and state judiciaries. Not surprisingly, the SEC's decision to pursue the pension obligation investigations came at the behest of a Congress that did not want the pension underfunding issue to end up on its doorstep.

If the fifty states as well as many city and local governments are committing fraud in publishing their financial statements how can the electorate of these jurisdictions be the informed voters that our Constitution requires?

### **Reality: Pervasive Fraud While the SEC Rearranges Deck Chairs on the Titanic**

The unfortunate truth is that every states' financial statements are fraudulent as a matter of law and many city and local governments' financial statements are fraudulent as a matter of law.

The U.S. Supreme Court in *TSC Industries v. Northway* held that a fact is material if there is a substantial likelihood that a reasonable shareholder could consider it important in deciding how to vote. Based on the \$27.3 trillion obligation reported in the 2015 Financial Report of the U.S. Government for the federal government's portion of Medicaid's costs, the fifty states have an aggregate net present value obligation for their portion of the Medicaid program of approximately \$17 trillion. The states' obligation is over four times the size of the entire municipal securities market and it is clearly material under the Supreme Court's definition. At Congress' suggestion in the Dodd-Frank Wall Street Reform and Consumer Protection Act's section 978 the SEC is providing funding for the Governmental Accounting Standards Board (GASB). It promulgated Statement No. 33 – Accounting and Financial Reporting for Nonexchange Transactions in 1998 which requires each state for periods beginning after June 15, 2000 to not recognize any costs or liability other than current year cash outlays or provide any additional disclosures for their Medicaid program. This accounting pronouncement requires accounting for the Medicaid program that violates the antifraud provisions as a matter of law.

Notwithstanding the SEC's success in prosecuting fraudulent disclosure of pension obligations it has taken no action with respect to states' fraudulent financial reporting for their portion of the Medicaid program. Why? One can speculate that pulling on that thread would end up exposing Congress' fraudulent financial reporting for Medicare, Social Security and Medicaid at the federal level. In addition, it would expose the integral role that the accounting profession has played in the federal and state frauds. Neither of these outcomes are things that Congress wants to become public.

State, city and local governments use of off-balance sheet vehicles to obfuscate spending as well as the size of their legal obligations rival Enron's fraudulent accounting.

## **Stop Sweeping the Problems Under the Rug**

Given the facts the SEC should either pursue the strategy proposed herein or publicly state that it has not fulfilled and cannot fulfill its stated mission of protecting investors in the municipal securities market. By way of contrast if a publicly traded company had been publishing fraudulent financial statements the SEC would require the company to disclose that it was under investigation, withdraw its prior fraudulent financial statements and disclose what steps it is taking to publish correct financial statements assuming the company was still a going concern.

The leadership's bravado about its accomplishments as well as its failure to use the bully pulpit to warn investors of the fraudulent disclosure by municipal issuers do a great disservice to investors as well as to the SEC's stated mission for the municipal securities market. The average investor is unaware of the serious and legitimate concerns about fraudulent disclosures.

## **Why has this Happened?**

Simply put, Congress does not want issuers in the municipal securities market held to any accounting standard that politicians do not effectively control. Their worst nightmare is that issuers would have to meet a clearly defined set of accounting principles and standards that did not provide substantial wiggle room for normal political shenanigans. Most importantly, Congress does not want to force issuers to tell citizens/voters exactly how much they have been spending. They prefer the current arrangements whereby financial statements substantially understate spending. The Tower Amendment makes Congress' position crystal clear. Congress does not want honest accounting in the municipal market now or anytime soon.

Congress did not give SEC control over accounting standards in 1933 or since despite the SEC asking for such authority repeatedly. Is this likely to change? No! A former Lt. Gov. of New York Richard Ravitch acknowledged a few years ago that requiring more disclosures ahead of sales "would be unpopular for mayors and governors and the municipal bond industry but that investors would appreciate the change. In addition, he indicated that he was unaware of any interest in Congress to revisit the Tower amendment. In October 2014 the National Association of State Treasurers readopted a resolution that opposes repealing or modifying the Tower amendment.

Finally, Congress has limited funding for the SEC so that they have minimal resources to go after the municipal securities market for antifraud violations. Does anyone think that this fact is lost on any Commissioner? The soon to be former Commissioner Mary Jo White has been the most aggressive Chair in the history of the SEC in going after abuses in the municipal securities market. To extend her reach she and her Director of Enforcement dreamed up the Municipalities Continuing Disclosure Cooperation Initiative ("MCDC"). One of the likely reasons they decided on this approach was lack of resources. Given the SEC's limited resources it would be best served in putting these resources against the two most important issues in the municipal market: accounting for Medicaid and the use of off-balance sheet vehicles to disguise spending and the size of legal obligations.

## **SEC Has Helped Create a Corrupt Environment**

We will start with the most fundamental issue. The financial statements produced for investors by each state serve double duty as disclosure to citizens/voters/taxpayers in each state with respect to political accountability for their politicians spending. The SEC is well aware of the dual role played

by issuers' financial statements. Therefore, there is no denying that Commissioners know that financial statements are a critical scorecard in our democracy.

The following quote is taken from the "State of the Municipal Securities Market."

*"As of December 2010, 38 states compel some or all of their political subdivisions, including counties, cities, and school districts, to prepare their financial reports in accordance with GASB standards."*

At this juncture it is important to highlight part of Justice Alito's concurring opinion in *Lebron v. National Passenger Corp.*

*"Liberty requires accountability. When citizens cannot readily identify the source of legislation or regulation that affects their lives, Government officials can wield power without owing up to the consequences. One way the Government can regulate without accountability is by passing off a Government operation as an independent private concern....The principle that Congress cannot delegate away its vested power exists is to protect liberty."*

While it is true that Justice Alito was discussing the federal government in his opinion his statement holds equally true for each state. A state government cannot give a private entity composed of unelected officials' lawmaking authority without substantial oversight or state review of the entity's pronouncements. Based on a review of the governing documents for the AICPA, FAF and GASB there is none by any of the 38 states! Therefore, the current delegation of lawmaking authority over their financial statements by the 38 states is as Justice Alito described:

*"When it comes to private entities, however, there is not even a fig leaf of constitutional justification. Private entities are not vested with 'legislative Powers.'" Art. I sec. 1. Nor are they vested with the "executive Power," Art II, sec 1, cl 1, which belongs to the President.....By any measure, handing off regulatory power to a private entity is "legislative delegation in its most obnoxious form." Carter v. Carter Coal Co., 298 U.S. 238, 311 (1936)."*

It is noteworthy that 12 states that have not delegated lawmaking authority to the GASB. However, this raises another point that is not mentioned by the SEC in its 2012 report. Does the SEC have authority to regulate voluntary compliance by the states with the GASB's pronouncements? However, before addressing that issue it is important to remember that the AICPA has a mechanism in place that forces all certified public accountants that are AICPA members to comply with its Code of Professional Conduct. This effectively forces them to comply with the GASB's pronouncements. Furthermore, while the SEC does not currently have the authority to require municipal issuers to obtain audit opinions the marketplace does. The marketplace requires audited financials for the vast majority of municipal security issuers, particularly the larger ones.

The SEC has the power to declare accounting principles and standards that have been promulgated by GASB and implemented by issuers as violating the antifraud provisions. But does the SEC have the power to go after the GASB for promulgating accounting principles and standards that violate the antifraud provisions? That question is outside the scope of this memorandum.

The SEC's involvement with the GASB has been much more pernicious than just not attacking its unlawful and unconstitutional pronouncements. It actively lobbied Congress to fund the GASB. This is evidenced by several references in speeches made by Commissioners. Moreover, the SEC

succeeded in its efforts to get funding. Enforcement of unconstitutional and fraudulent accounting principles and standards through the AICPA's rules of Professional Conduct is not "voluntary" when the SEC is funding GASB.

The SEC is desperately trying to create the same setup that it has in the corporate sector in the municipal securities market. However, it has failed to date and facts suggest it will continue to fail to achieve that goal because Congress has not and in all likelihood will not give the SEC the requisite authority. One has only to review the numerous recommendations in various speeches by SEC Commissioners and the Report on the Municipal Securities Market to know that this is true. The SEC is also employing what most would describe as a workaround strategy. Since Congress has prevented the SEC from regulating issuers disclosure documents directly the SEC and MSRB have placed disclosure requirements on underwriters of municipal securities.

What the SEC has to do is to look in the mirror and acknowledge that HOPE IS NOT A STRATEGY to fulfill its mission of protecting investors. Once the SEC candidly and dispassionately assesses the state of affairs the SEC must come to the conclusion that it has helped create a corrupt environment through its involvement with the GASB. GASB is an unlawful, corrupt standards setter and some of its pronouncements require accounting standards that violate the antifraud provisions as a matter of law. This relationship needs to be terminated.

The current setup is ideal for politicians since they effectively control the GASB, and therefore, financial reporting. In addition, this setup is ideal for the accounting profession as it allows them to sell accounting opinions to issuers of municipal securities.

The SEC likes to talk about a culture of compliance in the corporate sector. Since the SEC's boss (Congress) has no interest in allowing the SEC to fulfill its stated mission the SEC needs to be very aggressive in finding a way to stop the corruption. Unless they aggressively try to stop corruption they are part of the problem and, arguably, part of a political cover-up.

### **The SEC Needs to "Walk the Walk"**

In a recent Wall Street Journal editorial former SEC Chairman Arthur Levitt chastised Senator Elizabeth Warren for calling for the dismissal of the current SEC Chairman Mary Jo White for failing to devise and enforce a rule that would require companies to disclose their political contributions. His article contained one clear truth and one incredible lie. The truthful comment was "Whenever financial regulation is determined by rank politics, the investing public suffers." The lie was "The SEC does not operate as a pass-through entity for Congress, merely following Congressional direction. Rather, it is an independent agency..."

The bottom line is that if Arthur Levitt wants to "talk the talk" about independence for the SEC he had to be willing and future SEC Chairs have to be willing to "walk the walk." Since he did not put fraudulent financial reporting by all states for the Medicaid program on his "Agenda" the investing public has suffered. Hopefully, the soon-to-be-appointed Chairman will do the right thing.

## **b. Speaker of the House Paul Ryan & Senate Majority Leader Mitch McConnell: How Will You Handle Your Responsibility?**

Primary responsibility for the fraudulent and unconstitutional financial reporting by the federal and state governments lies with you as well as certain senior finance officials. The question is how will you handle that responsibility?

James Madison was prescient with the following remark. “I believe that there are more instances of the abridgement of the freedom of the people by gradual and silent encroachments of those in power than by violent and sudden usurpations.”<sup>1</sup> Over the last 100 years, Congress has abdicated its financial reporting responsibility for the federal government. Today the executive branch dominates all financial reporting with little to no input from Congress. The President’s Budget is prepared by the Office of Management and Budget (“OMB”) without input from Congress, and the Financial Report of the United States Government is prepared by Treasury Department and OMB based on principles promulgated by the Federal Accounting Standards Advisory Board (“FASAB”). The Combined Statement of Receipts, Outlays and Balances presents “budget results and the cash-based assets and liabilities of the Federal Government...” Practically speaking, the executive branch has effective veto power over any proposed accounting principle it does not like. The end result is that financial reporting by the federal government does not come close to reflecting its economic reality.

The House provided by resolution in 1791 in the second session of the 1<sup>st</sup> Congress that:

*RESOLVED: that it shall be the duty of the Secretary of the Treasury to lay before the House of Representatives...an accurate statement and account of the receipts and expenditures of all public moneys...in which statement shall also be distinguished the expenditures which fall under each head of appropriation, and shall show the sums, if any, which remain unexpended, and to be accounted for the next statement of each and every of such appropriations.*

The only reasonable interpretation of Article I, Section 9, Clause 7 that is consistent with democratic principles is that Congress must publish financial statements that consolidate all entities that are funded with “public money.” These consolidated statements must include large controlled entities as well as the full cost of the nation’s social insurance programs (Medicare and Social Security) and Medicaid. The fact that Congress has put in place permanent appropriations for these programs makes it clear that the statement and account’s balance sheet must include the net present value cost of these programs and the “income statement” must include the expense associated with the annual increase or decrease in the net present value cost of these programs.

Despite the clarity of what is required the government continues to use the cash basis of accounting which it knows is substantially misleading, to prepare the Statement and Account and the President’s Budget. It does not accrue for the estimated \$127 trillion of entitlement obligations for which Congress has enacted permanent appropriations and it does not consolidate in its financial statements the Federal Reserve System, Fannie Mae and Freddie Mac, each a multi-trillion dollar enterprise.

The Supreme Court has not decided the meaning of the Statement and Account Clause. However, this has not stopped the federal government from relying on the Court’s dicta in the only case involving the clause to reach the Supreme Court to justify to the electorate their unconstitutional accounting practices.

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<sup>1</sup> THE WRITINGS OF JAMES MADISON 103 (Gaillard Hunt, ed. 1910).

In addition, Congress has created an environment that ensures that financial reporting in the municipal securities market is fraudulent. It has effectively directed that the Securities and Exchange Commission (“SEC”) fund the Governmental Accounting Standards Advisory Board, knowing that this generally-accepted accounting principles (“GAAP”) standards setter is a “private entity” created by the accounting industry that is not under meaningful control by either the federal or state governments. Justice Alito described this type of arrangement in a recent case as “*delegation in its most obnoxious form*.” Congress has given the SEC the power to enforce the antifraud provisions of the nation’s securities laws. However, it has prevented the SEC from promulgating accounting principles or standards for the municipal market and it has enacted the Tower Amendment to prevent the SEC from requiring the filing of disclosure documents prior to the sale of securities. As you are well aware there is no current appetite in Congress to change the Tower Amendment. The end result of Congress’ directives is that all fifty states publish financial statements that are fraudulent as a matter of law and many states, cities and local governments make extensive use of off-balance sheet vehicles that make a mockery of the concept of political accountability and clearly violate the antifraud provisions.

Congress has known for a very long time that its accounting standards setting process is unconstitutional. And states know that their accounting standards setting process is also unlawful. In addition, both the federal and state governments have actively worked to cover up their frauds. Not surprisingly, current arrangements permit federal and state politicians to disclaim any responsibility for federal and state financial reporting.

On August 30, 2016 Brazil's Senate voted to convict Brazil's President Dilma Rousseff on charges that she used improper accounting to cover-up a growing budget deficit and illegal loans from state-owned banks. A recent Wall Street Journal editorial remarked that millions of Americans are probably wondering why they cannot impeach Washington politicians for similar fiscal offenses. The fact that government financial reporting does not comply with Constitutional requirements means that a large number of our current and former politicians and senior finance officials have violated their oath<sup>2</sup> to uphold the Constitution and, arguably, they have committed “high crimes” described in our Constitution as providing a basis for their impeachment.

While Congress’ directives have severely reduced the effectiveness of the SEC in preventing fraud in the municipal market the SEC should interpret the U.S. Constitution and apply that interpretation to financial reporting by state, city and local governments. The most useful aspect of this approach is that it cannot be legislated away by Congress.

You should be aware that the implications for the accounting profession and its rule-making bodies for their role in the frauds may be much more serious. There is a real question as to whether current arrangements for accounting standards setting and auditing for the federal and/or state governments or any of their related entities rise to the level of being a “*criminal enterprise*” and a “*Political Protection Racket*” under the *RICO Act*. The author has addressed the issue to Director Comey and U.S. Attorney for the Southern District Bharara. In your political calculus you might determine that the accounting profession and its rule-making bodies are the perfect scapegoat!

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<sup>2</sup> Art. VI, sec 3 “Every state legislator and executive and judicial officer is solemnly committed by oath taken to support this Constitution.”

### **c. President-elect Trump and Vice President-elect Pence: Address the Problem and Do Not Kick the Can Down the Road**

Government accounting is the nation's deepest, darkest swamp and it must be drained. Most of us were taught growing up that it is always best to tell the truth and that not telling the truth can lead to very bad outcomes. The lack of truthfulness in financial reporting by federal, state, city and local governments has dire consequences. The problem must be addressed before it gets any worse.

First, it is important to acknowledge that primary responsibility for the financial accounting mess lies with Congress. However, prior Administrations, both Republican and Democrat have expanded the size and nature of the problem. The takeover of federal financial reporting by the Executive branch has led to financial reporting practices that are unconstitutional and fraudulent.

The fact that the United States Government's finances are in dire shape is not a new or novel concept. Politicians and senior finance professionals in the federal government have known that current policies are "unsustainable" for a very long time. In economic parlance this is described as the nation having a "structural deficit", which is a deficit that will widen no matter how the U.S. economy performs. This includes any faster GDP growth scenario for the nation or any scenario that attempts to eliminate all the government fraud, abuse and waste in its various programs. So, to be clear, no amount of success by the Trump administration in raising the nation's GDP growth rate will fix the problem.

#### **The Size of the Federal Government's Spending Problem**

Proper accounting would reveal federal government spending that is completely out of control. Over the last decade (2006-2015), using reported figures that are understated, incomplete estimates, the federal government spent almost \$63 trillion while it took in a little less than \$26 trillion. The government pretends that obligated money is not spent until the future arrives; a legally correct accounting must accrue for those future payments. The figures cited do not include the spending associated with material off-balance sheet entities such as the Federal Reserve System, Fannie Mae and Freddie Mac.

As you know the federal government's budget deficit does not include the multi-trillion dollar annual increases in the net present value of our Social Security, Medicare and Medicaid obligations. Everyone that has a credit card knows that the amount that you spent in any year is equal to the amount that you paid the credit card company plus or minus the increase or decrease in your year-end balance. The federal government conveniently ignores the second half of the calculation.

#### **The Federal and State Government's Legal Obligations are Enormous**

The net present value cost of the federal government's legal obligations that are funded with appropriations is approximately \$127 trillion.

The states' aggregate net present value obligation for the states' portion of the Medicaid program is approximately \$34 trillion. There is no disclosure in any state's financial reports about its net present value obligation for the Medicaid program. This means that every state's financial reports violate the antifraud provisions as a matter of law.

## **The Political Truth**

As a general rule no politician believes that financial disaster will hit on his or her watch. That is why they will always opt to kick the can down the road. Furthermore, no national politician who focuses on the cost of entitlements being “a problem” has any chance of winning an election. Therefore, not surprisingly, no politician has the required political will to fix the problem. However, a politician that campaigned as a Washington outsider with the slogan that he would “Make America Great Again!” must realize that he cannot achieve his objective if all that he does is continue to kick the can down the road.

## **The Presidential Election and the Pass Issued by the Media**

During the election season both major party candidates elected not to address the looming financial crises facing the federal and state governments. This is consistent with a global trend that a recent Wall Street Journal article noted. “Globally, the rise of political populism has pushed deficits down the list of priorities while elevating tax cuts and benefits for the working class.”

During the presidential campaign the media was willing to give both politicians a pass on this issue. They should not have done so. Why? The presidential election continued a lifetime tradition for citizens of casting their votes without the benefit of having access to an accurate and complete published account of the total receipts and expenditures of the U.S. Government. The federal government’s and all fifty states’ budget deficits and debt are exponentially higher than what they say that they are. None of the headline figures used as the basis of public discourse have any relevance to the true state of the federal or state governments’ finances.

## **The Time for Justice is Right Now!**

The ***Great Debaters*** was a movie released in 2007 directed and starring Denzel Washington, a Fordham University alumnus. It was a drama based on a true story of Melvin Tolson, a professor at Wiley College in Texas. In 1935 he inspired students to form the school’s first debate team which went on to challenge Harvard in the National Championship. There is a line delivered by Jurnee Smollett as Samantha Boone during a debate that rings true for the topic at hand. She says “the time for justice, the time for freedom and the time for equality is always, is always right now.”

## **Personal Note for Vice President-elect Pence**

I am the second oldest of Bernard and Ellen Marren’s seven children. My father’s father came to the United States around 1900 from the southwestern area of County Sligo.



#### **d. U.S. Supreme Court: A Society Built Upon Financial Fraud Cannot Last Long**

“A popular Government, without popular information, or the means of acquiring it, is but a Prologue to a Farce or a tragedy; or, perhaps both.”<sup>3</sup> We have reached the stage where federal and state financial reporting is both a farce and a tragedy. The legislation enacted by Congress that authorizes fraudulent reporting, as well as the actions by the executive branch usurping Congress’ financial reporting responsibilities, are clearly unconstitutional. The author is appealing to the United States Supreme Court to apply the rule of law and restore needed political accountability.

In a 2010 baseball game between the Detroit Tigers and the Cleveland Indians the Tigers pitcher Armando Galarraga nearly threw a perfect game. However, with two outs in the ninth inning an infield ground ball led the first base umpire to rule that the batter was safe at first base when, in fact, the throw by the infielder clearly beat the runner and he should have been called out. This story was and is important to professional baseball. There have been only twenty perfect games in over one hundred years of play. Hence, the stakes were very high with respect to the umpire’s decision and everyone in the stands that day and watching on television knew that important baseball history was unfolding before their eyes.

Now imagine the same fact pattern except that the first base umpire ruled after the throw to first base that a fan sitting in the centerfield bleacher seats interfered with the “fly ball” and that he was declaring that the batter had hit a home run. After the Cleveland Indian manager erupted in protest all of the umpires got together and talked it over and then confirmed that the first base umpire was indeed correct, there had been fan interference in centerfield and that the batter would be awarded a home run. Baseball fans everywhere would go crazy at the injustice imposed on the game by this umpiring crew. Yet the decision would stand.....at least until baseball initiated some version of instant replay to eliminate these type of injustices.

What in the world could this crazy story have anything to do with the nation’s terrible financial condition? Well imagine a circumstance where the United States Supreme Court was deciding a case (in actuality a number of cases) that required them to address certain provisions of the United States Constitution and yet they did not. It was the opinion of the Court that explicit provisions written in the Constitution could be ignored and that the Court could base their decision on the case at hand based upon their prior decisions or upon other provisions that they found more applicable or more to their liking....depending on your point of view. Furthermore, imagine that the case was just as critical to the functioning of our democracy as the perfect game scenario.

For those that think that the above scenario is implausible they should take note that in the over two hundred years of the Court’s existence it has never determined the meaning of the Statement and Account clause and how it interacts with the Appropriations Clause. Both clauses are found in Article I, section 9, clause 7. The memorandum will reveal why these clauses are some of the most critical in the Constitution in the context of political accountability.

The only real difference between the Supreme Court case and the perfect game is that the Tigers game was being watched by millions of American citizens who know and understand the rules of baseball. Hence the outrage by the people at the outcome in the Tigers ball game was instantaneous. The Supreme Court reasoning in this or for that matter any case is analyzed superficially by the media and then scrutinized by the legal community in a series of law review articles and conferences

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<sup>3</sup> THE WRITINGS OF JAMES MADISON 103 (Gaillard Hunt, ed. 1910).

targeted solely at the legal community. Since justices are appointed for life they are accountable to no one except under the most egregious of circumstances....some might say like in this instance.

The nation's budget deficit and debt are exponentially higher than what the executive and legislative branches say that they are. None of the headline figures used as the basis of public discourse have any relevance to the true state of the United States' finances. The federal government's legal obligations exceed \$127 trillion, and are over seven times the size of the United States' estimated gross domestic product in 2015 (\$18.1 trillion) and thirty-eight times the size of the government's revenues of \$3.3 trillion in fiscal 2015. According to budget accounting over the last decade (fiscal 2006 through fiscal 2015) the federal government spent \$1.30 for every dollar of revenue that it took in. A more realistic accounting would show that the federal government spent \$2.46 for every dollar of revenue. Just to be clear about the size of the problem, over the last decade, using understated, incomplete estimates, the federal government spent almost \$63 trillion while it took in a little less than \$26 trillion.

Meanwhile financial reporting by all fifty states is also fraudulent based on reporting for its largest single program – Medicaid. The author's estimate of the aggregate net present value obligation for all fifty states, Washington D.C. and U.S. territories including Puerto Rico, for their portion of the Medicaid program is approximately \$34.1 trillion. No state records their portion of this obligation in its balance sheet and the disclosure regarding the size of each state's obligation is non-existent. Furthermore, no state properly records the annual increase or decrease in the net present value obligation in its income statement. Many states, cities and local governments also have other material off balance-sheet operations that obfuscate their spending and liabilities in violation of the United States Constitution.

The federal and state government's accounting practices are designed to deceive the people. Congress, the executive and the states have lowered the bar for financial reporting to a level where fraudulent financial reporting has become the norm for an extended period of time. The fraud has become so comfortable for our politicians that they cannot recognize the depths to which they have taken our nation.

There is no financial report published by the federal government that reflects the nation's economic reality including the President's Budget, The Financial Report of the United States Government or the "official" statement and account, the Combined Statement of Receipts, Outlays and Balances. Since no report complies several private rights protected by our Constitution have been violated. The rights violated include the right to vote, freedom of speech, due process, equal protection, the right to financial information and political accountability. In addition, these rights have been violated by the states. States have violated the right to vote under the Fifteenth Amendment and the other rights have been violated pursuant to their incorporation under the Fourteenth Amendment.

The primary reason why citizen's rights have been infringed upon is that the legislative and executive branches and state legislatures have controlled financial reporting and thereby public opinion to minimize their accountability for spending. They have spent enormous sums of taxed and borrowed money to endear themselves to the electorate, but they do not want to be held accountable for the full extent of their spending. Hence, the legislative and executive branches and state governments underreport expenses. Proper reporting would lead to spending cutbacks, tax increases and/or recriminations for overspending, all of which are likely to cause voter dissatisfaction and changes at the polls.

The executive and legislative branches have violated the trust placed in them by the electorate, acted in a self-serving manner to the detriment of the ideals on which America was founded, subverted the democratic process and brought the nation to the brink of financial Armageddon. The failure to publish a complete and truthful statement and account of the nation's finances has made our republic dysfunctional, plagued by successive budget-deficit and debt-ceiling crisis.

Just as fear and greed are the primary motivators on Wall Street, they heavily influence actions of our political leaders. To date, there have been no downside implications for the legislative and executive branches and state governments for unconstitutional and fraudulent financial reporting. Fear of severe negative career consequences needs to be introduced into our leader's political calculus.

To date, the Supreme Court has failed to properly exercise its duty to interpret the Constitution of the United States by ignoring or misinterpreting certain key provisions of the Constitution. Just as the instant replay in the Tigers game showed what the correct call should have been, this memorandum carefully reviews applicable decisions by the Court and how they were erroneously decided based on incorrect facts or inapplicable provisions of the Constitution.

For those Justices that think the above description is both obnoxious and untrue ask yourself whether the federal and state governments putting forth their cash-based financials in the Obamacare litigation (Medicaid issue) was adequate or fair financial disclosure for the Supreme Court. The federal government failed to point out to the Court that its portion of the net present value cost of Medicaid was \$24 trillion in 2010, post passage of the ACA. This compares to a total amount of federal debt securities held by the public and accrued interest as of September 30, 2010 of approximately \$9 trillion. It had never published a figure defining the net present value cost prior to 2010, despite the program being around since the 1960s. Meanwhile the states put forth no number in the case as one does not exist in any state government's financial statements. This despite the fact that since Medicaid is effectively a joint venture between the federal and state governments with costs shared at that time roughly 57%/43%. At the time of the litigation, the state's net present value cost for its portion of Medicaid based on the published federal government's figure was approximately \$19 trillion. These facts justify the Court declaring a fraud on it under Rule 60 of the Federal Rules of Civil Procedure.

There is a second explanation for the Supreme Court's lack of wisdom with respect to the nation's deficient financial reporting. The explanation is the "Warren Buffet Rule". If you have been sitting at the card table for more than twenty minutes and you haven't figured out who the patsy is, you are the patsy. The decisions where the Supreme Court's wisdom has been most deficient have been in cases involving one or both of the other branches of government. In these instances the question can be appropriately asked....should the Court have shown deference to another branch of government? Or does showing deference actually make the Court the other branches' "patsy"? Arguably, for the last century the Court has been sitting at the table with the two other branches of government and it has not figured out that it is the patsy. The Court has options for dealing with this issue but they must first recognize that they have a problem.

Let's take a look at a quote by President Woodrow Wilson in 1903.

"No living thing can have its organs offset against each other as checks, and live," he declared. "There can be no successful government without leadership or without the intimate, almost instinctive, coordination of the organs of life and action."<sup>4</sup>

So with this kind of approach do you think President Wilson or any subsequent president espousing this same philosophy would have any constitutional qualms about doing whatever he wants to get the outcome he wants? Is this really a branch that the Court should show deference to?

President George W. Bush once made a joke that hits all too close to home...and hence is funny.

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<sup>4</sup> Woodrow Wilson, *Congressional Government: A Study in American Politics* (Baltimore: John Hopkins University Press, 1981; orig. ed., 1885), pp. 27, 215.

“my political philosophy is based on the premise that you can fool some of the people all the time – and I intend to concentrate on those people.”

The truly ironic part of the story is that with both the executive and legislative branches hopelessly corrupted over the issue of proper accounting for government spending, the judicial branch is the only branch capable of fixing the nation’s financial dilemma.

The author has struggled with the right tone for this appeal and this memorandum. There are some that will think that I have adopted a tone that shows lack of respect for the Court. In the end I opted for telling the unvarnished truth, as I see it, about all three branches of the federal government as well as state, city and local governments. While it may appear audacious to point out their lack of adherence to the Constitution, it is done with the intention of leading the Supreme Court to restore the rule of law and get the federal government to adhere to the directives of the Constitution.

### **The Author’s Hope**

As a graduate of Fordham Law School I hope that you will judge this memorandum as consistent with the Jesuit tradition of searching for the truth in the world, even if that truth is not what you want to find.

**e. Director of the Federal Bureau of Investigation, James Comey and U.S. Attorney for the Southern District of New York, Preet Bharara: Is There a RICO Violation?**

I am writing to follow up a letter I sent to you on April 1, 2016. Enclosed with the April letter was a copy of a memorandum dated March 2016 that I had submitted to the Federal Accounting Standards Advisory Board ("FASAB") in Washington DC in response to their request for comment letters regarding their "Insurance Programs" Exposure Draft. In the memo I had raised the question as to whether current arrangements in the accounting profession rose to the level of being a "criminal enterprise" and a "Political Protection Racket" under the RICO Act. At the time I believed and I still believe today that this question merits some scrutiny by the Federal Bureau of Investigation and the U.S. Attorney's office. The memorandum "Federal and Municipal Financial Reporting are Rigged!: Is the SEC's Acquiescence the Lynchpin?" supersedes the memorandum sent to you previously.

I am available to answer any questions that you or your staff might have regarding this matter.



## **B. Letter to the Federal Accounting Standards Advisory Board**

It is important to begin by summarizing the two fundamental problems with the FASAB and its pronouncements. First, FASAB is an unconstitutional entity that does not have the legal authority to set accounting standards for the federal government. Second, FASAB's Sponsors (GAO, Treasury and OMB) and its Board members do not believe that they have to adhere to the rule of law. They believe that it is completely within their jurisdiction to decide what is economically relevant for the federal government to report and how that information should be reported. They do not believe that the United States Constitution places any meaningful restrictions on them.

### **FASAB is an Unconstitutional Entity**

In the inside cover of the *Exposure Draft* is a summary description of the Federal Accounting Standards Advisory Board. It is reprinted below.

#### **The Federal Accounting Standards Advisory Board**

The Secretary of the Treasury, the Director of the Office of Management and Budget (OMB), and the Comptroller General of the United States, established the Federal Accounting Standards Advisory Board (FASAB or "the Board") in October 1990. The FASAB is responsible for promulgating accounting standards for the United States Government. These standards are recognized as generally accepted accounting principles (GAAP) for the federal government.

An accounting standard is typically formulated initially as a proposal after considering the financial and budgetary information needs of citizens (including the news media, state and local legislators, analysts from private firms, academe, and elsewhere), Congress, federal executives, federal program managers, and other users of federal financial information. The proposed standards are published in an exposure draft for public comment. In some cases, a discussion memorandum, invitation for comment, or preliminary views document may be published before an exposure draft is published on a specific topic. A public hearing is sometimes held to receive oral comments in addition to written comments. The Board considers comments and decides whether to adopt the proposed standard with or without modification. After review by the three officials who sponsor the FASAB, the Board publishes adopted standards in a Statement of Federal Financial Accounting Standards. The Board follows a similar process for Statements of Federal Financial Accounting Concepts, which guide the Board in developing accounting standards and formulating the framework for federal accounting and reporting.

Summarized below are the major criticisms of FASAB that are contained in the memorandum.

- 1) FASAB is an unconstitutional entity. Under current law, the Comptroller General sets accounting principles and standards for the federal government. SCOTUS has determined that Congress cannot delegate lawmaking authority to a subsidiary of itself. Furthermore, the joint venture that the Comptroller General has entered into with the Treasury Department and OMB circumvents the requirement for separation of powers.
- 2) Even if FASAB is deemed to be a constitutionally approved entity the description of FASAB on the inside cover of the *Exposure Draft* is materially misleading as FASAB does not set accounting principles and standards for the federal government. FASAB as legally

constructed is an advisory board that makes recommendations to its sponsors. This ruse is material as it misleads investors in government securities and voters with respect to who is setting accounting policy for the federal government.

- 3) FASAB's process for promulgating accounting standards does not follow constitutional requirements for making policy that binds the nation.
- 4) FASAB's pronouncements violate the Appropriations and Statement and Account clauses of the United States Constitution.
- 5) FASAB's pronouncements violate the antifraud provisions of the nation's securities laws which the author believes the United States Supreme Court and the SEC will determine to be inherent in the Statement and Account Clause.
- 6) FASAB's pronouncements can be viewed as an overt attempt to cover-up the federal government's fraudulent and unconstitutional financial reporting practices.
- 7) FASAB's creation and continuing use of the Nonexchange Transactions category is perpetuated by the *Exposure Draft*. As described earlier in this memorandum Nonexchange Transactions have no basis in Appropriations law and represent an accounting fiction to massively reduce the size of the federal government's expenditures and legal obligations.

### ***Exposure Draft: Statement of Federal Financial Accounting Concepts***

The following are excerpts from the *Exposure Draft*:

#### **WHAT IS THE BOARD PROPOSING?**

This Statement proposes concepts discussing the role of financial statements and required supplementary information (RSI) and their relationship to other reported financial information (ORFI). The concepts also discuss 1) the content and presentation of financial statements and RSI for government-wide and component reporting entities, 2) the presentation of budgetary information in component reporting entity financial statements and RSI, 3) the presentation of performance information in financial statements and RSI, and 4) summary level information relating to financial statements and RSI.

#### **HOW WOULD THIS PROPOSAL IMPROVE FEDERAL FINANCIAL REPORTING AND CONTRIBUTE TO MEETING THE FEDERAL FINANCIAL REPORTING OBJECTIVES?**

The federal financial reporting community is making a wide range of data and information available to users and considering various types of presentations to help achieve the financial reporting objectives. For instance, reporting entities are developing summary performance and financial information reports to communicate their results for the reporting period and making data available for users to perform their own analyses. Considering the vast body of information available, users expressed the need to better understand the relationship between information required by generally accepted accounting principles (GAAP) and ORFI. Users also



need to better understand the relationship among the types of information GAAP requires, such as budget, cost, and performance information, and the relationship between GAAP-based information presented by the government-wide reporting entity and component reporting entities.

The proposed concepts would assist the Federal Accounting Standards Advisory Board, in developing reporting models for the government-wide and component reporting entities. The concepts focus on providing information to contribute to the achievement of the Operating Performance and Stewardship objectives of financial reporting and to support achieving the Budgetary Integrity objective. The concepts would also assist preparers and users in understanding the purposes of information required by GAAP and how this information relates to ORFI.

## PURPOSE

1. This Statement provides a platform to address current and evolving reporting needs and capabilities and discusses concepts to assist the Federal Accounting Standards Advisory Board (FASAB or “the Board”) in developing reporting models for the government-wide and component reporting entities. The proposed concepts will also assist preparers and users in understanding the purposes of information required by generally accepted accounting principles (GAAP) and how this information relates to other reported financial information (ORFI). Hereinafter, information required by GAAP will be referred to as financial statements and required supplementary information (RSI).

2. The proposed concepts will enhance the Board’s conceptual framework regarding

- a. the relationship between financial statements and RSI and ORFI contributing to the financial reporting objectives,
- b. the content and presentation of financial statements and RSI for government-wide and component reporting entities,
- c. the presentation of budgetary information in component reporting entity financial statements and RSI,
- d. the presentation of performance information in financial statements and RSI, and
- e. summary level information relating to financial statements and RSI.

3. The enhancements to the conceptual framework address users’ need to better understand the variety of information available and its relationship to financial statements and RSI. Since FASAB developed its earlier concepts statements, the range of data and information available to the public has evolved. This information includes reports that comprise financial statements and RSI, budgetary information, non-financial performance information, and information on systems and control.

## FASAB is Rewriting the U.S. Constitution's Article I, Section 9, Clause 7?

One of the Exposure Draft's stated purposes is "to assist the Federal Accounting Standards Advisory Board in developing reporting models for the government-wide and component reporting entities."

We will start with the most basic of questions: what does the United States Constitution legally require the federal government publish from time to time? It is noteworthy that FASAB's *Exposure Draft* DOES NOT ADDRESS THIS ISSUE ANYWHERE. The answer should and would have profound ramifications for an Exposure Draft that is reportedly trying to address reporting for the entire U.S. Government!

"No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time."

We will summarize the basic requirements outlined in Article I, Section 9, Clause 7:

- 1) Legally enacted appropriations are required for the government to spend any money.
- 2) Public Money has been determined to mean Money that is in the Treasury. See the Miscellaneous Receipts Statute 31 U.S.C. sec. 3302(b).
- 3) The Statement and Account that the federal government must publish from time to time must include all public Money.

The House provided by resolution in 1791:

*"RESOLVED: that it shall be the duty of the Secretary of the Treasury to lay before the House of Representatives...an accurate statement and account of the receipts and expenditures of all public moneys...in which statement shall also be distinguished the expenditures which fall under each head of appropriation, and shall show the sums, if any, which remain unexpended, and to be accounted for the next statement of each and every of such appropriations."*

This resolution makes it clear the federal government's financial statements must include both appropriations and spending....and that unexpended appropriations must be detailed.

The FASAB cannot address the question of what is legally required by the Constitution because it has already published accounting principles and standards that cannot possibly be reconciled with the Constitution's required reporting. In addition, the Sponsors of FASAB DO NOT WANT TO PUBLISH WHAT IS REQUIRED BECAUSE THE REPORTING WOULD REVEAL MASSIVE DEFICITS AND LEGAL OBLIGATIONS!

Even if the FASAB views the government-wide financial statements as supplementary to the required Statement and Account they must put in place a full and transparent reconciliation to that required document. Providing reconciliation figures to the President's Budget does not come close to this reconciliation. One of the primary reasons why the Sponsors have no interest in providing the required reconciliation is that it would reveal how they have changed the concept of legal obligation from its meaning for purposes of appropriations law.

## Former FASAB Chairman's Remarks about Federal Financial Reporting?

David Mosso, former Chair of FASAB summarized the requirements for federal, state, city and local financial statements that provide true accountability at the “*Representation Without Accountability*” conference held at Fordham Law School on January 23, 2012. He captured the spirit and intent of the Founders’ Statement and Account clause.

*“To be effective communicators of accountability, an organization’s financial statements -- should be complete and transparent. That calls for a single consolidated balance sheet with all assets and liabilities controlled by an organization – the federal government in this case – no matter how many separate entities make up that controlling organization. Likewise it calls for a consolidated income statement showing all receipts and expenditures. And it calls further for an absence of netting assets against liabilities and receipts against expenditures.”*

The comment about the absence of netting assets against liabilities and receipts against expenditures is particularly apt as the government’s existing reporting practices regularly permit this on a widespread basis. The obvious reason to follow this practice is to control the electorate’s perception of the size of the government.

He made the following remarks about the President’s Budget and by implication the Combined Statement at the conference.

*“[T]he Office of Management and Budget (“OMB”) and the Congressional appropriations committees have been unwilling to change the accounting basis of the federal budget to the accrual basis....The Budget’s cash basis accounting, selectively applied, hollows out the fiscal body of the federal government...The accounting underlying the President’s Budget....obfuscates federal financial accountability..... [It] understates] ...the headline numbers that dominate Congressional and public discussion and that form perceptions of the government’s financial health. It seems to be an incontrovertible conclusion that the ship of state is being steered with a severely broken compass.....That false picture nurtures financial profligacy....Cash basis accounting in the President’s Budget is the spearhead of reckless fiscal policy, whether intentionally reckless or just bumbling along with inadequate and misunderstood information about federal financial health....As an accountability report, the President’s Budget woefully shortchanges the American public.”<sup>2</sup>*

Finally, he commented about the Financial Report at the conference.

*“The US Financial Report is the off-budget vehicle for reporting more fully, with business type accounting, on federal financial accountability but it suffers from the syndrome “out of Budget, out of mind.” Nobody pays attention to the US Financial Report in political discourse and decision making because its accruals are not integrated into the budget process.”<sup>3</sup>*

There is nothing in the *Exposure Draft* that moves financial reporting closer to where Mr. Mosso suggests it needs to be.

## Whitewashed Version of History of FASAB

Appendix A: Basis for Conclusions contains a “Project History.” A better name for this section should be “A Whitewashed Version of the Project’s History.” One only has to read Chapter 8 of the memorandum to understand that the depiction of the “Project’s History” omits a lot of bad behavior by the Sponsors to force independent members off the Board. They did this because the independent

Board members did not want to continue with some of the federal government's fraudulent and misleading accounting practices including some of the practices that FASAB has since institutionalized.

### **FASAB Board Membership – Unspoken Requirement**

Given the government's experience with truly independent Board members the Sponsors are much more careful as to whom they will allow on FASAB's Board. Generally, they will pick ex-officers of the government who they know have drunk the cool-aid with respect the federal government's accounting. This extra-special requirement is not described in any publication....and the AICPA is well aware of the problem...and looks the other way.

### **FASAB's Pronouncements Should All Have "PAAP" Warning Labels**

The FASAB's accounting principles, standards and concepts should all have warning labels indicating that they are "Politically Acceptable Accounting Principles" not GAAP.

*When in doubt, tell the truth.*

*Mark Twain*

## C. One Page Executive Summary

The federal government's and all fifty state's budget deficits and debt are exponentially higher than what the federal and state governments say that they are. None of the headline figures used as the basis of public discourse have any relevance to the true state of the federal or state government's finances. The presidential election continued a lifetime tradition for citizens of casting their votes without the benefit of having access to an accurate and complete published account of the total receipts and expenditures of the United States Government. The purpose of this memorandum is to describe the frauds on the electorates that have been perpetrated by the federal and state governments with substantial assistance from the accounting profession.

The federal and state governments have controlled financial reporting and thereby public opinion to minimize their accountability for spending. Our federal and state politicians do not want to be held accountable for the full extent of their spending and, generally, wish to make re-election easier for incumbents. Hence, they collude to underreport appropriations and expenses. Proper reporting would lead to spending cutbacks, tax increases and/or recriminations for overspending, all of which are likely to cause voter dissatisfaction and changes at the polls. The failure to publish a complete and truthful statement and account of the nation's finances has made our republic dysfunctional, plagued by successive budget-deficit and debt-ceiling crisis. Their frauds have brought the federal and state governments to the brink of financial Armageddon.

Article I, section 9, clause 7 of the United States Constitution states: "No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time," The first part is called the Appropriations Clause and the second part is called the Statement and Account Clause. Since the nation's founding, the Supreme Court has not opined on the meaning of the Statement and Account Clause, including how it interacts with the Appropriations Clause.

None of the Combined Statement of Receipts, Outlays and Balances, The President's Budget or the Financial Report of the United States Government complies with Article I, Section 9, Clause 7. As a result, several private rights protected by our Constitution have been violated including the right to vote, freedom of speech, due process, equal protection, the right to financial information and political accountability. These rights have also been violated by the states since their reporting violates the antifraud provisions and constitutional requirements. States have violated the right to vote under the Fifteenth Amendment and the other rights have been violated pursuant to their incorporation under the Fourteenth Amendment. Finally, the governments' financial reporting creates a perpetual fraud on the federal and state judiciaries.

Primary responsibility for the fraudulent and unconstitutional financial reporting by the federal government lies with the leadership on both sides of the aisle in the House of Representatives and the Senate. Therefore, a large number of our current and former politicians and senior finance officials have violated their oath<sup>4</sup> to uphold the Constitution and, arguably, they have committed "high crimes" providing a basis for their impeachment. The implications for the accounting profession and its rule-making bodies may be much more serious. The memorandum will raise the question as to whether current arrangements for accounting standards setting and auditing for the federal and/or state governments or any related entities rise to the level of being a "criminal enterprise" and a "Political Protection Racket" under the RICO Act.

The federal government has known for a very long time that its accounting standards setting process is unconstitutional and states know that their accounting standards setting process is also unlawful. Both the federal and state governments have actively worked to cover up their frauds. Not surprisingly, current arrangements permit federal and state politicians to disclaim any responsibility for federal and state financial reporting.

How could this happen? Where is Congress? Where is the people's financial champion in the United States Senate – Elizabeth Warren? Where is the SEC? Where are the Federal Reserve's Governors? This memorandum will answer these and many other related questions.



*The Framers of our Constitution deemed fiscal information essential if the electorate was to exercise any control over its representatives and meet their new responsibilities as citizens of the Republic.*

*Justice William O. Douglas*

## D. Executive Summary

**Chapter 1 Introduction** - An informed electorate is the cornerstone of our democracy. This memorandum's primary purpose is to shine a bright light on the federal and state governments' failures to publish what the Constitution mandates that they must publish for their electorates. It asserts that the federal and state governments are falsely reporting total receipts, total expenditures and the resulting deficit calculated by subtracting the second figure from the first. These three figures are not subject to the plenary power of Congress. It also describes how and why liberty has been sacrificed for almost a century as the federal and state government's financial reporting practices do not comply with the United States Constitution and violate the antifraud provisions of the nation's securities laws.

Article I, section 9, clause 7 of the United States Constitution states:

*"No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time,"*

The first part of the clause is called the Appropriations Clause and the second part is called the Statement and Account Clause. Together, they shall hereafter be called the "two clauses."

The right to financial information must exist if our democracy is to work properly. If citizens do not have a right to receive reasonably correct information about the nation's finances this would limit or abrogate entirely citizens' right to vote,<sup>5</sup> and freedom of speech and also violate their due process and equal protection<sup>6</sup> rights. In addition, without the right to financial information required political accountability is eliminated.

The primary reason why citizen's rights have been infringed upon is that the federal government's Legislative and Executive branches and the state governments have controlled financial reporting and thereby public opinion to minimize their accountability for spending. Congress and the state legislatures have spent enormous sums of taxed and borrowed money to endear themselves to their electorates, but they do not want to be held accountable for the full extent of their spending. Hence, the legislative and executive branches and state governments collude to underreport expenses. To accomplish their goal they have enlisted the support of the accounting profession and they have managed to keep the media silent on the issue.

In the last fifty years the problem has actually become much worse and more widespread as all fifty states, Washington D.C. and other cities, Puerto Rico and other U.S. territories and local governments have structural deficits and fraudulent accounting. These have been swept under the rug for the same reasons that the federal government's structural deficit and fraudulent accounting problems have been hidden. This fact appears to be lost on all those politicians and private citizens clamoring for a balanced budget amendment. The only thing that a balanced budget amendment would produce is more creative fraudulent accounting. The balanced state budgets touted by proponents are economic fiction.

Over the last 100 years, Congress has abdicated its financial reporting responsibility. Today the executive branch dominates all financial reporting with little to no input from Congress. The President's Budget is prepared by OMB without input from Congress, and the Financial Report of the United States Government is prepared by Treasury and OMB based on principles promulgated by FASAB. Practically speaking, the executive branch has effective veto power over any proposed accounting principle it does not like. The end result is that financial reporting by the federal government does not reflect economic reality.

In 1990 the Comptroller General, Treasury Secretary and Director of OMB established FASAB as an advisory committee to develop accounting standards and principles for the federal government. There is absolutely no discussion in the FASAB literature explaining how the accounting principles it has promulgated comply with the Statement and Account clause's "all public money" requirement. And no matter how much AICPA GAAP-compliant lipstick are put on FASAB's accounting principles this does not overcome their lack of compliance with the Constitution.

The Supreme Court has not decided the meaning of the Statement and Account Clause including how it interacts with the Appropriations Clause. However, this has not stopped the federal government from relying on the Court's dicta in the only case involving the clause to reach the Supreme Court to justify to the electorate its unconstitutional accounting practices.

The author believes that when faced with the question of interpreting the Statement and Account clause the Supreme Court is likely to rule that there are no exceptions permitted by the Constitution for entities or programs funded with public money that our politicians want to avoid accountability for by excluding them, putting them off balance sheet or describing them only in footnotes. In addition, the author believes that the Supreme Court will determine that the antifraud provisions in the nation's securities laws are inherent in the Statement and Account Clause.

After careful consideration the Court is likely to conclude that the information that is required to be provided to citizen/voters is no different than the information to be provided to investors. Both have a significant economic interest in the actions of their government. Furthermore, a government "*of the people, by the people and for the people*" with an explicit provision in its constitution requiring the publication of a Statement and Account of the Receipts and Expenditures of all public Money does not need an antifraud amendment to that constitution requiring the federal government publish truthful figures. To a certain extent Congress recognized the importance of the antifraud provisions by making the issuance of municipal securities subject to them.

The basic framework for the analysis contained in this memorandum was created for a first-of-its-kind conference "***Representation Without Accountability***" which was held at Fordham Law School on January 23, 2012. A copy of the conference brochure can be found in this Executive Summary.

**Chapter 2 Appropriations and Statement & Account Clauses Explained** - One of the important aspects of the Statement and Account clause is that the obligation runs to the legislature not to the executive branch to publish the Statement and Account. As early as 1791, the House provided by resolution<sup>7</sup>:

*RESOLVED: that it shall be the duty of the Secretary of the Treasury to lay before the House of Representatives...an accurate statement and account of the receipts and expenditures of all public moneys...in which statement shall also be distinguished the expenditures which fall under each head of appropriation, and shall show the sums, if any, which remain unexpended, and to be accounted for the next statement of each and every of such appropriations.*



# Representation Without Accountability?

The Fordham Corporate Law Center presents a conference that will review financial reporting by the federal government. The U.S. Constitution requires that “a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time.” One view of our government’s financial crisis is that it has been caused by our political leaders failing to comply with this important “check” on power. The conference will review the federal government’s actual expenditures, its current financial reporting, its historic choices about financial reporting, questions surrounding the Statement and Account clause—including whether financial reporting by the federal government comports with Constitutional requirements, and proposed reforms.

## The Fordham Corporate Law Center

Fordham Corporate Law Center was created in 2001 to serve as the Law School’s nexus for discourse on issues of business and financial law and policy. The Center hosts lectures open to the public that bring renowned national and international speakers to the Law School. In addition, it serves as a think tank for academic discussion of finance and business law through conferences and policy roundtables.

**Fordham Corporate Law Center programs and events are supported through the generosity of private donors. If you enjoyed today’s program, please consider supporting the Center with a financial contribution. For further information contact Joan Donahue at 212-636-6583 or [joan.donahue@law.fordham.edu](mailto:joan.donahue@law.fordham.edu).**

### Sean J. Griffith

*T.J. Maloney Chair in Business Law*

*Director, Fordham Corporate Law Center*

Professor Griffith is an expert in corporate and securities law. He joined the faculty in 2006 and in 2009 received the Teacher of the Year Award. He teaches Corporations, Mergers & Acquisitions, and a course on Global Finance in addition to serving as Moderator for the *Fordham Journal of Corporate & Financial Law*. Before joining the Fordham faculty, Professor Griffith taught at the University of Connecticut School of Law and University of Pennsylvania Law School. He was also a visiting lecturer in France at the Université D’Aix-Marseille. Prior to entering academia, he worked as an associate in the Corporate Department of Wachtell, Lipton, Rosen & Katz, where he focused on public company mergers and acquisitions. Professor Griffith received his J.D. magna cum laude from Harvard Law School, where he was an editor of the *Harvard Law Review* and a John M. Olin Fellow in Law and Economics. He received his B.A. degree from Sarah Lawrence College.

### KStone Partners LLC

KStone, an SEC registered investment advisor, specializes in managing absolute return funds of hedge funds for institutions and high net worth investors that are designed to produce superior risk-adjusted returns with low correlation to equity and fixed income markets. Its funds primarily invest in arbitrage and relative value strategies. Mr. Marren formed KStone with Mark Kenyon and Joe Drohan in 2008. Mr. Kenyon was the founder or co-founder and lead executive at two highly successful fund-of-hedge-fund enterprises including UBP Asset Management (UBPAM) and Blackstone Alternative Asset Management. Mr. Drohan worked extensively with Mr. Kenyon at UBPAM.

Individual

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## FORDHAM CORPORATE LAW CENTER

# Representation Without Accountability?

January 23, 2012 | 1:00 p.m.

A popular Government without popular information, or the means of acquiring it, is but a Prologue to a Farce or tragedy; or perhaps both.

—James Madison

Presented by

**Joseph H. Marren ’79**

**Joan M. Marren ’81**



Register: [law.fordham.edu/accountability](http://law.fordham.edu/accountability)

## Opening Remarks

SEAN J. GRIFFITH

T.J. Maloney Chair of Business Law

Director, Fordham Corporate Law Center

## Remarks and Panel Discussion

Representation Without Accountability?

## Panelists

DAVID MOSSO

BRIAN T. FITZPATRICK

JOSEPH H. MARREN

THE HON. DAVID M. WALKER

## Moderator

SEAN J. GRIFFITH

## Reception

Edith Guldi Platt Atrium



**David Mosso** retired, served as Vice Chair of the Financial Accounting Standards Board (FASB), the private sector body that sets accounting standards for U.S. corporate financial reporting, and as Chair of the Federal Accounting Standards Advisory Board (FASAB), the mixed private-public body that sets accounting standards

for federal agency accrual based (non-budgetary) financial reporting. Before taking on those standard setting roles, Mr. Mosso served as Fiscal Assistant Secretary of the U.S. Treasury Department in charge of managing the operational aspects of the federal public debt and the Treasury's cash position, and accounting for overall federal financial operations. He is author of a 2009 book critiquing current generally accepted accounting principles (GAAP) entitled *Early Warning and Quick Response: Accounting in the Twenty-first Century*. For a brief time, he was an adjunct Professor of Accounting at Fordham's Graduate School of Business Administration.



**Brian T. Fitzpatrick's** research at Vanderbilt has focused on class action litigation, federal courts, judicial selection and constitutional law. Professor Fitzpatrick joined Vanderbilt's law faculty in 2007, after serving as the John M. Olin Fellow at New York University School of Law. He graduated first in his class from Harvard Law School

and went on to clerk for Judge Diarmuid O'Scannlain on the U.S. Court of Appeals for the Ninth Circuit and Justice Antonin Scalia on the U.S. Supreme Court. After his clerkships, Professor Fitzpatrick practiced commercial and appellate litigation for several years at Sidley Austin in Washington, D.C., and served as Special Counsel for Supreme Court Nominations to U.S. Senator John Cornyn. Before earning his law degree, Professor Fitzpatrick graduated summa cum laude with a B.S. in chemical engineering from the University of Notre Dame. He received the Hall-Hartman Outstanding Professor Award, which recognizes excellence in classroom teaching, for his Civil Procedure course for the 2008–2009 academic year.



**Joseph H. Marren** is President and CEO of KStone Partners LLC, an alternative asset management company. Previously, he was a Managing Director (MD) and Head of the Strategic Opportunities Group at Sagent Advisors, a mergers and acquisitions (M&A) advisory boutique. He had been MD and Global Head-

M&A Business Development at Citigroup Global Markets and Credit Suisse First Boston, and MD and Head of the Business Development Group at Donaldson Lufkin & Jenrette. He began his career at Price Waterhouse & Co. Mr. Marren is the author of two M&A books and has taught a course on M&A at NYU Stern School. He received a BBA degree from the College of William & Mary, a JD from Fordham and an MBA from NYU Stern.



**Hon. David M. Walker** is Founder and CEO of the Comeback America Initiative and served as the seventh Comptroller General of the United States and head of the U.S. Government Accountability Office (GAO) for almost 10 years (1998–2008). In his current position, he leads CAI's efforts to promote fiscal responsibility

and sustainability by engaging the public and assisting key policymakers on a nonpartisan basis to help achieve solutions to America's federal, state and local fiscal imbalances.

He has over 20 years of private sector experience, including approximately 10 years as a Partner and Global Managing Director of Human Capital Services for Arthur Andersen LLP, and has headed three federal agencies.

He recently completed a four-year term as Chairman of the United Nations Independent Audit Advisory Committee. He is a member of the Boards for the Committee for a Responsible Federal Budget and serves on the Advisory Committees for The Public Company Accounting Oversight Board and the Peterson Foundation. He has authored three books; the latest is a national bestseller entitled *Comeback America: Turning the Country Around and Restoring Fiscal Responsibility* (2010). He is a frequent writer and media commentator, and he is a subject of the critically acclaimed documentary *I.O.U.S.A.*

In 1777 Louis XVI named a Swiss banker Jacques Necker as Director General of French Finances. His appointment threatened the status quo and led to significant resistance to his suggested changes. In response in 1781, in an effort to restore confidence and enable the nation to access additional credit, Necker published his *Compte Rendu au Roi* (Accounts Rendered to the King). This publication explained the nation's finances for the year. This was the first time that the French citizenry received information about government spending. Necker's *Compte rendu*, his writings and accounting reforms had a significant impact in the United States.

The Revolutionary War caused the states and Continental Congress to incur large debts. Repayment of this debt was one of the major issues that led to the Constitutional Convention. Furthermore, it is important to note that the Continental Congress had already bankrupted the nation during the war. In 1781 the \$241.5 million in paper currency issued by Congress had a value of two cents on the dollar.

The Articles of Confederation and Perpetual Union was the first written constitution for the U.S. Government. It was drafted in 1776-77 and became the working constitution in 1777. It was not formally ratified until 1781. There was no president, executive agencies, judiciary or tax base. The lack of a tax base meant that the government was unable to pay off state and national debts. At the Annapolis Convention in 1786 Alexander Hamilton led a group of federalists that believed in a strong central government that petitioned Congress to call a constitutional convention in Philadelphia in May 1787 to revise the Articles.

The United States Constitution is the contract underlying the largest merger in history. Thirteen sovereign states entered into this agreement to create the United States of America. Like all merger documents the two most important issues were governance and money.

The records of the convention as they relate to the Appropriations and Statement and Account Clauses appear below. A reading of the records indicate that from July 5 onward the Framers intended that no money could be spent by the federal government other than in pursuance of appropriations. In addition, a regular Statement and Account of the receipts and expenditures of all public money shall be published.

The congressional power of the purse refers to the power to appropriate funds and to prescribe the conditions governing the use of those funds. The Appropriations Clause has often been characterized as "*the most important single curb in the Constitution on Presidential power.*"<sup>8</sup> The Constitution gives Congress the so-called "*power of the purse*" by providing that only it can appropriate money from the Treasury.<sup>9</sup> The Supreme Court in *Cincinnati Soap Co. v. United States* (1937) indicated that the Appropriations Clause means that "no money can be paid out of the Treasury unless it has been appropriated by an act of Congress."

The Constitution does not provide instructions with respect to how Congress is to implement its appropriation power. As one court has put it: "*[The Appropriations Clause] is not self-defining and Congress has plenary power to give meaning to the provision.*" Congress has done this through the annual budget and appropriations process and through a series of permanent "*funding statutes.*"

Congress exercises its control over the power of the purse through several statutory directives including:

- 1) a statute will not be construed as making an appropriation unless it expressly so states *31 U.S.C. sec 1301(d)*;
- 2) agencies may not spend, or commit themselves to spend, in advance of or in excess of appropriations. *31 U.S.C. sec 1341 (Antideficiency Act)*;
- 3) appropriations may be used only for their intended purpose. *31 U.S.C. sec 1301 (a) ("purpose statute")*; and
- 4) unless authorized by law, an agency may not keep money it receives from sources other than congressional appropriations, but must deposit the money in the Treasury. *31 U.S.C. sec 3302(b) ("Miscellaneous Receipts" Statute)*.

The two basic authorities conferred by an appropriation law are the authority to incur obligations and the authority to make expenditures. An obligation results from some action that creates a liability or definite commitment on the part of the government to make an expenditure. The expenditure is the disbursement of funds to pay the obligation. Generally, appropriated funds are first obligated and then expended. The subsequent disbursement "liquidates" the obligation.

Congress may create permanent, substantive law through an appropriations bill only if it is clear about its intentions.<sup>10</sup> This type of authorizing legislation controls mandatory spending. A distinctive feature of these authorizing laws is that they provide agencies with the authority or requirement to spend money without first requiring Appropriations Committees to enact funding. Mandatory spending includes Social Security, Medicare and Medicaid.

The standards for the proper recording of obligations are found in *31 U.S.C. sec. 1501(a)* which prescribes specific criteria for recording obligations. It indicates that "[a]n amount shall be recorded as an obligation of the United States Government only when supported by documentary evidence" and then goes on to specify nine criteria for recording obligations. Once one of the criteria is met, the agency must record the transaction as an obligation.

Although Congress holds the purse-strings, it may not exercise this power in a manner inconsistent with the direct commands of the Constitution.<sup>11</sup> The courts have invalidated congressional funding restrictions when they found that the restrictions violated some independent constitutional bar. See *Legal Services Corp. v. Velasquez*<sup>12</sup> and *American Civil Liberties Union v. Moneta*.<sup>13</sup> This is a critical concept and one that the author wants to make clear to the reader. Congress cannot create legislation with "permanent appropriations" and then define the "permanent" part out of existence for purposes of recording the appropriation or for financial reporting purposes under the Statement and Account clause. Both are clearly intended to do one thing: mask the Legislature's accountability for spending, which the Constitution does not permit.

Viewed as a whole, the debates in the Constitutional Convention and the Virginia ratifying convention convey a very strong impression that the Framers of the Statement and Account Clause intended it to allow discretion to Congress and the President to preserve secrecy for expenditures related to military operations and foreign negotiations.

There is a crucial parallel between federal financial disclosures and those by corporations issuing securities. The essence of the disclosure philosophy of securities regulation and the Statement and Account Clause is that, when armed with information, investors or voters are well-positioned to

evaluate investment opportunities or candidates for public office and to allocate their capital or vote as they see fit. The crux of our federal securities laws and the Statement and Account Clause is that all material information must be disclosed. What other reasonable interpretation can there be for the Clause, particularly the “all Public Money” language?

On March 22, 2011, the Supreme Court issued a unanimous decision written by Justice Sotomayor in the matter of *Matrixx Initiatives v. Siracusano* (2011)<sup>14</sup>. The importance of the case is that the Court reaffirmed the traditional tests it laid out in *Basic, Inc. v. Levinson*<sup>15</sup> and *TSC Industries v. Northway, Inc.*<sup>16</sup>

*“Section 10(b) of the Securities and Exchange Act makes it unlawful for any person to “use or employ, in connection with the purchase or sale of any security...any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”<sup>17</sup>*

Sec Rule 10b-5 implements this provision by making it unlawful to, among other things,

*“make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.”<sup>18</sup>*

In *TSC Industries* the Court considered a claim of fraud in connection with a proxy solicitation and concluded that “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”<sup>19</sup> The Court does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard requires is a showing of a substantial likelihood that, under the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.

In the private sector a defendant cannot rebut a charge of having omitted a necessary material fact by pointing to facts that, while disclosed and technically sufficient to alert the investor to the truth, are buried or hidden within the relevant document as to be practically non-disclosed.<sup>20</sup> Under the “buried facts” doctrine, a disclosure is deemed inadequate if it is presented in a way that conceals or obscures the information sought to be disclosed. The doctrine applies when the fact in question is hidden in a voluminous document or is disclosed in a piecemeal fashion which prevents a reasonable shareholder from realizing the “correlation and overall import of the various facts interspersed throughout” the document.<sup>21</sup>

It is in this context that one needs to examine the federal government’s financial reporting regarding Social Security, Medicare and Medicaid. Prior to 2010 the government did not release any estimate of the net present value cost of Medicaid. In 2010 it released a figure as a single line item in the Required Supplementary Information in the back of a roughly two hundred fifty page Financial Report. In the 2015 Financial Report of the United States Government this information was included in the Statement of Long-Term Fiscal Projections of the U.S. Government. Meanwhile, the net present value cost of Medicare and Social Security are included in a required financial statement, the Statements of Social Insurance (“SOSI”), but the SOSI and the Statement of Long-Term Fiscal Responsibilities do not inter-relate with the government’s consolidated financial statements. In

addition, both statements which are required by the federal government's generally accepted accounting principles ("GAAP") as promulgated by FASAB violate the Anti-deficiency Act because they illustrate future expenditures under the Medicare and Social Security programs in excess of appropriated amounts. Nowhere in the SOSI or the Financial Report is there any adequate discussion relating appropriated amounts to the projected figures. Furthermore, the government did not and does not consolidate material government-controlled entities.

Only if the established omissions are "*so obviously important to an investor, that reasonable minds cannot differ on the question of materiality*" is the ultimate issue of materiality appropriately resolved "as a matter of law" by summary judgment.<sup>22</sup> Given the facts if the federal government were an entity subject to SEC rules there can be no doubt that it's financial reporting would be materially deficient as a matter of law.

### **Chapter 3 Overview of Feds' Financial Reporting and Major Items Reported Fraudulently**

- One must be familiar with three reports in order to understand the federal government's financial reporting practices. These include the Combined Statement of Receipts, Outlays, and Balances<sup>23</sup> (the "Combined Statement") which is the "*official*" Statement and Account, the President's Budget<sup>24</sup> and the Financial Report of the United States Government.<sup>25</sup> Collectively and individually, the federal government's Combined Statement, the President's Budget and the Financial Report make untrue statements about material facts, omit to state numerous material facts and hide material facts in footnotes.

The three major items that are fraudulently reported by the federal government in its two primary annual financial reports include:

- The Federal Reserve System, Fannie Mae and Freddie Mac, with total assets of \$4.5 trillion (as of March 4, 2016), \$3.2 trillion (as of 12/31/2015) and \$2 trillion (as of 12/31/2015), respectively, are not consolidated into the federal government's financial statements.

- The federal government's \$24.2 trillion net present value obligation for Medicaid was reported for the first time in the 2010 Financial Report and was buried in this and subsequent reports. Omitting the disclosure of material information, as was done from the creation of Medicaid through 2009, violates the laws against fraud, and the Supreme Court's "buried facts" doctrine which appears in its securities law decisions suggests that even current reporting is unlawful. The amount reported in the 2015 Financial Report was \$27.3 trillion.

- The total adjusted net present value obligation for Medicare and Social Security that is fully funded with appropriations reported in the Statements of Social Insurance ("SOSI") and in related footnotes in the 2015 Financial Report of the United States Government is \$46.3 trillion. But the SOSI does not interrelate with the other financial statements and no current expenses are recorded for required future payments.

**Chapter 4 U.S. v. Richardson, Standing and the Political Question Doctrine** - William Richardson was a citizen who in 1967 made an effort to discover the size of the CIA's "black budget" by writing a letter to the US Government Printing Office. He requested a copy of the CIA budget "*published by the Government in compliance with Article I section 9 clause 7.*"<sup>26</sup> Richardson was rebuffed by the US Treasury and started a court action.

The case reached the Supreme Court and in July 1974 issued its 5-4 decision in *United States v. Richardson*.<sup>27</sup> The Court declined to opine on the meaning of the Statement and Account Clause as it found that the plaintiff lacked standing. The Court held that Richardson's suit was nothing more than a generalized political grievance that needed to be dealt with through the political process. The Supreme Court concluded that it did not need to examine the merits of Richardson's case.

Justice Douglas in his dissent in *United States v. Richardson*<sup>28</sup> had numerous comments that illuminate the meaning of the Statement and Account Clause.

*"The mandate runs to the Congress and to the agencies it creates to make a regular Statement and Account... The beneficiary-as is abundantly clear from the constitutional history-is the public." "The Framers of the Constitution deemed financial information essential if the electorate was to exercise any control over its representatives and meet their new responsibilities as citizens of the Republic . . . ."*<sup>29</sup> *"From the history of the clause it is apparent that the Framers inserted it in the Constitution to give the public knowledge of the way public funds are expended."*<sup>30</sup> *"The sovereign in this Nation is the People, not the bureaucracy. The statement of accounts of public expenditures goes to the heart of the problem of sovereignty. If taxpayers may not ask that rudimentary question, their sovereignty becomes an empty symbol and a secret bureaucracy is allowed to run our affairs."*<sup>31</sup> *"Secrecy was the evil at which Article I, Sec 9 Cl 7 was aimed."*<sup>32</sup>

The *Principles of Federal Appropriations Law, Third Edition* contains the following passage which outlines the federal government's interpretation of *U.S. v. Richardson*:

*"The second part of article I, section 9, clause 7 requires "a regular statement and account of the Receipts and Expenditures of all public Money shall be published from time to time." Implementation of this provision, as a logical corollary of the appropriation power, is also wholly within the congressional province, and the courts have so held.*

At the "Representation Without Accountability" conference held at Fordham Law School on January 23, 2012 Professor Brian T. Fitzpatrick<sup>33</sup> of Vanderbilt Law School addressed the standing and political question doctrine issues. Selected excerpts of his remarks appear below:

*"I think that there are a bunch of people thankfully for whom there aren't any lower court cases or Supreme Court dicta out there that threaten their standing. There's a lot of people who have injuries that are not common to everybody, and they're real concrete in particularized injuries that I think could bring a suit, would have standing to bring a suit....Number one, those of us who have purchased or are considering purchasing government debt.....So I'm not so pessimistic that the standing obstacle cannot be overcome.*

*Now, I should say though, that there is another doctrine that's closely related to standing on which I think it's more likely a court would toss out one of these lawsuits, even if you...had purchased government debt and had standing....and this doctrine is called the political question doctrine. And the notion is here that if the lawsuit is something that's a political question, the courts shouldn't get involved. It's something that's best left to the politicians. We don't want to get involved if it's too political.*



*And so what can we say to the courts to persuade them that they shouldn't... just duck the question and say leave it to the politicians. Well, for one thing it's important for courts to get involved, it's especially important for courts to get involved on questions where we can't trust the political branches to enforce the Constitution themselves.... But what if the two political branches, the Congress and the President are conspiring with one another to keep out the American people? In those situations you only have one other branch of government to turn to. The judiciary. And I think there is a good argument that this is one of these cases, where both the President and the Congress both have the incentive to keep people in the dark about the true liabilities of the country. And those are the situations where we need courts the most. Because we can't just turn to the political branches."*

**Chapter 5 Financial Reporting by the U.S. Government is "Pure Applesauce" - "Money" is not "Money"** when the Executive and Legislative branches are interpreting Article I, section 9, clause 7. The federal government's fraud is two-fold.

- 1) Congress and the GAO effectively define permanent appropriations to be an ongoing series of one-year appropriations wherein the appropriations beyond one-year do not rise to the level of an unmatured commitment. As such they do not have to be recorded as obligations.
- 2) They "divide and conquer" by defining the concept of a "liability," a key component of public "Money," differently for financial reporting purposes than for purposes of appropriations law.

Practically speaking this means taking certain programs that are funded with permanent appropriations such as Medicare, Medicaid and Social Security which are clearly legal liabilities/obligations under "appropriations law" and redefining them for financial reporting purposes as not being legal liabilities/obligations of the United States Government. This approach means that the legally enacted expenses and obligations of the United States Government are significantly understated in all of its financial reports.

The recording of grants and subsidies is governed by *Sec. 1501(a)(5)*. It indicates that the grant must be supported by documentary evidence and that in order to properly obligate an appropriation for an assistance program, some action creating a definite liability against the appropriation must occur during the period of obligational availability of the appropriation. In some situations, the obligating action under *section 1501(a)(5)* involves a discretionary action by an agency of awarding a grant that is evidenced by a grant agreement. In other situations, the obligating action for purposes of *31 U.S.C. sec. 1501(a)(5)(A)* may take place by operation of law under a statutory formula grant or by virtue of actions authorized by law to be taken by others that are beyond the control of the agency (even when the precise amount of the obligation is not determined until a later time).

The above description of when an appropriation should be recorded as an obligation shows the lengths to which Congress and the GAO will go to obscure spending. Conceptually, we have spending that is "permanent" and automatic ("no vote by Congress is required"). Yet according to Congress and the GAO the government's obligation does not arise until a statutory formula for paying out benefits is met. Hence, there is no need to record any appropriation beyond the current year's appropriation or any long term obligation in the Statement and Account. One must recall, as previously discussed, the two basic authorities conferred by an appropriation: the authority to incur obligations and the authority to make expenditures. Permanent appropriations include both authorities with the disbursement tied to the statutory formula.



We will now turn to the federal government's admission that it uses a different definition of "liability" for financial reporting purposes. The GAO's September 2005 *"A Glossary of Terms Used in the Federal Budget Process"* ("GAO's Glossary of Terms") defines "Liability" as follows:

*"Liability - Defined differently for obligation (or budgetary) and proprietary (or financial) accounting purposes.*

*Obligational (or budgetary) accounting, designed to ensure compliance with fiscal laws, is based on the concept of legal liability. A legal liability is a claim that may be legally enforced against the government. It may be created in a variety of ways, such as by signing a contract, grant, or cooperative agreement or by operation of law.*

*Proprietary (or financial) accounting, designed to generate data for financial statement purposes, is based on the concept of accounting liability. For federal financial statement purposes, a liability is a probable future outflow or other sacrifice of resources as a result of past transactions or events. Generally, liabilities are thought of as amounts owed for items or services received, assets acquired, construction performed (regardless of whether invoices have been received), an amount received but not yet earned, or other expenses incurred."*

The Statement and Account Clause and Appropriations Clause are yoked together in the Constitution in Article I, Section 9, Clause 7 for a reason. Legislation that has been legally enacted and fully or partially funded with permanent appropriations must be reflected in the Statement and Account and other financial statements to the full extent of that funded obligation. Accounting principles governing federal financial reporting declare that legally enacted legislation that is fully or partially funded with permanent appropriations ARE NOT legal obligations for accounting purposes that need to be recorded in the Statement and Account or any of the nation's annual financial statements. The government uses the *"Due and Payable"* approach to record obligations associated with the entitlement programs.

The above discussion lays out another aspect of the federal government's fraud. For financial reporting purposes it will disclose "accounting liabilities" as opposed to the U.S. Government's actual legal obligations/liabilities pursuant to Appropriations law. Once the GAO has created different definitions they cannot put spending side-by-side with appropriations because it would be comparing apples to oranges. THAT is why the President's Budget and the Financial Report do not include appropriations.

The Supreme Court has no alternative but to weigh in on Congress' appropriations law and financial reporting practices as it did in *Lebron v. National Railroad Passenger Corp. (1995)* and *Department of Transportation ET AL v. Association of American Railroads (2015)*. In those cases the Supreme Court held that even when Congress has been quite specific in declaring that a corporation is not a federal instrumentality, it may still take on that status for constitutional purposes.

**Chapter 6 All State Financial Reporting Violates the Antifraud Provisions & U.S. Constitution** - It is highly probable that if states properly accounted for their spending the capital markets would require meaningfully higher rates of return on debt instruments issued by the states and, furthermore, several states might be considered to be bankrupt entities such that the capital markets would deny them access to additional borrowing. Therefore, state legislatures and the governors of each state have a substantial incentive in not having their legal expenditures and legal

obligations reported correctly. Proper financial reporting would lead to spending cutbacks, tax increases and/or recriminations for overspending, all of which are likely to cause voter dissatisfaction and changes at the polls.

State financial reporting is fraudulent based on reporting for its largest single program – Medicaid. Since the inception of the Medicaid program all fifty states have published financial statements that fail to disclose material information relating to it. Based on disclosure in the 2010 Financial Report of the U.S. Government the states aggregate net present value obligation for Medicaid as of September 30, 2010 is no less than \$18.3 trillion. By September 30, 2015 based on a reported obligation for the federal government the obligation for the states had fallen to \$16.8 trillion. Yet the states have not disclosed in any way their proportionate share of the net present value cost of Medicaid in any financial statement.

No state records their portion of this obligation in its balance sheet or properly records the annual increase or decrease in the net present value obligation in its income statement. Disclosure regarding the size of each state's obligation is non-existent. Any reasonable investor or citizen/voter in the average state would believe that not reporting \$682 billion of obligations (\$34.1 trillion (the author's estimate of the net present value obligation as of 2015) divided by 50 states – See **Exhibit 33**) omits a material fact that they would consider important. Furthermore, states also have other material off balance-sheet operations that obfuscate their spending and liabilities in violation of the United States Constitution.

**Chapter 7 Why It Matters to All American** - Since no report published by the federal government complies with the Appropriations and Statement and Account clauses several private rights protected by our Constitution have been violated. The rights violated include the right to vote, freedom of speech, due process, equal protection, the right to financial information and political accountability. In addition, these rights have been violated by the states. States have violated the right to vote under the Fifteenth Amendment and the other rights have been violated pursuant to their incorporation under the Fourteenth Amendment.

*Right to Financial Information* - The Constitution guarantees citizen/voters the right to financial information, which at a minimum includes total receipts, total expenditures and the resulting surplus or deficit. These figures are not subject to the plenary power of Congress. The right to financial information is a textually enumerated right.

The judiciary has sometimes indicated that public access is a matter for executive and legislative discretion. The Court averred in *Houchins v. KQED, Inc.* that “[t]he Constitution itself,” in Justice Stewart’s words, “is neither a Freedom of Information Act nor an Official Secrets Act.” The two reasons typically given to deny an affirmative right to information are that the judiciary lacks easily ascertainable standards for specifying the content of any access guarantee and that alternative methods are available for the public to access the information. However, the Court has arguably already determined the relevant standard which is the antifraud provisions. With respect to the second reason the concept that a citizen/voter can piece together consolidated financial information from the data that is published today is laughable as sophisticated financial executives who pore over the data for years can only get a sense for what these figures would actually be.

*Freedom of Speech*<sup>34</sup> - It is important to review what a lower court judge said in *U.S. v. Richardson (1974)*, the single Statement and Account Clause case to reach the Court. Judge Max Rosenn of the US Court of Appeals for the Third Circuit stated the following in the *Richardson* case:

“The debates at the Constitutional Convention in 1787 and the state ratifying conventions reveal that ... the citizenry should receive some form of accounting from the Government... Article II, section 3 requires the President “from time to time [to] give the Congress Information on the State of the Union,” and presumably the Framers could have utilized the same informal procedure with regard to the accounting if they had so wished. Instead, they chose to have the statement “published,” indicating that they wanted it to be more permanent and widely-circulated than the President’s message. The connotation must be that the statement was for the benefit and education of the public as well as coordinate branches of government.”

On January 21, 2010, in *Federal Election Commission (FEC) v. Citizens United*<sup>35</sup>, the Supreme Court resolved a First Amendment challenge to the Bipartisan Campaign Reform Act of 2002. In a 5-4 decision, the Court “rejected the argument that political speech of corporations or other associations should be treated differently under the First Amendment simply because such associations are not ‘natural persons.’” The Court held that political speech is “indispensable to decision-making in a democracy, and this is no less true because the speech comes from a corporation rather than an individual.” Furthermore, “[s]peech is an essential mechanism of democracy, for it is the means to hold officials accountable to the people . . . . [P]olitical speech must prevail against laws that would suppress it whether by design or inadvertence.” Laws burdening political speech are “subject to strict scrutiny,” which requires the Government to prove that the restriction “furthers a compelling interest and is narrowly tailored to achieve that interest.”

The Statement and Account is clearly “political speech” that is equal to or greater in importance than the requirement that the president deliver to Congress information regarding the State of the Union. The concepts that Congress has established appropriations rules that eliminate the need to record “permanent appropriations” beyond one year and that it has established one set of rules regarding appropriations and a different set of rules regarding reporting spending under those appropriations to the electorate cannot withstand strict scrutiny.

As Justice Kennedy stated “The Constitution... confers upon voters, not Congress, the power to choose the Members of the House of Representatives, Art I, sec 2, and it is a dangerous business for Congress to use election laws to influence the voters’ choices”. The fact that Congress is using the laws governing appropriations and the publication of the Statement and Account to influence voters’ choices as well as state decision-making regarding federal grants (e.g., the Affordable Care Act and Medicaid) does not make it any less dangerous.

The several laws enacted by Congress that have led to the publication of a false and misleading statement and account must be viewed in essentially the same manner as the FEC rules in *Citizens United* that the Court struck down. The publication of a false and incomplete statement and account interferes with the right of free speech as it is a required political document for the electorate.

*Right to Vote* - In *Federal Election Commission (FEC) v. Akins* (1998)<sup>36</sup>, the Court was dealing with an attempt on the part of a group of voters to compel the FEC to regulate the American Israel Public Affairs Committee (AIPAC) as a “political committee” within the meaning of federal election law.<sup>37</sup> The voters sought information that AIPAC would have to disclose (lists of donors, contributions, and expenditures) if it were so regulated. The FEC opposed regulation, and argued that the voters lacked standing. In analyzing the issue, the Court found that the plaintiffs had satisfied the injury

requirement by showing that a decision to regulate would produce information valuable to their roles as informed citizens and voters.<sup>38</sup>

In *Akins*, the plaintiffs identified concrete injury because they claimed “informational injury” that directly affected voting rights. The court explained that the plaintiffs had suffered injury because they were deprived of information and, without the sought information, they were less able, “to evaluate candidates for public office” and “to evaluate the role” that the financial assistance to candidates “might play in a specific election.”<sup>39</sup>

Based on the *Akins* decision, the lack of a complete and accurate Statement and Account is an informational injury directly affecting voting rights.

*Political Accountability* - Politicians have subverted the democratic process to protect their self interests. Congress cannot enact legislation and related permanent appropriations and then have these obligations largely defined out of existence for purposes of recording the appropriation or for financial reporting purposes. When Congress enacts permanent appropriations for legally enacted legislation it must record the appropriation and accrue for the funded obligation in the Statement and Account. It cannot continue to use cash-based accounting as it is completely misleading and contrary to Appropriations law. The full costs associated with the permanent appropriation needs to be recognized in the Statement and Account at the time of the appropriation. Not recognizing those costs destroys political accountability entirely and effectively binds all future Congresses. It is a political windfall for the Congress that enacted the legislation and puts an insurmountable burden on a future Congress that might otherwise be inclined to stop this spending.

The federal and state government’s fraudulent and unconstitutional accounting is substantially worse than the facts the Supreme Court faced in *New York v. United States (1992)* wherein the Court indicated that if Congress’ scheme was permitted state and federal officials could engage in a political shell game wherein each could disclaim responsibility. In the case of financial reporting the electorate has no idea what the true amount of expenditures and obligations are at either the federal or state level. Hence, responsibility cannot be pinned on any politician.

SCOTUS Should Not Show Any deference to Congress - The dissent in *Citizens United* (Justices Stevens, Ginsburg, Breyer and Sotomayor) believes that Congress’ “careful legislative adjustment of the federal election laws...warrants considerable deference...” and that “we should instead start by acknowledging that “Congress surely has both wisdom and experience in these matters that is far superior to ours.” However, “[t]his is not to say that deference would be appropriate if there was a solid basis for believing that a legislative action was motivated by the desire to protect incumbents or that it will degrade the competitiveness of the electoral process.”<sup>40</sup> This approach appears warranted for examining financial reporting laws and Congress’ abdication of its responsibility.

*Equal Protection*<sup>41</sup> - Financial reporting by the federal government, on which states rely, effectively forces a state to participate in action that violates the equal protection clause. For the Medicaid program the government reports no costs in any of its financial statements for the legal obligations that must be paid in the future. This has the effect of disguising a very substantial wealth transfer from future generations to pay for the current generation’s health care. This wealth transfer is an equal protection violation as it is unlikely that funds will exist to cover future generation’s same costs. An accurate statement and account of the nations finances would reveal this violation.

*Due Process*<sup>42</sup> - Congress cannot enact legislation regarding financial reporting that impinges on citizens' right to a true and correct accounting of the government's financial results and financial position. On June 8, 2009, the U.S. Supreme Court in a 5-4 decision in *Caperton v. A.T. Massey Coal Co.* found that campaign expenditures made in support of West Virginia Supreme Court Justice Brent Benjamin violated the Due Process Clause of the Fourteenth Amendment.

Justice Kennedy in his Opinion of the Court cited several cases including *Tumey v. Ohio*<sup>43</sup>. "The *Tumey* Court concluded that the Due Process Clause incorporated the common-law rule that a judge must recuse himself when he has "a direct, substantial, pecuniary interest" in the case. This rule reflects the maxim that "[n]o man is allowed to be a judge in his own cause; because his interest would certainly bias his judgment, and, not improbably, corrupt his integrity."<sup>44</sup>

If we apply the Court's logic to Congress' responsibility to publish the Statement and Account several notions become obvious. First, while the Constitution is clear that Congress is responsible for publishing the Statement and Account, it cannot unilaterally determine whether it is complying with the Clause. This would violate the maxim cited by the Court that no man is allowed to be a judge in his own cause. James Madison in *Federalist No. 10* extended this concept beyond a single judge, "With equal, nay with greater reason, a body of men are unfit to be both judges and parties at the same time". Second, it can be argued that Congress has "a direct, personal, substantial, pecuniary interest" in the determination of whether it is complying with Constitution as it is in their interest to under-report expenses in an effort to endear themselves with the electorate, protect incumbents and degrade the competitiveness of the electoral process. Furthermore, if we apply the Court's logic to the Appropriations clause it is clear that Congress cannot determine whether its' defining permanent appropriations out of existence for financial reporting purposes or its using different definitions of "liability" complies with the Appropriations and Statement and Account clauses.

The Court in *Caperton* stated that the facts of the case were "exceptional," "extreme," "rare" and "extraordinary." If \$3 million in campaign contributions to a state supreme court's judge's campaign is critical to the Court's analysis of whether due process has been violated then what would the Court consider Congress keeping over \$73.6 trillion of legal obligations that are fully funded with appropriations and numerous multi-trillion enterprises that the federal government controls off the governments' books as its members seek re-election.

It is significant to note that the Supreme Court does not have to conclude that the Congress intentionally published misleading or fraudulent financial statements. The Court merely has to conclude that there would be a possible temptation for the average Congress to not hold the balance nice, clear and true in determining the methodology of compiling the Statement and Account and its content. If it so concluded, the probability of actual bias on the part of Congress is too high to be constitutionally tolerable as the arbiter of whether it is complying with the Constitution.

**Chapter 8 Federal GAAP-Setting Process is Unconstitutional** - The Statement and Account Clause is found in Article I which defines the powers and limitations of Congress. Congress has the duty to produce the statement and account. It has unlawfully delegated responsibility for determining and defining the accounting principles and policies to be used by the federal government to the Comptroller General, the highest ranking officer of the GAO, an agency controlled by Congress.

Nowhere in the Constitution does it indicate that the Executive Branch has any authority in defining the information required to be published in the statement and account. Yet, the Comptroller General has entered into a joint venture with the Executive branch to define accounting principles and standards for the federal government. In addition, Congress has abdicated its responsibility for producing the statement and account required by the Constitution and handed control over the production of the statement and account to the Executive branch's Treasury Department and OMB.

It is hard to understand why the FASAB exists except as an unconstitutional political accommodation. Furthermore, it is inconceivable that under our Constitution Congress or the Executive could publish and discuss as relevant to the nation's financial condition figures that materially differ from the required statement and account (i.e., The President Budget or the Financial Report).

Since 1991, GAO has implemented its responsibility under U.S.C. sec 3511 largely through FASAB – a federal advisory committee jointly created by the Comptroller General, the Secretary of the Treasury, and the Director of the Office of Management and Budget (“Sponsors”). The Sponsors created FASAB to develop accrual accounting standards and principles for the United States Government.<sup>45</sup> Please note that FASAB and Congress have no input into the accounting principles used in creating the President's Budget.

The word Advisory was included in the Board's name to signify the retention of legal authority by the Sponsors, whose approval would be required before the Board's standards became effective. The Board can only recommend standards to the Sponsors. Although the Memorandum of Understanding creating FASAB indicates that the Sponsors have retained their authorities, separately and jointly, to establish and adopt accounting standards for the federal government this authority has never been used since the FASAB's inception. From a practical standpoint the Sponsors have bound themselves together. No accounting principle will be adopted unless all the Sponsors agree. Subsequently, provisions were included in the CFO Act that requires agency financial systems to comply with applicable accounting principles, standards and requirements. The Office of Federal Financial Management (“OFFM”), an office within OMB, decides upon new principles, standards and requirements for OMB after considering FASAB's recommendations.

The federal government has known for a very long time that its accounting standards setting process is unlawful under the Constitution. In *Bowsher v. Synar* the Supreme Court made it crystal clear that Congress cannot delegate lawmaking authority to a delegate of the Legislative branch. Chief Justice Burger delivered the opinion of the Court. He determined that the Comptroller General was an officer of the Legislative Branch, and as such, he may not be entrusted with executive powers. The Court then went on to conclude that the powers entrusted to the Comptroller General pursuant to the *Gramm-Rudman-Hollings Act* were executive in nature. Hence, the Act violates the command of the Constitution that the Congress play no direct role in the execution of the laws.

Under the *1921 Act* the executive branch was given the responsibility for preparing a budget. Currently, OMB prescribes all accounting rules involving the President's Budget. The “official” Statement and Account (“*Combined Statement of Receipts, Outlays and Balances*”) presents budget results and the cash-related assets and liabilities of the Federal Government. Please recall that OMB completely controls budget accounting. Hence, Congress has effectively given authority to the executive branch regarding the Statement and Account financial reporting without explicit legislation as to the principles to be used as to how it will be prepared. This is unconstitutional.

**Chapter 9 Federal Government's Cover-up** - The federal government has attempted to cover-up its unconstitutional accounting by having FASAB promulgate accounting principles and standards that justify the accounting treatment it uses. The fiction that the FASAB has concocted to effectively eliminate the federal government's enormous legal obligations for entitlement programs for financial reporting purposes is to define a category of transactions in such a manner that the federal government's obligation for those transactions will only be recognized at the last possible moment when funds are being disbursed. The transaction classification is called "*Nonexchange Transactions*." This classification is purely an accounting fiction that has no basis in appropriations law.

**Chapter 10 State GAAP-Setting Process is Unconstitutional** - The process by which GAAP is set for state and local governments is unconstitutional for several reasons. The primary reason is that none of the AICPA, FAF and GASB has been properly delegated legal authority by either the federal or state governments to establish laws that govern the preparation of financial statements by state or local governments. The electorate has a fundamental right to financial information under our Constitution and the determination as to how these financial scorecards are prepared cannot be determined by unelected accounting industry professionals that are not subject to substantial oversight and direction by either the federal or state governments. The arrangement that exists today for GAAP standards setting is "legislative delegation in its most obnoxious form."<sup>46</sup>

A second reason why the process is unconstitutional is that the Congress' current funding of GASB provided for under Dodd-Frank Section 978 enables the federal government to force the states to implement a federal program.

The AICPA has designated two accounting standards setting bodies GASB and FASAB which are both unconstitutional entities for the purposes for which they were created. In addition, certain of the accounting standards that they have promulgated require unconstitutional and fraudulent accounting. Nevertheless, if AICPA members do not follow GAAP as prescribed by GASB or FASAB its members will be disciplined pursuant to the AICPA's Code of Professional Conduct. The combination of these facts, which were well-known when Congress passed the Dodd-Frank legislation enabled Congress to force the nationwide acceptance of GASB's pronouncements as gospel as it relates to accounting standards.

Third, the current arrangement whereby private entities are wielding power in a manner that is unfair to both investors and the electorate can be challenged as violations of several private rights including Due Process, Equal Protection, Right to Financial Information, Political Accountability, Right to Vote and Freedom of Speech.

Justice Kennedy delivered the opinion of the Court on March 9, 2015 with respect to *Department of Transportation ET AL. v. Association of American Railroads*. Justice Kennedy cited *Lebron v. National Railroad Passenger Corp.*, 513 U. S. 374, as teaching that, for purposes of Amtrak's status as a federal actor or instrumentality under the Constitution, the practical reality of federal control and supervision prevails over Congress' disclaimer of Amtrak's governmental status. Justice Alito's concurring opinion sheds light on the issues described in this chapter.

"Liberty requires accountability. When citizens cannot readily identify the source of legislation or regulation that affects their lives, Government officials can wield power without owning up to the consequences. One way the Government can regulate without accountability is by passing off a Government operation as an independent private concern...

When it comes to private entities, however, there is not even a fig leaf of constitutional justification. Private entities are not vested with “legislative Powers.” Art. I, §1. Nor are they vested with the “executive Power,” Art. II, §1, cl. 1, which belongs to the President.... By any measure, handing off regulatory power to a private entity is “legislative delegation in its most obnoxious form.” *Carter v. Carter Coal Co.*, 298 U. S. 238, 311 (1936).....

**Chapter 11 State Government’s Cover-up** - The state governments have attempted to cover-up their fraudulent and unconstitutional accounting by having GASB promulgate accounting principles and standards that justify the accounting treatment that the states utilize.

State accounting for Medicaid is governed by *Statement No. 33 – Accounting and Financial Reporting for Nonexchange Transactions* which GASB promulgated in December 1998 and which took effect for periods beginning after June 15, 2000. The fiction that the GASB has concocted to effectively eliminate states’ enormous legal obligations for the Medicaid program for financial reporting purposes is to define a category of transactions for states in such a manner that the state’s obligation for those transactions will only be recognized at the last possible moment when funds are literally being disbursed by the states. The transaction classification is called “Nonexchange Transactions.”

**Chapter 12 Where is the Securities and Exchange Commission?** - The way forward for the SEC is to abandon its strategy of hope. It needs to interpret the U.S. Constitution’s Article I, section 9, clause 7. In addition, it must repudiate its relationship with the GASB, and institute enforcement actions against the fifty states for their fraudulent reporting with respect to the Medicaid program and one or more selected high profile targets that use non-consolidated off-balance sheet vehicles to hide massive spending and legal obligations. It should consider working with U.S. Attorneys and state AG’s to prosecute people and entities involved with perpetrating the massive frauds on the American people in the municipal securities market. The SEC might be astonished at the grass roots support that taking these actions would engender. Not surprisingly, this strategy would be highly unpopular in Congress. Thus, the SEC has to decide whether it wants to accomplish its mission or keep Congress happy.

It is the author’s contention that the SEC can and should interpret the antifraud provisions as being inherent in the Statement and Account Clause of the United States Constitution. A government “of the people, by the people and for the people” with an explicit provision in its constitution requiring the publication of a Statement and Account of the Receipts and Expenditures of all public Money does not need an antifraud amendment to that constitution requiring the federal government to publish truthful figures. To a certain extent Congress recognized the importance of the antifraud provisions by making the issuance of municipal securities subject to them.

The right to financial information described in the Statement and Account Clause is no different than other textually enumerated rights contained in the Bill of Rights. The SEC should interpret the Fourteenth Amendment as incorporating the right to financial information. If the SEC so interprets the Constitution all states, cities and local governments would have to comply with the Statement and Account Clause which requires proper reporting of total receipts, total expenditures and the resulting surplus or deficit in a single Statement and Account. These figures must include “all public money.” The off-balance sheet vehicles that are extensively used by state, city and local governments to mislead their respective electorates would need to be consolidated into one set of financial statements at each level of government. Assuming that the Constitution is interpreted in this manner many of the GASB’s accounting pronouncements would be unconstitutional. Several already violate the antifraud provisions.



The failure of the SEC to take on Congress over fraudulent accounting in the municipal securities market has implications far beyond that market. Why? Because the financial statements issued by state, city and local governments serve the dual purpose of informing investors and citizens/voters about how politicians are spending taxpayers' money. The unintended consequence of the SEC's failure is that all federal and state financial reporting is rigged. The failures of federal and state governments to publish complete and truthful statements and accounts of the federal government's and the fifty states' finances has made our republic dysfunctional, plagued by successive budget-deficit and debt-ceiling crises and headed towards financial Armageddon.

The failure of the SEC to go after the illegal structure of accounting standard setting in the municipal securities market has led to Congress setting up the same corrupt structure for federal financial reporting. If the SEC did its job and actually accomplished its mission of protecting investors in the municipal securities market this would expose Congress' corrupt practices at the federal level. Due to the failure of the SEC to aggressively pursue its stated mission, the GASB and FASAB are increasingly coordinating their accounting principles and standards to the detriment of investors and citizens/voters/taxpayers.

In addition it can be argued that the SEC determined the outcome of two recent Supreme Court decisions relating to the Affordable Care Act due to its decision not to go after improper state accounting for Medicaid. SCOTUS' decisions in the Obamacare cases were effectively based on fraudulent state financial information that did not reveal the extent of expenditures or the net present value of future legal obligations related to the Medicaid program. The SEC's decision not to prosecute improper state accounting for Medicaid stands in stark contrast to its prosecution of the states of New Jersey, Illinois and Kansas for the publication of fraudulent financial information related to pension obligations.

Furthermore, the SEC's conscious decision not to enforce the antifraud provisions as they relate to financial reporting by state governments regarding their participation in the Medicaid program produces a perpetual fraud on the federal and state judiciaries. Not surprisingly, the SEC's decision to pursue the pension obligation investigations came at the behest of a Congress that did not want the pension underfunding issue to end up on its doorstep.

The unfortunate truth is that every states' financial statements are fraudulent as a matter of law and many city and local governments' financial statements are fraudulent as a matter of law.

Based on the \$27.3 trillion obligation reported in the 2015 Financial Report of the U.S. Government for the federal government's portion of Medicaid's costs, the fifty states have an aggregate net present value obligation for their portion of the Medicaid program of approximately \$17 trillion. The states' obligation is over four times the size of the entire municipal securities market and it is clearly material under the Supreme Court's definition. At Congress' suggestion in the Dodd-Frank Wall Street Reform and Consumer Protection Act's section 978 the SEC is providing funding for the Governmental Accounting Standards Board (GASB). It promulgated Statement No. 33 – Accounting and Financial Reporting for Nonexchange Transactions in 1998 which requires each state for periods beginning after June 15, 2000 to not recognize any costs or liability other than current year cash outlays or provide any additional disclosures for their Medicaid program. This accounting pronouncement requires accounting for the Medicaid program that violates the antifraud provisions as a matter of law.

By way of contrast, in recent years Congress has been focused on the issue of the states' accounting for pension obligations and in 2011 "Public Employee Pension Transparency Act" legislation was

introduced in Congress. This legislation would have required states to more clearly reflect their pension finances and it provided an express ban on bailouts by the federal government. It was apparent that the members of Congress proposing this legislation did not want state pension fund obligations ending up on its doorstep. Not surprisingly, about the same time the SEC formed a specialized group to focus on public pension accounting and disclosure violations. The end result of its efforts was that the SEC found the states of New Jersey, Illinois and Kansas violated the antifraud provisions by publishing fraudulent financial statements in connection with multiple bond offerings.

Notwithstanding the SEC's success in prosecuting fraudulent disclosure of pension obligations it has taken no action with respect to states' fraudulent financial reporting for their portion of the Medicaid program. Why? One can speculate that pulling on that thread would end up exposing Congress' fraudulent financial reporting for Medicare, Social Security and Medicaid at the federal level. In addition, it would expose the integral role that the accounting profession has played in the federal and state frauds. Neither of these outcomes are things that Congress wants to become public.

State, city and local governments use of off-balance sheet vehicles to obfuscate spending as well as the size of their legal obligations rival Enron's fraudulent accounting.

Simply put, Congress does not want issuers in the municipal securities market held to any accounting standard that politicians do not effectively control. Their worst nightmare is that issuers would have to meet a clearly defined set of accounting principles and standards that did not provide substantial wiggle room for normal political shenanigans. Most importantly, Congress does not want to force issuers to tell citizens/voters exactly how much they have been spending. They prefer the current arrangements whereby financial statements substantially understate spending. The Tower Amendment makes Congress' position crystal clear. Congress does not want honest accounting in the municipal market now or anytime soon. It is unlikely that an appetite exists today in Congress for any changes with the new Trump Administration.

The following quote is taken from the *"State of the Municipal Securities Market."* *"As of December 2010, 38 states compel some or all of their political subdivisions, including counties, cities, and school districts, to prepare their financial reports in accordance with GASB standards."*

It is noteworthy that 12 states that have not delegated lawmaking authority to the GASB. However, this raises another point that is not mentioned by the SEC in its 2012 report. Does the SEC have authority to regulate voluntary compliance by the states with the GASB's pronouncements? However, before addressing that issue it is important to remember that the AICPA has a mechanism in place that forces all certified public accountants that are AICPA members to comply with its Code of Professional Conduct. This effectively forces them to comply with the GASB's pronouncements. Furthermore, while the SEC does not currently have the authority to require municipal issuers to obtain audit opinions the marketplace does. The marketplace requires audited financials for the vast majority of municipal security issuers, particularly the larger ones.

The SEC's involvement with the GASB has been much more pernicious than just not attacking its unlawful and unconstitutional pronouncements. It actively lobbied Congress to fund the GASB. This is evidenced by several references in speeches made by Commissioners. Moreover, the SEC succeeded in its efforts to get funding. Enforcement of unconstitutional and fraudulent accounting

principles and standards through the AICPA's rules of Professional Conduct is not "voluntary" when the SEC is funding GASB.

The SEC is desperately trying to create the same setup that it has in the corporate sector in the municipal securities market. However, it has failed to date and facts suggest it will continue to fail to achieve that goal because Congress has not and in all likelihood will not give the SEC the requisite authority. One has only to review the numerous recommendations in various speeches by SEC Commissioners and the Report on the Municipal Securities Market to know that this is true.

What the SEC has to do is to look in the mirror and acknowledge that HOPE IS NOT A STRATEGY to fulfill its mission of protecting investors. Once the SEC candidly and dispassionately assesses the state of affairs the SEC must come to the conclusion that it has helped create a corrupt environment through its involvement with the GASB. GASB is an unlawful, corrupt standards setter and some of its pronouncements require accounting standards that violate the antifraud provisions as a matter of law. This relationship needs to be terminated.

The current setup is ideal for politicians since they effectively control the GASB, and therefore, financial reporting. In addition, this setup is ideal for the accounting profession as it allows them to sell accounting opinions to issuers of municipal securities.

**Chapter 13 Perpetual Fraud Exists on Federal and State Judiciaries** - The nation needs the Supreme Court most when the other two branches of government have clearly failed to fulfill their Constitutional duties. Unless the judiciary restores the rule of law the lack of proper financial reporting ensures that our electorate remains uninformed and that the nation will go off the proverbial "financial cliff" with the concomitant severe economic disruption and civil unrest.

The federal and state government's fraudulent financial reporting has created a perpetual fraud on the state and federal judiciaries. The impact of this fraudulent reporting can be most easily seen by reviewing two Obamacare decisions: *NFIB v. Sebelius*<sup>47</sup> and *King v. Burwell*.

*NFIB v. Sebelius*<sup>48</sup> - On June 28, 2012 the Supreme Court resolved constitutional challenges to two provisions of the Patient Protection and Affordable Care Act of 2010 ("ACA" or the "Act"). Seven members of the Supreme Court agreed that the Medicaid expansion in the Act is unconstitutional.<sup>49</sup> Each of the opinions issued by the Court, Justice Ginsburg and the Dissenters (Justices Scalia, Kennedy, Thomas and Alito) contains economic and political accountability analysis that are seriously flawed and incomplete. All of the Justices ignored important facts associated with entitlement program spending and the federal government's financial results. None addressed the Appropriations or Statement and Account clauses, both directly applicable Constitutional provisions. Not surprisingly, the Court's remedy is clearly in error.

Information submitted in merit briefs and orally to the Supreme Court included financial information published by the federal government that does not comply with the Appropriations and Statement and Account clauses. In addition, relevant material financial information that was published only after the passage of the ACA but prior to the submission of merit briefs and oral argument was not raised or discussed in either. The fraudulent material submitted by each state to the Court relates to each state's financial results. This information is fraudulent as it does not include the full costs directly related to each state's participation in the Medicaid program. The full cost of the Medicaid program for each state has never been published by any state.

“We have repeatedly characterized . . . Spending Clause legislation as ‘much in the nature of a contract.’”<sup>50</sup> Furthermore, “Congress may use its spending power to create incentives for States to act in accordance with federal policies. But when ‘pressure turns into compulsion,’ the legislation runs contrary to our system of federalism.”<sup>51</sup> “In this case, the financial ‘inducement’ Congress has chosen is much more than ‘relatively mild encouragement’— it is a gun to the head.”<sup>52</sup> “The threatened loss of over 10 percent of a State’s overall budget . . . is economic dragooning that leaves the States with no real option but to acquiesce in the Medicaid expansion.”<sup>53</sup>

The federal government published a \$24 trillion estimate of the present value of the future net cost of the program for the first time in the 2010 Financial Report.<sup>54</sup> This figure was based on savings assumptions associated with the ACA similar to those used to generate the \$22.8 trillion Medicare figure published simultaneously. However, the assumptions were so unrealistic that the Administration published an alternate more realistic scenario which indicated a cost of \$35.2 trillion.<sup>55</sup> No alternate figure was published for Medicaid. The only costs recorded by the federal government or any state for Medicaid are current year cash expenditures. Second, since the State portion of Medicaid contributions averaged 43% of total expenditures this means that there is an additional \$18.3 trillion present value obligation. Therefore, Medicaid in total is a \$42.5 trillion program. No State records the full cost of its share of Medicaid costs in its financials.

The States cannot knowingly accept the full terms of the Medicaid contract if a fundamental assumption or condition on which they rely is materially in error. The ability of the federal government to provide financing is a key determinant whether a State wants to continue taking the money. Federal financial reporting is coercive because it significantly overstates the ability to continue providing funding. The failure to so advise the States through the publication of a truthful and accurate Statement and Account renders acceptance of the "contract" null and void as there could not be any meeting of the minds.

If the fifty states are committing fraud in publishing their financial statements how can the electorate of these states be the informed voters that our Constitution requires? Furthermore, given the length of time that Medicaid has been in existence and the lack of financial reporting how can the state’s politicians accept the federal government’s money? There cannot be a meeting of the minds as both sides are significantly under-reporting expenses related to Medicaid.

The chapter concludes with ten important concepts (four of which appear below) contained in Justice Kennedy’s concurring opinion in *Clinton v. City of New York* (1998). These concepts provide a helpful roadmap for illuminating the deficiencies of the federal judiciary’s decisions. The case involved the *Line Item Veto Act of 1996*. The Opinion of the Court delivered by Justice John Paul Stevens in 1998 indicated that the Act violated the Presentment Clause as it gave the President the power to unilaterally change laws passed by Congress.

- 1) “A nation cannot plunder its own treasury without putting its Constitution and its survival in peril.”
- 2) “Liberty is always at stake when one or more of the branches seek to transgress the separation of powers.”
- 3) “Money is the instrument of policy and policy affects the lives of citizens. The individual loses liberty in a real sense if that instrument is not subject to traditional constitutional constraints.”
- 4) “The Constitution is not bereft of controls over improvident spending. Federalism is one safeguard, for political accountability is easier to enforce within the States than nationwide. The other principal mechanism, of course, is control of the political branches by an informed and responsible electorate. Whether or not federalism and control by the electorate are adequate for the problem at hand, they are two of the structures the Framers designed for the problem the statute

*strives to confront. The Framers of the Constitution could not command statesmanship. They could simply provide structures from which it might emerge.”*

**Chapter 14 Federal and State Governments’ Actual Financial Results: A Closer Approximation** - This chapter provides 1) an estimate of the financial results of the Federal government for the last decade (fiscal year 2006 to fiscal year 2015) 2) two estimates of its financial position as of September 30, 2015 and 3) a revised estimate of the state’s aggregate net present value obligation for their portion of the Medicaid program.

The simplest way to think about our government's recent financial results is to add up all the expenditures and revenues over the last decade and divide the total expenditures by total revenues. This produces a "dollar spent per dollar of revenue" figure which everyone that manages a household can understand. **Exhibit 17** displays The President’s Budget for the years 2006 through 2015. Over the last decade, under budget accounting, the federal government has outlays of \$33.13 trillion while recording receipts of \$25.57 trillion. Thus, the Federal government has spent \$1.30 for every \$1 of revenue it has received. Please note that the budget deficit does not include the multi-trillion dollar annual increases in the present value of our Social Security, Medicare and Medicaid obligations. Everyone that has a credit card knows that the amount that you spent in any year is equal to the amount that you paid the credit card company plus or minus the increase or decrease in your year-end balance. The government conveniently ignores the second half of the calculation.

**Exhibit 18** depicts the Financial Report for the fiscal years 2006 through 2015. **Exhibit 20** depicts the balance sheet for September 30, 2015. **Exhibit 21** depicts the figures reported in the SOSI for the Open group (current and future participants) for Medicare and Social Security for the years 2006 through 2015. There are three adjustments to consider to the figures appearing in **Exhibit 21**.

The first set of adjustments to consider relates to the uncertainties associated with achieving some of the ACA’s projected cost reductions and the publication of an alternative scenario by the Medicare Trustees. **Exhibit 22** depicts an analysis of the excess of expenditures over income for Medicare under the alternative scenario for 2010, 2011, 2012, 2013, 2014 and 2015.

The second adjustment is due to the fact that both Social Security and Medicare Part A will run out of appropriated funds in coming years. **Exhibit 23** contains analysis of appropriated funds and unfunded amounts for each year from 2006 to 2015. For 2015 Medicare had \$25.0 trillion of net present value costs that were fully funded with appropriations.

The third adjustment is tied to the fact that Social Security and Medicare have permanent appropriations which do not stop at 75 years. The Infinite Horizon data for the period from 2006 through 2015 appear in **Exhibit 24**. It indicates that in 2015 the net present value costs of Social Security and Medicare under an Infinite Horizon were \$28.5 and \$43.5 trillion, for a total of \$72.0 trillion.

**Exhibit 25** and **Exhibit 26** summarize appropriations and unfunded amounts for Social Security and Medicare under the infinite horizon for each year from 2006 through 2015. **Exhibit 27** displays the reported net present value cost of the Federal Government’s portion of Medicaid from 2010 through 2015. There are two adjustments that one must consider to the \$27.3 trillion estimate for the net present value cost of Medicaid as of September 30, 2015.

The \$27.3 trillion figure was based upon savings assumptions associated with the ACA similar to those used to generate the \$27.9 trillion Medicare net present value cost figure published simultaneously. However, these assumptions were so unrealistic that the government published an alternate, and more realistic, scenario which indicated that Medicare had a net present value cost of \$36.8 trillion. No alternate figure was published for Medicaid.

The second adjustment that must be considered is related to the fact that Medicaid has permanent appropriations which do not stop at 75 years. As noted by the federal government for the social insurance obligations, “The shorter horizon understates financial needs by capturing relatively more of the revenues from current and future workers and not capturing all of the benefits that are scheduled to be paid to them.” Therefore, “Infinite Horizon” obligations for Medicaid are needed but the federal government does not calculate or publish these figures.

Medicaid Obligations Exceed \$1 Trillion for Four States - In order to calculate the state’s aggregate net present value obligation in 2015 we utilize the totals in columns 2 and 4 on **Exhibit 28**. Federal spending in 2015 of \$317,302 divided by total spending of \$512,315 produces a percentage of 61.934942%. If we divide the \$27.3 trillion figure published by the federal government for its portion of Medicaid by this percentage the result is \$44.078510 trillion. Subtracting the federal figure of \$27.3 trillion indicates that the state’s aggregate net present value obligation for Medicaid is \$16.778510 trillion.

Based on the states spending for the Medicaid program in 2015 there are four states that have a net present value cost obligation that exceeds \$1 trillion – California, Ohio, New York and Texas. This obligation appears nowhere in any of their financial statements. For example, the State of New York’s obligation is approximately \$1.4 trillion. **Exhibit 28** depicts the estimated obligation in 2015 for all fifty states. Each of these obligations is material to each state’s financial results and financial position.

**Exhibit 29** displays Medicare appropriations for the amounts reported in SOSI, the amounts reported in the alternative scenario and the amounts reported under the Infinite Horizon. The time frame analyzed is from 2006 through 2015. **Exhibit 30** depicts Social Insurance and Medicaid obligations that are fully funded with appropriations from 2006 through 2015. The Social Security figures are taken from **Exhibit 25**. The Medicare amounts are based on the Infinite Horizon and are taken from **Exhibit 26** and the Medicaid figures are taken from **Exhibit 27**. Please note that the Medicare obligations are understated because the Federal Government does not publish Infinite Horizon figures for the Alternate Scenario. In addition, the Medicaid obligations are significantly understated as the federal government has not published 1) Alternative Scenario, 2) Infinite Horizon or 3) Alternative Scenario Infinite Horizon figures for Medicaid for any period.

Federal Government’s Financial Results – A Closer Approximation - **Exhibit 31** displays The Financial Report’s Net Operating Cost figures adjusted to account for the annual changes in the net present value cost of the Social Insurance and Medicaid obligations that are fully funded with appropriations. These adjusted figures come much closer to reflecting the federal government’s economic reality.

Over the last decade, after adjusting the Federal Government’s accrual accounting used in the Financial Report to include the net change in the present value cost of legal obligations with appropriations it has spent \$62.89 trillion while recording revenues of \$25.57 trillion. Thus, the

Federal government has spent \$2.46 for every \$1 of revenue it has received. Just to be clear about the size of the problem, over the last decade, using reported figures that are understated, incomplete estimates, the federal government spent almost \$63 trillion while it took in a little less than \$26 trillion. The government pretends that obligated money is not spent until the future arrives; a legally correct accounting must accrue for those future payments.

First Estimate of Feds Financial Position as of September 30, 2015 - **Exhibit 32** shows that the federal government's legal obligations are almost \$92 trillion, which is far above the carefully defined debt-ceiling limit of \$18.1 trillion (currently suspended until March 2017) and are over five times the size of the gross domestic product and almost twenty-eight times the size of the government's revenues in fiscal 2015.

The Second Estimate of Financial Position – Economic Reality is Much Worse! - In this section we will do some “horseback arithmetic” to calculate the Federal Government's economic reality (i.e., how much worse the balance sheet is than the first estimate). It is not practical to estimate the impact on an annual basis for the 2006 to 2015 time frame on the Financial Report's Net Operating Cost.

**Exhibit 29** indicates that for 2015 the amount reported for the Alternative Scenario that has appropriations is \$29.2 trillion and the amount reported in SOSI with appropriations is \$25.0 trillion. The Alternative Scenario figure is 16.8% higher than the fully funded amount reported in SOSI. In addition, **Exhibit 29** indicates that the amount reported under the Infinite Horizon is \$43.5 trillion. This figure is 74% higher than the amount reported in SOSI. If we use the 74% figure to gross up the \$29.2 trillion amount for the Alternative Scenario, the result is a net present value cost for fully funded Infinite Horizon amounts for the Alternative Scenario of \$50.8 trillion, an increase of \$7.3 trillion over the fully funded Infinite Horizon figure.

In order to estimate the Infinite Horizon for the Alternative Scenario for Medicaid we will first gross up the Medicaid figure reported in **Exhibit 30** by 16.8% (the same as the Medicare figure above) to estimate the Alternative Scenario amount that is fully funded. This yields a figure of \$31.9 trillion. This figure is then grossed up by 74% to estimate the Infinite Horizon amount. It yields a figure of \$55.5 trillion. This exceeds the reported fully funded Medicaid figure of \$27.3 trillion by \$28.2 trillion.

Based on the two revised estimates for fully funded Medicare and Medicaid amounts the Federal Government's legal obligations for SOSI and Medicaid are estimated to be \$35.5 trillion higher than the \$73.6 trillion for 2015 reported on **Exhibit 30**. The Federal Government's Total Net Obligation on **Exhibit 32** would be \$127.3 trillion.

States' Aggregate Medicaid Obligation is \$34.1 Trillion - Based on the estimate of the federal government's net present value cost obligation for Medicaid of \$55.5 trillion we calculate the net present value cost of the entire program by dividing this figure by the federal governments' percentage of total spending in 2015. We utilize the totals in columns 2 and 4 of **Exhibit 33**. Federal spending of \$317,302 divided by total spending of \$512,315 produces a percentage of 61.934942%. Dividing \$55.5 trillion by this figure produces a result of \$89.610158 trillion. Subtracting the federal amount of \$55.5 trillion indicates that the states' aggregate net present value cost obligation for Medicaid is \$34.110158 trillion.

**Chapter 15 Who Might be Found to be Complicit in a Political Protection Racket?** - The purpose of this chapter is to raise the question of whether the federal and state governments, the

AICPA, FAF, FASAB and GASB are operating a “*criminal enterprise*” as defined under the Racketeer Influenced and Corrupt Organizations Act (“RICO Act or RICO”).<sup>56</sup> Even if the answer to the question is a clear “no,” going through the exercise of considering this outcome reveals just how shady the current arrangements are today.

It can be argued that the fundamental premise underlying this “*association-in-fact*” among the federal and state governments, the AICPA, FAF and GASB is that the parties have operated and will continue to operate a “*Political Protection Racket*.” Generally, a protection racket is a scheme whereby a group provides protection to other groups using behavior that is outside the law. The presumptive bargain struck for operating this criminal enterprise is that in return for

a) Federal and state governments:

- (1) Permitting the accounting industry to provide federal, state and local government entities assurance services (“audits”),
- (2) Funding the FAF, FASB and GASB and
- (3) Not pointing out that the AICPA has no legal authority to designate any accounting standards setting body for the federal or state governments which has a significant benefit to the AICPA in terms of assisting in growing its membership, and
- (4) Not pointing out that FAF and GASB have no legal authority to set GAAP for state and local governments;

b) The accounting industry will:

- (1) Promulgate generally accepted accounting principles (“GAAP”) that substantially understate spending by the federal, state and local governments, and
- (2) Prosecute AICPA members under its Code of Professional Conduct that do not conform to these GAAP standards; and

c) FASAB and GASB will coordinate their rule-making so as to minimize any possible difficulties associated with differing accounting rules for the federal and state governments.

The end result of this presumptive bargain is that politicians at both the federal and state level will be largely shielded from the negative consequences of their spending.

Primary responsibility for the fraudulent and unconstitutional financial reporting by the federal government lies with the leadership on both sides of the aisle in the House and the Senate. However, the Federal Reserve sets the nation’s monetary policy to promote the objectives of maximum employment, stable prices, and moderate long-term interest rates. These objectives cannot be effectively reached while the federal and state governments publish fraudulent and unconstitutional financial statements.

**Chapter 16 Counter-Arguments to Consider** - There are a number of reasons why the federal and state governments think that they can get away with their fraudulent financial reporting. Most importantly, they believe that the Supreme Court will not determine the meaning of the appropriations and statement and account clauses. A corollary to this thinking is that the issue of financial reporting should be left to the Legislative and Executive branches. The federal government has employed accounting experts to advise them on proper accounting for the federal government so the belief is that it would be entirely inappropriate for the Supreme Court to weigh in on the topic of proper accounting.



Most government officials believe that Congress has the plenary power to determine whatever financial reporting it deems appropriate for the electorate. In addition, most believe that current financial reporting practices fulfill any Constitutional requirement under the Statement and Account clause. The government publishes the Combined Statement of Receipts, Outlays and Balances as well as substantial additional disclosure in its annual Financial Report of the United States Government and the President's Budget. Furthermore, the federal government has been explicit in its annual Financial Report that current policies are unsustainable. This should be more than an adequate warning for the citizenry.

The federal government's arguments against recording any obligations for future payments include an argument that these obligations are so large that they can never be paid. Hence, recording these liabilities might hinder reforms. Finally, because these obligations can't be paid they are not really estimable.



*In a time of universal deceit – telling the truth is a revolutionary act.*

*George Orwell*

## 1 Introduction

An informed electorate is the cornerstone of our democracy. This memorandum's primary purpose is to shine a bright light on the federal and state governments' failures to publish what the Constitution mandates that they must publish for their electorates. It asserts that the federal and state governments are falsely reporting total receipts, total expenditures and the resulting deficit calculated by subtracting the second figure from the first. These three figures are not subject to the plenary power of Congress. It also describes how and why liberty has been sacrificed for almost a century as the federal and state government's financial reporting practices do not comply with the United States Constitution and violate the antifraud provisions of the nation's securities laws.

The term "fraud" is generally defined in the law as an intentional misrepresentation of material existing facts by one party to another with knowledge of its falsity. The misrepresentation is made for the purpose of inducing the other party to act, and upon which the other party relies with resulting injury or damage. The frauds by the federal and state governments fit the textbook definition.

### A. An Informed Electorate is Key to Our Democracy

Truthful financial reporting by our government is critical for the operation of our democracy. Liberty cannot be preserved without a general knowledge among the people of the character and conduct of their rulers. Their use of public money is central to this general knowledge. As Supreme Court Justice William O. Douglas said in his dissent in the *United States v. Richardson* case in 1974,

*"The Framers of our Constitution deemed fiscal information essential if the electorate was to exercise any control over its representatives and meet their new responsibilities as citizens of the Republic."*

James Madison also made the point clearly.

*"A popular Government, without popular information, or the means of acquiring it, is but a Prologue to a Farce or a tragedy; or, perhaps both."<sup>57</sup>*

We have reached the stage where federal and state financial reporting is both a farce and a tragedy. The legislation enacted by Congress that authorizes fraudulent reporting, as well as the actions by the executive branch usurping Congress financial reporting responsibilities, are clearly unconstitutional.

#### a. Right to Financial Information is Written into Our Constitution

Article I, section 9, clause 7 of the United States Constitution states:

*"No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time,"*

The first part of the clause is called the Appropriations Clause and the second part is called the Statement and Account Clause. Together, they shall hereafter be called the “two clauses.”

The right to financial information must exist if our democracy is to work properly. If citizens do not have a right to receive reasonably correct information about the nation’s finances this would limit or abrogate entirely citizens’ right to vote,<sup>58</sup> and freedom of speech and also violate their due process and equal protection<sup>59</sup> rights. In addition, without the right to financial information required political accountability is eliminated.

The Right to Financial Information is consistent with the importance of information in our democracy and the principles upon which our nation was founded. The distinction between cash-based accounting versus accrual accounting is irrelevant for purposes of the right. The public is entitled to an accounting that reflects the economic reality of the government’s finances under the Constitution. If accrual accounting more accurately reflects economic reality then this is what is required.

Given that the Framers wanted voters to have accurate information about federal spending at what point does the federal and state governments’ publication of false and misleading financial information render a citizen’s vote meaningless? When the government is spending at twice the level that it reports to its citizens? Three times? Four times?

The federal and state government’s accounting rules mislead voters about the consequences of their votes. The rules make a mockery of the idea of political accountability. Financial reporting leaves voters with no idea how large federal or state government expenditures are. Voters cannot send the responsible federal politicians packing because they retired from Congress years ago. Their current representatives say that their hands are tied on mandatory spending and that they cannot be held accountable.

Finally, the fraud hampers our political leaders. The decisions being made by our political leaders are based in large part upon fraudulent financial information.

## **B. Why Have Federal and State Politicians Under-Reported Spending?**

The primary reason why citizen’s rights have been infringed upon is that the federal government’s Legislative and Executive branches and the state governments have controlled financial reporting and thereby public opinion to minimize their accountability for spending. Congress and the state legislatures have spent enormous sums of taxed and borrowed money to endear themselves to their electorates, but they do not want to be held accountable for the full extent of their spending. Hence, the legislative and executive branches and state governments collude to underreport expenses. To accomplish their goal they have enlisted the support of the accounting profession and they have managed to keep the media silent on the issue.

Proper reporting would lead to spending cutbacks, tax increases and/or recriminations for overspending, all of which are likely to cause voter dissatisfaction and changes at the polls. The executive and legislative branches and state governments have violated the trust placed in them by the electorate, acted in a self-serving manner to the detriment of the ideals on which America was founded and subverted the democratic process all in an effort to make re-election easier for incumbents.

### **a. Federal and State Finances Have Been in Bad Shape for a Long Time**

The fact that the United States Government's finances are in dire shape is not a new or novel concept. Politicians and senior finance professionals in the federal government have known that current policies are "unsustainable" for a very long time. In economic parlance this is described as the nation having a "structural deficit", which is a deficit that will widen no matter how the U.S. economy performs. This includes any faster Gross Domestic Product ("GDP") growth scenario for the nation or any scenario that attempts to eliminate all the government fraud, abuse and waste in its various programs.

In 1994 President Clinton's Commission on Entitlement Reform (Kerrey-Danforth Commission) found unanimously that the cost of entitlement programs and interest on the national debt would consume all federal spending by 2030 and stated that these programs were "unsustainable."

In 2004 the International Monetary Fund pointed towards a huge and growing imbalance between what the federal government is likely to record in revenues and what it has promised to pay in future benefits.

That America's fiscal policies are "unsustainable" from an economic point of view is important for the electorate to know. The Constitution requires that our government publish an accurate and complete Statement and Account of the nation's finances.

*"Over and over again, good accounting practices have produced the level of trust necessary to found stable governments and vital capitalist societies, and poor accounting and its attendant lack of accountability have led to financial chaos, economic crimes, civil unrest, and worse."<sup>60</sup>*

In the last fifty years the problem has actually become much worse and more widespread as all fifty states, Washington D.C. and other cities, Puerto Rico and other U.S. territories and local governments have structural deficits and fraudulent accounting. These have been swept under the rug for the same reasons that the federal government's structural deficit and fraudulent accounting problems have been hidden. This fact appears to be lost on all those politicians and private citizens clamoring for a balanced budget amendment. The only thing that a balanced budget amendment would produce is more creative fraudulent accounting. The balanced state budgets touted by proponents are economic fiction.

## **C. Reporting Requirements Have Changed Since Constitution Adopted**

### **a. Accounting in the Private Sector <sup>61</sup>**

Prior to the late 1800s there was little need for financial statements. Beginning in the 1820s the number of corporations expanded rapidly with the growth of railroads. This increased the demand for financial information. In addition, with the separation of management and ownership in corporations, there arose a need for an independent party to review the financial statements. Moreover, there was an expectation that the independent review would discover whether managers were violating their fiduciary duties to the owners.

The American Association of Public Accountants (AAPA) was incorporated in 1887. The AAPA was reorganized as the American Institute of Accountants (AIA). In 1921, the American Society of Certified Public Accountants (ASCPA) was established and became a rival. The ASCPA merged with the AIA in 1937. In 1957, the AIA became the American Institute of Certified Public Accountants (AICPA).

During the nineteenth century, the federal government generally allowed accounting to regulate itself. Then, in 1913, Congress established the Federal Reserve System and, one year later, the Federal Trade Commission (FTC). From this date forward, federal agencies have had an increasing impact on accounting.

The government's first major attempt at the formalization of authoritative reporting standards was in 1917 with the Federal Reserve Board's publication of Uniform Accounting. In 1918, the bulletin was reissued as Approved Methods for the Preparation of Balance Sheet Statements.

The impetus for stricter financial reporting was provided by the collapse of the securities market in 1929 and the revelation of massive fraud in a company listed on the New York Stock Exchange (NYSE). In 1933, the NYSE announced that companies applying for a listing on the exchange must have their financial statements audited by an independent public accountant. The scope of these audits had to follow the revised guidelines set forth by the Federal Reserve in 1929.

The Securities Act of 1933 conferred upon the FTC the authority to prescribe the accounting methods for companies. Under this act, accountants could be held liable for losses that resulted from material omissions or misstatements in registration statements they had certified. The Securities and Exchange Act of 1934 transferred the authority to prescribe the accounting methods to the newly established Securities and Exchange Commission (SEC) and required that financial statements filed with the SEC be certified by an independent accountant.

In 1938, the SEC delegated much of the authority to prescribe accounting practices to the AIA and its Committee on Accounting Procedures (CAP). In 1939, CAP issued the first of fifty-one Accounting Research Bulletins. In 1959, the AICPA replaced the CAP with the Accounting Principles Board (APB). The APB was designed to issue accounting opinions after it had considered previous research studies, and in 1962, the APB issued the first of thirty-one opinions. Although the SEC had delegated much of its standard setting authority to the AICPA, the commission exercised its right to approve all standards.

The Financial Accounting Standards Board (FASB) was established in 1973 to replace the APB. This board is independent of the AICPA and issued its first statement in 1973.

The SEC and the FASB, as well as its predecessors, have for many years indicated a preference for accrual-based accounting.<sup>62</sup>

## **b. Brief History of Federal Government's Accounting**

The U.S. Department of the Treasury was created by an Act of Congress on September 2, 1789. The Congress directed the Treasury to provide for the collection, safeguarding, and disbursement of public money, and to maintain a system of account for the government's collections and payments. Although the collection and control of money is critical to any government, the federal financial infrastructure remained very small for more than 100 years. The Register of the Treasury originally carried out the account-keeping functions. Individual departments and independent agencies conducted most disbursing functions without Treasury oversight. By modern standards the administration of federal finances was extremely loose, but then the federal government was much smaller than it is today, and its duties were far more limited. Other than during the few major wars, the government did not collect or spend very much money, and so the need to centralize or modernize its payment, collection, or accounting systems did not exist.

The first major financial management reform took place just after World War I. In late 1919, Treasury Secretary Carter Glass created the forerunners of the current fiscal operations bureaus, Financial Management Service (“FMS”) and the Bureau of Public Debt, by approving the positions of the Commissioner of Accounts and deposits and the Commissioner of the Public Debt.

It is critical to note that reporting requirements have changed since the nation’s founding. The combination of the amendment permitting income taxes and the passage of legislation creating massive social insurance programs with permanent appropriations have completely changed the size and complexity of the federal government’s operations. Most importantly, Congress changed the nature of appropriations from just single year appropriations. Also, in the last 100 years Congress has created the Federal Reserve System, Fannie Mae and Freddie Mac, each a multi-trillion dollar enterprise. Yet, the Federal government’s balance sheet does not consolidate these or other material controlled entities.<sup>63</sup>

In light of these changes it is not a reasonable interpretation of the Statement and Account clause’s “all public Money” requirement that Congress can allow the Treasury Department publish a cash disbursements ledger broken down by annual appropriations only, while the Executive branch publishes two sets of annual financial statements that have no references to appropriations anywhere and that cannot pass antifraud provision scrutiny.

#### **D. Congress Has Abdicated Its Financial Reporting Responsibilities**

James Madison was prescient with the following remark.

*“I believe that there are more instances of the abridgement of the freedom of the people by gradual and silent encroachments of those in power than by violent and sudden usurpations.”<sup>64</sup>*

Over the last 100 years, Congress has abdicated its financial reporting responsibility. Today the executive branch dominates all financial reporting with little to no input from Congress. The President’s Budget is prepared by OMB without input from Congress, and the Financial Report of the United States Government is prepared by Treasury and OMB based on principles promulgated by FASAB. Practically speaking, the executive branch has effective veto power over any proposed accounting principle it does not like. The end result is that financial reporting by the federal government does not reflect economic reality.

In 1990 the Comptroller General, Treasury Secretary and Director of OMB established FASAB as an advisory committee to develop accounting standards and principles for the federal government. There is absolutely no discussion in the FASAB literature explaining how the accounting principles it has promulgated comply with the Statement and Account clause’s “all public money” requirement. And no matter how much AICPA GAAP-compliant lipstick are put on FASAB’s accounting principles this does not overcome their lack of compliance with the Constitution.

#### **E. Numerous Attempts to Fix the Problem Have Failed**

Over the years numerous good faith and half-hearted attempts have been made to address the federal government’s structural deficit and accounting problems. These attempts include Congress enacting various spending limitations measures, Presidential Commissions being appointed to make recommendations regarding solving the problem and efforts by private citizens to inform the electorate and provide grass roots support for addressing the issue. In the 1950s Congress passed legislation requiring that the President’s Budget be prepared using accrual accounting. The

Executive branch ignored the law. It is fair to say that these efforts have been a colossal failure and the nation continues on its path towards financial Armageddon.

## **F. There Never Will Be a Happy Ending to the Problem**

The author is well aware that there will be no happy ending to the problem that is being addressed. Furthermore, the author is not likely to be popular in most quarters for illuminating the problem. There is a story that Jacob Soll recounted in his recent book *"The Reckoning"* which accurately portrays the authors' view on how this memorandum will likely be received by many, particularly those in government and in the accounting professions rules setting organizations for government accounting.

*"...Cicero complained of bad accounts in his attacks on Mark Anthony, known for his debts and shady dealings. He claimed Mark Anthony had kept bad account books and, in doing so, had "squandered a countless sum of moneys" stolen from Caesar and even forged accounts and signatures. ...later that year...Mark Anthony hunted down Cicero and had his head and hands chopped off and displayed in the Forum. This grimly illustrates a constant maxim: The powerful don't respond well to those who call for their books to be opened." <sup>65</sup>*

## **G. U.S. Supreme Court Must Restore the Rule of Law**

The Supreme Court has not decided the meaning of the Statement and Account Clause including how it interacts with the Appropriations Clause. However, this has not stopped the federal government from relying on the Court's dicta in the only case involving the clause to reach the Supreme Court to justify to the electorate its unconstitutional accounting practices.

The Supreme Court knows that the nation has a "spending problem." Justices live for a substantial part of the year in Washington D.C. so they are very aware of the state of the fight between the two political parties over government spending. Furthermore, they have had several cases that dealt directly with Congressional attempts to reign in federal spending. Finally, the "unsustainable" nature of the federal government's spending is mentioned in numerous prominent government documents such as the President's Budget and the Financial Report. It is reasonable to assume that the leaders of a co-equal branch of government have some familiarity with these documents. The irony is that with both the Executive and Legislative branches hopelessly corrupted over the issue of proper accounting for government spending, the Judicial branch is the only branch capable of fixing the nation's financial dilemma.

SCOTUS will, at some point, likely consider the arguments contained herein. It is important to know that the author assumes that the Legislative or the Executive branches WILL NEVER be willing to adhere to our Constitution's financial reporting requirements....unless the Court requires them to return the nation to the rule of law. However, the author is optimistic about the SEC, an independent agency, taking action with respect to financial reporting by the states.

The author believes that when faced with the question of interpreting the Statement and Account clause the Supreme Court is likely to rule that there are no exceptions permitted by the Constitution for entities or programs funded with public money that our politicians want to avoid accountability for by excluding them, putting them off balance sheet or describing them only in footnotes. In addition, the author believes that the Supreme Court will determine that the antifraud provisions in the nation's securities laws are inherent in the Statement and Account Clause.

After careful consideration the Court is likely to conclude that the information that is required to be provided to citizen/voters is no different than the information to be provided to investors. Both have a significant economic interest in the actions of their government. Furthermore, a government *"of the*



*people, by the people and for the people*” with an explicit provision in its constitution requiring the publication of a Statement and Account of the Receipts and Expenditures of all public Money does not need an antifraud amendment to that constitution requiring the federal government publish truthful figures. To a certain extent Congress recognized the importance of the antifraud provisions by making the issuance of municipal securities subject to them.

#### a. **Politicians Believe That SCOTUS Will Never Address the Issue**

The author has had numerous conversations with former senior finance officials about how a hypothetical lawsuit to compel the federal government to produce financial reports that comply with the United States Constitution would be received by the Supreme Court. All of these former senior finance officials believe that the Supreme Court will never take a case premised upon federal financial reporting being fraudulent or unconstitutional. However, the author believes that these former senior finance officials and their legal advisors are very wrong in this thinking.

### **H. Key Assumptions**

This memorandum is not intended to support either policy option (raising taxes or cutting spending) that are required to stabilize the nation’s finances. Furthermore, no commentary is made or intended about the validity or need for any government program. The author believes that once all members of Congress and the Administration must deal with the same set of facts with respect to the nation’s financial results and financial position, they will navigate their way to an acceptable outcome for the electorate. This should also hold true for each state, city and local government. Finally, this memorandum does not attempt to assign blame for the current state of financial reporting. There is more than enough for both major political parties.

The author has learned numerous truths in the course of studying federal and state financial reporting. One is that almost all politicians and senior finance officials have little interest in having the electorate understand the government’s spending or its accounting practices. Another is that given the immense size and scope of the government’s activities it is easy to get lost in the details. Hence, the author has attempted to simplify matters in analyzing the government’s financial reporting by following the Pareto principle also known as the 80-20 rule. This rule essentially states that for many things, 80% of the effects come from 20% of the causes. This memorandum focuses on the twenty percent that really matters for proper accounting for the government. Realistically, this means focusing on the federal government’s few multi-trillion dollar issues and ignoring the many “billion dollar” issues. All figures that you will see in this memorandum are taken or calculated from the federal government’s financial reports and all figures are in trillions of dollars except where noted.

### **I. Acknowledgements**

The basic framework for the analysis contained in this memorandum was created for a first-of-its-kind conference “**Representation Without Accountability**” which was held at Fordham Law School on January 23, 2012. The conference addressed the federal government’s actual expenditures, its current financial reporting and questions surrounding the Statement and Account Clause including whether financial reporting by the federal government comports with Constitutional requirements. A nonpartisan panel of speakers included the Hon. David Walker, former Comptroller General, David Mosso, former Chairman of the Federal Accounting Standards Advisory Board (“FASAB”), Professor Brian Fitzpatrick, a constitutional law professor at Vanderbilt Law School and Joseph Marren, President and CEO of KStone Partners. Professor Sean Griffith, Director of the Fordham Law Corporate Center and the T.J. Maloney Chair in Business Law delivered opening

remarks and acted as moderator for the conference. The conference was presented by the Fordham Corporate Law Center and sponsored by Joseph and Joan Marren and KStone Partners LLC.

The author is deeply appreciative of the support given over many years by Professor Sean Griffith. In addition, Mr. Marren is indebted to his fellow panelists at the “Representation Without Accountability” conference particularly David Mosso.

*Money is the instrument of policy and policy affects the lives of citizens. The individual loses liberty in a real sense if that instrument is not subject to traditional constitutional constraints.*

*Justice Anthony M. Kennedy*

## 2 Appropriations and Statement & Account Clauses Explained

Article I, section 8 of the United States Constitution enumerates a number, but not all, of Congress' legislative powers. Article I, section 9 obligates Congress to expend public funds only on authorized activities and to report that authorized spending to the electorate. Article I, section 9, clause 7 of the United States Constitution states:

*"No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time,"*

One of the important aspects of the Statement and Account clause is that the obligation runs to the legislature not to the executive branch to publish the Statement and Account. As early as 1791, the House provided by resolution<sup>66</sup>:

*RESOLVED: that it shall be the duty of the Secretary of the Treasury to lay before the House of Representatives...an accurate statement and account of the receipts and expenditures of all public moneys...in which statement shall also be distinguished the expenditures which fall under each head of appropriation, and shall show the sums, if any, which remain unexpended, and to be accounted for the next statement of each and every of such appropriations.*

By the second session of the 1<sup>st</sup> Congress, the Treasurer of the United States was providing quarterly accounts of public expenditures.<sup>67</sup> The earliest statements and accounts of public expenditures were not more specific than each "head of appropriation."<sup>68</sup>

Early State of the Union Messages reveal that presidents routinely reported national budgets-as well as statements and accounts of receipts and expenditures.<sup>69</sup> President Washington concluded his first State of the Union Message by stating, "I have directed the proper officers to lay before you, respectively, such papers and estimates as regard the affairs particularly recommended to your consideration, and necessary to convey to you that information of the state of the union which it is my duty to afford."<sup>70</sup> Thomas Jefferson stated in his fourth annual message "Accounts of the receipts and expenditures of the last year, with estimates for the ensuing one, will as usual be laid before you."

### A. Impact of French and English Accounting on the Framers

The father of accounting is Luca Pacioli who published his accounting manual "*Summa de Arithmetica, Geometria, Proportioni, et Proportionalita*" (Treatise on Arithmetic, Geometry and Proportion) in Italy in 1494. The book's chapter on accounting "De computis" described basic finance

concepts that were essential in running any large enterprise including a nation. Double-entry accounting had existed for about two hundred years prior to his publication.

#### a. France

In 1661, Louis XIV of France came of age and took control of France. At his side was Jean Baptiste Colbert (1619-1683), his accountant. In Colbert's "Historical Memoirs on French Financial Affairs" (1663), he explained how he taught Louis the Italian method of accounting and how they integrated accounting into running the nation. In 1673 Colbert had laws written requiring French businesses to keep double entry books. He also required secrecy of government finances from all within the government. Colbert died in 1683 and by 1715 when Louis died France was bankrupt.

The French launched a company to exploit the opportunities in the Mississippi area in an effort to improve the government's finances. However, the Mississippi Company enterprise failed in 1720. Thereafter, there was little financial reform and the nation floundered for many years near bankruptcy without an effective taxation system.

The French Revolution was caused to a certain extent by accounting. While the English were openly debating sinking funds, bailouts and interest rates, there was virtually no publicly available information about government spending in France. When the American Revolutionary War began France's debts increased and the nation had much more difficulty borrowing money. In 1777 Louis XVI named a Swiss banker Jacques Necker as Director General of French Finances. His appointment threatened the status quo and led to significant resistance to his suggested changes. In response in 1781, in an effort to restore confidence and enable the nation to access additional credit, Necker published his *Compte Rendu au Roi* (Accounts Rendered to the King). This publication explained the nation's finances for the year. This was the first time that the French citizenry received information about government spending.

The *Compte rendu* indicated that total revenues were 264 million livres. Expenditures were 65 million livres for the military, 26 million on the court and his household, 8 million for the comte d'Artois's household, 5 million for roads and bridges, 1.5 million for the Paris police and cleaning, 0.9 million for the homeless poor. This accounting made the government's priorities very clear. As became public much later, Necker omitted 50 million livres in this accounting for military and debt-related spending. The *Compte rendu* became an overnight sensation. There were 60,000 copies sold in its first month. More than 100,000 were sold in 1781 alone. There were foreign editions and translations.

Necker published a royal declaration of accountability at the same time as *Compte rendu*. The impact of the publication was that it permitted political debates to focus on numbers and not just concepts. Some of the nobility reacted very poorly to the publication calling the revelation of state secrets a subversive act. The King dismissed Necker after the publication in 1781. Necker went on to write *Treatise on the Administration of Finances* in 1784. This was another huge best-seller which inspired Robert Morris and Alexander Hamilton in the United States.

The press had a field day with the revelations of the *Compte rendu*. The *Gazette de Leyede*, the *Mercure de France*, and the *Courrier d'Avignon* covered the publication and all the subsequent calculations by Necker's enemies. In 1788 Necker returned to power due to public acclaim. On July

11, 1789 the King fired Necker once more. By the end of the day the French Revolution was in full motion.

For the decade after the publication of *Compte rendu* Necker had an ongoing public battle with Charles Alexandre, Vicomte de Calonne. This was one of the first public debates about a nation's publicly disclosed financial results.

### **b. England**

In 1651 Thomas Hobbes, a British political philosopher, wrote in his book, *Leviathan* about the connection between accounting, ethics and politics.<sup>5</sup>

Robert Walpole who lived from 1676 to 1745 was England's First Lord of the Treasury, Chancellor of the Exchequer, and Britain's first Prime Minister. In 1715 Walpole managed to have Parliament pass a plan to lower interest costs through the use of a sinking fund. Britain had incurred significant debts as a result of a war with France.

In 1720 the South Sea Company was created to convert a substantial portion of Britain's debt to equity in the company. The plan was modeled after the French Mississippi company. However, the financial results for the company did not materialize as planned and the company issued more and more stock to pay dividends. The company's stock price soared until mid-1720 when the scheme collapsed. The company was too big to fail so Walpole orchestrated a bailout to keep the Bank of England's and the South Sea Company's finances afloat. One of the keys to the financial restructurings was that there was no audit of the company's or the Bank of England's books and the South Seas Company's cashier, Robert Knight, fled the country with the records of the bribes that had been paid to get required support for the restructuring plan.

Walpole's tactics were attacked by Thomas Gordon and John Trenchard who called for the opening of the government's books and the auditing of its ministers. Thomas Gordon equated political liberty with public accounting.

In 1736, John Mair wrote an influential English-language accounting manual "*Book-keeping methodiz'd*" It became the most prominent accounting manual in 18<sup>th</sup> century North America.

England was able to get along servicing its public debt until the American Revolutionary War when its debt skyrocketed. By 1788, Britain was spending 70 percent of its tax revenue to service a debt that had risen to approximately 250 million pounds.

### **c. Impact in America**

Necker's *Compte rendu*, his writings and accounting reforms had a significant impact in the United States. Many of the delegates to the Constitutional convention were well versed in accounting including, but not limited to, George Washington, Benjamin Franklin, Robert Morris and Alexander

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<sup>5</sup> Thomas Hobbes, *Leviathan*, ed. Richard Tuck (Cambridge: Cambridge University Press, 1996), chap. 4, p. 29; chap. 5., p. 31.

Hamilton. John Mair's *Bookkeeping Methodiz'd* had widespread distribution in the U.S. and George Washington had a personal copy in his library.

It should be noted that Benjamin Franklin was ambassador to France for the period from 1776 to 1785. He corresponded with Necker around the time of the publication of *Compte rendu* but he negotiated the \$8 million in loans the U.S. secured with Pierre-Augustin de Beaumarchais.

In 1783 George Washington handed over his Revolutionary War expense accounts to auditors for publication to counteract charges that he profited from the war. These indicated that his receipts fell well short of his expenditures.

### **B. Congress Had Bankrupted the Nation**

The Revolutionary War caused the states and Continental Congress to incur large debts. Repayment of this debt was one of the major issues that led to the Constitutional Convention. Furthermore, it is important to note that the Continental Congress had already bankrupted the nation during the war. In 1781 the \$241.5 million in paper currency issued by Congress had a value of two cents on the dollar.

One of the results of this bankruptcy was that on February 7, 1781 Congress appointed Robert Morris as the first American superintendent of finances. Morris had studied Necker's reforms and how he attempted to centralize tax collections. He wrote to Necker asking for advice. In 1782 Morris published "*A General View of Receipts and Expenditures of Public Monies, by Authority from the Superintendent of Finance, from the Time of his entering on the Administration of the Finances to the 31<sup>st</sup> December, 1781.*" (Philadelphia: Register's Office, 1782).

Alexander Hamilton was influenced by Hobbes, Locke, Montesquieu, Blackstone and Hume. He admired the centralized financial administration of the French and Colbert. This is in part why Hamilton's vision for a federalist government included a centralized financial and auditing system. He wanted powerful central ministries similar to the French. In 1789 when George Washington asked Robert Morris to be first Treasury Secretary, he declined and recommended Alexander Hamilton. In 1790 Hamilton wrote his "Report Relative to a Provision for the Support of Public Credit."

### **C. Articles of Confederation and Perpetual Union and the Inability to Pay the Nation's Debts**

The Articles of Confederation and Perpetual Union (hereafter the "Articles" or the "Articles of Confederation") was the first written constitution for the U.S. Government. It was created by the delegates from the states in the Second Continental Congress. It was drafted in 1776-77 and became the working constitution in 1777. It was not formally ratified until 1781.

The new states preferred to think of themselves as separate republics in an alliance of convenience. The Articles of Confederation described "a firm league of friendship." Article II made it clear that the individual states were not subject to the United States: Each state retained its sovereignty, freedom, and independence, and every power, jurisdiction, and right, which was not expressly delegated to the

United States. One of the major problems with the Articles was the requirement that all thirteen states had to approve any changes.

There was no president, executive agencies, judiciary or tax base. The lack of a tax base meant that the government was unable to pay off state and national debts. The government was funded by money from the states when nine states voted to do so. As a result funds were contributed sporadically and Congress printed money in large amounts which had the effect of depreciating its value.

In May 1779 John Jay, president of the Continental Congress requested \$45 million from the states saying that taxes were “the price of liberty, the peace, and the safety of yourselves and posterity.” He argued that Americans should avoid having it said “that America had no sooner become independent than she became insolvent” or that “her infant glories and growing fame were obscured and tarnished by broken contracts and violated faith.” The states did not respond with any of the money requested from them. Between 1781 and 1784, less than \$1.5 million came into the Treasury although the states were asked for \$2 million in the single year 1783.<sup>71</sup>

Congress under the Articles did not have the power to regulate either foreign trade or interstate commerce and, as a result, all the states maintained control over their trade policies. By 1787 states had started attacking private contracts and interstate commerce.

At the Annapolis Convention in 1786 Alexander Hamilton led a group of federalists that believed in a strong central government that petitioned Congress to call a constitutional convention in Philadelphia in May 1787 to revise the Articles. It should be noted that Hamilton estimated that as of 1790 that the Confederation government owed approximately \$52 million to its creditors.<sup>72</sup> The inability to repay its debt was one of the principal reasons for calls for a stronger national government.<sup>73</sup>

#### **D. Constitutional Convention**

The United States Constitution is the contract underlying the largest merger in history. Thirteen sovereign states entered into this agreement to create the United States of America. Like all merger documents the two most important issues were governance and money.

The Constitutional Convention met in Philadelphia between May 25 and September 17, 1787. The debates of the Convention indicated that there was widespread agreement that, in the words of Roger Sherman, “*money matters*” were “*the most important of all*”; or, as Madison put it, the “*complete power of taxation [was] the highest prerogative of supremacy . . . proposed to be vested in the National Govt.*”<sup>74</sup> Throughout the Convention, delegates focused on the “*purse strings*” or the “*purse*”.<sup>75</sup> —Every discussion was based on the premise that the protection of the people’s money is a legislative function.<sup>76</sup>

The Framers were vitally concerned about ensuring democratic control and accountability over the revenue and appropriations powers. In addition, one of the most challenging issues during the convention concerned the apportionment of seats in the legislative branch. States with small populations preferred the existing practice under the Articles of Confederation which was equal representation of the states. The more populous states, such as Virginia and Massachusetts, preferred that legislative representation reflect a state’s population. In addition the debates demonstrate that the Framers viewed fixing responsibility for taxing and spending was critical to

the success of the new constitution. In this regard, no delegate argued that the President or any combination of Executive officers should possess the power to tax or spend. All believed that a democratically accountable Legislature should have this power.

In June 1787, the draft of the Constitution allowed either house to originate taxation and appropriations measures. During the debates on June 13, Elbridge Gerry, of Massachusetts, “[m]oved to restrain the Senatorial branch from originating money bills.”<sup>77</sup> He reasoned that “[t]he other branch was more immediately the representatives of the people, and it was a maxim that the people ought to hold the purse-strings.”<sup>78</sup> Gerry’s motion was defeated, by a margin of three states in favor and eight opposed.<sup>79</sup>

When the Convention reached an impasse between the large and small states regarding the apportionment of seats in the House and Senate the delegates appointed a special committee to consider the question of apportionment.<sup>80</sup> The Committee of Eleven presented its report to the Convention on July 5, 1787.<sup>81</sup>

The Committee of Eleven proposed the Great Compromise.<sup>82</sup> The Great Compromise established a bicameral legislature with proportional representation in the House of Representatives and equal representation of the states in the Senate. In order to appease the larger states for accepting equal representation of all states in the Senate, the power of originating taxation and appropriations measures was vested in the House of Representatives and the Senate was prohibited from either originating or amending such legislation (described as strong version of the Origination Clause). However, this agreement did not hold.

George Mason, of Virginia suggested that “[t]he consideration which weighed with the Committee was that the [first] branch would be the immediate representatives of the people, the [second] would not.”<sup>83</sup> In light of this, “[s]hould the latter have the power of giving away the peoples [sic] money, they might soon forget the Source from whence they received it” and “[w]e might soon have an aristocracy.”<sup>84</sup>

Benjamin Franklin agreed saying “it was always of importance that the people should know who had disposed of their money, & how it had been disposed of.”<sup>85</sup> Franklin added that “those who feel, can best judge” and “[t]his end would . . . be best attained, if money affairs were to be confined to the immediate representatives of the people.”<sup>86</sup>

On July 16, 1787, the delegates adopted the Great Compromise. The resolution incorporated the strong version of the Origination Clause and passed by a vote of five to four, with one state delegation abstaining.<sup>87</sup> On July 26, 1787, the delegates charged a “Committee of Detail” with preparing a new working draft that would reflect and incorporate the various resolutions and amendments adopted up to that point.<sup>88</sup>

On August 6, John Rutledge, of South Carolina, delivered the Report of the Committee of Detail.<sup>89</sup> Article IV, section 5 of the working draft included a strong version of the Origination Clause.

The Convention considered this provision on August 8, 1787. At that time, Charles Pinckney, of South Carolina, moved to strike the provision from the draft. He argued that “[i]f the Senate can be trusted with the many great powers proposed, it surely may be trusted with that of originating money bills.”<sup>90</sup>



George Mason objected strongly to the motion. Mason argued that “[t]o strike out the section, was to unhinge the compromise of which it made a part.”<sup>91</sup> Mason was referring to the equal suffrage of all states, regardless of population, in the Senate. Characterizing the Senate as a bastion of “[a]ristocracy,” Mason believed that “[t]he purse strings should never be put into its hands.”<sup>92</sup>

The delegates voted in favor of Pinckney’s motion by a margin of seven states in favor and four states against.<sup>93</sup> This vote had the effect of striking the Origination Clause and put the Great Compromise in doubt. For several representatives’ control over taxation and appropriations was so important that, without it, they were willing to revisit the decision to provide equal representation in the Senate.

On August 9, 1787, Edmund Randolph, of Virginia gave the Convention notice that he would seek reconsideration of the vote at a later time. On August 11, 1787, he moved for reconsideration.<sup>94</sup>

Randolph’s motion to reconsider passed by a vote of nine states in favor to one state opposed, with one state abstaining. Two days later, on August 13, 1787, the Federal Convention took up reconsideration of the Origination Clause. At this juncture, the linkage between the issues of origination and equal representation was obvious.

Randolph moved to limit the clause to “revenue raising” bills.<sup>95</sup> This amendment served to eliminate the objection that the term “money bills” was overly broad so as to potentially bring within the restriction “all bills under which money might incidentally arise.”<sup>96</sup>

George Mason spoke strongly in favor of vesting the House of Representatives with control over the power of taxation and spending. Mason’s argument largely focused on the character of the Senate as distanced from and unaccountable to the voting citizens. This was so because as constituted “the Senate did not represent the people, but the States in their political character.”<sup>97</sup> Accordingly, “[i]t was improper therefore that it should tax the people.”<sup>98</sup> He concluded that “in all events he would contend that the purse strings should be in the hands of the Representatives of the people.”<sup>99</sup>

Gerry stated “Taxation and representation are strongly associated in the minds of the people, and they will not agree that any but their immediate representatives shall meddle with their purses.”<sup>100</sup> He warned that “acceptance of the plan will inevitably fail, if the Senate be not restrained from originating Money bills.”<sup>101</sup>

The vote in favor of restoring the origination restriction was defeated and the Origination Clause was to be stricken.<sup>102</sup>

On August 15, 1787, Caleb Strong moved to amend to include a weaker version of the Origination Clause that the delegates had rejected. Strong’s amendment provided that:

Each House shall possess the right of originating all Bills, except Bills for raising money for the purposes of revenue or for appropriating the same and for the fixing of salaries of the Officers of Government which shall originate in the House of Representatives; but the Senate may propose or concur with amendments as in other cases.<sup>103</sup>

The delegates postponed debate on the amendment without comment, by a vote of six to five.<sup>104</sup>

On August 31, 1787, the delegates created the Committee of Eleven, consisting of a delegate from each state, to consider “such parts of the Constitution as have been postponed, and such parts of

reports as have not been acted on.”<sup>105</sup> On September 5 the Committee proposed a weaker version of the original Origination Clause—the House of Representatives would have the power to originate revenue measures, but the Senate would enjoy full powers of amendment to such legislation. The provision was reworked over the next several days into “but the Senate may propose or concur with amendments as in other bills”<sup>106</sup> and was agreed to by the delegates.

The Federal Convention delegates signed the Constitution on September 17, 1787. Significantly, Randolph, Mason, and Gerry—all supporters of a strong version of the Origination Clause—refused to sign the draft.

### **E. Records of the Federal Convention Regarding the Two Clauses** <sup>107 108</sup>

The records of the convention as they relate to the Appropriations and Statement and Account Clauses appear below. A reading of the records indicate that from July 5 onward the Framers intended that no money could be spent by the federal government other than in pursuance of appropriations. In addition, a regular Statement and Account of the receipts and expenditures of all public money shall be published. The House resolution of early 1791 described earlier shows how closely linked the Framers viewed expenditures and appropriations:

*“in which statement shall also be distinguished the expenditures which fall under each head of appropriation, and shall show the sums, if any, which remain unexpended, and to be accounted for the next statement of each and every of such appropriations.”*

The Framers clear indication that unexpended appropriations had to be shown has profound implications for Congress’ invention of Permanent Appropriations.

[1:524; *Journal*, 5 July]

. . . and that no money shall be drawn from the public Treasury but in pursuance of appropriations to be originated by the first Branch.

[1:538; *Journal*, 6 July]

. . . and that no money shall be drawn from the Public Treasury but in pursuance of appropriations to be originated by the first Branch.

it passed in the affirmative [Ayes--5; noes--3; divided--3.]

[2:14; *Journal*, 16 July]

. . . and that no money shall be drawn from the Public Treasury but in pursuance of appropriations to be originated by the first Branch.

[2:154, 164; *Committee of Detail*, VI, IX]

. . . No money shall be drawn from the public Treasury, but in Pursuance of Appropriations that shall originate in the House of Representatives.

[2:200; *Madison*, 13 Aug.]

Question on the last clause of sect: 5--Art: IV--viz "No money shall be drawn from the Public Treasury, but in pursuance of *appropriations* that shall originate in the House of Reps. It passed in the negative

N. H. no. Mas. ay Con. no N. J no. Pa. no Del no. Md no Va no. N. C. no. S. C. no. Geo. no. [Ayes--1; noes--10.]

[2:545; *Journal*, 8 Sept.]

no money shall be drawn from the Treasury but in consequence of appropriations made by law.

which passed in the affirmative.

[2:568, 596; *Committee of Style*]

No money shall be drawn from the Treasury but in consequence of appropriations made by law.

[2:618; *Madison*, 14 Sept.]

Col. Mason moved a clause requiring "that an Account of the public expenditures should be annually published" Mr Gerry 2ded. the motion

Mr Govr. Morris urged that this wd. be impossible in many cases.

Mr. King remarked, that the term expenditures went to every minute shilling. This would be impracticable. Congs. might indeed make a monthly publication, but it would be in such general Statements as would afford no satisfactory information.

Mr. Madison proposed to strike out "annually" from the motion & insert "from time to time". which would enjoin the duty of frequent publications and leave enough to the discretion of the Legislature. Require too much and the difficulty will beget a habit of doing nothing. The articles of Confederation require half-yearly publications on this subject--A punctual compliance being often impossible, the practice has ceased altogether--

Mr Wilson 2ded. & supported the motion--Many operations of finance cannot be properly published at certain times.

Mr, Pinkney was in favor of the motion.

Mr. Fitzimmons--It is absolutely impossible to publish expenditures in the full extent of the term.

Mr. Sherman thought "from time to time" the best rule to be given.

"Annual" was struck out--& those words--inserted nem: con:

The motion of Col. Mason so amended was then agreed to nem: con: and added after--"appropriations by law as follows--"And a regular statement and account of the receipts& expenditures of all public money shall be published from time to time."

## F. Federalist Papers Commentary on the Two Clauses

It is a key fact that unexpended appropriations should be clearly identified within the Statement and Account. The linkage between appropriations and expenditures is made clear by Hamilton. He noted in Federalist No. 72 that the executive's functions included

*"the application and disbursement of the public moneys in conformity to the general appropriations of the legislature."*<sup>109</sup>

Hamilton also explained,

*"no money can be expended, but for an object, to an extent, and out of a fund, which the laws have prescribed."*

The "extent" or amount of funding modifies and shapes the "object" funded.

In *Federalist No. 78*, Hamilton argued for an independent judiciary and mentioned the appropriations power of Congress:

*"Whoever attentively considers the different departments of power must perceive that, in a government in which they are separated from each other, the judiciary, from the nature of its functions, will always be the least dangerous to the political rights of the Constitution; because it will be least in a capacity to annoy or injure them. The executive not only dispenses the honors but holds the sword of the community. The legislature not only commands the purse but prescribes the rules by which the duties and rights of every citizen are to be regulated. The judiciary, on the contrary, has no influence over either the sword or the purse . . ."*<sup>110</sup>

In *Federalist No. 48*, Madison argued that the legislative power was by far the most extensive, in part because *"the legislative department alone has access to the pockets of the people."*<sup>111</sup>

In *Federalist No. 58*, Madison, responding to a concern that the equality of representation in the Senate might allow a minority to frustrate the majority's will of a majority, stated:

*"The House of Representatives cannot only refuse, but they alone can propose the supplies requisite for the support of government. They, in a word, hold the purse—that powerful instrument by which we behold, in the history of the British Constitution, an infant and humble representation of the people gradually enlarging the sphere of its activity and importance, and finally reducing, as far as it seems to have wished, all the overgrown prerogatives of the other branches of the government. This power over the purse may, in fact, be regarded as the most complete and effectual weapon with which any constitution can arm the immediate representatives of the people, for obtaining a redress of every grievance, and for carrying into effect every just and salutary measure."*

*To those causes we are to ascribe the continual triumph of the British House of Commons over the other branches of the government, whenever the engine of a money bill has been employed."*<sup>112</sup>

Alexander Hamilton, in Federalist No. 66, stated that “[t]he exclusive privilege of originating money bills will belong to the House of Representatives,”<sup>113</sup> as an argument against concerns that the Senate would have too much power given its lack of proportional representation.

### G. Contemporaneous Statements Regarding the Two Clauses

In an early session of Congress, Madison stated “*The constitution . . . places the power in the House of originating money bills.*”<sup>114</sup> He explained that “[t]he principal reason why the constitution had made this distinction was, because they were chosen by the People, and supposed to be best acquainted with their interests, and ability [to pay taxes].”<sup>115</sup>

In New York, Chancellor Livingston reminded his hearers on June 27, 1788

*“to keep in mind, as an important idea, that the accounts of the general government are “from time to time” to be submitted to the public inspection...Will not the representatives consider it essential to their popularity to gratify their constituents with full and frequent statements of the public accounts. There can be no doubt of it.”*<sup>116</sup>

St. George Tucker’s comments are also instructive with respect to the Statement and Account Clause.<sup>117</sup>

*“These provisions form a salutary check, not only upon the extravagance, and profusion, in which the executive department might otherwise indulge itself, and its adherents and dependents; but also against misappropriation, which a rapacious, ambitious or otherwise untruthful executive might be disposed to make.”*<sup>118</sup>

Justice Joseph Story averred that

*“[t]he object is . . . to secure regularity, punctuality, and fidelity, in the disbursements of the public money . . . Congress is made the guardian of this treasure; and to make their responsibility complete and perfect, a regular account of the receipts and expenditures is required to be published, that the people may know, what money is expended, for what purposes, and by what authority.”*<sup>119</sup>

### H. Statements by Early Presidents

A review of statements made by three of our early Presidents conveys the importance of information to the operation of our democracy.

*“A popular Government, without popular information, or the means of acquiring it, is but a Prologue to a Farce or a tragedy; or, perhaps both. Knowledge will forever govern ignorance. And a people who mean to be their own Governors, must arm themselves with the power which knowledge gives.”*<sup>120</sup>

*“If a nation expects to be ignorant and free, in a state of civilization, it expects what never was and never will be.”*<sup>121</sup>

*“Liberty cannot be preserved without a general knowledge among the people, who have a right, from the frame of their nature, to knowledge, as their great Creator, who does nothing in vain, has given them understandings, and a desire to know; but besides this, they have a right, an indisputable, unalienable, indefeasible, divine right to that most dreaded and envied kind of knowledge; I mean, of the characters and conduct of their rulers.”*<sup>122</sup>

## I. Appropriations Clause aka “The Power of the Purse”

The congressional power of the purse refers to the power to appropriate funds and to prescribe the conditions governing the use of those funds. It is derived from several Constitutional provisions. Article I, section 8 empowers Congress to “*pay the Debts and provide for the common Defence and general Welfare of the United States*” and to “*make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers [listed in art. I, sec 8], and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.*”

The Appropriations Clause has often been characterized as “*the most important single curb in the Constitution on Presidential power.*”<sup>123</sup> The Constitution gives Congress the so-called “*power of the purse*” by providing that only it can appropriate money from the Treasury.<sup>124</sup> The Supreme Court in *Cincinnati Soap Co. v. United States* (1937) indicated that the Appropriations Clause means that “no money can be paid out of the Treasury unless it has been appropriated by an act of Congress.” In *Reeside v. Walker* (1850) the Supreme Court stated “*However much money may be in the Treasury at any one time, not a dollar of it can be used in the payment of any thing not....previously sanctioned by a congressional appropriation.*” In *Office of Personnel Management v. Richmond* (1990) the Supreme Court reiterated that any exercise of power by a government agency “*is limited by a valid reservation of congressional control over funds in the Treasury.*”

Professor Kate Stith of Yale Law School has described two governing principles<sup>125</sup> of the power of the purse:

*“Principle of the Public Fisc:* All funds belonging to the United States-received from whatever source, however obtained, and whether in the form of cash, intangible property, or physical assets-are public monies, subject to public control and accountability. This principle implies that all monies received by the United States are in “the Treasury,” to use the language of the Constitution.

*Principle of Appropriations Control:* All expenditures from the public fisc must be made pursuant to a constitutional “Appropriation made by Law.”

Together, the two principles prescribe that there may be no spending in the name of the United States except pursuant to legislative appropriation.”

Please note that appropriations law is also referred to by the government as “Budgetary Accounting” or “Obligational Accounting” and financial reporting is also described as “Proprietary Accounting.”

### a. How Does Congress Control the Power of the Purse?

The Constitution does not provide instructions with respect to how Congress is to implement its appropriation power. As one court has put it: “[*The Appropriations Clause*] is not self-defining and Congress has plenary power to give meaning to the provision.” Congress has done this through the annual budget and appropriations process and through a series of permanent “*funding statutes.*”

Congress exercises its control over the power of the purse through several statutory directives including:

- 1) a statute will not be construed as making an appropriation unless it expressly so states *31 U.S.C. sec 1301(d)*;
- 2) agencies may not spend, or commit themselves to spend, in advance of or in excess of appropriations. *31 U.S.C. sec 1341 (Antideficiency Act)*;
- 3) appropriations may be used only for their intended purpose. *31 U.S.C. sec 1301 (a) (“purpose statute”)*; and
- 4) unless authorized by law, an agency may not keep money it receives from sources other than congressional appropriations, but must deposit the money in the Treasury. *31 U.S.C. sec 3302(b) (“Miscellaneous Receipts” Statute)*.

The *Miscellaneous Receipts* statute<sup>126</sup> and the *Anti-Deficiency Act*<sup>127</sup> are critical to understand Congress’ view of the appropriations requirement.

#### **i. The Miscellaneous Receipts Statute<sup>128</sup>**

“The Act of March 3, 1849 provided that all funds “received from customs, from the sale of public lands, and from all miscellaneous sources, for the use of the United States, shall be paid into the Treasury of the United States. As now codified in section 3302 of title 31 of the United States Code (“Money and Finance”), the statute provides that any “official or agent of the Government receiving money for the Government from any source shall deposit the money into the Treasury.”

Pursuant to the requirements of the Miscellaneous Receipts statute, all funds belonging to the United States-received “*for the use of the United States*” or “*for the Government*” –are part of the public fisc. All such funds must be deposited into the federal Treasury, from there to be appropriated by law.”

#### **ii. The Anti-Deficiency Act<sup>129</sup>**

The Act defines the scope of public expenditure. The two major provisions of this Act-the rule against deficiencies and the rule against voluntary service-were enacted in response to federal agencies incurring “coercive” deficiencies and thereby circumventing amount limitations in appropriations legislation.

#### **b. “Money” is “Money” in the Two Clauses<sup>130</sup>**

“The complementary nature of the Appropriations and Statement and Account requirements is indicated not only by their placement and wording but also by their broader functions. Without statement and account review, executive agencies could evade the object and amount limitations of appropriations.<sup>131</sup> Hence, the appropriations requirement implements not only the idea of “no taxation without representation,” but also the foundational premise of a federal government which is limited to constitutionally authorized activities.<sup>132</sup> If there could be “public Money” that is not deposited in “the Treasury” prior to expenditure, then the scope of these complementary constitutional provisions would differ. As a matter of textural coherence, the two phrases should be regarded as synonymous.”

### **c. What Constitutes an Appropriation?**

31 U.S.C. sec 1301(d) provides:

*“A law may be construed to make an appropriation out of the Treasury or to authorize making a contract for the payment of money in excess of an appropriation only if the law specifically states that an appropriation is made or that a contract may be made.”*

Thus the rule is that the making of an appropriation must be expressly stated and it cannot be inferred or made by implication.

The Comptroller General (“CG”) has indicated that the obligating of appropriations must be “definite and certain.” The CG has also stated that an obligation is “a definite commitment which creates a legal liability of the Government for the payment of appropriated funds for goods and services ordered or received.” In 1963 the CG defined an obligation as

*“A legal duty on the part of the United States which constitutes a legal liability or which could mature into a legal liability by virtue of actions on the part of the other party beyond the control of the United States.”*

What action is necessary or sufficient to create an obligation? The CG has determined that an obligation arises when the definite commitment is made, even though the actual payment may not take place until a future fiscal year, and that the term “*obligation*” includes both matured and unmatured commitments. A matured commitment is a legal liability that is currently payable. An unmatured commitment is a liability which is not yet payable but for which a definite commitment nevertheless exists. The fact that an unmatured liability may be subject to a right of cancellation does not negate the obligation.

### **d. Appropriations Confer Two Basic Authorities**

The two basic authorities conferred by an appropriation law are the authority to incur obligations and the authority to make expenditures. An obligation results from some action that creates a liability or definite commitment on the part of the government to make an expenditure. The expenditure is the disbursement of funds to pay the obligation. Generally, appropriated funds are first obligated and then expended. The subsequent disbursement “liquidates” the obligation. Thus an agency “uses” appropriations in two basic ways – direct expenditures (disbursements) and obligations. Not surprisingly, the concept of “*obligation*” is central to appropriations law. This is because of the principle that an obligation must be charged against the relevant appropriation in accordance with the rules relating to purpose, time and amount. The term “*available for obligation*” refers to availability as to purpose, time and amount.

### **e. Requirements for Appropriated Funds Being Legally Available**

Whether appropriated funds are legally available requires that:

- 1) the purpose of the obligation or expenditure must be authorized;
- 2) the obligation must occur within the time limits applicable to the appropriation, and
- 3) the obligation and the expenditure must be within the amounts Congress has established.



All three must be observed for the obligation or expenditure to be legal.

#### **f. Permanent Appropriations**

Congress may create permanent, substantive law through an appropriations bill only if it is clear about its intentions.<sup>133</sup> This type of authorizing legislation controls mandatory spending. A distinctive feature of these authorizing laws is that they provide agencies with the authority or requirement to spend money without first requiring Appropriations Committees to enact funding. Mandatory spending includes Social Security, Medicare and Medicaid. Mandatory spending programs continue indefinitely.<sup>134</sup>

In 1996 the General Accountability Office (“GAO”) prepared a report, *“Budget Issues: Inventory of Accounts With Spending Authority and Permanent Appropriations, 1996”* (“GAO’s 1996 Report”), in response to the Senate’s Committee on the Budget’s request to update the 1987 inventory of accounts with spending authority and permanent appropriations, commonly referred to as *“backdoor authority.”* Backdoor authority is authority to obligate federal funds that is not controlled through the appropriations process. Basically, it represents mandatory spending that is provided and controlled indirectly through other forms of legislation.

The Congressional Budget Act of 1974, as amended, defines spending authority as authority provided in laws other than appropriations acts to obligate the U.S. government to make payment. A permanent appropriation is an appropriation that is available as a result of previously enacted legislation, remains so until repealed, and does not require current appropriations by the Congress. In *Atlantic Fish Spotters Ass’n v. Evans* (1<sup>st</sup> Cir. 2003), the court cautioned:

*“Congress may create permanent, substantive law through an appropriations bill only if it is clear about its intentions. Put another way, Congress cannot rebut the presumption against permanence by sounding an uncertain trumpet.”*

The GAO’s 1996 Report indicates that Social Security, Medicare and Medicaid have spending authority and permanent appropriations in the following accounts – Social Security (Federal Old-Age and Survivors Insurance Trust Fund Account #20-8006-0-7-651, Federal Disability Insurance Trust Fund Account #20-8007-0-7-651, Payments to Social Security Trust Funds Account #28-0404-0-1-651 and Supplemental Security Income Program Account #28-0406-0-1-609) , Medicare (Federal Hospital Insurance Trust Fund Account #20-8005-0-7-571 and Federal Supplementary Medical Insurance Trust Fund Account #20-8004-0-7-571) and Medicaid (Grants to States for Medicaid Account #75-0512-0-1-551).

Entitlement Authority is defined at 2 U.S.C. sec 622(9)(A) as statutory authority whether temporary or permanent.,

*“to make payments (including loans and grants), the budget authority for which is not provided for in advance by appropriation Acts, to any person or government if, under the provisions of the law containing that authority, the United States is obligated to make such payments to persons or governments who meet the requirements established by that law. Entitlement authority is treated as spending authority during congressional consideration of the budget.”*

Several commentators have made the point that Congress renders meaningless the principles of the public fisc and of appropriations control if it creates spending authority without amount or time limitations and fails to subject such authority to periodic legislative review.<sup>135</sup> However, the Supreme Court has been clear that Congress has the power to enact such legislation. In these decisions the Court has not ruled on is the impact that permanent appropriations or mandatory authorizing legislation has on the reporting requirements under the Statement and Account Clause. Presumably, such legislation raises the bar with respect to proper reporting. Given the fact that cash outlays associated with permanent appropriations and mandatory authorizing legislation comprises more than 50% of outlays and the total obligations for social insurance plus Medicaid exceed \$100 trillion it is hard to imagine that the Supreme Court would rule that cash-based reporting achieves the appropriate level of disclosure required by the Constitution.

#### **g. When Must an Obligation be Recorded?**

In 1953 the CG indicated:

*“In order to determine the status of appropriations, both from the viewpoint of management and the Congress, it is essential that obligations be recorded in the accounting records on a factual and consistent basis throughout the Government. Only by the following of sound practices in this regard can data on existing obligations serve to indicate program accomplishments and be related to the amount of additional appropriations required.”*

The standards for the proper recording of obligations are found in 31 U.S.C. sec. 1501(a) which prescribes specific criteria for recording obligations. It indicates that “[a]n amount shall be recorded as an obligation of the United States Government only when supported by documentary evidence” and then goes on to specify nine criteria for recording obligations. Once one of the criteria is met, the agency must record the transaction as an obligation.

Sec. 1501(a)(1) establishes the criteria for recording contracts. Essentially, a contract must be recorded if there is a binding agreement, in writing, for an authorized purpose, executed in a period of obligational availability and it calls for specific goods or services.

#### **h. Limitations on Congress’ Power of the Purse**

There are several places in the Constitution that limit Congress’ power to tax and spend including the General Welfare Clause, the Uniformity Clause, the Apportionment of Direct Taxes, and other restrictions on spending. In addition, in *South Dakota v. Dole* (1987) the Supreme Court addressed Congress’s use of the spending power to impose conditions on the use of federal grants.

*“[T]he power of Congress to authorize expenditure of public moneys for public purposes is not limited by the direct grants of legislative power found in the Constitution. Thus, objectives not thought to be within Article I’s enumerated legislative fields....may nevertheless be attained through the use of the spending power and the conditional grant of federal funds.”*

However, “[t]he spending power is of course not unlimited.” The Court outlined four general restrictions: an exercise of the spending power must be in pursuit of the general welfare, conditions imposed on the use of federal funds must be reasonably related to the articulated goal; the intent of Congress to impose conditions must be authoritative and unambiguous; and the action in questions must not be prohibited by an independent constitutional bar.<sup>136</sup> The Court added a fifth restriction

that “*Our decisions have [also] recognized that in some circumstances the financial inducement offered by Congress might be so coercive as to pass the point at which ‘pressure turns into compulsion.’*” The Supreme Court’s recent decision finding a financial inducement that was coercive is discussed later in this memorandum.

Although Congress holds the purse-strings, it may not exercise this power in a manner inconsistent with the direct commands of the Constitution.<sup>137</sup> The courts have invalidated congressional funding restrictions when they found that the restrictions violated some independent constitutional bar. See *Legal Services Corp. v. Velasquez*<sup>138</sup> and *American Civil Liberties Union v. Moneta*.<sup>139</sup> This is a critical concept and one that the author wants to make clear to the reader. Congress cannot create legislation with “permanent appropriations” and then define the “permanent” part out of existence for purposes of recording the appropriation or for financial reporting purposes under the Statement and Account clause. Both are clearly intended to do one thing: mask the Legislature’s accountability for spending, which the Constitution does not permit.

## J. Statement and Account Clause

“The Statement and Account Clause was first proposed in the final week of the Constitutional Convention, when George Mason moved on 14 September 1787 that a clause be adopted requiring “that an Account of the public expenditures should be annually published.”<sup>140</sup> George Mason’s timing for his proposal was not accidental. Mason’s fervor for the strong version of the Origination Clause, his lack of success in achieving its inclusion and his views on the need for direct accountability to the people on tax and spending matters all clearly impacted his desire for the Clause. The fact that the provision was adopted given that all at the Convention knew Mason’s strongly held views on accountability needs to be taken into consideration when considering the meaning of the Clause. The important change to Mason’s proposal that added all receipts to the Clause clearly reflects a desire to have the Statement and Account be complete and encompass the Government’s entire economic reality.

In the initial debate on Mason’s proposal, Gouverneur Morris urged that such accounting would be “*impossible in many cases.*” And Rufus King remarked that it would be “*impracticable*” to account for “*every minute shilling.*”<sup>141</sup> James Madison then proposed an amendment to require an accounting “from time to time” rather than annually. The debate surrounding the adoption of Madison’s amendment is important. Farrand gives a brief account of the debate at the Convention, taken from Madison’s notes. Madison thought that the substitution of “*from time to time*” for “*annually*” would ensure frequent publication and “*leave enough to the discretion of the Legislature.*”<sup>142</sup> Madison’s notes from the Convention do not elaborate on the concept of legislative discretion, except to say that if too much is required, “*the difficulty will beget a habit of doing nothing.*”<sup>143</sup>

The rationale behind Madison’s amendment came more fully to light in the debate in the Virginia ratifying convention. On 12 June 1788 Madison stated that under the Constitution as proposed, congressional proceedings were to be “*occasionally published,*” and that this requirement included all receipts and expenditures of public money.<sup>144</sup> He praised this as a security not enjoyed under the then existing system of government. Then, in a sentence reflecting on the degree of discretion to be allowed under Clause 7, he stated:

*“That part which authorizes the government to withhold from the public knowledge what in their judgment may require secrecy, is imitated from the confederation-that very system the gentleman advocates.”<sup>145</sup>*

Madison’s language strongly indicates that he believed that the Statement and Account Clause, following his amendment, would allow government authorities ample discretion to withhold some expenditure items which require secrecy.

Any ambiguity in Madison’s statement is removed by a more lengthy debate that occurred five days later on 17 June 1788 between Madison and George Mason. Arguing against Madison’s “from time to time” provision, Mason criticized it as too loose an expression. He then summarized the arguments made by proponents of the provision:

*“The reasons urged in favor of this ambiguous expression, was [sic], that there might be some matters which might require secrecy. In matters relative to military operations, and foreign negotiations, secrecy was necessary sometimes. But he did not conceive that the receipts and expenditures of the public money ought ever to be concealed. The people, he affirmed, had a right to know the expenditures of their money.”<sup>146</sup>*

Mason’s statement clarifies several points concerning the Framers’ intent. First, it appears that Madison’s comment on government discretion to maintain the secrecy of some expenditures, far from being an isolated statement, was representative of his fellow proponents of the “from time to time” provision. Second, as to what items might legitimately require secrecy, the debates contain prominent mention of military operations and foreign negotiations. Finally, we learn that opponents of the “from time to time” provision, exemplified by Mason, favored secrecy only for the operations and negotiations themselves, not for receipts and expenditures of public money connected with them. But the Statement and Account Clause, as adopted and ratified, incorporates the view not of Mason, but rather of his opponents, who desired discretionary secrecy for the expenditures as well as the related operations.

In reply to Mason’s argument, Madison did not pursue the point on the need for secrecy, but argued that publication from time to time would provide more satisfactory and fuller reports to the public and would be of sufficient frequency. He added that he believed that *“this provision went farther than the constitution of any state in the union, or perhaps in the world.”<sup>147</sup>* The remainder of the exchange between Madison and Mason was brief, and did not touch on secrecy of expenditures.<sup>148</sup>

In addition to the statements of Madison and Mason, there is only one other statement from the Virginia ratifying convention expressing a view on the secret expenditure issue. This is a statement of Patrick Henry on 15 June 1788, apparently expressing a fear of the effect of the “from time to time” provision:

*“By that paper the national wealth is to be disposed of under the veil of secrecy; for the publication from time to time will amount to nothing, and they may conceal what they may think requires secrecy. How different it is in your own government!”<sup>149</sup>*

Though perhaps more exaggerated than Mason’s language, Henry’s statement further confirms the interpretation of the Madison-Mason debate.

Viewed as a whole, the debates in the Constitutional Convention and the Virginia ratifying convention convey a very strong impression that the Framers of the Statement and Account Clause intended it to allow discretion to Congress and the President to preserve secrecy for expenditures related to military operations and foreign negotiations.

Madison mentions the legislature specifically, but not exclusively.<sup>150</sup> That the President shares in this discretion is suggested by one of the Federalist Essays of John Jay, who had gained diplomatic experience in the service of the Continental Congress during the Revolution and of the Confederation afterwards. Commenting on the newly proposed Constitution, he observed:

*“It seldom happens in the negotiation of treaties of whatever nature, but that perfect secrecy and immediate dispatch are sometimes requisite. There are cases where the most useful intelligence may be obtained, if the persons possessing it can be relieved from apprehension of discovery. Those apprehensions will operate on those persons whether they are actuated by mercenary or friendly motives, and there doubtless are many of both descriptions, who would rely on the secrecy of the president, but who would not confide in that of the senate, and still less in that of a large popular assembly. The convention have done well therefore in so disposing of the power of making treaties, that although the president must in forming them act by the advice and consent of the senate, yet he will be able to manage the business of intelligence in such manner as prudence may suggest.”*<sup>151</sup>

The establishment of secret funding practices soon after the Constitutional Convention indicates a contemporaneous understanding that the Framers of Clause 7 did not intend it to require disclosure of expenditures for secret military and foreign diplomacy matters. It is difficult to imagine stronger contemporaneous evidence of the Framers’ intent, when one considers that the contingent fund was initially requested by President Washington, who presided over the Constitutional Convention in 1787, and that a further secret funding measure was enacted under Madison, who in his earlier role as *“Father of the Constitution”* had introduced the *“from time to time”* amendment.”<sup>152</sup>

#### **a. Antifraud Provisions are Inherent in the Statement and Account Clause**

There is a crucial parallel between federal financial disclosures and those by corporations issuing securities. Federal securities laws consist of six separate statutes and corresponding implementing regulations enacted between 1933 and 1940.<sup>153</sup> The broad goal of securities regulation and the Statement and Account Clause is the same, to ensure full and fair disclosure.

The essence of the disclosure philosophy of securities regulation and the Statement and Account Clause is that, when armed with information, investors or voters are well-positioned to evaluate investment opportunities or candidates for public office and to allocate their capital or vote as they see fit. The crux of our federal securities laws and the Statement and Account Clause is that all material information must be disclosed. What other reasonable interpretation can there be for the Clause, particularly the “all Public Money” language? Furthermore, as mentioned previously, a government “of the people, by the people and for the people” with an explicit provision in its constitution requiring the publication of a Statement and Account does not need an antifraud amendment requiring that the government publish truthful figures.

### i. **Matrixx Initiatives v. Siracusano**

On March 22, 2011, the Supreme Court issued a unanimous decision written by Justice Sotomayor in the matter of *Matrixx Initiatives v. Siracusano* (2011)<sup>154</sup>. The importance of the case is that the Court reaffirmed the traditional tests it laid out in *Basic, Inc. v. Levinson*<sup>155</sup> and *TSC Industries v. Northway, Inc.*<sup>156</sup>

*“Section 10(b) of the Securities and Exchange Act makes it unlawful for any person to “use or employ, in connection with the purchase or sale of any security...any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”<sup>157</sup>*

Sec Rule 10b-5 implements this provision by making it unlawful to, among other things,

*“make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.”<sup>158</sup>*

To prevail on a section 10(b) claim, a plaintiff must show that the defendant made a statement that was “misleading as to a material fact.”<sup>159</sup> In *Basic*, the Supreme Court held that this materiality requirement is satisfied when there is

*“a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.”<sup>160</sup>*

The Court was “careful not to set too low a standard of materiality,” for fear that management would “bury the shareholders in an avalanche of trivial information.”<sup>161</sup>

Moreover, it bears emphasis that sec 10(b) and Rule 10b-5(b) do not create an affirmative duty to disclose any and all material information. Disclosure is required under these provisions only when necessary

*“to make...statements made, in the light of the circumstances under which they were made, not misleading.”<sup>162</sup><sup>163</sup>*

In *TSC Industries* the Court considered a claim of fraud in connection with a proxy solicitation and concluded that “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”<sup>164</sup> The Court does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard requires is a showing of a substantial likelihood that, under the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.

The Supreme Court has been quite clear and consistent in its use of the reasonable investor standard in the materiality context.<sup>165</sup> Furthermore, materiality is a mixed question of law and fact, ordinarily determined by the fact finder.<sup>166</sup> It would seem that a reasonable citizen/voter standard

and a fact-based approach to materiality with respect to meeting the Statement and Account Clause's "all Public Money" reporting requirement are necessary.

When discussing financial reporting, a government's financial statements are the critical item. If the numbers in the financial statements cannot be trusted to provide relevant and reliable financial information about the government, citizens have no basis for making voting decisions. In the private sector a defendant cannot rebut a charge of having omitted a necessary material fact by pointing to facts that, while disclosed and technically sufficient to alert the investor to the truth, are buried or hidden within the relevant document as to be practically non-disclosed.<sup>167</sup> Under the "*buried facts*" doctrine, a disclosure is deemed inadequate if it is presented in a way that conceals or obscures the information sought to be disclosed. The doctrine applies when the fact in question is hidden in a voluminous document or is disclosed in a piecemeal fashion which prevents a reasonable shareholder from realizing the "*correlation and overall import of the various facts interspersed throughout*" the document.<sup>168</sup>

It is in this context that one needs to examine the federal government's financial reporting regarding Social Security, Medicare and Medicaid. Prior to 2010 the government did not release any estimate of the net present value cost of Medicaid. In 2010 it released a figure as a single line item in the Required Supplementary Information in the back of a roughly two hundred fifty page Financial Report. In the 2015 Financial Report of the United States Government this information was included in the Statement of Long-Term Fiscal Projections of the U.S. Government. Meanwhile, the net present value cost of Medicare and Social Security are included in a required financial statement, the Statements of Social Insurance ("SOSI"), but the SOSI and the Statement of Long-Term Fiscal Responsibilities do not inter-relate with the government's consolidated financial statements. In addition, both statements which are required by the federal government's generally accepted accounting principles ("GAAP") as promulgated by FASAB violate the Anti-deficiency Act because they illustrate future expenditures under the Medicare and Social Security programs in excess of appropriated amounts. Nowhere in the SOSI or the Financial Report is there any adequate discussion relating appropriated amounts to the projected figures. Furthermore, the government did not and does not consolidate material government-controlled entities.

Only if the established omissions are "*so obviously important to an investor, that reasonable minds cannot differ on the question of materiality*" is the ultimate issue of materiality appropriately resolved "as a matter of law" by summary judgment.<sup>169</sup> Given the facts if the federal government were an entity subject to SEC rules there can be no doubt that it's financial reporting would be materially deficient as a matter of law.





*Liberty requires accountability.  
Justice Samuel Alito*

### 3 Overview of Feds' Financial Reporting & Major Items Reported Fraudulently

#### A. Overview of the Federal Government's Financial Reporting

David Mosso, former Chair of FASAB summarized the requirements for federal, state, city and local financial statements that provide true accountability at the “*Representation Without Accountability*” conference. He captured the spirit and intent of the Founders’ Statement and Account clause.

*“To be effective communicators of accountability, an organization’s financial statements -- should be complete and transparent. That calls for a single consolidated balance sheet with all assets and liabilities controlled by an organization – the federal government in this case – no matter how many separate entities make up that controlling organization. Likewise it calls for a consolidated income statement showing all receipts and expenditures. And it calls further for an absence of netting assets against liabilities and receipts against expenditures.”*

The comment about the absence of netting assets against liabilities and receipts against expenditures is particularly apt as the government’s existing reporting practices regularly permit this on a widespread basis. The obvious reason to follow this practice is to control the electorate’s perception of the size of the government.

#### a. Three Reports are Key

Historically, it was not unusual for merchants to keep two sets of books. There was a *libro segreto*, a secret set of books for their eyes only and a plausible set of public books for the tax collectors. The federal government extends this concept further....there are two sets of public books – one cash-based and the other accrual based. However, neither is the *libro segreto*. The Feds scary set of libro segreto books are described later in this memorandum. Please note that the Feds do not maintain the libro segreto set of books. In addition the federal government keeps a third set of books to account for appropriations.

One must be familiar with three reports in order to understand the federal government’s financial reporting practices. These include the Combined Statement of Receipts, Outlays, and Balances<sup>170</sup> (the “Combined Statement”) which is the “*official*” Statement and Account, the President’s Budget<sup>171</sup> and the Financial Report of the United States Government.<sup>172</sup> Collectively and individually, the federal government’s Combined Statement, the President’s Budget and the Financial Report make untrue statements about material facts, omit to state numerous material facts and hide material facts in footnotes.

Two of the three reports described above are the federal government’s primary annual financial reports. The more well-known of the two reports is the President's Budget, which is cash-based. Unfortunately, it has little to do with economic reality. Under budget accounting rules, outlays are recorded only when bills are paid. Americans know that real expense is incurred when one makes

spending commitments. This is the reason why every publicly traded company is required to use accrual accounting. The little-known alternative is the Financial Report, which is seriously flawed as it does not consolidate numerous material government controlled entities and it does not include the full costs of the entitlement programs.

## **b. Federal Government Fraudulently Reports Three Major Items**

The three major items that are fraudulently reported by the federal government in its two primary annual financial reports include:

-- The Federal Reserve System, Fannie Mae and Freddie Mac, with total assets of \$4.5 trillion (as of March 4, 2016), \$3.2 trillion (as of 12/31/2015) and \$2 trillion (as of 12/31/2015), respectively, are not consolidated into the federal government's financial statements.

-- The federal government's \$24.2 trillion net present value obligation for Medicaid was reported for the first time in the 2010 Financial Report and was buried in this and subsequent reports. Omitting the disclosure of material information, as was done from the creation of Medicaid through 2009, violates the laws against fraud, and the Supreme Court's "buried facts" doctrine which appears in its securities law decisions suggests that even current reporting is unlawful. The amount reported in the 2015 Financial Report was \$27.3 trillion.

-- The total adjusted net present value obligation for Medicare and Social Security that is fully funded with appropriations reported in the Statements of Social Insurance ("SOSI") and in related footnotes in the 2015 Financial Report of the United States Government is \$46.3 trillion. But the SOSI does not interrelate with the other financial statements and no current expenses are recorded for required future payments.

## **c. Combined Statement of Receipts, Outlays and Balances <sup>173</sup>**

When the plaintiff in *United States v. Richardson* wrote to the Government Printing Office in 1967 and requested that he be provided with the documents published by the Government in compliance with Article I, section 9, clause (7) of the United States Constitution the Fiscal Service of the Bureau of Accounts of the Department of the Treasury replied, explaining that it published the document known as the *Combined Statement of Receipts, Expenditures, and Balances of the United States Government* (this was the document's previous name).<sup>174</sup>

The Combined Statement is virtually unknown by the general public. It is not referred to by any recent Congress or Administration with respect to the financial condition or results of the U.S. Government. It is not mentioned by any third party analysts that examine the government's finances.

The Transmittal letter of the Commissioner of the Treasury's Bureau of the Fiscal Service dated December 15, 2015 indicates

*"In accordance with the provisions of Section 114(a) of the Act of September 12, 1950 (31 U.S.C. 3513(a)), I am transmitting herewith the Combined Statement of Receipts, Outlays,*

*and Balances of the United States Government for the fiscal year ended September 30, 2015. This statement presents budget results and the cash-related assets and liabilities of the Federal Government with supporting details.”*

The Preface states

*“The Bureau of the Fiscal Service (Fiscal Service), which is a bureau of the Department of the Treasury, performs a critical role in fulfilling the Treasury’s mission as the Government’s financial manager.... In its role as Federal financial agent, Fiscal Service publishes the “Combined Statement of Receipts, Outlays, and Balances of the United States Government.”*

The Preface indicates under the heading

“Legislative Requirement – The Constitution of the United States, Article 1, Section 9, clause 7, outlines requirements for a report on the receipts and outlays of the Government. It provides, in part, that “No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time.

31 U.S.C. 3513(a) provides in part, “The Secretary of the Treasury shall prepare reports that will inform the President, Congress, and the public on the financial operations of the United States Government.”

This statement is recognized as the official publication of receipts and outlays. Several major Government bodies rely on data found in this report. The Congressional Budget Office uses it to serve the needs of Congress; the Office of Management and Budget uses the data to review the President’s Budget programs; the Governmental Accountability Office uses it to perform audit services; the various departments and agencies of the Government use it to reconcile their accounts; and the public uses it to review the operations of their Government.”

One last point is important to note: The Combined Statement is required by OMB Agency Budget Formulation reporting requirements to reconcile with the President’s Budget, Appendix Document, Agency Program and Finance Schedule regarding the Current Fiscal Year financial results by Treasury Appropriation, Fund, and Receipt Account Symbol and Title for Budget Authority, Outlays and Obligations.

#### **d. President’s Budget**

The President’s Budget is the only financial report that politicians discuss and the Budget Deficit is the single most important figure discussed with respect to the government’s finances.

A summary description of the President’s Budget is found on page 2 of “A Citizens Guide to the 2015 Financial Report of the U.S. Government” which is contained in the 2015 Financial Report of the United States Government.<sup>175</sup> It states

*“The Budget is the Government’s primary financial planning and control tool. It accounts for past Government receipts and spending, and presents the President’s proposed receipt and spending plan. The Budget focuses on receipts, or cash received by the Government (Government), and outlays, or payments made by the Government to the public. An excess of*

*receipts over outlays is called a budget surplus; an excess of outlays over receipts is called a budget deficit.”*

David Mosso, who was Chairman of FASAB for the ten years ending in 2006, made the following remarks about the President’s Budget and by implication the Combined Statement at the “Representation Without Accountability” conference held at Fordham Law School in 2012.

*“[T]he Office of Management and Budget (“OMB”) and the Congressional appropriations committees have been unwilling to change the accounting basis of the federal budget to the accrual basis....The Budget’s cash basis accounting, selectively applied, hollows out the fiscal body of the federal government...The accounting underlying the President’s Budget....obfuscates federal financial accountability..... [It] understates[s] ...the headline numbers that dominate Congressional and public discussion and that form perceptions of the government’s financial health. It seems to be an incontrovertible conclusion that the ship of state is being steered with a severely broken compass.....That false picture nurtures financial profligacy....Cash basis accounting in the President’s Budget is the spearhead of reckless fiscal policy, whether intentionally reckless or just bumbling along with inadequate and misunderstood information about federal financial health....As an accountability report, the President’s Budget woefully shortchanges the American public.”<sup>176</sup>*

#### **e. Financial Report of the United States Government**

David Mosso also commented about the Financial Report at the conference at Fordham Law School.

*“The US Financial Report is the off-budget vehicle for reporting more fully, with business type accounting, on federal financial accountability but it suffers from the syndrome “out of Budget, out of mind.” Nobody pays attention to the US Financial Report in political discourse and decision making because its accruals are not integrated into the budget process.”<sup>177</sup>*

*“Treasury generally prepares the financial statements in th[e] Financial Report on an “accrual basis” of accounting as prescribed by U.S. GAAP for federal entities.<sup>178</sup> A summary description of the Financial Report is found on page 2 of “A Citizens Guide to the 2015 Financial Report of the U.S. Government.”<sup>179</sup> It states*

*“The Financial Report focuses on the Government’s costs and revenues (what went out and what came in), assets and liabilities (what it owns and owes), and other important financial information. The Financial Report compares the Government’s revenues (amounts earned but not necessarily collected), with its costs (amounts incurred, but not necessarily paid) to derive net operating cost.*

*Management’s Discussion and Analysis – Introduction - The fiscal year (FY) 2015 Financial Report of the United States Government (Report) provides the President, Congress and the American people with a comprehensive view of the Federal Government’s finances, i.e., its financial position and condition its revenues and costs, assets and liabilities, and other obligations and commitments. The Financial Report also discusses important financial issues and significant conditions that may affect future operations, including the need to achieve fiscal sustainability over the medium and long-term.<sup>180</sup>*

*Pursuant to 31 U.S.C. sec 331 (e)(1), the Department of the Treasury ("Treasury") in cooperation with the Office of Management and Budget (OMB), must submit an audited (by the Government Accountability Office or GAO) financial statement for the preceding fiscal year, covering all accounts and associated activities of the executive branch of the United States Government – the central component of the Financial Report - to the President and Congress no later than six months after the September 30 fiscal year end. To encourage timely and relevant reporting, OMB accelerated both individual agency and government-wide reporting deadlines."*

The Report is prepared from audited financial statements of specifically designated Federal agencies, including the Cabinet departments and many smaller, independent agencies.



*Separation of powers helps to ensure the ability of each branch to be vigorous in asserting its proper authority. In this respect the device operates on a horizontal axis to secure a proper balance of legislative, executive, and judicial authority. Separation of powers operates on a vertical axis as well, between each branch and the citizens in whose interest powers must be exercised. The citizen has a vital interest in the regularity of the exercise of governmental power.*

*Justice Anthony M. Kennedy*

## **4 U.S. v. Richardson, Standing and the Political Question Doctrine**

### **A. United States v. Richardson**

William Richardson was a citizen who in 1967 made an effort to discover the size of the CIA's "black budget" by writing a letter to the US Government Printing Office. He requested a copy of the CIA budget "*published by the Government in compliance with Article I section 9 clause 7.*"<sup>181</sup> Richardson was rebuffed by the US Treasury and started a court action. He argued that the CIA Act was repugnant to the Constitution since it operates to falsify the regular Statement and Account of all public money. After three years Richardson's case was dismissed by Pittsburgh Federal Judge, Joseph P. Wilson who decided that Richardson did not have standing.

Richardson appealed and in 1971, succeeded in having his case heard before a full bench of the United States Court of Appeals in Philadelphia. In the Circuit Court all parties conceded that there is no prior decision which directly controlled the outcome of the case. The nine federal judges ruled in a 6-3 decision in 1972 that Richardson did have legal standing since the Court reasoned that a responsible and intelligent taxpayer and citizen of course wants to know how his tax money is spent because without this information he cannot intelligently follow the actions of the Congress or the Executive, nor could he properly fulfill his obligations as a member of the electorate. The Circuit Court majority and dissent both found that the intent behind the clause was that the citizenry should receive some form of accounting from the government.<sup>182</sup>

The Federal Government appealed to the Supreme Court and in July 1974 issued its 5-4 decision in *United States v. Richardson*.<sup>183</sup> The Court declined to opine on the meaning of the Statement and Account Clause as it found that the plaintiff lacked standing. The Court held that Richardson's suit was nothing more than a generalized political grievance that needed to be dealt with through the political process. The Supreme Court concluded that it did not need to examine the merits of Richardson's case.

Chief Justice Burger's opinion included dictum that appears to have become the gospel for the Court to ignore the Statement and Account provision since that decision.

*"[I]t is clear that Congress has plenary power to exact any reporting and accounting it considers appropriate in the public interest."<sup>184</sup> "Not controlling, but surely not unimportant, are nearly two centuries of acceptance of a reading of cl 7 as vesting in Congress plenary power to spell out the details of precisely when and with what specificity Executive agencies must report the expenditure of appropriated funds and to exempt certain secret activities from comprehensive public reporting."<sup>185</sup>*

While these statements are clearly true as they relate to details associated with the nation's financial reports and most assuredly information related to national security matters, Congress has a constitutional obligation to report truthful and complete information with respect to total receipts, total expenditures and the resulting surplus or deficit. Justice Douglas focused on this fact in his dissent in *Richardson*. He thought that Chief Justice Burger's interpretation effectively read the Statement and Account Clause out of the Constitution. Whether Congress is complying with the Statement and Account Clause is a matter for the Supreme Court to decide, not Congress.

Furthermore, Chief Justice Burger's reference to "*two centuries of acceptance*" is hollow. Over the last two hundred years the Statement and Account Clause requirements have increased as the federal government's finances have become exponentially more complex. Arguably, a cash-based statement of receipts and expenditures was acceptable to fulfill the Statement and Account's Clause's required accounting when the government was small. However, once the government's finances grew in complexity and especially after the Sixteenth Amendment was ratified and Congress enacted social insurance programs and the Medicaid program funded with permanent appropriations, Congress was required by the interaction of the Statement and Account and Appropriations Clauses to begin publishing accrual-based financial statements.

Justice Douglas in his dissent in *United States v. Richardson*<sup>186</sup> had numerous other comments that illuminate the meaning of the Statement and Account Clause.

*"The mandate runs to the Congress and to the agencies it creates to make a regular Statement and Account... The beneficiary-as is abundantly clear from the constitutional history-is the public." "The Framers of the Constitution deemed financial information essential if the electorate was to exercise any control over its representatives and meet their new responsibilities as citizens of the Republic . . . ."<sup>187</sup> "From the history of the clause it is apparent that the Framers inserted it in the Constitution to give the public knowledge of the way public funds are expended."<sup>188</sup> "The sovereign in this Nation is the People, not the bureaucracy. The statement of accounts of public expenditures goes to the heart of the problem of sovereignty. If taxpayers may not ask that rudimentary question, their sovereignty becomes an empty symbol and a secret bureaucracy is allowed to run our affairs."<sup>189</sup> "Secrecy was the evil at which Article I, Sec 9 Cl 7 was aimed."<sup>190</sup>*

Judge Max Rosenn, the Circuit Judge in the *Richardson* case stated that

*"[t]he debates at the Constitutional Convention in 1787 and the state ratifying conventions reveal that....the citizenry should receive some form of accounting from the Government....Article II, section 3 requires the President "from time to time to give Congress Information on the State of the Union," and presumably the Framers could have utilized the same informal procedure with regard to the accounting if they had so wished. Instead, they chose to have the statement "published," indicating that they wanted it to be more permanent and widely-circulated than the President's message. The connotation must be that the*



*statement was for the benefit and education of the public as well as coordinate branches of government.”<sup>191</sup>*

Judge Rosenn believed that the constitutional obligation to account to the public was supported by the Congressional enactment of *31 U.S.C. section 66b(a)*<sup>192</sup> which provides:

*“The Secretary of the Treasury shall prepare such reports for the information of the President, the Congress, and the public as will present the results of the financial operations of the Government...(emphasis supplied)”*

In furtherance of this general duty, Congress enacted *31 U.S.C. sections 1027-1030* which provide for various specific reports, including the Combined Statement of Receipts and Expenditures provided for in *Section 1029*. Thus, Judge Rosenn reasoned that Congress’ own language indicates that the Secretary’s duty to present financial reports runs not only to the President and the Congress, but also to the public at large. If these reports are misleading and inadequate, there is no reason why Richardson, as a taxpayer, should not be able to require the appropriate executive officer to perform his obligations.

Judge Rosenn also stated

*“The right of the taxpayer to receive reasonably complete reports of governmental expenditures is within the “zone of interest(s) protected...by the statute...in question” and one for which he may suffer a cognizable injury.”<sup>193</sup>*

Judge Adams, the Circuit Judge who authored a dissenting opinion that was joined by Judges Aldisert and Hunter wrote that:

*“The argument that the duty to report the accounting runs to the public is based on a comparison of Article I, Section 9, Clause 7 with Article II, Section 3. The language of Article I, Section 9, Clause 7 mandates that “a regular Statement and Account\*\*\*shall be published\*\*\*”, whereas Article II, Section 3 requires that the President “shall from time to time give to the Congress information of the State of the Union\*\*”. Thus, the impact of the distinction between “shall be published” and “shall from time to time give to the Congress” becomes apparent. Furthermore, the Articles of Confederation, drafted by many of the same persons as the Constitution, required only that Congress inform the states of its indebtedness, as opposed to the requirement of publication of the receipt and expenditures of all public money.”<sup>194</sup>*

One of the key issues that has never been determined by the Supreme Court is what information is required by the Clause. Is limited financial reporting that includes a discrete number of consolidated figures all that is needed or are complete consolidated financial statements required?

#### **a. Federal Government’s Interpretation of U.S. v. Richardson**

The *Principles of Federal Appropriations Law, Third Edition* contains the following passage:

*“The second part of article I, section 9, clause 7 requires “a regular statement and account of the Receipts and Expenditures of all public Money shall be published from time to time.” Implementation of this provision, as a logical corollary of the appropriation power, is also wholly within the congressional province, and the courts have so held. Washington Post Co. v.*

*United States Department of State*, 685 F2d 698, 700 (D.C. Cir. 1982) (“the plenary authority of Congress in this area will be respected”), vacated as moot, 464 U.S. 979 (1983); *United States v. Richardson*, 418 U.S. 166, 178 n. 11 (1974)(it is clear that Congress has plenary power to exact any reporting and accounting it considers appropriate in the public interest”); *Harrington v. Bush*, 553 F2d at 195; *Hart’s Case*, 16 Ct. Cl. 459, 484 (1880), *aff’d* *Hart v. United States*, 118 U.S. 62 (1886)(“[a]uditing and accounting are but parts of a scheme of payment”). See also B-300192, n. 10, Nov. 13, 2002.”

#### **b. SCOTUS’ Logic Applied to the Statement and Account Clause**

If we apply the Court’s logic in the *Matrixx*, *Basic* and *TSC* cases to the Statement and Account Clause the information that a reasonable citizen/voter would want/require the government to produce are financial statements that consolidate all material entities and accrue for all costs associated with legally enacted programs for which Congress has appropriated funds.

What facts give rise to this conclusion? First, these statements are the only information that will provide a voter with an accurate account of the financial results and financial position of the United States Government. Second, the Sarbanes-Oxley Act of 2002<sup>195</sup> requires registered companies to disclose “all material off-balance sheet transactions.”<sup>196</sup> A reasonable voter would require the government to follow this requirement because to not comply would render the financial statements misleading.

### **B. Standing and the Political Question Doctrine**

At the “*Representation Without Accountability*” conference held at Fordham Law School on January 23, 2012 Professor Brian T. Fitzpatrick<sup>197</sup> of Vanderbilt Law School addressed the standing and political question doctrine issues. Selected excerpts of his remarks appear below:

*“The Constitution permits federal courts to hear only cases and controversies...[which] has been interpreted by the Supreme Court to limit the kinds of disputes that can be brought into the federal judiciary. The notion is that the courts want to make sure that this is a real dispute, not a fake dispute....And the notion of this being a real dispute has been operationalized into three requirements...Number one, whoever brings a lawsuit has to show they have been personally injured by the defendant....They have to show that the relief that they’re requesting the court to give them will likely redress the injury that they are suffering or have suffered, and they have to show that the injury that they’ve suffered is traceable to the defendant’s actual conduct.*

*I think that there are a bunch of people thankfully for whom there aren’t any lower court cases or Supreme Court dicta out there that threaten their standing. There’s a lot of people who have injuries that are not common to everybody, and they’re real concrete in particularized injuries that I think could bring a suit, would have standing to bring a suit....Number one, those of us who have purchased or are considering purchasing government debt.....So I’m not so pessimistic that the standing obstacle cannot be overcome.*

*Now, I should say though, that there is another doctrine that’s closely related to standing on which I think it’s more likely a court would toss out one of these lawsuits, even if you...had purchased government debt and had standing....and this doctrine is called the political question doctrine. And the notion is here that if the lawsuit is something that’s a political question, the courts shouldn’t get involved. It’s something that’s best left to the politicians. We*

*don't want to get involved if it's too political. And there's several categories of cases that the Supreme Court has said fall into this political question situation, and I'll list them here for you.*

*One category is the question in the case is texturally or historically committed to the political branches of government. So something the Constitution, the text the Constitution says this is really something that only the Congress or only the President should be able to decide for themselves. This is not something that really you should go to the courts. It's within the discretion of the political branches.*

*Another category that's too political for the Supreme Court is situations where there's no judicially discoverable or manageable standards. So the Constitution says something, but there's no possible standards the courts can think of to enforce the constitutional provision. There's also a category of cases where deciding the question requires a policy determination that is better left to the political branches. Judges are supposed to do law, politicians are supposed to do policy. Another category is, there's no way to decide the case without disrespecting one of the political branches of government. Another category is there's an unusual need to adhere to a political decision that was already made by one of the branches of government. Or, the last category, there'd be some embarrassment if different departments of the government, the judiciary, Congress, the President, answered a question differently. So these are these kind of general vague categories of cases the Supreme Court said are not justiciable. They're not appropriate for judicial determination.*

*Now the problem with these categories is they're so vague and broad you can really make an argument with any case falls into them at any time. You really could. Lack of a judicial standard, you know, would it be disrespectful to one of the branches of government? I mean, you could make that argument in every case. These categories are very vague. And that's a problem because if the courts didn't want to hear this lawsuit, they could easily find one of these categories and say, well, maybe it would be disrespectful for us to get involved here, so we're not going to. Be very easy for them to do that.*

*And so what can we say to the courts to persuade them that they shouldn't do that? That they shouldn't just duck the question and say leave it to the politicians. Well, for one thing it's important for courts to get involved, it's especially important for courts to get involved on questions where we can't trust the political branches to enforce the Constitution themselves. So if you have a dispute between the President and a dispute between the Congress, Congress and President have a disagreement about something, that's the kind of thing that you can leave to the political branches to sort out for themselves because you can trust the voters at the next election to vote for a new President or vote for a new Congress and resolve the dispute. But what if the two political branches, the Congress and the President are conspiring with one another to keep out the American people? In those situations you only have one other branch of government to turn to. The judiciary. And I think there is a good argument that this is one of these cases, where both the President and the Congress both have the incentive to keep people in the dark about the true liabilities of the country. And those are the situations where we need courts the most. Because we can't just turn to the political branches."*

**a. Violation of the Right to Financial Information Should Create Standing**

The private right to financial information should give the electorate standing in the courts to challenge the government if it believes that Congress is not providing the required financial information. Otherwise, there is no check on Congress' obligation to publish the Statement and Account. It is noteworthy that in the *United States v. Richardson* case both the majority and the dissent at the Court of Appeals believed that the public was entitled to some form of accounting. Justice Douglas focused on this fact in his dissent when the case reached the Supreme Court as previously noted.

Justice Rehnquist has famously characterized the implied private right of action under Rule 10b-5 of the nation's securities laws as "a judicial oak which has grown from little more than a legislative acorn." It would appear that the country would receive similar benefits if the Supreme Court were to adopt the same posture with respect to citizens' ability to challenge the federal government's financial reporting. This approach of enshrining a private right of action by citizens will result in the federal government most closely fulfilling its obligations under the Statement and Account and Appropriations Clauses.

*A popular Government, without popular information, or the means of acquiring it, is but a Prologue to a Farce or a Tragedy; or perhaps both. Knowledge will forever govern ignorance. And a people who mean to be their own Governors, must arm themselves with the power which knowledge gives.*

*James Madison*

## **5 Financial Reporting by the U.S. Government is “Pure Applesauce”**

### **A. When is “Money” Not “Money”?**

“Money” is not “Money” when the Executive and Legislative branches are interpreting Article I, section 9, clause 7. The federal government’s fraud is two-fold.

- 3) Congress and the GAO effectively define permanent appropriations to be an ongoing series of one-year appropriations wherein the appropriations beyond one-year do not rise to the level of an unmatured commitment. As such they do not have to be recorded as obligations.
- 4) They “divide and conquer” by defining the concept of a “liability,” a key component of public “Money,” differently for financial reporting purposes than for purposes of appropriations law.

Practically speaking this means taking certain programs that are funded with permanent appropriations such as Medicare, Medicaid and Social Security which are clearly legal liabilities/obligations under “appropriations law” and redefining them for financial reporting purposes as not being legal liabilities/obligations of the United States Government. This approach means that the legally enacted expenses and obligations of the United States Government are significantly understated in all of its financial reports.

The federal government publishes the President’s Budget and the Financial Report without including appropriations because of the definitional difference. Publishing financial statements that intentionally do not include all of the legal liabilities/obligations of the federal government constitutes a fraud on the American people and violates their right to an accounting from the government under the Statement and Account Clause.

The Federal Government acknowledges in a key GAO publication that it uses different definitions of “liability” for appropriations law and financial reporting purposes.

### **B. Congress/GAO Create Alternate Universe for Permanent Appropriations**

The recording of grants and subsidies is governed by *Sec. 1501(a)(5)*. It indicates that the grant must be supported by documentary evidence and that in order to properly obligate an appropriation for an assistance program, some action creating a definite liability against the appropriation must occur during the period of obligational availability of the appropriation. In some situations, the obligating

action under *section 1501(a)(5)* involves a discretionary action by an agency of awarding a grant that is evidenced by a grant agreement. In other situations, the obligating action for purposes of *31 U.S.C. sec. 1501(a)(5)(A)* may take place by operation of law under a statutory formula grant or by virtue of actions authorized by law to be taken by others that are beyond the control of the agency (even when the precise amount of the obligation is not determined until a later time).

The above description of when an appropriation should be recorded as an obligation shows the lengths to which Congress and the GAO will go to obscure spending. Conceptually, we have spending that is “*permanent*” and automatic (“no vote by Congress is required”). Yet according to Congress and the GAO the government’s obligation does not arise until a statutory formula for paying out benefits is met. Hence, there is no need to record any appropriation beyond the current year’s appropriation or any long term obligation in the Statement and Account. One must recall, as previously discussed, the two basic authorities conferred by an appropriation: the authority to incur obligations and the authority to make expenditures. Permanent appropriations include both authorities with the disbursement tied to the statutory formula.

Effectively, what Congress’ and the GAO’s interpretation does is require there to be a binding two-way legal obligation before the government records any expense or liability. This for Social Security, Medicare and Medicaid benefits that flow one-way from the government to the electorate. The only reason for having a “permanent” appropriation arise based on a statutory formula is to attempt to control the recording of the appropriation for both appropriations and statement and account clause purposes.

Later in the memorandum we will discuss the disagreement among FASAB members over accounting for social insurance programs. However, at this juncture it is important to point out that during that disagreement the Treasury representative, Ed Reid, indicated that “*social insurance was more of a contractual obligation than a recordable liability.*” This reveals that the government agrees that permanent appropriations create a legal obligation.....they just want to interpret that obligation in a way that doesn’t require any expense beyond the current year to be recorded for either appropriations law or Statement and Account clause purposes.

The fact that, absent Congressional action, the federal government has made a legal commitment to fund the permanent appropriation is ignored. This fraudulent accounting allows a Congress to completely mask enormous government commitments and control all future Congresses. According to SCOTUS any Congress is not permitted to control a future Congress. Yet this is exactly what has happened. Why? From a purely practical perspective the Congress that enacted the permanent legislation is not charged any amount on the nation’s books for the enormous future obligations that must be paid yet gets the goodwill benefit from the electorate for enacting that legislation. The electorate understands the implication to their personal financial well being of the government’s largesse. Furthermore, future Congresses are faced with the political nightmare of having to affirmatively vote to stop the government spending which will cost them dearly at the polls. It is inconceivable that the proper accounting for permanent appropriations under the two clauses involves recording the expense for the current year only and not recording any amount for future expenditures. This accounting approach completely destroys political accountability.

Why have Congress and the GAO created an alternate universe for recording permanent appropriations? The answer is that the numbers associated with permanent appropriations are staggering in size so no Congress wants to enact these programs and have the electorate know the

full cost of the programs. Congress and its CG have defined and interpreted the requirements for recording these permanent appropriations in such a way that it achieves permanent appropriations and a minimal amount recorded as an appropriation. Congress wants to have it both ways and under current accounting practices it achieves the desired result. And since no liability past the immediate year is recorded by the GAO for appropriations purposes there can't be one to record for accounting purposes. This is the primary vehicle utilized to perpetrate the massive fraud on the American people.

### C. "Liability" Redefined for Financial Reporting Purposes

We will now turn to the federal government's admission that it uses a different definition of "liability" for financial reporting purposes. The GAO's September 2005 "A Glossary of Terms Used in the Federal Budget Process" ("GAO's Glossary of Terms") defines "Liability" as follows:

*"Liability - Defined differently for obligation (or budgetary) and proprietary (or financial) accounting purposes.*

*Obligational (or budgetary) accounting, designed to ensure compliance with fiscal laws, is based on the concept of legal liability. A legal liability is a claim that may be legally enforced against the government. It may be created in a variety of ways, such as by signing a contract, grant, or cooperative agreement or by operation of law.*

*Proprietary (or financial) accounting, designed to generate data for financial statement purposes, is based on the concept of accounting liability. For federal financial statement purposes, a liability is a probable future outflow or other sacrifice of resources as a result of past transactions or events. Generally, liabilities are thought of as amounts owed for items or services received, assets acquired, construction performed (regardless of whether invoices have been received), an amount received but not yet earned, or other expenses incurred."*

In *Appendix III* of the *Glossary* the GAO explains further the different methods for tracking funds.

*"The federal government uses two different but overlapping methods for tracking funds. This reflects the fact that the federal government is made up of many different entities and serves multiple constituencies. ....For example, Congress seeks to monitor the obligation and expenditure of federal funds it appropriates and evaluates the need for additional funds; managers of federal entities seek to control the cost of operations....Although the budget and budget process largely use obligational accounting, users of this glossary should recognize that the terms used in obligational accounting might have different meanings when used in proprietary accounting."*

The Statement and Account Clause and Appropriations Clause are yoked together in the Constitution in Article I, Section 9, Clause 7 for a reason. Legislation that has been legally enacted and fully or partially funded with permanent appropriations must be reflected in the Statement and Account and other financial statements to the full extent of that funded obligation. Accounting principles governing federal financial reporting declare that legally enacted legislation that is fully or partially funded with permanent appropriations ARE NOT legal obligations for accounting purposes that need to be recorded in the Statement and Account or any of the nation's annual

financial statements. The government uses the “*Due and Payable*” approach to record obligations associated with the entitlement programs.

The above discussion lays out another aspect of the federal government’s fraud. For financial reporting purposes it will disclose “accounting liabilities” as opposed to the U.S. Government’s actual legal obligations/liabilities pursuant to Appropriations law. Once the GAO has created different definitions they cannot put spending side-by-side with appropriations because it would be comparing apples to oranges. THAT is why the President’s Budget and the Financial Report do not include appropriations.

The Supreme Court has indicated that Congress has the plenary power to decide the rules governing appropriations. However, Congress does not have the plenary power to enact appropriations with restrictions attached that prevent the proper recording of those appropriations. As mentioned previously, this violates one of the restrictions outlined by SCOTUS in *South Dakota v. Dole* which indicated that spending legislation must not be prohibited by an independent constitutional bar. In this case the independent constitutional bars are the Appropriations and Statement and Account clauses. In addition, Congress does not have plenary power to enact or have the GAO enact accounting rules for the Statement and Account that are contrary to its rules under the Appropriations Clause. In essence, the rules Congress has enacted under the Appropriations Clause require the federal government to use accrual accounting to accurately portray its financial results and financial position pursuant to the Statement and Account Clause yet Congress clings to using cash-based accounting for financial reporting. The cash-based accounting rules that Congress has enacted eliminate or materially obscure Congress accountability for spending, to the detriment of several rights of the nation’s citizens/voters.

The federal government’s accounting rules and gimmickry regarding permanent appropriations as well as off-balance sheet agencies and corporations cannot be reconciled with the Statement and Account clause’s “all public Money” requirement. The clause has no exceptions for entities (e.g., Federal Reserve, Fannie Mae and Freddie Mac) or programs (e.g., Social Security, Medicare and Medicaid) that our politicians want to put off-budget, off-balance sheet, describe only in footnotes or eliminate entirely from its financial statements.

#### **D. SCOTUS Must Determine the Meaning of the Two Clauses**

The Supreme Court has no alternative but to weigh in on Congress’ appropriations law and financial reporting practices as it did in *Lebron v. National Railroad Passenger Corp. (1995)* and *Department of Transportation ET AL v. Association of American Railroads (2015)*. In those cases the Supreme Court held that even when Congress has been quite specific in declaring that a corporation is not a federal instrumentality, it may still take on that status for constitutional purposes. In the *Lebron* case, Amtrak claimed that it was not a federal entity for First Amendment purposes since its statutory charter declared that it “*will not be an agency or establishment of the United States Government.*” The Court indicated that Amtrak’s reliance on the statutory disclaimer language was “*misplaced*” and that “*it is not for the Congress to make the final determination of Amtrak’s status as a Government entity for purposes of determining the constitutional rights of citizens affected by its actions.*”



*If the nation expects to be ignorant and free  
in a state of civilization, it expects what never  
was and never will be.*

*Thomas Jefferson*

## **6 All State Financial Reporting Violates the Antifraud Provisions & the U.S. Constitution**

It is highly probable that if states properly accounted for their spending the capital markets would require meaningfully higher rates of return on debt instruments issued by the states and, furthermore, several states might be considered to be bankrupt entities such that the capital markets would deny them access to additional borrowing. Therefore, state legislatures and the governors of each state have a substantial incentive in not having their legal expenditures and legal obligations reported correctly. Proper financial reporting would lead to spending cutbacks, tax increases and/or recriminations for overspending, all of which are likely to cause voter dissatisfaction and changes at the polls.

This section will shine a bright light on how state accounting for the Medicaid program clearly violates the antifraud provisions of the nation's securities laws. First, it is important to note that the securities laws governing municipal securities did not give the SEC authority to prescribe accounting standards in the municipal securities market. They were enacted with broad exemptions for municipal securities from all their provisions, except for the antifraud provisions of *Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5*. Generally, these prohibit fraudulent or deceptive practices by issuers including making any untrue statement of a material fact or omitting to state a material fact necessary in order to make statements made not misleading.

In addition, although they have never opined on the issue, state financial reporting should also be held by SCOTUS and the SEC to violate the Statement and Account clause. SCOTUS and the SEC should apply the right to financial information described later in this memorandum to the states by interpreting the Fourteenth Amendment as incorporating the Statement and Account Clause.

The right to financial information is no different than other textually enumerated rights contained in the Bill of Rights. If the Supreme Court interpreted the Fourteenth Amendment as incorporating the right to financial information, all states, cities and local governments would have to comply with the Statement and Account Clause which requires proper reporting of total receipts, total expenditures and the resulting surplus or deficit in a single Statement and Account. These figures must include "*all public money*." The off-balance sheet vehicles that are extensively used by state, city and local governments to mislead their respective electorates would need to be consolidated into one set of financial statements at each level of government. Assuming that the Constitution is interpreted in this manner many of the rules promulgated by the accounting profession for state, city and local financial reporting would be unconstitutional.

### **A. States Accounting for Medicaid Violates the Antifraud Provisions**

State financial reporting is fraudulent based on reporting for its largest single program – Medicaid. Since the inception of the Medicaid program all fifty states have published financial statements that fail to disclose material information relating to it. Based on disclosure in the 2010 Financial Report of the U.S. Government the states aggregate net present value obligation for Medicaid as of

September 30, 2010 is no less than \$18.3 trillion. By September 30, 2015 based on a reported obligation for the federal government the obligation for the states had fallen to \$16.8 trillion. Yet the states have not disclosed in any way their proportionate share of the net present value cost of Medicaid in any financial statement.

No state records their portion of this obligation in its balance sheet or properly records the annual increase or decrease in the net present value obligation in its income statement. Disclosure regarding the size of each state's obligation is non-existent. Any reasonable investor or citizen/voter in the average state would believe that not reporting \$682 billion of obligations (\$34.1 trillion (the author's estimate of the net present value obligation as of 2015) divided by 50 states – See **Exhibit 33**) omits a material fact that they would consider important. Furthermore, states also have other material off balance-sheet operations that obfuscate their spending and liabilities in violation of the United States Constitution.

Basically, the states fraudulent financial reporting involves redefining each state's legal obligation associated with the Medicaid program to be a small fraction of the state's legal obligation. This redefinition for accounting purposes completely eliminates political accountability.

The fact that the states comply with an accounting pronouncement by the GASB regarding non-exchange transaction accounting is irrelevant as these rules are designed to obfuscate political accountability for spending. GASB's accounting rule was enacted to mislead investors, citizens and voters with respect to the financial consequences of legally enacted legislation in an effort to protect politicians from voter dissatisfaction associated with excessive spending. Furthermore, following the GASB rules does not absolve states from having to comply with the antifraud provisions and it does not prevent the SEC from prosecuting this violation.

#### **B. State's Medicaid Obligation is Nine Times the Size of the Municipal Securities Market**

No state, Puerto Rico, other territories or the District of Columbia records the full cost of its share of Medicaid costs in its income statement or balance sheet. The fact that none of these governments are recording any expense or liability for the increase in the net present value cost of the program in their financial statements or have any relevant disclosure regarding their enormous financial obligations means that all of the states' financial statements are fraudulent under the standards recently endorsed by the Supreme Court and used by the Securities and Exchange Commission and the States of Illinois, New Jersey and Kansas in their respective settlements. These state settlements are discussed later in this memorandum.

*The Constitution is not bereft of controls over improvident spending. Federalism is one safeguard, for political accountability is easier to enforce within the States than nationwide. The other principle mechanism, of course, is control of the political branches by an informed and responsible electorate.*

*Justice Anthony M. Kennedy*

## 7 Why it Matters to All Americans

Since no report published by the federal government complies with the Appropriations and Statement and Account clauses several private rights protected by our Constitution have been violated. The rights violated include the right to vote, freedom of speech, due process, equal protection, the right to financial information and political accountability. In addition, these rights have been violated by the states. States have violated the right to vote under the Fifteenth Amendment and the other rights have been violated pursuant to their incorporation under the Fourteenth Amendment.

### A. Right to Financial Information

The Constitution guarantees citizen/voters the right to financial information, which at a minimum includes total receipts, total expenditures and the resulting surplus or deficit. These figures are not subject to the plenary power of Congress.

The right to financial information is a texturally enumerated right. There is no other meaning that one, at any point in time, could ascribe to the text of second part of Article I, Section 9, Clause 7 then it creates a right for the public to receive revenue and expense information and imposes a concurrent affirmative duty on the government's part to publish this financial information.

*"As we have explained, "the framers of the Constitution were not mere visionaries, toying with speculations or theories, but practical men, dealing with the facts of political life as they understood them, putting into form the government they were creating, and prescribing in language clear and intelligible the powers that government was to take." South Carolina v. United States, 199 U. S. 437, 449 (1905)."*<sup>198</sup>

Both the majority and dissenting Court of Appeals judges in the *United States v. Richardson* case referred to the right to financial information.<sup>199</sup> The right does not override the government's right to suppress financial information related to national security matters nor does it go to the issue of how much detailed financial information Congress is required to provide.

#### a. The Right is Not a Matter for Legislative/Executive Discretion

The judiciary has sometimes indicated that public access is a matter for executive and legislative discretion. The Court averred in *Houchins v. KQED, Inc.* that "[t]he Constitution itself," in Justice Stewart's words, "is neither a Freedom of Information Act nor an Official Secrets Act." The two reasons typically given to deny an affirmative right to information are that the judiciary lacks easily ascertainable standards for specifying the content of any access guarantee and that alternative

methods are available for the public to access the information. However, the Court has arguably already determined the relevant standard which is the antifraud provisions. With respect to the second reason the concept that a citizen/voter can piece together consolidated financial information from the data that is published today is laughable as sophisticated financial executives who pore over the data for years can only get a sense for what these figures would actually be. Furthermore, in addressing the argument denying an affirmative right to financial information the Court must confront the Supremacy Clause and the words of the Appropriations and Statement and Account clauses.

It is the duty of the Judiciary to interpret the legal meaning of the Constitution. If the Court does not acknowledge the right of financial information it is effectively saying that the Constitution does not permit anyone to challenge Congress with respect to its self-proclaimed adherence to a Constitutional requirement. This is so even when Congress' non-adherence benefits its incumbents to the detriment of the electorate. Furthermore, as previously noted, the lack of an interpretation of the Statement and Account Clause has dire implications for several other constitutionally protected rights. In addition, the Court should not invoke the political question doctrine as this would nullify an important check on power that the Framers explicitly made a part of the Constitution. Finally, if the Court refuses to interpret the Clause it will remain susceptible to making errant decisions based on false and incomplete economic data as it did with its ACA decisions.

## **B. Freedom of Speech<sup>200</sup>**

It is important to repeat what a lower court judge and a Supreme Court justice said in *U.S. v. Richardson* (1974), the single Statement and Account Clause case to reach the Court. Justice William Douglas' dissent describes the importance of the Clause:

*"The Framers of the Constitution deemed financial information essential if the electorate was to exercise any control over its representatives and meet their new responsibilities as citizens of the Republic...From the history of the clause it is apparent that the Framers inserted it in the Constitution to give the public knowledge of the way public funds are expended... The sovereign in this Nation is the People, not the bureaucracy. The statement of accounts of public expenditures goes to the heart of the problem of sovereignty. If taxpayers may not ask that rudimentary question, their sovereignty becomes an empty symbol and a secret bureaucracy is allowed to run our affairs....Secrecy was the evil at which Art. I, Sec. 9, cl 7, was aimed."*

Judge Max Rosenn of the US Court of Appeals for the Third Circuit stated the following in the *Richardson* case:

*"The debates at the Constitutional Convention in 1787 and the state ratifying conventions reveal that ... the citizenry should receive some form of accounting from the Government... Article II, section 3 requires the President "from time to time [to] give the Congress Information on the State of the Union," and presumably the Framers could have utilized the same informal procedure with regard to the accounting if they had so wished. Instead, they chose to have the statement "published," indicating that they wanted it to be more permanent and widely-circulated than the President's message. The connotation must be that the statement was for the benefit and education of the public as well as coordinate branches of government."*

### a. FEC v. Citizens United

On January 21, 2010, in *Federal Election Commission (FEC) v. Citizens United*<sup>201</sup>, the Supreme Court resolved a First Amendment challenge to the Bipartisan Campaign Reform Act of 2002. In a 5-4 decision, the Court “*rejected the argument that political speech of corporations or other associations should be treated differently under the First Amendment simply because such associations are not ‘natural persons.’*” The Court held that political speech is “*indispensable to decision-making in a democracy, and this is no less true because the speech comes from a corporation rather than an individual.*” Furthermore, “[s]peech is an essential mechanism of democracy, for it is the means to hold officials accountable to the people . . . . [P]olitical speech must prevail against laws that would suppress it whether by design or inadvertence.” Laws burdening political speech are “*subject to strict scrutiny,*” which requires the Government to prove that the restriction “*furtheres a compelling interest and is narrowly tailored to achieve that interest.*”

In 2008, Citizens United released a documentary about Presidential candidate Hillary Clinton and produced television ads for video-on-demand of the film scheduled to be available within 30 days of the election. The non-profit corporation was concerned about possible civil and criminal penalties for violating Section 441b which prohibits corporations and unions from making independent expenditures for speech that is an “*electioneering communication*” (“*any broadcast, cable, or satellite communication*” that “*refers to a clearly identified candidate for Federal office*”) or for speech that expressly advocates the election or defeat of a candidate. Citizens United sought declaratory and injunctive relief, arguing that 441b is unconstitutional as applied to its documentary. The District Court denied Citizens United a preliminary injunction and granted the FEC summary judgment.

The Supreme Court overruled the District Court stating that Section 441b’s prohibition on corporate independent expenditures is thus a ban on speech. As a “*restriction on the amount of money a person or group can spend on political communication during a campaign,*” that statute “*necessarily reduces the quantity of expression by restricting the number of issues discussed, the depth of their exploration, and the size of the audience reached.*” Were the Court to uphold these restrictions, the Government could repress speech by silencing certain voices at any of the various points in the speech process.

The Court noted that “[i]n a republic where the people are sovereign, the ability of the citizenry to make informed choices among candidates for office is essential.” The right of citizens to inquire, to hear, to speak, and to use information to reach consensus is a precondition to enlightened self-government and a necessary means to protect it. The First Amendment “*has its fullest and most urgent application*” to speech uttered during a campaign for political office.” Furthermore, “[d]iscussion of public issues and debate on the qualifications of candidates are integral to the operation of the system of government established by our Constitution.”

“*Under the Constitution it is ‘We The People’ who are sovereign. The people have the final say. The legislators are their spokesmen. The people determine through their votes the destiny of the nation. It is therefore important – vitally important – that all channels of communication be open to them during every election, that no point of view be restrained or barred, and that the people have access to the views of every group in the community.*” The worth of speech “*does not depend upon the identity of its source, whether corporation, association, union or individual.*” [T]he concept that government may restrict the speech of some elements of our society in order to enhance the relative voice of others is wholly foreign to the First Amendment.”

The Statement and Account is clearly “*political speech*” that is equal to or greater in importance than the requirement that the president deliver to Congress information regarding the State of the Union. The ideas that Congress has established appropriations rules that eliminate the need to record “permanent appropriations” beyond one year and that it has established one set of rules regarding appropriations and a different set of rules regarding reporting spending under those appropriations to the electorate cannot withstand strict scrutiny.

As Justice Kennedy stated “*The Constitution... confers upon voters, not Congress, the power to choose the Members of the House of Representatives, Art I, sec 2, and it is a dangerous business for Congress to use election laws to influence the voters’ choices*”. The fact that Congress is using the laws governing appropriations and the publication of the Statement and Account to influence voters’ choices as well as state decision-making regarding federal grants (e.g., the Affordable Care Act and Medicaid) does not make it any less dangerous. The First Amendment is premised on a mistrust of governmental power and provides that “*Congress shall make no law...abridging the freedom of speech*”. The laws that Congress has put in place that have led to current federal financial reporting clearly violate the people’s freedom of speech.

The several laws enacted by Congress that have led to the publication of a false and misleading statement and account must be viewed in essentially the same manner as the *FEC* rules in *Citizens United* that the Court struck down. The publication of a false and incomplete statement and account interferes with the right of free speech as it is a required political document for the electorate.

### C. Right to Vote

In *Federal Election Commission (FEC) v. Akins* (1998)<sup>202</sup>, the Court was dealing with an attempt on the part of a group of voters to compel the FEC to regulate the American Israel Public Affairs Committee (AIPAC) as a “*political committee*” within the meaning of federal election law.<sup>203</sup> The voters sought information that AIPAC would have to disclose (lists of donors, contributions, and expenditures) if it were so regulated. The FEC opposed regulation, and argued that the voters lacked standing. In analyzing the issue, the Court found that the plaintiffs had satisfied the injury requirement by showing that a decision to regulate would produce information valuable to their roles as informed citizens and voters.<sup>204</sup>

In *Akins*, the plaintiffs identified concrete injury because they claimed “*informational injury*” that directly affected voting rights. The court explained that the plaintiffs had suffered injury because they were deprived of information and, without the sought information, they were less able, “*to evaluate candidates for public office*” and “*to evaluate the role*” that the financial assistance to candidates “*might play in a specific election.*”<sup>205</sup>

Given that the framers wanted voters to have accurate information about government spending at what point does the government’s publication of false and misleading financial information render a citizen’s vote meaningless? Based on the *Akins* decision, the lack of a complete and accurate Statement and Account is an informational injury directly affecting voting rights.

### D. Political Accountability

Politicians have subverted the democratic process to protect their self interests. Congress cannot enact legislation and related permanent appropriations and then have these obligations largely defined out of existence for purposes of recording the appropriation or for financial reporting

purposes. When Congress enacts permanent appropriations for legally enacted legislation it must record the appropriation and accrue for the funded obligation in the Statement and Account. It cannot continue to use cash-based accounting as it is completely misleading and contrary to Appropriations law. The full costs associated with the permanent appropriation needs to be recognized in the Statement and Account at the time of the appropriation. Not recognizing those costs destroys political accountability entirely and effectively binds all future Congresses. It is a political windfall for the Congress that enacted the legislation and puts an insurmountable burden on a future Congress that might otherwise be inclined to stop this spending.

The federal and state government's fraudulent and unconstitutional accounting is substantially worse than the facts the Supreme Court faced in *New York v. United States* (1992) wherein the Court indicated that if Congress' scheme was permitted state and federal officials could engage in a political shell game wherein each could disclaim responsibility. In the case of financial reporting the electorate has no idea what the true amount of expenditures and obligations are at either the federal or state level. Hence, responsibility cannot be pinned on any politician.

#### **a. New York v. United States**

The Court in *New York v. United States*,<sup>206</sup> sought to protect "*the accountability of both state and federal officials*" to their electorate.<sup>207</sup> Employing this rationale, the Court held unconstitutional a federal statute that commanded the states either to remove radioactive nuclear waste or to take title to it. If Congress' scheme were permitted state and federal officials could engage in a kind of political shell game where each level of government might disclaim responsibility by pointing fingers at the other. There was a danger, then, that accountability would wither. Arguably, this case introduced the accountability rationale into the jurisprudence supporting constitutional federalism.

In key language explaining why the State could not consent to being commandeered by Congress, Justice O'Connor relied on the accountability rationale:

*"[I]t is likely to be in the political interest of each individual official to avoid being held accountable to the voters for the choice of location. If a federal official is faced with the alternatives of choosing a location or directing the States to do it, the official may well prefer the latter, as a means of shifting responsibility for the eventual decision. If a state official is faced with the same set of alternatives-choosing a location or having Congress direct the choice of a location-the state official may also prefer the latter, as it may permit the avoidance of personal responsibility....[F]ederalism is hardly being advanced."*

The federal and state governments did not publish any financial results with respect to Medicaid other than current year cash outlays until 2010. At that time the federal government indicated that the net present value obligation related to its portion was \$24.2 trillion. The states have still not acknowledged their legal obligation's net present value cost of \$18.3 trillion as of 2010 in their financial statements. What aspect of this fact pattern meets the accountability requirement set forth by Justice O'Connor? It would appear that accounting for Medicaid is a political shell game.

#### **b. SCOTUS Should Not Show Any Deference to Congress**

The dissent in *Citizens United* (Justices Stevens, Ginsburg, Breyer and Sotomayor) believes that Congress' "*careful legislative adjustment of the federal election laws...warrants considerable*

*deference,..” and that “we should instead start by acknowledging that “Congress surely has both wisdom and experience in these matters that is far superior to ours.” However, “[t]his is not to say that deference would be appropriate if there was a solid basis for believing that a legislative action was motivated by the desire to protect incumbents or that it will degrade the competitiveness of the electoral process.”*<sup>208</sup> This approach appears warranted for examining financial reporting laws.

Over the last one hundred years Congress has abdicated its financial reporting responsibility. Today, the Executive branch dominates federal financial reporting and this reporting is completely politically motivated. The President’s Budget is prepared by OMB without input from Congress. Congress enacted legislation in the 1950s requiring the Executive branch to complete the President’s Budget using cost-based accrual accounting.<sup>209</sup> The Executive branch refused to comply with this legislation. The Financial Report is prepared by Treasury and OMB without input from Congress other than through the agreed directives of the FASAB.

An example of the irrelevance of Congressional input today is the treatment of Fannie Mae and Freddie Mac. After the U.S. government assumed control in 2008 of these two federally chartered institutions the CBO concluded that the institutions had effectively become government entities whose operation should be included in the federal budget. However, OMB felt differently, and the Combined Statement reflected the Budget’s approach.<sup>210</sup>

The bottom line is that Supreme Court deference is wholly inappropriate to a Legislative branch that has abdicated its financial reporting responsibility in an effort to diminish its political accountability. This effort has significantly degraded the electoral process as citizens must vote without the benefit of financial information required to be published by the Constitution.

There are two other critical facts with respect to financial reporting and political accountability. The first is that the Legislative and Executive branches have a direct conflict of interest in not having expenditures reported correctly as they have been elected by promising to maintain or increase spending levels. Proper financial reporting would lead to spending cutbacks, tax increases and/or recriminations for overspending, all of which are likely to cause voter dissatisfaction and changes at the polls. The second is that Social Security, Medicare and Medicaid have permanent appropriations.<sup>211</sup>

When you couple permanent appropriations with inadequate financial disclosure political accountability disappears altogether. Voters have no idea what the level of expenditures are and they cannot send the responsible representatives packing because they have retired years ago. Their current representatives’ stance is that their hands are tied and they have nothing to do with mandatory spending.

#### **E. Equal Protection<sup>212</sup>**

Financial reporting by the federal government, on which states rely, effectively forces a state to participate in action that violates the equal protection clause. It should be noted that in recent years to a large degree the FASAB and GASB coordinate their accounting pronouncements. For the Medicaid program the federal and state governments report no costs in any of its financial statements for the legal obligations that must be paid in the future. This has the effect of disguising a very substantial wealth transfer from future generations to pay for the current generation’s health care. This wealth transfer is an equal protection violation as it is unlikely that funds will exist to



cover future generation's same costs. An accurate statement and account of the nation's finances would reveal this violation.

The Supreme Court in *South Dakota v. Dole*,<sup>213</sup> indicated that this spending power is of course not unlimited but is instead subject to several restrictions. The fourth restriction by *Dole* is that "other constitutional provisions may provide an independent bar to the conditional grant of federal funds."<sup>214</sup> The Court used the example of a grant of federal funds conditioned on a state's infliction of cruel and unusual punishment to clarify the types of conditions that would be unacceptable under the restriction.<sup>215</sup>

The Comptroller General recently stated *"the federal government continues to face an unsustainable fiscal path."*<sup>216</sup> The *Citizens Guide to the 2011 Financial Report* states *"The Nation must bring social insurance expenses and resources into balance before the deficit and debt reach unprecedented heights. Delays will only increase the magnitude of the reforms needed and will place more of the burden on future generations."*<sup>217</sup>

## **F. Due Process<sup>218</sup>**

Congress cannot enact legislation regarding financial reporting that impinges on citizens' right to a true and correct accounting of the government's financial results and financial position.

### **a. Caperton v. A.T. Massey Coal Co.**

On June 8, 2009, the U.S. Supreme Court in a 5-4 decision found that campaign expenditures made in support of West Virginia Supreme Court Justice Brent Benjamin violated the Due Process Clause of the Fourteenth Amendment. *Caperton v. A.T. Massey Coal Co.*<sup>219</sup>, a case that inspired a best-selling novel and two editorials in the New York Times, started in 1998 when Caperton filed suit against Massey in the circuit court of Boone County, West Virginia. After the jury found Massey liable for fraudulent misrepresentation, concealment, and tortuous interference with existing contractual relations and awarded Caperton \$50 million in damages, West Virginia held its 2004 judicial elections. Massey CEO Don Blankenship contributed \$3 million to Brent Benjamin's campaign knowing that the State Supreme Court of Appeals would consider the appeal.

Before Massey filed its appeal, Caperton moved to disqualify Justice Benjamin under the Due Process Clause and the State's Code of Judicial Conduct, based on the conflict caused by Blankenship's campaign contributions. Justice Benjamin denied the motion, indicating that he found nothing showing bias for or against any litigant. Ultimately, Benjamin cast the deciding vote to overturn the \$50 million verdict. During the rehearing process, Justice Benjamin refused twice more to recuse himself, and the court once again reversed the verdict. Several months later, Justice Benjamin filed a concurring opinion, defending the court's opinion and his recusal decision.

On appeal, the U.S. Supreme Court found that the \$3 million spent on Benjamin's behalf created a risk of actual bias sufficient to violate Caperton's Fourteenth Amendment right to an impartial adjudicator. In doing so, the Court recognized for the first time that campaign expenditures could create a due process violation.

Justice Kennedy in his Opinion of the Court cited several cases including *Tumey v. Ohio*<sup>220</sup>. "The *Tumey* Court concluded that the Due Process Clause incorporated the common-law rule that a judge must recuse himself when he has *"a direct, substantial, pecuniary interest"* in the case. This rule

reflects the maxim that “[n]o man is allowed to be a judge in his own cause; because his interest would certainly bias his judgment, and, not improbably, corrupt his integrity.”<sup>221</sup>

In *Tumey*, “the mayor of a village had the authority to sit as a judge (with no jury) to try those accused of violating a state law prohibiting the possession of alcoholic beverages. Inherent in this structure were two potential conflicts. First, the mayor received a salary supplement for performing judicial duties, and the funds for that compensation derived from the fines assessed in a case. No fines were assessed upon acquittal. The mayor-judge thus received a salary supplement only if he convicted the defendant.<sup>222</sup> Second, sums from the criminal fines were deposited in the village’s general treasury fund for village improvements and repairs.”<sup>223</sup>

The Court held that the Due Process Clause required disqualification

“both because of [the mayor-judge’s] direct pecuniary interest in the outcome, and because of his official motive to convict and to graduate the fine to help the financial needs of the village.”<sup>224</sup>

The Court articulated the controlling principle:

“Every procedure which would offer a possible temptation to the average man as a judge to forget the burden of proof required to convict the defendant, or which might lead him not to hold the balance nice, clear and true between the State and the accused, denies the latter due process of law.”<sup>225</sup>

If we apply the Court’s logic to Congress’ responsibility to publish the Statement and Account several notions become obvious. First, while the Constitution is clear that Congress is responsible for publishing the Statement and Account, it cannot unilaterally determine whether it is complying with the Clause. This would violate the maxim cited by the Court that no man is allowed to be a judge in his own cause. James Madison in *Federalist* No. 10 extended this concept beyond a single judge, “With equal, nay with greater reason, a body of men are unfit to be both judges and parties at the same time”. Second, it can be argued that Congress has “a direct, personal, substantial, pecuniary interest” in the determination of whether it is complying with Constitution as it is in their interest to under-report expenses in an effort to endear themselves with the electorate, protect incumbents and degrade the competitiveness of the electoral process. Furthermore, if we apply the Court’s logic to the Appropriations clause it is clear that Congress cannot determine whether its’ defining permanent appropriations out of existence for financial reporting purposes or its using different definitions of “liability” complies with the Appropriations and Statement and Account clauses.

If the Court were to determine that Congress did not have “a direct, personal, substantial, pecuniary interest” the Court would then proceed to its analysis of the more general concepts of bias. Justice Kennedy stated that

“the *Tumey* Court was also concerned with a more general concept of interests that tempt adjudicators to disregard neutrality. ... As new problems have emerged that were not discussed at common law..., the Court has identified additional instances which, as an objective matter, require recusal. There are circumstances “in which experience teaches that the probability of actual bias on the part of the judge or decisionmaker is too high to be constitutionally tolerable.”<sup>226</sup>

This concern was discussed in *Ward v. Monroeville*<sup>227</sup>, which invalidated a conviction in another mayor's court. In *Monroeville* the mayor received no money. The fines the mayor assessed went to the town's general fisc. The Court held that

*"[t]he fact that the mayor [in Tumey] shared directly in the fees and costs did not define the limits of the principle."*<sup>228</sup> *The principle, instead, turned on the "possible temptation" the mayor might face; the mayor's executive responsibilities for village finances might make him partisan to maintain a high level of contribution [to those finances] from the mayor's court.*<sup>229</sup>

As the Court reiterated in *Gibson v. Berryhill*, another case that Term, *"the [judge's] financial stake need not be as direct or positive as it appeared to be in Tumey."*<sup>230</sup>

The Court in *Caperton* stated that the facts of the case were *"exceptional," "extreme," "rare" and "extraordinary."* If \$3 million in campaign contributions to a state supreme court's judge's campaign is critical to the Court's analysis of whether due process has been violated then what would the Court consider Congress keeping over \$73.6 trillion of legal entitlement obligations that are fully funded with appropriations and numerous multi-trillion enterprises that the federal government controls off the governments' books as its members seek re-election.

It is significant to note that the Supreme Court does not have to conclude that the Congress intentionally published misleading or fraudulent financial statements. The Court merely has to conclude that there would be a possible temptation for the average Congress to not hold the balance nice, clear and true in determining the methodology of compiling the Statement and Account and its content. If it so concluded, the probability of actual bias on the part of Congress is too high to be constitutionally tolerable as the arbiter of whether it is complying with the Constitution.

The Supreme Court in *Caperton v. A.T. Massey Coal Co.* asks not whether the judge is actually, subjectively biased, but whether the average judge in his position is *"likely"* to be neutral, or whether there is an unconstitutional *"potential for bias."*....*"In defining these standards the Court has asked whether "under a realistic appraisal of psychological tendencies and human weakness," the interest "poses such a risk of actual bias or prejudgment that the practice must be forbidden if the guarantee of due process is to be adequately implemented."*<sup>231</sup>

## **b. Psychological Factors Affecting Financial Reporting**

There are several important psychological factors that have influenced and continue to influence financial reporting for the federal and state governments. This section attempts to explain how and why Congress and the states have put the nation into a situation where financial reporting is so distorted from economic reality? This analysis suggests that there are very significant, some would say insurmountable barriers, to changing our current circumstance through the legislative process and therefore, the only resolution is through the judiciary. The framework for the analysis is inspired by a talk given by Charlie Munger, *The Psychology of Human Misjudgment*.<sup>232</sup> Mr. Munger is the long time business partner of Warren Buffett.

Congress and the Executive have created a set of circumstances that takes advantage of multiple psychological tendencies that affects all parties interested in the electoral process. These psychological factors, which are generally well documented in psychology literature, ensure that political accountability is significantly diminished and that the competitiveness of the electoral process is materially degraded. It is hard not to view the creation and alignment of these

psychological factors as “corruption”. Mr. Munger calls the alignment of multiple psychological tendencies all working in the same direction as the “Lollapalooza Tendency”.

Let’s begin with “*incentives*”. B.F. Skinner, the famous Harvard psychology professor, proved that incentives could cause significant behavioral change.<sup>233</sup> His experiments proved that bad behavior is intensely habit-forming when it is rewarded. When choosing between different outcomes, elected representatives can be expected to consider which course of action is most likely to contribute to their own reelection and, which course of action is most consistent with the ideological commitments and policy goals of their constituents.

As Hamilton famously wrote when explaining the benefits of a public official making decisions with an eye toward reelection, “*the desire of reward is one of the strongest incentives of human conduct...[and] the best security for the fidelity of mankind is to make their interest coincide with their duty.*”<sup>234</sup> In Pennsylvania, elected trial court judges sentence criminal defendants to longer and longer prison sentences as an impending election gets closer and closer. In Chicago, criminal defendants convicted of murder are 15% more likely to receive the death penalty if their trial occurs during an election year for the presiding judge. And across the nation, in cases between one in-state party and one out-of-state party, elected state court judges are more likely to decide cases in favor of the in-state litigant than appointed judges.<sup>235</sup>

Since entitlement programs were first created, Democrats and Republicans have had a significant incentive to be less than forthright with respect to their cost. They get elected by promising that benefits are guaranteed and that additional entitlements are possible. Yet, they do not permit any expense or liability associated with promises that must be paid in the future included in any financial statement to which they could be held accountable. Doing so would reveal massive deficits far exceeding our current Budget Deficit that would be impossible to justify and would likely lead to many elected officials losing their “jobs”.

Punishments strongly influence behavior which is why politicians are very familiar with the Persian Messenger Syndrome. In ancient times Persians killed some messengers whose sole transgression was that they brought home truthful bad news. This is why no politician at any level wants to take the lead on informing the electorate as to the true state of the nation’s finances. George Washington hanged deserters forty feet high as an example to others.<sup>236</sup> Unfortunately, over the years there have never been any negative repercussions for any of the politicians responsible for the federal or state government’s deficient financial reporting.

The population’s tendency to reciprocate favors and disfavor is well known to politicians. They know that their constituents want to hear about better benefits and nothing about increased costs. Politicians fully understand how the world works. You enact legislation that provides better benefits for me or lowers taxes and I will vote for you. You take away my benefits or raise my taxes and I will vote you out of office. This reciprocation tendency has stopped wars for considerable periods of time. It is also the reason why there are periods when no prisoners are taken. It is why purchasing agents at most large commercial establishments are not allowed to take anything from a vendor. The reciprocation tendency coupled with other tendencies discussed below ensures that a political candidate for office challenging an incumbent cannot use the fraudulent financial reporting issue to win over the electorate. It is a losing political strategy in all cases. One may inform voters but the candidate will never get elected.

Successful politicians are very good at voter psychology and pursue strategies to take advantage of the Liking/Loving Tendency and the Disliking/Hating Tendency. It will surprise no one that politicians prefer being liked by their constituents. Hence, they exhibit behavior to maintain this state of affection which involves ignoring the facts as they relate to the federal and state government's financial results and financial condition and making sure that the true status of their finances are not made public. Similarly, the electorate likes getting additional benefits especially if it does not cost them anything.

*"Politics is the art of marshalling hatreds."*<sup>237</sup> An important factor that has led to a significantly distorted electoral process is that the electorate does not want to know the truth about the poor condition of the nation's finances. Everyone likes a *"free lunch"* but as economics texts instruct, there are no *"free lunches"*. Not surprisingly, the people do not want to know any bad facts associated with the cost of their benefits. Politicians have used and continue to use people's dislike for any negative facts associated with any of the nation's social insurance programs to their advantage, particularly in negative advertising. The electorate hates being told bad news especially if it entails a possible bill for them.

The Social-Proof Tendency is the tendency for a person to think and act as others around him are thinking and acting. It tends to be triggered in periods of stress. Given that no one in Congress, the Administration, the SEC or the states is pointing out the fact that the federal or state government's financial reports fail to reflect economic reality this is social proof that the federal and state governments' financial statements must be correct. If a politician dared to raise the issue his reception among his colleagues and the electorate would be similar to the reception that the corrupt New York police division gave to Frank Serpico.<sup>238</sup> The corruption in the New York police was driven by social proof plus incentives.

It is highly likely that the dysfunctional behavior surrounding financial reporting by Congress, the Executive and the states will continue as significant stress causes dysfunction (the "Stress Influence Tendency"). The noted researcher, Pavlov realized that extreme stress created unanticipated extreme changes in behavior. During the great Leningrad Flood of the 1920s, Pavlov had many dogs in cages. As the waters rose many dogs reached a point where they had almost no airspace at the top of their cage they were subjected to maximum stress. This changed the behavior of many dogs.<sup>239</sup> To a certain extent this explains some of the dysfunctional behaviors that our politicians exhibit with the ongoing budget deficit and debt ceiling debates.

Politicians know that rational or reasonable explanations increase compliance with orders/requests. The Reason-Respecting Tendency is the reason that there is an enormous bureaucracy associated with the President's Budget. This bureaucracy ensures that there will always be reasons supporting the figures presented.

When confronted with the federal government's and state's fiscal distress most politicians talk about our ability to deal with the issue by growing our economy. This displays man's excessive optimism (the "Overoptimism Tendency"). The right approach is to focus on the hard numbers, something that Congress, the Executive and state governments are loath to do.

Politicians know that if reality is too painful to bear, they should distort the facts until they become bearable. This *"psychological denial"* could explain at least one of the arguments for maintaining the current accounting for social insurance. "Recognition of future social insurance benefits on the

financial statements would diminish significantly the relative size and importance of other expenses and liabilities shown on the financial statements”<sup>240</sup>

When’s steps are taken towards disaster but each of these steps are small and barely discernible, a person’s Contrast-Misreaction Tendency will often let the person go too far. The reason is that each step is such a small contrast from the person’s current position. Ben Franklin said “A small leak will sink a great ship.”<sup>241</sup> In the case of financial reporting it is so because over the last 81 years politicians and the electorate have intentionally hidden or ignored the “leak.”

The Authority-Misinfluence Tendency explains how authority figures (the “Executive”) can lead ordinary people into gross misbehavior. Stanley Milgram conducted experiments to show how far authority figures could lead people into such misbehavior.<sup>242</sup> The Framers of the Constitution distrusted the Executive. Distrust of the Executive is what led the Framers to put financial responsibility solely in Congress’ hands.

One of the truths about the electorate is that, on the whole, they exhibit the Excessive Self-Regard Tendency (the “Endowment Effect”). Once owned, or thought to be owned, social insurance benefits become worth more to a citizen than if they were offered for sale to the person and the person didn’t own them. The Excessive Self-Regard Tendency is illustrated by a Tolstoy passage: “According to Tolstoy, the worst criminals don’t appraise themselves as all that bad. They come to believe either (1) that they didn’t commit their crimes or (2) that, considering the pressures and disadvantages of their lives, it is understandable and forgivable that they behaved as they did and became what they became.”<sup>243</sup> One could easily substitute our politicians into this story in place of criminals.

A final truth about the electorate is that loss seems to hurt much more than gain adds to man’s pleasure (the “Deprivation-Supprereaction Tendency”). Therefore, it is not surprising that the electorate will react with almost irrational intensity to any loss or threatened loss, however small, of social insurance or Medicaid benefits.

### **c. The Lesson of Caperton**

Using the Court’s analysis in *Caperton* it is impossible to conclude that either Congress including the GAO, CBO or the Comptroller General or the Executive branch including the Treasury or OMB is the appropriate body to determine whether Congress or the Executive is complying with the Appropriations and Statement and Account clauses. This conclusion flies in the face of Chief Justice Burger’s dictum in *United States v. Richardson* that “it is clear that Congress has plenary power to exact any reporting and accounting it considers appropriate in the public interest.” This is so unless one reads the Justice’s remarks to be targeted solely to the amount of detail that Congress must publish.

*Failure of political will does not justify unconstitutional remedies.*

*Justice Anthony M. Kennedy*

## **8 Federal GAAP-Setting Process Is Unconstitutional**

The Statement and Account Clause is found in Article I which defines the powers and limitations of Congress. Congress has the duty to produce the statement and account. It has unlawfully delegated responsibility for determining and defining the accounting principles and policies to be used by the federal government to the Comptroller General, the highest ranking officer of the GAO, an agency controlled by Congress.

Nowhere in the Constitution does it indicate that the Executive Branch has any authority in defining the information required to be published in the statement and account. Yet, the Comptroller General has entered into a joint venture with the Executive branch to define accounting principles and standards for the federal government. In addition, Congress has abdicated its responsibility for producing the statement and account required by the Constitution and handed control over the production of the statement and account to the Executive branch's Treasury Department and OMB.

It is hard to understand why the FASAB exists except as an unconstitutional political accommodation. Furthermore, it is inconceivable that under our Constitution Congress or the Executive could publish and discuss as relevant to the nation's financial condition figures that materially differ from the required statement and account (i.e., The President Budget or the Financial Report).

### **A. Budget and Accounting Act of 1921**

Section 309 of the *Budget and Accounting Act of 1921* indicates that "The Comptroller General shall prescribe the forms, systems, and procedure for administrative appropriation and fund accounting in the several departments and establishments..."

### **B. Budget and Accounting Procedures Act of 1950**

The *Budget and Accounting Procedures Act of 1950* modified this language somewhat. Section 112(a) of the *Budget and Accounting Procedures Act of 1950* indicates that:

*"The Comptroller General of the United States, after consulting the Secretary of the Treasury and the Director of Bureau of the Budget concerning their accounting, financial reporting, and budgetary needs, and considering the needs of the other executive agencies, shall prescribe the principles, standards and related requirements for accounting to be observed by each executive agency, including requirements for suitable integration between the accounting processes of each executive agency and the accounting of the Treasury Department. Requirements prescribed by the Comptroller General shall be designed to permit the executive agencies to carry out their responsibilities under section 113 of this part, while providing a basis for integrated accounting for the Government, full disclosure of the results of the financial operations of each executive agency and the Government as a whole, and financial information and control necessary to enable the Congress and the President to discharge their respective responsibilities. The Comptroller General shall continue to exercise the authority*

*vested in him by... and, to the extent necessary, the authority vested in him by section 309 of the Budget and Accounting Act, 1921. Any such exercise of authority shall be consistent with the provisions of this section.”*

**C. 31 U.S.C. 3511**

Currently, 31 U.S.C. section 3511 states:

*“Sec. 3511. Prescribing accounting requirements and developing accounting systems*

- (a) The Comptroller General shall prescribe the accounting principles, standards, and requirements that the head of each executive agency shall observe. Before prescribing the principles, standards, and requirements, the Comptroller General shall consult with the Secretary of the Treasury and the President on their accounting, financial reporting, and budgetary needs, and shall consider the needs of the heads of the other executive agencies.*
- (b) Requirements prescribed under subsection (a) of this section shall –*
  - 1) Provide for suitable integration between the accounting process of each executive agency and the accounting of the Department of the Treasury;*
  - 2) Allow the head of each agency to carry out section 3512 of this title; and*
  - 3) Provide a method of –*
    - A. Integrated accounting of the United States Government;*
    - B. Complete disclosure of the results of the financial operations of each agency and the Government,; and*
    - C. Financial information and control the President and Congress require to carry out their responsibilities.*
- (c) Consistent with subsections (a) and (b) of this section –*
  - a. The authority of the Comptroller general continues under section 121(b) of title 40; and*
  - b. The Comptroller General may prescribe the forms, systems, and procedures that the judicial branch of the Government (except the Supreme Court) shall observe.*
- (d) The Comptroller General, the Secretary, and the President shall conduct a continuous program for improving accounting and financial reporting in the Government.”*

**D. Congress Cannot Delegate Law Making Authority to the Comptroller General**

Congress cannot delegate law making authority to a delegate of the Legislative branch. Hence, the Comptroller General does not have constitutional authority to set accounting principles and standards for the federal government. From the time that the *Budget and Accounting Act of 1921* was passed the Executive branch has appropriately refused to acknowledge the authority of the Comptroller General to set accounting principles and standards for the federal government

Over the last century federal financial reporting grew increasingly dysfunctional as the Executive and Legislative branches were at odds over proper accounting standards. The Legislature could have solved the impasse by either (1) passing laws dictating accounting principles and standards and then using the power of the purse to ensure that the Executive branch implemented them or (2) by delegating responsibility for promulgating these principles and standards to an Executive branch agency. In the 1950s it tried the first approach but the Executive branch unlawfully refused to follow



the laws promulgated by Congress and Congress refused to use the power of the purse to discipline the Executive branch into compliance.

The net result is that the Executive branch has unconstitutionally usurped Congress' responsibility to publish the Statement and Account of the receipts and expenditures of all public money. The Executive branch has done this because it recognizes that it cannot control spending priorities unless it also controls financial reporting and, therefore, public opinion.

**a. The Comptroller General Formed FASAB in 1990**

Since 1991, GAO has implemented its responsibility under U.S.C. sec 3511 largely through FASAB – a federal advisory committee jointly created by the Comptroller General, the Secretary of the Treasury, and the Director of the Office of Management and Budget (“Sponsors”). The Sponsors created FASAB to develop accrual accounting standards and principles for the United States Government.<sup>244</sup> Please note that FASAB and Congress have no input into the accounting principles used in creating the President’s Budget.

The FASAB was created to bridge the gap in constitutional interpretation between the Legislative and Executive branches. For the first time, the two branches agreed to work together in an agreed framework, with an open, public process, to determine the accounting standards that federal agencies should follow. The Memorandum of Understanding (“MOU”)<sup>245</sup> cited the JFMIP and the Federal Advisory Committee Act, as amended (5 U.S.C. App) as the basis for establishing the Board.

The reason that the FASAB was created was that the Comptroller General at the time of its creation was unwilling to either launch the required legal battle or use the power of the purse as Madison described in Federalist No. 58 to get the Executive branch to stop poaching Congress’ constitutionally mandated responsibilities. The OMB’s constitutional objections regarding accounting for Executive departments are a political power play that camouflages an unconstitutional intrusion by the Executive branch into accounting for the government’s finances. It is understandable from a political standpoint why the legal battle between Congress and the Executive branch has never been fought. However, this does not mean that the resulting compromise is constitutional.

The word Advisory was included in the Board’s name to signify the retention of legal authority by the Sponsors, whose approval would be required before the Board’s standards became effective. The Board can only recommend standards to the Sponsors. Although the Memorandum of Understanding creating FASAB indicates that the Sponsors have retained their authorities, separately and jointly, to establish and adopt accounting standards for the federal government this authority has never been used since the FASAB’s inception. From a practical standpoint the Sponsors have bound themselves together. No accounting principle will be adopted unless all the Sponsors agree. Subsequently, provisions were included in the CFO Act that requires agency financial systems to comply with applicable accounting principles, standards and requirements. The Office of Federal Financial Management (“OFFM”), an office within OMB, decides upon new principles, standards and requirements for OMB after considering FASAB’s recommendations.

In the 2015 Financial Report Footnote B. Basis of Accounting and Revenue Recognition contains a sub-section “Consolidated Financial Statements” that includes the following:

*“The consolidated financial statements of the Government were prepared using GAAP, primarily based on FASAB’s Statement of Federal Financial Accounting Standards (SFFAS).”*

This comment is in keeping with Congress’ century long practice of attempting to avoid responsibility for federal financial reporting and it clearly overstates FASAB’s legal authority. The only thing that FASAB does is make recommendations to its Sponsors. It cannot and does not set accounting principles. However, FASAB’s recommendations cannot be legally utilized by the Comptroller General to set accounting principles and standards per the Supreme Court’s decision in *Bowsher*. Therefore, the only reasonable conclusion is that FASAB is an unconstitutional entity whose purpose is to help facilitate accounting standards setting practices that Congress knows, or should know, is unconstitutional.

#### **b. FASAB’s Board Membership, AICPA’s Designation and Social Insurance**

The membership of the Board of FASAB initially was a member from each of the Treasury Department, OMB, GAO and the CBO as well as two other members representing civilian and defense agencies and three public members. In 1999, FASAB sought and received designation from the AICPA as the GAAP standards-setter for the federal government (Rule 203 status).<sup>246</sup> The government wanted the AICPA to bless the FASAB in order to have their pronouncements be viewed as GAAP. Approval by the AICPA was deemed critical by the Sponsors as it was viewed as “the Good Housekeeping seal of approval” and had real meaning in the private sector.

One of the AICPA’s major concerns was independence.<sup>247</sup> Veto power, however, was retained by FASAB’s Sponsors.<sup>248</sup> AICPA said that if veto was ever used it would rescind FASAB’s status.<sup>249</sup> At that time Robert Elliott, Chairman of the AICPA Board of Directors expressed confidence in FASAB’s impartiality. “FASAB has committed to replace any members who are not materially independent and the AICPA can rescind its recognition if FASAB does not act independently. This small risk must be balanced against a probable larger gain: a better informed U.S. Government and citizenry.”<sup>250</sup>

In 2003, in order to persuade the AICPA to continue to designate the FASAB as a promulgator of GAAP, the board was reconstructed and given greater autonomy. The reorganization resulted in four federal government members and six public members. However, as soon as the Board was reconstructed with real outside members the public members demanded that some amount of social insurance obligations be recorded in the government’s consolidated financial statements. The Sponsors threatened to veto any such proposal and arranged for the balance of power to shift on the Board.

Social Insurance has been the most controversial issue for the Board since its inception. It has been considered and reconsidered. In May 2006 the Board voted 6 to 4 to proceed with an Exposure Draft that included a provision that some part of Social Security beyond the “due and payable” amount would be recognized on the federal balance sheet as a liability. All six public members voted in favor and all four federal members voted against. At the March 2006 Board meeting the Treasury representative, Ed Reid, said that “social insurance was more of a contractual obligation than a recordable liability. Getting a solid majority behind this was essential. He said that he did not think the Board could survive having it go the way it is. He said he thought it would be very dangerous.” At the May 2006 meeting the Comptroller General indicated “the last thing in the world that I want

is for a veto to be made on a standard...I hope it never happens, but feelings on this are pretty strong.”<sup>251</sup>

Then one public Board member retired after 10 years and another Board member was not renewed. In subsequent votes the Board deadlocked at 5 to 5. The replacements had previously represented OMB. Once the Board was “re-adjusted” the FASAB killed the Social Insurance project.

Recently, the AICPA completed its second five-year review and Robert Harris Chairman of the AICPA conveyed the results to Tom Allen FASAB Chairman.<sup>252</sup> The result of the Council approval means that AICPA members, as preparers and auditors of federal entity financial statements, will continue to recognize accounting standards promulgated by the FASAB as GAAP for federal government financial reporting.

### **c. FASAB’s Fight Over Social Insurance**

The FASAB has promulgated the following principles with respect to the financial reporting of social insurance:

- 1) Statement of Federal Financial Accounting Standard (“SFFAS”) 5 which was issued in 1995 established that social insurance programs were non-exchange transactions. Only due and payable amounts would be recognized as expenses or liabilities in the consolidated financial statements.
- 2) SFFAS 17 which was issued in 1999 required the information presented in the Statement of Social Insurance (“SOSI”).
- 3) SFFAS 25 which was issued in 2003 required the SOSI to be reclassified as a basic financial statement.
- 4) SFFAS 28 which was issued in 2005 deferred the effective date for SFFAS 25.
- 5) SFFAS 37 which was issued in 2010 required additional information including a statement of changes in social insurance amounts.

However, it is important to understand the divisions within the Board on the issue of financial reporting for social insurance expenses and obligations. This can be accomplished through a review of the Preliminary Views document published after the contentious Board meetings in the summer of 2006.<sup>253</sup>

After the May 2006 Board meeting the FASAB issued a Preliminary Views document to solicit views rather than proceed with an Exposure Draft. The Preliminary Views document outlined both a Primary View and an Alternate View reflecting the split at the Board. As noted above six members believed that an expense is incurred and a liability arises for social insurance programs when participants meet eligibility requirements during their working lives in covered employment, and that some portion of the benefits accumulated at the balance sheet date should be recognized as a liability (Primary View). Three members believed that, consistent with current reporting requirements, an expense is incurred and a liability arises for social insurance programs when the participants have met all eligibility requirements and the benefit is “due and payable” (Alternative View). One member abstained from an expression of views but supported issuance of the preliminary views document so that responses can be considered.

The supporters of the Primary View believed that their proposed recognition and measurement standard would conform to the new definition for liability and expense proposed in the Exposure Draft of a Concepts Statement entitled Definition and Recognition of Elements of Accrual-Basis Financial Statements. Also, the Primary View would link the amounts reported for social insurance on the balance sheet and statement of net cost to the SOSI. Such linkage or “articulation” would illustrate how the amounts reported on these principal financial statements relate to the present values of the cash inflow and outflow over the next 75 years that are presented in the SOSI.

Members supporting the Alternative View saw a fundamental distinction in financial reporting of exchange transactions, which are voluntary market exchanges of goods and services for a price, and non-exchange transactions resulting from decisions made collectively by the Congress and the President to levy taxes and to authorize programs.

The Alternative View is that social insurance programs comprise two separate non-exchange transactions – the compulsory payment of taxes during an individual’s working life and the Government’s payment of benefits after the individual has satisfied all eligibility criteria.<sup>254</sup> In the Alternative View expenses and liabilities are incurred for social insurance programs when the participants have met all eligibility requirements and the amount of the benefit is “due and payable” to or on behalf of beneficiaries.

They put forth six reasons for excluding any future costs in its financial statements:

- 1) Congress can at any time make any changes it deems fit including termination,
- 2) the Supreme Court has ruled that citizens do not have a contractual right to any benefit,
- 3) recognition would result in a significant mismatch between costs recorded and services provided in any given year,
- 4) recognition would diminish the relative size and importance of other expenses and liabilities,
- 5) recording future benefits as expenses and liabilities may undermine needed reforms, and
- 6) given the un-sustainability of benefits with current financing the amount of benefit payments are uncertain and not reliably estimable.<sup>255</sup>

The Alternative View proposed to maintain the recognition and measurement of expense and liability for social insurance programs required in SFFAS 17. That is, the entity would recognize a liability and a related expense for social insurance benefits when all eligibility criteria are met such that an individual beneficiary is entitled to receive a benefit (e.g., a cash payment, goods or services). At that point, those who supported the Alternative View believed the Government has a present obligation and the benefits become “due and payable.” Thus, under the Alternative View the amounts reported on the balance sheet and statement of net cost for social insurance benefits would not change from what was currently reported under SFFAS 17. Those supporting the Alternative View believed their proposed recognition and measurement standard was consistent with the proposed definition for liability and expense currently under consideration in the Elements exposure draft.

The counter-argument for inclusion is straightforward. Recognizing the full costs of the social insurance programs is the only way to have a Statement and Account that reflects the federal government's economic reality. Congress has legally enacted these programs with permanent appropriations or mandatory authorizing legislation. Finally, almost every politician has publicly stated that these benefits will be paid.

As discussed above the Social Insurance project was terminated after the Board membership changed. The minutes for the September 19-20, 2007 meeting to discuss the Social Insurance project are illustrative of the divisions within the Board:

"Some members said the economic cost is the change in the statement of social insurance (SOSI) amounts during the reporting period. For example, if the net present value (NPV) of the social insurance commitments last year was \$44 trillion and this year it is \$45 trillion, then the economic cost would be \$1 trillion. Others defined it more narrowly as the change in the present value of future benefits attributed to work in covered employment already performed, exclusive of the present value of future benefits attributable to work in covered employment to be performed in the future." Others had a different view."<sup>256</sup>

#### **d. Other Examples of FASAB's Operations**

Other examples of how FASAB has operated are informative. As a result of the veto power retained by the Sponsors, the Board has not included certain solutions to an issue because it knew those solutions would lead to a veto. For example, OMB was openly opposed to explicitly disclosing and labeling a Closed Group dollar amount for Social Insurance. As a result that option was not considered for SFFAS 17. Also, the Department of Defense ("DoD") was able to exercise near veto power with respect to certain specialized defense situations. The Board's deference was due to the fact that DoD had many powerful allies in Congress who might be willing to provide exemptions or bring into question the FASAB's role.<sup>257</sup>

#### **e. FASAB Board Membership – Unspoken Requirement**

Given the government's experience with truly independent Board members the Sponsors are much more careful as to whom they will allow on FASAB's Board. Generally, they will pick ex-officers of the government who they know have drunk the cool-aid with respect the federal government's accounting. This extra-special requirement is not described in any publication....and the AICPA is well aware of the problem...and looks the other way.

#### **f. Bowsher v. Synar**

The federal government has known for a very long time that its accounting standards setting process is unlawful under the Constitution. In *Bowsher v. Synar* the Supreme Court made it crystal clear that Congress cannot delegate lawmaking authority to a delegate of the Legislative branch. Chief Justice Burger delivered the opinion of the Court. He determined that the Comptroller General was an officer of the Legislative Branch, and as such, he may not be entrusted with executive powers. The Court then went on to conclude that the powers entrusted to the Comptroller General pursuant to the *Gramm-Rudman-Hollings Act* were executive in nature. Hence, the Act violates the command of the Constitution that the Congress play no direct role in the execution of the laws.

Justice Stevens, with whom Justice Marshall joined, delivered a concurring opinion which contains important language that directly impacts the provisions delegating authority to the Comptroller General to prescribe accounting principles for the federal government. A substantial part of Justice Stevens' opinion is reprinted below.

*"The Gramm-Rudman-Hollings Act assigns to the Comptroller General the duty to make policy decisions that have the force of law. The Comptroller General's report is, in the current statute, the engine that gives life to the ambitious budget reduction process. It is the Comptroller General's report that "provide[s] for the determination of reductions" and that "contain[s] estimates, determinations, and specifications for all of the items contained in the report" submitted by the Office of Management and Budget and the Congressional Budget Office...It is the Comptroller General's report that the President must follow and that will have conclusive effect. It is, in short, the Comptroller General's report that will have a profound, dramatic, and immediate impact on the Government and on the Nation at large.*

*Article I of the Constitution specifies the procedures that Congress must follow when it makes policy that binds the Nation: its legislation must be approved by both of its Houses and presented to the President. In holding that an attempt to legislate by means of a "one-House veto" violated the procedural mandate in Article I, we explained:*

*"We see therefore that the Framers were acutely conscious that the bicameral requirement and the Presentment Clauses would serve essential constitutional functions. The President's participation in the legislative process was to protect the Executive Branch from Congress and to protect the whole people from improvident laws. The division of the Congress into two distinctive bodies assures that the legislative power would be exercised only after opportunity for full study and debate in separate settings. The President's unilateral veto power, in turn, was limited by the power of two-thirds of both Houses of Congress to overrule a veto thereby precluding final arbitrary action of one person...It emerges clearly that the prescription for legislative action in Art I, sec 1, 7, represents the Framers' decision that the legislative power of the Federal Government be exercised in accord with a single, finely wrought and exhaustively considered procedure." INS V. CHADHA, 462 U.S., AT 951, 103 S.Ct., at 2784.*

*If Congress were free to delegate its policymaking authority to one of its components, or to one of its agents, it would be able to evade "the carefully crafted restraints spelled out in the Constitution." Id., at 959, 103 S.Ct., at 2788<sup>258</sup> That danger - congressional action that evades constitutional restraints - is not present when Congress delegates lawmaking power to the executive or to an independent agency.<sup>259</sup>*

*The distinction between the kinds of action that Congress may delegate to its own components and agents and those that require either compliance with Article I procedures or delegation to another branch pursuant to defined standards is reflected in the practices that have developed over the years regarding congressional resolutions. The joint resolution, which is used for "special purposes and...incidental matters," 7 Deschler's Precedents of the House of Representatives 334 (1977), makes binding policy and "requires an affirmative vote by both Houses and submission to the President for approval" id., at 333 the full Article I requirements. A concurrent resolution, in contrast, makes no binding policy; it is "a means of*

*expressing fact, principles, opinions, and purposes of the two Houses,” Jefferson’s Manual and Rules of the House of Representatives 176 (1983), and thus does not need to be presented to the President. It is settled, however, that if a resolution is intended to make policy that will bind the Nation and thus is “legislative in its character and effect,” S.Rep. No. 1335, 54<sup>th</sup> Cong., 2d Sess., 9 (1897)-then the full Article I requirements must be observed. For “the nature or substance of the resolution, and not its form, controls the question of its disposition.” Ibid.*

*In my opinion, Congress itself could not exercise the Gramm-Rudman-Hollings functions through a concurrent resolution. The fact that the fallback provision in section 274 requires a joint resolution rather than a concurrent resolution indicates that Congress endorsed this view.<sup>260</sup> I think it equally clear that Congress may not simply delegate those functions to an agent of the Congressional Budget Office. Since I am persuaded that the Comptroller General is also fairly deemed to be an agent of Congress, he too cannot exercise such functions.<sup>261</sup>*

*As a result, to decide this case there is no need to consider the Decision of 1789, the President’s removal power, or the abstract nature of “executive powers.” Once it is clear that the Comptroller General, whose statutory duties define him as an agent of Congress, has been assigned the task of making policy determinations that will bind the Nation, the question is simply one of congressional process. There can be no doubt that the Comptroller General’s statutory duties under Gramm-Rudman-Hollings do not follow the constitutionally prescribed procedures for congressional lawmaking.<sup>262</sup>*

*In short, even though it is well settled that Congress may delegate legislative power to independent agencies or to the Executive, and thereby divest itself of a portion of its lawmaking power, when it elects to exercise such power itself, it may not authorize a lesser representative of the Legislative Branch to act on its behalf.<sup>263</sup> It is for this reason that I believe section 251(b) and section 251(c)(2) of the Act are unconstitutional.<sup>264</sup>*

*Thus, the critical inquiry in this case concerns not the manner in which executive officials or agencies act, but the manner in which Congress and its agents may act. As we emphasized in Chadha, when Congress legislates, when it makes binding policy, it must follow the procedures prescribed in Article I. Neither the unquestioned urgency of the national budget crisis nor the Comptroller General’s proud record of professionalism and dedication provides a justification for allowing a congressional agent to set policy that binds the Nation. Rather than turning the task over to its agent, if the Legislative Branch decides to act with conclusive effect, it must do so through a process akin to that specified in the fallback provision-through enactment by both Houses and presentment to the President.”*

#### **g. Comptroller General’s Testimony before Committee on Government Operations, House of Representatives on Bowsher v. Synar**

Following this decision Comptroller General Bowsher testified before a Committee of the House of Representatives regarding the implications of the Supreme Court’s decision. He indicated that the decision had serious implications for the way that the GAO and the Comptroller General operate.

Selected quotes from Comptroller General Bowsher’s testimony:

*“The 1921 Act also gave the Comptroller General the responsibility of prescribing accounting principles and standards for the federal government.”*

*“We recognize that the Supreme Court’s decision in Bowsher v. Synar may also affect some of the other functions carried out by GAO. “*

It is hard to view this testimony as anything but an acknowledgment that the Comptroller General cannot prescribe accounting principles and standards for the federal government.

*U.S. Code section 3511*, the statute requiring the Comptroller General to prescribe accounting principles and standards, is the linchpin upon which most federal financial reporting laws and accounting practices depend.

#### **h. What Do Former Comptroller Generals Believe?**

The author asked former Comptroller General Charles Bowsher and former Comptroller General David Walker whether they believed that the Comptroller General has the legal authority to set accounting principles and standards for the federal government. One referred the author to the current administration for an answer and the other indicated that the Comptroller General does not have legal authority to set accounting principles and standards for the federal government.

#### **E. Executive Branch Has Poached Congress’ Financial Reporting Responsibilities**

Under the *1921 Act* the executive branch was given the responsibility for preparing a budget. Currently, OMB prescribes all accounting rules involving the President’s Budget. The “official” Statement and Account (*“Combined Statement of Receipts, Outlays and Balances”*) presents budget results and the cash-related assets and liabilities of the Federal Government. Please recall that OMB completely controls budget accounting. Hence, Congress has effectively given authority to the executive branch regarding the Statement and Account financial reporting without explicit legislation as to the principles to be used as to how it will be prepared. This is unconstitutional.

Since 1921 the GAO has had an extremely difficult time getting executive branch agencies to comply with its directives regarding accounting. Furthermore, Congress amended the *Budget and Accounting Act of 1921* and the *Budget and Procedures Act of 1950* in 1956 to require executive agencies to prepare cost-based budgets in accordance with principles and standards prescribed by the CG. OMB ignored the amendments claiming constitutional objections. The OMB’s constitutional objections regarding accounting for Executive departments are a political power play that camouflages an unconstitutional intrusion by the Executive branch into accounting for the government’s finances. It is understandable from a political standpoint why the legal battle between Congress and the Executive branch has never been fought. However, this does not mean that the resulting compromise (the creation of FASAB) is constitutional. There is grave danger in this as Justices Scalia, Kennedy, Thomas and Alito have expressed as the Dissenters in the Obamacare litigation.

*“Structural protections—notably, the restraints imposed by federalism and separation of powers—are less romantic and have less obvious a connection to personal freedom than the provisions of the Bill of Rights or the Civil War Amendments. Hence they tend to be undervalued or even forgotten by our citizens. It should be the responsibility of the Court to teach otherwise, to remind our people that the Framers considered structural protections of freedom the most important ones, for which reason they alone were embodied in the original Constitution and not left to later amendment. The fragmentation of power produced by the*



*structure of our Government is central to liberty, and when we destroy it, we place liberty at peril.”*

Under the Constitution Congress has primary responsibility for money and for publishing the Statement and Account. Therefore, pursuant to the Court’s decision in *Bowsher v. Synar* it cannot outsource the determination of the proper accounting policies for the government to a joint venture with the Executive branch.

## **F. Legislative History**

### **a. Taft Commission and Prior Reform Efforts**

Starting in the 1880s there were a series of investigations including the Cockrell Committee, Dockery-Cockrell Commission, Roosevelt’s Keep Commission and the Taft Commission on Economy and Efficiency (“Taft Commission”), that dealt with the issue of how to improve Federal administration. These investigations were prompted by the increasing size and scope of the nation’s business. The Dockery-Cockrell Commission, for example, had, in the 1890s, reiterated Congress’ preeminent role in financial management based on the Constitution. Prior to the Taft Commission the results of these efforts were limited.

The Taft Commission was created in June 1910 with the purpose to investigate the business and methods of the Government. The Taft Commission is notable because it proposed that a budget for the U.S. Government be established. Subsequently, President Taft submitted the first consolidated budget. Congress ignored this budget but the Commission’s recommendation ultimately led to the passage of the Budget and Accounting Act of 1921 described below. Many citizens were in favor of these changes as they believed that it would lead to better government.

### **b. Impact of Woodrow Wilson**

Woodrow Wilson, the President from 1913 to 1921, thought that separation of powers was the product of an outmoded theory of politics. In particular, he had no use for separated powers. “No living thing can have its organs offset against each other as checks, and live,” he declared. *“There can be no successful government without leadership or without the intimate, almost instinctive, coordination of the organs of life and action.”*<sup>265</sup> His views stand in sharp contrast to the importance of separation of powers as described by James Madison in Federalist No. 51.<sup>266</sup>

Although a longtime advocate of the budget system, he vetoed the bill ultimately passed in 1921, described below, rather than submit to its limitation of his removal power of the Comptroller General.

### **c. Sixteenth Amendment**

The Sixteenth Amendment was ratified by the 36<sup>th</sup> state on February 13, 1913. Eight months later, in October the Congress enacted a new federal income tax law. By the end of WWI the federal government’s revenue generating sources had changed dramatically. Prior to the war, tariffs and excise taxes supplied more than 90% of Federal revenues. After the war income taxes generated 58%.

#### **d. Budget and Accounting Act of 1921<sup>267</sup>**

There was no unified Executive budget prior to the Act. Agency requests were simply packaged by the Treasury Department and transmitted to Congress without change. Following ten years of political maneuvering and debate after the Taft Commission first proposed a budget President Harding signed the Act in 1921. Thereafter, requests from Executive agencies were funneled into the Bureau of the Budget (“BOB”), which functioned as a central clearinghouse.

The Act built on efforts to develop a new budget process and involved trade-offs with the Legislature and the Executive. The Act created the BOB, the forerunner of the OMB, and established presidential authority over the budget formulation process. As a counterweight to the enhancements of Executive power in the budget process, Congress established the General Accounting Office (“GAO”), now known as the General Accountability Office. The statute transferred to GAO auditing, accounting and claims functions previously carried out by the Department of the Treasury. The office was designed to be “independent of the executive departments,” which were placed under its audit and review powers.<sup>268</sup>

By the early 20<sup>th</sup> century it had become apparent that the removal power of the President had curtailed the effectiveness of Treasury officials monitoring executive compliance with appropriations limitations. By transferring the auditing function to an independent officer not answerable to the President and removable by legislation only for cause Congress sought better to ensure Executive compliance with spending legislation.

A major feature of the Act was that it gave the GAO power to “prescribe the forms, systems, and procedure for administrative appropriation and fund accounting in the several departments and establishments...”<sup>269</sup> The Act specified that control of agency accounting systems and the pre-audit were also responsibilities of the GAO. The Act directed the Comptroller General to prescribe accounting principles and standards in executive agencies.<sup>270</sup> Later legislation enacted exceptions to GAO’s jurisdiction over executive branch and independent agencies including: (1) the CIA, (2) foreign operations and money market policies of the Federal Reserve<sup>271</sup> and (3) the President may proscribe GAO access to certain foreign intelligence and counterintelligence operations. To enforce access to information the Comptroller General has power to sue a non-complying agency.

By law, the Comptroller General cooperates with the Secretary of the Treasury and the Director of the OMB in developing for use by all federal agencies standardized systems, terminology, definitions, classifications, and codes for federal fiscal, budgetary and program related data and information.

More federal agencies ignored GAO’s guidance than complied in the years after the Act was passed.<sup>272</sup>

#### **e. Brownlow Committee**

The Executive branch’s perspective on the issue of which branch was in charge of determining accounting policies was articulated by the President’s Committee on Administrative Management (the Brownlow Committee) during FDR’s administration and reiterated by the later Hoover Commissions. The Brownlow Committee in 1937 called for a stronger BOB to help the President centralize fiscal management. It recognized that effective fiscal management required a good accounting system to control spending. Since the President’s duty was to faithfully execute the law including appropriations laws the committee reasoned that accounting was an Executive function.

The committee therefore advocated separating the GAO's accounting and audit functions. Specifically, it recommended the authority to prescribe and supervise accounting systems, forms and procedures in the Federal establishments should be transferred to and vested in the Secretary of the Treasury. This would limit the GAO to post audit functions. The Brownlow's assertion of accounting as an exclusive executive function was unacceptable to Congress.

#### **f. Executive Reorganization Plan of 1939**

The Bureau of the Budget was moved from Treasury into the Executive Office of the President pursuant to this Act. This further increased the Executive's power over the budget. The Executive Office of the President had originally been proposed by the Taft Commission and again by President Harding.

#### **g. First Hoover Commission**

The Hoover Commission, officially named the Commission on Organization of the Executive Branch of the Government was appointed in 1947 by President Truman. It took its name from former President Herbert Hoover who was appointed by Truman to chair it. In 1949 it made 273 recommendations of which over 100 were implemented in legislation over ensuing years. It recommended the use of accrual accounting by the federal government.

#### **h. Joint Financial Management Improvement Program**

The Joint Financial Management Improvement Program ("JFMIP") is a program authorized by the Budget and Accounting Procedures Act of 1950<sup>273</sup> to improve financial management practices. It was originally set up in 1948 by the Comptroller General, the Director of the OMB and the Secretary of the Treasury. It is a joint and cooperative action undertaken by the Treasury Department, GAO, OMB and the Office of Personnel Management. The program name was originally the Joint Program for Improving Accounting in the Federal Government but it was changed in 1959.

#### **i. Accounting and Auditing Act of 1950<sup>274</sup>**

The recommendations of the First Hoover Commission led to the passage of the Act. It was signed into law by President Truman in September 1950. The Act listed the accounting policies, principles and standards that were to be used by government agencies. After the Act, agencies had to use accrual accounting and cost-based budgeting. They also had to uniformly classify their accounting structures and keep up with an inventory of physical inventory.

The Act directed the Comptroller General to prescribe the principles, standards and related requirements for accounting to be observed by Executive agencies after consulting with the Secretary of the Treasury and the President. The use of accrual accounting, cost-based budgeting, consistent classification, simplification of allotment structure, and adequate control of property is required to establish and maintain adequate systems of accounting and internal control. Furthermore, accrual accounting enhances the ability of agencies to execute cost-based budgeting.<sup>275</sup>

In response to the legislation, the GAO issued accounting standards in its Policy and Procedures Manual for Guidance to Federal Agencies (Title 2). Throughout the 1950s and 1960s the GAO reported to Congress that federal agencies had responded poorly to their guidance.

The Act governed the way all government agencies submitted and maintained financial information, including the Executive branch. This brought up a constitutional question as to whether Congress could pass a piece of legislation that governed the Executive branch. Some OMB officials asserted that the GAO standard setting provision was unconstitutional because it authorized a legislative agency to define accounting standards for executive agencies. As a result of the constitutional question of whether the legislative branch can issue standards for the Executive branch the GAO, OMB and Treasury never reached agreement.

#### **j. Second Hoover Commission**

The second Hoover Commission was created by Congress in 1953 during the Eisenhower administration. It sent its report to Congress in 1955. It recommended the continued use of performance budgeting, in addition to agencies formulating and administering their budgets on a cost basis. The usefulness of formulating and administering budgets on a cost basis was recognized in 1956 amendments described below but it continues to be largely ignored.

#### **k. Amendments to 1921 and 1950 Acts<sup>276</sup>**

Amendments to the Budget and Accounting Act, 1921 and the Budget and Procedures Act of 1950 were passed on August 1, 1956.

The Congress provided the following amendments to the 1921 Act:

##### *Sec. 1*

*(b) The requests of the departments and establishments for appropriations shall, in such manner and at such times as may be determined by the President, be developed from cost-based budgets.*

*(c) For purposes of administration and operation, such cost-based budgets shall be used by all departments and establishments and their subordinate units. Administrative subdivisions of appropriations or funds shall be made on the basis of such cost-based budgets."*

*Amendments to the Budget and Accounting Procedures Act of 1950 were as follows:*

*Sec. 113 of such Act is amended by adding at the end thereof the following new subsection:*

*(c) As soon as practicable after the date of enactment of this subsection, the head of each executive agency shall, in accordance with principles and standards prescribed by the Comptroller General, cause the accounts of such agency to be maintained on an accrual basis to show the resources, liabilities, and costs of operations of such agency with a view to facilitating the preparation of cost-based budgets as required by section 216 of the Budget and Accounting Act, 1921, as amended.*

#### **l. President's Commission on Budget Concepts**

The President's Commission on Budget Concepts was established early in 1967 by President Johnson. Its task was to review the budget concepts and models of presentation then in use and to recommend appropriate changes. Its report was issued in October 1967 and it recommended accrual accounting and that the annual budget be presented on an accrued expenditure basis. This was endorsed by two administrations but not implemented.

### **m. Executive Reorganization Plan of 1970**

Under President Nixon, a second Executive reorganization plan was passed. The Bureau of the Budget was renamed OMB. All functions assigned to the BOB were now delegated to the Director of the OMB. Most importantly, all Executive departments, agencies and other bureaucratic units had to funnel their budget requests through OMB and the President. If these had to depend on OMB and the President they would more likely follow the President's wishes. This further strengthened the Executive branches control over the budget.

Meanwhile in Congress, the budget was not treated as a single entity but as thirteen separate bills. Its budgetary process was uncoordinated and confusing.

### **n. Congressional Budget and Impoundment Control Act of 1974 <sup>277</sup>**

This law was enacted for two reasons: 1) Congress realized that it had no means to develop an overall budget plan and 2) there existed no framework for Congress to establish its own spending priorities before work began on specific spending and revenue bills. The Act created House and Senate Budget Committees and established the Congressional Budget Office ("CBO"). The Act also moved the government's fiscal year end from June 30 to September 30.

### **o. Arthur Andersen & Company Study <sup>278</sup>**

In the 1970s Arthur Andersen & Company ("AA") studied the government's financial reporting. In 1975 AA issued a report and proposed that the government prepare consolidated financial statements on an accrual basis for all entities in the Government and all programs which may require future taxes for present liabilities. AA reasoned that both Hoover Commissions had recommended accrual accounting, and this had led to the passage of Public Law 84-863. This law, supplemented by related Treasury Regulations, specifies that Government agencies must prepare business-type, accrual-basis financial reports. These laws and regulations were in existence since 1956 but had only been partially implemented.

AA recommended discounting the outlays and receipts of a number of transfer programs including social security, civil service retirement and disability, veterans' benefits, and military retirement. Changes in present values were recommended to be included in the budget.<sup>279</sup>

### **p. Prototype Consolidated Financial Statements**

The first prototype Financial Report was produced by AA for 1973 and 1974. In 1975, the Treasury Department began issuing annual prototype government-wide financial statements on an accrual basis.

### **q. Reaction by CBO to AA Report**

In response to the AA study the CBO prepared a Technical Analysis Paper "Federal Financial Reporting: Accrual Accounting and the Budget" (1977) that reflected the CBO's reaction. Essentially, it argued that if the AA recommendations were implemented the unified budget would be useless. It described accrual accounting as undefined in the law and that Congress had left that responsibility to the Comptroller General.<sup>280</sup> Furthermore, it attacked the AA recommendations regarding the discounting of transfer payment liabilities and the depreciation of assets. It reasoned that if transfer

payments are discounted then everything in the budget should be as well. It is ironic that this notion has been institutionalized in FASAB's Statement of Long-Term Fiscal Projections.

**r. Title 2 of the GAO Policy and Procedure Manual for Guidance of Federal Agencies**

In 1984 GAO required audited agency statements on an accrual basis. Title 2 of the GAO Policy and Procedure Manual for Guidance of Federal Agencies was revised to require Federal agencies to prepare consolidated financial statements using the accrual basis of accounting.

**s. Managing the Cost of Government: Building An Effective Financial Management Structure**

In February 1985 then Comptroller General, Chuck Bowsher, put forth a detailed recommendation for a completely revised integrated approach for financial reporting for the Federal Government.<sup>281</sup> The GAO called for accrual-based consolidated financial statements and recording social insurance obligations in all budgeting and financial reports. Arthur Andersen supported the GAO's stance. OMB budget officials reacted very negatively.

**t. Balanced Budget and Emergency Control Act of 1985**

This law, commonly known as the Gramm-Rudman-Hollings Act, instituted rules designed to cut the budget deficit which at that time was the largest in history. The rules required automatic spending cuts if the deficit exceeded a set of fixed deficit targets.

**u. Chief Financial Officers Act of 1990 (the "CFO Act")**

The CFO Act required for the first time in history that federal agencies prepare annual financial statements and that these statements be independently audited. It required compliance with applicable accounting principles, standards, requirements and internal control standards. However, the Act did not define the source or nature of the applicable standards. At this point in time, OMB officials still held to their point of view that the GAO standard setting provision of the 1950 Act was unconstitutional because it authorized a legislative agency to define accounting standards for Executive agencies. The Act also established an Office of Federal Financial Management (OFFM) headed by a controller within OMB.<sup>282</sup>

**v. The Government Management Reform Act of 1994**

The Act requires that the head of each Executive agency submit audited financial statements to the Director of the OMB. The Act also requires the Secretary of the Treasury and the Director of the OMB to submit to the President and the Congress annual Government-wide financial statements (now known as "The Financial Report of the United States Government" or the "Financial Report") that contain the results of operations of the Executive branch.<sup>283</sup>

**w. *Flemming v. Nestor*<sup>284</sup>**

In this 1960 Supreme Court decision Nestor's denial of benefits was upheld even though he had contributed to the program for 19 years and was already receiving benefits. Under a 1954 law, Social Security benefits were denied to persons deported for, among other things, having been a member of the Communist party. Accordingly, Mr. Nestor's benefits were terminated. He appealed the

termination arguing, among other claims, that promised Social Security benefits were a contract and that Congress could not renege on that contract. In its ruling, the Court rejected this argument and established the principle that entitlement to Social Security benefits is not a contractual right.





*Nearly all men can stand adversity, but if you want to test a man's character, give him power.*

*Abraham Lincoln*

## 9 The Federal Government's Cover-up

The federal government has attempted to cover-up its unconstitutional accounting by having FASAB promulgate accounting principles and standards that justify the accounting treatment it uses. The accounting principles and standards promulgated by FASAB severely understate expenditures and obligations/liabilities of the U.S. Government according to Appropriations law.

### A. Accounting for Entitlement Programs

The fiction that the FASAB has concocted to effectively eliminate the federal government's enormous legal obligations for entitlement programs for financial reporting purposes is to define a category of transactions in such a manner that the federal government's obligation for those transactions will only be recognized at the last possible moment when funds are being disbursed. The transaction classification that FASAB came up with is called "*Nonexchange Transactions*."

A nonexchange transaction arises when one party to a transaction receives value without directly giving or promising value in return. There is a one-way flow of resources or promises. Please note that there is no federal law that differentiates between exchange and nonexchange transactions for purposes of appropriations of funds for various programs. The classification that FASAB has invented is purely an accounting fiction that has no basis in appropriations law.

The applicable FASAB pronouncements are *Accounting for Liabilities – Statement of Federal Financial Accounting Standards ("SFFAS") No. 5* which regulates the federal government's accounting for Medicaid and *Accounting for Social Insurance – SFFAS No. 17* which regulates accounting for Social Security (including Old-Age, Survivors and Disability Insurance) and Medicare (including Hospital Insurance (Part A) and Supplementary Medical Insurance (Part B)). Statement No. 5 became effective for periods after September 30, 1996 and Statement No. 17 was effective for periods after September 30, 1999. These standards define legal obligations/liabilities in a completely different way than Appropriation law.

*SFFAS No. 5* which was issued in 1995 defines "liability" as a probable future outflow or other sacrifice of resources as a result of past transactions or events. For federal nonexchange transactions, SFFAS indicates that a liability should be recognized for any unpaid amounts due as of the reporting date. This includes amounts due from the federal entity to pay for benefits, goods, or services provided under the terms of the program, as of the federal entity's reporting date, whether or not such amounts have been reported to the federal entity (for example, estimated Medicaid payments due to health providers for service that has been rendered and that will be financed by the federal entity but have not yet been reported to the federal entity).

In reaching its conclusion with respect to proper accounting FASAB indicated that it perceives Medicaid-type legislation and permanent appropriations as follows:

*“the obligation may be more a matter of what is perceived as equitable and good public policy than a legally enforceable claim. Although there may be a high probability that a grant, a subsidy, or an income transfer will be made or will continue in future years, the recipients of such grants, subsidies, or transfers do not have a right to receive such payments in the future from the federal government as do those who receive payments in exchange for service they have performed.”*

The fact that FASAB's point of view directly contradicts Appropriation law is not discussed by FASAB. It is enough for FASAB that estimates of future expenditures are reported in supplementary information. "...[I]t is possible to make meaningful estimates of the future amounts required to continue present policies regarding such programs. These estimates are relevant to certain decisions and should be disclosed or otherwise reported, as discussed further in "Supplementary Stewardship Reporting." In the context of the Board's definition, however, estimates of future nonexchange payments should not be recognized as a current period liability.”

SFFAS 17 which was issued in 1999 presents accounting standards for federal social insurance programs. The standards cover the following programs: Social Security (Old-Age, Survivors, and Disability Insurance), Medicare (Hospital Insurance [Part A] and Supplementary Medical Insurance [Part B]), Railroad Retirement benefits, Black Lung benefits, and Unemployment Insurance.

*The Board believes that the annual expenses of such programs should be the benefits paid during the accounting period plus any increase (or less any decrease) in the liability from the end of the prior period to the end of the current period, including claims incurred but not reported. The liability should be social insurance benefits due and payable to or on behalf of beneficiaries at the end of the reporting period, and supplementary stewardship information should be provided as described in the standards. Estimates of future nonexchange payments should not be recognized as a current period liability. Supplementary stewardship information is to be reported to facilitate assessing the program's long-term sustainability and the ability of the program and the nation to raise resources from future program participants to pay for benefits proposed to present participants.*

**a. Where are the Social Security and Medicare Trust Funds?**

Some readers might ask where are the Social Security and Medicare trust fund balances on the Financial Report's Balance Sheet. They have been eliminated in consolidation as they are merely IOUs from one government pocket to another.

*“When asked about the inability of his trust funds to effect genuine savings, [President Roosevelt] once answered, “Those taxes were never part of the economics. They are politics all the way through. We put those payroll taxes there so as to give the contributors a legal, moral and political right to collect their pensions....With those taxes there, no damn politician can ever scrap my social security program.”<sup>285</sup>*

The above recitations of FASAB's positions make the fraud and related cover-up readily apparent.

*No legacy is so rich as Honesty.  
William Shakespeare*

## 10 State GAAP-Setting Process Is Unconstitutional

The process by which GAAP is set for state, city and local governments is unconstitutional for several reasons. The primary reason that the process is unconstitutional is that none of the AICPA, FAF and GASB has been properly delegated legal authority by either the federal or state governments to establish laws that govern the preparation of financial statements by state or local governments. The electorate has a fundamental right to financial information under our federal and state constitutions and the determination as to how these financial scorecards are prepared cannot be determined by unelected accounting industry professionals that are not subject to substantial oversight and direction by either the federal or state governments. The arrangement that exists today for GAAP standards setting is “legislative delegation in its most obnoxious form.”<sup>286</sup>

There are a number of insidious aspects to the illegal delegation of GAAP standards setting to a private party by Congress and state governments.

- a. First and foremost, this delegation has provided Congress and the states politicians with the perfect outcome for each to escape all responsibility for the content of state and local government financial statements. GASB and the FAF are completely independent from Congress and the state legislatures. Yet, Congress and the fifty states have tremendous leverage over GASB. It does not take much imagination to see the leverage that Congressional funding of the GASB or the existence of the Governmental Accounting Standards Advisory Council (“GASAC”) provides in setting GASB’s agenda and priorities. And GASAC is filled with people that have significant ties with those in political office. This is the reason why proper accounting for Medicaid will never find its way onto GASB’s agenda.
- b. Second, Congress’ delegation to the SEC pursuant to Dodd-Frank sec. 978 to make the determination as to whether to fund the GASB coupled with a favorable GAO study (the outcome of which was never in doubt and the details of which can be found in Appendix II) and the clear intent of Congress to fund the GASB puts the SEC in a terrible position to enforce the antifraud provisions against the very accounting rule setting body that it agreed to fund.
- c. Furthermore, it is incredibly ironic that in the same legislation that authorizes the funding of GASB there is a Congressional proclamation that the accounting support fees collected for GASB shall not be considered public monies of the United States. As will be discussed below this is another pronouncement by Congress that would have no impact in a court of law.

A second reason why the process is unconstitutional is that the Congress’ current funding of GASB provided for under Dodd-Frank Section 978 enables the federal government to force the states to implement a federal program. The following quotes are taken from Supreme Court justices comments in *NFIB v. Sebelius*. Furthermore,

*“[p]ermitting the Federal Government to force the States to implement a federal program would threaten the political accountability key to our federal system.”<sup>287</sup> “When Congress compels the States to do its bidding, it blurs the lines of political accountability.”<sup>288</sup>*

By that, Justice Ginsburg believes, the Court means *“voter confusion: Citizens upset by unpopular government action . . . may ascribe to state officials blame more appropriately laid at Congress’ door.”<sup>289</sup>*

The AICPA has designated two accounting standards setting bodies GASB and FASAB which are both unconstitutional entities for the purposes for which they were created. In addition, certain of the accounting standards that they have promulgated require unconstitutional and fraudulent accounting. Nevertheless, if AICPA members do not follow GAAP as prescribed by GASB or FASAB its members will be disciplined pursuant to the AICPA’s Code of Professional Conduct. The combination of these facts, which were well-known when Congress passed the Dodd-Frank legislation enabled Congress to force the nationwide acceptance of GASB’s pronouncements as gospel as it relates to accounting standards. The language appearing in Dodd-Frank section 978 Non-interference with States has absolutely no impact on this mechanism of enforcement.

Third, the current arrangement whereby private entities are wielding power in a manner that is unfair to both investors and the electorate can be challenged as violations of several private rights including Due Process, Equal Protection, Right to Financial Information, Political Accountability, Right to Vote and Freedom of Speech. The actions may be brought in federal court under section 1983 of the reconstruction Civil Rights Acts and the Administrative Procedures Act.

The author recommends that readers that are unfamiliar with the AICPA, FAF and GASB read Appendices I and II before proceeding.

#### **A. Important Facts Impacting State and Local Government Financial Reporting**

To summarize, none of the AICPA, FAF or GASB Council, trustees, board members or officers has:

- 1) Been elected to their position in a federal or state election,
- 2) Been appointed by the President and has a commission as an officer of the United States government,
- 3) Been appointed to their position as an officer of any state government,
- 4) Sworn an oath to uphold the Constitution of the United States or the constitution of any individual state,
- 5) Any regular reporting requirements to the federal or any state government,
- 6) The possibility of being considered an “inferior officer” of the United States Government.

In addition, the GASB’s pronouncements with respect to GAAP for state and local governments are not subject to any further regulatory or judicial review with the possible exception that the SEC could determine that any particular accounting rule violated the antifraud provisions of the nation’s securities laws.

There are a number of important facts that need to be highlighted about state and local government financial reporting and the current arrangements in the accounting profession.

- 1) Financial reporting by state and local governments is a key factor for investors and potential investors considering investments in municipal securities. In addition, state and local government financial reporting is a critically important scorecard for the electorate to judge its state and local political leaders. Generally, these facts are acknowledged by the various accounting institutions.
- 2) The primary function of public accountants as relates to state and local governments is to provide assurance services (“audits”) with respect to their financial statements that attest to the reasonableness of disclosures, the absence of material misstatements and the adherence to generally accepted accounting principles. Public accountants must evaluate these financial statements based on generally accepted auditing standards (“GAAS”).
- 3) Notwithstanding the facts that public accountants are paid by state and local governments or related entities for their services, the primary clients of the independent auditor are investors and the electorate.
- 4) If no GAAP standard exists there is no baseline standard against which the public accountant can render an opinion. Without GAAP, the auditors’ opinion lacks impact in the marketplace. In addition, and more importantly, the public accountant’s ability to charge states or local governments a fee for their services is substantially diminished. **THIS IS A VERY IMPORTANT FACT!**
- 5) The AICPA is governed by a Council of 265 members that is comprised of members elected by the AICPA membership in each state, representatives of state societies of CPAs, twenty-one at-large members, all members of the Board of Directors of the Institute as well as all past presidents and chairmen of the board of the AICPA.
- 6) The AICPA Board of Directors acts as the executive committee for the governing Council which determines Institute programs and establishes general policies.
- 7) Membership in the AICPA is not obligatory for CPAs.
- 8) Upon joining the AICPA, a member agrees to abide by its Code of Professional Conduct and Bylaws adopted by a vote of the membership. The bylaws provide a structure for enforcement of the Code by the Institute’s Ethics Division. When allegations come to the attention of the Ethics Division regarding a violation of the Code, the division investigates the matter, under due process procedures, and depending upon the facts found in the investigation, may take a confidential disciplinary action, settle the matter with suspension or revocation of membership rights, or refer the matter to a panel of the Trial Board Division for a hearing. The bylaws mandate publishing the member’s name if he or she is found guilty by a hearing panel, is suspended or expelled by settlement.

The bylaws of 51 state and/or territorial CPA societies provide for their participation in a Joint Ethics Enforcement Program so that, depending upon membership status, actions taken by one or more of these societies or the AICPA are in the names of both the society and AICPA.

State regulatory agencies (Boards of Accountancy) issue practice licenses to CPAs and only those agencies may act to affect those licenses. The AICPA does not license CPAs. Those state regulatory agencies may take disciplinary action affecting practice licenses under statutes, regulations and rulings of the state. Also, the SEC and other Federal government agencies may, under Federal law or regulation, discipline CPAs who practice before these agencies.

- 9) The AICPA Code of Professional Conduct ET Section 203 Accounting Principles states that “A member shall not (1) express an opinion or state affirmatively that the financial statements...are presented in conformity with generally accepted accounting principles....if such statements....contain any departure from an accounting principle promulgated by bodies designated by council to establish such principles that has a material effect on the statements...taken as a whole.

Council is authorized under Rule 203 to designate bodies to establish accounting principles. Council has designated...the Governmental Accounting Standards Board (GASB) with respect to Statements of Governmental Accounting Standards issued in July 1984 and thereafter, as the body to establish financial accounting principles for state and local governmental entities pursuant to Rule 203. Council has also designated the Federal Accounting Standards Advisory Board (FASAB) with respect to Statements of Federal Accounting Standards adopted and issued March 1993 and subsequently, as the body to establish accounting principles for federal government entities pursuant to Rule 203....In determining the existence of a departure from an accounting principle as established....by a Statement of Governmental Accounting Standards or a Statement of Federal Accounting Standards encompassed by Rule 203, the division of professional ethics will construe such codification or statements, in the light of any interpretations thereof issued by...GASB or FASAB.

- 10) The Financial Accounting Foundation is a non-stock Delaware corporation that operates exclusively for charitable, educational, scientific and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code. It is governed by a Board of Trustees comprising 14-18 members from varied backgrounds – users, preparers, and auditors of financial statements, state and local government officials; academics and regulators. At least three of the Trustees shall be designated as “Governmental Trustees” and shall be individuals who, in the judgment of the Board, have extensive experience as financial officers or as elected officials of state and local governmental entities. The remaining Trustees shall be “at-large Trustees.” Nominations for at-large Trustees, other than the Chairman Trustee, shall be sought by the Foundation from a broad array of groups, as the Board of Trustees, or any designated committee thereof, deems appropriate. The Board of Trustees, or any designated committee thereof, shall have sole authority to nominate all candidates for the office of Chairman Trustee. Candidates for each Governmental Trustee

position shall be nominated pursuant to procedures adopted jointly by the Government Finance Officers Association, the National Association of State Auditors, Comptrollers and Treasurers, the Council of State Governments, the International City/County Management Association, the National Association of Counties, the National Conference of State Legislatures, the National Governors' Association, the National League of Cities, and the U.S. Conference of Mayors.

- 11) The FAF's stated mission is to establish and improve financial accounting and reporting standards, fostering financial reporting that provides decision-useful information to investors and other users of financial reports. This mission is accomplished through a comprehensive and independent standard-setting process that encourages broad participation, objectively considers all stakeholder views, and is subject to appropriate oversight and accountability.
- 12) The Governmental Accounting Standards Board was organized by the FAF in 1984. The GASB has been delegated the authority to establish standards of financial accounting and reporting for state and local governmental entities. GASB pronouncements are recognized as generally accepted and authoritative.
- 13) The Governmental Accounting Standards Advisory Council ("GASAC") is comprised of GASB constituents. The GASAC consults with the GASB on technical issues, project priorities, and other matters likely to concern the GASB.
- 14) The Board of Trustees of FAF shall not direct the GASB to undertake or to omit to undertake any particular project or activity or otherwise affect the exercise by the GASB of their respective authorities, functions, and powers in the establishment and improvement of financial accounting and reporting standards, and the Board of Trustees shall take care not to impair, in fact or perception, the independence and objectivity of the GASB in the establishment of financial accounting and reporting standards.
- 15) FAF's Board of Trustees shall provide for the appropriate funding and resources for the Foundation, the GASB and GASAC.
- 16) In connection with the exercise of its authority, functions and powers, FAF's Board of Trustees shall provide oversight on an ongoing basis, over the activities of the GASB and their due process practices, policies and procedures.
- 17) FAF's Board of Trustees shall appoint the GASB board without regard to employment or discipline and shall have appropriate qualifications including knowledge of governmental accounting and finance and a concern for the public interest in matters of finance accounting and reporting. The number of GASB's board shall be seven for terms of up to five years. The Chair of GASB shall serve full-time. GASB's Board members shall be compensated as determined by FAF's Board of Trustees.
- 18) FAF's Board of Trustees shall establish a council of not less than twenty persons who, in the judgment of the Board of Trustees, shall be knowledgeable about the

issues involving, and impact of, financial accounting and reporting by state and local governmental entities or shall possess an expertise of value to the GASB. This council shall be known as the Governmental Accounting Standards Advisory Council (“GASAC”).

- 19) GASAC shall consult with the GASB concerning major technical issues, the GASB’s agenda of projects and the assigning of priorities thereto, matters likely to require the GASB’s attention, the selection and organization of GASB task forces and other groups, and such other matters as may be requested by the GASB or its Chair.
- 20) Pursuant to the provisions of Section 978(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”), the SEC issued an order instructing FINRA to establish a reasonable accounting support fee (GASB ASF) to adequately fund the annual budget of the GASB and rules and procedures for the equitable allocation, assessment and collection of the GASB ASF from FINRA’s members.
- 21) One of GASB’s Guiding Principles states the following: “To weigh carefully the views of its constituents in developing standards and concepts so that they will: a) Meet the accountability and decision-making needs of the users of government financial reports, and b) gain general acceptance among state and local preparers and auditors of financial reports.
- 22) GASB does not have enforcement authority except through the laws of some individual states and the control that its regulations exert over auditors who render opinions on the fairness of financial statements. This control comes from the auditors requirement to adhere to the AICPA’s Code of Professional Conduct.

## **B. Dodd-Frank Section 978 Funding for GASB**

This section contains the full text of Section 978 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. Please note that a significant portion of the GAO study called for in the legislation appears in Appendix II.

### **Section 978. Funding for Governmental Accounting Standards Board**

(a) Amendment to the Securities Act of 1933 - Section 19 of the Securities Act of 1933 (15 U.S.C. 77s), as amended by section 912, is further amended by adding at the end the following:

(g)Funding for the GASB

(1)In general - The Commission may, subject to the limitations imposed by section 15B of the Securities Exchange Act of 1934 (15 U.S.C. 78o–4), require a national securities association registered under the Securities Exchange Act of 1934 to establish—

(A)a reasonable annual accounting support fee to adequately fund the annual budget of the Governmental Accounting Standards Board (referred to in this subsection as the GASB); and

(B)rules and procedures, in consultation with the principal organizations representing State governors, legislators, local elected officials, and State and local finance officers, to provide for the



equitable allocation, assessment, and collection of the accounting support fee established under subparagraph (A) from the members of the association, and the remittance of all such accounting support fees to the Financial Accounting Foundation.

(2)Annual budget - For purposes of this subsection, the annual budget of the GASB is the annual budget reviewed and approved according to the internal procedures of the Financial Accounting Foundation.

(3)Use of funds - Any fees or funds collected under this subsection shall be used to support the efforts of the GASB to establish standards of financial accounting and reporting recognized as generally accepted accounting principles applicable to State and local governments of the United States.

(4)Limitation on fee - The annual accounting support fees collected under this subsection for a fiscal year shall not exceed the recoverable annual budgeted expenses of the GASB (which may include operating expenses, capital, and accrued items).

(5)Rules of construction –

(A)Fees not public monies - Accounting support fees collected under this subsection and other receipts of the GASB shall not be considered public monies of the United States.

(B)Limitation on authority of the Commission -Nothing in this subsection shall be construed to—

(i)provide the Commission or any national securities association direct or indirect oversight of the budget or technical agenda of the GASB; or

(ii)affect the setting of generally accepted accounting principles by the GASB.

(C)Noninterference with States - Nothing in this subsection shall be construed to impair or limit the authority of a State or local government to establish accounting and financial reporting standards.

.(b)Study of funding for Governmental Accounting Standards Board

(1)Study - The Comptroller General of the United States shall conduct a study that evaluates—

(A)the role and importance of the Governmental Accounting Standards Board in the municipal securities markets; and

(B)the manner and the level at which the Governmental Accounting Standards Board has been funded.

(2)Consultation - In conducting the study required under paragraph (1), the Comptroller General shall consult with the principal organizations representing State governors, legislators, local elected officials, and State and local finance officers.

(3)Report - Not later than 180 days after the date of enactment of this Act, the Comptroller General shall submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives a report on the study required under paragraph (1).

### C. Process Required When Congress Wants to Make Policy That Binds the Nation

As previously cited, in *Bowsher v. Synar* Justice Stevens, with whom Justice Marshall joined, delivered a concurring opinion. Relevant portions of Justice Stevens' opinion are reprinted again below.

*"Article I of the Constitution specifies the procedures that Congress must follow when it makes policy that binds the Nation: its legislation must be approved by both of its Houses and presented to the President. In holding that an attempt to legislate by means of a "one-House veto" violated the procedural mandate in Article I, we explained:*

*"We see therefore that the Framers were acutely conscious that the bicameral requirement and the Presentment Clauses would serve essential constitutional functions. The President's participation in the legislative process was to protect the Executive Branch from Congress and to protect the whole people from improvident laws. The division of the Congress into two distinctive bodies assures that the legislative power would be exercised only after opportunity for full study and debate in separate settings. The President's unilateral veto power, in turn, was limited by the power of two-thirds of both Houses of Congress to overrule a veto thereby precluding final arbitrary action of one person...It emerges clearly that the prescription for legislative action in Art I, sec 1, 7, represents the Framers' decision that the legislative power of the Federal Government be exercised in accord with a single, finely wrought and exhaustively considered procedure." INS V. CHADHA, 462 U.S., AT 951, 103 S.Ct., at 2784."*

The accounting standards setting process for state and local governments do not follow this requirement.

### D. Structural Protections are Critical for Our Democracy

Justices Scalia, Kennedy, Thomas and Alito spoke of the importance of structural protection as the Dissenters in the Obamacare litigation.

*"Structural protections—notably, the restraints imposed by federalism and separation of powers—are less romantic and have less obvious a connection to personal freedom than the provisions of the Bill of Rights or the Civil War Amendments. Hence they tend to be undervalued or even forgotten by our citizens. It should be the responsibility of the Court to teach otherwise, to remind our people that the Framers considered structural protections of freedom the most important ones, for which reason they alone were embodied in the original Constitution and not left to later amendment. The fragmentation of power produced by the structure of our Government is central to liberty, and when we destroy it, we place liberty at peril."*

The arrangements for determining GAAP make of mockery of the concept of federalism.

### **E. Dodd-Frank Section 978 Exceeds the Power of the Purse**

As discussed previously, Congress' power of the purse is very broad yet does have limitations. In *South Dakota v. Dole* (1987) the Supreme Court addressed Congress's use of the spending power to impose conditions on the use of federal grants. "[T]he power of Congress to authorize expenditure of public moneys for public purposes is not limited by the direct grants of legislative power found in the Constitution. Thus, objectives not thought to be within Article I's enumerated legislative fields....may nevertheless be attained through the use of the spending power and the conditional grant of federal funds." However, "[t]he spending power is of course not unlimited." The Court outlined four general restrictions including that the intent of Congress to impose conditions must be authoritative and unambiguous and that the action in question must not be prohibited by an independent constitutional bar.

Dodd-Frank Section 978 clearly exceeds Congress' authority to delegate law-making authority to a private party. In addition, it can be argued that this law violates the concept of federalism embodied in the Constitution.

### **F. Department of Transportation ET AL. v. Association of American Railroads**

Justice Kennedy delivered the opinion of the Court on March 9, 2015, in which Justices Roberts, Scalia, Ginsburg, Breyer, Alito, Sotomayor, Kagan joined. Justice Alito filed a concurring opinion, much of which appears below. Justice Thomas filed an opinion concurring in the judgment.

Congress created the National Railroad Passenger Corporation (Amtrak) in 1970 and gave it priority to use track systems owned by the freight railroads for passenger rail travel. In 2008 Congress gave Amtrak and the Federal Railroad Administration (FRA) joint authority to issue "metrics and standards" addressing the performance and scheduling of passenger railroad services, see §207(a), 122 Stat. 4907, including Amtrak's on-time performance and train delays caused by host railroads.

Thereafter, the Association of American Railroads (respondent) sued the Department of Transportation, the FRA, and two officials. Petitioner claimed that the metrics and standards must be invalidated because it is unconstitutional for Congress to allow and direct a private entity like Amtrak to exercise joint authority in their issuance. The petitioners' argument was based on the Fifth Amendment Due Process Clause and the constitutional provisions regarding separation of powers.

The District Court rejected respondent's claims, but the District of Columbia Circuit reversed as to the separation of powers claim, reasoning in central part that Amtrak is a private corporation and thus cannot constitutionally be granted regulatory power under §207. The Court of Appeals based their decision on the statutory command that Amtrak "is not a department, agency, or instrumentality of the United States Government," 49 U. S. C. §24301(a)(3), and the pronouncement that Amtrak "shall be operated and managed as a for profit corporation," §24301(a)(2).

The United States Supreme Court determined that the Court of Appeals' premise that Amtrak is a private entity was flawed. It found that congressional pronouncements are not dispositive of Amtrak's status as a governmental entity for purposes of separation of powers analysis under the Constitution. The Court determined that Amtrak's ownership, corporate structure, the control exerted over Amtrak's Board of Directors and its priorities and operations, its broad public objectives

and financial support all suggest that Amtrak was created by the government, is controlled by the government and operates for its benefit.

**a. Lebron v. National Railroad Passenger Corp.**

Justice Kennedy cited *Lebron v. National Railroad Passenger Corp.*, 513 U. S. 374, as teaching that, for purposes of Amtrak's status as a federal actor or instrumentality under the Constitution, the practical reality of federal control and supervision prevails over Congress' disclaimer of Amtrak's governmental status.

An excerpt from the Court's decision in the above described case follows:

*"On that point this Court's decision in Lebron v. National Railroad Passenger Corp., 513 U.S. 374 (1995), provides necessary instruction. In Lebron, Amtrak prohibited an artist from installing a politically controversial display in New York City's Penn Station. The artist sued Amtrak, alleging a violation of his First Amendment rights. In response Amtrak asserted that it was not a governmental entity, explaining that "its charter's disclaimer of agency status prevent[ed] it from being considered a Government entity." Id., at 392. The Court rejected this contention, holding "it is not for Congress to make the final determination of Amtrak's status as a Government entity for purposes of determining the constitutional rights of citizens affected by its actions." Ibid. To hold otherwise would allow the Government "to evade the most solemn obligations imposed in the Constitution by simply resorting to the corporate form." Id., at 397. Noting that Amtrak "is established and organized under federal law for the very purpose of pursuing federal governmental objectives, under the direction and control of federal governmental appointees," id., at 398, and that the Government exerts its control over Amtrak "not as a creditor but as a policymaker," the Court held Amtrak "is an agency or instrumentality of the United States for the purpose of individual rights guaranteed against the Government by the Constitution." Id., at 394, 399. Lebron teaches that, for purposes of Amtrak's status as a federal actor or instrumentality under the Constitution, the practical reality of federal control and supervision prevails over Congress' disclaimer of Amtrak's governmental status. Lebron involved a First Amendment question, while in this case the challenge is to Amtrak's joint authority to issue the metrics and standards. But "[t]he structural principles secured by the separation of powers protect the individual as well." Bond v. United States, 564 U. S. \_\_\_, \_\_\_ (2011) (slip op., at 10)."*

**b. Justice Alito's Concurring Opinion**

Justice Alito's concurring opinion sheds light on the issues described in this chapter. Hence, the author has quoted liberally from his opinion.

*"Liberty requires accountability. When citizens cannot readily identify the source of legislation or regulation that affects their lives, Government officials can wield power without owning up to the consequences. One way the Government can regulate without accountability is by passing off a Government operation as an independent private concern. Given this incentive to regulate without saying so, everyone should pay close attention when Congress "sponsor[s] corporations that it specifically designate[s] not to be agencies or establishments of the United States Government." Lebron v. National Railroad Passenger Corporation, 513 U. S. 374, 390 (1995). Recognition that Amtrak is part of the Federal Government raises a host of*

*constitutional questions. I begin with something that may seem mundane on its face but that has a significant relationship to the principle of accountability. Under the Constitution, all officers of the United States must take an oath or affirmation to support the Constitution and must receive a commission. See Art. VI, cl. 3 (“[A]ll executive and judicial Officers . . . shall be bound by Oath or Affirmation, to support this Constitution”); Art. II, §3, cl. 6 (The President “shall Commission all the Officers of the United States”). There is good reason to think that those who have not sworn an oath cannot exercise significant authority of the United States. See 14 Op. Atty. Gen. 406, 408 (1874) (“[A] Representative . . . does not become a member of the House until he takes the oath of office”); 15 Op. Atty. Gen. 280, 281 (1877) (similar).\**

*Both the Oath and Commission Clauses confirm an important point: Those who exercise the power of Government are set apart from ordinary citizens. Because they exercise greater power, they are subject to special restraints. There should never be a question whether someone is an officer of the United States because, to be an officer, the person should have sworn an oath and possess a commission. Here, respondent tells the Court that “Amtrak’s board members do not take an oath of office to uphold the Constitution, as do Article II officers vested with rulemaking authority.” Brief for Respondent 47. The Government says not a word in response. Perhaps there is an answer. The rule, however, is clear. Because Amtrak is the Government, ante, at 11, those who run it need to satisfy basic constitutional requirements.*

*The language from §207 quoted thus far should raise red flags. In one statute, Congress says Amtrak is not an “agency.” 49 U. S. C. §24301(a)(3). But then Congress commands Amtrak to act like an agency, with effects on private rail carriers. No wonder the D. C. Circuit ruled as it did. The oddity continues, however. Section 207(d) of the PRIIA also provides that if the FRA and Amtrak cannot agree about what the regulatory standards should say, then “any party involved in the development of those standards may petition the Surface Transportation Board to appoint an arbitrator to assist the parties in resolving their disputes through binding arbitration.” 122 Stat. 4917. The statute says nothing more about this “binding arbitration,” including who the arbitrator should be. Looking to Congress’ use of the word “arbitrator,” respondent argues that because the arbitrator can be a private person, this provision by itself violates the private nondelegation doctrine. The United States, for its part, urges the Court to read the term “arbitrator” to mean “public arbitrator” in the interests of constitutional avoidance.*

*Rather, the formal reason why the Court does not enforce the nondelegation doctrine with more vigilance is that the other branches of Government have vested powers of their own that can be used in ways that resemble lawmaking. See, e.g., *Arlington v. FCC*, 569 U. S. \_\_\_, \_\_\_–\_\_\_, n. 4 (2013) (slip op., at 13–14, n. 4) (explaining that agency rulemakings “are exercises of— indeed, under our constitutional structure they must be exercises of—the ‘executive Power’” (quoting Art. II, §1, cl. 1)). Even so, “the citizen confronting thousands of pages of regulations—promulgated by an agency directed by Congress to regulate, say, ‘in the public interest’—can perhaps be excused for thinking that it is the agency really doing the legislating.” 569 U. S., at \_\_\_–\_\_\_ (ROBERTS, C. J., dissenting) (slip op., at 4–5). When it comes to private entities, however, there is not even a fig leaf of constitutional justification. Private entities are not vested with “legislative Powers.” Art. I, §1. Nor are they vested with the “executive Power,” Art. II, §1, cl. 1, which belongs to the President. Indeed, it raises*

*“[d]ifficult and fundamental questions” about “the delegation of Executive power” when Congress authorizes citizen suits. Friends of the Earth, Inc. v. Laidlaw Environmental Services (TOC), Inc., 528 U. S. 167, 197 (2000) (KENNEDY, J., concurring). A citizen suit to enforce existing law, however, is nothing compared to delegated power to create new law. By any measure, handing off regulatory power to a private entity is “legislative delegation in its most obnoxious form.” Carter v. Carter Coal Co., 298 U. S. 238, 311 (1936).*

*As to the merits of this arbitration provision, I agree with the parties: If the arbitrator can be a private person, this law is unconstitutional. Even the United States accepts that Congress “cannot delegate regulatory authority to a private entity.” 721 F. 3d, at 670. Indeed, Congress, vested with enumerated “legislative Powers,” Art. I, §1, cannot delegate its “exclusively legislative” authority at all. Wayman v. Southard, 10 Wheat. 1, 42–43 (1825) (Marshall, C. J.). The Court has invalidated statutes for that very reason. See A. L. A. Schechter Poultry Corp. v. United States, 295 U. S. 495 (1935); Panama Refining Co. v. Ryan, 293 U. S. 388 (1935); see also Mistretta v. United States, 488 U. S. 361, 373, n. 7 (1989) (citing, inter alia, Industrial Union Dept., AFL–CIO v. American Petroleum Institute, 448 U. S. 607, 646 (1980)). The principle that Congress cannot delegate away its vested powers exists to protect liberty. Our Constitution, by careful design, prescribes a process for making law, and within that process there are many accountability checkpoints. See INS v. Chadha, 462 U. S. 919, 959 (1983). It would dash the whole scheme if Congress could give its power away to an entity that is not constrained by those checkpoints. The Constitution’s deliberative process was viewed by the Framers as a valuable feature, see, e.g., Manning, Lawmaking Made Easy, 10 Green Bag 2d 202 (2007) (“[B]icameralism and presentment make lawmaking difficult by design” (citing, inter alia, The Federalist No. 62, p. 378 (J. Madison), and No. 63, at 443–444 (A. Hamilton))), not something to be lamented and evaded.*

*As I read the Government’s briefing, it does not dispute any of this (other than my characterization of the PRIIA as regulatory, which it surely is). Rather than trying to defend a private arbitrator, the Government argues that the Court, for reasons of constitutional avoidance, should read the word “arbitrator” to mean “public arbitrator.” The Government’s argument, however, lurches into a new problem: Constitutional avoidance works only if the statute is susceptible to an alternative reading and that such an alternative reading would itself be constitutional. Here, the Government’s argument that the word “arbitrator” does not mean “private arbitrator” is in some tension with the ordinary meaning of the word. Although Government arbitrators are not unheard of, we usually think of arbitration as a form of “private dispute resolution.” See, e.g., Stolt-Nielsen S. A. v. AnimalFeeds Int’l Corp., 559 U. S. 662, 685 (2010). Likewise, the appointment of a public arbitrator here would raise serious questions under the Appointments Clause. Unless an “inferior Office[r]” is at issue, Article II of the Constitution demands that the President appoint all “Officers of the United States” with the Senate’s advice and consent. Art. II, §2, cl. 2. This provision ensures that those who exercise the power of the United States are accountable to the President, who himself is accountable to the people. See Free Enterprise Fund, 561 U. S., at 497–498 (citing The Federalist No. 72, p. 487 (J. Cooke ed. 1961) (A. Hamilton)). The Court has held that someone “who exercis[es] significant authority pursuant to the lawsof the United States” is an “Officer,” Buckley v. Valeo, 424 U. S. 1, 126 (1976) (per curiam), and further that an officer who acts without supervision must be a principal officer, see Edmond v. United States, 520 U. S. 651, 663 (1997) (“[W]e think it evident that ‘inferior officers’ are officers whose work is directed and*

*supervised at some level by others who were appointed by Presidential nomination with the advice and consent of the Senate”). While some officers may be principal even if they have a supervisor, it is common ground that an officer without a supervisor must be principal. See id., at 667 (Souter, J., concurring in part and concurring in judgment). Here, even under the Government’s public-arbitrator theory, it looks like the arbitrator would be making law without supervision—again, it is “binding arbitration.” Nothing suggests that those words mean anything other than what they say. This means that an arbitrator could set the metrics and standards that “shall” become part of a private railroad’s contracts with Amtrak whenever “practicable.” As to that “binding” decision, who is the supervisor? Inferior officers can do many things, but nothing final should appear in the Federal Register unless a Presidential appointee has at least signed off on it. See 75 Fed. Reg. 26839 (2010) (placing the metrics and standards in the Federal Register); Edmond, supra, at 665.*

*As explained above, accountability demands that principal officers be appointed by the President. See Art. II, §2, cl. 2. The President, after all, must have “the general administrative control of those executing the laws,” Myers v. United States, 272 U. S. 52, 164 (1926), and this principle applies with special force to those who can “exercis[e] significant authority” without direct supervision, Buckley, supra, at 126; see also Edmond, supra, at 663. Unsurprisingly then, the United States defends the non-Presidential appointment of Amtrak’s president on the ground that the Amtrak president is merely an inferior officer. Given Article II, for the Government to argue anything else would be surrender. This argument, however, is problematic. Granted, a multimember body may head an agency. See Free Enterprise Fund, supra, at 512–513. But those who head agencies must be principal officers.*

## **G. Differentiating Delegation of Licensing Powers to a Private Group**

In certain cases courts have been willing to approve the delegation of licensing powers to a private group where public agency or court review is provided. The most well-known example of this involves the National Association of Securities Dealers which was created pursuant to the Maloney Act of 1938<sup>290</sup> as a body, equipped with disciplinary powers over its members, whose determinations are subject to review de novo by the Securities and Exchange Commission, which in turn is subject to a lesser degree of review by the courts. The Act so structures the apparatus of securities regulation as to in effect require that all brokers and dealers belong to the NASD. Nonmembers of the group are deprived by statute of the opportunity to participate in important distributions, so that membership is in effect compulsory for persons not members of a stock exchange. The delegation was summarily upheld.<sup>291</sup>





*Character is like a tree and reputation like a shadow. The shadow is what we think of it, the tree is the real thing.*

*Abraham Lincoln*

## 11 The State Governments' Cover-up

The state governments have attempted to cover-up their fraudulent and unconstitutional accounting by having GASB promulgate accounting principles and standards that justify the accounting treatment that the states utilize.

State accounting for Medicaid is governed by Statement No. 33 – Accounting and Financial Reporting for Nonexchange Transactions which GASB promulgated in December 1998 and which took effect for periods beginning after June 15, 2000. The fiction that the GASB has concocted to effectively eliminate states' enormous legal obligations for the Medicaid program for financial reporting purposes is to define a category of transactions for states in such a manner that the state's obligation for those transactions will only be recognized at the last possible moment when funds are literally being disbursed by the states. The transaction classification that GASB came up with is called "Nonexchange Transactions."

In a *nonexchange* transaction, a government gives (or receives) value without directly receiving (or giving) equal value in return. Please note that there is no law at the state level that differentiates between exchange and nonexchange transactions for purposes of state appropriations of funds for various programs. The classification that GASB has invented is purely an accounting fiction that has no basis in appropriations law.

With respect to government-mandated nonexchange transactions the proper accounting prescribed by GASB is as follows: Where providers of resources in government-mandated transactions, (like the federal government) establish eligibility requirements that are required to be met before a transaction occurs, the provider does not have a liability, the recipient (the states) does not have a receivable, and the recognition of expenses or revenues for resources transmitted in advance should be deferred. Essentially, there is no recognition of any costs or liability other than current year cash outlays.

In Statement 33 GASB has taken the following position in promulgating this accounting standard.

*"The Board believes that, [when the provider is a Government], a government appropriation is **not** the equivalent to an authorization to pay an existing liability, such as the approval of a vendor's invoice for payment related to an exchange transaction that has occurred. Rather, an appropriation is essential to make the enabling legislation effective for a particular period of time. In these circumstances, the Board believes that a government does not have a liability to transmit resources under a particular program, and a recipient does not have a receivable, unless an appropriation for that program exists and the period to which the appropriation applies has begun. Once those requirements (and all other applicable eligibility requirements) have been met, a provider government should recognize a liability and a qualified recipient should recognize a receivable."*

The fact that GASB's belief is contrary to established appropriations law is all that one needs to know to understand why its definition of a "liability" and how it deals with accounting for legal liabilities/obligations that it does not define as a "liability" for financial reporting purposes are fraudulent.

*Do the right thing. It will gratify some people  
and astonish the rest.*

*Mark Twain*

## **12 Where is the Securities and Exchange Commission?**

The SEC Chair boasts in two recent speeches about the substantial strides made in enforcement in the municipal securities market since she took office. Based on the facts the author must acknowledge that Chair White has apparently done more to enforce the securities laws in the municipal securities market than all of her predecessors combined. Yet the SEC's efforts have come up woefully short of having the SEC achieve its stated mission in the municipal securities market.

In football there is an old saying that "You are what your record says you are!" The author is introducing a new metric for the SEC to evaluate its performance relative to its stated mission. It is the SEC's won/loss record with respect to whether or not the fifty states have published financial statements that can pass antifraud provision review. Based on this metric and Chair Mary Jo White's approximate four-year term her won/loss record is 0 Wins and 200 losses (50 states x 4 years). The next Chair of the SEC has to improve on that record.

Albert Einstein said that "Insanity is doing the same thing over and over again and expecting different results." It is time for the SEC to take a hard look in the mirror and come to the conclusion that it has to take a different approach in the municipal securities market to have a chance to succeed at fulfilling its stated mission.

The way forward for the SEC is to abandon its strategy of hope. It needs to interpret the U.S. Constitution's Article I, section 9, clause 7. In addition, it must repudiate its relationship with the GASB, and institute enforcement actions against the fifty states for their fraudulent reporting with respect to the Medicaid program and one or more selected high profile targets that use non-consolidated off-balance sheet vehicles to hide massive spending and legal obligations. It should consider working with U.S. Attorneys and state AG's to prosecute people and entities involved with perpetrating the massive frauds on the American people in the municipal securities market. The SEC might be astonished at the grass roots support that taking these actions would engender. Not surprisingly, this strategy would be highly unpopular in Congress. Thus, the SEC has to decide whether it wants to accomplish its mission or keep Congress happy. If it decides to keep Congress happy then it had better stop claiming that it is independent.

### **A. Shining a Bright Light on the SEC**

Louis Brandeis, whose ideas were a major influence on disclosure philosophy of securities regulation, stated "publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."<sup>292</sup> This chapter shines a bright light on the Securities and Exchange Commission's failure to fulfill its mission to protect investors in municipal securities.

The SEC has always indicated that it seeks input from investors and others on ways to improve. This memorandum may test the limits of the SEC's ability to take constructive criticism as the author points out several serious mistakes have been made with respect to regulation of the

municipal securities market. For example, on the SEC's website there is a page describing "What We Do" that contains a list of "The Laws That Govern the Securities Industry." Unfortunately and prophetically, the SEC does not list the United States Constitution as one of those laws....so the SEC's problems start with the most basic of issues.

Some may ask the question: Why raise the issue now? The answer is simple. Several years ago the author discussed with a senior SEC attorney (name available to the SEC upon request) the issue of improper accounting by states for the Medicaid program. He said that the issue had been discussed at the highest levels and that it was clear that it would take a change in administration for the SEC to tackle the problem.

One of the author's primary purposes in writing this memorandum is to outline a practical approach for the SEC that will lead to almost all financial reporting in the municipal securities market complying with the antifraud provisions. The suggested approach is based on the knowledge gained over the last decade poring over government documents, law review articles, accounting pronouncements, history books and the like as well as preparing for the "Representation Without Accountability" conference described herein, writing articles and giving speeches. The author is optimistic that the SEC, an independent agency, will ultimately take the necessary action to clean up financial reporting in municipal securities.

## **B. SEC's Stated Mission Must Include Enforcing the U.S. Constitution**

According to the "What We Do" section of the SEC's website:

"The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.... The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it.

It is the responsibility of the Commission to: interpret and enforce federal securities laws..."

In the SEC's Report on the Municipal Securities Market the SEC asserts that:

"Protecting investors in the municipal securities market is a core function of the Commission..."

It is the author's contention that the SEC can and should interpret the antifraud provisions as being inherent in the Statement and Account Clause of the United States Constitution. A government "of the people, by the people and for the people" with an explicit provision in its constitution requiring the publication of a Statement and Account of the Receipts and Expenditures of all public Money does not need an antifraud amendment to that constitution requiring the federal government to publish truthful figures. To a certain extent Congress recognized the importance of the antifraud provisions by making the issuance of municipal securities subject to them.

The right to financial information described in the Statement and Account Clause is no different than other textually enumerated rights contained in the Bill of Rights. The SEC should interpret the Fourteenth Amendment as incorporating the right to financial information. If the SEC so interprets the Constitution all states, cities and local governments would have to comply with the Statement and Account Clause which requires proper reporting of total receipts, total expenditures and the resulting surplus or deficit in a single Statement and Account. These figures must include

“all public money.” The off-balance sheet vehicles that are extensively used by state, city and local governments to mislead their respective electorates would need to be consolidated into one set of financial statements at each level of government. Assuming that the Constitution is interpreted in this manner many of the GASB’s accounting pronouncements would be unconstitutional. Several already violate the antifraud provisions.

### **C. Why is the SEC’s Mission Failure So Important to the Nation?**

The failure of the SEC to take on Congress over fraudulent accounting in the municipal securities market has implications far beyond that market. Why? Because the financial statements issued by state, city and local governments serve the dual purpose of informing investors and citizens/voters about how politicians are spending taxpayers’ money.

SEC Commissioner Elisse B. Walter in delivering the 10<sup>th</sup> Annual A.A. Sommer, Jr. Corporate Securities and Financial Law Lecture at Fordham Law School in New York City on October 28, 2009 “*Regulation of the Municipal Securities Market: Investors are Not Second-Class Citizens*” made the following statements:

*“Indeed, the concerns of a citizen qua taxpayer and the same citizen qua investor have something very important in common. Just as an investor wants to understand the true financial health of an entity whose debt it purchases, a taxpayer has an interest in understanding the true fiscal health of the state or local municipality in which he or she lives. So the call for greater federal regulation of the municipal securities market could have benefits for both taxpayers and investors alike. Sunlight makes the best disinfectant in politics as well as in finance!....*

*In addition, municipal disclosure serves a dual purpose. It both reports on the financial state of a municipal securities issuer and it tells citizens about how the municipality spends their hard earned tax dollars. There is nothing quite like this in the corporate space.<sup>83</sup>*

The SEC’s publication “The State of the Municipal Securities Market” included the following:

*“As the Governmental Accounting Standards Board (“GASB”) has explained, there are differences between the purposes of financial reports of governmental entities and those of private-sector business enterprises.*

*In the case of governmental accounting, on the other hand, the principal focus frequently is on public accountability for resources entrusted to the stewardship of the government (i.e., taxes), including how public resources such as taxes are acquired and used; whether resources are sufficient to meet current and future costs; and whether the government’s ability to provide services improves or deteriorates on a period-to-period basis.”*

The unintended consequence of the SEC’s failure is that all federal and state financial reporting is rigged. The failures of federal and state governments to publish complete and truthful statement and accounts of the federal government’s and the fifty states’ finances has made our republic dysfunctional, plagued by successive budget-deficit and debt-ceiling crises and headed towards financial Armageddon.

The failure of the SEC to go after the illegal structure of accounting standard setting in the municipal securities market has led to Congress setting up the same corrupt structure for federal financial reporting. If the SEC did its job and actually accomplished its mission of protecting

investors in the municipal securities market this would expose Congress' corrupt practices at the federal level. Due to the failure of the SEC to aggressively pursue its stated mission, the GASB and FASAB are increasingly coordinating their accounting principles and standards to the detriment of investors and citizens/voters/taxpayers.

In addition and to reiterate a claim made elsewhere in this memorandum it can be argued that the SEC determined the outcome of two recent Supreme Court decisions relating to the Affordable Care Act due to its decision not to go after improper state accounting for Medicaid. SCOTUS' decisions in the Obamacare cases were effectively based on fraudulent state financial information that did not reveal the extent of expenditures or the net present value of future legal obligations related to the Medicaid program. The SEC's decision not to prosecute improper state accounting for Medicaid stands in stark contrast to its prosecution of the states of New Jersey, Illinois and Kansas for the publication of fraudulent financial information related to pension obligations.

Furthermore, the SEC's conscious decision not to enforce the antifraud provisions as they relate to financial reporting by state governments regarding their participation in the Medicaid program produces a perpetual fraud on the federal and state judiciaries. Existing state financial reporting for their Medicaid expenditures and obligations violates the antifraud provisions as a matter of law. Not surprisingly, the SEC's decision to pursue the pension obligation investigations came at the behest of a Congress that did not want the pension underfunding issue to end up on its doorstep.

If the fifty states as well as many city and local governments are committing fraud in publishing their financial statements how can the electorate of these jurisdictions be the informed voters that our Constitution requires?

#### **D. Criticism is Focused on SEC's Handling of the Municipal Securities Market**

When a corporation is being reviewed for possible fraudulent accounting in one of its operations the SEC does not want to hear about the good things that the corporation is doing in its other divisions/subsidiaries. Likewise, none of the discussion in this chapter relates to the SEC's regulation of public companies and the SEC should get no benefit of the doubt because it is doing a good job in its regulatory efforts in that market. Nevertheless, sometimes it appears that Commissioners like Chair White blur the line between the SEC's efforts in the two markets.

Chair Mary Jo White delivered the 14<sup>th</sup> Annual A.A. Sommer, Jr. Corporate Securities and Financial Law Lecture at Fordham Law School in New York City on October 3, 2013. The title of her lecture was "The Importance of Independence." Selected excerpts follow:

"In 1996, when he was given the William O. Douglas award, the SEC's highest honor, former Commissioner Sommer captured the essence of the SEC this way:

"The staff of the Commission has never lacked for courage. They have gone to the mat with investment bankers, exchanges, the public utility industry, the accounting profession, the legal profession, and, for that matter, on occasions with the entire world of American industry. In every case there were loud howls, efforts to bring political pressure to bear; unfailingly the Commission stuck to its guns and fought to implement the policies it thought were right. It may rightly be said that the SEC has done more to raise the moral level of the marketplace than any other institution, public or private, in the United States."<sup>[2]</sup>

That is the wonderful legacy of the SEC and its staff.

I have always had a very strong affinity for the SEC – because of its incredibly important mission and its talented and dedicated staff. But, it is also the independence of the SEC that was one of the main reasons I agreed to accept the opportunity offered to me by the President to serve as its Chairman.

When I served as the United States Attorney for the Southern District of New York from 1993 to 2002, I headed an office that was referred to as the “Sovereign District” – and that was not meant as a term of endearment. But the Southern District U.S. Attorney’s Office is an office older than the Department of Justice, and sovereignty, as well as its nickname, have served it very well. As I used to say as U.S. Attorney, your conscience is your client and your only mandate is to do the right thing in the public’s best interest.

The SEC does not need a nickname to establish its independence. Under the law, the SEC is an independent agency, consisting of five Commissioners, no more than three of whom can be from the same political party.<sup>[3]</sup> As with other independent agencies, the President cannot remove a Commissioner without cause and the agency does not report or answer to the White House or any part of the administration. This independence and the quality of its people allow the agency the freedom to do what it believes is right for investors and our markets, without the interference of politics or outside pressures.

### *Maintaining Our Independence*

Being independent, of course, does not mean that the SEC does not listen to the ideas and recommendations that come from beyond our building. It also does not mean that we should not welcome the views of investor advocates, companies, Members of Congress, or financial institutions.

Indeed, we depend upon hearing and evaluating the ideas and recommendations of those who will be impacted by our rules, including those required to comply with them. In fact, the laws that govern our “notice and comment” rulemaking process direct us to seek out these views and, more importantly, consider them.<sup>[4]</sup> And, if we do not do so, the courts could potentially strike down the rule and send us back to the drawing board.

More importantly, seeking out and considering public comment by all interested and affected parties makes for much better decisions and much better rules.

At the end of the day, however, we make our decisions based on an impartial assessment of the law and the facts and what we believe will further our mission – and never in response to political pressure, lobbying, or even public clamor. All comments and recommendations, from whatever the source, are judged on their merits – and their validity has no greater weight just because more influential or better connected commenters say so, or say so more loudly.

The professionals at the SEC, like those in a prosecutor’s office, know that they are better able to perform that impartial assessment when they honor the mission of the agency, respect its independence, and check their party affiliations at the door.

A few years ago, at the request of Senator Charles Schumer, I testified before the Senate Judiciary Committee investigating the firing of a number of sitting U.S. Attorneys.<sup>[5]</sup> The circumstances of those firings suggested they were not based on the merits, but rather on purported failures to be sufficiently responsive to Justice Department policies or to politicians seeking to influence decisions.<sup>[6]</sup> United States Attorneys, like SEC Commissioners, are appointed by the President and confirmed by the Senate.

My testimony, which like tonight was about the importance of independence,<sup>[7]</sup> echoed the views of those fired United States Attorneys whose joint written testimony made the point very well. They said:

“Every United States Attorney knows that he or she is a political appointee, but also recognizes the importance of supporting and defending the Constitution in a fair and impartial manner that is devoid of politics. . . . The prosecution of individual cases must be based on justice, fairness, and compassion -- not political ideology or partisan politics.”<sup>[8]</sup>

In my view, SEC Commissioners are no different....

Now, even I realize that there are limits on Washington’s ability to be politically independent. Commissioner Sommer understood this too. Although endorsed by Republican Chairman Garrett to succeed him as the next Chairman, Commissioner Sommer, as a Democrat, ultimately was “passed over” by a Republican President.<sup>[12]</sup>

I imagine Commissioner Sommer may well have shrugged and thought, as I would have, that perhaps that degree of independence was a step too far for Washington to bear, even for the head of an independent agency. Though, I do note that both I and former Chairman Mary Schapiro are independents. So maybe there is hope.

#### *A Track Record of Independence*

Proudly, I can say that this talk about the importance of independence is not rhetoric. There are many examples in the history of the SEC, where the agency stood its ground and stood tall as the independent body that it is.

Years later, Chairman Harvey Pitt would declare in another case that: “No one in this country gets a pass...No one gets special treatment.”<sup>[20]</sup>

Disclosure is indeed a key ingredient in the securities arena. It gives investors the information they need about their investments. It provides them with information about the operations, management and financial condition of the companies they invest in. And, it allows informed investors to participate in a free and fair market.

My former colleague Commissioner Troy Paredes, who delivered the Sommer lecture in 2011, put it this way: “[T]he foundational cornerstone of the [SEC’s] regulatory regime has remained fixed. It is disclosure. For over 75 years, the SEC’s signature mandate has been to use disclosure to promote transparency.”<sup>[23]</sup>

To be sure, we can and should proactively urge that, as an independent and expert agency, we be accorded the freedom and respect by Congress to fully exercise our disclosure authority to further the mission that is so vital to the capital markets and investors.

#### *Conclusion*

At the SEC, the staff and Commission have a long and proud history of standing up to outside pressures of all kinds that have challenged our independence. The Chairs who have come before me have held firmly to this independence, and so have the thousands of members of the SEC staff who worked with them. To my mind, the SEC achieves the best results and best fulfills its mission, when it uses its expertise, acts independently, and defends that independence against all comers. It is a simple principle. And, as long as I am Chair, I will be guided by it.”

<sup>[2]</sup> Remarks at the Annual Meeting of the Association of SEC Alumni, A.A. Sommer, March 8, 1996.



[3] SEC v. Blinder, Robinson & Co., Inc. and Meyer Blinder, 855 F.2d 677 (10th Cir.1988).

[4] See Administrative Procedure Act, 5 U.S.C. 553 (2006).

[5] Preserving Prosecutorial Independence: Is the Department of Justice Politicizing the Hiring and Firing of U.S. Attorneys? Hearing Before the S. Comm. on the Judiciary, 110th Cong. (2007).

[6] See Statement of Mary Jo White, Preserving Prosecutorial Independence, Hearing Before the S. Comm. on the Judiciary, 110th Cong. (2007)

[7] See id.

[8] "Joint Statement of Former United States Attorneys Before House Committee on the Judiciary, Subcommittee on Commercial and Administrative Law," March 6, 2007 <http://judiciary.house.gov/hearings/March2007/jointstatement070306.pdf>.

[12] See <http://www.sechistorical.org/museum/galleries/rev/rev02a.php>.

[20] "SEC Chief Vows Tough Halliburton Probe," Chicago Tribune, July 15, 2002, [http://articles.chicagotribune.com/2002-07-15/news/0207150167\\_1\\_sec-scrutiny-overruns-on-construction-jobs-halliburton](http://articles.chicagotribune.com/2002-07-15/news/0207150167_1_sec-scrutiny-overruns-on-construction-jobs-halliburton).

[23] "Twelfth Annual A.A. Sommer, Jr. Lecture on Corporate, Securities and Financial Law," Commissioner Troy Paredes, New York, N.Y., October 27, 2011.

## **E. SEC Views Its Ability to Police the Municipal Securities Market as Limited**

In this section excerpts from two speeches will appear below.

The first is a speech by Chair Mary L. Shapiro as delivered by Andrew J. Donahue, Director, Division of Investment Management at the Investment Company Institute 2010 General Membership Meeting held in Washington, D.C. on May 7, 2010.

"And so, I find it surprising that such an important and omnipresent sector of the capital markets is subject to such limited regulatory oversight.

The fact is that access to public markets should come with certain obligations and responsibilities. Investors who fund municipal growth and the taxpayers who pay the dividends, deserve disclosure and transparency that produces relevant, timely and accurate information.

Perhaps it made sense when the securities laws were written to create a regime of reduced disclosure. It was, after all a small market, composed mostly of institutional investors buying traditional governmental bonds. In 1945, for example, there was less than \$20 billion of state and local debt outstanding.

But today, investors hold approximately \$2.8 trillion of municipal debt.....

In addition, unlike the municipal market of the 1930s, more than a quarter of the municipal bond offerings today are, in reality, unregistered corporate bonds that finance private activities and yet still bear a tax-exempt interest rate. In short, this market has almost nothing in common with the municipal bond market of the 1930s.

Save for cases of securities fraud, the SEC's authority over municipal issuers is expressly constrained under existing laws.

We have regulatory authority over brokers and dealers who underwrite issuances or engage in municipal securities transactions. And we can require dealers to determine whether a particular bond is suitable for a customer — but we can't require an issuer to make information available to assist that dealer.

Similarly, we cannot require a corporate borrower accessing the public market through a municipal bond offering to make the complete disclosure that a corporate offering would require. These gaps limit the information — or at least the uniformity, timeliness and comparability of information — available to investors in the muni world.....

Investors in municipal securities need to engage in a thorough evaluation of those securities' risk, credit, and relative value — from the securities' issuance until their maturity.

More transparent, reliable and timely information about municipal securities will allow both regulators and markets to discourage excessive risk and to reward rational behavior. Unfortunately, investors in municipal securities today do not always have access to the type of information they need to evaluate their municipal investments.....

Nevertheless, there are limits on our statutory authority to provide muni investors with the type of disclosure regime that assures timely, relevant and comparable information.

For example, SEC rules require public companies to file audited annual financial statements within 60-90 days after the end of their fiscal year. But, state and local governments generally do not make their annual financial statements available for six or more months after their fiscal year ends, because there is no requirement to move more rapidly. And these financial statements are not always prepared according to generally accepted accounting standards.

As we think about designing a regulatory regime specifically for the needs of the municipal securities market, we should consider the following elements — some of which have been suggested in the past, and, of course new ideas are emerging. I think all ideas to improve municipal securities disclosure should be on the table.

These could include:

- Requiring standardized offering documents and periodic reports, so that investors can comparison shop when purchasing municipal securities — and can stay informed of developments that could affect that security;
- Requiring disclosure of financial information on a periodic basis. Such information could be tailored to the relevant security offered, and include tax revenues, expenditures, tax base changes or current pension obligations;
- Mandating use of uniform accounting standards, such as those by the Government Accounting Standards Board; placing the GASB under SEC oversight; and providing an independent funding source, such as a small fee assessed on new offerings. These reforms are similar to the reforms made to FASB for corporate issuers in 2002;
- Ensuring that private companies, such as hospitals and developers, who access the municipal market indirectly by using municipal issuers as conduits, meet appropriate disclosure standards;

The sum of these actions would be to make the finances, strategies, risks and obligations behind municipal securities offerings far more visible to investors, broker-dealers, taxpayers and the SEC alike.

But transparency is more than putting numbers on a page. It's also limiting bad practices and incentives — like "pay to play", conflicts of interest, and guidance from unqualified advisors — that can lead to poor issuer decisions and obscure an investor's view of the real risks of a municipal security.

SEC Commissioner Elisse B. Walter delivered the 10<sup>th</sup> Annual A.A. Sommer, Jr. Corporate Securities and Financial Law Lecture at Fordham Law School in New York City on October 28, 2009 “Regulation of the Municipal Securities Market: Investors are Not Second-Class Citizens.”

“What is far less understandable, however, is the relative lack of attention being given to the municipal securities market. SEC Chairmen ranging from David Ruder and Arthur Levitt to Christopher Cox and Mary Schapiro have advocated taking a hard look at this area.<sup>9</sup> But, beyond recommendations in the Treasury White Paper that the Commission’s authority to promote transparency be expanded and limitations be placed on the marketing of derivatives to small municipalities, this topic has not received serious consideration in recent regulatory reform

discussions.<sup>10</sup> And yet, this market is enormous and operates with increasing participation by retail investors. Municipal securities are securitized and both large and small municipalities use complex structured products and financial derivatives whose risks even sophisticated investors sometimes have trouble understanding. As Arthur Levitt put it this past summer, “our nation’s leaders . . . risk committing a major error if they don’t carefully consider the workings of the municipal-bond market. The opacity of this market is unrivaled and thus presents a significant threat to our economy.”<sup>11</sup> I am deeply concerned that the perfect municipal storm may be brewing.<sup>12</sup>

### *III. Current Disclosure Requirements*

Despite its size and obvious importance, however, the municipal securities market, unfortunately, lacks many of the protections customary in many other sectors of the U.S. capital markets.<sup>26</sup> Investors in municipal securities are, in certain respects, afforded “second-class treatment” under current law.<sup>27</sup> Let me briefly outline the current disclosure requirements for municipal issuers, with apologies and permission for a short nap again going to those of you for whom this background is unnecessary.

Congress exempted offerings of municipal securities from the registration requirements and civil liability provisions of the Securities Act and the system of periodic reporting under the Exchange Act.<sup>28</sup> The Commission is thus prohibited from imposing mandatory disclosure obligations on municipal issuers or mandating that municipal issuers use “generally accepted” governmental accounting standards. Nonetheless, the Commission is authorized to take enforcement actions against any person or entity, including issuers of municipal securities, who violate the antifraud provisions of the federal securities laws.<sup>29</sup> These antifraud provisions prohibit any person, including municipal issuers and brokers, dealers, and municipal securities dealers, from making a false or misleading statement of material fact, or omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase, or sale of any security, in light of the circumstances.<sup>30</sup>

As part of the Securities Acts Amendments of 1975, Congress established a limited regulatory scheme for municipal securities intermediaries. This included mandatory registration of municipal securities brokers and dealers, and the creation of the Municipal Securities Rulemaking Board (“MSRB”).<sup>31</sup> Federal regulatory authority over issuers of municipal securities, however, was specifically limited by Section 15B(d)(1) of the Exchange Act (commonly known as the Tower Amendment, after the late Republican Senator John Tower of Texas) which prohibits the Commission and the MSRB from requiring any issuer of municipal securities, either directly or indirectly, to make any filings with the Commission or the MSRB prior to the sale of securities.<sup>32</sup> The MSRB is further limited in its ability to require any municipal issuer to furnish it or any purchaser or prospective purchaser with any documents.<sup>33</sup>

In 1989, in response to consistently slow dissemination of information in connection with primary offerings of municipal securities, the Commission adopted Rule 15c2-12, under the Exchange Act, which requires underwriters participating in primary offerings of municipal securities of \$1,000,000 or more to obtain, review, and distribute to investors copies of the issuer’s disclosure documents.<sup>34</sup> In the same release, the Commission issued interpretive guidance concerning the due diligence obligations of underwriters of municipal securities.<sup>35</sup>

Four years later, in 1993, the then Division of Market Regulation conducted a comprehensive review of many aspects of the municipal securities market, including secondary market disclosure.<sup>36</sup> The resulting staff report found growing participation by unsophisticated individual investors and a proliferation of complex structured products in the municipal securities market.<sup>37</sup> The 1993 staff report also highlighted the need for improved disclosure practices in both the primary and secondary municipal securities markets.<sup>38</sup>

To enhance the quality, timing, and dissemination of disclosure in the secondary municipal securities market, under Chairman Levitt's leadership, the Commission adopted amendments to Rule 15c2-12 in 1994.<sup>39</sup> Among other things, these amendments prohibit an underwriter from participating in a municipal offering, unless it has reasonably determined that an issuer of municipal securities or an obligated person has undertaken in a written agreement or contract for the benefit of holders of such securities to provide specified annual information and event notices to certain information repositories. In the same year, the Commission also issued significant interpretive guidance concerning the disclosure obligations of municipal bond market participants under the antifraud provisions of the federal securities laws.<sup>40</sup>

Since that time, the Commission has adopted further amendments to Rule 15c2-12 to provide for a single centralized repository, the MSRB, for the electronic collection and availability of information about outstanding municipal securities in the secondary market.<sup>41</sup> The system is known as EMMA, which stands for Electronic Municipal Market Access.<sup>42</sup> As is widely recognized, the municipal securities market has needed a single centralized repository for a long time.<sup>43</sup> EMMA should help provide ready and prompt access to continuing disclosure documents to investors and help fulfill the regulatory and information needs of municipal market participants. The MSRB deserves high praise for working so hard to get EMMA up and running so successfully, as well as for its plans to enhance the system in the future.

#### *IV. Continuing Legitimacy of Exemption*

Now I would like to turn to a consideration of the continuing legitimacy of the exemption for municipal securities under the 33 and 34 Acts. Three reasons are typically given for affording special treatment to municipal securities under the federal securities laws: (i) the lack of perceived abuses in the municipal securities market, compared with the corporate market; (ii) the fact that the typical purchasers of municipal securities are institutional investors with financial expertise; and (iii) intergovernmental comity.<sup>47</sup> In my view, these rationales are no longer compelling.<sup>48</sup>

Regarding the first rationale — namely, the lack of perceived abuses in the municipal market, the Commission has brought dozens of enforcement actions in recent years that highlight the continued disclosure weaknesses in the municipal market and raised concerns about governmental accounting.<sup>49</sup> These actions involved a wide range of disclosure violations by municipal issuers, such as the failure to disclose liabilities that place the municipality in serious financial jeopardy; falsely claiming a surplus for general and debt service funds; and the failure to disclose material information about the municipality's high risk investment pool and financial condition that brought into question its ability to repay its securities....<sup>50</sup>

Finally, there have been numerous bid rigging, price fixing, pay to play, and other scandals in this market. There have also been a number of instances of abusive practices by financial advisors, who are largely unregulated by the Commission.<sup>56</sup>

The second rationale for exempting municipal securities — namely that it is a sophisticated institutional market — is clearly no longer valid today. As I mentioned earlier, there is extensive retail participation in the municipal securities market.<sup>57</sup> With the baby boomers starting to enter retirement, this is probably only going to increase as senior investors increasingly include fixed-income and tax-free offerings in their retirement portfolios.<sup>58</sup> The Commission is very concerned about fraud perpetrated against our nation's seniors, who have spent much of their lives building a retirement nest egg and so the fact that municipal securities are being used as retirement vehicles raises heightened regulatory concern.<sup>59</sup>

In my view, the private gatekeepers who operate in this market — the credit rating agencies in particular — did not provide the necessary backstops for investors. The record of credit rating agencies in recent years has led both retail and institutional investors to focus more closely on the disclosure documents of municipal issuers rather than merely relying on a bond rating. And this trend is likely going to be heightened by the increased difficulty some municipal issuers are having getting credit enhancements for their bonds because of the severe financial deterioration of municipal bond insurers (or “monolines,” as they are sometimes called).<sup>60</sup>

The third rationale for exempting municipal securities — namely intergovernmental comity — is more difficult to dismiss. I should begin by noting that this is not a federalism issue under the Tenth Amendment to the U.S. Constitution, which limits the federal government’s ability to regulate state and local governments. For over 30 years the Commission has brought enforcement actions against municipal issuers for violations of the federal securities laws.<sup>61</sup> No one seriously questions anymore the Constitutional right of the federal government to regulate municipal issuers.<sup>62</sup> Rather intergovernmental comity is a matter of balancing the respect due to the local interests of municipalities and their citizens, on the one hand, and the federal interest in maintaining the integrity of the national market system for the benefit of investors, on the other.

This simple contrast between state and local interests and federal interests is a little misleading, however, when you consider that municipalities are populated by taxpayers who also are frequently investors in our national markets, perhaps even in the bonds issued by those same municipalities. Indeed, the concerns of a citizen qua taxpayer and the same citizen qua investor have something very important in common. Just as an investor wants to understand the true financial health of an entity whose debt it purchases, a taxpayer has an interest in understanding the true fiscal health of the state or local municipality in which he or she lives. So the call for greater federal regulation of the municipal securities market could have benefits for both taxpayers and investors alike. Sunlight makes the best disinfectant in politics as well as in finance!

In thinking about regulation of the municipal markets, we also have to appreciate the obligations municipalities owe to their citizens. Not only are their interests critical, there is an understandable incentive for municipal officers to placate their constituency at the expense of investors. As Warren Buffet put it, “What mayor or city council is going to choose pain to local citizens in the form of major tax increases over pain to a faraway bond insurer?”<sup>63</sup> While Buffet may be stating the problem in particularly dramatic terms, we have to take this dynamic into account when considering how best to regulate the municipal securities market.

### *B. Legislative Reform*

But, as important as these regulatory and industry steps might be, municipal securities disclosure issues can only be addressed adequately through authority that federal securities regulators do not now possess. Therefore, to fully reform the regulation of the municipal securities market, I believe Congressional action is necessary in a number of areas.

*2. Conduit Borrowers.* Next, I believe that Congress should permit the Commission to apply the registration and disclosure standards to non-governmental conduit borrowers that would apply if they issued their securities directly without using municipal issuers as conduits. This is something the Commission has long advocated and I fully support the recommendation.<sup>76</sup> Commercial entities responsible for debt obligations under a conduit borrowing arrangement should be subject to the same level of disclosure obligations as a corporate issuer directly obtaining financing in the public securities markets.<sup>77</sup> The fact that the bonds are tax-exempt does not change the fact that these are private obligations in which investors look to a private entity for repayment.<sup>78</sup>

*4. Repeal of the Tower Amendment.* Further, as politically unpopular as this suggestion may be, I believe that the exemptions for municipal securities should be removed from the 33 and 34 Acts and the Tower Amendment should be repealed.

Let me say immediately that I fully appreciate that deference should be shown to the special questions concerning disclosure and accounting that municipal issuers present; municipal securities should not be treated exactly like corporate securities. Moreover, there cannot be a one-size-fits all approach to municipal disclosure, given the wide range of purposes and structures of the over 50,000 municipal issuers. I fully agree with what the Commission staff wrote in its 2007 White Paper to Congress when it said that

[t]he regulatory model applicable to the securities of public companies should not . . . be duplicated and applied wholesale to municipal securities. Implementation of steps such as these must be tailored to accommodate the unique character of municipal issuers and special attributes of the municipal securities market.<sup>82</sup>

In addition, municipal disclosure serves a dual purpose. It both reports on the financial state of a municipal securities issuer and it tells citizens about how the municipality spends their hard earned tax dollars. There is nothing quite like this in the corporate space.<sup>83</sup>

Nonetheless, appropriate legislative change would allow the Commission to take important steps to improve the quality and availability of municipal issuer information to investors.

First, the Commission could require that municipal issuers make available to investors offering documents and periodic reports that contain information similar, although not identical, to that required of issuers and offerings of corporate securities. Municipal issuers should not necessarily be required to receive pre-approval of offerings from the Commission. To me, what is most important is the integrity of the continuing disclosure obligations of issuers, not whether they receive pre-approval from the Commission before issuing a bond. Complete, timely, and accurate disclosure is essential for the proper functioning of the municipal securities markets, in particular for efficient pricing. Timeliness is a particular concern. With the appropriate authority, the Commission could mandate that municipal disclosures be issued in a time period that makes critical information available when investment decisions are made. I think we greatly underestimate the timeliness of information problem in the muni market today.

Of course, municipal issuers, like corporate issuers, should have an alternative to the registered public offering. With new authority, the Commission would need to engage in tailored rulemaking that would provide appropriate exemptions, for example, for small issuances and private placements, just as currently exists for corporate securities offerings. One possibility worth considering is a tranching approach to issuer obligations. The largest issuers could be required to provide disclosures similar to public companies, while smaller issuers would be subject to a less rigorous disclosure regime. This could help to level the playing field between the municipal and corporate markets, without obscuring the important differences between them.<sup>84</sup>

Second, legislation could give the Commission the authority to mandate that municipal issuers use “generally accepted” governmental accounting standards. In some states, deviation from GASB GAAP is required by state law, and the situation seems to be only getting worse.<sup>85</sup> Comparability of investment opportunities is critical and today the only real way to compare municipal investments is by yield and ratings; that is not sufficient. Lack of uniform accounting standards makes financial statements hard to understand and difficult to compare, particularly for less sophisticated investors.

As part of this accounting reform, I believe that Congress should provide an independent funding mechanism for the GASB and permit Commission oversight of the GASB, as is now provided by

Sections 108 and 109 of the Sarbanes-Oxley Act for the Financial Accounting Standards Board (“FASB”). Currently, GASB is a not-for-profit organization that operates under the oversight of the Financial Accounting Foundation (“FAF”). It is funded by voluntary payments and contributions from states and local governments and the financial community, as well as sales of its publications. I do not believe that this funding mechanism is adequate to ensure that GASB is a truly independent organization that is able to develop high-quality governmental accounting standards without being unduly pressured by the issuer community.

9 See David S. Ruder, Chairman, U.S. Securities and Exchange Commission, “Disclosure in the Municipal Securities Markets,” Remarks Before the Public Securities Association (Oct. 23, 1987), available at <http://www.sec.gov/news/speech/1987/102387ruder.pdf>; Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, “Public Trust and Public Obligations in the Municipal Bond Market,” Remarks Before the National Federation of Municipal Analysts, Baltimore, Maryland (May 8, 1996), available at <http://www.sec.gov/news/speech/speecharchive/1996/spch098.txt>; Christopher Cox, Chairman, U.S. Securities and Exchange Commission, “Integrity in the Municipal Market,” Los Angeles, California (July 18, 2007), available at <http://www.sec.gov/news/speech/2007/spch071807cc.htm>; and Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission, Address before the New York Financial Writers’ Association Annual Awards Dinner, New York, New York (June 18, 2009), available at <http://www.sec.gov/news/speech/2009/spch061809mls-2.htm>.

10 See Treasury White Paper at 49 & 70. See Andrew Ackerman, “Obama Unveils Plan to Expand SEC Regulation,” *The Bond Buyer* (June 18, 2009), available at [http://www.bondbuyer.com/issues/118\\_116/-304627-1.html](http://www.bondbuyer.com/issues/118_116/-304627-1.html).

11 Arthur Levitt Jr., “Muni Bonds Need Better Oversight,” *The Wall Street Journal* (May 9, 2009), available at <http://online.wsj.com/article/SB124182780923802551.html>.

12 See Troy L. Kilpatrick and Antonio Portuondo, The Bank of New York Trust Company, N.A., “Commentary: Is This the Last Chance for the Muni Industry to Self-Regulate?,” *The Bond Buyer* (Aug. 6, 2007) (warning that a “perfect storm may be brewing”).

26 See Ruder, note 13, *supra* (providing a very helpful description of the differences between the corporate disclosure system and the municipal disclosure system); see also Martha Mahan Haines, Attorney-Fellow, Office of Municipal Securities, U.S. Securities & Exchange Commission, “Disclosure in the Municipal Market: Fundamental Concepts for Issuers,” Remarks Before the Michigan Municipal Finance Officers Association Thomsonville, Michigan (Sep. 19, 2000), available at <http://www.sec.gov/news/speech/spch400.htm>.

27 See Cox, note 9, *supra*.

28 See Exchange Act Rel. No. 33741 (Interpretive Guidance on the Antifraud Provisions — Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others) (Mar. 9, 1994) (“1994 Interpretive Guidance”), available at [http://www.nabl.org/AM/Template.cfm?Section=Archive\\_Disclosure\\_Original\\_Issue](http://www.nabl.org/AM/Template.cfm?Section=Archive_Disclosure_Original_Issue).

29 See, e.g., *Dolphin and Bradbury, Inc. v. SEC*, 512 F.3d 634, 638 (D.C. Cir. 2008) (“The antifraud provisions of the federal securities laws prohibit fraudulent or deceptive practices in the offer and sale of municipal securities”) (quoting the 1994 Interpretive Guidance).

30 See 1994 Interpretive Guidance.

31 Congress also amended the securities laws in 1975 to expand the definition of “person” in Section 3(a)(9) of the Exchange Act to include municipal securities issuers, thus clarifying that state and local government issuers were not exempt from the antifraud provisions of the federal securities law. See Gellis, “Mandatory Disclosure for Municipal Securities,” note 4, *supra*, at note 6.

32 Section 15B(d)(1) of the Exchange Act provides: “Neither the Commission nor the Board is authorized under this title, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.”

33 Section 15B(d)(2) of the Exchange Act provides: “The Board is not authorized under this title to require any issuer of municipal securities, directly or indirectly through a municipal securities broker or municipal securities dealer or otherwise, to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer. . . .”

34 See Exchange Act Rel. No. 26985 (June 28, 1989), available at [http://www.nabl.org/AM/Template.cfm?Section=Archive\\_Disclosure\\_Original\\_Issue](http://www.nabl.org/AM/Template.cfm?Section=Archive_Disclosure_Original_Issue).

35 See *id.*

36 See Staff Report on the Municipal Securities Market (Sep. 1993), available at <http://www.sec.gov/info/municipal/mr-munimarketreport1993.pdf>.

37 See *id.*

38 See *id.* (noting that information about the issuer and other obligated persons is as critical to the secondary market, where little information about municipal issuers and obligated persons was regularly disseminated, as it is in primary offerings, where, as a general matter, better disclosure practices existed).

39 See Exchange Act Rel. No. 34961 (Nov. 10, 1994), available at <http://www.sec.gov/rules/final/adpt6.txt>.

40 See note 28, *supra*.

41 See Exchange Act Rel. No. 59062 (Dec. 5, 2008), available at <http://www.sec.gov/rules/final/2008/34-59062.pdf>.

42 See <http://emma.msrb.org/>.

43 See Andrew Ackerman, “SEC OKs EMMA as NRMSIR,” *The Bond Buyer* (Dec. 5, 2008), available at [http://www.bondbuyer.com/issues/117\\_232/-297217-1.html](http://www.bondbuyer.com/issues/117_232/-297217-1.html).

47 See Ruder, note 9, *supra* (citing H.R. Rep. No. 85, 73<sup>rd</sup> Cong., 1<sup>st</sup> Sess. 7 (1933)).

48 Already in 1976, Commissioner Evans recognized: “During the intervening thirty years [since 1945], there have been significant changes in both the size and the nature of the municipal securities marketplace. Municipal securities are no longer assumed to be total riskless investments. Investors in such securities are not necessarily financial institutions or wealthy or sophisticated individuals. And there have been egregious frauds and abuses in connection with primary distributions and secondary trading of municipal securities.” John Evans, Commissioner, U.S. Securities and Exchange Commission, “SEC’s Role in ‘Municipal Fiscal Crises,’” National Institute: “Freedom From Fiscal Fiasco,” American Bar Association, Section of Local Government Law, Washington, D.C. (Dec. 3, 1976), available at <http://www.sec.gov/news/speech/1976/120376evans.pdf>.

49 See Municipal Securities Cases and Materials on the Commission Website, available at <http://www.sec.gov/info/municipal/municase07.htm>; see also Martha Mahan Haines, Assistant Director, Office of Municipal Securities, Division of Market Regulation, U.S. Securities and Exchange Commission, “Perspectives on Public Transparency,” Second Internal Control & Fraud Conference of the Association of Governmental Accountants, Atlanta, Georgia (Sep. 11, 2007), available at <http://www.sec.gov/news/speech/2007/spch091107mmh.htm>.

50 See U.S. Securities and Exchange Commission Staff White Paper to Congress, “Disclosure and Accounting Practices in the Municipal Securities Market” (July 26, 2007) at 1-2 (“Staff White Paper”), available at <http://www.sec.gov/news/press/2007/2007-148wp.pdf>.

56 Financial advisors who limit their advisory activities to advising municipal issuers as to the structuring of their financings rather than providing advice for compensation regarding the investment of assets may not need to register as an investment adviser. See Division of Investment Management: Staff Legal Bulletin No. 11, Applicability of the Advisers Act to Financial Advisors of Municipal Securities Issuers (Sep. 19, 2000) (explaining the circumstances under which financial advisors (a) may be investment advisers, and (b) may give advice to issuers of municipal securities regarding the investment of offering proceeds without being deemed to be investment advisers), available at <http://www.sec.gov/interp/legal/slbim11.htm>.

57 See Schapiro, note 9, *supra*; see also Seymour, note 18, *supra*.

58 See Nicole Bullock, “Muni Bond Issuer Enjoy Record Appeal,” *Financial Times Online* (Sep. 20, 2009) (“Also underpinning demand is a shift that has the retiring ‘baby boomer’ generation increasingly seeking the income of investments such as munis over the total return offered by stocks. The anticipated rise in US tax rates to pay for schemes to bolster the financial system over the past year only heightens the appeal of the tax breaks of munis.”), available at <http://www.ft.com/cms/s/0/799f1d90-adec-11de-87e7-00144feabdc0.html>; see also Gabaldon, note 7, *supra*, at 759-60.

59 See the Commission’s Website at <http://www.sec.gov/investor/seniors.shtml> for investing information especially for seniors.

60 See Dan Seymour, “Assured/FSA: Last One Standing,” *The Bond Buyer* (Oct. 16, 2009), available at [http://www.bondbuyer.com/issues/118\\_199/assured-fsa-1002586-1.html](http://www.bondbuyer.com/issues/118_199/assured-fsa-1002586-1.html).

61 See Cases and Materials on the Commission’s Website at <http://www.sec.gov/info/municipal.shtml>.

62 See Gellis, “Mandatory Disclosure for Municipal Securities,” note 4, *supra*, at 87-88 (claiming that “little question remains” regarding the constitutionality of federal intrusion into state affairs when they issue securities “even if it involves administrative rulemaking and review of proposed disclosure”); see also Gabaldon, note 7, *supra*, at 753-57 (concluding that “the betting money” is still on the constitutionality of federal regulation of municipal issuers based, in part, on the “undoubtedly sweeping federal ability to regulate interstate commerce”).

63 Quoted at Mysak, note 23, *supra*.

76 See Staff White Paper at 11. The Commission does have “statutory authority, in addition to antifraud authority, over securities offerings involving conduit borrowers, whether a public reporting company or a private entity, where the exemption from the registration requirements of the federal securities laws is unavailable to the conduit borrower due to the type of securities offering involved.” Staff White Paper at note 14.

77 See Ruder, note 9 *supra*, at note 47 (discussing past attempts by the Commission to regulate conduit borrowing).

78 See 1994 Interpretive Guidance.

82 Staff White Paper at 11-12.

83 See, e.g., Government Accounting Standards Board, White Paper, “Why Governmental Accounting and Financial Reporting is — and Should Be — Different” (2006), available at [http://www.gasb.org/white\\_paper\\_full.pdf](http://www.gasb.org/white_paper_full.pdf).

84 As Arthur Levitt rightfully noted, “We may not want to treat municipals like we do other securities — but we do need to level the playing field between the corporate and municipal markets and address all risks to the financial system. Municipal issuers are ill-equipped and some are reluctant to do this on their own.” Levitt, note 71, *supra*.

85 See Gabaldon at 752 (noting, for example, that the Texas legislature had passed a law withdrawing all Texas municipal issuers from GASB compliance).

## F. State of the Municipal Securities Market in Its Own Words

This section includes selected excerpts from the State of the Municipal Securities Report dated July 12, 2012 as well as selected excerpts of three speeches, a public statement and testimony given by various Commissioners and the Director, Division of Enforcement.

“The Securities and Exchange Commission has conducted a review of the municipal securities market, examining a wide range of issues including disclosure and transparency, financial reporting and accounting, and investor protection and education.

The SEC issued a comprehensive report in July 2012 that includes recommendations to help improve the structure of the \$3.7 trillion municipal securities market and enhance the disclosures provided to investors. The recommendations address concerns raised by market participants and others in public field hearings and meetings as well as the public comment process during the agency’s review, which was initiated by SEC Chairman Mary Schapiro in mid-2010 and led by SEC Commissioner Elisse Walter.”

### *Report on the Municipal Securities Market* (Selected Excerpts)

Except with respect to securities fraud, the Securities and Exchange Commission’s (the “SEC” or “Commission”) authority over the disclosure practices of municipal issuers is significantly constrained under existing laws. Investors in municipal securities are often not afforded access to the types of timely and accurate information available to investors in other securities.

The mission of the SEC is to protect investors – including investors in municipal securities – maintain fair, orderly, and efficient markets, and facilitate capital formation.

State and local laws, including state constitutions, statutes, city and county charters, and municipal codes govern these public bodies. Such constitutions, statutes, charters, and codes impose on municipal issuer’s requirements relating to governance, budgeting, accounting, and other financial matters. The governing bodies of municipal issuers are as varied as the types of issuers, ranging from state governments, cities, towns, and counties with elected officials to special purpose entities with appointed members.

The Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act of 1934 (“Exchange Act”) were both enacted with broad exemptions for municipal securities from all of their provisions except for the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder. Congress, as part of the 1975 Amendments, created a limited regulatory scheme for the municipal securities market at the federal level in response to the growth of the market, market abuses, and the increasing participation of retail investors.



The 1975 Amendments required firms transacting business in municipal securities to register with the Commission as broker-dealers, required banks dealing in municipal securities to register as municipal securities dealers, and gave the Commission broad rulemaking and enforcement authority over such broker-dealers and municipal securities dealers. In addition, the 1975 Amendments created the MSRB and granted it authority to promulgate rules governing the sale of municipal securities by broker-dealers and municipal securities dealers.

The 1975 Amendments did not create a regulatory regime for, or impose any new requirements on, municipal issuers. Pursuant to provisions commonly known as the “*Tower Amendment*,” the 1975 Amendments expressly limited the Commission’s and the MSRB’s authority to require municipal securities issuers, either directly or indirectly, to file any application, report, or document with the Commission or the MSRB prior to any sale by the issuer. The 1975 Amendments do not, by their terms, preclude the Commission from promulgating disclosure standards in municipal offerings, but there is no express statutory authority contained in the Exchange Act over disclosure by municipal issuers. The Dodd– Frank Wall Street Reform and Consumer Protection Act (“Dodd– Frank Act”) did not change these provisions, but required a study and review by the U.S. Comptroller General of municipal securities disclosure, possible recommendations for municipal issuer disclosure requirements, and the advisability of the repeal or retention of the Tower Amendment.

In the absence of a statutory scheme for municipal securities registration and reporting, the Commission’s investor protection efforts in the municipal securities market have been accomplished primarily through regulation of broker-dealers and municipal securities dealers pursuant to Exchange Act Rule 15c2-12, Commission interpretations, enforcement of the antifraud provisions of federal securities laws, and Commission oversight of the MSRB. The Commission first recommended, over 15 years ago, that for-profit conduit borrowers utilizing industrial development financings through municipal entities and their agencies and instrumentalities be subject to the registration and disclosure provisions of the Securities Act.

#### *b. Antifraud Authority*

In light of the national scope of the municipal securities market and its importance to the economy and state and local governments, there is an overriding federal interest in assuring that there be adequate disclosure of all material information by issuers of municipal securities. As noted above, Congress did not exempt transactions in municipal securities from the coverage of the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder. The antifraud provisions of the federal securities laws prohibit any person, including municipal issuers and dealers, from making any untrue statement of material fact, or omitting any material facts necessary to make statements made, in the light of the circumstances under which they were made, not misleading, in connection with the offer, purchase, or sale of any security. Municipal issuer disclosures, such as disclosures in official statements and ongoing annual, periodic and event-related disclosure, are subject to these prohibitions. In addition, broker-dealers, municipal securities dealers, and municipal advisors are subject to regulations adopted by the Commission, including those regulations adopted to define and prevent fraud.

Exchange Act Rule 15c2-12 was adopted in 1989 to establish standards for the procurement and dissemination of disclosure documents by underwriters as a means of enhancing the accuracy and timeliness of disclosure to municipal securities investors. Rule 15c2-12 also was designed to assist

underwriters in meeting their responsibilities under the antifraud provisions of the federal securities laws by requiring them to review issuer disclosure documents before commencing sales to investors. In 1994, the Commission amended Rule 15c2-12 to improve disclosure practices in the secondary markets by prohibiting underwriters from purchasing or selling municipal securities in connection with a primary offering unless the issuer had committed to providing continuing disclosure regarding the security and issuer, including its financial condition and operating data.

In 2008, the Commission amended Rule 15c2-12 to establish a single centralized disclosure repository for the electronic collection and availability of information about municipal securities. The Commission's rulemaking was intended to improve the availability of information about municipal securities to investors, market professionals, and the public generally. This repository, established and maintained by the MSRB, is its Electronic Municipal Market Access system, known by the acronym EMMA, and is freely accessible to all investors on the Internet.

The issuance of securities by states, local governments, and their agencies and instrumentalities is controlled by the constitution of the relevant state and the laws of the relevant state and local government. The scope of these laws is broad, covering matters from the lending of credit, permitted use of public funds, tax and debt limitations, public records and open meeting laws to specific conditions for, and restrictions on, the manner and purposes for which bonds may be issued. In some cases a referendum is required to authorize the issuance of bonds, particularly those payable from ad valorem taxes revenues.

Disclosure practices in municipal securities offerings and on an ongoing basis have developed as a result of the antifraud provisions of federal and state securities laws, Exchange Act Rule 15c2-12, Commission interpretive guidance, MSRB rules, and voluntary guidelines published by various industry groups.

Participants in the municipal securities market have worked together to develop voluntary disclosure guidelines and best practices designed to improve the level and quality of disclosure in primary offerings of municipal securities and continuing disclosure in the secondary market. This guidance is in the form of voluntary disclosure guidelines and best practices relating to the municipal securities market, both with regard to primary offerings and secondary market disclosure. Involved industry groups include the Government Finance Officers Association ("GFOA"), National Federation of Municipal Analysts ("NFMA"), National Association of State Auditors, Comptrollers and Treasurers ("NASACT"), the National Association of Bond Lawyers ("NABL"), and the American Bankers Association, Corporate Trust Division. The existing industry guidelines and best practices relate to, among other matters, the content and timing of financial statements and financial information, disclosure of pension liabilities, industry and financing specific guidelines (discussed below), disclosure controls and procedures of a municipal issuer, and methods of providing disclosure.

In addition to industry group disclosure guidelines, there are also a variety of legal publications aimed at providing disclosure guidance to municipal securities market participants. These publications include *"The Securities Law of Public Finance," "Making Good Disclosure – the Roles and Responsibilities of State and Local Officials Under the Federal Securities Laws,"* and *"Disclosure Roles of Counsel in State and Local Government Securities Offerings."* These publications provide extensive guidance to municipal market participants regarding their disclosure and other responsibilities in municipal securities offerings and on an ongoing basis.

As discussed above, Rule 15c2-12 obligates municipal securities underwriters in most offerings to obtain, review, and distribute to investors copies of the issuer's disclosure documents.

Although the official statement may be prepared by counsel to the underwriter, bond counsel, the issuer's disclosure counsel or financial advisor, the Commission has clearly stated that the official statement is legally the issuer's document. Although market participants that assist the issuer are subject to the antifraud provisions of the federal securities laws, the issuer has ultimate responsibility for ensuring that its official statements meet the disclosure standards of the securities laws and has primary liability for failure to meet them.

As a result of the operation of Rule 15c2-12,<sup>364</sup> the application of the antifraud provisions of the federal securities laws, Commission interpretive guidance, and industry initiatives, a continuing disclosure scheme for municipal securities issuers and obligated persons has developed.

As the Commission stated in the 1994 Interpretive Release, sound financial statements are critical to the integrity of the primary and secondary markets for municipal securities, just as they are for corporate securities. Municipal issuer financial statements provide investors with critical information to assess the financial condition of municipal issuers and to enable investors to analyze their investments. This information is also important to other stakeholders, such as government agencies and taxpayers.

As the Governmental Accounting Standards Board ("GASB") has explained, there are differences between the purposes of financial reports of governmental entities and those of private-sector business enterprises.

In the case of governmental accounting, on the other hand, the principal focus frequently is on public accountability for resources entrusted to the stewardship of the government (i.e., taxes), including how public resources such as taxes are acquired and used; whether resources are sufficient to meet current and future costs; and whether the government's ability to provide services improves or deteriorates on a period-to-period basis.

As noted above, the financial disclosure practices of municipal issuers are influenced by a variety of factors, including the demands of market participants, voluntary/industry guidelines, general antifraud considerations, and the continuing disclosure provisions relating to financial information in Rule 15c2-12.

There are no uniformly applied accounting standards in the municipal securities market, and the Commission generally lacks authority to prescribe the accounting standards that municipal issuers must use. However, the GASB establishes generally accepted accounting principles ("GAAP"), which are used by many states and local governments of widely varying size and complexity.

Although there has been no comprehensive study to determine the exact number of municipalities that prepare financial statements on a basis other than GASB standards, generally speaking, larger governments are more likely to adhere to GASB standards than smaller governments. A 2011 study undertaken by GASB, for instance, found that the vast majority of annual financial reports ("AFRs") of 350 larger governments surveyed (991 AFRs out of 1,050 AFRs, or 94%, of the large government AFRs surveyed) were prepared using GASB standards. In contrast, of the 193 smaller governments surveyed by GASB, 81% of the AFRs collected were prepared using GASB standards.

As of December 2010, 38 states compel some or all of their political subdivisions, including counties, cities, and school districts, to prepare their financial reports in accordance with GASB standards. Along with these mandates, certification programs, such as those sponsored by the GFOA and the Association of School Business Officials International, promote the use of GASB standards by recognizing governments that prepare high-quality GAAP financial reports (based on GASB standards). Nonetheless, the absence of a uniform requirement on the part of municipal entities to adhere to GASB standards means that municipal entities that issue municipal securities can (and some do) prepare their financial reports on a basis other than GASB standards. On rare occasion, some governments that otherwise are compliant with GASB standards may not be permitted to, or may choose not to, apply certain GASB standards.

Also in 2010, the Commission brought charges for the first time against a state for violations of the federal securities laws when it charged the State of New Jersey with securities fraud for misrepresenting and failing to disclose to investors in municipal bond offerings that it was underfunding the state's two largest pension plans by billions of dollars, masking the fact that New Jersey was unable to make contributions to those pension plans without raising taxes, cutting other services, or otherwise affecting its budget.

As stated above, the issuer has ultimate responsibility for ensuring that its official statements meet the disclosure standards of the federal securities laws. Additionally, any information released to the public by an issuer that is reasonably expected to reach investors and the trading markets is subject to the antifraud provisions. In preparing their official statements and other disclosures, some issuers look to written disclosure controls that they have in place while others do not have a formal disclosure control system. Municipal issuers generally base their disclosure policies, procedures, and controls on state law requirements, other governmental mandates or their own customs and practices. However, issuers may also look to Commission enforcement actions or other Commission guidance.

The following are possible legislative approaches that could provide the Commission authority to establish improved disclosures and practices in the municipal securities market.

- Authorize the Commission to require that municipal issuers prepare and disseminate official statements and disclosure during the outstanding term of the securities, including timeframes, frequency for such dissemination and minimum disclosure requirements, including financial statements and other financial and operating information, and provide tools to enforce such requirements.

This legislative approach would provide the Commission authority to establish disclosure requirements and principles, timeframes and frequency of dissemination of municipal securities offerings and continuing disclosures. This legislative approach would not entail any repeal or modification to the existing proscriptions on the SEC or the MSRB requiring any presale of disclosure documents, known as the "Tower Amendment." Nor would this approach involve elimination of the exemptions for municipal securities under Section 3(a)(2) of the Securities Act or the exemptions under the Exchange Act. This legislative approach, however, would meaningfully enhance disclosure practices by municipal issuers and could be accomplished in a short period of time.

This recommendation is intended to enhance disclosure in a meaningful way. The legislative proposal does not envision detailed line item disclosure requirements such as those applicable to corporate issuers under Regulation S-K. Rather it is intended as a more principles-based approach.

- Amend the municipal securities exemptions in the Securities Act and Exchange Act to eliminate the availability of such exemptions to conduit borrowers who are not municipal entities under Section 3(a)(2) of the Securities Act, without differentiation based on the size of the financing due to the continuing availability of other exemptions, including those available for small businesses, private offerings, and non-profit entities that take into account different types of offerings and issuers.

As discussed above, conduit bonds have represented approximately 70% of all municipal bond defaults despite representing a relatively small percentage of municipal bonds issued.

- Authorize the Commission to establish the form and content of financial statements for municipal issuers who issue municipal securities, including the authority to recognize the standards of a designated private-sector body as generally accepted for purposes of the federal securities laws, and provide the Commission with attendant authority over such private-sector body.

This legislative approach would provide explicit authority to the Commission to establish the form and content of financial statements used in municipal securities offerings and establish standards and designate a private-sector body as the GAAP standard setter for municipal issuer financial statements. As the Report notes, the Commission currently does not have authority to establish the form and content of financial statements of municipal securities issuers that are used in connection with primary offerings of municipal securities or provided on an ongoing basis in connection with outstanding municipal securities. Moreover, the Commission does not have direct authority over the standard setter for those financial statements. This authorization could be for purposes of the federal securities laws only, thereby allowing municipal issuers to continue to comply with other state accounting principles as applicable in the preparation of their financial statements. Most states already prepare their financial statements in accordance with GAAP as set by the GASB. This approach recognizes the importance of having financial statements of different issuers that are prepared on the same basis, thereby allowing comparisons between municipal issuers and municipal securities.

This approach would further the interests of the Commission and market participants in improving the presentation of financial information. As noted above, many market participants believed that adherence to GASB standards promotes consistency and comparability of financial information between and among municipal issuers and differing types of municipal securities. In addition, many of the Commission's enforcement actions regarding materially misleading statements or omissions in official statements involved deficient financial statements provided by issuers or underlying obligors.

- Authorize the Commission, as it deems appropriate, to require municipal securities issuers to have their financial statements audited, whether by an independent auditor or a state auditor.

Improving the quality of financial reporting by municipal securities issuers would further the interests of the Commission and market participants. As the Commission stated in the 1994 Interpretive Release, an audit is a "reasonable expectation" for investors to have. Additionally, audited financial statements are referred to in Rule 15c2-12 and in GFOA's guidelines and the CAFR

program. This legislative proposal could be a scaled or tiered requirement, beginning with the largest issuers.

- The Commission could consider amendments to Exchange Act Rule 15c2-12 to further improve the disclosures made regarding municipal securities.

The Commission could consider further amendments to Exchange Act Rule 15c2-12 to improve the disclosures made with respect to municipal securities, both in primary offerings and on an ongoing basis. The Commission and market participants have identified a number of areas in which there could be improvements in the disclosure practices regarding municipal securities and where amendments to Rule 15c2-12 may be helpful.

### ***Speeches and Testimony by Commissioners and the Director, Division of Enforcement***

There are three speeches, a public statement and Chair White's testimony before the Committee on Financial Services House of Representatives included in this section.

The first speech "A New Model for SEC Enforcement: Producing Bold and Unrelenting Results" was delivered by Chair Mary Jo White at an event hosted by the New York University School of Law Program on Corporate Compliance and Enforcement and New York University School of Law Pollack Center for Law and Business on November 18, 2016.

"During my confirmation hearing, I pledged that I would pursue a "bold and unrelenting" enforcement agenda as SEC Chair.<sup>[1]</sup> And through the hard work and dedication of the staff of the SEC's Enforcement Division – and the many other parts of the agency that support the Division – we have delivered on that promise. By every measure, the SEC's enforcement program has been a resounding success. While numbers are a small part of the story, in the last three fiscal years, we have brought record numbers of enforcement actions, obtained unprecedented monetary remedies in the billions of dollars, and returned hundreds of millions of dollars to harmed investors.<sup>[2]</sup>

### ***Public Finance Enforcement***

Public finance, and the municipal securities market in particular, is another critically important area where we have brought to bear our bolder and more unrelenting approach to enforcement to change industry behavior. As many of you know, the Commission's regulatory jurisdiction over the municipal securities market is more circumscribed than in the public company realm since we cannot directly require municipalities to make periodic disclosures. So, we have to be more innovative in targeting misconduct that is occurring in the municipal market.<sup>[3]</sup>

We have done this by bringing many first-of-their-kind actions, where we have used a range of legal theories and remedies. These include using controlling person liability to target municipal officials not directly accused of knowledge of misrepresentations in offerings, but who had control over the entities or individuals involved in the misconduct and the bond offerings,<sup>[4]</sup> using our emergency asset freeze authority to stop a municipal offering that we believed was fraudulent,<sup>[5]</sup> and proceeding against an audit firm and engagement partner for issuing fraudulent audit reports in connection with municipal bond offerings.<sup>[6]</sup>

One dramatic example of the Commission's impactful work in this area is the Division's MCDC initiative. MCDC, the Municipalities Continuing Disclosure Cooperation Initiative, is a cooperation initiative which encouraged issuers and underwriters of municipal securities to self-report violations of the federal securities laws related to continuing disclosure.<sup>[7]</sup> Under the MCDC initiative, the

Enforcement staff recommended standardized, favorable settlement terms for municipal issuers and underwriters who self-reported that they made inaccurate statements in bond offerings about their prior compliance with continuing disclosure obligations and who agreed to enhance their procedures going forward.<sup>[44]</sup>

While not every self-report resulted in an enforcement action, the Commission charged 72 broker-dealers, representing about 96 percent of the market for municipal underwritings.<sup>[45]</sup> And, this past August, the Commission charged 71 municipal issuers for making false statements or misleading omissions in their bond offering documents.<sup>[46]</sup> All indications are that MCDC has vastly increased issuer compliance with their continuing disclosure obligations.<sup>[47]</sup> It is a good example of our innovative, wide-ranging enforcement program – bolder and unrelenting – that is bringing about new, demonstrable benefits for investors.

[2] See Press Release 2016-212, *SEC Announces Enforcement Results for FY 2016* (Oct. 11, 2016), available at <https://www.sec.gov/news/pressrelease/2016-212.html>; Press Release 2015-245, *SEC Announces Enforcement Results For FY 2015* (Oct. 22, 2015), available at <https://www.sec.gov/news/pressrelease/2015-245.html>; Press Release 2014-230, *SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases* (Oct. 16, 2014), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660>.

[39] See generally Andrew J. Ceresney, Director, Division of Enforcement, U.S. Securities and Exchange Commission, *The Impact of SEC Enforcement on Public Finance* (Oct. 13, 2016), available at <https://www.sec.gov/news/speech/speech-ceresney-10132016.html>.

[40] See, e.g., Press Release 2016-93, *Mayor in Illinois Settles Muni Bond Fraud Charges* (May 19, 2016), available at <https://www.sec.gov/news/pressrelease/2016-93.html>; Press Release 2014-249, *SEC Charges Allen Park, Mich. And Two Former City Leaders in Fraudulent Muni Bond Offering for Movie Studio Project* (Nov. 6, 2014), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543373355>.

[41] See, e.g., Press Release 2014-122, *SEC Obtain Court Order to Halt Fraudulent Bond Officer by City of Harvey, Ill.* (June 25, 2014), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542163027>.

[42] See, e.g., Press Release 2016-229, *Firm and Partner Charged With Issuing Fraudulent Audit Reports* (Oct. 31, 2016), available at <https://www.sec.gov/news/pressrelease/2016-229.html>.

[43] Press Release 2014-156, *SEC Enforcement Division Modifies Municipal Disclosure Initiative* (Jul. 31, 2014), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542578459>; Press Release 2014-46, *SEC Launches Enforcement Cooperation Initiative for Municipal Issuers and Underwriters* (Mar. 10, 2014), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541090828>; Statement by Division of Enforcement, *Municipalities Continuing Disclosure Cooperation Initiative* (Mar. 10, 2014), available at <https://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml> (“MCDC Statement”).

[44] MCDC Statement, *supra* note 43.

[45] Press Release 2016-18, *SEC Completes Muni-Underwriter Enforcement Sweep* (Feb. 2, 2016), available at <https://www.sec.gov/news/pressrelease/2016-18.html>.

[46] Press Release 2016-166, *SEC Charges 71 Municipal Issuers in Muni Bond Disclosure Initiative* (Aug. 24, 2016), available at <https://www.sec.gov/news/pressrelease/2016-166.html>.

[47] See, e.g., Ceresney, *The Impact of SEC Enforcement on Public Finance*, *supra* note 39 (citing Jack Casey, *How MCDC Has Changed Continuing Disclosure Practices*, The Bond Buyer (Sep. 21, 2016), available at <http://www.bondbuyer.com/news/washington-enforcement/how-has-mcdc-changed-continuing-disclosure-practices-1114036-1.html>; Jack Casey, *MCDC Has Improved Disclosure but Issues Remain*, The Bond Buyer (Apr. 22, 2016), available at <http://www.bondbuyer.com/news/washington-securities-law/mcdc-has-improved-disclosure-but-issues-remain-1101990-1.html>; MCDC *Credited with Boosting Muni Disclosure*, The Bond Buyer (Feb. 3, 2016), available at <http://www.bondbuyer.com/news/washington-securities-law/mcdc-credited-with-boosting-muni-disclosure-1095588-1.html>).

Chair Mary Jo White testified before the Committee on Financial Services United States House of Representatives in Washington, DC on November 15, 2016. Excerpts of her testimony “*Examining the SEC’s Agenda, Operations, and FY 2018 Budget Request*” follow.

### ***Chairman Hensarling, Ranking Member Waters, and Members of the Committee:***

The Commission’s actions and accomplishments since I became Chair in April of 2013 a little over three and half years ago, have been extensive.<sup>[2]</sup> The last three and a half years have been marked by vigorous enforcement and examination programs, empowered with new tools and methods to detect and hold wrongdoers accountable and protect investors.

*Municipal Advisors.* In 2014, the Commission established a new regulatory regime to protect municipalities and investors from conflicted advice and unregulated advisors by requiring municipal advisors to register with the SEC and to comply with the rules of the Municipal Securities Rulemaking Board (MSRB). And we continue to work with the MSRB to establish the full suite of regulatory obligations for municipal advisors.

### ***Enhancing Focus on Key Areas of Misconduct***

The Commission also continues to focus resources on key areas of misconduct. One critical area is financial reporting and issuer disclosure. Comprehensive, accurate, and reliable financial reporting is the bedrock upon which our markets are based, and is essential to ensuring public confidence in

them. And at my direction, since 2013, our Enforcement Division has intensified its focus on pursuing violations in this area.

### *Building Stronger, Safer Markets for Investors and Issuers*

The SEC continues to pursue an extensive program of rulemaking and other policy efforts designed to ensure that our securities markets continue to optimally and securely serve investors and issuers. The SEC has significantly progressed in implementing mandatory rulemakings under three separate statutes, as well as in pursuing an impressive range of important discretionary initiatives.

### *Deepening Oversight of the Fixed Income Markets*

Fixed income market structure has long been a focus at the Commission, and the continued impact of technology, regulation, and other forces require us to deepen our oversight. In particular, as I have remarked before, technology in the fixed income markets may not be deployed today to achieve all of the benefits it could for investors, including the broad availability of pre-trade pricing information, lower search costs, and greater price competition.<sup>[62]</sup>

One important step is to ensure that the best execution and pricing disclosure rules for the corporate bond and municipal securities markets are robust and useful to investors, and FINRA and the MSRB have moved forward on such reforms. At the Commission's urging,<sup>[63]</sup> the MSRB in December 2014 adopted a best execution rule for the municipal bond market similar to FINRA's best execution rule.<sup>[64]</sup> And both SROs have since developed and published additional guidance on the best execution obligations of broker-dealers and municipal securities dealers.<sup>[65]</sup> In 2014, I also urged both FINRA and the MSRB to move forward on markup and markdown disclosure rules, a reform also publicly supported by my fellow Commissioners.<sup>[66]</sup> Both have submitted proposals for markup and markdown disclosure to the SEC for approval, and SEC staff is evaluating comments received on those proposals.<sup>[67]</sup>

[2] See generally SEC Accomplishments: Protecting Investors and Our Markets through Rigorous Oversight, Vigorous Enforcement, and Transformative Rulemaking (June 13, 2016), available at <https://www.sec.gov/about/sec-accomplishments.htm>.

[62] See Chair Mary Jo White, *Intermediation in the Modern Securities Markets: Putting Technology and Competition to Work for Investors* (June 20, 2014) ("Chair White Fixed Income Speech"), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370542122012>.

[63] See SEC Report on the Municipal Securities Markets (July 31, 2012), available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf>.

[64] See MSRB Rule G-18 (Best Execution); Release No. 34-73764, *Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Order Granting Approval of a Proposed Rule Change Consisting of Rule G-18, on Best Execution of Transactions in Municipal Securities, and Amendments to Rule G-48, on Transactions with Sophisticated Municipal Market Professionals ("SMMP"), and Rule D-15, on the Definition of SMMP* (December 5, 2014), available at <https://www.sec.gov/rules/sro/msrb/2014/34-73764.pdf>.

[65] See MSRB Implementation Guidance on MSRB Rule G-18, on Best Execution (November 2015), available at <http://www.msrb.org/~media/Files/MISC/Best-Ex-Implementation-Guidance.ashx?la=en>; and FINRA Regulatory Notice 15-46 (November 2015), available at [https://www.finra.org/sites/default/files/notice\\_doc\\_file\\_ref/Notice\\_Regulatory\\_15-46.pdf](https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf).

[66] See, e.g., Chair White Fixed Income Speech, *supra* note 62; and Commissioners Kara M. Stein and Michael S. Piwowar, *Statement on Edward D. Jones Enforcement Action* (August 13, 2015), available at <http://www.sec.gov/news/statement/statement-on-edward-jones-enforcement-action.html>.

[67] See Exchange Act Release No. 34-78573 (Aug. 15, 2016), available at <https://www.sec.gov/rules/sro/finra/2016/34-78573.pdf>; Exchange Act Release No. 34-78777 (Sep. 7, 2016), available at <https://www.sec.gov/rules/sro/msrb/2016/34-78777.pdf>.

The second speech "*The Impact of SEC Enforcement on Public Finance*" was delivered by Andrew J. Ceresney, Director, Division of Enforcement as the Keynote Address at the Securities Enforcement Forum 2016 on October 13, 2016. Selected excerpts of the speech appear below:

### *Introduction*

Today I am going to talk about the Commission's enforcement efforts in the area of public finance. Public finance, and the municipal securities market in particular, is a critically important area, and one on which the Enforcement Division needs to be, and has been, focused over the last few years. Our numerous recent enforcement actions have resulted in significant changes in the public finance market, where the Commission has brought many first-of-their-kind actions and used a range of legal theories and remedies.



I thought I would start my remarks today with some background on the public finance market and discuss the historical context of our actions in the public finance area. Then, I will focus on the Commission's current efforts in this space to expose and address misconduct in this market. Finally, I will discuss the effects that the Commission's efforts have had on the public finance market and the behavior of market participants.

### *Background on the Public Finance Marketplace*

From the perspective of the Division of Enforcement, the public finance market is essentially divided into two significant areas – municipal securities and public pensions.

#### *Municipal Securities*

The municipal securities market consists of securities valued at over \$3.7 trillion. One overriding characteristic of this market is its diversity. Issuers of municipal securities range from the nation's largest states, counties and cities, to the smallest towns and school districts. They include not only political subdivisions like state and local governments, but also public authorities that operate housing, airports, power plants, water sources, and other community services. The number of municipal issuers in the United States is estimated to be about 44,000, compared to approximately 8,600 corporate issuers.<sup>[2]</sup> And the securities they issue are extremely varied in their credit structures; it is estimated that there are over 1 million different municipal bonds outstanding compared to 60,000 corporate bonds.<sup>[3]</sup> And in 2015 alone, there were over 14,000 new municipal bond issues.<sup>[4]</sup>

[O]n the investor side, what is somewhat distinctive about this market is that municipal bonds are held largely by retail investors who hold the bonds either directly or through mutual funds. Estimates are that as much as 69% of outstanding bonds are held directly or indirectly by retail investors.<sup>[5]</sup>

Despite its importance, this market is substantially less regulated than many others. Municipal securities are exempt from the registration and reporting requirements of the federal securities laws and municipal issuers therefore are not required to file offering materials, or quarterly or annual reports, with the Commission. The Municipal Securities Rulemaking Board establishes rules, which the SEC reviews, approves and, along with FINRA, enforces, for the municipal securities firms, banks and municipal advisors that engage in municipal securities and advisory activities.<sup>[6]</sup> But investors in municipal bonds are often not afforded access to the types of timely and accurate information available to investors in other markets.

Additionally, municipal bonds are not traded on any exchange; they trade only in a decentralized, over-the-counter dealer market. This secondary market is relatively opaque and investor access to pre-trade pricing information has historically been very limited. The lack of transparency can make it difficult for investors to ascertain whether they are getting a fair price. Indeed, one study has demonstrated that muni bond investors pay more in markups and other transaction costs than investors in other securities.<sup>[7]</sup> As former SEC Chairman Elisse Walter observed, investors in municipal securities are, in certain respects, afforded “second-class treatment’ under current law.”<sup>[8]</sup> In part, the lack of protection afforded to investors in municipal securities led Chair Mary Jo White to reaffirm that “protecting our municipal securities markets and investors must be a priority.”<sup>[9]</sup> This makes Enforcement's role in protecting investors in this area especially important.

#### *Public Pensions*

...The current issues in public pension funding and the impact on state and local government finances are beyond the scope of my remarks today. But the Enforcement Division primarily is

focused on two areas that impact public pensions – accurate disclosure of pension fund liabilities, and public corruption, such as pay-to-play and other schemes in the investment and safeguarding of public pension fund assets.

Accurate disclosure of pension fund liabilities is critical to ensure that investors have adequate information to evaluate the impact of pension fund liability on an issuer's overall financial condition. A focus on pay-to-play abuses in this space also is critical because there is a lot at stake: Public pension funds in the United States hold over \$3.8 trillion of assets,<sup>[10]</sup> and the opportunity to earn fees to manage and custody those assets therefore is very valuable. Government officials are typically responsible for selecting the investment professionals who will earn those fees. If political contributions or improper payments to government officials play a role in the selection of investment professionals, the fairness of the process by which public contracts are awarded is undermined. These practices, known as “pay-to-play,” also distort the process by which professionals are selected and may result in pension funds receiving inferior services and paying higher fees, thereby harming retirees and the taxpaying residents of the states.<sup>[11]</sup>

### *A Specialized Approach to Securities Enforcement in Public Finance*

Since 2009, and even prior, SEC Commissioners have been sounding the alarm about the risk of abuses in the public finance area.<sup>[12]</sup> Over time, there have been some important enforcement matters dealing with public finance, including actions against Orange County in 1996,<sup>[13]</sup> the yield burning cases of the late 1990's,<sup>[14]</sup> the City of San Diego in 2006,<sup>[15]</sup> and actions involving Jefferson County, Alabama in 2008.<sup>[16]</sup> But this area has lacked sustained enforcement attention and the development of deep expertise regarding abuses in public financing.

In 2010, we created a specialized Enforcement unit to address abuses in this area.<sup>[17]</sup> As noted when the unit was announced, its focus was to be on misconduct in the large municipal securities market and in connection with public pension funds including: offering and disclosure fraud; tax or arbitrage-driven fraud; pay-to-play and public corruption violations; public pension accounting and disclosure violations; and valuation and pricing fraud. The Enforcement Division staffed the unit with experienced attorneys and hired non-attorney specialists with real world experience in the public finance industry to provide training and to assist in enforcement investigations. The unit, which we recently renamed the Public Finance Abuse Unit to recognize its broad scope and role, also partners with the Commission's Office of Municipal Securities. In addition, the expertise developed within the Unit has been leveraged by professionals working in other groups within Enforcement, who have brought significant cases as well.

And today it is clear that, by every measure, the investment made in 2010 has paid off in a big way. Since that time, and increasing substantially in the last few years, the Division has focused on enforcement in the public finance arena and has had a clear, measurable impact in this area.

### *Increased Enforcement Activity in Public Finance*

While numbers tell a small part of the story, they provide some context for the marked increase in activity. The Commission is bringing actions against more municipal issuers and public officials. For example, since the beginning of 2013, the Commission has brought enforcement actions against 76 state or local government entities (including 4 U.S. states), 13 obligated persons<sup>[18]</sup> and 16 public officials. In contrast, for the entire 10 year period from 2002 to 2012, there were enforcement actions brought against 6 government entities, 6 obligated persons and 12 public officials.

### *Using Sweeps to Reveal and Address Widespread Misconduct*

One approach that the Enforcement Division has taken to leverage our resources and increase our effectiveness in this area is to conduct enforcement sweeps. A sweep is a group of enforcement

actions brought simultaneously against different parties who have engaged in similar violations. Sweeps can be particularly effective where there is widespread misconduct. And it is fair to say that our sweeps have revealed widespread misconduct in some significant areas of the municipal securities market.

Our most prominent sweep has been our MCDC initiative. MCDC stands for the Municipalities Continuing Disclosure Cooperation Initiative.<sup>[24]</sup> It is the first self-reporting initiative undertaken by the Enforcement Division since the 1970s.<sup>[25]</sup> The initiative was designed to address what the Division perceived was likely a widespread problem in the market: municipal issuers had undertaken in their offerings to provide investors with important financial and other information – known as “continuing disclosure” – but were failing to provide that information in a timely fashion, or sometimes, failing to provide it at all. Then, when the municipal issuers went back to market to offer new bonds, they were falsely telling potential new investors that they had fully complied with their disclosure obligations. The Enforcement Division was also concerned that underwriters were failing to conduct sufficient due diligence on the representations made by the issuers and were selling bonds to their customers using offering materials that contained false statements. The program, announced by the Commission in 2014, offered standard settlement terms to municipal issuers and underwriters who had conducted offerings which included these kinds of false statements.<sup>[26]</sup> To encourage participation, the terms of the standard settlements were more lenient than those that would have been imposed in a litigated action, and included only negligence-based charges, with reduced civil penalties for underwriters and no civil penalties for issuers.

The initiative prompted a large number of underwriters and issuers to conduct self-reviews and to self-report potential misconduct. In our review of the submissions, the Enforcement Division found widespread failures of due diligence by underwriters. While not every self-report resulted in an enforcement action, the Commission charged 72 broker-dealers, representing about 96% of the market for municipal underwriting.<sup>[27]</sup> And, this past August, the Commission charged 71 municipal issuers for making false statements or misleading omissions in their bond offering documents.<sup>[28]</sup> The issuer-respondents included a broad range of issuers and obligated persons from 45 states, including small issuers (such as towns, school districts and charter schools), larger issuers (such as states and large state-level agencies such as transportation departments and housing agencies), and a diverse set of obligated persons (including hospitals, universities, and an assisted living community). This initiative exposed widespread misconduct and has had a significant impact on the market, which I will discuss later in my remarks.

### *Penalties Against Municipal Issuers*

Another area where we have changed the landscape involves penalties against issuers of municipal bonds. Although the Commission historically has not sought penalties against municipal issuers, that has changed in recent years.

### *Controlling Person Liability And Conduct-Based Injunctions Against Public Officials*

Another area where Enforcement has increased its focus is on municipal issuer officials. Today we are increasingly holding those people accountable where they engage in violations, and where necessary, we are using new approaches and remedies to do so.

For example, controlling person liability under Section 20(a) of the Exchange Act can be used to hold public officials responsible based on their control of the municipal entity that engaged in the fraud. While the Commission has used controlling person liability for many years in the corporate context, it was used for the first time in the municipal securities context against the former mayor of the City of Allen Park, Michigan.<sup>[45]</sup>

## Coordination with Criminal Authorities

Finally, another area where Enforcement has increased its focus is in our parallel coordination with criminal authorities on public finance matters. A recent case involving the Town of Ramapo, N.Y. is a good example.

## Impact on Market and Market Participants

To close today, I want to talk a little about the impact that the Commission's actions in the public finance space have had on the market. Like private equity, where I recently discussed the impact of Enforcement actions on the market,<sup>[55]</sup> I believe that Enforcement efforts in the public finance space have changed behavior in some important respects. For example, there are many indications that issuers are increasing their compliance with continuing disclosure obligations. In the months following the announcement of the MCDC initiative in 2014, issuer submissions to the MSRB's Electronic Municipal Market Access (EMMA) system increased dramatically.<sup>[56]</sup> I believe that this was due to issuers making filings in order to correct delinquencies that they identified as a result of MCDC. The increase in continuing disclosure filings in EMMA continued into 2015, with the total filings in EMMA significantly exceeding the pre-MCDC levels.<sup>[57]</sup>

More generally, the Commission's focus on abuses in the public finance area has raised awareness among market participants about their obligations under the securities laws. In response to the MCDC Initiative and other enforcement actions, the Enforcement Division is hearing from all corners that there is a renewed focus on disclosure by issuers, underwriters and public finance lawyers.<sup>[58]</sup>

I am pleased that the industry has taken notice. In fact, one municipal securities industry commentator recently observed of the last 3½ years that "[t]here is a definite change in tone."<sup>[59]</sup> I am here to say that this change in the tone of Enforcement is here to stay. You can expect continued activity in this area to protect investors.

[2] See Securities and Exchange Commission, Report on the Municipal Securities Market (July 31, 2012), available at <https://www.sec.gov/news/studies/2012/munireport073112.pdf>; Financial Industry Regulatory Authority (FINRA), Trade Reporting And Compliance Engine (TRACE) data (Sep. 2016).

[3] *Id.*

[4] See EMMA Market Statistics, Municipal Securities Rulemaking Board, available at <http://emma.msrb.org/MarketActivity/ViewStatistics.aspx>.

[5] Federal Reserve Board, "Financial Accounts of the United States" Table L.212 (Second Quarter 2016), available at <http://www.federalreserve.gov/releases/z1/Current/z1.pdf>.

[6] <http://www.msrb.org/msrb1/pdfs/MSRB-brochure-2014.pdf>.

[7] Lawrence E. Harris & Michael S. Piowar, *Secondary Trading Costs in the Municipal Bond Market*, 61 J. Fin. 1361, 1393 (June 2006).

[8] Commissioner Elisse B. Walter, U.S. Secs. & Exch. Comm'n, *Regulation of the Municipal Securities Market: Investors are Not Second Class Citizens* (Oct. 28, 2009), available at <https://www.sec.gov/news/speech/2009/spch102809ebw.htm> (citing Chairman Christopher Cox, *Integrity in the Municipal Market* (July 18, 2007), available at <https://www.sec.gov/news/speech/2007/spch071807cc.htm>).

[9] Chair Mary Jo White, U.S. Secs. & Exch. Comm'n, *Statement at Opening Meeting – Municipal Advisors and Pay Ratio Disclosure* (Sept. 18, 2013), available at <https://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370542566073>.

[10] U.S. Census Bureau, *Annual Survey of Public Pensions: State- and Locally- Adminstrated Defined Benefit Data Summary Brief: 2015* (June 2016), available at <https://www.census.gov/content/dam/Census/library/publications/2016/econ/g15-aspp-sl.pdf>.

[11] *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 2043 at 5-6 (July 1, 2010), available at <https://www.sec.gov/rules/final/2010/ia-3043.pdf>.

[12] See, e.g., Commissioner Daniel M. Gallagher, U.S. Secs. & Exch. Comm'n, *A Watched Pot Never Boils: The Need for SEC Supervision of Fixed Income Liquidity, Market Structure and Pension Accounting* (March 10, 2015), available at <https://www.sec.gov/news/speech/031015-spch-cdmg.html>; Commissioner Luis A. Aguilar, U.S. Secs. & Exch. Comm'n, *Statement on Making the Municipal Securities Market More Transparent, Liquid and Fair*, (Feb. 13, 2015), available at <https://www.sec.gov/news/statement/making-municipal-securities-market-more-transparent-liquid-fair.html>; Commissioner Michael S. Piowar, U.S. Secs. & Exch. Comm'n, *Remarks at the 2014 Municipal Finance Conference presented by The Bond Buyer and Brandeis International Business School* (Aug. 1, 2014), available at <https://www.sec.gov/News/Speech/Detail/Speech/1370542588006>; Chair Mary Jo White, U.S. Secs. & Exch. Comm'n, *Intermediation in the Modern Securities Markets: Putting Technology and Competition to Work for Investors* (June 20, 2014), available at <https://www.sec.gov/News/Speech/Detail/Speech/1370542122012>; Chairman Mary L. Schapiro, U.S. Secs. & Exch. Comm'n, *Remarks at Investment Company Institute 2010 General Membership Meeting* (May 10, 2010), available at <https://www.sec.gov/news/speech/2010/spch050710mls.htm>; Arthur Levitt Jr., *Muni Bonds Need Better Oversight*, (May 9, 2009), available at <http://www.wsj.com/articles/SB12182780923802551>.

[13] Litigation Release No. 14792, *SEC Initiates Actions in Orange County Investigation* (Jan. 24, 1996), available at <https://www.sec.gov/litigation/litreleases/lr14792.txt>.

[14] Press Release 2000-45, *SEC Settles with Ten Brokerage Firms as Part of Global Resolution of Yield Burning Claims* (Apr. 6, 2000), available at <https://www.sec.gov/news/press/2000-45.txt>.

[15] Press Release 2006-191, *SEC Sanctions the City of San Diego for Fraudulent Municipal Bond Offerings and Orders the City to Retain an Independent Consultant* (Nov. 14, 2006), available at <https://www.sec.gov/news/press/2006/2006-191.htm>.

[16] Press Release 2009-232, *J.P. Morgan Settles SEC Charges in Jefferson County, Ala. Illegal Payments Scheme* (Nov. 4, 2009), available at <https://www.sec.gov/news/press/2009/2009-232.htm>; Press Release 2008-69, *SEC Charges Birmingham Mayor and Friends for Undisclosed Payment Scheme in Municipal Bond Deals* (April 30, 2008) available at <https://www.sec.gov/news/press/2008/2008-69.htm>.

[17] Press Release 2010-5, *SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence* (Jan. 13, 2010), available at <https://www.sec.gov/news/press/2010/2010-5.htm>.

- [18] An “obligated person” generally means any person or entity that is committed by contract or other arrangement to support payment of all or part of the obligations on the municipal securities being offered. See 17 C.F.R. § 240.15c2-12(f)(10).
- [24] Press Release 2014-156 *SEC Enforcement Division Modifies Municipal Disclosure Initiative* (July 31, 2014), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542578459>; Statement by Division of Enforcement, *Municipalities Continuing Disclosure Cooperation Initiative* (Mar. 10, 2014), available at <https://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml>.
- [25] Alma M. Angotti, Mark B. Lewis, & William R. McLucas, *Common Sense, Flexibility and Enforcement of the Federal Securities Laws*, 51 Bus. Law. 1221, 1224-1226 (Aug. 1996) (describing “voluntary disclosure program” announced in 1975 in which public companies that might have made undisclosed foreign payments were invited to conduct their own internal investigations and report the results to the SEC).
- [26] Press Release 2014-46, *SEC Launches Enforcement Cooperation Initiative for Municipal Issuers and Underwriters* (Mar. 10, 2014), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541090828>.
- [27] Press Release 2016-18, *SEC Completes Muni-Underwriter Enforcement Sweep* (Feb. 2, 2016) available at <https://www.sec.gov/news/pressrelease/2016-18.html>; Press Release 2015-220, *SEC Sanctions 22 Underwriting Firms for Fraudulent Municipal Bond Offerings* (Sept. 30, 2015), available at <https://www.sec.gov/news/pressrelease/2015-220.html>; Press Release 2015-125, *SEC Charges 36 Firms for Fraudulent Municipal Bond Offerings* (June 18, 2015), available at <https://www.sec.gov/news/pressrelease/2015-125.html>.
- [28] Press Release 2016-166, *SEC Charges 71 Municipal Bond Issuers in Muni Bond Disclosure Initiative* (Aug. 24, 2016), available at <https://www.sec.gov/news/pressrelease/2016-166.html>.
- [45] Press Release 2014-249, *SEC Charges Allen Park, Mich. And Two Former City Leaders in Fraudulent Muni Bond Offering for Movie Studio Project* (Nov. 6, 2014), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543373355>.
- [55] Andrew J. Ceresney, Director, Div. of Enforcement, U.S. Secs. & Exch. Comm’n, *Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement* (May 12, 2016), available at <https://www.sec.gov/news/speech/private-equity-enforcement.html>.
- [56] See, e.g., MSRB: *Financial Disclosures Way Up, Bank Loans Not so Much*, The Bond Buyer (Mar. 4, 2015), available at <http://www.bondbuyer.com/news/washington-securities-law/msrb-financial-disclosures-way-up-bank-loans-not-so-much-1071038-1.html>; *MCDC Spurs More Notices of Disclosure Failures*, The Bond Buyer (June 2, 2014), available at [http://www.bondbuyer.com/issues/123\\_104/mcdc-spurs-more-notices-of-disclosure-failures-1062944-1.html](http://www.bondbuyer.com/issues/123_104/mcdc-spurs-more-notices-of-disclosure-failures-1062944-1.html).
- [57] See *2015 Fact Book*, Municipal Securities Rulemaking Board, at 66, available at <http://www.msrb.org/msrb1/pdfs/msrb-fact-book-2015.pdf>.
- [58] See, e.g., Jack Casey, *How MCDC Has Changed Continuing Disclosure Practices*, The Bond Buyer (Sep. 21, 2016), available at <http://www.bondbuyer.com/news/washington-enforcement/how-has-mcdc-changed-continuing-disclosure-practices-1114036-1.html>; Jack Casey, *MCDC Has Improved Disclosure but Issues Remain*, The Bond Buyer (Apr. 22, 2016), available at <http://www.bondbuyer.com/news/washington-securities-law/mcdc-has-improved-disclosure-but-issues-remain-1101990-1.html>; *MCDC Credited with Boosting Muni Disclosure*, The Bond Buyer (Feb. 3, 2016) found at <http://www.bondbuyer.com/news/washington-securities-law/mcdc-credited-with-boosting-muni-disclosure-1095588-1.html>.
- [59] Robert Doty, *Expanding Municipal Securities Enforcement: Profound Changes for Issuers and Officials*, The Bond Buyer (July 12, 2016), available at <http://www.bondbuyer.com/news/commentary/expanding-municipal-securities-enforcement-profound-changes-for-issuers-1108290-1.html>.

Commissioner Luis A. Aguilar’s public statement “Statement on Making the Municipal Securities Market More Transparent, Liquid and Fair” was published on February 13, 2015. Excerpts of his public statement follow:

### *Introduction*

It is difficult to overstate the importance of the municipal securities market. There is perhaps no other market that so profoundly influences the quality of our daily lives. Municipal securities provide financing to build and maintain schools, hospitals, and utilities, as well as the roads and other basic infrastructure that enable our economy to flourish. Municipal bonds’ tax-free status also makes them an important investment vehicle for individual investors, particularly retirees.<sup>[1]</sup> Ensuring the existence of a vibrant and efficient municipal bond market is essential, particularly at a time when state and local government budgets remain stretched.

Unfortunately, despite its size and importance, the municipal securities market has been subjected to a far lesser degree of regulation and transparency than other segments of the U.S. capital markets.<sup>[2]</sup> In fact, investors in municipal securities are afforded “second-class treatment” under current law in many ways. This has allowed market participants to cling to outdated notions about how the municipal securities market should operate. The result is a market that, in the view of many, is excessively opaque, illiquid, and decentralized.

### *Disclosures by Issuers of Municipal Securities*

The municipal securities market is characterized by stark disparities in the availability of timely, accurate, and complete financial information about issuers. There are several reasons for this, but one principal driver is that municipal securities are exempted from the Securities Act’s registration requirements, as well as from the Exchange Act’s periodic reporting regime.<sup>[39]</sup> The Commission, thus, cannot establish mandatory disclosure requirements for municipal offerings, or require them to follow a uniform accounting standard. The Tower Amendment, named after the late Senator John Tower of Texas, also plays a critical role in denying investors accurate and timely disclosures, by limiting federal regulatory authority over issuers of municipal securities. Specifically, the Tower Amendment prohibits the Commission and the MSRB from requiring municipal securities issuers to

submit information to them prior to the sale of securities.<sup>[40]</sup> The Tower Amendment further prohibits the MSRB from requiring any municipal issuer to furnish it, or any purchasers or prospective purchasers, with any information either before or after the sale of securities.<sup>[41]</sup> Instead, the Commission indirectly regulates municipal securities offerings through its Rule 15c2-12,<sup>[42]</sup> which requires underwriters of municipal securities offerings to obtain issuers' disclosures for the securities they intend to sell and provide them to purchasers.

In addition, varying approaches to disclosure have developed over the years. This stems from a combination of a diverse mix of municipal issuers, and the absence of uniform regulatory oversight of disclosures.<sup>[43]</sup> By one estimate, there are more than 78,000 potential issuers of municipal securities, which range from small school districts and water authorities to states.<sup>[44]</sup> Disclosure practices have also evolved in such a way that they vary across different types of municipal bonds, such as general obligation bonds, revenue bonds, and conduit bonds. Disclosure practices also vary across the different subgroups within these broader categories of municipal securities.<sup>[45]</sup> The absence of uniform disclosure protocols vastly complicates investors' efforts to assess the risks they face when purchasing these securities.

Investors and other market participants have long criticized the quality, consistency, and timeliness of the disclosures provided by municipal issuers.<sup>[46]</sup> With respect to the initial disclosures that are made when bonds are first issued, there are concerns over the absence of detailed information about issuers' outstanding debt, such as liens and collateral pledges.<sup>[47]</sup> There is also widespread concern that issuers are not disclosing bank loans, which issuers have been pursuing in greater numbers in recent years.<sup>[48]</sup> Municipal issuers also have a contractual obligation to provide continuing disclosure for the vast majority of the securities they issue.<sup>[49]</sup> But here, too, there are pervasive problems. Industry participants have long complained that many issuers struggle to meet their obligation to provide complete and timely disclosures to the secondary market.<sup>[50]</sup>

Industry efforts to improve the quality and consistency of disclosures have yielded improvements in recent years,<sup>[51]</sup> and the availability of disclosures has advanced considerably since 2009, when the MSRB's EMMA system began serving as a central repository for municipal issuers' disclosures.<sup>[52]</sup> Nevertheless, serious problems still remain. This is evidenced not only by criticisms levied by industry participants,<sup>[53]</sup> but also by the numerous enforcement actions the Commission has brought in recent years against municipal issuers for failing to make disclosures, or for making misleading disclosures that ran afoul of the antifraud provisions of the federal securities laws. These actions have not been limited to smaller issuers, but have included state governments that are frequent participants in the municipal securities markets, as well.<sup>[54]</sup> Additionally, pervasive shortcomings in issuers' and underwriters' compliance with their obligation to provide continuing disclosures led the Division of Enforcement to launch the Municipalities Continuing Disclosure Cooperation Initiative ("MCDC") in March of last year.<sup>[55]</sup> The MCDC seeks to encourage issuers and underwriters to police themselves by self-reporting materially inaccurate statements in continuing disclosures regarding an issuer's prior compliance with its continuing disclosure obligations. Members of the industry have informed my office that the MCDC initiative has instilled "shock and awe" in issuers and underwriters alike. This is deeply troubling, as it signals not only a widespread failure to satisfy the Commission's limited disclosure requirements, but also an entrenched culture of non-compliance.

#### 1. Repeal of the Tower Amendment and the Exemption for Municipal Securities from the Registration and Disclosure Provisions of the Securities Act and the Exchange Act

Repealing the Tower Amendment would allow the Commission and the MSRB to require issuers of municipal securities to file disclosure materials for review before offering securities to investors. But even without the Tower Amendment, the Commission and the MSRB would still lack the authority to determine what information municipal issuers need to disclose, and when they need to disclose

it.<sup>[94]</sup> Along with the Tower Amendment's repeal, therefore, Congress should repeal municipal securities' exemption from the Securities Act's registration provisions, and from the Exchange Act's ongoing reporting requirements, as well. Alternatively, Congress could leave these exemptions in place, but give the Commission broad authority to establish improved disclosure practices in the municipal securities market.

[1] Conrad de Aenlle, *Should You Invest in Municipal Bonds?*, AARP (Apr. 18, 2012), available at <http://www.aarp.org/money/budgeting-saving/info-04-2012/investing-in-municipal-bonds.html>.

[2] U.S. Securities and Exchange Commission, *Report on the Municipal Securities Market*, ii (July 31, 2012), available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf>.

[39] See *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*, SEC Release No. 33-7049 (Mar. 9, 1994) ("1994 Interpretive Guidance"), available at <http://www.sec.gov/rules/interp/1994/33-7049.pdf>.

[40] 15 U.S.C. § 78o-4(d)(1) ("Neither the Commission nor the Board is authorized under this chapter, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities."). According to a 1975 Senate report, congressional reasons for the decision to continue to limit direct regulation of issuers when the 1975 amendments to the securities acts were enacted included respect for the rights of state governments to access the capital markets, concerns about the costs of regulation for state and local government issuers, and the perceived lack of abuses in the municipal market that would justify such an incursion on the states' prerogatives. See S. Rep. No. 94-75 (1975).

[41] 15 U.S.C. § 78o-4(d)(2) ("The Board is not authorized under this chapter to require any issuer of municipal securities, directly or indirectly through a municipal securities broker, municipal securities dealer, municipal advisor, or otherwise, to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer. . . .").

[42] 17 CFR 240.15c2-12.

[43] Andrew Ang and Richard C. Green, *Lowering Borrowing Costs for States and Municipalities Through CommonMuni*, The Hamilton Project Discussion Paper 2011-01, 8 (Feb. 2011), available at [http://www.brookings.edu/~media/Research/Files/Papers/2011/2/municipal%20bond%20ang%20green/02\\_municipal\\_bond\\_ang\\_green\\_paper.PDF](http://www.brookings.edu/~media/Research/Files/Papers/2011/2/municipal%20bond%20ang%20green/02_municipal_bond_ang_green_paper.PDF).

[44] BlackRock, *The Benefits of Scale in Municipal Bond Execution*, available at [https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=FP\\_GENERIC&serviceName=FPServiceView&ContentID=1111124889](https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=FP_GENERIC&serviceName=FPServiceView&ContentID=1111124889).

[45] U.S. Securities Exchange Commission, *Report on the Municipal Securities Market*, 56 (July 31, 2012), available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf>.

[46] Kyle Glazier, *NFMA to Increase Efforts to Improve Disclosure*, *New Chair Says*, The Bond Buyer (Feb. 9, 2015) (noting that "[t]he issue of municipal bond disclosure [is] a drum [the National Federation of Municipal Analysts] has been beating for all of its more than 30 year history . . . ."), available at <http://www.bondbuyer.com/news/washington-securities-law/nfma-to-increase-efforts-to-improve-disclosure-new-chair-says-1070282-1.html>;

Statement of Gerald McBride, Chairman, Municipal Securities Division, Public Securities Association, Before the House Committee on Energy and Commerce, Telecommunications and Finance Subcommittee, 5 (October 7, 1993) (testifying that "secondary market information is difficult to come by even for professional municipal credit analysts, to say nothing of retail investors."); *Municipal Securities Disclosure*, SEC Release No. 34961 (Nov. 10, 1994) (S7-5-94) ("Information about the issuer and other obligated persons is as critical to the secondary [municipal securities] market, where little information about municipal issuers and obligated persons is regularly disseminated."), available at <http://www.sec.gov/rules/final/adpt6.txt>; U.S. Securities Exchange Commission, *Report on the Municipal Securities Market*, 65 (July 31, 2012), available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf>; Andrew Ang and Richard C. Green, *Lowering Borrowing Costs for States and Municipalities Through CommonMuni*, 10 (Feb. 2011), available at [http://www.brookings.edu/~media/Research/Files/Papers/2011/2/municipal%20bond%20ang%20green/02\\_municipal\\_bond\\_ang\\_green\\_paper.PDF](http://www.brookings.edu/~media/Research/Files/Papers/2011/2/municipal%20bond%20ang%20green/02_municipal_bond_ang_green_paper.PDF).

[47] U.S. Securities Exchange Commission, *Report on the Municipal Securities Market*, 65 (July 31, 2012), available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf>.

[48] Liz Farmer, *Are Muni Bonds Being Replaced by Direct Loans?*, *Governing* (Nov. 26, 2014), available at <http://www.governing.com/topics/finance/gov-muni-bonds-replaced-direct-bank-loans.html>.

[49] Municipal Securities Regulatory Board, *Municipal Securities Disclosure Report*, 1 (Sept. 2014), available at <http://www.msrb.org/msrb1/pdfs/MSRB-Continuing-Disclosure-Report-September-2014.pdf>.

[50] Statement of Gerald McBride, Chairman, Municipal Securities Division, Public Securities Association, Before the House Committee on Energy and Commerce, Telecommunications and Finance Subcommittee, 5 (October 7, 1993) (testifying that "secondary market information is difficult to come by even for professional municipal credit analysts, to say nothing of retail investors."); *Municipal Securities Disclosure*, SEC Release No. 34961 (Nov. 10, 1994) (S7-5-94) ("Information about the issuer and other obligated persons is as critical to the secondary [municipal securities] market, where little information about municipal issuers and obligated persons is regularly disseminated."), available at <http://www.sec.gov/rules/final/adpt6.txt>; U.S. Securities Exchange Commission, *Report on the Municipal Securities Market*, 67 (July 31, 2012), available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf>.

[51] U.S. Securities Exchange Commission, *Report on the Municipal Securities Market*, 19 (July 31, 2012), available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf>.

[52] See *Municipal Securities Disclosure*, SEC Release No. 34961 (Nov 10, 1994), available at <http://www.sec.gov/rules/final/adpt6.txt>.

[53] For example, the National Federation of Municipal Analysts issued a white paper in June 2014 arguing that disclosure practices for initial offerings of municipal securities need to be improved in a variety of ways. See National Federation of Municipal Analysts, *White Paper on Best Municipal Bond Issuance Practices* (June 2014), available at <http://www.nfma.org/assets/documents/position.stmt/wp.newissue.final.pdf>.

[54] See, e.g., *In the Matter of the State of Kansas*, Securities Act Release No. 9626 (Aug. 11, 2014), available at <http://www.sec.gov/litigation/admin/2014/33-9629.pdf>; *In the Matter of the State of Illinois*, Securities Act Release No. 9389 (Mar. 11, 2013), available at <http://www.sec.gov/litigation/admin/2013/33-9389.pdf>; *In the Matter of the State of New Jersey*, Securities Act Release No. 9135 (Aug. 18, 2010), available at <https://www.sec.gov/litigation/admin/2010/33-9135.pdf>.

[55] SEC Website, *Municipalities Continuing Disclosure Cooperation Initiative* (Nov. 13, 2014) ("Based on available information, and as highlighted in the Commission's August 2012 Municipal Market Report, there is significant concern that many issuers have not been complying with their obligation to file continuing disclosure documents and that federal securities law violations involving false statements concerning such compliance may be widespread."), available at <http://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml>.

[94] GAO Report to Congressional Committees, *Municipal Securities: Options for Improving Continuing Disclosure*, 23 (July 2012) (noting that, while MSRB and SEC staff said that repealing the Tower Amendment would remove the prohibitions on requiring issuers to file certain materials with the Commission and the MSRB, the staff further opined that the Tower Amendment's repeal would have no real effect on what they can require issuers to disclose, because municipal issuers are exempt from SEC registration and MSRB does not otherwise have affirmative authority to regulate municipal issuers), available at <http://www.gao.gov/assets/600/592669.pdf>.

Commissioner Elisse B. Walter gave a speech before the 43<sup>rd</sup> Annual Securities Regulation Seminar in Los Angeles on October 29, 2010. Excerpts of her remarks appear below.

*Independent Funding for GASB (Section 978)*

The Governmental Accounting Standards Board (“GASB”), a not-for-profit organization that operates under the oversight of the Financial Accounting Foundation, has been funded only by voluntary payments and contributions from states and local governments and the municipal bond community, as well as sales of its own publications. Last fall, in a speech about municipal securities, I took the position that Congress should instead provide for an independent and more reliable funding mechanism for GASB as well as Commission oversight — an approach analogous to the one in place for the Financial Accounting Standards Board.<sup>4</sup>

I was thus very pleased to see in Dodd-Frank a provision granting the Commission authority to require a national securities association — in other words, the Financial Industry Regulatory Authority — to establish a reasonable annual accounting support fee to fund GASB’s annual budget and to establish rules and procedures for the equitable allocation, assessment, and collection of the accounting support fee. Although the Act ultimately did not provide for Commission oversight of GASB, the first step of independent funding is crucial. It should help to ensure GASB’s independence as a standard setter that is able to develop high-quality governmental accounting standards without undue pressure.

The Act also requires the Government Accountability Office (“GAO”) to conduct a study regarding GASB, pursuant to Section 978, which is due to Congress by January. Commission staff is consulting with the GAO on this and other studies required by the Act.

*New Office of Municipal Securities*

Another relevant provision of the Act obligates the SEC to establish an Office of Municipal Securities, whose director reports directly to the Chairman. The new office will administer the rules pertaining to broker-dealers, advisors, investors, and issuers of municipal securities and coordinate with the MSRB on rulemaking and enforcement actions. We anticipate creating this office imminently and transferring over existing staff who perform these duties — and, the search for a new director is in full swing. I believe that the office will be in an excellent position to harness staff and resources from across the Commission who are involved in the municipal securities market from a variety of vantage points.

I am delighted with the establishment of this new office — it resonates with my belief in the critical importance of the municipal securities market.

The conduit issue is important, but it involves only a portion of the municipal marketplace. The biggest limitation on our ability to regulate and oversee this market stems from the fact that Congress — back in 1933 and 1934 — exempted offerings of municipal securities from the registration requirements and civil liability provisions of the Securities Act of 1933 (“‘33 Act”) and the system of periodic reporting under the Securities Exchange Act of 1934 (“‘34 Act”). Thus, the Commission is constrained in requiring municipal issuers to comply with mandatory disclosure requirements or — as I stated a moment ago — to apply GASB principles.

I have suggested in the past that Congress should repeal the exemptions for municipal securities from the ‘33 and ‘34 Acts. Given the wide range of purposes and structures of the over 50,000 municipal issuers, however, I would certainly not propose to treat municipal securities exactly like corporate securities — and I do not believe that a one-size-fits-all approach would be appropriate. Nonetheless, appropriate legislative change would allow the Commission to take important steps to improve the quality and availability of municipal issuer information to investors.



### *Rule 15c2-12*

For example, and importantly, the Commission has worked to protect investors in municipal securities for the past 21 years by exerting its authority over entities that underwrite or sell municipal securities. In 1981, the Commission adopted Rule 15c2-12, under the Exchange Act, as a means to foster transparency in the municipal securities market. The rule, as it has been amended over the years, generally prohibits underwriters from purchasing or selling municipal securities unless they have reasonably determined that the municipality or other designated entity has agreed to make certain key information available to investors on an ongoing basis.

Despite the disclosure obligations in the rule, until recently, average investors in municipal securities had no free and convenient way to get important information about the municipal bonds in which they invest. In 2008, the Commission adopted amendments to Rule 15c2-12 that made the MSRB the central repository for ongoing disclosures by municipal issuers. It also approved a separate MSRB rule change, which enabled the MSRB's Electronic Municipal Market Access system — EMMA — to make these disclosures available to investors similar to the way that the SEC's EDGAR system does for corporate disclosures.

This past May, the Commission further strengthened Rule 15c2-12, by imposing additional requirements with respect to the disclosure of specified events. The amendments strengthen the rule's requirements with respect to the scope of securities covered, the nature of the events that issuers must have agreed to disclose, and the time period in which disclosure is to be made.

### *Anti-Fraud and Enforcement*

In addition to our authority over intermediaries — we have broad antifraud authority over all participants in the municipal securities market. The Commission has acted under the anti-fraud provisions to bring enforcement actions against people and entities, including issuers of municipal securities. In 1994, along with its changes to Rule 15c2-12, the Commission issued an interpretive release to provide guidance to the market participants concerning the types of municipal market questions that may raise issues under the antifraud provisions.

To strengthen and streamline our enforcement efforts in this area, the Commission recently created a Municipal Securities and Public Pensions Unit as one of five national specialized units organized in the Enforcement Division. Under the leadership of Elaine Greenberg and Mark Zehner of our Philadelphia Office, this unit is expanding our enforcement presence in the municipal area, building a comprehensive program that will develop case law and legal precedent through high-impact cases. It is also proactively seeking to identify market activities that pose the greatest risk of harm to investors and are indicative of potential violations.

The unit currently is focusing its efforts on investigating and pursuing enforcement actions in specific categories of misconduct, including: (1) offering and disclosure fraud; (2) tax or arbitrage-driven fraud; (3) pay-to-play and public corruption violations; (4) public pension accounting and disclosure violations; and (5) valuation and pricing fraud.

<sup>4</sup> See Commissioner Elisse B. Walter, Regulation of the Municipal Securities Market: Investors Are Not Second-Class Citizens, 10th Annual A. A. Sommer, Jr. Corporate, Securities and Financial Law Lecture, New York, NY (October 28, 2009) available at <http://www.sec.gov/news/speech/2009/spch102809ebw.htm> ("Sommer Lecture").

## **G. Reality: Pervasive Fraud While the SEC Rearranges Deck Chairs on the Titanic**

The unfortunate truth is that every states' financial statements are fraudulent as a matter of law and many city and local governments' financial statements are fraudulent as a matter of law.

The SEC is charged with enforcing the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 in the municipal securities market. Generally, these prohibit fraudulent or deceptive practices by issuers including making any untrue statement of a material fact or omitting to state a material fact necessary in order to make statements made not misleading.

The U.S. Supreme Court in *TSC Industries v. Northway* held that a fact is material if there is a substantial likelihood that a reasonable shareholder could consider it important in deciding how to vote. Based on the \$27.3 trillion obligation reported in the 2015 Financial Report of the U.S. Government for the federal government's portion of Medicaid's costs, the fifty states have an aggregate net present value obligation for their portion of the Medicaid program of approximately \$17 trillion. The states' obligation is over four times the size of the entire municipal securities market and it is clearly material under the Supreme Court's definition. At Congress' suggestion in the Dodd-Frank Wall Street Reform and Consumer Protection Act's section 978 the SEC is providing funding for the Governmental Accounting Standards Board (GASB). It promulgated Statement No. 33 – Accounting and Financial Reporting for Nonexchange Transactions in 1998 which requires each state for periods beginning after June 15, 2000 to not recognize any costs or liability other than current year cash outlays or provide any additional disclosures for their Medicaid program. This accounting pronouncement requires accounting for the Medicaid program that violates the antifraud provisions as a matter of law.

By way of contrast, in recent years Congress has been focused on the issue of the states' accounting for pension obligations and in 2011 "Public Employee Pension Transparency Act" legislation was introduced in Congress. This legislation would have required states to more clearly reflect their pension finances and it provided an express ban on bailouts by the federal government. It was apparent that the members of Congress proposing this legislation did not want state pension fund obligations ending up on its doorstep. Not surprisingly, about the same time the SEC formed a specialized group to focus on public pension accounting and disclosure violations. The end result of its efforts was that the SEC found the states of New Jersey, Illinois and Kansas violated the antifraud provisions by publishing fraudulent financial statements in connection with multiple bond offerings.

Notwithstanding the SEC's success in prosecuting fraudulent disclosure of pension obligations it has taken no action with respect to states' fraudulent financial reporting for their portion of the Medicaid program. Why? One can speculate that pulling on that thread would end up exposing Congress' fraudulent financial reporting for Medicare, Social Security and Medicaid at the federal level. In addition, it would expose the integral role that the accounting profession has played in the federal and state frauds. Neither of these outcomes are things that Congress wants to become public.

State, city and local governments use of off-balance sheet vehicles to obfuscate spending as well as the size of their legal obligations rival Enron's fraudulent accounting.

## **H. Stop Sweeping the Problems Under the Rug**

Given the facts the SEC should either pursue the strategy proposed herein or publicly state that it has not fulfilled and cannot fulfill its stated mission of protecting investors in the municipal securities market and that it is aware that states are publishing financial statements that are, in its opinion, fraudulent as a matter of law due to their accounting for the Medicaid program. If a publicly traded company had been publishing fraudulent financial statements the SEC would require a publicly traded company to disclose that it was under investigation, withdraw its prior fraudulent financial statements and disclose what steps it is taking to publish correct financial statements assuming the company was still a going concern.

The leadership's bravado about its accomplishments as well as its failure to use the bully pulpit to warn investors of the fraudulent disclosure by municipal issuers do a great disservice to investors as well as to the SEC's stated mission for the municipal securities market. The average investor is unaware of the serious and legitimate concerns about fraudulent disclosures.

### **I. Why has this Happened?**

Simply put, Congress does not want issuers in the municipal securities market held to any accounting standard that politicians do not effectively control. Their worst nightmare is that issuers would have to meet a clearly defined set of accounting principles and standards that did not provide substantial wiggle room for normal political shenanigans. Most importantly, Congress does not want to force issuers to tell citizens/voters exactly how much they have been spending. They prefer the current arrangements whereby financial statements substantially understate spending. The Tower Amendment makes Congress' position crystal clear. Congress does not want honest accounting in the municipal market now or anytime soon. It is unlikely that an appetite exists today in Congress for any changes with the new Trump Administration.

Congress did not give SEC control over accounting standards in 1933 or since despite the SEC asking for such authority repeatedly. Is this likely to change? No! A former Lt. Gov. of New York Richard Ravitch acknowledged a few years ago that requiring more disclosures ahead of sales "would be unpopular for mayors and governors and the municipal bond industry but that investors would appreciate the change. In addition, he indicated that he was unaware of any interest in Congress to revisit the Tower amendment. In October 2014 the National Association of State Treasurers readopted a resolution that opposes repealing or modifying the Tower amendment.

Finally, Congress has limited funding for the SEC so that they have minimal resources to go after the municipal securities market for antifraud violations. Does anyone think that this fact is lost on any Commissioner? The soon to be former Commissioner Mary Jo White has been the most aggressive Chair in the history of the SEC in going after abuses in the municipal securities market. To extend her reach she and her Director of Enforcement dreamed up the Municipalities Continuing Disclosure Cooperation Initiative ("MCDC"). One of the likely reasons they decided on this approach was lack of resources. Given the SEC's limited resources it would be best served in putting these resources against the two most important issues in the municipal market: accounting for Medicaid and the use of off-balance sheet vehicles to disguise spending and the size of legal obligations.

## J. SEC Has Helped Create a Corrupt Environment

We will start with the most fundamental issue. The financial statements produced for investors by each state serve double duty as disclosure to citizens/voters/taxpayers in each state with respect to political accountability for their politicians spending. As noted above, the SEC is well aware of the dual role played by issuers' financial statements. Therefore, there is no denying that Commissioners know that financial statements are a critical scorecard in our democracy.

The previous chapter set forth detailed reasons why the state GAAP-setting process is unconstitutional. Here we will make clear how the SEC is well aware of the circumstances. The following quotes are taken from the "State of the Municipal Securities Market" excerpts mentioned previously in this chapter.

*"There are no uniformly applied accounting standards in the municipal securities market, and the Commission generally lacks authority to prescribe the accounting standards that municipal issuers must use. However, the GASB establishes generally accepted accounting principles ("GAAP"), which are used by many states and local governments of widely varying size and complexity...."*

*"Although there has been no comprehensive study to determine the exact number of municipalities that prepare financial statements on a basis other than GASB standards, generally speaking, larger governments are more likely to adhere to GASB standards than smaller governments. A 2011 study undertaken by GASB, for instance, found that the vast majority of annual financial reports ("AFRs") of 350 larger governments surveyed (991 AFRs out of 1,050 AFRs, or 94%, of the large government AFRs surveyed) were prepared using GASB standards. In contrast, of the 193 smaller governments surveyed by GASB, 81% of the AFRs collected were prepared using GASB standards."*

*As of December 2010, 38 states compel some or all of their political subdivisions, including counties, cities, and school districts, to prepare their financial reports in accordance with GASB standards. Along with these mandates, certification programs, such as those sponsored by the GFOA and the Association of School Business Officials International, promote the use of GASB standards by recognizing governments that prepare high-quality GAAP financial reports (based on GASB standards). Nonetheless, the absence of a uniform requirement on the part of municipal entities to adhere to GASB standards means that municipal entities that issue municipal securities can (and some do) prepare their financial reports on a basis other than GASB standards. On rare occasion, some governments that otherwise are compliant with GASB standards may not be permitted to, or may choose not to, apply certain GASB standards."*

*"Municipal issuers generally base their disclosure policies, procedures, and controls on state law requirements, other governmental mandates or their own customs and practices. However, issuers may also look to Commission enforcement actions or other Commission guidance."*

At this juncture it is important to repeat part of Justice Alito's concurring opinion in *Lebron v. National Passenger Corp.* that appeared in the prior chapter.

*“Liberty requires accountability. When citizens cannot readily identify the source of legislation or regulation that affects their lives, Government officials can wield power without owning up to the consequences. One way the Government can regulate without accountability is by passing off a Government operation as an independent private concern.”*

*“The principle that Congress cannot delegate away its vested power exists to protect liberty.”*

While it is true that Justice Alito was discussing the federal government in his opinion his statement holds equally true for each state. A state government cannot give a private entity composed of unelected officials’ lawmaking authority without substantial oversight or state review of the entity’s pronouncements. Based on a review of the governing documents for the AICPA, FAF and GASB there is none by any of the 38 states! Therefore, the current delegation of lawmaking authority over their financial statements by the 38 states is as Justice Alito described:

*“When it comes to private entities, however, there is not even a fig leaf of constitutional justification. Private entities are not vested with ‘legislative Powers.’” Art. I sec. 1. Nor are they vested with the “executive Power,” Art II, sec 1, cl 1, which belongs to the President.....By any measure, handing off regulatory power to a private entity is “legislative delegation in its most obnoxious form.” Carter v. Carter Coal Co., 298 U.S. 238, 311 (1936).”*

It is noteworthy that 12 states that have not delegated lawmaking authority to the GASB. However, this raises another point that is not mentioned by the SEC in its 2012 report. Does the SEC have authority to regulate voluntary compliance by the states with the GASB’s pronouncements? However, before addressing that issue it is important to remember that the AICPA has a mechanism in place that forces all certified public accountants that are AICPA members to comply with its Code of Professional Conduct. This effectively forces them to comply with the GASB’s pronouncements. Furthermore, while the SEC does not currently have the authority to require municipal issuers to obtain audit opinions the marketplace does. The marketplace requires audited financials for the vast majority of municipal security issuers, particularly the larger ones. This is evidenced by the SEC’s statistics cited above.

Does the SEC have authority to regulate voluntary compliance by the states with the GASB’s pronouncements? The answer is that they have the authority to do so. Quoting from the excerpts of the Report on the Municipal Securities Market above:

*“Congress did not exempt transactions in municipal securities from the coverage of the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder. The antifraud provisions of the federal securities laws prohibit any person, including municipal issuers and dealers, from making any untrue statement of material fact, or omitting any material facts necessary to make statements made, in the light of the circumstances under which they were made, not misleading, in connection with the offer, purchase, or sale of any security. Municipal issuer disclosures, such as disclosures in official statements and ongoing annual, periodic and event-related disclosure, are subject to these prohibitions.”*

So the SEC has the power to declare accounting principles and standards that have been promulgated by GASB and implemented by issuers as violating the antifraud provisions. But does the SEC have the power to go after the GASB for promulgating accounting principles and standards

that violate the antifraud provisions? This question is outside the scope of this memorandum. However, it should be noted that Andrew J. Ceresney, Director, Division of Enforcement noted in his speech “The Impact of SEC Enforcement on Public Finance” on October 13, 2016 the following:

“Finally, another area where Enforcement has increased its focus is in our parallel coordination with criminal authorities on public finance matters....In addition, as part of the Enforcement Division’s focus on pay-to-play abuses in both the municipal securities and public pension contexts, we have been increasing our parallel coordination with specialized corruption and public integrity units within the U.S. Attorneys’ Offices and with the FBI.”

However, the SEC’s involvement with the GASB has been much more pernicious than not attacking its unlawful and unconstitutional pronouncements. It actively lobbied Congress to fund the GASB. This is evidenced by several references in speeches made by Commissioners excerpted above. Moreover, the SEC succeeded in its efforts to get funding. Enforcement of unconstitutional and fraudulent accounting principles and standards through the AICPA’s rules of Professional Conduct is not “voluntary” when the SEC is funding GASB.

In addition, it must be noted that the SEC has actively responded to Congress’ prodding on the pension accounting issue, which to an independent observer, undermines its independence arguments.

In recent years government pension funding obligations have been front page news as Detroit’s bankruptcy focused the nation on the importance of this issue. The issue is huge as underfunding for state and other municipal government pension benefits may exceed \$4 trillion according to the U.S. Senate Committee on Finance 2012 publication “*State and Local Government Defined Benefit Plans: The Pension Crisis that Threatens America.*” Congress focused on this issue and introduced legislation in 2011 “*Public Pension Transparency Act*” clearly intended to put pressure on states to clean up their pension issues so that they do not end up on Congress’ doorstep. Meanwhile the SEC formed a specialized group within its Division of Enforcement to focus on public pension accounting and disclosure violations. The SEC has brought actions against three states. We will review each case.

In 2010 the SEC found that the State of New Jersey violated Section 17(a) in connection with the sale of over \$26 billion in bonds from 2001 through 2007. The State made material misrepresentations and omissions that created the fiscal illusion that its pension plans were being adequately funded and masked the fact that New Jersey was unable to contribute to the plans without raising taxes or cutting other services, or otherwise impacting the budget. As of June 30, 2009, the two largest pension funds had an unfunded actuarial accrued liability (“UAAL”) of approximately \$27 billion. The SEC found that information regarding the State’s underfunding of the pension plans and their financial health was important to investors in evaluating New Jersey’s overall financial condition and financial prospects.

In 2013 the SEC found that in connection with multiple bond offerings raising over \$2.2 billion from 2005 through 2009 the State of Illinois misled bond investors about the adequacy of the statutory plan to fund its pension obligations and the risks created by the State’s underfunding of its pension systems. As of 2011 Illinois’ Pension Systems were unfunded by \$83 billion. In April 2012, the State acknowledged that “[u]nsustainable pension costs are squeezing core programs in education, public safety, and human services in addition to, limiting [the State’s] ability to pay [its] bills.” The SEC

determined that reasonable investors would have considered information regarding the underfunding of Illinois' pensions, the risks created by that underfunding, and the financial condition of the pension plans to be important factors in the investment decision-making process. Reasonable investors would have viewed such information as significantly altering the total mix of information available regarding the State's future financial prospects.

In August, 2014 the SEC found that in connection with eight series of bond offerings in 2009 and 2010 by the Kansas Development Finance Authority ("KDFA") raising \$273 million the State and its agencies misled bond investors about the significant unfunded liability in the Kansas Public Employees Retirement System ("KPERS"). As of December 31, 2008 KPERS had an UAAL of \$8.3 billion and a 59% funded ratio. The Kansas Legislature must annually appropriate money to pay the principal and interest on the debt. Bond holders are at risk that it may not choose to appropriate funds. Issuers of municipal securities must ensure that information contained in their disclosure documents is not materially misleading. Proper disclosure allows investors to understand and evaluate the financial health of the municipality in which they invest. The SEC determined that the State's bond offering documents ("Official Statements") did not disclose the significant unfunded liability in the State's pension system.

The SEC is desperately trying to create the same setup that it has in the corporate sector in the municipal securities market. However, it has failed to date and facts suggest it will continue to fail to achieve that goal because Congress has not and likely will not give the SEC the requisite authority. One has only to review the numerous recommendations in the various speeches by SEC Commissioners and the Report on the Municipal Securities Market to know that this is true. The SEC is also employing what most would describe as a workaround strategy. Since Congress has prevented the SEC from regulating issuers disclosure documents directly the SEC and MSRB have placed disclosure requirements on underwriters of municipal securities.

What the SEC has to do is to look in the mirror and acknowledge is that HOPE IS NOT A STRATEGY to fulfill its mission of protecting investors. Once the SEC candidly and dispassionately assesses the state of affairs the SEC must come to the conclusion that it has helped create a corrupt environment through its involvement with the GASB. GASB is an unlawful, corrupt standards setter and some of its pronouncements require accounting standards that violate the antifraud provisions as a matter of law. This relationship needs to be terminated.

The current setup is ideal for politicians since they effectively control the GASB, and therefore, financial reporting. In addition, this setup is ideal for the accounting profession as it allows them to sell accounting opinions to issuers of municipal securities.

The SEC likes to talk about a culture of compliance in the corporate sector. Since the SEC's boss (Congress) has no interest in allowing the SEC to fulfill its stated mission the SEC needs to be very aggressive in finding a way to stop the corruption. Unless they aggressively try to stop corruption they are part of the problem and, arguably, part of a political cover-up.

Finally, it is important to talk about ethical behavior. Quite simply the SEC's ethical behavior has been abysmal. Let's take a look at some recent remarks by Wesley R. Bricker, Chief Accountant of the SEC. He delivered the Keynote Address "*Working Together to Advance High Quality Information in the Capital Markets*" before the 2016 AICPA Conference on Current SEC and PCAOB Developments in Washington D.C. on December 5, 2016. Selected excerpts of his remarks follow.

*“Standard-setters*

*Let me now turn to the importance of standard setters to high quality, reliable financial reporting.*

*In a fundamental sense, good financial reporting cannot occur without strong accounting standards designed by independent standard setters to produce transparent, neutral financial reporting.*

*While the Commission retains the ultimate standard-setting authority for financial reporting in the U.S. public capital markets, it has consistently looked to the private sector for leadership in establishing and enhancing high-quality accounting standards.*

*A private sector standard-setter is best positioned to promulgate accounting standards free from undue influence, whether commercial, political, national, or financial, so that investors’ continue to rightly place a high degree of confidence in not only the accounting standards but also the process by which they are developed.*

*Setting a standard must be informed by all relevant viewpoints, but the standard must ultimately provide objective, representationally faithful, and neutral information about relevant economic activities useful for investor decisions, even if those decisions change the economic activities of market participants.*

*Investors benefit from the expertise and careful judgment of the FASB in its role as the designated accounting standard-setter for U.S. GAAP, [20] as they do from the International Accounting Standards Board (IASB), whose IFRSs may be used by foreign private issuers in filings with the SEC without reconciliation to U.S. GAAP....[21]*

*I am a CPA. I am here at one of the largest conferences where we as licensed CPAs gather. As CPAs, we should challenge ourselves and each other to consistently keep ethical behaviors—objectivity, integrity, trust, and, most importantly, independence—that underpin the lasting value of our profession. Even as we work to ensure the public remains confident in the ethics, professionalism, and services of CPAs, we must also position ourselves and future generations of accountants and auditors to innovatively identify and solve the challenging and complex issues facing the evolving public interest.”*

[20] See Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Release No. 33-8221 (April 25, 2003), available at <https://www.sec.gov/rules/policy/33-8221.htm>.

[21] See Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP, Release No. 33-8818 (July 2, 2007), available at <http://www.sec.gov/rules/proposed/2007/33-8818.pdf>.

Please note that Mr. Bricker correctly does not include the GASB in his remarks because he could not say the same positive things about it that he has to say about FASB. However, the author assumes that Mr. Bricker, as Chief Accountant is responsible for advising the SEC on municipal securities. Given his comments on ethical behavior for CPAs it appears that none of the AICPA, FAF, GASB or SEC has met the standard he sets forth.

## **K. The SEC Needs to “Walk the Walk”**

In a recent Wall Street Journal editorial former SEC Chairman Arthur Levitt chastised Senator Elizabeth Warren for calling for the dismissal of the current SEC Chairman Mary Jo White for



failing to devise and enforce a rule that would require companies to disclose their political contributions. His article contained one clear truth and one incredible lie. The truthful comment was “Whenever financial regulation is determined by rank politics, the investing public suffers.” The lie was “The SEC does not operate as a pass-through entity for Congress, merely following Congressional direction. Rather, it is an independent agency...”

The bottom line is that if Arthur Levitt wants to “talk the talk” about independence for the SEC he had to be willing and future SEC Chairs have to be willing to “walk the walk.” Since he did not put fraudulent financial reporting by all states for the Medicaid program on his “Agenda” the investing public has suffered. Hopefully, the soon-to-be-appointed Chairman will do the right thing.



*By increasing the power of the President beyond what the Framers envisioned, the statute compromises the political liberty of our citizens, liberty which the separation of powers seeks to secure.*

*Justice Anthony M. Kennedy*

## **13 Perpetual Fraud Exists on Federal and State Judiciaries**

The nation needs the Supreme Court most when the other two branches of government have clearly failed to fulfill their Constitutional duties. Unless the judiciary restores the rule of law the lack of proper financial reporting ensures that our electorate remains uninformed and that the nation will go off the proverbial "financial cliff" with the concomitant severe economic disruption and civil unrest.

The federal and state government's fraudulent financial reporting has created a perpetual fraud on the state and federal judiciaries. The impact of this fraudulent reporting can be most easily seen by reviewing two Obamacare decisions: *NFIB v. Sebelius*<sup>293</sup> and *King v. Burwell*. The decisions in the two Obamacare cases also highlight another important question. Did the litigants in these cases adequately represent the interests of the sovereign or did the legislative and executive branches and/or the states direct conflict of interest in not having expenditures reported correctly bias their approach in these cases? In addition, there are cases winding its way through the federal courts including *House of Representatives v. Burwell* and others involving Fannie Mae and Freddie Mac and the Treasury Department and Obamacare. The concepts contained in this memorandum have a direct bearing on the outcome of these cases.

In order to understand the fraud on the federal and state judiciaries' one must appreciate the intricacies of the federal government's financial reporting pre- and post-enactment of the Affordable Care Act ("ACA").

### **A. Reported Financial Status of Federal Government and Social Insurance Pre-ACA**

#### **a. Overview**

This section will provide on an overview of Medicare as well as describing the federal government's and its social insurance programs' financial status pre-ACA. Please note that the federal government does not consider Medicaid a social insurance program and, unless otherwise indicated, quotes in this section are taken from the 2009 Financial Report of the United States Government ("Financial Report").

Congress passed legislation in 1965 establishing the Medicare and Medicaid programs as Title XVIII and Title XIX, respectively, of the Social Security Act. Until 1977 the Social Security Administration ("SSA") managed the Medicare program and the Social and Rehabilitation Service managed the Medicaid program. In 1977 responsibility for administering the Medicare and Medicaid programs was entrusted to the Health Care Financing Administration, renamed in 2001 the Centers for Medicare & Medicaid Services ("CMS").

Medicare was established for the medical care needs of the elderly and it was intended to complement the retirement, survivors, and disability insurance benefits under Title II of the Social Security Act. Medicare was formally designated “Health Insurance for the Aged and Disabled.” When Medicare was first implemented it covered most persons aged 65 or over. In 1973 and 2001 additional groups became eligible for benefits.

Medicare originally consisted of two parts: Hospital Insurance (“HI”), also known as Part A, and Supplementary Medical Insurance (“SMI”), which was also known as Part B. Part A helps pay for inpatient hospital, home health, skilled nursing facility, and hospice care. Part A is provided free of premiums to most eligible people. Part B helps pay for physician, outpatient hospital, home health, and other services. All eligible people pay a monthly premium for Part B coverage.

The Medicare+Choice program was established by the Balanced Budget Act (“BBA”) of 1997. It was subsequently renamed the Medicare Advantage program. This part was modified by the Medicare Prescription Drug, Improvement, and Modernization Act (“MMA”) of 2003. It expanded beneficiaries’ options for participation in private sector healthcare plans. The MMA also established Part D which helps pay for prescription drugs not otherwise covered by Parts A or B. After an initial phase-in period, it provided subsidized access to prescription drug insurance coverage on a voluntary basis, upon payment of premium, for all beneficiaries. There were premium and cost-sharing subsidies for low-income enrollees.

When Medicare began on July 1, 1966, approximately 19 million people enrolled. In 2009, almost 46 million people were enrolled in one or both of Parts A and B, and almost 11 million were participating in a Medicare Advantage plan. Total expenditures in 2009 were \$509 billion.

All financial operations for Medicare are handled through two trust funds, one for HI (Part A) and one for SMI (Parts B and D). These trust funds are credited with all receipts and expenditures for benefits and administrative costs. Congress has enacted permanent appropriations for HI (Part A) essentially equal to current earmarked tax collections plus trust fund balances. Congress has enacted permanent appropriations from general revenues for all SMI expenditures.

#### **b. 2009 Financial Report of the United States Government**

The 2009 Financial Report was published early in 2010 just prior to the passage of the ACA. GAO issued, for the thirteenth year in a row a ‘disclaimer’ of opinion on the accrual-based consolidated financial statements for the fiscal years ended September 30, 2009 and 2008. This means that sufficient information was not available for the auditors to determine whether the reported financial results were reliable.

“Three major impediments continued to prevent the GAO from rendering an opinion on the accrual-based consolidated financial statements:

- (1) serious financial management problems at the Department of defense (“DOD”) that have prevented DOD’s financial statements from being auditable,
- (2) the federal government’s inability to adequately account for and reconcile intragovernmental activity and balances between federal entities, and

(3) the federal government's ineffective process for preparing consolidated financial statements."

The Financial Report contains a Statement of Social Insurance ("SOSI") which has been a required statement since 2006. The SOSI does not interrelate with the Financial Report's accrual-based consolidated financial statements and no liability or expense is recorded in these statements for future benefit payments not yet due. The SOSI compares the actuarial present value of the Government's estimated expenditures for future scheduled benefits for Social Security, Medicare, and other social insurance programs over a 75-year period to a subset of the revenues that support these programs (e.g., the payroll taxes and revenue from taxation of benefits that support Social Security, and Medicare Part A, but not the general revenues that support Medicare Parts B and D.). Expenditures include scheduled benefit payments and administrative expenses. Scheduled benefits are projected based on the benefit formulas under current law. However, one must note that Social Security and Medicare Part A provide for full benefit payments only to the extent there are sufficient balances in the trust funds. The estimates in the SOSI are based on the economic and demographic assumptions which are summarized in the Financial Report's footnote on Social Insurance. The net present value cost of Medicaid is not reported in the SOSI because the federal government believes that Medicaid is a "general assistance" program and not a social insurance program like Medicare.

The GAO gave an unqualified audit opinion on the 2009, 2008, and 2007 SOSI indicating that they are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. "Given the importance of social insurance programs to the federal government's long-term fiscal outlook, the SOSI is critical to understanding the federal government's financial condition and fiscal sustainability." The GAO disclaimed an opinion on the 2006 SOSI and did not express an opinion on the SOSI for 2005.

**Exhibit 1** depicts the President's Budget and **Exhibit 2** depicts the Financial Report for the fiscal years 2000 through 2009. In 2009 the nation's GDP was approximately \$14.4 trillion and the federal government total revenues were \$2.1 trillion. It is important to note that the only costs for Medicare included in **Exhibits 1 and 2** are actual cash outlays each year. No obligation beyond this is recorded in any financial statement. Future expenditures for social insurance or Medicaid benefit payments are not recorded as liabilities as such benefit payments are deemed non-exchange transactions. The government believes that this accounting is proper as Congress at any time can make changes that it deems fit to the programs, including termination. Furthermore, the Supreme Court has ruled that citizens do not have a right to expect payment until they have met all eligibility requirements. The government calls this accounting the "Due and Payable" approach.

**Exhibit 3** depicts the balance sheet for September 30, 2009. The most significant liabilities reported on the balance sheet are Federal debt securities held by the public and accrued interest and Federal employee and veteran benefits payable. "The Government's publicly held debt, or debt held by the public, totaled approximately \$7.6 trillion at the end of FY 2009, and was held by the public in the form of Treasury securities, such as bills, notes, and bonds, and accrued interest payable....In addition to debt held by the public, the Government has outstanding nearly \$4.4 trillion in intergovernmental debt, which arises when one part of the Government borrows from another. It represents debt issued by the Treasury and held by Governmental funds, including Social Security (\$2.5 trillion) and Medicare (\$372 billion) trust funds." Intergovernmental debt is eliminated in the consolidated financial statements and, therefore, does not appear on the balance sheet.

**Exhibit 4** depicts the figures reported in the SOSI for the Open group (current and future participants) for Medicare and Social Security for the years 2000 through 2009. The schedule indicates that the net present value costs of Social Security and Medicare as of January 1, 2009 as reported in the SOSI for the Open Group were \$7.7 and \$38.1 trillion, for a total of \$45.8 trillion. The \$8.1 trillion obligation in 2004 reflects the creation of Part D by the MMA. The schedule also indicates that the total net present value cost of Social Security and Medicare has grown by trillions of dollars each year from 2000 through 2009.

**i. Adjustments to Consider for Reported SOSI Figures**

There are three adjustments that must be considered to the figures appearing in **Exhibit 4**.

**1) Limitation for Appropriated Funds**

The first adjustment is due to the fact that both Social Security and Medicare Part A will run out of appropriated funds in coming years. “In fact, payment of Social Security and Medicare Hospital Insurance (Part A) benefits are limited by law to the balances in the respective trust funds. Consequently, future scheduled benefits are limited to future revenues plus existing trust fund assets.” As discussed in the Supplemental Information section of the 2009 Financial Report, “the Social Security and Medicare Part A trust funds are projected to be exhausted in 2037 and 2017 respectively, at which time they will be unable to pay the full amount of scheduled future benefits.” For Social Security, “[b]y 2037, the trust fund reserves (and thus reserve spending authority) are projected to be exhausted. Even if a trust fund’s assets are exhausted, however, tax income will continue to flow into the fund.” “Present tax rates would be sufficient to pay 76 percent of scheduled benefits after trust fund exhaustion in 2037 and 74 percent of scheduled benefits in 2083.” “Similarly, for Medicare Part A, projected future revenues would be sufficient to pay 81 percent of scheduled benefits in 2017, the year of trust fund exhaustion, and decreasing to 29 percent of scheduled benefits in 2083.” “[U]nder current law, General Fund transfers to the SMI Trust Fund will occur into the indefinite future and will continue to grow with the growth in health care expenditures.”

**Exhibit 5** summarizes the analysis of funds appropriated and unfunded amounts for the 2009 SOSI figures. There are \$27.1 trillion of obligations that are fully funded (i.e., Congress has appropriated funds) under the law and \$18.7 trillion of obligations that are unfunded (i.e., Congress has not appropriated funds).

**2) Adjustment for Physician Payments**

The second adjustment relates to physician payments under SMI Part B. “SMI Part B projections assume significant reductions in physician payments, as required under current law, which may or may not occur. The Congress has overridden scheduled reductions in physician payments calculated for each of the last 7 years, including 2009, and also for January and February 2010....If scheduled reductions continue to be overridden in the future, actual SMI Part B expenditures could be materially greater than the amounts presented in the 2009 Statement of Social Insurance.” These expenditures are fully funded with permanent appropriations.

*“The potential magnitude of the understatement of Part B expenditures due to the physician payment mechanism can be illustrated using two hypothetical examples of changes to current law.....Under current law, the projected 75-year present value of future Part B expenditures is*

*\$23.2 trillion. An alternative scenario indicated that if Congress were to set future physician payment updates at zero percent per year, then absent other provisions to offset these costs, the projected present value would increase to \$23.7 trillion. Similarly, if Congress were to set future physician payment updates equal to the Medicare Economic Index (projected to be 2 to 2.5 percent per year), the present value would be \$25.7 trillion.”*

### **3) Permanent Appropriations Do Not End at 75 Years**

The third adjustment is tied to the fact that Social Security and Medicare have permanent appropriations which do not stop at 75 years. “The shorter horizon understates financial needs by capturing relatively more of the revenues from current and future workers and not capturing all of the benefits that are scheduled to be paid to them.” Therefore, “Infinite Horizon” obligations for both Medicare and Social Security are published in the Financial Report’s Supplemental Information section. These figures have only been reported since 2004 and appear in **Exhibit 6**. The schedule indicates that the net present value costs of Social Security and Medicare under an Infinite Horizon were \$17.5 and \$89.5 trillion, for a total of \$107.0 trillion. For the 2009 fiscal year these obligations are 7.7 times the size of the nation’s GDP and greater than 50 times the federal governments reported revenues.

**Exhibit 7** summarizes the analysis of funds appropriated and unfunded amounts for social insurance programs under the infinite horizon as of 2009. There are \$55.5 trillion of obligations that are fully funded (i.e. Congress has appropriated funds) under the law and \$51.5 trillion of obligations that are unfunded (i.e. Congress has not appropriated funds).

#### **ii. GAO’s Conclusion in 2009 Financial Report**

The GAO reaches the following conclusion. “[T]he federal government is on an unsustainable long-term fiscal path driven by rising health care costs and known demographic trends. The Statement of Social Insurance, for example, shows that the present value of projected scheduled benefits exceeds earmarked revenues for social insurance programs (e.g., Social Security and Medicare) by about \$46 trillion over the next 75-yr period.” The Citizens Guide of the 2009 Financial Report indicates that “The nation must change course and bring social insurance expenses and resources in balance before the deficit and debt reach unprecedented heights. Delays will only increase the magnitude of the reforms needed and will place more of the burden on future generations.”

### **B. Reported Financial Status of Federal Government and Social Insurance Post-ACA**

#### **a. Overview**

This section describes the size and scope of the nation’s social insurance programs (Social Security and Medicare) after passage of the ACA. Quotes in this section are taken from the 2010 Financial Report of the United States Government published in December 2010.

#### **b. 2010 Financial Report of the United States Government**

GAO issued for the fourteenth consecutive year a ‘disclaimer’ of opinion on the accrual-based 2010 consolidated financial statements. This means that sufficient information was not available for the auditors to determine whether the reported financial results were reliable.

**Exhibit 8** depicts the President's Budget and **Exhibit 9** depicts the Financial Report for the fiscal years 2001 through 2010. As indicated the nation's GDP in 2010 was approximately \$15.1 trillion and the federal government total revenues were \$2.2 trillion. It is important to again note that the only costs for Medicare included in **Exhibits 8 and 9** are actual cash outlays each year.

**Exhibit 10** depicts the balance sheet for September 30, 2010. The Federal debt securities held by the public and accrued interest increased from \$7.6 trillion to \$9.1 trillion during FY 2010 due primarily to the continued need to fund the budget deficit.

*"In addition to debt held by the public, the Government has outstanding nearly \$4.6 trillion of intragovernmental debt....including the Social Security (\$2.6 trillion) and Medicare (\$350.5 billion) trust funds. Intragovernmental debt is primarily held in Government trust funds in the form of special nonmarketable securities....Because these amounts are both liabilities of the Treasury and assets of the Government trust funds, they are eliminated as part of the consolidation process for the governmentwide financial statements. When those securities are redeemed, e.g., to pay future Social Security benefits, the Government will need to obtain the resources necessary to reimburse the trust funds."*

GAO also disclaimed an opinion on the 2010 SOSI as its Auditor's Report indicated that:

*"Medicare projections in the 2010 [SOSI] were based on full implementation of the provisions of the [ACA], including a significant decrease in projected Medicare costs from the 2009 [SOSI] related to*

*(1) reductions in physician payment rates totaling 30 percent over the next three years and*

*(2) productivity improvements for most other categories of Medicare providers.*

*However, there are significant uncertainties concerning the achievement of these projected decreases in Medicare costs....*

*Management has developed an illustrative alternative projection intended to provide additional context regarding the long-term sustainability of the Medicare program and to illustrate the uncertainties in the [SOSI] projections. The present value of future estimated expenditures in excess of future estimated revenue for Medicare, included in the illustrative alternative projection, exceed the \$22.8 trillion estimate in the 2010 [SOSI] by \$12.4 trillion....*

*As a result, readers are cautioned that amounts in the 2010 [SOSI] and related Notes may not fairly present, in all material respects, the financial condition of the federal government's social insurance programs, in conformity with GAAP. The uncertainties related to the 2010 [SOSI] also affect the projected Medicare and Medicaid costs reported in the Fiscal Projections for the U.S. government, which is presented in Supplemental Information...."*

**Exhibit 11** depicts the figures reported in the SOSI for the Open group (current and future participants) for Medicare and Social Security for the years 2001 through 2010. The exhibit indicates that the net present value costs of Social Security and Medicare as of January 1, 2010 as reported in the SOSI for the Open Group was approximately \$31 trillion, a decline from the \$46 trillion reported in the 2009 SOSI.



i. **Adjustments to Consider for Reported SOSI Figures**

There are three adjustments to consider to the figures appearing in **Exhibit 11**.

**1) Medicare Trustees' Alternative Scenario**

The first set of adjustments to consider relates to the uncertainties associated with achieving some of the ACA's projected cost reductions and the publication of an alternative scenario by the Medicare Trustees. These uncertainties are discussed in Note 26. Social Insurance in the 2010 Financial Report.

*"The Affordable Care Act improves the financial outlook for Medicare substantially, however, the effects of some of the new law's provisions on Medicare are not known at this time, with the result that the projections are much more uncertain than normal, especially in the longer-range future. For example, the ACA initiative for aggressive research and development has the potential to reduce Medicare costs in the future; however, as specific reforms have not yet been designed, tested, or evaluated, their ability to reduce costs cannot be estimated at this time, and thus no specific savings have been reflected in the projections for the initiative...."*

*Another important example involves lower payment rate updates to cost categories of Medicare providers in 2011 and later. These updates will be adjusted downward by the increase in productivity experienced in the economy overall. Since the provision of health services tends to be labor-intensive and is often customized to match an individuals' specific needs, most categories of health providers have not been able to improve their productivity to the same extent as the economy at large. Over time, the productivity adjustments mean that the prices paid for health services by Medicare will grow about 1.1 percent per year more slowly than the increase in prices that providers must pay to purchase goods and services they use to provide health care services. Unless providers could reduce their cost per service correspondingly, through productivity improvements, or other steps, they would eventually become unwilling or unable to treat Medicare beneficiaries.*

*It is possible that providers can improve their productivity, reduce wasteful expenditures, and take other steps to keep their cost growth within the bounds imposed by the Medicare price limitations. Similarly, the implementation of payment and delivery system reforms, facilitated by the ACA research and development program, could help constrain cost growth to a level consistent with the lower Medicare payments. These outcomes are far from certain, however. Many experts doubt the feasibility of such sustained improvements and anticipate that over time the Medicare price constraints would become unworkable and that Congress would likely override them, much as they have done to prevent the reductions in physician payment rates otherwise required by the sustainable growth rate formula in current law....*

*The SOSI projections are based on current law. Therefore, the productivity adjustments are assumed to occur in all future years, as required by the ACA. In addition, reductions in Medicare payment rates for physician services, totaling 30 percent over the next three years, are assumed to be implemented as required under current law, despite the virtual certainty that Congress will continue to override these latter reductions. Therefore, it is important to note that the actual future costs for Medicare are likely to exceed those shown by these current-law projections....*

*The Medicare Board of Trustees, in their annual report to Congress, references an alternative scenario to illustrate the potential understatement of costs under current law. This alternative scenario assumes that the productivity adjustments are gradually phased out over the 15 years starting in 2020 and that the physician fee reductions are overridden. These examples were developed by management for illustrative purposes only; the calculations have not been audited; and the examples do not attempt to portray likely or recommended future outcomes. Thus, these illustrations are useful only as general indicators of the substantial impacts that could result from future legislation affecting the productivity adjustments and physician payments under Medicare and of the broad range of uncertainty associated with such impacts.”*

**Exhibit 12** depicts a comparison of the Medicare 75-year present values of income and expenditures under current law with those under the alternative scenario.

*“As expected, the differences between the current-law projections and the illustrative alternative are substantial for Part A and Part B. All Part A fee-for-service providers are affected by the productivity adjustments, so the current law projections reflect an estimated 1.1 percent reduction in annual Part A cost growth per year. If the productivity adjustments were gradually phased out, as illustrated under the alternative scenario, the present value of Part A expenditures is estimated to be roughly 27 percent higher than the current-law projection. As indicated above, the present value of Part A income is unchanged under the alternative scenario.*

*The Part B expenditure projections are significantly higher under the alternative scenario than under current law, both because of the assumed gradual phase-out of the productivity adjustments and the assumption that the scheduled physician fee reductions would be overridden and based on annual increases in the Medicare Economic Index. The productivity adjustments are assumed to affect more than half of Part B expenditures at the time their phase-out is assumed to begin. Similarly, physician fee schedule services are assumed to be roughly 30 percent higher under the alternative scenario than under current law at that time. The combined effect of these two factors results in a present value of Part B expenditures under the alternative scenario that is approximately 59 percent higher than the current-law projection.*

*The Part D projections are unaffected under the alternative projection because the services are not impacted by the productivity adjustments or the physician fee reductions.”*

The government comments further on the Medicare projections in the Supplemental Information section of the 2010 Financial Report.

*“The most important cost saving provision in the ACA is a revision in payment rates for parts A and B services other than for physicians’ services. Relative to payment rates made under prior law that were based on the rate at which prices for inputs used to provide Medicare services increase, the ACA reduces those payment rates by the rate at which productive efficiency in the overall economy increases, which is projected to average 1.1 percent per year. The ACA also achieves substantial cost savings by reducing payment rates for private health plans providing Parts A and B services (Part C or Medicare Advantage) to more closely match per beneficiary costs. Partly offsetting these changes was an increase in prescription drug*

*coverage. In addition, the ACA increases Part A revenues by: (a) taxing high-cost employer-provided health care plans and thereby giving employers incentives to increase the share of compensation paid as taxable earnings, and (b) imposing a new 0.9 percent surtax on earnings in excess of \$200,000 (individual tax return filers) or \$250,000 (joint tax return filers) starting in 2013.*

*“In addition to the growth in the number of beneficiaries per worker, the Medicare Program has the added pressure of expected growth in the use and cost of health care per person that is driven in large part by new technology. Growth in Medicare cost per beneficiary in excess in growth in per capita GDP is referred to as “excess cost growth.” In last year’s Financial Report, excess cost growth was assumed to be about 1 percentage point—that is, Medicare expenditures per beneficiary were assumed to grow, on average, about one percentage point faster than per capita GDP over the long range. An assumption for excess cost growth was smaller than in recent history; excess cost growth averaged 1-1/2 points between 1990 and 2007. The combination of more beneficiaries per worker and 1 percent excess cost growth caused projected Medicare expenditures to grow substantially more rapidly than GDP in the 2009 Financial Report. In this year’s Report, however, long-term excess cost growth is essentially zero because of the productivity adjustments to payment rates called for by the ACA. As a result, the long-term projected Medicare spending share of GDP in this report is driven primarily by the same demographic trends that drive OASDI spending share of GDP.”*

## **2) Limitation for Appropriated Funds**

The second adjustment is due to the fact that both Social Security and Medicare Part A will run out of appropriated funds in coming years. “The 2010 Medicare Trustees Report projects that, with enactment of the Affordable Care Act (ACA), the Hospital Insurance (HI) Trust Fund will remain solvent until 2029 under current law – 12 years longer than was projected in the 2009 Trustees Report. The projected share of scheduled benefits that can be paid from trust fund income is 85 percent in 2029, declines to about 77 percent in 2050, and then increases to 89 percent in 2084. The Social Security Trust Funds also face a long-run shortfall. Under current law, the OASDI Trust Funds are projected to be exhausted in 2037 and the projected share of scheduled benefits payable from trust fund income is 78 percent in 2037 and 75 percent in 2084. Under current law, General Fund transfers to the SMI Trust Fund will occur into the indefinite future and will continue to grow with the growth in health care expenditures. **Exhibit 13** summarizes the analysis of funds appropriated and unfunded amounts in the 2010 SOSI.

## **3) Permanent Appropriations Do Not End at 75 Years**

The third adjustment is tied to the fact that Social Security and Medicare have permanent appropriations which do not stop at 75 years. “The shorter horizon understates financial needs by capturing relatively more of the revenues from current and future workers and not capturing all of the benefits that are scheduled to be paid to them.”

“Infinite Horizon” obligations for both Medicare and Social Security are published in the Financial Report’s Supplemental Information section. These figures have only been reported since 2004 and appear in **Exhibit 14**. The exhibit indicates that the net present value costs of Social Security and Medicare under an Infinite Horizon were \$18.7 and \$59.2 trillion, for a total of \$77.9 trillion, a decrease of over \$29 trillion.

**Exhibit 15** summarizes the analysis of permanent appropriations and unfunded amounts for social insurance figures under the infinite horizon for 2010. As of 2010 there are \$55.4 trillion of obligations that are fully funded (i.e. Congress has appropriated funds) under the law and \$22.5 trillion of obligations that are unfunded (i.e. Congress has not appropriated funds).

## **ii. GAO's Conclusion in 2010 Financial Report**

The GAO reaches the following conclusion. “As discussed in the 2010 Financial Report, the federal government is on an unsustainable long-term fiscal path driven on the spending side primarily by rising health care costs and known demographic trends.” The government summarized the impact of the ACA and the nation’s financial future in the Supplemental Information section which contains Fiscal Projections for the U.S. Government – Fiscal Year 2010. “The United States took a potentially significant step towards fiscal sustainability in 2010 by reforming its system of health insurance. The legislated changes for Medicare, Medicaid, and other health coverage hold the prospect of lowering the long-term trend for future health care costs and significantly reducing the long-term fiscal gap. But even with the new law, the projections discussed above indicate that, under current policies and the assumptions used in this report, the debt-to-GDP ratio will continually increase over the next 75-years and beyond, which means current policies are not sustainable. As indicated earlier, the longer policy action to avert these trends is delayed, the larger are the projected revenue increases and/or spending decreases necessary to reach a target debt-to-GDP ratio. These projections, however, are neither forecast nor predictions. They are presented here to provide a foundation upon which readers can form their own conclusions about fiscal sustainability.”

## **C. Reported Financial Status of Medicaid Pre- & Post-ACA**

### **a. Overview of Medicaid**

This section describes the financial size and scope of the nation’s Medicaid program before and after passage of the ACA. Unless otherwise indicated, quotes in this section are taken from the 2010 Financial Report of the United States Government.

Medicaid was established in response to the inadequacy of welfare medical care under public assistance. Medicaid is a Federal/State entitlement program that pays for medical assistance for certain individuals and families with low incomes and resources. It is a cooperative venture jointly funded by the Federal and State governments (including the District of Columbia and the Territories, collectively hereafter, the “State(s)”) to assist States in furnishing medical assistance to eligible needy persons. Medicaid is the largest source of funding for medical and health-related services for the poor.

Within guidelines established by Federal statutes, regulations and policies, each State established its own eligibility standards; determined the type, amount, duration, and scope of services; set the rate of payment for services; and administered its own program. State legislatures could change eligibility, services, and/or reimbursement at any time.

Title XXI of the Social Security Act, known as the State Children’s Health Insurance Program (“SCHIP”), is a program initiated by the Balanced Budget Act (“BBA”) of 1997. SCHIP provided more Federal funds for States to expand Medicaid eligibility to include a greater number of low-income children who were uninsured.

Medicaid operates as a vendor payment program. States may pay health care providers directly on a fee-for-service basis, or States may pay for services through various prepayment arrangements, such as health maintenance organizations (HMOs). States could impose nominal deductibles, coinsurance, or copayments on some Medicaid beneficiaries for certain services.

The Federal government pays a share of the medical assistance expenditures under each State's Medicaid program. That share, known as the Federal Medical Assistance Percentage ("FMAP"), is determined annually by a formula that compares a State's average per capita income level with the national income average. States with a higher per capita income are reimbursed a smaller share of their costs. By law FMAP cannot be lower than 50% or higher than 83%. For children covered through the SCHIP program, the Federal government pays States a higher share which averages about 70%. Matching share requirements are often intended to assure state interest and involvement through financial participation. This approach has been described as "cooperative federalism."

Medicaid was initially a medical care program for the poor emphasizing dependent children, their mothers, the disabled and the elderly. Over the years eligibility was expanded. More than 56 million persons received health care services through the Medicaid program in 2005.

#### **b. Medicaid Has Permanent Appropriations**

Congress has enacted permanent appropriations for the federal spending required under the Medicaid program. The GAO's Glossary of Budget Terms defines "Appropriated Entitlement" as "An entitlement whose source of funding is an annual appropriation act. However, because the entitlement is created by operation of law, if Congress does not appropriate the money necessary to fund the payments, eligible recipients may have legal recourse. ...Medicaid [is an example] of such [an] appropriated entitlement."

The only cost for Medicaid for the federal government that is included the President's Budget or the Financial Report is actual cash outlays each year. No obligation beyond this is recorded in any financial statement. This is also true for each State, the District of Columbia and the Territories. No obligation beyond actual cash outlays is recorded in any of their published financial statements.

Future expenditures for Medicaid benefit payments are not recorded as liabilities by either the federal government or any State as such benefit payments are deemed non-exchange transactions. The federal government's accounting for Medicaid is governed by *SFFAS No. 5 – Accounting for Liabilities*. The State government's accounting for Medicaid is governed by *Statement No. 33 of the GASB – Accounting and Financial Reporting for Nonexchange Transactions*. The GASB has never issued separate guidance for Medicaid despite the fact that for most States it is their largest program.

The federal and state governments believe that this accounting is proper as Congress at any time can make changes that it deems fit to the programs, including termination. Furthermore, the Supreme Court has ruled that citizens do not have a right to expect payment until they have met all eligibility requirements. The government calls this accounting the "Due and Payable" approach.

### c. SCOTUS on Medicaid

It is important to summarize certain economic facts regarding the Medicaid program highlighted by SCOTUS in *NFIB v. Sebelius*. The dissent (authored by Justices Antonin Scalia, Anthony Kennedy, Clarence Thomas and Samuel Alito) opined that “Medicaid has long been the largest federal program of grants to the States,” and Ruth Bader Ginsburg posited that, between 2005 and 2008, federal contributions toward the care of beneficiaries averaged 57% while state contributions averaged 43%. Chief Justice John Roberts asserted that “Medicaid spending accounts for over 20 percent of the average State’s total budget...”

”Between 1966 and 1990, annual federal Medicaid spending grew from \$631.6 million to \$42.6 billion; state spending rose to \$41 billion over the same period. Between 1990 and 2010, federal spending increased to \$269.5 billion. (references omitted)”

### d. Revelation Provided by SFFAS No. 36

Beginning with the 2010 Financial Report the federal government implemented Statement of Federal Financial Accounting Standard (“SFFAS”) No. 36, Reporting Comprehensive Long-Term Fiscal Projections of the U.S. Government. This required the federal government for the first time to disclose significantly more financial information about its obligations including Medicaid in a supplemental information section described as “Fiscal Projections for the U.S. Government – Fiscal Year 2010.”

*“[T]he Government is now required to include a statement presenting for all its activities (a) the present value of projected receipts and non-interest spending under current policy without change...[T]he Government is also required to disclose, the assumptions underlying the projections, the factors influencing trends, and significant changes in the projections from period to period.”*

The Supplemental Information section contained the following description of the projections.

*“This section...is intended to help readers of the Financial Report of the U.S. Government (FR) assess whether budgetary resources will be sufficient to sustain public services and to meet future obligations as they come due, assuming that the Federal Government’s current policies for spending and taxation are continued. Such an assessment requires prospective information about receipts and spending, the resulting debt, and how these amounts relate to the economy. The assessment is also referred to as reporting on “fiscal sustainability.”*

*The information in this section is important not only for its financial, but also its social and political, implications. Financial reports should provide information that can help readers assess the likelihood that the Government will be able to continue providing the equivalent level of public services and to assess whether financial burdens without related benefits will be shifted to future taxpayers. Fiscal sustainability reporting should assist the reader in understanding these financial, social, and political implications.*

*The projections and analysis presented here are mathematical extensions and extrapolations based on an array of assumptions as described below, including the assumption that current Federal policy does not change. These projections cannot be interpreted as forecasts or predictions of the future, in part because they encompass hypothetical future trends or events*

*that are improbable. This is the first year in which this information is included with the other Supplemental Information, and the methods and assumptions used in producing this section are still under development.*

*Statement of Long Term Fiscal Projections - Table 1...presents projections of the Federal Government's receipts and non-interest spending. (Footnote 3 "For the purposes of this analysis, spending is defined in terms of outlays.") Receipt categories include individual income taxes, Social Security, and Medicare payroll taxes, and all other receipts. On the spending side, the projections include both mandatory (entitlement) programs, such as Social Security and Medicare, which provide benefits under standing law, and discretionary programs, such as defense spending, which are funded through annual appropriations. The data in Table 1 are presented as in the Federal budget, which differs in some respects from the presentation of these data in the trustees' reports for Social Security and Medicare.... The projections for Social Security and Medicare are based on the same economic and demographic assumptions as are used for the 2010 trustees' reports for these programs. Projections for the other categories are also consistent with the assumptions used for the trustees' reports. The Federal budget provides the framework used for the projections. In order to produce a more realistic projection of the fiscal outlook under current policy, the projections assume several likely departures from current law, noted below."*

Table 1 which is labeled "Long Range Projections of Federal Receipts and Spending" indicates that the present value cost of Medicaid as of October 1, 2010 for the period from 2011 through 2085 is \$24.2 trillion.

*"The projections shown in Table 1 are made over a 75-year time frame, consistent with the time frame featured in the Social Security and Medicare trustees' reports....[O]ne notable difference introduced in broadening the fiscal perspective to the Government as a whole is that the projections are based on fiscal years starting on October 1, 2010, whereas the trustees' reports feature projections made on a calendar year basis. This change allows the projections to start with more current numbers, including the actual results from fiscal year 2010...."*

*The projections in Table 1 focus on future cash flows, and do not reflect either the accrual basis or the modified-cash basis of accounting....*

**Medicaid:** *The Medicaid program was also affected by the changes legislated in the ACA. Medicaid enrollment will be larger because of health reform, and many newly insured Americans will be covered through Medicaid. To reflect these changes, certain adjustments were made in the model that has been used to project Medicaid in past years for the Financial Report. The model starts with the projections from the 2008 Actuarial Report prepared by the Office of the Actuary, Centers for Medicare and Medicaid Services (CMS). As projections in that report only extend until 2018, the model assumes that Medicaid benefits in 2019 and later years grow at the same rate per beneficiary as Medicare benefits grow. Effects of the ACA, as calculated by CMS, were added to the base projections, as were other adjustments, to align base projections with the latest budget data. The Medicaid projections reflect the temporary increase in Medicaid spending due to the American Recovery and Reinvestment Act of 2009 (ARRA) as well as the phase-out of the Medicaid spending authorized by ARRA."*

#### i. Adjustments to Consider for Reported Medicaid Figure

There are several adjustments that one must consider to the \$24.2 trillion estimate for the net present value cost of Medicaid as of October 1, 2010.

### **1) No Alternative Scenario is Published for Medicaid**

First and foremost, one must recall the GAO's Auditor's Report for the 2010 Financial Report, mentioned in the previous section, which indicated that "The uncertainties related to the 2010 [SOSI] also affect the projected Medicare and Medicaid costs reported in the Fiscal Projections for the U.S. government, which is presented in Supplemental Information..." The \$24.2 trillion figure was based upon savings assumptions associated with the ACA similar to those used to generate the \$22.8 trillion Medicare net present value cost figure published simultaneously. However, these assumptions were so unrealistic that the government published an alternate, and more realistic, scenario which indicated that Medicare had a net present value cost of \$35.2 trillion. No alternate figure was published for Medicaid.

### **2) Permanent Appropriations Do Not Stop at 75 Years**

The second adjustment that must be considered is related to the fact that Medicaid has permanent appropriations which do not stop at 75 years. As noted by the federal government for the social insurance obligations, "The shorter horizon understates financial needs by capturing relatively more of the revenues from current and future workers and not capturing all of the benefits that are scheduled to be paid to them." Therefore, "Infinite Horizon" obligations for Medicaid are needed but the federal government does not calculate or publish these figures.

#### **e. State's Aggregate Obligation for Medicaid is Enormous**

Since, as Justice Ruth Bader Ginsburg indicated in *NFIB v. Sebelius*, the state portion of Medicaid contributions averaged 43 percent of total expenditures, a very low approximation of the aggregate net present value obligation of the States for Medicaid is \$18.3 trillion. The calculation is as follows: \$24.2 trillion divided by 57% (federal portion of Medicaid spending) to estimate the total net present value cost of Medicaid which is \$42.456140 trillion. Once the federal amount is subtracted this yields a figure of \$18.256140 trillion for the states aggregate net present value cost for the program. This estimate is based on the federal obligation being only \$24.2 trillion which as described above is highly unlikely. This also means that the total net present value cost of the Medicaid program is \$42.5 trillion. By way of reference at approximately \$18.3 trillion the aggregate State obligation for Medicaid is almost five times the size of the entire \$3.7 trillion municipal securities market.

#### **i. Medicaid Obligations Exceed \$1 Trillion for Five States**

Based on the states spending for the Medicaid program in 2010 there are five states that have a net present value cost obligation that exceeds \$1 trillion – California, New York, Massachusetts, Ohio and Pennsylvania. This obligation appears nowhere in any of these states financial statements. For example, the author's estimate for the State of New York's obligation is approximately \$1.6 trillion.

**Exhibit 16** depicts the estimated obligation as of 2010 for all fifty states. Each of these obligations is clearly material to each state's financial results and financial position.



**f. Medicaid Expansion Issue in NFIB v. Sebelius<sup>294</sup>**

On June 28, 2012 the Supreme Court resolved constitutional challenges to two provisions of the Patient Protection and Affordable Care Act of 2010 (“ACA” or the “Act”): the individual mandate and the Medicaid expansion.<sup>295</sup> The individual mandate requires most Americans maintain a “minimum essential” health insurance coverage.<sup>296</sup> For many this requires purchasing insurance.<sup>297</sup> Those who do not comply must pay a penalty to the IRS.<sup>298</sup> With respect to the individual mandate the Court decided that while it is not a valid exercise of Congress’ power under the Commerce Clause and the Necessary and Proper Clause it may be upheld as within Congress’s power under the Taxing Clause.<sup>299</sup> This section is focused solely on the second provision resolved by the Court, the Medicaid expansion.

Seven members of the Supreme Court agreed that the Medicaid expansion in the Act is unconstitutional.<sup>300</sup> Each of the opinions issued by the Court, Justice Ginsburg and the Dissenters (Justices Scalia, Kennedy, Thomas and Alito) contains economic and political accountability analysis that are seriously flawed and incomplete. All of the Justices ignored important facts associated with entitlement program spending and the federal government’s financial results. None addressed the Appropriations or Statement and Account clauses, both directly applicable Constitutional provisions. Not surprisingly, the Court’s remedy is clearly in error.

Information submitted in merit briefs and orally to the Supreme Court included financial information published by the federal government that does not comply with the Appropriations and Statement and Account clauses. In addition, relevant material financial information that was published only after the passage of the ACA but prior to the submission of merit briefs and oral argument was not raised or discussed in either. The fraudulent material submitted by each state to the Court relates to each state’s financial results. This information is fraudulent as it does not include the full costs directly related to each state’s participation in the Medicaid program. The full cost of the Medicaid program for each state has never been published by any state.

We will begin by summarizing certain facts highlighted by the Justices, the Court’s analysis and remedy.

As the Dissenters have noted:

*“Medicaid has long been the largest federal program of grants to the States”<sup>301</sup>. See Brief for Respondents in No. 11– 400, at 37. In 2010, the Federal Government directed more than \$552 billion in federal funds to the States. See Nat. Assn. of State Budget Officers, 2010 State Expenditure Report: Examining Fiscal 2009–2011 State Spending, p. 7 (2011) (NASBO Report). Of this, more than \$233 billion went to pre-expansion Medicaid. See id., at 47.<sup>14</sup> This amount equals nearly 22% of all state expenditures combined. See id., at 7. The States devote a larger percentage of their budgets to Medicaid than to any other item. Id., at 5. Federal funds account for anywhere from 50% to 83% of each State’s total Medicaid expenditures, see §1396d(b) (2006 ed., Supp. IV); most States receive more than \$1 billion in federal Medicaid funding; and a quarter receive more than \$5 billion, NASBO Report 47. These federal dollars total nearly two thirds—64.6%—of all Medicaid expenditures nationwide.<sup>15</sup> Id., at 46.”*

The *Brief of State Petitioners* on Medicaid indicates that:

*“To finance that massive expansion, the federal government anticipates that its share of Medicaid spending will increase by \$434 billion by 2020. CBO Estimate, Table 4 (Mar. 20, 2010). It further*

*estimates that state spending will increase by at least \$20 billion over the same timeframe. CBO Estimate, Table 4 n.c (Mar. 20, 2010). Other estimates suggest that both federal and state costs will be significantly higher. Kaiser Comm'n on Medicaid & the Uninsured, Medicaid Coverage & Spending in Health Reform: National and State-by-State Results for Adults at or Below 133% FPL 23 (May 2010) (estimating that increased costs could be as high as \$532 billion for federal government and \$43.2 billion for States)."*

The dissent (authored by Justices Scalia, Kennedy, Thomas and Alito) opined that "By 1982 every State had chosen to participate in Medicaid. Federal funds received through the Medicaid program have become a substantial part of state budgets, now constituting over 10 percent of most States' total revenue. Justice Ginsburg posited that between 2005 and 2008 federal contributions toward the care of beneficiaries averaged 57% and States contributions averaged 43%.<sup>302</sup> Chief Justice Roberts asserted that, for the States, "Medicaid spending accounts for over 20 percent of the average State's total budget See Nat. Assn. of State Budget Officers, *Fiscal Year 2010 State Expenditure Report*, p. 11, Table 5 (2011); 42 U. S. C. §1396d(b)."<sup>303</sup> "The Act increases federal funding to cover the States' costs in expanding Medicaid coverage. But if a State does not comply with the Act's new coverage requirements, it may lose not only the federal funding for those requirements, but all of its federal Medicaid funds."<sup>304</sup>

*"We have repeatedly characterized . . . Spending Clause legislation as 'much in the nature of a contract.'"<sup>305</sup> Furthermore, "Congress may use its spending power to create incentives for States to act in accordance with federal policies. But when 'pressure turns into compulsion,' the legislation runs contrary to our system of federalism."<sup>306</sup> "In this case, the financial 'inducement' Congress has chosen is much more than 'relatively mild encouragement'— it is a gun to the head."<sup>307</sup> "The threatened loss of over 10 percent of a State's overall budget . . . is economic dragooning that leaves the States with no real option but to acquiesce in the Medicaid expansion."<sup>308</sup>*

*Furthermore, "[p]ermitting the Federal Government to force the States to implement a federal program would threaten the political accountability key to our federal system."<sup>309</sup> "When Congress compels the States to do its bidding, it blurs the lines of political accountability."<sup>310</sup> By that, Justice Ginsburg believes, the Court means "voter confusion: Citizens upset by unpopular government action . . . may ascribe to state officials blame more appropriately laid at Congress' door."<sup>311</sup>*

In its decision the Court ruled that the constitutional violation and the political accountability issue are fully remedied by precluding the Secretary of Health and Human Services from applying the Act to withdraw existing Medicaid funds from the States for their failure to comply with the requirements set out in the expansion.<sup>312</sup>

Let us review key economic facts regarding Medicaid not discussed by the parties or the Court. First, since Medicaid's inception, the federal government has never reported its full costs in either the President's Budget or the Financial Report. Justice Roberts quoted the impact of the ACA on the federal government. "In light of the expansion in coverage mandated by the Act, the Federal Government estimates that its Medicaid spending will increase by approximately \$100 billion per year, nearly 40 percent above current levels. Statement of Douglas W. Elmendorf, *CBO's Analysis of the Major Health Care Legislation Enacted in March 2010*, p. 14, Table 2 (Mar.30, 2011)." "The Federal Government estimates that it will pay out approximately \$3.3 trillion between 2010 and 2019 in order to cover the costs of *pre-expansion* Medicaid. *Brief for United States* 10, n. 6."<sup>313</sup> Despite this huge increase in spending the litigants and the Court did not review any overall financial data for the federal government.

The federal government published a \$24 trillion estimate of the present value of the federal government's future net cost of the program for the first time in the 2010 Financial Report.<sup>314</sup> This figure was based on savings assumptions associated with the ACA similar to those used to generate the \$22.8 trillion Medicare figure published simultaneously. However, the assumptions were so unrealistic that the Administration published an alternate more realistic scenario which indicated a cost of \$35.2 trillion.<sup>315</sup> No alternate figure was published for Medicaid. The only costs recorded by the federal government or any state for Medicaid are current year cash expenditures. Second, since the State portion of Medicaid contributions averaged 43% of total expenditures this means that there is an additional \$18.3 trillion present value obligation. Therefore, Medicaid in total is a \$42.5 trillion program. No State records the full cost of its share of Medicaid costs in its financials.

The Court's analysis is focused on the Act's economic impact on the State's income statements as opposed to the financial results of both parties. In commercial joint ventures it is typical for the parties to represent and warrant that they have the financial wherewithal to hold up their end of the bargain. These are often tied to audited financials. However, the states have no need for these because they and their citizens are entitled to rely on the Statement and Account.

The States cannot knowingly accept the full terms of the Medicaid contract if a fundamental assumption or condition on which they rely is materially in error. The ability of the federal government to provide financing is a key determinant whether a State wants to continue taking the money. Federal financial reporting is coercive because it significantly overstates the ability to continue providing funding. The failure to so advise the States through the publication of a truthful and accurate Statement and Account renders acceptance of the "contract" null and void as there could not be any meeting of the minds.

If threatening to withdraw over 10% of a State's budget is a gun to the head then what is underreporting expenditures by over two thirds of total expenditures? Is it reasonable that those practical Framers that drafted the Statement and Account Clause thought it appropriate for the government to be able to spend at a level three times the amount that it publicly reported?

If the fifty states are committing fraud in publishing their financial statements how can the electorate of these states be the informed voters that our Constitution requires? Furthermore, given the length of time that Medicaid has been in existence and the lack of financial reporting how can the state's politicians accept the federal government's money? There cannot be a meeting of the minds as both sides are significantly under-reporting expenses related to Medicaid.

The government knows that it cannot possibly fund its existing entitlement programs. "... the federal government faces long-term challenges resulting from large and growing structural deficits that are driven primarily by rising health-care costs and known demographic trends. This unsustainable path must be addressed soon by policymakers. The longer actions are delayed, the more difficult adjustments are likely to become." These words in the 2009 Financial Report of the U.S. Government were written by Gene L. Dodaro, acting comptroller general. It is hard to square these comments with Justice Ginsburg's assertion that "Thus there can be no objection to the ACA's expansion of Medicaid as an 'unfunded mandate.' Quite the contrary, the program is impressively well funded."<sup>316</sup>

The Comptroller General stated in 2011 "the federal government continues to face an unsustainable fiscal path."<sup>317</sup> The Citizens Guide to the 2011 Financial Report states "The Nation must bring social insurance expenses and resources into balance before the deficit and debt reach unprecedented heights. Delays will only increase the magnitude of the reforms needed and will place more of the burden on future generations."<sup>318</sup>

The Supreme Court's dissenters (Justices Scalia, Kennedy, Thomas and Alito) in the *National Federation of Independent Business v. Sebelius* case put forth the following argument about accountability.

*"Taxes have never been popular, see, e.g., Stamp Act of 1765, and in part for that reason, the Constitution requires tax increases to originate in the House of Representatives. See Art. I, §7, cl. 1. That is to say, they must originate in the legislative body most accountable to the people, where legislators must weigh the need for the tax against the terrible price they might pay at their next election, which is never more than two years off. The Federalist No. 58 "defend[ed] the decision to give the origination power to the House on the ground that the Chamber that is more accountable to the people should have the primary role in raising revenue." United States v. Munoz-Flores, 495 U. S. 385, 395 (1990)."*

Under-reporting expenses by Congress is directly related to the desire by members of Congress to get re-elected. The under-reporting is aimed at putting off the day of reckoning regarding spending until some other politician is in office, presumably long after the present politician is gone.

Medicaid has mandatory authorizing legislation. A distinctive feature of authorizing legislation for mandatory spending is that it provides agencies with the authority or requirement to spend money without first requiring committees to enact funding. This is critical in the context of accountability because current members of Congress can and do wash their hands of any responsibility with respect to mandatory spending.<sup>319</sup>

#### **g. Chief Justice Roberts Questions General Verrilli**

Chief Justice Roberts in questioning General Verrilli in oral argument in this Obamacare case came the closest to understanding the likely outcome of the under-reporting of expenses by both the federal and state governments with the following exchange.

*Chief Justice Roberts:* Well, the Secretary has the discretion. We're talking about something else. We're talking about fiscal realities and whether or not the Federal Government is going to say we need to lower our contribution to Medicaid and leave it up to the States because we want the people to be mad at the States when they have to have all these budget cuts to keep it up, and not at the Federal Government.

*General Verrilli:* But that would be true, Mr. Chief Justice, whether this Medicaid expansion occurred or not. So –

*Chief Justice Roberts:* I know, but you've been emphasizing that the Federal Government is going to pay 90 percent of this, 90 percent of this. And it's not something you can take to the bank, because the next day or the next fiscal year, they can decide we're going to pay a lot less, and you, States, are still on the hook, because you don't – you say it's not an easy choice. We can say – ask whether it's coercion. You're not going to be able to bail out of Medicaid. You just have to pay more because we're going to pay less.

#### **h. Conclusion on NFIB v. Sebelius**

Accounting and financial reporting standards are essential for public accountability and for an efficient and effective functioning of our democratic system of government. Our Declaration of Independence's closing sentence reads "And for the support of this Declaration, with a firm reliance

on the protection of divine Providence, we mutually pledge to each other our Lives, our Fortunes and our sacred Honor. It is time for Congress to find its Honor but it is unlikely to do so absent a ruling from the Supreme Court. Therefore, the nation needs the Supreme Court most when the other two branches of government have clearly failed to fulfill their Constitutional duties. As Chief Justice Roberts has clearly pointed out:

*“Proper respect for a co-ordinate branch of the government” requires that we strike down an Act of Congress only if “the lack of constitutional authority to pass [the] act in question is clearly demonstrated.” United States v. Harris, 106 U. S. 629, 635 (1883). Members of this Court are vested with the authority to interpret the law; we possess neither the expertise nor the prerogative to make policy judgments. Those decisions are entrusted to our Nation’s elected leaders, who can be thrown out of office if the people disagree with them. It is not our job to protect the people from the consequences of their political choices.*

*Our deference in matters of policy cannot, however, become abdication in matters of law. “The powers of the legislature are defined and limited; and that those limits may not be mistaken, or forgotten, the constitution is written.” Marbury v. Madison, 1 Cranch 137, 176 (1803). Our respect for Congress’s policy judgments thus can never extend so far as to disavow restraints on federal power that the Constitution carefully constructed. “The peculiar circumstances of the moment may render a measure more or less wise, but cannot render it more or less constitutional.” Chief Justice John Marshall, A Friend of the Constitution No. V, Alexandria Gazette, July 5, 1819, in John Marshall’s Defense of McCulloch v. Maryland 190–191 (G. Gunther ed. 1969). And there can be no question that it is the responsibility of this Court to enforce the limits on federal power by striking down acts of Congress that transgress those limits. Marbury v. Madison, supra, at 175–176.<sup>320</sup>*

#### i. **King v. Burwell**

In *King v. Burwell*, the plaintiff brought a suit challenging the validity of an Internal Revenue Service (“IRS”) final rule implementing the premium tax credit provision of the ACA. King, the Petitioner, argued that in an apparent effort to fix several problems associated with the lack of participation by the states the IRS issued a rule in May 2012 that extended eligibility for tax credits and subsidies to those individuals who purchase health insurance on both state-run insurance Exchanges and federally-facilitated Exchanges. The Petitioner contended that the IRS’s interpretation was contrary to the language of the statute, which they asserted, authorizes tax credits only for individuals who purchase insurance on state-run Exchanges. Only sixteen states and the District of Columbia had set up Exchanges; thirty-four states rely on federally-facilitated Exchanges. As the district court stated in *King v. Sebelius* “Congress did not expect the states to turn down federal funds and fail to create and run their own Exchanges.”

The D.C. Circuit Court in a related case on the same issue and the Fourth Circuit in *King* had reached opposite conclusions with respect to the IRS Rule. The D.C. Circuit found that the IRS Rule was contrary to the text of the ACA and ordered that it be vacated. The Fourth Circuit found that the ACA was ambiguous with respect to whether an Exchange established by HHS qualified for tax credits and subsidies and applied “Chevron” deference to the IRS’ ruling. *Chevron U.S.A. Inc. v. National Resource Defense Council, Inc.* was a case decided in 1984 which addressed the question of judicial deference to an agency’s construction of a statute. It created a two-part inquiry for courts to

follow in reviewing agency interpretations of law. Presumably, the Supreme Court took the case, at least in part to resolve the conflict between the Circuit Courts.

**i. Supreme Court Should Have Looked at All of the Facts**

In order to understand how and why *King v. Burwell* was a critically important first amendment case one has to take a hard look at all of the facts associated with the ACA, the proverbial “big picture” and not just the select subset of facts surrounding the language of the statute and the ACA’s legislative history on which the lower courts, the parties and legal commentators were focused. Most importantly, one has to revisit the facts cited in the Supreme Court’s decision with respect to the Medicaid issue in *NFIB v. Sebelius*. The previous sections devoted to this case explain how and why the Supreme Court’s decision regarding the Medicaid issue was erroneous as it was based on an understanding of the facts that was far from complete. As a result each of the opinions issued by the Supreme Court contains economic and political accountability analysis that is seriously flawed and the Court’s remedy was in error.

**ii. Facts are Clear That There Cannot Have Been a Contract**

Federal and state financial reporting, particularly as they relate to Medicare and Medicaid, were relevant in *King v. Burwell*, as it went directly to the issue of whether there could be a meeting of the minds between the federal and state governments.

The parties to the grant contract cannot possibly have agreed to the terms of the ACA as both the state and federal governments have been publishing fraudulent and unconstitutional financial statements. It can be argued that the federal government’s financial disclosures fraudulently induced the states into accepting the grant because those disclosures clearly overstated the Feds ability to continue funding the Medicaid program. Furthermore, it can be argued that the federal government conditioned the grant on the state’s acceptance of its fraudulent financial reporting. This fraudulent disclosure by the federal and state governments has gone on for almost fifty years, in large part because of politicians’ unwillingness to properly account for any entitlement programs including, as applicable, Medicare and Medicaid.

The federal government’s financial accounting disclosures are in conflict with and directly contradict the organic legislation regarding the entitlement programs that Congress has legally enacted and funded with permanent appropriations. State financial disclosures are fraudulent, and have been for decades, because they clearly violate the antifraud provisions of the nation’s securities laws. The fact that federal and state financial reporting has been fraudulent for an extended period of time and continues to this day required a finding by the Supreme Court that the ACA is null and void.

The federal and state governments cannot possibly agree to expand the nation’s healthcare programs when they have been fraudulently portraying their financial implications to constituents for decades. The argument that financial reporting by either the federal or state governments is entirely separate from the enactment of the ACA is spurious because of the magnitude of the funds involved with the existing programs and the modifications required by the ACA.

**D. Conclusion: Words of Wisdom from Justice Kennedy**

In concluding the analysis contained in this chapter it is appropriate to review ten important concepts contained in Justice Kennedy’s concurring opinion in *Clinton v. City of New York* (1998).

These concepts provide a helpful roadmap for illuminating the deficiencies of the federal judiciary's decisions. The case involved the Line Item Veto Act of 1996. The Opinion of the Court delivered by Justice John Paul Stevens in 1998 indicated that the Act violated the Presentment Clause as it gave the President the power to unilaterally change laws passed by Congress. There are ten key concepts that Justice Kennedy discussed in his concurring opinion. These include:

- 1) *"A nation cannot plunder its own treasury without putting its Constitution and its survival in peril."*

The Statement and Account was added by the Framers to the Constitution as a protection for the people. It required financial information to be published because the Framers viewed it as critical political information for citizens/voters. This is a basic concept that SCOTUS has ignored completely in disregarding the Statement and Account Clause and Appropriations Clause.

- 2) *"Failure of political will does not justify unconstitutional remedies."*

The federal judiciary's failure to address the meaning of the Statement and Account Clause including how it interacts with the Appropriations Clause has led to several unconstitutional decisions! Justice Kennedy's concept is as applicable to the judicial branch as it is to Congress.

- 3) *"Liberty is always at stake when one or more of the branches seek to transgress the separation of powers."*

The federal judiciary seems to believe that the only cases it needs to resolve arise where the political branches are at odds with one another. It appears to be inconceivable to them that the two political branches could be at loggerheads while working in unison to the detriment of the people and the proper working of the third branch of government.

- 4) *"The conception of liberty embraced by the Framers was not so confined. They used the principles of separation of powers and federalism to secure liberty in the fundamental political sense of the term, quite in addition to the idea of freedom from intrusive governmental acts. The idea and the promise were that when the people delegate some degree of control to a remote central authority, one branch of government ought not possess the power to shape their destiny without a sufficient check from the other two. In this vision, liberty demands limits on the ability of any one branch to influence basic political decisions."*

Congress' passage of the "*Budget and Accounting Act of 1921*" effectively started a process by which the Executive has wrested control of the nation's financial reporting from Congress. This has resulted in the two political branches of government being joined at the hip when it comes to fraudulent and deficient federal financial reporting. The judicial branch is the ONLY branch that can limit the ability of the other two branches to influence basic political decisions. But it has apparently determined that it will NOT fulfill its responsibility because this will put it at direct odds with these two political branches, for others reasons described hereafter, or for some other reason.

- 5) *"Money is the instrument of policy and policy affects the lives of citizens. The individual loses liberty in a real sense if that instrument is not subject to traditional constitutional constraints."*

The Statement and Account and Appropriations Clauses were inserted into the Constitution to provide a means for the people to control their representatives. At the time that the Constitution was ratified the Statement and Account was considered to be much more important than the President's "State of the Union" information. Not determining the meaning of the Statement and Account Clause and how it interacts with the Appropriations Clause allows the two political branches to determine

its meaning. They have defined it in a twisted way such that reported spending has little to do with legally enacted appropriations. It is inconceivable that the Framers intended Article I, Section 9, Clause 7 to mean what the two political branches now interpret it to mean. The final determination as to what the Statement and Account Clause means is not up to the two political branches.

- 6) *“That a congressional cession of power is voluntary does not make it innocuous. The Constitution is a compact enduring for more than our time, and one Congress cannot yield up its own powers, much less those of other Congresses to follow.”*

Politicians have subverted the democratic process to protect their self interests. Congress cannot enact legislation and related permanent appropriations and then have these obligations largely defined out of existence for purposes of recording the appropriation or for financial reporting purposes. When Congress enacts permanent appropriations it must record the appropriation and accrue for the funded obligation in the Statement and Account. It cannot continue to use cash-based accounting as it is completely misleading and contrary to Appropriations law. The full costs associated with the permanent appropriation needs to be recognized in the Statement and Account at the time of the Appropriation. Not recognizing those costs destroys political accountability entirely and effectively binds all future Congresses. It is a political windfall for the Congress that enacted the legislation and appropriation and puts an insurmountable burden on any future Congress that might otherwise be inclined to stop this spending.

- 7) *“Abdication of responsibility is not part of the constitutional design.”*

The fact that Congress has given up its financial reporting authority to the Executive branch is not permissible. Furthermore, the federal judiciary cannot abdicate its constitutional role to interpret the Constitution.

- 8) *“Separation of powers helps to ensure the ability of each branch to be vigorous in asserting its proper authority. In this respect the device operates on a horizontal axis to secure a proper balance of legislative, executive, and judicial authority. Separation of powers operates on a vertical axis as well, between each branch and the citizens in whose interest powers must be exercised. The citizen has a vital interest in the regularity of the exercise of governmental power.”*

In certain of the Obamacare cases either the States are suing the federal government or you have the Executive branch and the Legislative branch squaring off. The federal judiciary has adjudicated these cases without recognizing their profound impact on the liberty of the people. The proper action that should have been taken in many of these cases is for the court to appoint counsel to represent the people's interest, because it most assuredly is different than the interest of the States or the two political branches of the federal government.

- 9) *“By increasing the power of the President beyond what the Framers envisioned, the statute compromises the political liberty of our citizens, liberty which the separation of powers seeks to secure.”*

The Executive has wrested almost complete control of federal financial reporting from the Legislative branch. This is an increase in the power of the Executive branch beyond what was clearly intended by the Framers. This increase in the Executive's power has been an important feature in diminishing the liberty of the people and the protection that was incorporated into the document that was ratified by the people.



- 10) *“The Constitution is not bereft of controls over improvident spending. Federalism is one safeguard, for political accountability is easier to enforce within the States than nationwide. The other principal mechanism, of course, is control of the political branches by an informed and responsible electorate. Whether or not federalism and control by the electorate are adequate for the problem at hand, they are two of the structures the Framers designed for the problem the statute strives to confront. The Framers of the Constitution could not command statesmanship. They could simply provide structures from which it might emerge.”*

The two political branches of government have acted in concert to control federal financial reporting as well as financial reporting by the states. Meanwhile the federal judiciary has refused to address the fact that an important constitutional safeguard has been circumvented. The result is an uninformed electorate that is making political decisions without the political information that the Framers thought to be critical.



*That a congressional cession of power is voluntary does not make it innocuous. The Constitution is a compact enduring for more than our time, and one Congress cannot yield up its own powers, much less those of other Congresses to follow.*

*Justice Anthony M. Kennedy*

## **14 Federal and State Governments Actual Financial Results – A Closer Approximation**

This chapter will provide:

- 1) an estimate of the financial results of the Federal government for the last decade (fiscal year 2006 to fiscal year 2015)
- 2) two estimates of its financial position as of September 30, 2015 and
- 3) a revised estimate of the state's aggregate net present value obligation for their portion of the Medicaid program.

The review of the federal government's financial results for the period 2006 to 2015 will attempt to adjust the Statements of Net Cost and the Balance Sheets to correctly account for the Social Insurance and Medicaid programs. However, no attempt will be made to consolidate the Federal Reserve System, Fannie Mae and Freddie Mac into the government's reported results. Please note that the federal government does not consider Medicaid a social insurance program.

With respect to the second item above the first estimate of the federal government's financial position as of September 30, 2015 will be based solely on amounts calculated from figures published by the Federal government. In calculating the second estimate of the federal government's financial position as of September 30, 2015 the author will make some reasonable assumptions to estimate amounts that the Federal government should have published. Unless otherwise indicated, quotes in this chapter are taken from the 2015 Financial Report of the United States Government.

### **A. The President's Budget**

The simplest way to think about our government's recent financial results is to add up all the expenditures and revenues over the last decade and divide the total expenditures by total revenues. This produces a "dollar spent per dollar of revenue" figure which everyone that manages a household can understand.

**Exhibit 17** displays The President's Budget for the years 2006 through 2015. Over the last decade, under budget accounting, the federal government has outlays of \$33.13 trillion while recording receipts of \$25.57 trillion. Thus, the Federal government has spent \$1.30 for every \$1 of revenue it has received.

Please note that the budget deficit does not include the multi-trillion dollar annual increases in the net present value of our Social Security, Medicare and Medicaid obligations. Everyone that has a

credit card knows that the amount that you spent in any year is equal to the amount that you paid the credit card company plus or minus the increase or decrease in your year-end balance. The government conveniently ignores the second half of the calculation.

## **B. The 2015 Financial Report of the United States Government**

The 2015 Financial Report was published in late February 2016. GAO issued, for the nineteenth year in a row a ‘disclaimer’ of opinion on the accrual-based consolidated financial statements for the fiscal years ended September 30, 2015 and 2014. This means that sufficient information was not available for the auditors to determine whether the reported financial results were reliable. Gene Dodaro in his “Statement of the Comptroller General of the United States” letter dated February 25, 2016 which was included in the Financial Report stated:

*“However, since the federal government began preparing consolidated financial statements 19 years ago, three major impediments continued to prevent us from rendering an opinion on the federal government’s accrual-based consolidated financial statements over this period:*

- (1) serious financial management problems at DOD that have prevented its financial statements from being auditable,*
- (2) the federal government’s inability to adequately account for and reconcile intragovernmental activity and balances between federal entities, and*
- (3) the federal government’s ineffective process for preparing consolidated financial statements.”*

Footnote B. Basis of Accounting and Revenue Recognition contains a sub-section “Consolidated Financial Statements” that includes the following:

*“The consolidated financial statements of the Government were prepared using GAAP, primarily based on FASAB’s Statement of Federal Financial Accounting Standards (SFFAS).”*

### **a. Statements of Social Insurance in 2015 Financial Report**

The Financial Report contains a Statement of Social Insurance (“SOSI”) which has been a required statement since 2006. The SOSI does not interrelate with the Financial Report’s accrual-based consolidated financial statements and no liability or expense is recorded in these statements for future benefit payments not yet due.

The following statement is found in the Social Insurance sub-section of the Management’ Discussion and Analysis section of the 2015 Financial Report:

*“The SOSI provides perspective on the Government’s long-term estimated exposures and costs for social insurance programs. While these expenditures are not considered Government liabilities, they do have the potential to become expenses and liabilities in the future, based on the continuation of the social insurance programs’ provisions contained in current law.”*

Note 23. Social Insurance contains the following:

*“The basis for the projections has changed since last year due to the enactment of the Medicare Access and Children’s health Insurance Program (CHIP) Reauthorization Act (MACRA) of 2015. This law repealed the sustainable growth rate (SGR) formula that set physician fee schedule payments, and replaced it with specified payment updates for physicians. In last year’s report, the income, expenditures, and assets for Medicare Part B reflected the projected baseline scenario, which assumed an override of the SGR payment provisions and an increase in the physician fee schedule equal to the average of the most recent 10 years of SGR overrides (through March 2015) or 0.6 percent. Since the new legislation has replaced the SGR system with specified payment updates for physicians, the projections in this year’s report are based on the continuation of program provisions contained in current law, with one exception in regard to payment reductions that would result from the projected depletion of the Social Security and Medicare Hospital Insurance (Part A) Trust Funds; under current law, payments would be reduced to levels that could be covered by incoming tax and premium revenues when the Social Security and Medicare Hospital Insurance (Part A) Trust Funds are depleted.”*

In the U.S. Government Accountability Office Independent Auditor’s Report is found a section “Sustainability Financial Statements” which includes the following (footnotes omitted):

*“Significant uncertainties (discussed in Note 23 to the consolidated financial statements), which primarily relate to the achievement of projected reductions in Medicare cost growth, affect the sustainability financial statements.... As a result of these significant uncertainties and material weakness, readers are cautioned that amounts reported in the 2015 Statement of Long-Term Fiscal Projections; the 2015, 2014, 2013, 2012, and 2011 Statements of Social Insurance; the 2015 and 2014 Statements of Changes in Social Insurance Amounts; and the related notes to such financial statements may not fairly present, in all material respects, the sustainability information for those years in accordance with U.S. generally accepted accounting principles.*

*For 2015, these significant uncertainties primarily relate to the following.*

*□ Medicare projections in the 2015 Statement of Long-Term Fiscal Projections and the 2015 Statement of Social Insurance were based on benefit formulas under current law and included a significant reduction in Medicare payment rates for productivity improvements relating to most categories of Medicare providers, based on full implementation of the provisions of the Patient Protection and Affordable Care Act, as amended (ACA), and physician payment updates specified by the Medicare Access and CHIP Reauthorization Act of 2015 (MACRA).*

*□ Management has noted that actual future costs for Medicare are likely to exceed those shown by the current law projections presented in the 2015 Statement of Social Insurance due, for example, to the likelihood of modifications to the scheduled reductions in Medicare payment rates for productivity adjustments relating to most categories of Medicare providers and to the specified physician payment updates. The extent to which actual future costs exceed the current law amounts due to changes to the scheduled reductions in Medicare payment rates for productivity adjustments and to specified physician payment updates depends on both the specific changes that might be legislated and whether such legislation would include*

*further provisions to help offset such costs. Consequently, there are significant uncertainties concerning the achievement of these projected reductions in Medicare payment rates.*

*□ Management has developed an illustrative alternative projection intended to provide additional context regarding the long-term sustainability of the Medicare program and to illustrate the uncertainties in the Statement of Social Insurance projections. The present value of future estimated expenditures in excess of future estimated revenue for Medicare, included in the illustrative alternative projection in Note 23, exceeds the \$27.9 trillion estimate in the 2015 Statement of Social Insurance by \$8.9 trillion.*

*□ Management noted that these significant uncertainties about projected reductions in health care cost growth also affect the projected Medicare and Medicaid costs reported in the 2015 Statement of Long-Term Fiscal Projections.*

*The 2014, 2013, 2012, and 2011 Statements of Social Insurance were affected by significant uncertainties, primarily related to the achievement of projected reductions in Medicare payment rates for productivity improvements. The 2013, 2012, and 2011 Statements of Social Insurance were also affected by uncertainties related to projected reductions in Medicare payment rates for physician services. Specifically, the Medicare projections in the 2013, 2012, and 2011 Statements of Social Insurance were based on benefit formulas in current law and included significant reductions in Medicare payment rates for productivity improvements and physician services. The 2014 Statement of Social Insurance reflected a change from the assumption regarding scheduled reductions in Medicare payment rates for physician services that was used in the 2013, 2012, and 2011 Statements of Social Insurance. Specifically, the 2014 Statement of Social Insurance reflected a projected baseline that assumed that the physician payment rate reductions would not occur and that physician payment rates would annually increase at a rate equal to the average sustainable growth rate (SGR) override that occurred over the 10-year period ending on March 31, 2015. For 2014, 2013, 2012, and 2011, management noted that actual future costs for Medicare were likely to exceed those shown by the current-law projections presented in the 2014, 2013, 2012, and 2011 Statements of Social Insurance due, for example, to the likelihood of modifications to the scheduled reductions in Medicare payment rates for productivity adjustments.”*

In the 2015 Financial Report GAO issued disclaimers of opinion on the 2015, 2014, 2013, 2012 and 2011 SOSI. As mentioned previously, GAO had issued a disclaimer of opinion on the 2010 SOSI.

**b. Statement of Long-Term Fiscal Projections in 2015 Financial Report**

In the 2015 Financial Report in the Management’s Discussion and Analysis section is a sub-section titled “The Long-Term Fiscal Outlook: “Where We Are Headed.” The following statement appears therein:

*“Pursuant to federal accounting standards, this FY 2015 Financial Report introduces a Statement of Long-Term Fiscal Projections as a basic financial statement and a related Note Disclosure (Note 24). This statement, note disclosure, and additional related information had previously appeared collectively in the Financial Report as required Supplementary Information (RSI). The Statement displays the present value of 75-year projections of the federal government’s receipts and non-interest spending for FY 2015 and FY 2014 (see*

*Table 1). Additional information about these projections may be found in Note 24 and the RSI section of this Financial Report.”*

The author wishes to point out that the single most important informational item reported in the new Statement of Long-Term Fiscal Projections is the net present value cost of the federal government’s portion of the Medicaid program. This information has been reported in the RSI since 2010 and it is reported nowhere else by the federal government. The GAO issued a disclaimer of opinion on the 2015 Statement of Long-Term Fiscal Projections.

The Financial Statements section of the Financial Report contains a sub-section “Sustainability Financial Statements which is described, in part, as follows:

*“The sustainability financial statements comprise the Statement of Long-Term Fiscal Projections, covering all federal government programs, and the Statement of Social Insurance and the Statement of Changes in Social Insurance Amounts, covering social insurance programs (Social Security, Medicare, Railroad Retirement, and Black Lung programs). The sustainability financial statements are designed to illustrate the relationship between projected receipts and expenditures if current policy is continued over a 75 year time horizon. For this purpose, the projections assume that scheduled social insurance benefit payments would continue after related trust funds are projected to be exhausted, contrary to current law, and that debt could continue to rise indefinitely without severe economic consequences. The sustainability financial statements are intended to help citizens understand current policy and the importance and magnitude of policy reforms necessary to make it sustainable.”*

Immediately following this general description is a sub-section “Statements of Long-Term Fiscal Projections” which is described as follows:

*“The new statement of Long-Term Fiscal Projections in 2015 is intended to assist readers of the government’s financial statements in assessing the financial condition of the federal government and how the government’s financial condition has changed (improved or deteriorated) during the year and may change in the future. It is also intended to assist readers in assessing whether future budgetary resources of the Government will likely be sufficient to sustain public services and to meet obligations as they come due, assuming that current policy for federal government public services and taxation is continued without change.*

*The Statements of Long-Term Fiscal Projections display the present value of 75-year projections by major category of the Federal Government’s receipts and non-interest spending. These projections show the extent to which future receipts of the Government exceed or fall short of the Government’s non-interest spending. The projections are presented both in terms of present value dollars and in terms of present value dollars as a percent of present value Gross Domestic Product (GDP). Unaudited fiscal year 2014 projections from last year’s Financial Report are included for comparison. The projections are on the basis of policies currently in place and are neither forecasts nor predictions. These projections are consistent with the projections for Social Security and Medicare presented in the Statements of Social Insurance and are based on the same economic and demographic assumptions as underlie the Statements of Social Insurance. Note 24, Long-Term Fiscal Projections, further explains the methods used to prepare these projections and provides additional information such as the*

*fiscal gap. Unaudited required supplementary information further assesses the sustainability of current fiscal policy and provides results based on alternative assumptions to those used in the basic statement.*

*As discussed further in Note 24, a sustainable policy is one where the ratio of debt held by the public to GDP (the debt-to-GDP ratio) is stable or declining over the long term. GDP measures the size of the Nation's economy in terms of the total value of all final goods and services that are produced in a year. Considering financial results relative to GDP is a useful indicator of the economy's capacity to sustain the Government's many programs."*

### **c. Results Per Financial Report for 2006 Through 2015**

**Exhibit 17** depicts the President's Budget and **Exhibit 18** depicts the Financial Report for the fiscal years 2006 through 2015. As indicated the nation's GDP in 2015 was approximately \$18.1 trillion and the federal government total revenues were \$3.3 trillion. It is important to again note that the only costs for social insurance and Medicaid included in **Exhibits 17 and 18** are actual cash outlays each year.

**Exhibit 19** shows the reconciliation from the Net Operating Cost in the Financial Report to the Budget Deficit in the President's Budget for the years 2006 through 2015. It is important to note that this is the only exhibit in which dollars are presented in billions not trillions.

**Exhibit 20** depicts the balance sheet for September 30, 2015. The Federal debt securities held by the public and accrued interest increased from \$12.8 trillion to \$13.2 trillion during FY 2015 due primarily to the continued need to fund the budget deficit.

*"In addition to debt held by the public, the Government has about \$5.1 trillion of intragovernmental debt....including the Social Security (\$2.8 trillion) and Medicare (\$261.6 billion) trust funds. Intragovernmental debt is primarily held in Government trust funds in the form of special nonmarketable securities....Because these amounts are both liabilities of the Treasury and assets of the Government trust funds, they are eliminated as part of the consolidation process for the governmentwide financial statements. When those securities are redeemed, e.g., to pay future Social Security benefits, the Government will need to obtain the resources necessary to reimburse the trust funds."*

**Exhibit 21** depicts the figures reported in the SOSI for the Open group (current and future participants) for Medicare and Social Security for the years 2006 through 2015. The exhibit indicates that the net present value costs of Social Security and Medicare as of January 1, 2015 as reported in the SOSI for the Open Group was approximately \$41.4 trillion, a decline from the \$41.8 trillion reported in the 2014 SOSI. As noted previously, Medicaid is not reported in the SOSI because the government believes that it is a "general assistance" program and not a social insurance program.

### **i. Adjustments to Consider for Reported SOSI Figures**

There are three adjustments to consider to the figures appearing in **Exhibit 21**.



## 1) Medicare Trustees Alternative Scenario

The first set of adjustments to consider relates to the uncertainties associated with achieving some of the ACA's projected cost reductions and the publication of an alternative scenario by the Medicare Trustees. These uncertainties are discussed in Note 23. Social Insurance in the 2015 Financial Report (footnote omitted).

*"The financial projections for the Medicare program reflect substantial, but very uncertain, cost savings deriving from provisions of the ACA and the specified physician updates put in place by the MACRA. However, it is important to note that the improved results for HI and SMI Part B since 2010 depend in part on the long-range feasibility of the various cost-saving measures in the ACA—most importantly, the reductions in the annual payment rate updates for most categories of Medicare providers by the growth in economy-wide productivity. Under the ACA, the rate of increase of Medicare payment rates is equal to the prior law rate of increase (equal to the rate of increase in the prices of inputs used to produce Medicare services) less the rate of increase of total economy multifactor productivity. Without fundamental change in the current delivery system, these productivity-related adjustments to Medicare payment rates would probably not be viable indefinitely. However, this outcome is achievable if health care providers are able to realize productivity improvements at a faster rate than experienced historically. On the other hand, if the health sector cannot transition to more efficient models of care delivery and achieve productivity increases commensurate with economy-wide productivity, and if the provider reimbursement rates paid by commercial insurers continue to follow the same negotiated process used to date, then the availability and quality of health care received by Medicare beneficiaries would, under current law, fall over time relative to that received by those with private health insurance.*

*A transformation of health care in the United States, affecting both the means of delivery and the method of paying for care, is also a possibility. The ACA takes important steps in this direction by initiating programs of research into innovative payment and service delivery models, such as accountable care organizations, patient-centered medical homes, improvement in care coordination for individuals with multiple chronic health conditions, improvement in coordination of post-acute care, payment bundling, pay for performance, and assistance for individuals in making informed health choices. Such changes have the potential to reduce health care costs as well as cost growth rates and could, as a result, help lower Medicare cost growth rates to levels compatible with the lower price updates payable under current law.*

*The ability of new delivery and payment methods to significantly lower cost growth rates is uncertain at this time, since specific changes have not yet been designed, tested, or evaluated. Preliminary indications are that some of these delivery reforms have had modest levels of success in lowering costs, but at this time it is too early to tell if these reductions in spending will continue, or if they will grow to the magnitude needed to align with the statutory Medicare price updates. The ability of health care providers to sustain the price reductions for those providers impacted by the productivity adjustments and the specified updates to physician payments will be challenging, as the best available evidence indicates that most providers cannot improve their productivity to this degree for a prolonged period given the labor-intensive nature of these services and that physician costs will grow at a faster rate than the specified updates. As a result, actual Medicare expenditures are highly uncertain for reasons apart from the inherent difficulty in projecting health care cost growth over time.*

*The reduction in provider payment updates, if implemented for all future years as required under current law, could have secondary impacts on provider participation, beneficiary access to care; quality of services; and other factors. These possible impacts are very speculative and at present there is no consensus among experts as to their potential scope. Further research and analysis will help to better inform this issue and may enable the development of specific projections of secondary effects under current law in the future.*

*The SOSI projections are based on current law, with one exception in regard to payment reductions that would result from the projected depletion of the Medicare Hospital Insurance (Part A) Trust Fund; under current law, payments would be reduced to levels that could be covered by incoming tax and premium revenues when the Medicare Hospital Insurance (Part A) Trust Funds are depleted.*

*The extent to which actual future Part A and Part B costs exceed the projected amounts due to changes to the productivity adjustments and specified physician updates depends on what specific changes might be legislated and whether Congress would pass further provisions to help offset such costs. However, absent an unprecedented change in health care delivery systems and payment mechanisms, the prices paid by Medicare for health services will fall increasingly short of the cost of providing such services. If this issue is not addressed by subsequent legislation, it is likely that access to, and quality of, physicians' services would deteriorate over time for beneficiaries. By the end of the long-range projection period, Medicare prices for many services would be less than half of their level without consideration of the productivity price reductions and physician payments would be 30 percent lower than they would have been under the SGR. Before such an outcome would occur, lawmakers would likely intervene to prevent the withdrawal of providers from the Medicare market and the severe problems with beneficiary access to care that would result. Overriding the productivity adjustments and specified physician updates, as lawmakers have done repeatedly in the case of physician payment rates, would lead to substantially higher costs for Medicare in the long range than those projected in this report.*

*To help illustrate and quantify the potential magnitude of the cost understatement, the Trustees asked the Office of the Actuary at CMS to prepare an illustrative Medicare Trust Fund projection under a hypothetical alternative that assumes that, starting in 2020, the economy-wide productivity adjustments gradually phase down to 0.4 percent, and starting in 2024, physician payments transition from a payment update of 0.0 percent to an increase of 2.3 percent. In addition, the illustrative alternative also assumes that requirements for the Independent Payment Advisory Board would not be implemented. This alternative was developed for illustrative purposes only; the calculations have not been audited; no endorsement of the policies underlying the illustrative alternative by the Trustees, CMS, or the Office of the Actuary should be inferred; and the examples do not attempt to portray likely or recommended future outcomes. Thus, the illustrations are useful only as general indicators of the substantial impacts that could result from future legislation affecting the productivity adjustments and physician updates under Medicare and of the broad range of uncertainty associated with such impacts. The table below contains a comparison of the Medicare 75-year present values of estimated future income and estimated future expenditures under current law with those under the illustrative alternative scenario."*

**Exhibit 22** depicts an analysis of the excess of expenditures over income for Medicare under the alternative scenario for 2010, 2011, 2012, 2013, 2014 and 2015. The \$36.8 trillion net present value cost for Medicaid under the alternative scenario is \$8.9 trillion larger than the \$27.9 trillion figure reported in the 2015 SOSI.

The quote below relates to 2015 amounts in **Exhibit 22**.

*“The difference between the current law and illustrative alternative projections is substantial for Parts A and B. All Part A fee-for-service providers and roughly half of Part B fee-for-service providers are affected by the productivity adjustments, so the current-law projections reflect an estimated 1.1 percent reduction in annual cost growth each year for these providers. If the productivity adjustments were gradually phased out and physician updates transitioned to the Medicare Economic Index update of 2.3 percent, as illustrated under the alternative scenario, the estimated present value of Part A and Part B expenditures would be higher than the current law projections by roughly 22 percent and 23 percent, respectively. As indicated above, the present value of Part A income is basically unaffected under the alternative scenario.*

*The Part D values are similar under each projection because the services are not affected by the productivity adjustments or the physician updates. The very minor impact is the result of a slight change in the discount rates that are used to calculate the present values.*

*The extent to which actual future Part A and Part B costs exceed the projected amounts due to changes to the productivity adjustments and physician updates depends on what specific changes might be legislated and whether Congress would pass further provisions to help offset such costs. As noted, these examples reflect only hypothetical changes to provider payment rates.”*

## **2) Limitation for Appropriated Funds**

The second adjustment is due to the fact that both Social Security and Medicare Part A will run out of appropriated funds in coming years.

A footnote on page 5 of “A Citizen’s Guide to the 2015 Financial Report of the United States Government follows:

*“The 2015 Medicare Trustees Report projects that the Hospital Insurance (HI) Trust Fund will remain solvent until 2030 (unchanged from last year’s report). Under current law, tax revenue would be sufficient to pay 86 percent of estimated HI cost in 2030 and 84 percent by 2089. As for Social Security, under current law, the Old-Age, Survivors, and Disability Insurance (OASDI) Trust Fund reserves, considered on a theoretical combined basis, are projected to be depleted in 2034 (one year later than shown in last year’s Financial Report), at which time the projected share of scheduled benefits payable from trust fund income is 79 percent, declining to 73 percent in 2089. The Disability Insurance (DI) Trust Fund alone was expected to deplete by the end of 2016, at which time 81 percent of scheduled benefits would be payable. However, the impending depletion of the DI Trust Fund was circumvented by the passage of the Bipartisan Budget Act of 2015, which reallocated a portion of the payroll tax rate from the Old Age Survivors Insurance Trust Fund to the DI Trust Fund. This reallocation is expected to ensure full payment of disability benefits into 2022. The projections*

*assume full Social Security and Medicare benefits are paid after the corresponding trust funds are exhausted. See <http://www.ssa.gov/oact/trsum/index.html> pp 3, 10, 11”*

On page 28 in the Management’s Discussion and Analysis section is the following language (footnotes omitted):

*“Costs as a percent of GDP of both Medicare and Social Security, which are analyzed annually in the Medicare and Social Security Trustees’ Reports, are projected to increase substantially through 2035 because: (1) the number of beneficiaries rises rapidly as the baby-boom generation retires and (2) the lower birth rates that have persisted since the baby boom cause slower growth in the labor force and GDP. According to the Medicare Trustees’ Report, spending on Medicare is projected to rise from its current level of approximately 3.5 percent of GDP to 5.6 percent in 2040 and to 6.0 percent in 2089. The Hospital Insurance (HI) Trust Fund is now expected to remain solvent until 2030, (unchanged from last year’s report). Under current law, scheduled HI tax revenue would be sufficient to pay 86 percent of HI costs after depletion in 2030 and then gradually increasing to 84 percent by 2089.*

*As for Social Security, combined spending is projected to increase gradually from its current level of 4.9 percent of GDP to about 6.0 percent by 2035, declining to 5.9 percent by 2050 and rises to 6.2 percent by 2089. The Social Security Trustees’ Report indicates that annual OASDI income, considered on a theoretical basis, including interest on trust fund assets, will exceed annual cost and trust fund assets will increase every year until 2020, at which time it will be necessary to begin drawing down on trust fund assets to cover part of expenditures until asset reserves become depleted in 2034 (one year later than indicated in last year’s Report). Continuing tax income would be sufficient to pay 79 percent of scheduled benefits in 2034 and 73 percent of scheduled benefits in 2089. The Disability Insurance (DI) Trust Fund alone was expected to deplete much sooner, by the end of 2016. However, the impending depletion of the DI Trust Fund was circumvented by the passage of the Bipartisan Budget Act of 2015, which reallocated a portion of the payroll tax rate from the Old Age Survivors Insurance (OASI) Trust Fund to the DI Trust Fund. This reallocation is expected to ensure full payment of disability benefits into 2022. The projections assume that full Social Security and Medicare benefits are paid after the corresponding trust fund assets are depleted.”*

**Exhibit 23** contains an analysis of appropriated funds and unfunded amounts for each year from 2006 to 2015. For 2015 Medicare had \$25.0 trillion of net present value costs that were fully funded with appropriations.

### **3) Permanent Appropriations Do Not End at 75 Years**

The third adjustment is tied to the fact that Social Security and Medicare have permanent appropriations which do not stop at 75 years. The following passage is found on page 199 of the Financial Report:

*“The 75-year horizon represented in Table 5 (Author’s Note: Table not shown in this memorandum) is consistent with the primary focus of the Social Security and Medicare Trustees’ Reports. For the OASDI Program, for example, an additional \$13.4 trillion in present value will be needed above currently scheduled taxes to pay for scheduled benefits (\$10.7 trillion from the trust fund perspective). Yet, a 75-year projection can be a misleading*

*indicator of all future financial flows. For example, when calculating unfunded obligations, a 75-year horizon includes revenue from some future workers but only a fraction of their future benefits. In order to provide a more complete estimate of the long-run unfunded obligations of the programs, estimates can be extended to the infinite horizon. The open-group infinite horizon net obligation is the present value of all expected future program outlays less the present value of all expected future program tax and premium revenues. Such a measure is provided in Table 6 (Author's Note: Table Not Shown in this Memorandum) for the three trust funds represented in Table 5.*

*From the budget or governmentwide perspective, the values in line 1 plus the values in line 4 of Table 6 represent the value of resources needed to finance each of the programs into the infinite future. The sums are shown in the last line of the table (also equivalent to adding the values in the second and fifth lines). The total resources needed for all the programs sums to \$72.0 trillion in present value terms. This need can be satisfied only through increased borrowing, higher taxes, reduced program spending, or some combination.*

*The second line shows the value of the trust fund at the beginning of 2015. For the HI and OASDI Programs this represents, from the trust fund perspective, the extent to which the programs are funded. From that perspective, when the trust fund is subtracted, an additional \$25.7 trillion is needed to sustain the OASDI program into the infinite future, while an additional \$0.01 trillion is needed to sustain the HI program. However, looking just at present values ignores timing differences in the underlying projected cash flows; the HI Trust Fund is projected to remain solvent only until 2030. As described above, from the trust fund perspective, the SMI Program is fully funded, from a governmentwide basis, the substantial gap that exists between premiums, state transfer revenue, and program expenditures in the SMI Program (\$28.2 trillion and \$14.9 trillion for Parts B and D, respectively) represents future general revenue obligations of the federal budget.*

*In comparison to the analogous 75-year number in Table 5, extending the calculations beyond 2089, captures the full lifetime benefits, plus taxes and premiums of all current and future participants. The shorter horizon understates the total financial needs by capturing relatively more of the revenues from current and future workers and not capturing all of the benefits that are scheduled to be paid to them.*

The Infinite Horizon data for the period from 2006 through 2015 appear in **Exhibit 24**. It indicates that in 2015 the net present value costs of Social Security and Medicare under an Infinite Horizon were \$28.5 and \$43.5 trillion, for a total of \$72.0 trillion

“Infinite Horizon” obligations for both Medicare and Social Security for 2015 are published in Table 6 on page 200 of the Financial Report. These figures have only been reported by the federal government since 2004. Since 2004 each year’s Financial Report contains a table analyzing that year’s Infinite Horizon data.

**Exhibit 25** and **Exhibit 26** summarize appropriations and unfunded amounts for Social Security and Medicare under the infinite horizon for each year from 2006 through 2015. As of 2015 there are \$2.8 trillion of obligations that are fully funded (i.e. Congress has appropriated funds) for Social Security and there are \$43.5 trillion of obligations that are fully funded for Medicare.

In addition, **Exhibit 25** and **Exhibit 26** indicate that there are \$25.7 trillion of unfunded obligations for Social Security and there are no unfunded obligations for Medicare.

**d. GAO's Conclusion in 2015 Financial Report**

In the U.S. Government Accountability Office Independent Auditor's Report is a section labeled "Long-Term Fiscal Challenges" which contains the following (footnotes omitted):

*"While the near-term outlook has improved, the comprehensive long-term fiscal projections presented in the Statement of Long-Term Fiscal Projections, and related information in Note 24 and in the unaudited Required Supplementary Information section of the 2015 Financial Report shows that absent policy changes, the federal government continues to face an unsustainable long-term fiscal path. In the near term, the projections in the 2015 Financial Report show the primary deficit continuing to decline from the recent historic highs. However, these projections do not reflect recent legislation enacted subsequent to September 30, 2015, which, in order to achieve certain national priorities and goals, causes deficits to increase in the near term. Over the long term, the imbalance between spending and revenue that is built into current law and policy is projected to lead to continued growth of debt held by the public as a share of gross domestic product (GDP). This situation—in which debt grows faster than GDP—means the current federal fiscal path is unsustainable.*

*Under these projections, spending for the major health and retirement programs will increase in coming decades more rapidly than GDP as more members of the baby boom generation become eligible for benefits. These projections, with regard to Social Security and Medicare, are based on the same assumptions underlying the information presented in the Statement of Social Insurance and assume that the provisions enacted in the ACA designed to slow the growth of Medicare costs are sustained and remain effective throughout the projection period. They also reflect the effects of the MACRA, which, among other things, revised the methodology for determining physician payment rates.<sup>18</sup> If, however, the Medicare cost containment measures and physician payment rate methodology are not sustained over the long term—concerns expressed by the Trustees of the Medicare trust funds, the Centers for Medicare & Medicaid Services' (CMS) Chief Actuary, the Congressional Budget Office, and others—spending on federal health care programs will grow more rapidly than assumed in the projections."*

**C. Net Present Value Cost of Medicaid Reported 2010 to 2015**

Beginning with the 2010 Financial Report the federal government implemented Statement of Federal Financial Accounting Standard ("SFFAS") No. 36, Reporting Comprehensive Long-Term Fiscal Projections of the U.S. Government. (Author's Note: Statement is not shown in this memorandum) This required the federal government for the first time to disclose significantly more financial information about its obligations including Medicaid in a supplemental information section described as "Fiscal Projections for the U.S. Government – Fiscal Year 2010."

*"[T]he Government is now required to include a statement presenting for all its activities (a) the present value of projected receipts and non-interest spending under current policy without change...[T]he Government is also required to disclose, the assumptions underlying the*

*projections, the factors influencing trends, and significant changes in the projections from period to period.”*

Footnote 24. Long-Term Fiscal Projections in the 2015 Financial Report contains the following excerpted descriptions of the assumptions used in the projections (footnotes omitted):

*“The projections and analysis presented here are extrapolations based on an array of assumptions described in detail below. A fundamental assumption is that current Federal policy will not change. This assumption is made so as to inform the question of whether current fiscal policy is sustainable and, if it is not sustainable, the magnitude of needed reforms to make fiscal policy sustainable. The projections are therefore neither forecasts nor predictions. If policy changes are implemented, perhaps in response to projections like those presented here, then actual financial outcomes will of course be different than those projected. The methods and assumptions underlying the projections are subject to continuing refinement.*

*The projections focus on future cash flows, and do not reflect either the accrual basis or the modified-cash basis of accounting. These cash-based projections reflect receipts or spending at the time cash is received or when a payment is made by the Government. In contrast, accrual-based projections would reflect amounts in the time period in which income is earned or when an expense or obligation is incurred. The cash basis accounting underlying the long-term fiscal projections is consistent with methods used to prepare the Statements of Social Insurance (SOSI) and the generally cash-based Federal budget.*

*The basic financial statement, Long-Term Fiscal Projections for the U.S. Government, displays the present value of 75 year projections for various categories of the Federal Government’s receipts and non-interest spending. Unaudited fiscal year 2014 projections from last year’s Financial Report are included for comparison. The projections for fiscal years 2015 and 2014 are expressed in present value dollars and as a percentage of the present value of Gross Domestic Product (GDP) as of September 30, 2015 and September 30, 2014, respectively.”*

*“As is true for prior fiscal year projections, the assumptions for GDP, interest rates, and other economic factors underlying this year’s projections are the same assumptions that underlie the most recent Social Security and Medicare trustees’ report projections. The use of discount factors consistent with the Social Security trustees’ rate allows for consistent present value calculations over 75 years between the Statements of Long-Term Fiscal Projections and the Statements of Social Insurance.”*

**“Medicaid:** *The Medicaid spending projections start with the projections from the 2014 Actuarial Report on the Financial Outlook for Medicaid prepared by the Office of the Actuary, Centers for Medicare & Medicaid Services (CMS). These projections are based on recent trends in Medicaid spending, the demographic, economic, and health cost growth assumptions in the 2014 Medicare Trustees’ Report, and projections of the effect of the Affordable Care Act (ACA) on Medicaid enrollment. The projections, which end in 2023, are adjusted to accord with the actual Medicaid expenditures in fiscal year 2015. After 2023, the projections assume no further expansion in State Medicaid coverage under the ACA, with the number of Medicaid beneficiaries expected to grow at the same rate as total population, and Medicaid costs per*

*beneficiary assumed to grow at the same rate as Medicare benefits per beneficiary, as is generally consistent with the experience since 1987. Between 1987 and 2014, the average annual growth rate of outlays per beneficiary for Medicaid and Medicare were within 0.4 percentage point of each other. Projections of Medicaid spending are subject to added uncertainty related to: (1) assumed reductions in health care cost growth discussed above in the context of Medicare, and (2) the projected size of the Medicaid enrolled population, which depends on a variety of factors, including the future extent of the ACA Medicaid expansion.”*

The Statement of Long-Term Fiscal Projections for the U.S. Government displays figures for Medicaid for 2015 and 2014 of \$27.3 trillion and \$26.0 trillion, respectively. **Exhibit 27** displays the reported net present value cost of the Federal Government’s portion of Medicaid from 2010 through 2015.

#### **a. Adjustments to Consider for Medicaid’s Net Present Value Cost**

There are two adjustments that one must consider to the \$27.3 trillion estimate for the net present value cost of Medicaid as of September 30, 2015.

- 1) First and foremost, one must recall the quote earlier in this memorandum taken from the GAO’s Auditor’s Report for the 2015 Financial Report which indicated that:

*“Management noted that these significant uncertainties about projected reductions in health care cost growth also affect the projected Medicare and Medicaid costs reported in the 2015 Statement of Long-Term Fiscal Projections.”*

The \$27.3 trillion figure was based upon savings assumptions associated with the ACA similar to those used to generate the \$27.9 trillion Medicare net present value cost figure published simultaneously. However, these assumptions were so unrealistic that the government published an alternate, and more realistic, scenario which indicated that Medicare had a net present value cost of \$36.8 trillion. No alternate figure was published for Medicaid.

- 2) The second adjustment that must be considered is related to the fact that Medicaid has permanent appropriations which do not stop at 75 years. As noted by the federal government for the social insurance obligations, “The shorter horizon understates financial needs by capturing relatively more of the revenues from current and future workers and not capturing all of the benefits that are scheduled to be paid to them.” Therefore, “Infinite Horizon” obligations for Medicaid are needed but the federal government does not calculate or publish these figures.

#### **b. Medicaid Obligations Exceed \$1 Trillion for Four States**

In order to calculate the states net present value obligation in 2015 we utilize the totals in columns 2 and 4 on **Exhibit 28**. Federal spending in 2015 of \$317,302 divided by total spending of \$512,315 produces a percentage of 61.934942%. If we divide the \$27.3 trillion figure published by the federal government for its portion of Medicaid by this percentage the result is \$44.078510 trillion. Subtracting the federal figure of \$27.3 trillion indicates that the states net present value obligation for Medicaid is \$16.778510 trillion.



Based on the states spending for the Medicaid program in 2015 there are four states that have a net present value cost obligation that exceeds \$1 trillion – California, Ohio, New York and Texas. This obligation appears nowhere in any of these states financial statements. For example, the State of New York's obligation is approximately \$1.4 trillion.

**Exhibit 28** depicts the estimated obligation in 2015 for all fifty states. Each of these obligations is clearly material to each state's financial results and financial position.

### **c. Analysis of Medicare Appropriations - SOSI, Alternative Scenario and Infinite Horizon**

**Exhibit 29** displays Medicare appropriations for the amounts reported in SOSI, the amounts reported in the alternative scenario and the amounts reported under the Infinite Horizon. The time frame analyzed is from 2006 through 2015.

As of 2015 Medicare has appropriations of \$25 trillion for the amounts recorded in SOSI. Meanwhile, it has \$29.2 trillion of appropriations for the amounts recorded in the illustrative alternative scenario for Medicare published for 2015. Finally, under the Infinite Horizon Medicare has \$43.5 trillion in appropriations.

For purposes of the first estimate described in the opening paragraphs of this chapter we will use the \$43.5 trillion figure for Medicare for balance sheet purposes as of September 30, 2015. In addition, we will utilize the change in Medicare amounts over the Infinite Horizon from 2005 through 2015 for purposes of calculating the impact on the Statements of Net Cost for that time frame.

**Exhibit 30** depicts Social Insurance and Medicaid obligations that are fully funded with appropriations from 2006 through 2015. The Social Security figures are taken from **Exhibit 25**. The Medicare amounts are based on the Infinite Horizon and are taken from **Exhibit 26** and the Medicaid figures are taken from **Exhibit 27**.

Please note that the Medicare obligations are understated because the Federal Government does not publish Infinite Horizon figures for the Alternate Scenario. In addition, the Medicaid obligations are significantly understated as the federal government has not published 1) Alternative Scenario, 2) Infinite Horizon or 3) Alternative Scenario Infinite Horizon figures for Medicaid for any period.

### **i. An Adjustment to Consider - The Discount Rate is Too High**

Using a discount rate that is too high has the effect of substantially lowering the net present value cost of the Social Insurance and Medicaid programs. The rate used by the government over the long-term has been 5.7% or lately, 5.6%. Both are substantially higher than the highest 30-year rate recorded in the last decade.

The discount rate assumption used in the long-term, as opposed to the varying rates used in the first ten years, looks too high based on the last decades' 30-year Treasury rates as reported by the United States Department of the Treasury in its "Daily Yield Curve Rates" schedule posted on its web site. Please note that the Financial Reports do not display the discount rates used in all years.

The highest rates for the 30-year Treasury for each individual year with the date listed appear below.

2006	5/12/2006	5.29%
2007	6/12/2007	5.35%
2008	6/13/2008	4.79%
2009	6/10/2009	4.76%
2010	4/5/2010	4.85%
2011	2/8/2011	4.76%
2012	3/19/2012	3.48%
2013	12/31/2013	3.96%
2014	1/3/2014	3.93%
2015	6/26/2015	3.25%
2016	1/5/2016	3.01%

The discount rates depicted in the 2006 Financial Report that were used to discount all of the obligations associated with the SOSI were 4.9% for 2006, 5.9% for 2010 and 5.7% for 2020 and all later years.

The discount rates depicted in the 2009 Financial Report that were used to discount all of the obligations associated with the SOSI were 3.0% for 2009, 4.0% for 2010 and 5.7% for 2020 and all later years.

The discount rates depicted in the 2010 Financial Report that were used to discount all of the obligations associated with the SOSI and Medicaid were 3.4% for 2010 and 5.7% for 2020 and all later years.

The discount rates depicted in the 2015 Financial Report that were used to discount all of the obligations associated with the SOSI and Medicaid were 2.2% for 2015, 5.3% for 2020 and 5.6% for 2030 and all later years.

#### **D. Estimated Financial Results for 2006 Through 2015**

**Exhibit 31** displays The Financial Report's Net Operating Cost figures adjusted to account for the annual changes in the net present value cost of the Social Insurance and Medicaid obligations that are fully funded with appropriations. These adjusted figures come much closer to reflecting the federal government's economic reality.

Over the last decade, after adjusting the Federal Government's accrual accounting used in the Financial Report to include the net change in the present value cost of legal obligations with appropriations it has spent \$62.89 trillion while recording revenues of \$25.57 trillion. Thus, the Federal government has spent \$2.46 for every \$1 of revenue it has received.

Just to be clear about the size of the problem, over the last decade, using reported figures that are understated, incomplete estimates, the federal government spent almost \$63 trillion while it took in a little less than \$26 trillion. The government pretends that obligated money is not spent until the future arrives; a legally correct accounting must accrue for those future payments.

##### **a. First Estimate of Financial Position as of September 30, 2015**

**Exhibit 32** shows that the federal government's legal obligations are almost \$92 trillion, which is far above the carefully defined debt-ceiling limit of \$18.1 trillion (currently suspended until March 2017)

and are over five times the size of the gross domestic product and almost twenty-eight times the size of the government's revenues in fiscal 2015.

### **b. Second Estimate of Financial Position – Economic Reality is Much Worse!**

In this section we will do some “horseback arithmetic” to calculate the Federal Government's economic reality (i.e., how much worse the balance sheet is than the first estimate). It is not practical to estimate the impact on an annual basis for the 2006 to 2015 time frame on the Financial Report's Net Operating Cost.

As noted above the Medicare obligations are understated in the first estimate because the Federal Government does not publish Infinite Horizon figures for the Alternate Scenario. In addition, the Medicaid obligations are significantly understated as the federal government has not published 1) Alternative Scenario, 2) Infinite Horizon or 3) Alternative Scenario Infinite Horizon figures for Medicaid for any period.

#### **i. Fully Funded Infinite Horizon Amounts for the Alternative Scenario for Medicare**

**Exhibit 29** indicates that for 2015 the amount reported for the Alternative Scenario that has appropriations is \$29.2 trillion and the amount reported in SOSI with appropriations is \$25.0 trillion. The Alternative Scenario figure is 16.8% higher than the fully funded amount reported in SOSI. In addition, **Exhibit 29** indicates that the amount reported under the Infinite Horizon is \$43.5 trillion. This figure is 74% higher than the amount reported in SOSI. If we use the 74% figure to gross up the \$29.2 trillion amount for the Alternative Scenario, the result is a net present value cost for fully funded Infinite Horizon amounts for the Alternative Scenario of \$50.8 trillion, an increase of \$7.3 trillion over the fully funded Infinite Horizon figure.

#### **ii. Fully Funded Infinite Horizon Amounts for the Alternative Scenario for Medicaid**

In order to estimate the Infinite Horizon for the Alternative Scenario for Medicaid we will first gross up the Medicaid figure reported in **Exhibit 30** by 16.8% (the same as the Medicare figure above) to estimate the Alternative Scenario amount that is fully funded. This yields a figure of \$31.9 trillion. This figure is then grossed up by 74% to estimate the Infinite Horizon amount. It yields a figure of \$55.5 trillion. This exceeds the reported fully funded Medicaid figure of \$27.3 trillion by \$28.2 trillion.

#### **iii. Second Estimate – Financial Report's Adjusted Balance Sheet**

Based on the two revised estimates for fully funded Medicare and Medicaid amounts the Federal Government's legal obligations for SOSI and Medicaid are estimated to be \$35.5 trillion higher than the \$73.6 trillion for 2015 reported on **Exhibit 30**. The Federal Government's Total Net Obligation on **Exhibit 32** would be \$127.3 trillion.

#### **iv. States' Aggregate Medicaid Obligation is \$34.1 Trillion**

Based on the estimate of the federal government's net present value cost obligation for Medicaid of \$55.5 trillion we calculate the net present value cost of the entire program by dividing this figure by

the federal governments' percentage of total spending in 2015. We utilize the totals in columns 2 and 4 of **Exhibit 33**. Federal spending of \$317,302 divided by total spending of \$512,315 produces a percentage of 61.934942%. Dividing \$55.5 trillion by this figure produces a result of \$89.610158 trillion. Subtracting the federal amount of \$55.5 trillion indicates that the states' aggregate net present value cost obligation for Medicaid is \$34.110158 trillion.

*Liberty is always at stake when one or more branches seek to transgress the separation of powers.*

*Justice Anthony M. Kennedy*

## **15 Who Might Be Found to be Complicit in a Political Protection Racket?**

The purpose of this chapter is to raise the question of whether the federal and state governments, the AICPA, FAF, FASAB and GASB are operating a “*criminal enterprise*” as defined under the Racketeer Influenced and Corrupt Organizations Act (“RICO Act or RICO”).<sup>321</sup> Even if the answer to the question is a clear “no,” going through the exercise of considering this outcome reveals just how shady the current arrangements are today.

It can be argued that the fundamental premise underlying this “*association-in-fact*” among the federal and state governments, the AICPA, FAF and GASB is that the parties have operated and continue to operate a “*Political Protection Racket*.” Generally, a protection racket is a scheme whereby a group provides protection to other groups using behavior that is outside the law.

The end result of this presumptive bargain is that politicians at both the federal and state level will be largely shielded from the negative consequences of their spending.

### **A. Truth is Treason in an Empire of Lies?<sup>322</sup>**

The presumptive bargain struck for operating this criminal enterprise is that in return for:

#### **a) Federal and state governments:**

(1) Permitting the accounting industry to provide federal, state and local government entities assurance services (“audits”), and

(2) Funding the FAF, FASB and GASB, and

(3) Not pointing out that the AICPA has no legal authority to designate any accounting standards setting body for the federal or state governments which has a significant benefit to the AICPA in terms of assisting in growing its membership, and

(4) Not pointing out that FAF and GASB have no legal authority to set GAAP for state and local governments;

#### **b) The accounting industry will:**

(1) Promulgate generally accepted accounting principles (“GAAP”) that substantially understate spending by the federal, state and local governments, and

(2) Prosecute AICPA members under its Code of Professional Conduct that do not conform to these GAAP standards; and

- c) FASAB and GASB will coordinate their rule-making so as to minimize any possible difficulties associated with differing accounting rules for the federal and state governments.

Since the early 1970s thirty-three states have adopted RICO laws to be able to prosecute similar conduct. The meaning of racketeering activity as set out in 18 U.S.C. sec. 1961 includes securities fraud, bribery, extortion, fraud and robbery among many other acts.

The legal questions associated with any potential RICO prosecution including the issue of immunity are beyond the scope of this memorandum. Nevertheless, one of the obvious and interesting aspects of this alleged criminal enterprise is that it is not difficult to see how it is likely to end. When the nation's finances finally go "off the cliff" and Treasury yields skyrocket Congress and state politicians will do what they do best, identify a party other than themselves to blame. It is fairly predictable that politicians will find that the AICPA, FAF, FASAB and GASB fill that role perfectly.

While many readers might dismiss the notion of a Political Protection Racket as outrageous, the facts suggest that law enforcement officials at the Federal Bureau of Investigation, Department of Justice and the states' Attorneys General offices might reach a different conclusion. In an effort to stem initial skepticism one should note that the following entities and individuals have been prosecuted under RICO:

- 1) Los Angeles Police Department – In 2000 a federal judge ruled in a Rampart scandal case that plaintiffs could pursue RICO claims against the LAPD. However, a U.S. District judge reversed that decision indicating that the plaintiffs did not have standing because they alleged personal injuries as opposed to the required economic or property damage.
- 2) Key West Police Department – In 1984 several senior officers of the department were arrested on charges that they were running a protection racket for drug smugglers.
- 3) Luzerne County Court of Common Pleas Judges Michael Conahan and Mark Ciavarella were charged under RICO for wire fraud, mail fraud, tax evasion and money laundering. The judges were accused of taking kickbacks in what was called the "Kids for cash scandal."
- 4) Michael Milken was indicted on ninety-eight counts of racketeering and fraud relating to allegations of insider trading and other offenses. He pleaded guilty to six lesser felonies of securities fraud and tax evasion. This was one of the first cases brought against an individual with no ties to organized crime.
- 5) RICO suits have been filed against Catholic dioceses to prosecute senior members for abuses committed by those under their authority.

## B. RICO Charges – U.S. Department of Justice Description

The following description of RICO is found on the U.S. Department of Justice website:

“It is unlawful for anyone employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt. 18 U.S.C.A. § 1962(c) (West 1984). The Racketeer Influenced and Corrupt Organization Act (RICO) was passed by Congress with the declared purpose of seeking to eradicate organized crime in the United States. *Russello v. United States*, 464 U.S. 16, 26-27, 104 S. Ct. 296, 302-303, 78 L. Ed. 2d 17 (1983); *United States v. Turkette*, 452 U.S. 576, 589, 101 S. Ct. 2524, 2532, 69 L. Ed. 2d 246 (1981). A violation of Section 1962(c), requires (1) conduct (2) of an enterprise (3) through a pattern (4) of racketeering activity. *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 496, 105 S. Ct. 3275, 3285, 87 L. Ed. 2d 346 (1985).

A more expansive view holds that in order to be found guilty of violating the RICO statute, the government must prove beyond a reasonable doubt: (1) that an enterprise existed; (2) that the enterprise affected interstate commerce; (3) that the defendant was associated with or employed by the enterprise; (4) that the defendant engaged in a pattern of racketeering activity; and (5) that the defendant conducted or participated in the conduct of the enterprise through that pattern of racketeering activity through the commission of at least two acts of racketeering activity as set forth in the indictment. *United States v. Phillips*, 664 F. 2d 971, 1011 (5th Cir. Unit B Dec. 1981), *cert. denied*, 457 U.S. 1136, 102 S. Ct. 1265, 73 L. Ed. 2d 1354 (1982).

An "enterprise" is defined as including any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity. 18 U.S.C.A. § 1961(4) (West 1984). Many courts have noted that Congress mandated a liberal construction of the RICO statute in order to effectuate its remedial purposes by holding that the term "enterprise" has an expansive statutory definition. *United States v. Delano*, 825 F. Supp. 534, 538-39 (W.D.N.Y. 1993), *aff'd in part, rev'd in part*, 55 F. 3d 720 (2d Cir. 1995), cases cited therein.

"Pattern of racketeering activity" requires at least two acts of racketeering activity committed within ten years of each other. 18 U.S.C.A. § 1961(5) (West 1984). Congress intended a fairly flexible concept of a pattern in mind. *H.J., Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 239, 109 S. Ct. 2893, 2900, 106 L. Ed. 2d 195 (1989). The government must show that the racketeering predicates are related, and that they amount to or pose a threat of continued criminal activity. *Id.* Racketeering predicates are related if they have the same or similar purposes, results, participants, victims, or methods of commission, or otherwise are interrelated by distinguishing characteristics and are not isolated events. *Id.* at 240, 109 S. Ct. at 2901; *Ticor Title Ins. Co. v. Florida*, 937 F. 2d 447, 450 (9th

Cir. 1991). Furthermore, the degree in which these factors establish a pattern may depend on the degree of proximity, or any similarities in goals or methodology, or the number of repetitions. *United States v. Indelicato*, 865 F. 2d 1370, 1382 (2d Cir.), *cert. denied*, 493 U.S. 811, 110 S. Ct. 56, 107 L. Ed. 2d 24 (1989).

Continuity refers either to a closed period of repeated conduct, or to past conduct that by its nature projects into the future with a threat of repetition. *H.J., Inc.*, 492 U.S. at 241-42, 109 S. Ct. at 2902. A party alleging a RICO violation may demonstrate continuity over a closed period by proving a series of related predicates extending over a substantial period of time. *Id.* Predicate acts extending over a few weeks or months and threatening no future criminal conduct do not satisfy this requirement as Congress was concerned with RICO in long-term criminal conduct. *Id.*

As to the continuity requirement, the government may show that the racketeering acts found to have been committed pose a threat of continued racketeering activity by proving: (1) that the acts are part of a long-term association that exists for criminal purposes, or (2) that they are a regular way of conducting the defendant's ongoing legitimate business, or (3) that they are a regular way of conducting or participating in an ongoing and legitimate enterprise. *Id.*

When a RICO action is brought before continuity can be established, then liability depends on whether the threat of continuity is demonstrated. *Id.* However, Judge Scalia wrote in his concurring opinion that it would be absurd to say that "at least a few months of racketeering activity. . .is generally for free, as far as RICO is concerned." *Id.* at 254, 109 S. Ct. at 2908. Therefore, if the predicate acts involve a distinct threat of long-term racketeering activity, either implicit or explicit, a RICO pattern is established. *Id.* at 242, 109 S. Ct. at 2902.

The RICO statute expressly states that it is unlawful for any person to conspire to violate any of the subsections of 18 U.S.C.A. § 1962. The government need not prove that the defendant agreed with every other conspirator, knew all of the other conspirators, or had full knowledge of all the details of the conspiracy. *Delano*, 825 F. Supp. at 542. All that must be shown is: (1) that the defendant agreed to commit the substantive racketeering offense through agreeing to participate in two racketeering acts; (2) that he knew the general status of the conspiracy; and (3) that he knew the conspiracy extended beyond his individual role. *United States v. Rastelli*, 870 F. 2d 822, 828 (2d Cir.), *cert. denied*, 493 U.S. 982, 110 S. Ct. 515, 107 L. Ed. 2d 516 (1989)."

### **C. AICPA Designates Two Unconstitutional Bodies as GAAP Standards Setters**

The AICPA has designated two organizations, FASAB and GASB, as GAAP standards setters. These entities have promulgated rules that result in misleading and/or fraudulent financial statements that violate the constitutional rights of Americans. Nevertheless, both federal agencies and state governments' publish financial statements that are "U.S. GAAP compliant." One can argue that there could be is no greater attempt by Congress or the states at diminishing their accountability,



degrading the competitiveness of the electoral process and protecting incumbents than to have the accounting mess that they created be effectively blessed by the leading “independent” accounting entity.

**a. AICPA’s Hammer – The Code of Professional Conduct**

The AICPA Code of Professional Conduct prohibits members from expressing an opinion or stating affirmatively that financial statements or other data are in conformity with generally accepted accounting principles, if such information departs in any way from accounting principles promulgated by a body designated by the AICPA Council to establish such principles.

**b. AICPA’s Commercial Interests Trump Its Ethical Principles**

Even if law enforcement officials do not determine that the AICPA has participated in a criminal enterprise the organization has some real soul-searching to do. Given AICPA’s behavior as it relates to continuing to recognize FASAB it is clear that its commercial interests outweigh its ethical principles.

**c. AICPA’s Code of Ethics Appear to be “Window Dressing”**

**Article I - Responsibilities** – In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.

**Article II – The Public Interest** – Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

**Article III – Integrity** – To maintain and broaden confidence, members should perform all professional responsibilities with the highest sense of integrity.

**Article IV – Objectivity and Independence** – A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

**Article V – Due Care** – A member should observe the profession’s technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member’s ability.

**d. Ethical Questions for the AICPA to Think About?**

Has the AICPA aided and abetted in the publication of financial results that do not comply with the Constitution?

What culpability does the AICPA have for the publication of financial statements for the federal and state governments that do not meet the requirements of the Constitution?

What does it say about the AICPA’s integrity that they have arguably assisted in misleading the citizens of the United States with respect to the nation’s financial results and financial position?

Has the AICPA designated two unconstitutional entities, FASAB and GASB, as GAAP standard setters?

What public interest has been served by blessing rule making bodies that require the publication of misleading/incomplete financial results?

Given the public disputes at the FASAB between public official representatives and “independent” directors regarding proper accounting for the Nation’s social insurance obligations how can the AICPA continue to designate FASAB as the GAAP standards setter?

Is there anything that could lead the AICPA to withdraw its designation?

How can one possibly debate whether the FASAB is an independent Board? It cannot be so by law and the facts that are publicly documented show that it has never acted in an independent manner.

#### **D. Close Coordination Between FASAB and GASB**

FASAB’s website indicates that FASAB hosted the first joint meeting with GASB on August 21, 2008 and that the second and third joint meetings were held on August 27, 2009 and June 24, 2010.

In addition, there is a person that sits on both Boards – FASAB and GASB. This individual was first appointed to FASAB in July 2009 and was appointed to a second term on July 11, 2014. The individual was first appointed to GASB on July 10, 2010 and was reappointed for a second term on July 1, 2015.

#### **E. Where is Congress and, in particular, Where is Senator Elizabeth Warren?**

Primary responsibility for the fraudulent and unconstitutional financial reporting by the federal government lies with the leadership on both sides of the aisle in the House and the Senate. Senator Elizabeth Warren can be used as the lightning rod for the criticism to be leveled at Congress for a variety of reasons.

Senator Warren is arguably one of, if not the most knowledgeable senator about financial matters that is serving in Congress. As such, she needs to take a good hard look in the mirror. She has always been a strong advocate of accountability. The author believes that as a member of Congress she bears direct responsibility for the unlawful state of financial reporting by the federal government and the state governments. She demands that everyone “play by the same rules.” As a longstanding teacher she knows when someone warrants an “F” as a grade. To date Senator Warren has earned that grade with respect to the issues of federal and state financial reporting.

Senator Elizabeth Warren’s biography on her website makes the following points about her background and expertise:

*“Elizabeth is recognized as one of the nation’s top experts on bankruptcy and financial pressures facing the middle class families....She is widely credited for the original thinking, political courage, and relentless persistence that led to the creation of the Consumer Financial Protection Bureau.....During her campaign for the Senate, Elizabeth promised to fight for middle class families and to make sure that everyone has a fair shot to get ahead. She called for policies that would level the regulatory playing field for small businesses and ensure that everyone – even large and powerful corporations – pay a fair share in taxes and is held accountable for breaking the law.....Senator Warren was a law professor for more than 30 years, including nearly 20 years as the Leo Gottlieb Professor of Law at Harvard Law*

*School....She taught courses on commercial law, contracts, and bankruptcy and wrote more than a hundred articles and ten books, including three national best-sellers, A Fighting Chance, The Two-Income Trap, and All Your Worth."*

Senator Elizabeth Warren wrote a scathing letter to Mary Jo White, Chair of the Securities and Exchange Commission on June 2, 2015. In it she charged that the SEC under the Chair's leadership has failed to require admissions of wrongdoing from companies that appear to have violated the law.

*"The public relies on the SEC to act as the cop on the beat for an honest marketplace – issuing rules that ensure that investors can make informed decisions and holding rule breakers accountable for their actions. When the SEC falls down on the job, the impact is felt throughout the economy, and it touches every American family.*

*During your confirmation hearings two years ago, I said, "The SEC needs a strong leader to issue meaningful and final rules under the Dodd-Frank Act and to hold big banks and other powerful interests accountable when they break the law."*

In January 2016 a report that was prepared for Senator Warren "*Rigged Justice: 2016 – How Weak Enforcement Lets Corporate Offenders Off Easy*" was released. The report details many companies breaking the law and getting a proverbial slap on the wrist.

Her speech at the Democratic National Convention included the following:

*"People feel like the system is rigged against them. And here's the painful part: They're right. The system is rigged. Look around. Oil companies guzzle down billions in subsidies. Billionaires pay lower tax rates than their secretaries. Wall Street CEOs – the same ones who wrecked our economy and destroyed millions of jobs-still strut AROUND Congress, no shame, demanding favors, and acting like we should thank them.*

*No one is asking for a handout. All we want is a country where everyone pays a fair share, a country where we build opportunities for all of us; a country where everyone plays by the same rules and everyone is held accountable."*

The reason why Senator Warren is being singled out for her failure to act should be obvious. Here is an incredibly knowledgeable person that has been all over the SEC about its actions or lack thereof that has turned a blind eye to the fact that the all fifty states (including her own State of Massachusetts which has an estimated \$1.3 trillion legal obligation) are publishing fraudulent and unconstitutional financial statements. To the authors' knowledge she has never focused on or publicly commented on the SEC's finding three states (New Jersey, Illinois and Kansas) guilty of violating the antifraud provisions of the nation's securities laws. In those cases not even a slap on the wrist was administered by the SEC. Where is her outrage about those frauds on the American people or the lack of punishment of public officials?

## **F. The Federal Reserve's Governors Also Fail to Act**

The Federal Reserve sets the nation's monetary policy to promote the objectives of maximum employment, stable prices, and moderate long-term interest rates. These objectives cannot be effectively reached while the federal and state governments publish fraudulent and unconstitutional financial statements. Yet, the most aggressive attempt by a Federal Reserve Chairman to change the

federal government's accounting policies could be Chairman Alan Greenspan's semiannual monetary policy report to the Congress delivered before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate over thirteen years ago on February 11, 2003.<sup>323</sup> An excerpt of his testimony appears below.

*"Policies intended to improve the flexibility of the economy seem to fall outside the sphere of traditional monetary and fiscal policy. But decisions on the structure of the tax system and spending programs surely influence flexibility and thus can have major consequences for both the cyclical performance and long-run growth potential of our economy. Accordingly, in view of the major budget issues now confronting the Congress and their potential implications for the economy, I thought it appropriate to devote some of my remarks today to fiscal policy. In that regard, I will not be emphasizing specific spending or revenue programs. Rather, my focus will be on the goals and process determining the budget and on the importance, despite our increasing national security requirements, of regaining discipline in that process. These views are my own and are not necessarily shared by my colleagues at the Federal Reserve.*

*One notable feature of the budget landscape over the past half century has been the limited movement in the ratio of unified budget outlays to nominal GDP. Over the past five years, that ratio has averaged a bit less than 19 percent, about where it was in the 1960s before it moved up during the 1970s and 1980s. But that pattern of relative stability over the longer term has masked a pronounced rise in the share of spending committed to retirement, medical, and other entitlement programs. Conversely, the share of spending that is subject to the annual appropriations process, and thus that comes under regular review by the Congress, has been shrinking. Such so-called discretionary spending has fallen from two-thirds of total outlays in the 1960s to one-third last year, with defense outlays accounting for almost all of the decline.*

*The increase in the share of expenditures that is more or less on automatic pilot has complicated the task of making fiscal policy by effectively necessitating an extension of the budget horizon. The Presidents' budgets through the 1960s and into the 1970s mainly provided information for the upcoming fiscal year. The legislation in 1974 that established a new budget process and created the Congressional Budget Office required that organization to provide five-year budget projections. And by the mid-1990s, CBO's projection horizon had been pushed out to ten years. These longer time periods and the associated budget projections, even granted their imprecision, are useful steps toward allowing the Congress to balance budget priorities sensibly in the context of a cash-based accounting system.<sup>1</sup> But more can be done to clarify those priorities and thereby enhance the discipline on the fiscal process.*

*A general difficulty concerns the very nature of the unified budget. As a cash accounting system, it was adopted in 1968 to provide a comprehensive measure of the funds that move in and out of federal coffers. With a few modifications, it correctly measures the direct effect of federal transactions on national saving. But a cash accounting system is not designed to track new commitments and their translation into future spending and borrowing. For budgets that are largely discretionary, changes in forward commitments do not enter significantly into budget deliberations, and hence the surplus or deficit in the unified budget is a reasonably accurate indicator of the stance of fiscal policy and its effect on saving. But as longer-term commitments have come to dominate tax and spending decisions, such cash accounting has been rendered progressively less meaningful as the principal indicator of the state of our fiscal affairs.*

*An accrual-based accounting system geared to the longer horizon could be constructed with a reasonable amount of additional effort. In fact, many of the inputs on the outlay side are already available. However, estimates of revenue accruals are not well developed. These include deferred taxes on retirement accounts that are taxable on withdrawal, accrued taxes on unrealized capital gains, and corporate tax accruals. An accrual system would allow us to keep better track of the government's overall accrued obligations and deferred assets. Future benefit obligations and taxes would be recognized as they are incurred rather than when they are paid out by the government.<sup>2</sup>*

*Currently, accrued outlays very likely are much greater than those calculated under the cash-based approach. Under full accrual accounting, the social security program would be showing a substantial deficit this year, rather than the surplus measured under our current cash accounting regimen.<sup>3</sup> Indeed, under most reasonable sets of actuarial assumptions, for social security benefits alone past accruals cumulate to a liability that amounts to many trillions of dollars. For the government as a whole, such liabilities are still growing.*

*Estimating the liabilities implicit in social security is relatively straightforward because that program has many of the characteristics of a private defined-benefit retirement program. Projections of Medicare outlays, however, are far more uncertain even though the rise in the beneficiary populations is expected to be similar. The likelihood of continued dramatic innovations in medical technology and procedures combined with largely inelastic demand and a subsidized third-party payment system engenders virtually open-ended potential federal outlays unless constrained by law.<sup>4</sup> Liabilities for Medicare are probably about the same order of magnitude as those for social security, and as is the case for social security, the date is rapidly approaching when those liabilities will be converted into cash outlays.*

*Accrual-based accounts would lay out more clearly the true costs and benefits of changes to various taxes and outlay programs and facilitate the development of a broad budget strategy. In doing so, these accounts should help shift the national dialogue and consensus toward a more realistic view of the limits of our national resources as we approach the next decade and focus attention on the necessity to make difficult choices from among programs that, on a stand-alone basis, appear very attractive.*

*Because the baby boomers have not yet started to retire in force and accordingly the ratio of retirees to workers is still relatively low, we are in the midst of a demographic lull. But short of an outsized acceleration of productivity to well beyond the average pace of the past seven years or a major expansion of immigration, the aging of the population now in train will end this state of relative budget tranquility in about a decade's time. It would be wise to address this significant pending adjustment sooner rather than later. As the President's just-released budget put it, "The longer the delay in enacting reforms, the greater the danger, and the more drastic the remedies will have to be."<sup>5</sup>*

*Accrual-based revenue and outlay projections, tied to a credible set of economic assumptions, tax rates, and programmatic spend-out rates, can provide important evidence on the long-term sustainability of the overall budget and economic regimes under alternative scenarios.<sup>6</sup> Of course, those projections, useful as they might prove to be, would still be subject to enormous uncertainty. The ability of economists to assess the effects of tax and spending programs is hindered by an incomplete understanding of the forces influencing the economy.*

*It is not surprising, therefore, that much controversy over basic questions surrounds the current debate over budget policy. Do budget deficits and debt significantly affect interest rates and, hence, economic activity? With political constraints on the size of acceptable deficits, do tax cuts ultimately restrain spending increases, and do spending increases limit tax cuts? To what extent do tax increases inhibit investment and economic growth or, by raising national saving, have the opposite effect? And to what extent does government spending raise the growth of GDP, or is its effect offset by a crowding out of private spending?"*

Is this really the best that the Federal Reserve can do in terms of pointing out the fraudulent financial reporting by both the federal and state governments? From this authors' vantage point all of the Federal Reserve's efforts to fulfill its mission are pointless if the federal and state governments continue to mislead the electorate. It is ironic that former Chairman Alan Greenspan recently pointed out that the U.S. is "way underestimating" the national debt. The time to use the bully pulpit is not long after one has retired.

But there seems to be another "closer to home" reason why the Federal Reserve's Governors keep their mouths shut. They can't very well point out that the federal and state governments are failing to adhere to the Constitution if the Governors don't want to follow its requirements either!

#### **a. The Federal Reserve Refuses to Adhere to the Constitution**

On July 2, 2013 Louise L. Riseman, Director Division of Reserve Bank Operations and Payments Systems Division and Donald V. Hamond, Chief Operating Officer sent a letter to the FASAB commenting on its *Reporting Entity* exposure draft. Selected portions of their letter are replicated below:

*"We appreciate the opportunity to comment on the Federal Accounting Standards Advisory Board's (FASAB) proposed Statement of Federal Financial Accounting Standards entitled Reporting Entity.*

*...We have no concerns continuing the current general purpose federal financial reports (GPFFR) practice of including substantial information about the Federal Reserve System's financial interactions with the federal government in the footnotes. Similarly, we have no objections to including within the GPFFR additional information sourced from our audited annual financial statements....We do have concerns, however, if the provisions of the proposed standard were to suggest that the Board or the Reserve Banks should consolidate their financial statements with those of the rest of the federal government. Consolidation of this nature would unnecessarily reduce transparency, undermine the statutorily protected independence of the Federal Reserve System, distort the statements of the U.S. Government, and increase the costs of preparing and auditing the GPFFR.*

*....We believe that the information we provide to the public demonstrates our ongoing commitment to transparency and should be sufficient for meeting the purposes of the standard without incurring additional costs.*

*Disclosure of financial information in the GPFFR footnotes, as opposed to consolidation in the federal government's financials, will provide relevant financial information while avoiding*

*misleading perceptions about the relationship between the federal government and the Federal Reserve System.*

*...The Reporting Entity exposure draft recognizes that the federal government achieves its objectives through a wide range of organizations, which fall at different points on the control spectrum.*

*....At the other end of the continuum, by statute, the Federal Reserve operates independently with respect to determining and implementing monetary policy, and that function has a much more significant effect on its financial condition and operating results. The Federal Reserve Act provides the Board, the Reserve Banks, and the Federal Open Market Committee with specific separate authorities and responsibilities and is designed to preserve the independence of the Federal Reserve System entities from other government departments and agencies, including the U.S. Treasury. The current FASAB Statement of Federal Financial Accounting Concepts 2: Entity and Display recognizes the independence of the monetary policy authority, stating that the Federal Reserve System's "organization and functions pertaining to monetary policy are traditionally separated from and independent of the other central government organizations and functions in order to achieve more effective monetary and fiscal policies and economic results. Therefore, the Federal Reserve System would not be considered part of the government-wide reporting entity." Further, Reserve Banks are not government agencies, and the treatment in the GPFRR should be consistent with their character.*

*Consolidation of the Federal Reserve System's financial information in the GPFRR would partially eliminate assets and liabilities stemming from both fiscal and monetary policy operations in a way that would reduce the transparency of the government's fiscal operations. For example, the Reserve Bank's holdings of Treasury securities acquired in the conduct of monetary policy would be eliminated along with the U.S. Treasury's debt liabilities after consolidation, obscuring the federal debt resulting from the federal government's fiscal operations. The portion of interest expense paid on the Reserve Bank's holdings of U.S. Treasury securities would also be eliminated. Consolidation would also result in presenting deposits of private financial institutions held at the Reserve Banks as obligations of the federal government, which they are not.*

*....FASAB's authority, which is derived from statutory authorities of the OMB, GAO, and the Treasury, does not include authority to impose reporting requirements on the Board and Reserve Banks, given that (1) the Board is an independent entity in the executive branch; (2) neither the Board nor the Reserve Banks have reporting or other relationships to FASAB; and (3) Congress has separately established the financial reporting requirements applicable to the Federal Reserve System and vested final authority over those reports in the Board without directing the Board or the Reserve Banks to issue financial statements in accordance with FASAB requirements.<sup>324</sup> To the extent requirements to report about the Federal Reserve System would be imposed on another entity, such as the Department of the Treasury, it is unclear how the Treasury can be expected to fulfill this obligation when the requested information pertains to the central bank, not the Treasury, and the central bank does not report to the Treasury."<sup>325</sup>*

In reviewing the comments made in the Federal Reserve's letter to FASAB there is only one crucial question that needs to be answered. Is the Federal Reserve System funded with "public money?"

Given that the answer to this question is clearly that the Federal Reserve System is funded with public money, it has to be consolidated into a proper and complete Statement and Account. Congress' statutory authority creating the Federal Reserve System and its reporting cannot override the explicit words of the Appropriations and Statement and Account clauses.

If the Federal Reserve believes that it does not have to follow the Constitution the Governors should publish a position paper outlining in detail their legal reasoning why the Federal Reserve is above the law.



*Liberty cannot be preserved without a general knowledge among the people, who have a right, from the frame of their nature, to knowledge, as their great Creator, who does nothing in vain, has given them understandings, and a desire to know; but besides this, they have a right, an indisputable, unalienable, indefeasible, divine right to that most dreaded and envied kind of knowledge; I mean, of the characters and conduct of their rulers.*

*John Adams*

## **16 Counter Arguments To Consider**

There are a number of reasons why the federal and state governments think that they can get away with their fraudulent financial reporting. Most importantly, they believe that the Supreme Court will not determine the meaning of the appropriations and statement and account clauses. A corollary to this thinking is that the issue of financial reporting should be left to the Legislative and Executive branches. The federal government has employed accounting experts to advise them on proper accounting for the federal government so the belief is that it would be entirely inappropriate for the Supreme Court to weigh in on the topic of proper accounting.

Most government officials believe that Congress has the plenary power to determine whatever financial reporting it deems appropriate for the electorate. In addition, most believe that current financial reporting practices fulfill any Constitutional requirement under the Statement and Account clause. The government publishes the Combined Statement of Receipts, Outlays and Balances as well as substantial additional disclosure in its annual Financial Report of the United States Government and the President's Budget. Furthermore, the federal government has been explicit in its annual Financial Report that current policies are unsustainable. This should be more than an adequate warning for the citizenry.

The federal government's arguments against recording any obligations for future payments include an argument that these obligations are so large that they can never be paid. Hence, recording these liabilities might hinder reforms. Finally, because these obligations can't be paid they are not really estimable.

### **A. Supreme Court Will Never Hear the Case**

Many, if not most, current and retired government officials believe that the Supreme Court will never be willing to rule on the meaning of the statement and account clause. The belief is that the Court will duck any case based on the issue of standing or, assuming that a plaintiff gets by that requirement, by invoking the political question doctrine. The author believes that this belief is founded in a hope that the Supreme Court will never address the issue.

The Supreme Court may consider dodging the issue based on standing to sue as it did in *United States v. Richardson*. However, the fraudulent financial reporting problem is impossible to correct

through the normal democratic process because the government's promises to pay which should be reflected as liabilities on its financial statements are assets on the electorate's individual balance sheets. Hence, this is not a problem that the electorate is willing or looking to correct because it will have bad financial implications for them.

The judiciary has sometimes indicated that public access is a matter for executive and legislative discretion. The Court averred in *Houchins v. KQED, Inc.* that "[t]he Constitution itself," in Justice Stewart's words, "is neither a Freedom of Information Act nor an Official Secrets Act." The two reasons typically given to deny an affirmative right to information are that the judiciary lacks easily ascertainable standards for specifying the content of any access guarantee and that alternative methods are available for the public to access the information. However, the argument can be made that the Supreme Court has already determined the relevant standard for judging the content of the financial information that the government must reveal. This standard is the antifraud provisions of the nation's securities laws. With respect to the second reason to deny access the concept that a citizen/voter can piece together consolidated financial information from the data that is published today is laughable as sophisticated financial executives who pore over the data for years can only get a sense for what these figures would actually be. Furthermore, in addressing the argument denying the affirmative right to financial information the Court must confront the Supremacy Clause and the words of the Appropriations and Statement and Account clauses.

It is the duty of the Judiciary to interpret the legal meaning of the Constitution. If the Court does not acknowledge the right of financial information it is effectively saying that the Constitution does not permit anyone to challenge Congress with respect to its self-proclaimed adherence to a Constitutional requirement. This is so even when Congress' non-adherence benefits its incumbents to the detriment of the electorate. Furthermore, as previously noted, the lack of an interpretation of the Statement and Account Clause has dire implications for several other constitutionally protected rights. In addition, the Court should not invoke the political question doctrine as this would nullify an important check on power that the Framers explicitly made a part of the Constitution. Finally, if the Court refuses to interpret the Clause it will remain susceptible to making errant decisions based on false and incomplete economic data as it did with its ACA decision last summer.

## **B. Congress Has Plenary Power to Determine the Meaning of the Statement and Account Clause**

Many believe that the Statement and Account is subject to the plenary power of Congress and that no court or citizen has any ability to challenge any financial reporting that Congress wishes to undertake.

The *Principles of Federal Appropriations Law, Third Edition* contains the following passage:

*"The second part of article I, section 9, clause 7 requires "a regular statement and account of the Receipts and Expenditures of all public Money shall be published from time to time." Implementation of this provision, as a logical corollary of the appropriation power, is also wholly within the congressional province, and the courts have so held. Washington Post Co. v. United States Department of State, 685 F2d 698, 700 (D.C. Cir. 1982) ("the plenary authority of Congress in this area will be respected"), vacated as moot, 464 U.S. 979 (1983); United States v. Richardson, 418 U.S. 166, 178 n. 11 (1974)(it is clear that Congress has plenary power to exact any reporting and accounting it considers appropriate in the public interest");*

*Harrington v. Bush*, 553 F2d at 195; *Hart's Case*, 16 Ct. Cl. 459, 484 (1880), *aff'd* *Hart v. United States*, 118 U.S. 62 (1886) (“[a]uditing and accounting are but parts of a scheme of payment”). See also B-300192, n. 10, Nov. 13, 2002.”

In its 1974 5-4 decision in *United States v. Richardson*,<sup>326</sup> the Court declined to opine on the meaning of the Statement and Account Clause as it found that the plaintiff lacked standing. Chief Justice Burger’s opinion included dictum that appears to have become the gospel for the Court to ignore the provision.

*“[I]t is clear that Congress has plenary power to exact any reporting and accounting it considers appropriate in the public interest.”*<sup>327</sup> *“Not controlling, but surely not unimportant, are nearly two centuries of acceptance of a reading of cl 7 as vesting in Congress plenary power to spell out the details of precisely when and with what specificity Executive agencies must report the expenditure of appropriated funds and to exempt certain secret activities from comprehensive public reporting.”*<sup>328</sup>

While these statements are clearly true as they relate to details associated with the nation’s financial reports and most assuredly information related to national security matters, Congress has a Constitutional obligation to report truthful and complete information with respect to total receipts, total expenditures and the resulting surplus or deficit. Justice Douglas focused on this fact in his dissent in *Richardson*. He thought that Chief Justice Burger’s interpretation effectively read the Statement and Account Clause out of the Constitution. Whether Congress is complying with the Statement and Account Clause is a matter for the Supreme Court to decide, not Congress.

### **C. Feds are Already Publishing Required Statement and Account**

The Transmittal letter of the Commissioner of the Treasury’s Bureau of the Fiscal Service dated December 15, 2015 indicates “In accordance with the provisions of Section 114(a) of the Act of September 12, 1950 (31 U.S.C. 3513(a)), I am transmitting herewith the Combined Statement of Receipts, Outlays, and Balances of the United States Government for the fiscal year ended September 30, 2015. This statement presents budget results and the cash-related assets and liabilities of the Federal Government with supporting details.”

### **D. Information is Already Available**

On August 28, 2013 Joseph Marren testified at FASAB’s Public Hearing regarding its Reporting Entity exposure draft. In the question and answer session Mr. Marren had the following exchange with a Board member.

MR. GRANOF (Board member): All of the information that you’ve presented is in the public domain.

MR. MARREN: It is right out of the Financial Report of the United States Government.

MR. GRANOF: Exactly, it’s all in the public domain. The empirical evidence, the academic evidence is overwhelming. That when information is available in the public domain, users of financial statements incorporate it into their decisions. The question is this, why don’t you believe-- or to put it another way, what decisions do you think will be affected if indeed the government were to consolidate all of this in one financial statement? The related question is what studies have you

relied upon to indicate that this notion of the public incorporating all available information is inappropriate?

MR. MARREN: I guess I have several reactions. What jumps to mind is a circumstance where someone in the private sector has published fraudulent financials and is in front of the SEC. What I would tell you is you don't get to ask that question in front of the SEC. The only question is are the financials right or not. That's number one.

The next reaction that I have is related to the Constitution. The bottom line is that unless the Feds put together financial reports that are consistent with the requirements of the Constitution, you are violating all of those rights that I enumerated. If we get to a point where the Supreme Court determines that federal financial reporting is fraudulent and is violating those rights, the government is going to have to put out correct financial statements.

#### **E. SCOTUS Will Never Overrule Accounting Experts**

The dialogue continues between Mr. Marren and Mr. Granoff:

MR. GRANOF: Let me make one comment, and that is to say that the reason that the Federal Reserve is not consolidated, and the reason we don't consolidate Social Security and social insurance, is not because we're unaware of it. It's because a group of accounting experts believe that that constitutes the most appropriate financial reporting.

MR. MARREN: I don't disagree with your statement whatsoever. Unfortunately, I think it is in direct contravention to the Constitution of the United States. The Constitution of the United States is crystal clear. If it's funded with public money, it has to be in the financial statements.

MR. GRANOF: It is in the financial statements. The Constitution does not use the word "balance sheet".

MR. MARREN: Hence, that is why I made the point this will get resolved ultimately at the Supreme Court. FASAB is slicing the apple so many ways and so many times in terms of the financial reporting requirements that you're all dreaming up that I think a court of law will come to a different conclusion than you do.

MR. GRANOF: They would overrule accounting experts?

MR. MARREN: Yes, because it does not comply with the Constitution.

**F. The Federal Government Has Adequately Warned the Public**

FASAB seems to believe that statements in the federal governments' Financial Report warning that current policies are unsustainable is adequate warning to the public. The author's reaction to this notion is that the reader should consider the following analogous hypothetical: Imagine a publicly traded company in the United States that had been publishing fraudulent financial statements for years but had a warning in its Management Discussion and Analysis section of its annual report indicating that there was trouble ahead for the company. Mr. Marren's exchange with the FASAB Chair follows:

MR. ALLEN: Let me ask another question. Obviously I'm not going to defend what we've done or not done. Obviously we wouldn't be here if we didn't think we were contributing to the information. That's why most people serve on this board, all people serve on the board. You in the written comments made some comments about the American Institute of Certified Public Accountants, or the AICPA, which is the organization that decides whether we can set generally accepted accounting principles. I think that's consistent with Mike saying if they looked at it, they looked at the process, and they've made that determination we are sufficiently independent to set those standards. You pointed out part of the challenge of them arriving at that point, and you actually quoted the then chairman of the AICPA when that was granted and made a comment that, and I paraphrase because I can't remember exactly the quote, but the paraphrase was that we acknowledge there are potentially some challenges to independence based on this structure. Nevertheless we grant GAAP authority because we believe that is in the best public interest to get this information out. Whether it's out in the right form by having a separate statement of social insurance versus including it in the balance sheet are issues that this board has debated for probably over half of its existence. We've had at least three major projects and other discussions about how to best account for and treat. As you well know, the opinions around this table vary in how best to treat that information. I guess I would ask you, would you disagree-- you're very critical of the AICPA, and it seemed like what they were doing was being open. Yet, they were saying in the broader public interest for information, we grant that GAAP authority. I'm curious as to somebody who believes in broad, public information, why you would then attack them in that process?

MR. MARREN: I guess I again have multiple reactions to your question. First of all, I indicated in the list of questions that those that aided and abetted in the publication of fraudulent financial statements might have a concern about criminal or civil liability. I think that's on the table. I'm not going to give anybody legal advice, but if in fact the Supreme Court of the United States determines that the federal government is publishing fraudulent financial statements, I suspect it's not in the AICPA's interest to have backed the group that helped promulgate standards that created fraudulent financial statements.

MR. ALLEN: If they don't reach that conclusion--

MR. MARREN: If they don't reach that conclusion, then we just have terrible accounting. One of the things that I think-- we have very smart people here. You can disagree with almost every point that I've made. This is a financial train wreck. For people in the government that are just used to having things go on and on, they will. In the private sector, things actually go bankrupt. There is a bad ending to things, and we are clearly headed there.

MR. ALLEN: I guess one of the things that this board supported though didn't do-- this actually comes from the Treasury Department itself-- is their attempt to try and broadly try and get that message out to all citizens. This is a specific guide to citizens of the United States. It's a guide that you can go online and any of the sponsor agencies probably and find that-- it makes a very clear statement here within this that we are not on a sustainable path. Our projections of obligations far exceed our projections of revenue and we need to make some changes. The fact that Congress maybe hasn't acted on that is not, I don't believe, the responsibility of the agencies themselves who published this information or of our board who tries to get that information, financial information, out.

#### **G. Social Insurance Obligations Cannot Be Paid**

In the internal fight at FASAB in 2005-2006 over accounting for social insurance programs two of the six reasons cited in support of not recognizing any future costs of social insurance in the federal governments' financial statements were:

- 1) Recording future benefits as expenses and liabilities may undermine needed reforms, and
- 2) Given the current un-sustainability of benefits with current financing the amount of benefit payments are uncertain and not reasonably estimable.

### **H. Compassion Requires Current Accounting Practices**

The ethical tradeoff that one is confronted with as to whether to deal with fraudulent accounting now or wait until the government's finances collapse is made clear by the following question. Do you require proper accounting now which will likely result in benefit reductions that may hurt those in need today, or do you allow the current situation to continue and have the nation "go off the cliff" at some point in the future at which time those who need assistance will be largely abandoned completely?





## **Appendices**

### **I. Overview of the American Institute of Certified Public Accountants**

#### **A. American Institute of Certified Public Accountants – FAQs**

The AICPA's website page answering Frequently Asked Questions about the AICPA include the following excerpts:

##### **What is the AICPA?**

The American Institute of Certified Public Accountants (AICPA) is the national professional organization for Certified Public Accountants (CPAs) in the United States.

##### **What is the AICPA's Mission and how is it carried out?**

The AICPA's mission is powering the success of global business, CPAs, CGMAs (author's note: This acronym means Chartered Global Management Accountant) and specialty credentials by providing the most relevant knowledge, resources and advocacy, and protecting the evolving public interest. In fulfilling its mission, the AICPA works with state CPA organizations and gives priority to those areas where public reliance on CPA skills is most significant.

##### **When was the AICPA founded?**

The AICPA was founded in 1887 and upon its creation, established accountancy as a profession distinguished by rigorous educational requirements, high professional standards, a strict code of professional ethics, licensing status and a commitment to serving the public interest.

##### **Who leads the AICPA?**

The AICPA Board of Directors acts as the executive committee for the governing Council which determines Institute programs and establishes general policies. The Council is made up of elected and appointed members from each of the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands and Guam. The Board oversees management and organizes the various volunteer committees which report to it.

##### **How many members are there?**

The AICPA has more than 412,000 members in 144 countries, including CPAs in business and industry, public accounting, government, education, student affiliates and international associates.

##### **Who determines GAAP?**

Generally Accepted Accounting Principles (GAAP) are uniform minimum standards of, and guidelines to, financial accounting and reporting. The Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB) are authorized to establish these principles.

## B. FAQs - Become a CPA

The AICPA's website page FAQs – Become a CPA answering frequently asked questions about becoming a CPA. It includes the following excerpts:

### 1. Does the AICPA license CPAs?

No. The licensing authority and requirements for CPAs falls under the jurisdiction of the Board of Accountancy for the state, district, or country in which a CPA practices. In adherence to the AICPA mission, the Institute seeks the highest possible level of uniform certification and licensing standards while promoting and protecting the CPA designation. The national organization representing the state boards is the National Association of State Boards of Accountancy ([NASBA](#)).

### 2. What are the requirements for becoming a CPA?

The requirements, which are set by each state board of accountancy, include: completing a program of study in accounting at a college or university, passing the Uniform CPA Exam, and obtaining a specific amount of professional work experience in public accounting (the required amount and type of experience varies according to licensing jurisdiction). You can learn more about your state requirements and find your state board's contact information on the AICPA's website for college students and CPA candidates in the [state requirements section](#).

### Who disciplines CPAs when something goes wrong? Can the AICPA revoke the license of a CPA?

Upon joining the AICPA, a member agrees to abide by its [Code of Professional Conduct](#) and [Bylaws](#) adopted by a vote of the membership. The bylaws provide a structure for enforcement of the Code by the Institute's [Professional Ethics Division](#). When allegations come to the attention of the Ethics Division regarding a violation of the Code, the division investigates the matter, under due process procedures, and depending upon the facts found in the investigation, may take a confidential disciplinary action, settle the matter with suspension or revocation of membership rights, or refer the matter to a panel of the Trial Board Division for a hearing. The bylaws mandate publishing the member's name if he or she is found guilty by a hearing panel, is suspended or expelled by settlement.

The bylaws of 51 state and/or territorial CPA societies provide for their participation in a Joint Ethics Enforcement Program so that, depending upon membership status, actions taken by one or more of these societies or the AICPA are in the names of both the society and AICPA.

State regulatory agencies (Boards of Accountancy) issue practice licenses to CPAs and only those agencies may act to affect those licenses. The AICPA does not license CPAs. Those state regulatory agencies may take disciplinary action affecting practice licenses under statutes, regulations and rulings of the state. Also, the Securities and Exchange Commission (SEC) and other Federal government agencies may, under Federal law or regulation, discipline CPAs who practice before these agencies.

### **C. AICPA Governing Body, Its Composition and Powers**

The AICPA web site describes its governing body as follows:

Council is the governing body of the AICPA and is comprised of approximately 265 members and representatives from every state and U.S. Territory. Council meets twice a year, in May and October, and Regional Council meetings are held every year in March.

The AICPA bylaws indicate that the Council shall be composed of:

**3.3.1.1** Members of the Institute directly elected by the membership in each state in accordance with sections **6.1.1 through 6.1.6**;

**3.3.1.2** Representatives of the recognized state societies of certified public accountants selected in accordance with **section 6.2**;

**3.3.1.3** Twenty-one members-at-large selected in accordance with **section 6.3**;

**3.3.1.4** All members of the Board of Directors of the Institute;

**3.3.1.5** All past presidents of the American Institute of Certified Public Accountants who served prior to December 31, 1973, and are members of the Institute;

**3.3.1.6** All past chairmen of the board of the American Institute of Certified Public Accountants who are members of the Institute.

The bylaws also indicate that the Council shall have the following powers and is required to report its actions to the membership of the AICPA.

#### **3.3.2 Powers**

The Council may exercise all powers requisite for the purposes of the Institute, not inconsistent with these bylaws or with duly enacted resolutions of the membership, including but not limited to the authority to prescribe the policies and procedures of the Institute and to enact resolutions binding upon the Board of Directors, the officers, committees, and staff.

#### **3.3.3 Reports to Membership**

The actions of the Council shall be reported to the membership at least annually.

## **D. AICPA Code of Professional Conduct – Rule 203**

All members of the AICPA must follow its Code of Professional Conduct and Bylaws dated June 1, 2013.

### **ET Section 203**

#### **Accounting Principles**

**.01 Rule 203 – Accounting principles** A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and a member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

**.03 203-2 – Status of FASB, GASB and FASAB interpretations** Council is authorized under Rule 203 [sec. 203 par. .01] to designate bodies to establish accounting principles. Council has designated the Financial Accounting Standards Board (FASB) as such a body and has resolved that FASB *Accounting Standards Codification*<sup>TM</sup> (ASC) constitutes accounting principles as contemplated in Rule 203 [sec. 203 par. .01]. Council has also designated the Governmental Accounting Standards Board (GASB), with respect to Statements of Governmental Accounting Standards issued in July 1984 and thereafter, as the body to establish financial accounting principles for state and local governmental entities pursuant to Rule 203 [sec. 203 par. .01]. Council has also designated the Federal Accounting Standards Advisory Board (FASAB), with respect to Statements of Federal Accounting Standards adopted and issued in March 1993 and subsequently, as the body to establish accounting principles for federal government entities pursuant to Rule 203 [sec. 203 par. .01].

In determining the existence of a departure from an accounting principle as established in FASB ASC and encompassed by Rule 203 [sec. 203 par. .01], or the existence of a departure from an accounting principle established by a Statement of Governmental Accounting Standards or a Statement of Federal Accounting Standards encompassed by Rule 203 [sec. 203 par. .01], the division of professional ethics will construe such codification or statements, in the light of any interpretations thereof issued by FASB, GASB or FASAB.

## II. Overview of the Financial Accounting Foundation and Governmental Accounting Standards Board

### A. “Facts About FAF” (from its website)

**Organized in 1972, the Financial Accounting Foundation (FAF) is the independent, private-sector organization with responsibility for:**

Establishing and improving financial accounting and reporting standards;

Educating constituents about those standards;

Selecting the members of the standard-setting Boards and Advisory Councils;

The oversight, administration, and finances of its standard-setting Boards, the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB), and their Advisory Councils; and

Protecting the independence and integrity of the standard-setting process.

The Foundation is a non-stock Delaware corporation that operates exclusively for charitable, educational, scientific, and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code. The Foundation, FASB, and GASB are located in Norwalk, CT.

### B. FAF Mission

To establish and improve financial accounting and reporting standards, fostering financial reporting that provides decision-useful information to investors and other users of financial reports. This mission is accomplished through a comprehensive and independent standard-setting process that encourages broad participation, objectively considers all stakeholder views, and is subject to appropriate oversight and accountability.

### C. FAF Organizations

#### **Financial Accounting Standards Board (FASB)**

Established by the FAF in 1973, the FASB has been delegated the authority to establish standards of financial accounting and reporting for private-sector entities, including business and not-for-profit organizations. FASB standards are recognized as generally accepted and authoritative.

#### **Governmental Accounting Standards Board (GASB)**

Organized by the FAF in 1984, the GASB has been delegated the authority to establish standards of financial accounting and reporting for state and local governmental entities. GASB pronouncements are recognized as generally accepted and authoritative.

#### **Financial Accounting Standards Advisory Council (FASAC)**

Comprised of FASB constituents, the Financial Accounting Standards Advisory Council consults with the FASB on technical issues, project priorities, and other matters likely to concern the FASB.

#### **Governmental Accounting Standards Advisory Council (GASAC)**

Comprised of GASB constituents, the Governmental Accounting Standards Advisory Council

consults with the GASB on technical issues, project priorities, and other matters likely to concern the GASB.

**Private Company Council (PCC)**

The PCC determines alternatives to existing nongovernmental U.S. GAAP to address the needs of users of private company financial statements, based on criteria mutually agreed upon by the PCC and the FASB. Before being incorporated into U.S. GAAP, PCC recommendations will be subject to a FASB endorsement process. The PCC also serves as the primary advisory body to the FASB on the appropriate treatment for private companies for items under active consideration on the FASB's technical agenda.

**D. FAF Governance****About the FAF Trustees**

The FAF Board of Trustees comprises 14-18 members from varied backgrounds—users, preparers, and auditors of financial statements; state and local government officials; academics; and regulators. The FAF directs the effective, efficient, and appropriate stewardship of the FASB and GASB in carrying out their missions; selects and appoints FASB and GASB members and their advisory councils; oversees the Boards' activities and due process; and promotes and protects the independence of the Boards.

**E. By-Laws of the Financial Accounting Foundation**

Selected excerpts of the By-laws appear below:

**CHAPTER A, ARTICLE I - BOARD OF TRUSTEES***Section 1. Authority, Functions, and Powers.*

(a) The business and affairs of the Financial Accounting Foundation (the "Foundation") shall be managed by or under the direction of its Board of Trustees (the "Board of Trustees"), which shall have and may exercise all authority and powers, and perform all functions of the Foundation and do such lawful acts and things as are not, by the Certificate of Incorporation (as may be amended or restated from time to time, the "Certificate of Incorporation") or by or pursuant to these By-Laws, directed or required to be exercised or performed by the Financial Accounting Standards Board (the "FASB"), or by the Governmental Accounting Standards Board (the "GASB"), or the Financial Accounting Standards Advisory Council (the "FASAC") in its advisory capacity, or by the Governmental Accounting Standards Advisory Council (the "GASAC") in its advisory capacity.

(b) In carrying out its authority, functions, powers, and oversight responsibilities under this Article, the Board of Trustees shall not direct the FASB or the GASB to undertake or to omit to undertake any particular project or activity or otherwise affect the exercise by the FASB or the GASB of their respective authorities, functions, and powers in the establishment and improvement of financial accounting and reporting standards, and the Board of Trustees shall take care not to impair, in fact or perception, the independence and objectivity of the FASB or the GASB in the establishment and improvement of financial accounting and reporting standards.

(c) Subject to the foregoing:

i. The Board of Trustees shall provide for the appropriate funding and resources for the Foundation, the FASB, the GASB, the FASAC, and the GASAC.

ii. The Board of Trustees shall oversee the strategic planning, promotion and positioning of the Foundation, the FASB and the GASB in the evolution of financial accounting and reporting standards for the private and public sectors.

iii. The Board of Trustees shall perform reviews of, and have power of approval over, the annual budgets of the Foundation, the FASB and the GASB as prepared and presented to it by the President of the Foundation, the Chair of the FASB and the Chair of the GASB, respectively, and shall review the financial statements of the Foundation, as prepared and presented to it by the President of the Foundation.

#### *Section 2. Oversight.*

(a) In connection with the exercise of its authority, functions, and powers under *Section 1* of this Article, the Board of Trustees, among other things, shall provide oversight, on an ongoing basis, over the activities of the FASB, the GASB and their due process practices, policies and procedures, including, but not limited to, agenda setting, solicitation and consideration of public comments; post-issuance evaluation of the effectiveness and efficiency of FASB and GASB standards and standard-setting activities; the performance of the FASB and the GASB within the context of their mission statements; and such other activities and matters as the Board of Trustees, in its discretion, may determine.

#### *Section 4. Qualifications.*

(a) Of the number of Trustees comprising the full Board of Trustees from time to time, at least three (3) shall be designated as “Governmental Trustees” and shall be individuals who, in the judgment of the Board of Trustees, have extensive experience as financial officers or as elected officials of state or local governmental entities, and the remaining Trustees shall be designated as “at-large Trustees” and shall be individuals with business, investment, capital markets, accounting, accounting and business education, financial, government, regulatory, investor advocate or other experience who, in the judgment of the Board of Trustees, can contribute to advancing the purposes of the Foundation. The responsibilities of a Trustee shall be personal to each person elected as a Trustee, and no Trustee shall have any power of substitution or delegation of authority as a Trustee.

#### *Section 5. Nominations.*

(a) Nominations for at-large Trustees, other than the Chairman Trustee, shall be sought by the Foundation from a broad array of groups, as the Board of Trustees, or any designated committee thereof, deems appropriate. Such groups may include domestic and international investor, accounting, and business organizations; financial and capital markets participants; accounting and business academicians; consumer groups; regulatory organizations; and other interested entities and persons. The Trustees may also nominate candidates for at-Large Trustees. The Board of Trustees, or any designated committee thereof, shall have sole authority to nominate all candidates for the office of Chairman Trustee, and any nominee for such office may, but need not, be a member of the Board of Trustees at the time nominated.

(b) Subject to the provisions of this *Section 5*, candidates for each Governmental Trustee position shall be nominated pursuant to procedures adopted jointly by the Government Finance Officers Association, the National Association of State Auditors, Comptrollers and Treasurers, the Council of State Governments, the International City/County Management Association, the National Association of Counties, the National Conference of State Legislatures, the National Governors' Association, the National League of Cities, and the U.S. Conference of Mayors (such associations being hereinafter referred to collectively as the “Governmental Organizations”); provided that, if requested by the Foundation, the Governmental Organizations shall be obligated, as a condition to

their continuing rights under this *Section 5*, to consult with the Foundation on attributes, skills and specific experiences desired by the Foundation of candidates for any particular Governmental Trustee office, and to review the credentials of, and consider as potential nominees in their nominating processes, candidates identified to such Governmental Organizations by the Foundation.

## **CHAPTER A, ARTICLE IV - GOVERNMENTAL ACCOUNTING STANDARDS BOARD**

*Section 1. Governmental Accounting Standards Board.* The Board of Trustees shall appoint a board, which shall be known as the Governmental Accounting Standards Board (“GASB”), whose members shall be appointed without regard to employment or discipline and shall have the qualifications provided in *Section 2* of this Article. The GASB shall have and may exercise all authority, functions, and powers of the Foundation and the Board of Trustees in respect of the establishment and improvement of standards of financial accounting and reporting, including the conduct of all activities related thereto not reserved to the Board of Trustees or others in the Certificate of Incorporation or in these By-Laws, in respect of activities and transactions of state and local governmental entities, which authority, functions, and powers shall be exercised by the GASB in conformity with these By-Laws.

*Section 2. Number and Qualifications of Members.* The number of members that shall constitute a full Governmental Accounting Standards Board shall be seven (7). Each member of the GASB shall, in the judgment of the Board of Trustees, have knowledge of governmental accounting and finance and a concern for the public interest in matters of financial accounting and reporting. Members of the GASB shall receive compensation as determined by the Board of Trustees. The Chair of the GASB shall serve full time. Unless all members of the GASB shall be appointed to serve as full-time GASB members, such other members of the GASB shall serve on either a full-time or part-time basis as the Board of Trustees from time to time shall determine, and if part time, may be in the employ of other organizations while serving on the GASB, subject to such policies as the Board of Trustees may from time to time approve.

*Section 5. Statements of the GASB; Voting; Quorum.* The GASB is hereby authorized to issue Statements of Governmental Accounting Standards, as hereinafter described in this Article. The Rules of Procedure prescribed by the GASB shall set forth and provide for procedures with respect to the establishing of project plans of the GASB and issuing of Statements. Such rules shall provide that the GASB prepare short – and long – range project plans, including the agenda of projects and their priorities, which plans and all modifications thereto shall be approved by at least a majority of the GASB’s members. The GASB’s Statements shall relate to accounting and presenting financial information by state and local governmental entities.

The GASB shall not issue any Statement of Governmental Accounting Standards, or any Exposure Draft of any such Statement, without the approval of at least a majority of its members, except in the case of vacancy, disability of any duration or character preventing any member from voting, or in the event that any member, at any time prior to the vote, disqualifies himself or herself from voting for reasons related to a policy of the Board of Trustees adopted pursuant to *Section 4* of this Article, in any of which events the approval of not less than a majority (but in no event less than three) of the remaining members of the GASB shall be sufficient.



## **CHAPTER A, ARTICLE V - GOVERNMENTAL ACCOUNTING STANDARDS ADVISORY COUNCIL**

*Section 1. Governmental Accounting Standards Advisory Council.* The Board of Trustees shall establish a council of not less than twenty persons who, in the judgment of the Board of Trustees, shall be knowledgeable about the issues involving, and impact of, financial accounting and reporting by state and local governmental entities or shall possess an expertise of value to the GASB, which council shall be known as the Governmental Accounting Standards Advisory Council (the "GASAC"). The membership of the GASAC shall broadly represent varied professional and occupational backgrounds with no profession or occupation dominating. As a means of involving the public in the governmental accounting standard-setting process, the Board of Trustees, in initially appointing the members of the GASAC, shall invite the following organizations to nominate an individual to serve on the GASAC: American Accounting Association; American Institute of Certified Public Accountants; Association of Government Accountants; Association of School Business Officials; Council of State Governments; Financial Accounting Foundation; Government Finance Officers Association; Healthcare Financial Management Association; International City/County Management Association; National Association of College and University Business Officers; National Association of Counties; National Association of State Auditors, Comptrollers and Treasurers; National Conference of State Legislatures; National Governors' Association; National League of Cities; United States Conference of Mayors; and United States Government Accountability Office. In addition, in initially appointing the members of the GASAC, the Board of Trustees shall seek an individual knowledgeable in the municipal bond rating process, an individual knowledgeable in underwriting government securities offerings, and a user of the financial reports of state and local governmental entities (such as a bank or insurance company investment officer).

*Section 3. Functions of the GASAC.* The GASAC shall consult with the GASB concerning major technical issues, the GASB's agenda of projects and the assigning of priorities thereto, matters likely to require the GASB's attention, the selection and organization of GASB task forces and other groups, and such other matters as may be requested by the GASB or its Chair. Members of the GASAC are expected to provide comments in respect of Exposure Drafts of Statements of Governmental Accounting Standards, discussion documents, proposed Technical Bulletins and other documents proposed for issuance by the GASB, as well as comments and other expressions of views on such other matters as may be referred to the GASAC or its members from time to time by the Chair of the GASAC or by the GASB or its Chair. Members of the GASAC are also expected to consider and provide comments on broader policy questions, such as whether an issue needs addressing, criteria for adding projects to the GASB's technical agenda, relative priorities of agenda projects, whether stakeholder views are being appropriately balanced, cost/benefit relationships, and due process considerations.

## **CHAPTER B, ARTICLE VII - FINANCES**

*Section 1. Funds.* The funds necessary to conduct the business of the Foundation may be provided through business operations of the Foundation, funding provided through federal, state and/or local legislation, or as otherwise determined by the Board of Trustees, subject to the applicable provisions of the Certificate of Incorporation.

## **F. The FAF, FASB and GASB Have Developed a Strategic Plan**

The Financial Accounting Foundation (FAF), the Financial Accounting Standards Board (FASB), and the Governmental Accounting Standards Board (GASB), working jointly, have developed a strategic plan to articulate the long-range vision and mission of each of the groups and the organization collectively. This plan represents an evolution and a refinement of previous plans and mission statements developed by the groups. The language and content will be familiar to those who have followed the work of the FAF, the FASB, and the GASB.

The strategic plan affirms the discrete, individual roles of the groups comprising the FAF, while describing the overarching vision and mission that we share. The plan recognizes that the FASB and the GASB are solely responsible for developing and establishing financial accounting and reporting standards. The plan also recognizes that the role of the FAF management team is to provide strategic counsel and services that support the mission, activities, and independence of the FASB and the GASB. The FAF Trustees are responsible for overall governance of the FAF, oversight of the FASB and the GASB, and for protecting the independence of the standard-setting process, while also respecting that independence.

Together, the FASB, the GASB, and the FAF management, according to their specific roles, work to achieve their collective objective of developing the highest-quality financial accounting standards—standards that promote financial reporting that provides investors, lenders, taxpayers, public officials, and other users of financial statements with a clear understanding of the financial performance and position of companies—both public and private; not-for-profit organizations; and state and local governments. The plan recognizes that a second critical element of our collective mission is to foster better understanding among stakeholders—those who use, prepare, and audit financial statements—as to how those standards should be applied and implemented.

The strategic plan also describes four goals that, if achieved, will enable the FASB, the GASB, the FAF Trustees, and the FAF management to realize our collective vision and fulfill our collective mission:

Practicing and promoting continued excellence in standard setting

Demonstrating a commitment to leadership in standard setting

Building and maintaining trust with stakeholders

Promoting public discourse on current and future financial reporting issues

## **G. The FAF's and GASB's Funding**

The FAF's Budget for the Year Ending December 31, 2015 ("FAF Budget") contains the following language regarding funding under the heading "FAF Budget Organization:"

"The FAF presently obtains funding from subscription and publication revenues, accounting support fees under Sarbanes-Oxley to fund the annual recoverable expenses of the FASB, and accounting support fees under Section 978 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") to fund the annual recoverable expenses of the GASB."

The Total Budget Summary on page 4 of the FAF Budget indicates that FASB budget revenues are \$49.4 million with Accounting Support Fees – FASB comprising 48.3%, Accounting support fees – GASB comprising 14.9%, contributed services comprising 0.5% and Subscriptions and Publications comprising 36.3%.

The FAF's Budget for the Year Ending December 31, 2015 contains the following under "Budget Notes:"

#### Accounting Support Fees – GASB

Pursuant to the provisions of Section 978(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), the Securities and Exchange Commission (SEC) issued an order instructing the Financial Industry Regulatory Authority (FINRA) to establish (a) a reasonable annual accounting support fee (GASB ASF) to adequately fund the annual budget of the GASB and (b) rules and procedures to provide for the equitable allocation, assessment and collection of the GASB ASF from FINRA's members.

### **H. FAF's Comment Letter to FASAB Regarding Reporting Entity Exposure Draft**

A revealing description of FAF and its funding is contained in a comment letter to FASAB regarding the Reporting Entity exposure draft written by Jeffrey W. Rubin, Vice President and General Counsel for FAF. The letter appears below in its entirety.

"We are writing in response to the invitation by the Federal Accounting Standards Advisory Board ("FASAB") to comment on the FASAB's exposure draft (the "Exposure Draft") relating to its proposed Statement of Federal Financial Accounting Standards entitled *Reporting Entity*. The purpose of the Exposure Draft is to provide principles to guide preparers of financial statements at the government-wide and component reporting entity levels in determining what organizations should be included in the reporting entity's general purpose federal financial reports ("GPFFRs") for financial accountability purposes. The FASAB developed the Exposure Draft to improve guidance for identifying organizations to include in the GPFFRs, and thereby to assist in meeting federal financial reporting objectives.

The Exposure Draft sets forth three basic inclusion principles for determining whether an organization should be included in the government-wide GPFFR.<sup>329</sup> As described in greater detail below, we recommend that the inclusion principles be revised to either eliminate or modify the scope of the inclusion principle relating to an organization that is "in the Budget" – that is, an organization with an account or accounts listed in the *Budget of the United States Government: Analytical Perspectives – Supplemental Materials* schedule entitled "*Federal Programs by Agency and Account*." Our view with respect to this matter is based on the particular circumstances of the Financial Accounting Standards Board (the "FASB"), one of the standard-setting bodies within the Financial Accounting Foundation (the "FAF"), and similarly situated organizations.

"Although the FASB has an account listed in the Budget, we believe that the inclusion principle requiring the FASB to be included in the government-wide GPFFR solely because it is in the Budget would be inconsistent with the general concepts relating to inclusion set forth in the Exposure Draft, and would potentially undermine the integrity and utility of the GPFFRs. We do not believe that the objectives of the Exposure Draft would be met if organizations that do not receive taxpayer funds, and are not owned or operationally controlled by the federal government, are included in the GPFFR.

## Background

The FAF is a Delaware nonprofit non-stock corporation, incorporated in 1972, which was created for the purpose of providing a corporate structure for the FASB, the body whose financial accounting and reporting standards for nongovernmental entities have been recognized as authoritative by the American Institute of CPAs (“AICPA”) and the U.S. Securities and Exchange Commission (“SEC”). The structure of the FAF and the FASB reflects the view that a standard-setter should be independent from preparers of financial statements, from accounting and auditing firms, and from political or governmental influence. This independence is necessary to assure that the interests of the users of financial statements remain paramount, and has been critical to the integrity of our financial and capital markets.

Prior to the passage of the Sarbanes-Oxley Act of 2002 (“SOX”), concern was expressed that the objectivity and independence of the FAF and the FASB could be affected if their funding was dependent upon groups having interests in the standard-setting process. Although the FAF derived some revenues from sales and licensing of its publication, the FAF’s principal revenues resulted from voluntary contributions. This concern was addressed in Section 109 of SOX, which provided that, going forward, the FASB would receive its funding from mandatory accounting support fees assessed on public companies.<sup>330</sup> Section 109 of SOX states that “[a]ccounting support fees and other receipts of ... such standard-setting body shall not be considered public monies of the United States.” Moreover, the Rules of Construction set forth in Section 109 provide that “[n]othing in this section shall be construed to render [the FASB] subject to procedures in Congress to authorize or appropriate public funds....”<sup>331</sup>

In addition to not being dependent upon governmental appropriations, neither the FAF nor the FASB is subject to the operational control of the federal government. The FAF is governed by a Board of Trustees consisting of from 14 to 18 members, none of whom is a federal government employee. A Trustee’s term is generally five years, and new FAF Trustees are appointed by the FAF’s Board of Trustees. The Board of Trustees, in turn, appoints the members of the FASB. Although the FASB has a cooperative working relationship with the SEC and with other federal governmental organizations, and governmental representatives regularly attend meetings of the FASB’s advisory committees and consult with the FASB with respect to standards and initiatives, the SEC does not operationally control the FAF or the FASB.<sup>332</sup>

For reasons the FAF does not fully understand, the Office of Management and Budget (the “OMB”) has included the FASB in the Budget.<sup>333</sup> The line item in the Budget with respect to the FASB refers to mandatory appropriations and mandatory outlays; as we believe is clear from the language in Section 109 of SOX, however, the FASB does not receive any appropriations or any outlays from the federal budget.<sup>334</sup>

## The Exposure Draft

As noted above, the FASAB issued the Exposure Draft to provide principles to guide preparers of financial statements at the government-wide and component reporting entity levels in determining what organizations should be included in the reporting entity’s GPFFR for financial accountability purposes. The Executive Summary of the Exposure Draft sets forth the principal conceptual underpinning of the Exposure Draft, stating that the government-wide GPFFR should include all organizations:

1. budgeted for by elected officials of the federal government,
2. owned by the federal government, or
3. controlled by the federal government with risk of loss or expectation of benefits.<sup>335</sup>

When any of these conditions exists, the FASAB believes that information regarding the organization is necessary to provide accountability.

Having stated the above three conditions, the Exposure Draft goes on to set forth (in paragraph 21) three principles for inclusion in the government-wide GPFFR. The first inclusion principle refers to an organization that is “in the Budget,” which is defined in paragraph 22 as an organization with an account or accounts listed in the Budget.<sup>336</sup> The Exposure Draft creates an exception with respect to a non-federal organization receiving federal financial assistance. Any non-federal organization receiving federal financial assistance is to be evaluated on the basis of the two additional inclusion principles (the “majority ownership interest” principle and the “control with risk of loss or expectation of benefit” principle). However, the Exposure Draft does not define the term “non-federal organization,” and the term “federal financial assistance” is tied to the definition of the term in the Single Audit Act Amendments of 1996, such as grants, loans, etc., which the FASB does not receive.<sup>337</sup>

In discussing the basis for its conclusion that an organization with an account included in the Budget should be included in the government-wide GPFFR, the Exposure Draft states (in paragraph A12) that the:

“Identification of an organization in the President’s Budget is the clearest evidence that an organization should be included in the government-wide report. Absent budgetary actions – originating with the President’s Budget and leading to appropriations – federal organizations would be unable to conduct operations. Financial reporting objectives – budgetary integrity, operating performance, stewardship, and systems and controls – could not be met if Organizations identified in the budget were not included in the financial reports. Therefore, the most efficient means to identify organizations for inclusion in the GPFFR is by their participation in the budget process as evidenced by being listed in the [Budget].”

The Exposure Draft appears to take the view that inclusion in the Budget is equivalent to the first condition referred to above, that an organization is “budgeted for by elected officials of the federal government.” However, as the circumstances of the FASB indicate, there may be accounts included in the Budget which do not receive federal appropriations, for which elected officials are not accountable, and in which the federal government has no ownership interest and little or no operational control. Accordingly, a rule that inclusion in the Budget requires an organization’s financial information to be included in the GPFFRs may not reflect an appropriate consideration of the nature of organizations included in the Budget.<sup>338</sup> An inclusion principle that would require an entity in the Budget to be included in the GPFFRs therefore appears to be at odds with the concepts underlying the Exposure Draft, including the acknowledgement that an absence of federal funding, operational control or supervision should not result in an entity being within the scope of the GPFFRs.

We therefore recommend that the FASAB revise the proposed statement to eliminate the principle that inclusion of an organization in the Budget results in the organization being included in the GPFFRs.<sup>339</sup> As an alternative, the FASAB could expand the proposed exception to the Budget criterion beyond the scope of entities that receive federal financial assistance under the Single Audit Act Amendments of 1996 to refer as well to organizations that are not under federal governmental operational control or supervision, and which do not receive federal funds. Either such revision would avoid an anomalous result of including wholly independent entities within the GPFFRs, undermining their integrity and utility.

We appreciate the opportunity to comment on the FASAB’s proposal, and would be pleased to respond to any questions the FASAB or its staff may have.”<sup>340</sup>

## **I. Governmental Accounting Standards Board (GASB)**

The following descriptions of the GASB appear in different sections of its Rules of Procedure:

“The GASB is an independent body created in 1984 pursuant to agreement among the Foundation; the American Institute of Certified Public Accountants (AICPA); the Council of State Governments; the Government Finance Officers Association; the International City/County Management Association; the National Association of Counties; the National Association of State Auditors, Controllers and Treasurers; the National Conference of State Legislatures; the National League of Cities; the National Governors Association; and the U.S. Conference of Mayors to serve an important public interest and is charged with a responsibility of significance to the citizenry of the United States. It is the designated organization for establishing and improving standards of the financial accounting and reporting of state and local governmental entities. Those standards govern the preparation of financial reports.”

“The Foundation’s Restated Certificate of Incorporation delegates to the GASB all authority, functions, and powers of the Foundation and its Board of Trustees in respect of standards of financial accounting and reporting of state and local governmental entities. As a result, the GASB’s responsibilities include establishing and improving standards of financial accounting and reporting of state and local governmental entities by defining, issuing, and promoting such standards and by issuing other communications with regard to governmental financial accounting and reporting. It also includes conducting and commissioning research (including surveys, statistical compilations, and other studies) and sponsoring meetings, conferences, hearings, and seminars in respect of financial accounting and reporting of state and local governmental entities.

The GASB is recognized as the authoritative body for establishing and improving financial accounting and reporting standards of state and local governmental entities. In May 1986, the AICPA designated the GASB (with respect to standards issued in July 1984 and subsequently) as the body to establish accounting principles for state and local governmental entities pursuant to Rule 203 of the AICPA’s Code of Professional Conduct. The authoritative nature of GASB pronouncements also is or may be recognized in the statutes, charters, and/or constitutions of state and local governments.

The seven members constituting a full GASB are appointed by the Foundation’s Board of Trustees for terms of up to five years. A member may serve a maximum total of 10 years. The GASB Chairman serves full time. Unless all members of the GASB are appointed to serve full time, the other members of the GASB serve either full time or part time as the Trustees shall determine, and if part time, may be in the employ of other organizations while serving on the GASB. GASB members are required to have, in the judgment of the Trustees, knowledge of governmental accounting and finance and a concern for the public interest in matters of financial accounting and reporting.

The Foundation’s Trustees have adopted policies in respect of personal investments and other personal activities of GASB members and staff that are designed to prevent potential conflicts of interest. In addition, because of the limitations imposed by the employment of part-time GASB members by other organizations, such part-time members are required by the Trustees to periodically inform the Foundation’s Personnel Policies Committee of the detailed nature of their activities and any changes in their employment status.”

## **J. The Governmental Accounting Standards Advisory Council**

The following description of the GASAC appears in the Rules of Procedure:

“The GASAC has an integral advisory role in the GASB’s process of establishing and improving concepts and standards of financial accounting and reporting of state and local governmental entities. As an organization of knowledgeable and experienced individuals, the GASAC works closely with the GASB in an advisory capacity and strives to ensure that the views of its members are consistently and effectively communicated to the GASB on a timely basis.

To assure that a diversity of views will be represented, the GASAC consists of not fewer than 20 persons appointed by the Foundation’s Board of Trustees. GASAC members are required to be, in the judgment of the Trustees, knowledgeable about the issues involving, and the impact of, financial accounting and reporting by state and local governmental entities, or to possess an expertise of value to the GASB.

The GASAC’s membership broadly represents varied professional and occupational backgrounds with no profession or occupation dominating. As an additional means of involving the public in the GASB’s standards-setting process, the Board of Trustees invites organizations representing issuers, auditors, and users of state and local governmental financial reports to nominate an individual to serve on the GASAC. The GASAC also includes individuals knowledgeable in particular aspects of government and the governmental financing process.

Members of the GASAC, other than its Chairman, are appointed for two-year terms expiring on December 31 in the second calendar year of their election, generally may be reappointed for up to two additional consecutive terms, and serve without remuneration. Vacancies in unexpired terms may be filled by the Trustees as deemed desirable by them, and will be filled whenever necessary to maintain the membership of the GASAC at not fewer than 20. Membership on the GASAC is personal to members, and functions of members or attendance at meetings may not be delegated to others.

The By-Laws of the Foundation charge the GASAC with responsibility for consulting with the GASB or its Chairman as to major technical issues, the GASB’s agenda of projects and the priorities of the projects, matters likely to require the GASB’s attention, the selection and organization of GASB task forces and other groups, and such other matters as may be requested by the GASB or its Chairman, and for assisting the Trustees in raising funds for the GASB and the GASAC.

In fulfilling that responsibility, GASAC members are expected to provide input in respect of Exposure Drafts of Statements of Governmental Accounting Standards and Interpretations, discussion documents, proposed Technical Bulletins, and other documents proposed for issuance by the GASB, as well as input on such other matters as may be referred to them or the GASAC from time to time by the GASAC Chairman or by the GASB or its Chairman. Members of the GASAC also are expected to be alert to publicly expressed views and concerns regarding existing governmental financial accounting and reporting concepts and standards (including implementation issues and the effect of subsequent events and circumstances) and to advise the GASAC and the GASB as to the desirability of the GASB’s reviewing or reexamining those standards. Additionally, members of the GASAC are expected to communicate their individual perceptions of potential effects of proposed or effective pronouncements and to provide comments on broader policy questions, such as whether constituent views are being appropriately balanced, cost/benefit relationships, and

due process considerations. GASAC members are encouraged to consult with one another and with others and to speak and write publicly on issues with respect to the work of the GASAC and the GASB.

To facilitate the work of the GASAC, its Chairman also may organize and appoint committees of GASAC members as deemed appropriate.”

## **K. The Mission, Uses and Users, How the Mission is Accomplished, Guiding Principles and Due Process of the GASB**

### **Mission Statement**

The mission of the GASB is to establish and improve standards of state and local governmental accounting and financial reporting that will:

- Result in useful information for users of financial reports, and
- Guide and educate the public, including issuers, auditors, and users of those financial reports.

The mission is accomplished through a comprehensive and independent process that encourages broad participation, objectively considers all stakeholder views, and is subject to oversight by the Financial Accounting Foundation’s Board of Trustees.

### **Uses and Users of Governmental Accounting and Financial Reporting**

Accounting and financial reporting standards are essential to the efficient and effective functioning of our democratic system of government:

- Financial reporting plays a major role in fulfilling government’s duty to be publicly accountable.
- Financial reporting by state and local governments is used to assess that accountability and to make economic, social, and political decisions.

The primary users of state and local government financial reports are those:

- To whom government is primarily accountable—its citizens
- Who directly represent the citizens—legislative and oversight bodies
- Who finance government or who participate in the financing process— taxpayers, other governments, investors, creditors, underwriters, and analysts.

Government administrators are also users of financial reports; whether they are considered primary users depends on whether they have ready access to internal information.

### **How the Mission Is Accomplished**

To accomplish its mission, the GASB acts to:

- Issue high-quality standards that improve the usefulness of financial reports based on the needs of financial report users and on the underlying concepts set out in the GASB’s conceptual framework
- Keep standards current to reflect changes in the governmental environment
- Provide guidance on implementation of standards
- Consider significant areas of accounting and financial reporting that can be improved through the standards-setting process



- Improve the common understanding of the nature and purposes of information contained in financial reports.

The GASB develops and uses concepts to guide its work of establishing standards. Those concepts provide a frame of reference, or conceptual framework, for resolving accounting and financial reporting issues.

The GASB's work on both standards and concepts is based on research conducted by the GASB's technical staff and others. The GASB actively solicits and considers the views of its various constituencies on all accounting and financial reporting issues. The GASB's activities are open to public participation and observation under the "due process" mandated by these Rules of Procedure.

### **Guiding Principles**

In establishing standards and concepts, the GASB exercises its judgment after research, due process, and careful deliberation. It is guided by these principles:

- To be objective and neutral in its decision making and to ensure, as much as possible, that the information resulting from its standards is a faithful representation of the effects of state and local government activities. Objective and neutral mean freedom from bias, precluding the GASB from placing any particular interest above the interests of the many who rely on the information contained in financial reports.
- To weigh carefully the views of its constituents in developing standards and concepts so that they will:
  - a. Meet the accountability and decision-making needs of the users of government financial reports, and
  - b. Gain general acceptance among state and local government preparers and auditors of financial reports.
- To establish standards only when the expected benefits exceed the perceived costs. The GASB strives to determine that proposed standards (including disclosure requirements) fill a significant need and that the costs they impose, compared with possible alternatives, are justified when compared to the overall public benefit.
- To consider the applicability of its standards to the separately issued general purpose financial statements of governmentally owned special entities. The GASB is aware of the unique and distinguishing characteristics of the government environment, which may require different standards from those used by similar private-sector entities. However, it specifically evaluates similarities of special entities and of their activities and transactions in both the public and private sectors, and the need, in certain instances, for comparability with the private sector.
- To bring about needed changes in ways that balance the desire to minimize disruption of accounting and financial reporting processes with the need for information in financial reports to communicate effectively to users. The GASB establishes reasonable effective dates and transition provisions when new standards are introduced.
- To review the effects of past decisions and interpret, amend, or replace standards when appropriate.

### **Due Process**

The GASB is committed to following an open, orderly process for standards setting. The procedures followed by the GASB, as more fully discussed below, are designed to permit timely, thorough, and open study of accounting and financial reporting issues. These procedures are designed to encourage broad public participation in the GASB's standards-setting process by creating channels for the

communication of all points of view and expressions of opinion at all stages of the process. Considering the expressed opinions of those concerned with or affected by governmental accounting and financial reporting is fundamental to the operation of the GASB. Of particular importance to the GASB is the receipt of thoughtful, reasoned, and timely input during the GASB's research, discussion, and deliberative processes. The GASB recognizes that acceptance of its conclusions is enhanced by demonstrating that the input received in due process is considered carefully.

#### **L. Dodd-Frank Wall Street Reform Act: Role of the Governmental Accounting Standards Board in the Municipal Securities Market and Its Past Funding**

In a letter addressed to Senators Tim, Johnson and Richard Shelby and Stephen Bachus and Barney Frank, Chairman and Ranking member of the Committee on Financial services, House of Representatives, dated January 18, 2011 two officers of the United States Government Accountability Office, Paula M. Rascona, Director – Financial Management and Assurance and Orice Williams Brown, Director – Financial Markets and Community Investments, formally transmitted the documents used for an oral briefing that the officers gave to the addressees offices in January 12-13, 2011, in response to the Dodd-Frank Wall Street reform and Consumer Protection Act.<sup>341</sup> The entire transmittal letter and a substantial portion of the presentation documents used for the oral briefing are duplicated below.

##### **1. Transmittal Letter**

*Subject: Dodd-Frank Wall Street Reform Act: Role of the Governmental Accounting Standards Board in the Municipal Securities Markets and Its Past Funding*

This letter formally transmits the documents used for an oral briefing we gave to your offices on January 12-13, 2011, in response to the Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>1</sup> See enclosure 1 for a copy of our briefing slides. GAO was directed to study the role and importance of the Governmental Accounting Standards Board (GASB) in the municipal securities markets as well as the manner and level at which GASB has been funded. GASB establishes standards of accounting and financial reporting for U.S. state and local governments. Established in 1984 as an operating component of the Financial Accounting Foundation (the Foundation), GASB is recognized by the American Institute of Certified Public Accountants as the body that sets generally accepted accounting principles (GAAP) for state and local governments.

In conducting this study, GAO was to consult with the principal organizations representing state governors, legislators, local elected officials, and state and local finance officers. Specifically, in accordance with the mandate and discussions with your offices, our objectives were to address the following key questions: (1) What are key stakeholder views on the role and relevance of GASB in the municipal securities markets? and (2) What is the manner and the level at which GASB has been funded?

To address these objectives, we:

- Reviewed academic studies and other documentation derived from numerous sources, including GASB itself.
- Consulted with key stakeholders through structured interviews, a roundtable discussion held at GAO headquarters, teleconferences, and meetings. As required by the mandate, these consultations included organizations representing state governors, legislators, local elected officials, and state and local finance officers. To ensure that we obtained the perspectives of a broad base of knowledgeable and interested stakeholders, we also consulted with users of state and local governments' financial statements, such as

investors, rating agencies, and bond insurers; auditors; and other participants in the municipal securities markets, including GASB and the Foundation.

- Obtained and reviewed audited financial statements of the Foundation and other financial data specific to GASB.

As further elaborated in the attached briefing slides, stakeholders expressed a range of views on the role and relevance of GASB in the municipal securities markets. This discussion was framed around the following topics: the use of GASB's accounting principles, benefits and limitations of GAAP reporting, GAAP use after the credit crisis, and GASB's continuing role in the municipal securities markets. For example, while some stakeholders indicated that GASB's responses to the evolving needs of the securities markets have been appropriate, others indicated that GASB could do more to alleviate the burden that the cost and complexity of preparing GAAP-basis financial statements places on governments. With regard to the manner and level at which GASB has been funded, our briefing slides include an overview of the Foundation's financial responsibilities with regard to GASB as well as information on GASB expenses and sources of funding for 2006 through 2009. In our consultations with stakeholders on GASB funding issues, they expressed a range of views. For example, while most stakeholders agreed that GASB needed a steady, sustainable stream of funding, several stakeholders were concerned with the level and nature of GASB's expenditures as well as a perceived lack of transparency associated with its budget process.

We conducted our work from September 2010 to January 2011 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions. See enclosure 2 for further details on our scope and methodology. See enclosure 3 for a list of organizations that participated in our study. Enclosure 4 provides an overview of academic research on the impact of GAAP on municipal securities markets. Enclosure 5 provides a schedule of GASB's program expenses from 2006 through 2009. Enclosure 6 provides GAO contact information and acknowledges contributors to this report.

We are sending copies of this report to the appropriate congressional committees, the Chairman of the Board of Trustees of the Financial Accounting Foundation, the President and Chief Executive Officer of the Financial Accounting Foundation, the Chairman of the Governmental Accounting Standards Board, and the Chairman of the Securities and Exchange Commission. We are also sending copies to the roundtable participants, the stakeholders with whom we consulted, and other interested parties. This report will also be available at no charge on our Web site at <http://www.gao.gov>. Should you or your staffs have any questions concerning this report, please contact either of us at [rasconap@gao.gov](mailto:rasconap@gao.gov) or (202) 512-9816 or [williamso@gao.gov](mailto:williamso@gao.gov) or (202) 512-8678. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.

## 2. Oral Presentation Documents

Briefing for offices of the  
Committee on Banking, Housing, and Urban Affairs  
United States Senate  
Committee on Financial Services  
House of Representatives  
January 12 and 13, 2011

- The Dodd-Frank Wall Street Reform and Consumer Protection Act included a requirement for GAO to study the role and importance of the Governmental Accounting Standards Board (GASB) in the municipal securities markets and the manner and level at which GASB has been funded.
- GASB establishes standards of accounting and financial reporting for U.S. state and local governmental entities. Established in 1984 as an operating component of the Financial Accounting Foundation (the Foundation), GASB is recognized by the American Institute of Certified Public Accountants as the body that sets generally accepted accounting principles (GAAP) for state and local governments.
- The Municipal Securities Rulemaking Board (MSRB)<sup>342</sup> reported that there were over 10 million trades of municipal securities in the secondary market amounting to approximately \$3.8 trillion in 2009.

Issuers of municipal securities include states, counties, cities and towns, school districts, and special government districts, such as public benefit corporations and authorities, public employee retirement systems, governmental utilities, public hospitals and other public health care providers, and public colleges and universities.

In accordance with the mandate and discussions with committee offices, our study addressed the following key questions:

Objective 1: What are key stakeholder<sup>343</sup> views on the role and relevance of GASB in the municipal securities markets?

Objective 2: What is the manner and the level at which GASB has been funded?

Objective 1: To obtain key stakeholder views on the role and relevance of GASB in the municipal securities markets, we:

- Consulted with key stakeholders through structured interviews and a roundtable discussion held at GAO headquarters. The roundtable discussion was organized around the following four general topics:

Topic 1: Use of GASB's accounting principles

Topic 2: Benefits and limitations of GAAP reporting

Topic 3: GAAP use after the credit crisis

Topic 4: GASB's continuing role in the municipal securities markets

- Reviewed academic studies that analyzed the impact of financial statements prepared in accordance with GAAP on municipal securities markets.

Objective 2: To describe the manner and level at which GASB has been funded, we:

- Obtained and reviewed audited financial statements of the Foundation, which included certain key financial data of GASB.
- Interviewed officials from GASB to obtain and discuss unaudited financial data specific to GASB, including separate operating financial data and the percentage of the Foundation's allocation of common costs to GASB.
- Provided key facts related to GASB funding to Foundation officials for their confirmation.
- Consulted with key stakeholders through teleconferences and meetings.

For both objectives:

- As required by the mandate, we consulted with the principal organizations representing state governors, legislators, local elected officials, and state and local finance officers.

- To obtain the perspectives of a broad base of knowledgeable and interested stakeholders, we also consulted with users of state and local governments' financial statements, such as investors, rating agencies, and bond insurers; auditors; and other participants in the municipal securities markets, including GASB and the Financial Accounting Foundation.

The summary of views included in this report captures the collective discussion of roundtable participants and the comments made by stakeholders in numerous interviews and consultations. The views summarized are not attributable to any individual or organization and do not necessarily represent the views of any single organization, including GAO.

Enclosure 2 includes details on our scope and methodology. Enclosure 3 provides a list of organizations that participated in our study.

We conducted our work from September 2010 to January 2011 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions.

GASB's mission is to establish and improve standards of state and local governmental accounting and financial reporting that will result in useful information for users of financial reports, and guide and educate the public, including issuers, auditors, and users of those financial reports.

- GAAP encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines for general application, but also detailed practices and procedures. Those conventions, rules, and procedures provide a standard by which to measure financial presentations.
- An independent auditor's report may contain an opinion as to whether the financial statements present fairly an entity's financial position in conformity with GAAP.
- Audited financial statements are used by a variety of stakeholders in the municipal securities markets. See figure 1 for a description of the key steps in the issuance of a municipal security and the stakeholders that typically use issuers' audited financial statements in their review of a security.

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#### **Topic 1: Use of GASB's accounting principles**

Publicly traded companies are required by the Securities and Exchange Commission (SEC) to prepare and issue financial statements based on GAAP; however, municipal issuers are not subject to this requirement. State requirements regarding the use of GAAP by local governments vary, but institutional investors and rating agencies generally agreed that most municipal issuers use GAAP.

- While all state governments use GAAP for state-level financial reporting, GAAP use by local governmental entities varies. Some states require, either by state law or regulation, that the local governmental entities within those states use GAAP. Other states, however, do not require GAAP use by their local governments.
- We identified no definitive studies quantifying the use of GAAP by municipal issuers. However, representatives of several institutional investors and rating agencies agreed that most of the issuers whose securities they evaluate use GAAP.
- In states where GAAP use is not required for local governments, local governments preparing GAAP-basis financial statements tend to be
  - larger, or
  - more frequent debt issuers.

## Topic 2: Benefits and limitations of GAAP reporting

Stakeholders viewed GAAP-basis financial statements as highly useful for assessing the quality of municipal securities.

- Several analysts, issuers, and other stakeholders stated that GAAP-basis financial statements are comprehensive.<sup>344</sup> These views included:

- GAAP-basis financial statements provide a fuller, more transparent picture of a government's financial position than those prepared in accordance with other bases of accounting.
- GAAP-basis financial statements provide important information on topics such as pensions, post-employment benefit plans, and derivatives.
- The statistical reporting section in GAAP-basis financial statements provides helpful longer-term trend information, and the management discussion and analysis section and enhanced disclosures in the notes sections provide context on an issuer's financial position.
- Stakeholders generally agreed that use of GAAP's reporting framework provides consistency and facilitates comparability of financial information across different municipal issuers and securities.
- A few analysts stated that they might bypass a security from an issuer that does not have GAAP-basis financial statements because of the greater amount of analysis required to understand its financial position.

Analysts generally agreed that, while GAAP-basis financial statements are important, they are not the only source of information they use to assess the quality of municipal securities, nor does the use of GAAP necessarily equate to a high-quality security.

- For example, several analysts stated that they value budgets for forward-looking financial information.
- A few representatives of rating agencies and bond insurers pointed out that, unlike other market participants, they are able to ask issuers for any additional information they need to conduct a credit assessment. Therefore, the lack of GAAP-basis financial statements does not necessarily lead to a higher credit risk determination.
- A few stakeholders commented that analysts and investors should take caution to not confuse GAAP-basis reporting with a good financial position or good credit quality.

Several stakeholders believed that GAAP-basis financial statements are associated with lower borrowing costs, although others stated that it is difficult to attribute lower costs to the use of GAAP alone.

- Several issuers stated that they do not know exactly how GAAP impacts their borrowing costs, but they hope or believe their costs are lower as a result of using GAAP.
- A few stakeholders, including issuers and investors, stated that many factors impact borrowing costs, such as strong financial management, income tax revenues, and use of bond insurance, and that isolating the impact of GAAP use on borrowing costs is difficult.
- Enclosure 4 discusses the key findings and limitations of several studies that evaluate the impact of GAAP-basis financial statements on the municipal securities markets, including borrowing costs.

Stakeholders stated that GAAP-basis financial statements are complex and expensive to prepare, particularly for small, infrequent issuers.

- A few stakeholders told us that preparing GAAP-basis financial statements requires issuers to hire or outsource accounting professionals with an advanced skill set. This can be cost-prohibitive for many small issuers with limited resources, particularly those that do not issue debt on a regular basis.

-A rating agency analyst and several issuers stated that governments, if given the option of whether to use GAAP or another basis of accounting, must weigh the cost of preparing GAAP-basis financial statements against potential benefits, such as potentially reduced borrowing costs.

Stakeholders generally agreed that governments are not always timely in issuing audited financial statements, making them less useful to analysts and other users, although a few stakeholders maintained that other publicly available information compensates for the lack of timeliness.

- Issuers and analysts explained that the delay in completing GAAP-basis financial statements is due to:

- the complex and comprehensive nature of GAAP;
- the complexity of state and local governments;
- limited staff time and resources; and
- higher priority placed by elected officials on the preparation of the annual budget.

A National Association of State Comptrollers survey found that states completed their Fiscal Year 2009 audited financial statements in an average of 206 days, or nearly 7 months, from the end of their fiscal year. Seven states took over 9 months to issue their financial statements.<sup>345</sup>

- Untimely financial statements may require analysts to rely on outdated information or to try to obtain additional, unaudited information from issuers.
- Issuers noted that they are aware of the timeliness issue, and some are taking steps to address the problem. For example, the National Association of State Auditors, Comptrollers, and Treasurers (NASACT) has established a working group to identify states' top obstacles and opportunities with regard to issuing faster annual financial reports.

Unlike corporations, state and local governments also often post annual budgets, board meeting agendas, and meeting minutes online; and public hearings are frequently accessible online or through the news media. Such publicly available information may mitigate the lack of timeliness to some extent, according to two issuers.

### **Topic 3: GAAP use after the credit crisis**

According to a study by a rating agency and discussions with bond insurers, the percentage of newly issued securities with insurance has decreased from over 50 percent in 2005 to less than 10 percent of newly issued securities in 2010.<sup>346</sup> As the use of bond insurance has decreased, analysts and investors may be more reliant on GAAP-basis financial statements to determine the quality of municipal securities.

- A few analysts said that, rather than focusing strictly on the bond insurer's rating in cases where issuers purchase insurance, they have always evaluated the credit quality of the underlying bond they are considering. In conducting this analysis, GAAP-basis financial statements have been important to them.
- Several analysts said the decrease in the availability of bond insurance forces analysts and investors to look more carefully at the credit quality of issuers. As such, they will likely place more importance now on the issuer's financial statements and other disclosures.

### **Topic 4: GASB's continuing role in the municipal securities markets**

Stakeholders discussed several issues related to GASB's ongoing standards setting and outreach efforts.

- A few stakeholders noted that GASB has improved the quantity and quality of its education materials and has worked hard to teach stakeholders more about financial statements and GAAP.

- A few stakeholders also indicated that GASB-issued standards have made government accounting more complex and expensive and that GASB could do more to facilitate discussion about the relationship between the costs and benefits of GAAP-basis financial reporting. Others commented on the complexity of Financial Accounting Standards Board (FASB) standards and noted that complex financial reporting is a reflection of the complexity of the organization being reported on.<sup>347</sup>
- According to a GASB official, drivers of new standards or revisions to existing standards included user needs, internal research, and conformance with global or FASB standards.
- One issuer said that slowing down the rate at which GASB changes its standards so that smaller governments and other issuers can keep up would be helpful. Recently, GASB has issued new accounting standards almost every year.
- One issuer recommended that preparers and users of financial information conduct additional discussions on the costs and benefits of GAAP compliance.

### Overview of GASB Funding

The Financial Accounting Foundation, the parent organization of GASB and FASB, is a private-sector non-stock corporation qualified as a tax exempt organization under section 501(c)(3) of the U.S. Internal Revenue Code. The Foundation's mission is to establish and improve financial accounting and reporting standards to foster financial reporting that provides decision-useful information to users of financial reports.

Through its Board of Trustees and its executive management, the Foundation oversees FASB and GASB, including the standards boards' procedures for due process and maintaining independence.

Under the bylaws of the Foundation, the Governmental Accounting Standards Advisory Council, a standing advisory committee of GASB, is responsible for providing technical and other support to GASB, including consulting with GASB on a variety of matters, such as major technical issues and providing input on GASB's agenda of projects and assigning of priorities.

The Foundation is responsible for the oversight, administration, and finances for GASB and FASB. The Foundation currently receives its funding from subscription and publications revenues, accounting support fees for FASB pursuant to the Sarbanes-Oxley Act of 2002, and voluntary contributions in support of GASB.<sup>348</sup>

- For each of the 4 years that we reviewed, the Foundation's independent auditors, McGladrey & Pullen, LLP, issued unqualified "clean" opinions for the Foundation's financial statements.
- The GASB and FASB Chairmen are responsible for preparing annual budgets, with advice of their respective members, for review and approval by the Foundation's Board of Trustees.
- Establishment of the FASB annual accounting support fees through the Foundation's annual budget process is subject to review by SEC.

The Dodd-Frank Wall Street Reform and Consumer Protection Act granted SEC the authority to require a registered national securities association to establish

- a reasonable annual support fee to adequately fund GASB, and
- rules and procedures to provide for the equitable assessment and collection of the support fee from the members of the national securities association.<sup>349</sup>

As of January 4, 2011, SEC had not acted on this authority.

According to the Foundation's annual reports, in 1981, the Foundation established a Reserve Fund, which is currently intended to



- provide the Foundation, FASB, and GASB with sufficient reserves to fund expenditures not funded by accounting support fees or subscription and publication revenues;
- operate the Foundation, FASB, and GASB during any temporary or permanent funding transition periods; and
- fund any other unforeseen contingencies.

The Foundation's Trustees have adopted a policy establishing a targeted year-end Reserve Fund balance equal to 1 year of budgeted expenses for the entire organization, including the Foundation, FASB, and GASB, plus a working capital reserve equal to one quarter of the net operating expenses for the entire organization. Reserve Fund investments are unrestricted assets of the Foundation. Reserve Fund year-end balances for 2006 through 2009 were \$51.9 million, \$54.6 million, \$51.0 million, and \$54.4 million, respectively.

Foundation officials have said that they have had to use Foundation funds from the Reserve Fund to compensate for annual shortfalls in GASB's funding. The officials said that in recent years additions to the Reserve Fund have primarily resulted from (1) revenue from the sale of subscriptions and publications that exceeded operational needs and (2) investment income.

As described in the notes to the Foundation's audited financial statements, the Foundation presents its Statements of Activities based on the concept that standard setting is the sole program of the Foundation. Accordingly, these statements set forth separately the revenue, cost of sales, and certain program expenses of FASB and GASB, as deemed appropriate by management.

Table 1 provides information on GASB's voluntary monetary contributions and related program expenses as reported in the Foundation's Statements of Activities and related notes, along with unaudited information provided by Foundation officials on allocated support expenses. The allocation reflects additional Foundation services for accounting and finance, human resources, facilities management, technology and information systems, legal, development, and general administrative operating assistance.

The Foundation's audited financial statements reported net subscription and publication revenues for FASB and GASB related product offerings of \$10.7 million, \$9.1 million, \$10.2 million, and \$8.2 million for 2006 through 2009, respectively. According to Foundation officials, the Foundation has used these revenues to fund the GASB funding shortfall indicated in table 1.

### **Sources of GASB Voluntary Monetary Contributions**

As shown in figure 2, contributions from state governments are the largest single source of voluntary monetary contributions, and have remained steady in each of the 4 years.

- Combined contributions from state governments totaled \$1 million in each of the past 4 years. According to an official of the National Association of State Auditors, Comptrollers, and Treasurers (NASACT), the amount is not based on a written or contractual agreement.
- The total contribution is remitted by NASACT, which handles the administrative responsibilities of determining annual assessments for each state, invoicing and collecting the amounts, and remitting quarterly payments of \$250,000 to the Foundation. Assessments are calculated for each state based on a fixed amount per state and a variable amount calculated based on the state's population.
- According to a NASACT official, while all states and the District of Columbia are assessed a portion of the total remittance, contributions are voluntary and not all states contribute to GASB every year.

According to GASB officials, the Foundation's trustees have explored various options to obtain stable sources of funding for GASB over the past several years. Three of the larger voluntary sources of contributions have been (1) annual municipal government support, (2) the Municipal Bond Fee Assessment Program (a voluntary 3-year trial program that collected fees from participating issuers and concluded in 2007), and (3) direct solicitation and grant funding. The officials provided the following information on these funding options and stated none of these options has succeeded in providing a long-term, permanent, and sufficient funding source to GASB:

- A municipal government support campaign directed at the largest city and county governments, which peaked at nearly \$150,000 in 2006, declined to less than \$40,000 in 2009.
- Collections from the Municipal Bond Fee Assessment Program declined from a high of nearly \$450,000 in 2006 to residual collections of \$12,000 in 2009.
- Private funding by a not-for-profit organization, which totaled over \$1 million over a 7-year period, ended in 2006.

### **III. Securities and Exchange Commission – What We Do Selected Excerpts From SEC Website**

#### **What We Do**

##### **Introduction**

The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

As more and more first-time investors turn to the markets to help secure their futures, pay for homes, and send children to college, our investor protection mission is more compelling than ever....

The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. This provides a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security. Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions.

The result of this information flow is a far more active, efficient, and transparent capital market that facilitates the capital formation so important to our nation's economy. To insure that this objective is always being met, the SEC continually works with all major market participants, including especially the investors in our securities markets, to listen to their concerns and to learn from their experience.

The SEC oversees the key participants in the securities world, including securities exchanges, securities brokers and dealers, investment advisors, and mutual funds. Here the SEC is concerned primarily with promoting the disclosure of important market-related information, maintaining fair dealing, and protecting against fraud.

Crucial to the SEC's effectiveness in each of these areas is its enforcement authority. Each year the SEC brings hundreds of civil enforcement actions against individuals and companies for violation of the securities laws. Typical infractions include insider trading, accounting fraud, and providing false or misleading information about securities and the companies that issue them....

Though it is the primary overseer and regulator of the U.S. securities markets, the SEC works closely with many other institutions, including Congress, other federal departments and agencies, the self-regulatory organizations (e.g. the stock exchanges), state securities regulators, and various private sector organizations.

##### **Creation of the SEC**

....When the stock market crashed in October 1929, public confidence in the markets plummeted. Investors large and small, as well as the banks who had loaned to them, lost great sums of money in the ensuing Great Depression. There was a consensus that for the economy to recover, the public's faith in the capital markets needed to be restored. Congress held hearings to identify the problems and search for solutions.

Based on the findings in these hearings, Congress — during the peak year of the Depression — passed the Securities Act of 1933. This law, together with the Securities Exchange Act of 1934, which created the SEC, was designed to restore investor confidence in our capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing. The main purposes of these laws can be reduced to two common-sense notions:

Companies publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they are selling, and the risks involved in investing.

People who sell and trade securities – brokers, dealers, and exchanges – must treat investors fairly and honestly, putting investors' interests first.

Monitoring the securities industry requires a highly coordinated effort. Congress established the Securities and Exchange Commission in 1934 to enforce the newly-passed securities laws, to promote stability in the markets and, most importantly, to protect investors. President Franklin Delano Roosevelt appointed Joseph P. Kennedy, President John F. Kennedy's father, to serve as the first Chairman of the SEC.

### **Organization of the SEC**

The SEC consists of five presidentially-appointed Commissioners, with staggered five-year terms (see [SEC Organization Chart](#); [text version](#) also available). One of them is designated by the President as Chairman of the Commission — the agency's chief executive. By law, no more than three of the Commissioners may belong to the same political party, ensuring non-partisanship.....

It is the responsibility of the Commission to:

interpret and enforce federal securities laws;

issue new rules and amend existing rules;

oversee the inspection of securities firms, brokers, investment advisers, and ratings agencies;

oversee private regulatory organizations in the securities, accounting, and auditing fields; and

coordinate U.S. securities regulation with federal, state, and foreign authorities....

### **Divisions**

#### *Division of Trading and Markets*

The [Division of Trading and Markets](#) assists the Commission in executing its responsibility for maintaining fair, orderly, and efficient markets. The staff of the Division provide day-to-day oversight of the major securities market participants: the securities exchanges; securities firms; self-regulatory organizations (SROs) including the Financial Industry Regulatory Authority (FINRA), the Municipal Securities Rulemaking Board (MSRB), clearing agencies that help facilitate trade settlement; transfer agents (parties that maintain records of securities owners); securities information processors; and credit rating agencies.

#### *Division of Enforcement*

The [Division of Enforcement](#) assists the Commission in executing its law enforcement function by recommending the commencement of investigations of securities law violations, by recommending that the Commission bring civil actions in federal court or as administrative proceedings before an administrative law judge, and by prosecuting these cases on behalf of the Commission.

#### *Division of Economic and Risk Analysis*

The Division of Economic and Risk Analysis assists the Commission in executing its mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation by integrating robust economic analysis and rigorous data analytics into the work of the SEC. The Division has a broad role in Commission activities, interacting with nearly every Division and Office, providing sophisticated and data-driven economic and risk analyses to help inform the agency's policymaking, rulemaking, enforcement, and examinations.

There are two main functions for the Division. First, DERA staff provide vital support in the form of economic analyses in support of Commission rulemaking and policy development. Second, the Division also provides economic analysis and research, risk assessment, and data analytics to critically support the agency's resources on matters presenting the greatest perceived risks in

litigation, examinations, and registrant reviews, as well as providing economic support for enforcement matters.

## Offices

### *Office of the General Counsel*

The **General Counsel** is appointed by the Chairman as the chief legal officer of the Commission, with overall responsibility for the establishment of agency policy on legal matters. The General Counsel serves as the chief legal advisor to the Chairman regarding all legal matters and services performed within, or involving, the agency, and provides legal advice to the Commissioners, the Divisions, the Offices, and other SEC components as appropriate.

The General Counsel is also responsible for determining the adherence by attorneys in the SEC to appropriate professional standards, as well as for providing advice on standards of conduct to Commissioners and staff, as appropriate. It is responsible for the final drafting of all proposed legislation that the Chairman or the Commission choose to submit for consideration to the Congress or the states, and for coordinating the SEC staff positions on such legislation.

### *Office of the Chief Accountant*

The Chief Accountant is appointed by the Chairman to be the principal adviser to the Commission on accounting and auditing matters. The **Office of the Chief Accountant** assists the Commission in executing its responsibility under the securities laws to establish accounting principles, and for overseeing the private sector standards-setting process. The Office works closely with the Financial Accounting Standards Board, whose accounting standards the Commission has recognized as generally accepted for purposes of the federal securities laws, as well as the International Accounting Standards Board and the American Institute of Certified Public Accountants.

### *Office of Credit Ratings*

In July 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which amended Section 15E of the Securities Exchange Act of 1934 to enhance the regulation, accountability, and transparency of nationally recognized statistical rating organizations or "NRSROs."

### *Office of Investor Education and Advocacy*

The **Office of Investor Education and Advocacy** has three main functional areas:

The **Office of the Chief Counsel** creates public-facing content on securities-related topics (including for Investor.gov, the SEC's website designed for individual investors) and provides advice to OIEA on securities and administrative law issues.

### *Office of Municipal Securities*

The **Office of Municipal Securities** coordinates the SEC's municipal securities activities, administers SEC rules relating to the municipal securities market, advises the Commission on policy matters relating to the municipal bond market, and provides technical assistance in the development and implementation of major SEC initiatives in the municipal securities area.

### *Office of the Investor Advocate*

The **Office of Investor Advocate** has four core functions, to provide a voice for investors to ensure their needs are considered in SEC decision-making, to assist retail investors, to study investor behavior and to support the SEC's Investor Advisory Committee.

### *Office of the Chief Operating Officer*

The **Office of the Chief Operating Officer** assists the Chairman in developing and executing the management policies of the SEC. The Office formulates budget and authorization strategies, supervises the allocation and use of SEC resources, promotes management controls and financial integrity, manages the administrative support offices, and oversees the development and

implementation of the SEC's automated information systems. The Office has six main functional areas:

#### *Office of Legislative and Intergovernmental Affairs*

The [Office of Legislative Affairs and Intergovernmental Affairs](#) serves as the agency's formal liaison with the Congress, other Executive Branch agencies, and state and local governments. The staff carefully monitor ongoing legislative activities and initiatives on Capitol Hill that affect the Commission and its mission. Through regular communication and consultation with House and Senate members and staff, the Office communicates legislators' goals to the agency, and communicates the agency's own regulatory and management initiatives to the Congress.

The Office is responsible for responding to congressional requests for testimony of SEC officials, as well as requests for documents, technical assistance, and other information. In addition, the Office monitors legislative and oversight hearings that pertain to the securities markets and the protection of investors, even when an SEC witness is not present.

#### *Office of Public Affairs*

The [Office of Public Affairs](#) (OPA) assists the Commission in making the work of the SEC open to the public, understandable to investors and accountable to taxpayers. The Office helps every other SEC division and office accomplish the agency's mission – to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. OPA's principal activity is to communicate the agency's work and deliver the agency's data and other digital information to the public, market participants and other stakeholders on SEC.gov. In addition to managing SEC.gov and other digital media platforms, the Office administers internal and external communications programs.

#### *Office of the Secretary*

The Secretary of the Commission is appointed by the Chairman, and is responsible for the procedural administration of Commission meetings, rulemaking, practice, and procedure.....

The Office is responsible for publishing official documents and releases of Commission actions in the *Federal Register* and the *SEC Docket*, and it posts them on the SEC Internet website, [www.sec.gov](http://www.sec.gov). The Office also monitors compliance with the Government in the Sunshine Act.

#### *Office of the Inspector General*

The [Office of the Inspector General](#) conducts internal audits and investigations of SEC programs and operations. Through these audits and investigations, the Inspector General seeks to identify and mitigate operational risks, enhance government integrity, and improve the efficiency and effectiveness of SEC programs.

#### *Office of Administrative Law Judges*

The Commission's [Office of Administrative Law Judges](#) consists of independent judicial officers who conduct hearings and rule on allegations of securities law violations in cases initiated by the Commission. When the Commission initiates a public administrative proceeding, it refers the cases to the Office, where it is assigned to an individual Administrative Law Judge (ALJ). The ALJ then conducts a public hearing that is similar to a non-jury trial in the federal courts. Just as a federal judge can do, an ALJ issues subpoenas, rules on motions, and rules on the admissibility of evidence. At the conclusion of the hearing, the parties submit proposed findings of fact and conclusions of law. The ALJ prepares an [initial decision](#) that includes factual findings and legal conclusions that are matters of public record. Parties may appeal an initial decision to the Commission, which can affirm, reverse, modify, set aside or remand for further proceedings. Appeals from Commission action are to a United States Court of Appeals.

### **The Laws That Govern the Securities Industry**

NOTE: The United States Constitution is not listed

## **IV. Report on the Municipal Securities Market – U.S. Securities and Exchange Commission, July 31, 2012**

### **Selected Excerpts – Footnotes Omitted**

#### **I. INTRODUCTION**

##### **A. OVERVIEW OF THE MUNICIPAL SECURITIES MARKET**

Over the past 30 years, the municipal securities market has grown significantly and now represents an increasingly important part of the U.S. capital markets. The municipal securities market is also an extremely diverse market, with close to 44,000 state and local issuers, and with a total face amount of \$3.7 trillion (face amount is hereinafter referred to as “principal”).

Despite its size and importance, the municipal securities market historically has not been subject to the same level of regulation as other sectors of the U.S. capital markets. Except with respect to securities fraud, the Securities and Exchange Commission’s (the “SEC” or “Commission”) authority over the disclosure practices of municipal issuers is significantly constrained under existing laws. Investors in municipal securities are often not afforded access to the types of timely and accurate information available to investors in other securities. Additionally, because of the decentralized, dealer-intermediated over-the-counter market in which municipal securities trade, investors do not typically have access to the same types of pricing information as investors in other markets.

##### **B. REVIEW OF THE MUNICIPAL SECURITIES MARKET**

The mission of the SEC is to protect investors – including investors in municipal securities – maintain fair, orderly, and efficient markets, and facilitate capital formation.

#### **II. OVERVIEW OF THE MUNICIPAL SECURITIES MARKET**

##### **A. THE MUNICIPAL SECURITIES MARKET**

###### **1. Municipal Securities Issuers**

State and local governmental entities issue municipal securities to finance a variety of public projects, to meet cash flow and other governmental needs, and to finance nongovernmental private projects (through the use of “conduit” financings on behalf of private organizations that obtain lower-cost tax-exempt financing). Issuers of municipal securities consist of a diverse group of entities that includes states, their political subdivisions (such as cities, towns, counties and school districts), and their instrumentalities (such as housing, health care, airport, port, and economic development authorities and agencies). State and local laws, including state constitutions, statutes, city and county charters, and municipal codes govern these public bodies. Such constitutions, statutes, charters, and codes impose on municipal issuer’s requirements relating to governance, budgeting, accounting, and other financial matters. The governing bodies of municipal issuers are as varied as the types of issuers, ranging from state governments, cities, towns, and counties with elected officials to special purpose entities with appointed members.

In 2011, there were over one million different municipal bonds outstanding compared to fewer than 50,000 different corporate bonds. These municipal bonds totaled \$3.7 trillion in principal, while

corporate (and foreign) bonds and corporate equities outstanding totaled \$11.5 trillion and \$22.5 trillion, respectively.

As discussed in more detail below, the issuance of municipal securities is also affected by the availability of credit enhancement, which often takes the form of a letter of credit issued by a bank, a governmental guarantee, or an insurance policy issued by a bond insurance company. Municipal bond insurance was first introduced in 1971 and letter of credit-supported municipal bonds became very popular after the introduction of variable rate municipal bonds in the early 1980s.

Credit enhancements were common during 2000-2007, with more than half of the municipal securities principal issued supported by at least one type of credit enhancement during that period. This trend was reversed in 2008 due to the effect of the financial crisis on banks and municipal bond insurers. Since 2008, the availability of private sector credit enhancement, including bond insurance, has declined significantly: only 17% of the municipal securities principal issued in 2009, 2010, and 2011 had a credit enhancement (e.g., bond insurance, guarantees, letters of credit, or standby bond purchase agreements).

## B. REGULATORY STRUCTURE

### 1. Federal Securities Laws

#### a. Overview

The Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act of 1934 (“Exchange Act”) were both enacted with broad exemptions for municipal securities from all of their provisions except for the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder. Congress, as part of the 1975 Amendments, created a limited regulatory scheme for the municipal securities market at the federal level in response to the growth of the market, market abuses, and the increasing participation of retail investors.

The 1975 Amendments required firms transacting business in municipal securities to register with the Commission as broker-dealers, required banks dealing in municipal securities to register as municipal securities dealers, and gave the Commission broad rulemaking and enforcement authority over such broker-dealers and municipal securities dealers. In addition, the 1975 Amendments created the MSRB and granted it authority to promulgate rules governing the sale of municipal securities by broker-dealers and municipal securities dealers.

The 1975 Amendments did not create a regulatory regime for, or impose any new requirements on, municipal issuers. Pursuant to provisions commonly known as the “Tower Amendment,” the 1975 Amendments expressly limited the Commission’s and the MSRB’s authority to require municipal securities issuers, either directly or indirectly, to file any application, report, or document with the Commission or the MSRB prior to any sale by the issuer. The 1975 Amendments do not, by their terms, preclude the Commission from promulgating disclosure standards in municipal offerings, but there is no express statutory authority contained in the Exchange Act over disclosure by municipal issuers. The Dodd–Frank Wall Street Reform and Consumer Protection Act (“Dodd–Frank Act”) did not change these provisions, but required a study and review by the U.S. Comptroller General of municipal securities disclosure, possible recommendations for municipal



issuer disclosure requirements, and the advisability of the repeal or retention of the Tower Amendment.

In the absence of a statutory scheme for municipal securities registration and reporting, the Commission's investor protection efforts in the municipal securities market have been accomplished primarily through regulation of broker-dealers and municipal securities dealers pursuant to Exchange Act Rule 15c2-12, Commission interpretations, enforcement of the antifraud provisions of federal securities laws, and Commission oversight of the MSRB. The Commission first recommended, over 15 years ago, that for-profit conduit borrowers utilizing industrial development financings through municipal entities and their agencies and instrumentalities be subject to the registration and disclosure provisions of the Securities Act.

#### b. Antifraud Authority

In light of the national scope of the municipal securities market and its importance to the economy and state and local governments, there is an overriding federal interest in assuring that there be adequate disclosure of all material information by issuers of municipal securities. As noted above, Congress did not exempt transactions in municipal securities from the coverage of the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder. The antifraud provisions of the federal securities laws prohibit any person, including municipal issuers and dealers, from making any untrue statement of material fact, or omitting any material facts necessary to make statements made, in the light of the circumstances under which they were made, not misleading, in connection with the offer, purchase, or sale of any security. Municipal issuer disclosures, such as disclosures in official statements and ongoing annual, periodic and event-related disclosure, are subject to these prohibitions. In addition, broker-dealers, municipal securities dealers, and municipal advisors are subject to regulations adopted by the Commission, including those regulations adopted to define and prevent fraud.

Municipal issuers and other market participants also are subject to the antifraud provisions in connection with statements made after the securities have been sold. In fact, whenever a municipal issuer releases information to the public that is reasonably expected to reach investors and the trading markets, such disclosure is subject to the antifraud provisions.

#### c. Rule 15c2-12

Exchange Act Rule 15c2-12 was adopted in 1989 to establish standards for the procurement and dissemination of disclosure documents by underwriters as a means of enhancing the accuracy and timeliness of disclosure to municipal securities investors. Rule 15c2-12 also was designed to assist underwriters in meeting their responsibilities under the antifraud provisions of the federal securities laws by requiring them to review issuer disclosure documents before commencing sales to investors. In 1994, the Commission amended Rule 15c2-12 to improve disclosure practices in the secondary markets by prohibiting underwriters from purchasing or selling municipal securities in connection with a primary offering unless the issuer had committed to providing continuing disclosure regarding the security and issuer, including its financial condition and operating data.

In 2008, the Commission amended Rule 15c2-12 to establish a single centralized disclosure repository for the electronic collection and availability of information about municipal securities. The Commission's rulemaking was intended to improve the availability of information about

municipal securities to investors, market professionals, and the public generally. This repository, established and maintained by the MSRB, is its Electronic Municipal Market Access system, known by the acronym EMMA, and is freely accessible to all investors on the Internet.

On May 26, 2010, the Commission again amended Rule 15c2-12 to make significant changes to the material event notice requirements and to make the continuing disclosure requirements of the Rule applicable to variable rate demand obligations. These amendments apply to municipal securities issued on or after December 1, 2010.

#### d. Enforcement Actions

The Commission has pursued a significant number of enforcement actions involving municipal securities over the past 20 years. These enforcement cases have involved materially misleading statements and omissions in disclosure relating to municipal securities as well as many other improper activities of municipal securities market participants. Generally, the allegations in these enforcement actions have focused on (a) offering and disclosure fraud; (b) tax or arbitrage-driven fraud; (c) pay-to-play and public corruption violations; (d) public pension accounting and disclosure fraud; and (e) valuation/pricing issues.

### 3. Self-Regulation

#### a. Municipal Securities Rulemaking Board

Created by the 1975 Amendments, the MSRB is a self-regulatory organization (“SRO”) subject to Commission oversight. The MSRB has authority, as expanded by the Dodd-Frank Act, to adopt rules regulating: transactions in municipal securities by broker-dealers and municipal securities dealers; advice provided to or on behalf of municipal entities (including but not limited to issuers of municipal securities) and conduit borrowers and other obligated persons by municipal advisors with respect to municipal financial products or the issuance of municipal securities; and solicitations for compensation of certain business on behalf of broker-dealers, municipal securities dealers, and municipal advisors from municipal entities and obligated persons. The Dodd-Frank Act also changed the composition of the membership on the MSRB (or the “Board”) to require a majority of public representatives. The Board has the power to determine all matters relating to the operation and administration of the Board.

The MSRB rules, among other things, establish appropriate standards for broker-dealers, municipal securities dealers and municipal advisors and are designed, among other things, to prevent fraudulent and manipulative acts and practices and promote just and equitable principles of trade. The MSRB does not, however, have the authority to enforce its rules. Rather, Congress divided enforcement responsibility among multiple regulatory agencies. Currently, in addition to the Commission, the Financial Industry Regulatory Authority (“FINRA”), the Federal Deposit Insurance Corporation (“FDIC”), the Federal Reserve System (“FRS”), and the OCC (OCC together with the FDIC and FRS, the “bank regulators”) all play a role in the enforcement of MSRB rules. The MSRB, in turn, facilitates the enforcement efforts of these agencies through regulatory coordination and enforcement support programs, which provide the agencies with market information and reports of potential violations as they become known, and consultation concerning its rules.

The Commission’s 2008 amendment of Exchange Act Rule 15c2-12 designating the MSRB as the central repository for continuing municipal securities disclosure and the MSRB’s establishment in

2009 of the EMMA website significantly improved the availability of both primary market and continuing disclosure documents to investors. EMMA now serves as the official repository of municipal securities disclosure, providing the public with free access to relevant municipal securities data, and is the central database for information about municipal securities offerings, issuers, and obligors.

In addition to final official statements and advance refunding documents submitted by underwriters under MSRB rules and continuing disclosures submitted by municipal entities and obligated persons to EMMA pursuant to continuing disclosure agreements, the MSRB is authorized to accept disclosure that issuers of municipal securities, on a voluntary basis, submit to EMMA, including a number of additional categories of continuing disclosures such as quarterly or other interim financial and operating data, preliminary official statements, and other related pre-sale documents, official statements and advance refunding documents, as well as information relating to the preparation and submission of audited financial statements and/or annual financial information and hyperlinks to other information available from the issuer's website.

This issuer disclosure, in addition to real-time trade data, education resources, current interest rate information, liquidity documents, and other information for most variable rate municipal securities, as well as credit ratings from Fitch Ratings ("Fitch") and S&P, is available on EMMA at <http://emma.msrb.org>. The MSRB recently published its Long-Range Plan for Market Transparency Products, which includes its vision for enhancing EMMA to, among other things, expand the universe of information available and improve search functionality.

#### b. Financial Industry Regulatory Authority

FINRA is an SRO that oversees more than 4,400 securities firms and nearly 630,000 registered securities representatives in the United States.

- regulating broker-dealers and their registered persons; FINRA's responsibilities include:
- providing market information;
- adopting and enforcing rules to protect investors and the financial markets;
- examining broker-dealers for compliance with FINRA rules as well as federal securities laws, including the rules and regulations thereunder, and MSRB rules;
- informing and educating the investing public;
- providing industry utilities; and
- administering the largest dispute resolution forum for investors and registered firms.

While its responsibilities extend well beyond the municipal securities market, FINRA plays an instrumental role in overseeing the registration and examination process for municipal dealer professionals and encouraging, examining, and enforcing compliance with MSRB rules by nonbank municipal dealers. However, FINRA's rules explicitly do not apply to transactions in and business activities relating to municipal securities because transactions in municipal securities effected by municipal bond dealers, and municipal advisory activities engaged in by municipal advisors, are subject to the rules of the MSRB.

Approximately 1,800 MSRB-registered broker-dealers are members of and examined by FINRA, with the remaining dealers registered with the SEC as municipal securities dealers and examined primarily by the various federal bank regulators. The Commission recently approved a change to MSRB Rule G-16 (Periodic Compliance Examination) to provide for riskbased examinations for FINRA member brokers and dealers. In addition to examinations, FINRA surveils the marketplace with respect to the pricing of bond transactions and markups. In recent years, FINRA has conducted sweeps and targeted exams in the area of municipal sales practices; issued guidance reminding firms of their sales practice and due diligence obligations when selling municipal securities in the secondary market; and conducted an informal look at new-issue retail order periods to address concerns about the potential for “flipping” municipal bonds.

#### 4. Federal Bank Regulators

As noted above, federal banking regulators enforce MSRB rules for registered municipal securities dealers that are not members of a registered securities association. However, FINRA oversees the vast majority of entities that are registered with the MSRB as either brokers or dealers. MSRB Rule G-16 requires municipal securities dealers to be examined every two years.

#### 5. State Laws

The issuance of securities by states, local governments, and their agencies and instrumentalities is controlled by the constitution of the relevant state and the laws of the relevant state and local government. The scope of these laws is broad, covering matters from the lending of credit, permitted use of public funds, tax and debt limitations, public records and open meeting laws to specific conditions for, and restrictions on, the manner and purposes for which bonds may be issued. In some cases a referendum is required to authorize the issuance of bonds, particularly those payable from ad valorem taxes revenues.

In addition to the federal securities laws, municipal securities are also subject to state securities laws, commonly known as “blue sky laws.” The goal of these laws is to protect investors from offerings that are fraudulent or worthless.

### C. MUNICIPAL SECURITIES MARKET PARTICIPANTS

As discussed above, the primary participants in a municipal securities offering are the issuers of the securities (such as states, cities, counties, school districts, and limited-function state and local agencies and authorities such as housing or health facilities authorities and water and sewer authorities), the investors, and the market intermediaries who purchase the securities and sell them to investors.

In addition to these central participants, other municipal market participants play significant roles in municipal securities transactions and have responsibilities under the federal securities laws when they participate in municipal securities offerings. The availability of a wide variety of financing options has led to an increasing reliance on financial advisors by municipal entities that issue municipal securities to assist them in deciding among the multiplying array of structural choices for their debt issuances and to help them negotiate with the range of market intermediaries. Many of these entities are subject to registration requirements and related regulation under the federal securities laws, in addition to the antifraud provisions, as discussed below. Some of the entities are also subject to state registration requirements.

## 1. Broker-Dealers, Municipal Securities Dealers, and Related Market Participants

### a. Overview

As discussed above, municipal bond dealers play a key role in the distribution of municipal bonds through their underwriting activities. Municipal bond dealers also play a key role in the secondary market for municipal securities. Municipal bond dealers trade among themselves in the interdealer market. They may do so by contacting each other directly. Alternatively, they may use the services of broker's brokers that arrange transactions for these intermediaries through a combination of voice and electronic brokerage services. Trading in the interdealer market may also be effected through other electronic trading platforms such as ATSs. Municipal bond dealers trade in this market to obtain securities desired by customers or to manage their inventories. A small number of municipal bond dealers dominate the market. These firms execute almost all customer transactions in a principal capacity (with a portion of these principal trades effected on a "riskless principal" basis) and customers typically purchase and sell municipal securities through them.

### b. Registration and Regulation

All brokers-dealers that underwrite, trade, and sell municipal securities must register with the Commission. The Exchange Act defines a "broker" broadly as "any person engaged in the business of effecting transactions in securities for the account of others" and a "dealer" as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." If a person engages in the activities of a broker or dealer in municipal securities and does not satisfy an exception from the registration provisions of the Exchange Act, such person must register with the Commission and must join an SRO such as FINRA.

Banks transacting business in municipal securities are excluded from the general definitions of a broker-dealer. But banks can be "municipal securities dealers" because the term is defined to include any person engaged in the buying or selling of municipal securities for its own account, including a separately identifiable department or division of a bank. Bank municipal securities dealers are required to register with the Commission.

All municipal bond dealers that engage in municipal securities transactions also must register with the MSRB and may not act in contravention of its rules. The Exchange Act designates the agencies responsible for overseeing compliance with the provisions in the Exchange Act relating to municipal securities and the rules of the MSRB. The Commission has broad inspection and enforcement authority over municipal bond dealers with respect to MSRB rules, Commission rules, and the federal securities laws. FINRA has inspection and enforcement responsibility over its broker-dealer members and bank regulators have this responsibility for municipal securities dealers that are banks under their respective jurisdictions.

Municipal bond dealers are subject to a variety of sales practice, disclosure and due diligence obligations under the federal securities laws and MSRB rules. Several of the more significant obligations applicable to transactions with customers in municipal securities are discussed below:

#### i. Fair Dealing and Duty of Disclosure to Customers

MSRB Rule G-17, which the MSRB refers to as the "core" of its investor protection rules, provides that, in the conduct of its municipal securities or municipal advisory activities, each broker-dealer,

municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice. Rule G-17 includes an antifraud provision similar to that of Rule 10b-5 under the Exchange Act, and also establishes a general duty of fair dealing, even in the absence of fraud. The MSRB views all activities of the entities it regulates in light of these basic principles, even where other MSRB rules impose more particular requirements.

The MSRB has interpreted Rule G-17 to require a municipal bond dealer to disclose to its customer, at or before the time of trade, all material information concerning the transaction in municipal securities known by such firm, as well as material information about the security when such facts are reasonably accessible to the market. This disclosure obligation under MSRB Rule G-17 applies regardless of whether the municipal bond dealer has made a recommendation to the customer, and such disclosure does not relieve the firm of its suitability obligations (discussed below) if the firm has recommended transactions in municipal securities. The MSRB also has interpreted Rule G-17 as imposing on municipal bond dealers an obligation to make certain that the information they provide to their customers, whether under an affirmative obligation imposed by MSRB rules or otherwise (such as in response to a question from customer), is correct and not misleading.

In addition to establishing these broad disclosure principles, some MSRB rules also impose specific disclosure obligations. For example, MSRB Rule G-22 requires a municipal bond dealer that has a control relationship with the issuer of a security purchased, sold, or exchanged for a customer to disclose this relationship to the customer before effecting the transaction. If the disclosure is made orally, it must be supplemented by written disclosure at or before completion of the transaction.

#### iv. Fair Dealing and Duty of Disclosure to Issuers

MSRB Rule G-17 requires dealers to deal fairly with municipal entities in connection with the underwriting of municipal securities. With the passage of the Dodd-Frank Act, the MSRB was expressly directed by Congress to protect municipal entities and obligated persons. Accordingly, the MSRB recently issued interpretive guidance that provides additional guidance as to how MSRB Rule G-17 applies to dealers in their interactions with municipal entities as underwriters of municipal securities, as well as other activities, such as interest rate swap transactions. This guidance will become effective August 2, 2012.

## 2. Alternative Trading Systems

An ATS provides a marketplace for bringing together purchasers and sellers of securities. If registered as a broker-dealer and in compliance with certain rules, an ATS is exempt from the definition of an exchange and thus is not required to register as a national securities exchange. There are a number of ATSs that provide municipal bond dealers with access to electronic pools of liquidity and these ATSs account for a substantial portion of municipal securities transactions. ATSs play an important role in the municipal bond market by aggregating liquidity in a generally illiquid marketplace. Participation in an ATS generally is limited to municipal bond dealers.

## 3. Municipal Advisors

Another market participant involved in the issuance of securities is the municipal advisor. The Exchange Act defines the term “municipal advisor” to mean, in part, a person “that (i) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, . . . or (ii) undertakes a solicitation of a municipal

entity.” Municipal advisors include financial advisors who assist municipal issuers with both competitive and negotiated bond sales, reinvestment of bond proceeds, and the structuring and pricing of related products such as derivatives. Historically, municipal financial advisors and municipal financial advisory activities have been largely unregulated.

Section 975 of Title IX of the Dodd-Frank Act amended Section 15B of the Exchange Act to, among other things, make it unlawful for “municipal advisors” to provide certain advice to, or to solicit, municipal entities or certain other persons without registering with the Commission as a municipal advisor. The registration requirement for municipal advisors established by the Dodd-Frank Act became effective on October 1, 2010. The Commission has received approximately 1,000 confirmed registrations of municipal advisors, including approximately 300 registered broker-dealers, as well as approximately 700 other firms.

In addition, the Exchange Act, as amended by the Dodd-Frank Act, grants the MSRB regulatory authority over municipal advisors and imposes a fiduciary duty on municipal advisors when advising municipal entities. Since the passage of the Dodd-Frank Act, the MSRB has extended its existing Rules G-5 (disciplinary actions) and G-17 (fair dealing) to cover the activities of municipal advisors. The MSRB expects to propose additional rules governing the conduct of municipal advisors after the Commission adopts a final registration rule.

## 5. Attorneys

Lawyers, such as bond counsel, disclosure counsel, issuer’s (or borrower’s) counsel, trustee’s counsel, and counsel to the underwriters, also perform important roles in municipal securities offerings and have certain obligations.

Increasing focus on the disclosure duties of issuers has drawn issuer’s counsel into a more active role in the disclosure process and, increasingly, issuers hire special disclosure counsel to assist them in understanding and complying with their disclosure responsibilities in primary offerings and in complying with their secondary market disclosure undertakings and responsibilities.

### a. Market Participant Observations and Other Commentary

The overall decline in the use of credit enhancement, particularly bond insurance, has impacted the market for municipal securities and renewed investor focus on the disclosure practices and underlying credit quality of municipal issuers. When the majority of new issues of municipal securities were “wrapped” by bond insurance, default risk was viewed as being reduced, municipal bonds received their credit ratings based on the ratings of the bond insurer, and similar types of issues were treated similarly in terms of price. Post-2008, individual credit decisions became more important to market participants in determining whether to purchase a particular bond.

## 7. Nationally Recognized Statistical Rating Organizations (“NRSROs”)

Credit ratings for municipal securities are generally provided by one or more of three NRSROs - Moody’s, Fitch, and S&P and reflect a professional assessment of an issuer’s ability to meet its financial obligations. Ratings issued by these organizations are ordinarily paid for by the issuer (known as “issuer pay” models).

Rating agencies generally assign ratings upon the issuance of the security and periodically review and update the ratings to reflect changes in the issuer's credit status. Municipal credit ratings are also impacted by credit enhancement such as bond insurance, letters of credit, governmental guarantees, or standby bond purchase agreements. Municipal securities with these enhancement features might carry two ratings; the credit-enhanced rating and the unenhanced rating.

Although issuers disclose financial information in various disclosure documents available to investors, market participants noted that many investors nonetheless rely on municipal credit ratings. The Commission staff has been told by market participants that this reliance on credit ratings has changed over the last few years. Institutions rely on credit ratings less often to determine credit quality of the borrower, whereas retail investors may continue to look to those ratings in making investment decisions.

As of November 21, 2011, investors have access to Fitch and S&P's ratings on EMMA. However, Moody's ratings and proprietary reports, such as the underlying analytical reports on a particular rating or class of ratings, by each of the NRSROs, are not readily accessible to retail investors.

#### a. Regulation of NRSROs

In 2007, the Commission adopted rules implementing a registration and oversight program for credit rating agencies registered as NRSROs. However, the Commission is limited by statute in its ability to regulate the ratings methodology of NRSROs.

The Dodd-Frank Act mandates that the Commission adopt further rules relating to credit ratings and NRSROs. The Commission has adopted a new rule that requires NRSROs to make certain disclosures for asset-backed securities they rate. The Commission also has proposed the removal of other references to credit ratings or NRSROs in additional releases. The Commission proposed the remaining new rules and rule amendments related to NRSRO oversight required under the Dodd-Frank Act in an additional release.

### III. DISCLOSURE

#### A. OVERVIEW OF DISCLOSURE PRACTICES AND ISSUES

Disclosure practices in municipal securities offerings and on an ongoing basis have developed as a result of the antifraud provisions of federal and state securities laws, Exchange Act Rule 15c2-12, Commission interpretive guidance, MSRB rules, and voluntary guidelines published by various industry groups. In addition, investors' informational needs have had a role in shaping disclosure practices for municipal securities. To gauge the credit risk of different types of municipal securities, analysts and investors have historically needed information that depends on the type of issuer and credit involved. Thus, disclosure practices differ for major types of municipal securities (e.g., general obligation bonds, revenue bonds, and conduit bonds) and various subsectors of those major types.

##### 1. Voluntary Disclosure Initiatives and Disclosure Guidelines

Participants in the municipal securities market have worked together to develop voluntary disclosure guidelines and best practices designed to improve the level and quality of disclosure in primary offerings of municipal securities and continuing disclosure in the secondary market. This guidance is in the form of voluntary disclosure guidelines and best practices relating to the



municipal securities market, both with regard to primary offerings and secondary market disclosure. Involved industry groups include the Government Finance Officers Association (“GFOA”), National Federation of Municipal Analysts (“NFMA”), National Association of State Auditors, Comptrollers and Treasurers (“NASACT”), the National Association of Bond Lawyers (“NABL”), and the American Bankers Association, Corporate Trust Division. The existing industry guidelines and best practices relate to, among other matters, the content and timing of financial statements and financial information, disclosure of pension liabilities, industry and financing specific guidelines (discussed below), disclosure controls and procedures of a municipal issuer, and methods of providing disclosure.

Individual industry groups have developed disclosure and operational guidance that affect municipal participants. For example, the GFOA publishes procedural statements and guidelines for continuing disclosure that provide a framework for municipal issuers in providing information to the secondary market. In 2003, NASACT released a proposal discussing minimum quarterly disclosure by state and local governments of certain information, including budget to actual operations, cash receipts and disbursements, and changes in long- and shortterm debt.

The NFMA has prepared recommended disclosure practices that divide general obligation bonds, revenue bonds, and conduit bonds into fourteen major sectors based on variations in the nature of the security. The NFMA has noted that these sector-specific disclosure practices reflect the need of investors for information about particular issues that may change the pricing of municipal securities in a given credit sector. The stated purpose of these best practices is to enhance the ability of investors to differentiate among different types of bonds and among specific types of issuers.

In addition to industry group disclosure guidelines, there are also a variety of legal publications aimed at providing disclosure guidance to municipal securities market participants. These publications include “The Securities Law of Public Finance,” “Making Good Disclosure – the Roles and Responsibilities of State and Local Officials Under the Federal Securities Laws,” and “Disclosure Roles of Counsel in State and Local Government Securities Offerings.” These publications provide extensive guidance to municipal market participants regarding their disclosure and other responsibilities in municipal securities offerings and on an ongoing basis.

Moreover, partly as a result of open government laws and similar public accountability measures, state and local governmental bodies routinely make publicly available a large amount of information about issuers of municipal securities. The practices of market participants in voluntarily providing such additional information to investors are not, however, consistent. Large repeat issuers generally have more comprehensive disclosure than small, infrequent or conduit issuers, who may voluntarily provide little ongoing information to investors.

## 2. Initial Disclosure

As discussed above, Rule 15c2-12 obligates municipal securities underwriters in most offerings to obtain, review, and distribute to investors copies of the issuer’s disclosure documents. Commission interpretations issued in connection with Rule 15c2-12 emphasize the underwriter’s duty to have “a reasonable basis for belief in the truthfulness and completeness of the key representations made in any disclosure documents used in the offering” and to review these documents for omissions and misstatements. Additionally, Rule 15c2-12 requires that official statements “set forth information concerning the terms of the proposed issue of securities, including financial information or operating

data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the Offering.”

Although the official statement may be prepared by counsel to the underwriter, bond counsel, the issuer’s disclosure counsel or financial advisor, the Commission has clearly stated that the official statement is legally the issuer’s document. Although market participants that assist the issuer are subject to the antifraud provisions of the federal securities laws, the issuer has ultimate responsibility for ensuring that its official statements meet the disclosure standards of the securities laws and has primary liability for failure to meet them. In this regard, the Commission has pursued numerous antifraud enforcement actions against municipal issuers for materially misleading statements or omissions in offering materials.

For example, the Commission has brought enforcement actions against: Orange County, California, for failing to disclose the risks relating to, among other things, the County’s investment pools and its financial condition; Maricopa County, Arizona, for failing to disclose known material declines in its financial condition and operating cash flow; the City of Syracuse, New York, for falsely claiming a surplus for its general and debt service funds, materially overstating its ending fund balances in those funds, and misleading investors by describing certain financial information as audited; the City of Miami, Florida, for failing to disclose cash flow shortages that the city attempted to hide by using proceeds of issued bonds for operating costs; the Massachusetts Turnpike Authority for failing to disclose substantial cost overruns from the “Big Dig” road and tunnel project in Boston; the City of San Diego, California, for failing to disclose adequately the city’s looming pension fund crisis in connection with five municipal bond offerings between 2002 and 2003; and the State of New Jersey for misleading disclosure concerning the underfunding of its public pension funds, and the creation of the illusion that the public pension funds were being adequately funded.

Issuer officials who approve the issuance of bonds or the form of disclosure documents also have responsibilities under the federal securities laws. The Commission has brought numerous cases against underlying obligors or their chief executive officers for materially misleading statements or omissions in offering materials. Municipal securities underwriters have also been pursued by the Commission in enforcement actions regarding false and misleading disclosure. The parties to Commission enforcement proceedings involving municipal securities include national and regional investment banks, the heads of public finance departments at several investment banks, as well as individual investment bankers at various levels of seniority, issuers, issuer officials, financial advisers, attorneys and accountants.

### 3. Continuing Disclosure

As a result of the operation of Rule 15c2-12,<sup>364</sup> the application of the antifraud provisions of the federal securities laws, Commission interpretive guidance, and industry initiatives, a continuing disclosure scheme for municipal securities issuers and obligated persons has developed.

Under Rule 15c2-12, underwriters are required to reasonably determine that either the issuer of municipal securities or an obligated person (obligated to pay all or some portion of the principal and interest on the municipal securities) has undertaken in a written agreement or contract (commonly called a “continuing disclosure agreement”) to provide specified annual information and “material event” notices to certain information repositories (now, to EMMA, as discussed above). These requirements with respect to the content of continuing disclosure obligations for issuers and

obligated persons were further broadened by the Commission in 2010 in an amendment that required all event notices to be filed within ten business days, modified the events that are subject to a materiality determination before triggering a requirement to provide notice to the MSRB, and amended the list of events for which a notice is to be provided.

These disclosure obligations arising as a result of Rule 15c2-12 are enhanced by existing industry disclosure guidance. For example, the GFOA best practices related to continuing disclosure recommend that municipal issuers or obligated persons make public already prepared interim financial information that is of interest to investors. Nevertheless, the level and frequency of continuing disclosure continues to vary depending on the type and size of the municipal issuer or obligated person.

Similarly, while continuing disclosure obligations arising under Rule 15c2-12 have existed since 1995, compliance with such obligations is inconsistent.

#### 4. Market Participant Observations and Other Commentary

##### a. General Observations

Panelists at the field hearings noted the significant improvements over time in the disclosure practices of issuers in the municipal market due to Commission enforcement actions, private actions, and regulatory initiatives with respect to the primary market, as well as improvements through the efforts of industry participants, the SEC, and the MSRB.

##### d. Disclosure by Conduit Borrowers

Many types of conduit municipal financings historically have provided substantially less continuing information than municipal securities involving non-conduit financings. However, market participants have noted that since 1994, the health care sector in general, and hospitals in particular, have improved continuing disclosure compliance. Such hospitals, in fact, may be providing more timely disclosure than other municipal issuers and obligated persons. Some market participants believed that the same registration requirements and disclosure standards should apply to non-governmental conduit borrowers that apply to other non-governmental issuers selling securities directly into the corporate securities market.

## B. SUBSTANTIVE DISCLOSURE TOPICS

### 1. Financial Statements and Financial Information

#### a. Overview

As the Commission stated in the 1994 Interpretive Release, sound financial statements are critical to the integrity of the primary and secondary markets for municipal securities, just as they are for corporate securities. Municipal issuer financial statements provide investors with critical information to assess the financial condition of municipal issuers and to enable investors to analyze their investments. This information is also important to other stakeholders, such as government agencies and taxpayers. Additional financial information, such as budgetary information, can be used by investors and creditors to identify future demands on government resources that could negatively impact the ability of governments to repay their obligations. That same information can

be used by citizens and citizens groups to assist them in analyzing whether tax dollars were spent in accordance with budgetary restrictions.

As the Governmental Accounting Standards Board (“GASB”) has explained, there are differences between the purposes of financial reports of governmental entities and those of private-sector business enterprises. Consequently, financial statements prepared in accordance with accounting principles applicable to governments differ in certain fundamental ways from financial statements prepared in accordance with accounting principles applicable to for-profit business enterprises. These differences derive from several factors, principal among them the differing needs of end users of the financial information provided. In the case of financial report of business enterprises, users demand information that will allow creditors and equity holders to make decisions with respect to their financial investments. In the case of governmental accounting, on the other hand, the principal focus frequently is on public accountability for resources entrusted to the stewardship of the government (i.e., taxes), including how public resources such as taxes are acquired and used; whether resources are sufficient to meet current and future costs; and whether the government’s ability to provide services improves or deteriorates on a period-to-period basis.

As noted above, the financial disclosure practices of municipal issuers are influenced by a variety of factors, including the demands of market participants, voluntary/industry guidelines, general antifraud considerations, and the continuing disclosure provisions relating to financial information in Rule 15c2-12. Rule 15c2-12, and specifically the definition of “final official statement,” does not establish the form and content of financial information and operating data required to be disclosed in an official statement for a primary offering of municipal securities. In the 1994 amendments to Rule 15c2-12, the Commission did not adopt requirements mandating the use of audited financial statements, recognizing that not all issuers prepared such audited financial statements. The Commission recognized the need for flexibility in determining the content and scope of disclosed financial information given the diversity among types of issuers, types of issues, and sources of repayment.

Annual financial information is intended to be comprised of financial information and operating data of the type included in the final official statement. Rule 15c2-12 also requires that audited financial statements be provided, when and if available, if such financial statements have not been submitted as part of the annual financial information. Consequently, annual submissions should include: (1) financial information and operating data of the type included in the official statement; and (2) audited financial statements, when and if available.

Many of the Commission’s enforcement actions regarding materially misleading statements or omissions in official statements involved deficient financial statements or financial information provided by issuers or underlying obligors.

#### b. Content of Financial Statements - Governmental Accounting Standards

There are no uniformly applied accounting standards in the municipal securities market, and the Commission generally lacks authority to prescribe the accounting standards that municipal issuers must use. However, the GASB establishes generally accepted accounting principles (“GAAP”), which are used by many states and local governments of widely varying size and complexity.

Although there has been no comprehensive study to determine the exact number of municipalities that prepare financial statements on a basis other than GASB standards, generally speaking, larger governments are more likely to adhere to GASB standards than smaller governments. A 2011 study undertaken by GASB, for instance, found that the vast majority of annual financial reports (“AFRs”) of 350 larger governments surveyed (991 AFRs out of 1,050 AFRs, or 94%, of the large government AFRs surveyed) were prepared using GASB standards. In contrast, of the 193 smaller governments surveyed by GASB, 81% of the AFRs collected were prepared using GASB standards.

As of December 2010, 38 states compel some or all of their political subdivisions, including counties, cities, and school districts, to prepare their financial reports in accordance with GASB standards. Along with these mandates, certification programs, such as those sponsored by the GFOA and the Association of School Business Officials International, promote the use of GASB standards by recognizing governments that prepare high-quality GAAP financial reports (based on GASB standards). Nonetheless, the absence of a uniform requirement on the part of municipal entities to adhere to GASB standards means that municipal entities that issue municipal securities can (and some do) prepare their financial reports on a basis other than GASB standards. On rare occasion, some governments that otherwise are compliant with GASB standards may not be permitted to, or may choose not to, apply certain GASB standards.

As the Commission noted in the 1994 Interpretive Release, for financial statements that are not either prepared in accordance with GASB standards or accompanied by a quantified (if practicable) explanation of the differences, investors need to be informed of the basis of financial statement presentation (i.e., a full explanation of the accounting principles followed). Rating agencies and organizations such as the GFOA are broadly supportive of GASB standards.

b. Market Participant Observations and Other Commentary Regarding Content of Financial Statements – Governmental Accounting Standards

Participants in the field hearings expressed a range of opinions concerning GASB standards and the use of uniform accounting standards by municipal issuers. One participant noted that GASB has imposed strict accounting standards, and that the requirements of GASB standards as well as other federal and state requirements have resulted in substantial amounts of disclosure. Market participants appear to be in general agreement that adherence to GASB standards promotes consistency and comparability of financial information among municipal issuers and differing municipal securities, although one participant noted that there is flexibility within GASB standards – as there is in some places in FASB standards – that allows issuers to choose alternative presentations and hence diminishes comparability to some degree. Another participant made the observation, however, that adherence to GASB standards can be costly, particularly for smaller issuers, and that even issuers that do not follow GASB standards do in fact follow some other accounting standards.

2. Pension Funding Obligations and Other Post-Employment Benefits Disclosure

Disclosure regarding pension funding obligations of states and other municipal entities is at the forefront of discussions regarding the municipal securities market. Obligations to provide pension and OPEBs can significantly affect a municipal issuer’s financial health and may impact its ability to make debt service payments on municipal securities. There are over 3,400 state and local pension systems in the United States, according to the most recent Census Bureau Survey of State and Local

Public-Employee Retirement Systems. The GAO has reported that over 27 million employees and beneficiaries are covered by state and local pension plans. Recently, there has been much debate about the appropriate accounting treatment and disclosure relating to the pension funding obligations of state and local governments to such plans.

a. Enforcement Actions

The Commission has brought enforcement actions regarding inadequate disclosure by municipal entities as to the difficulty they were facing in meeting their funding obligations to their public pension systems.

Also in 2010, the Commission brought charges for the first time against a state for violations of the federal securities laws when it charged the State of New Jersey with securities fraud for misrepresenting and failing to disclose to investors in municipal bond offerings that it was underfunding the state's two largest pension plans by billions of dollars, masking the fact that New Jersey was unable to make contributions to those pension plans without raising taxes, cutting other services, or otherwise affecting its budget.

b. Calculation of Funding Levels

There are a number of issues affecting disclosures of pension plan liabilities and the funding obligations of state and local governments to such plans. Over the past few years, studies have noted that the underfunded portion of state and local pension liabilities has steadily increased, especially since the collapse of market asset values in 2008. It has been estimated recently that aggregate underfunding of state and local defined benefit pension plans may exceed \$4 trillion. Another study found that in 2011, these state and local pension liabilities amounted to \$3.6 trillion, compared with an estimated \$2.7 trillion in actuarial assets, representing a funded ratio of 75%.

The Boston College Report concluded that using a 5% discount rate, rather than the more widely used 8% discount rate would increase aggregate state and local pension liabilities from \$3.6 trillion to \$5.4 trillion, and decrease the funded ratio from 75% to 50%.

c. OPEBs

Concerns about unfunded liabilities for OPEBs are similar to the concerns about unfunded pension liabilities. The extent of these types of obligations was, in the past, difficult to ascertain, because the obligations were accounted for on a "pay-as-you-go" basis, under which the cost of the benefit to an employee was not recognized by the state until after the employee had retired and the payments were made. With the implementation of GASB Statement No. 45, state and local governments that follow GASB standards are now required to measure the annual OPEB cost and a net OPEB obligation. A recent study found that as of fiscal year 2010, only 5% of the \$660 billion liability for state retirees' health care and other non-pension benefits had been funded. However, according to one market participant, the unfunded actuarial liability for OPEBs is "inherently and significantly more volatile" than the unfunded liability for pension benefits for several reasons. For example, unlike pension benefits, in many jurisdictions healthcare benefits are not guaranteed by state law and can be more easily reduced or modified.

#### 4. Disclaimers of Responsibility for Information Included in Official Statements and Other Disclosures

Some municipal market participants attempt to disclaim responsibility for information included in official statements and other disclosure documents. Commission staff is also aware that legal counsel have encouraged the use of disclaimers in municipal offering documents in an attempt to protect against liability under Section 10(b) of the Exchange Act for portions of offering documents that have been prepared by “experts” and in part to avoid common law liability for implied warranties.<sup>609</sup>

The Commission has stated that “specific disclaimers of antifraud liability are contrary to the policies underpinning the federal securities laws.” As stated above, underwriters must have a reasonable basis for recommending any municipal securities and must review disclosure documents used in an offering for omissions and misstatements. The Commission has further stated that “disclaimers by underwriters of responsibility for the information provided by the issuer or other parties, without further clarification regarding the underwriter’s belief as to accuracy, and the basis therefore, are misleading and should not be included in official statements.”

#### 5. Disclosure of Conflicts of Interest and Other Relationships or Practices

As highlighted in the 1994 Interpretive Release and Commission enforcement actions, information concerning financial and business relationships or practices, such as undisclosed payments, political contributions, and bid rigging, among offering participants or decision makers may be critical to investors.

The role of advisors, such as swap and municipal advisors, to issuers also has raised questions regarding undisclosed conflicts of interest. The MSRB recently issued interpretive guidance under MSRB Rule G-17 that includes a requirement that underwriters disclose certain conflicts of interest to municipal issuers.

##### a. Pay-to-Play and Political Contributions

Among the types of relationships or practices that may affect municipal issuers are those involving pay-to-play issues. The MSRB adopted Rule G-37 in 1994 to address pay-to-play issues relating to obtaining municipal securities underwriting and other financial engagements. Pay-to-play restrictions have also been adopted by the CFTC in the context of swap transactions and proposed by the Commission in the context of security-based swaps transactions with municipalities. However, other forms of potentially problematic pay-to-play activities involving commodity trading advisors, municipal advisors, or other municipal securities market participants are not yet directly regulated but raise disclosure issues for investors and the market.

One form of political contribution that has been the subject of recent continued concern to market participants involves financial intermediaries funding bond ballot campaigns (“bond elections”). Bond elections often are required as a matter of state or local law to authorize the issuance of bonds, for example, to finance a particular project or group of projects. Independent ballot measure committees are typically formed to conduct campaigns in support of bond elections. Because governmental issuers are usually prohibited by state law from spending public funds to support bond elections, they are dependent on private third parties to support the campaign, either in the form of financial contributions or in-kind services (including the use of retained expert election consulting firms).

Such private third parties can include municipal finance firms, law and accounting firms, construction firms, and architects.

b. Enforcement Actions

The Commission has taken a number of actions, including enforcement actions in the municipal securities arena, to address conflicts arising from political contributions.

4. Disclosure Controls and Procedures

As stated above, the issuer has ultimate responsibility for ensuring that its official statements meet the disclosure standards of the federal securities laws. Additionally, any information released to the public by an issuer that is reasonably expected to reach investors and the trading markets is subject to the antifraud provisions. In preparing their official statements and other disclosures, some issuers look to written disclosure controls that they have in place while others do not have a formal disclosure control system. Municipal issuers generally base their disclosure policies, procedures, and controls on state law requirements, other governmental mandates or their own customs and practices. However, issuers may also look to Commission enforcement actions or other Commission guidance.

#### IV. MARKET STRUCTURE A. OVERVIEW OF SECONDARY MARKET FOR MUNICIPAL SECURITIES

1. Municipal Securities

c. Trading

Municipal securities trade in a decentralized over-the-counter dealer market. Municipal bond dealers execute virtually all customer transactions in a principal capacity, with a portion of these principal trades effected on a “riskless principal” basis. Municipal bond trading is heavily concentrated, with the top ten municipal bond dealers accounting for approximately 75% of customer trades by par amount in 2011.

The municipal securities market is characterized by relatively low liquidity and, following the initial distribution period, municipal securities trade only infrequently. For example, in 2011, about 99% of outstanding municipal securities did not trade on any given day. For those bonds that do trade, the number of trades is very low, averaging only 14 customer trades during the first sixty days after issuance. Newly issued municipal bonds are the most actively traded. While almost all municipal bonds trade in the first month after issuance, that figure drops to roughly 15% in the second month and declines substantially thereafter. Once the bond finds its way into retail and institutional portfolios, the volume of trading tends to drop off dramatically.

An investor who wishes to buy municipal securities typically would request that its municipal bond dealer identify bonds with credit, payment, tax, maturity, and/or other characteristics that meet the customer’s investment needs. The municipal bond dealer may recommend municipal securities that it holds in its own inventory or seek to obtain municipal securities from other municipal bond dealers in the over-the-counter market. If the municipal bond dealer wishes to contact another dealer, it may do so directly or use a “broker’s broker”: a municipal bond dealer that brokers transactions for other municipal bond dealers, typically through a combination of voice and electronic brokerage



services. The municipal bond dealer also may choose to access electronic platforms, including ATSs. ATSs are designed to facilitate trading among municipal bond dealers by helping them locate other municipal bond dealers with municipal securities appropriate for their customers.

While the municipal securities market is often described as a “buy-and-hold” market, investors from time to time sell their bonds for a variety of reasons. An investor who wishes to sell municipal securities would typically contact a municipal bond dealer, who may offer to purchase the securities directly from the customer and take them into inventory. If the municipal bond dealer does not wish to hold the customer’s bond in inventory, it will assist its customer in finding a buyer, either by contacting other municipal bond dealers directly or by using a broker’s broker or an ATS. Once the customer’s municipal bond dealer finds another municipal bond dealer willing to purchase the bonds, it typically will effect the transaction on a “riskless principal” basis by purchasing the securities from the customer and contemporaneously reselling them to the interested municipal bond dealer.

The secondary market for municipal securities is relatively opaque. As discussed below, while pricing information about completed trades (i.e., post-trade information) has been available from the MSRB since 1995, information about the prices at which market participants may be willing to buy or sell a municipal security, and who might be interested, is not broadly available (i.e., pre-trade information). In recent years, the necessity for market participants to undertake a more exacting analysis to value municipal securities has been made more apparent due to the declining use of bond insurance and other types of credit enhancement, as well as concerns about the reliability of credit ratings, both of which previously had been viewed as serving to “commoditize” assessments of the credit quality of disparate municipal securities and thereby often led market participants to make more simplified pricing judgments.

The relatively high overall levels of markups and other transaction costs in the municipal securities market generally are attributable to the illiquidity and opacity of the municipal securities market. In addition, some studies have found that markups and transaction costs tend to be higher for smaller-sized “retail” trades than for larger institutional trades. The lack of price transparency, as described below, also can make it difficult for customers – particularly retail customers – to assess the value of particular municipal securities, and the fairness of the prices that may be offered by municipal bond dealers. Finally, the lack of price transparency undermines municipal bond dealers’ ability to fulfill their fair pricing and best execution obligations, as well as regulators’ ability to assess municipal bond dealers’ compliance with those obligations.

## B. SPECIFIC MARKET STRUCTURE TOPICS

### 1. Price Transparency

#### a. Post-Trade Price Transparency

While the municipal securities market is relatively opaque, there have been significant improvements in recent years in the area of post-trade price transparency. The MSRB’s RealTime Transaction Reporting System (“RTRS”), which, with limited exceptions, requires municipal bond dealers to submit transaction data to the MSRB within 15 minutes of trade execution, has been operational since 2005. In addition, in early 2009, the MSRB implemented the Short-Term Obligation Rate Transparency (“SHORT”) system to collect and disseminate current interest rates and related information for municipal auction rate securities and municipal variable rate demand

obligations. Transaction data can be accessed by the public free-of-charge through the MSRB's EMMA website. Data is searchable on EMMA and includes: trade date and time; security description and CUSIP number; maturity date; interest rate; price; yield; trade amount; trade type (i.e., customer bought, customer sold, or interdealer); and credit rating by S&P and Fitch, if available. Accordingly, current information about trades that have occurred in individual municipal securities is available today to those investors who seek it out, as well as to data vendors who wish to incorporate it into their "value-added" products. This data also is available to regulators for surveillance and enforcement purposes.

#### b. Pre-Trade Price Transparency

While the availability of post-trade transaction information has improved substantially in recent years, municipal securities investors have very limited access to pre-trade price information. Firm bid and ask quotations are generally not available for all municipal securities. Pre-trade price information is generally limited, as discussed below, to dealers providing indicative prices or submitting an RFQ through an electronic network operated by a broker's broker, an ATS, or otherwise. This pre-trade price information, however, is not widely available to the public.

To the extent there is pre-trade price transparency in the municipal securities market, the Staff understands that it tends to be provided through electronic networks operated by broker's brokers, ATSs, or similar trading systems. Today, there are a number of ATSs and broker's brokers that provide municipal bond dealers with electronic access to other dealers who may be interested in trading municipal bonds. While these trading platforms account for a substantial portion of municipal securities transactions, they represent only a small percentage of the dollar volume, which supports the premise that they are used primarily for smaller, retail-size orders.

Larger institutional trades tend to be effected through more traditional means, such as direct voice negotiations with a municipal bond dealer or voice brokerage, and thus do not generate any pre-trade price transparency outside of the bilateral negotiation process.

#### c. Other Sources of Pricing Information

Because of the relative illiquidity and lack of transparency in the municipal securities market, market participants have developed alternative means to value municipal bonds. For example, if there have been no recent trades reported to the MSRB, municipal bond dealers may look to see if recent trades have been reported in "comparable" bonds (i.e., those with similar credit quality, maturity, and other key structural characteristics). Recent transactions in comparable securities provide insight into the price at which market participants may be willing to transact in a bond for which no recent trades have occurred.

In addition, market participants often rely on benchmark yield curves to assist in valuing a bond. A benchmark yield curve is a graph of the estimated current yield of bonds of similar credit quality across the range of possible maturities. Municipal Market Advisors ("MMA"), for example, publishes the "MMA AAA Median Municipal Benchmark," which represents an estimate of the mid-market price for a "natural" AAA-rated general obligation municipal bond (i.e., has not been pre-refunded or insured) based on input MMA receives from a variety of municipal bond dealers and other institutions. Similarly, Thomson Reuters' Municipal Market Data Group ("MMD") publishes the "MMD AAA-rated General Obligation Municipal Yield Curve." The Staff understands that

proprietary yield curves such as these are based both on objective facts – such as recent MSRB transaction reports – and subjective assessments of the opinions of market participants, news, economic conditions, and other factors. Market participants can use benchmark yield curves such as these to form judgments as to the value of a particular municipal bond by looking at the estimated yield for the comparable maturity and then making appropriate adjustments for differences in credit quality and other key characteristics.

Furthermore, because of the complexity of valuing illiquid municipal securities, market participants may rely on an independent professional pricing service to value their bonds. These pricing services use available pre- and post-trade information to estimate the current market price of a particular municipal security, including the benchmark yield curves described above; relevant public information about the issuer, economic conditions, and other matters; and the pricing service evaluator's professional judgment. Pricing services may be used, for example, by institutions to value their holdings, and by mutual funds to calculate daily net asset values.

#### d. Access to Pricing Information

Municipal bond dealers generally have access to most or all of the sources of municipal securities pricing information described above, including transaction data reported to the MSRB; indicative quotes or RFQs disseminated by broker's brokers or ATSS; benchmark yield curves; and independent pricing services. Municipal bond dealers also may have access to other professional tools, such as Bloomberg terminals, that efficiently convey available pricing and other information (such as continuing disclosure filings) about a municipal issuer. Municipal bond dealers also may have the ability to do enhanced searches of transaction reports, enabling them to find efficiently last sale information of specific or comparable municipal securities. Finally, municipal bond dealers maintain a variety of business relationships with competing dealers, customers, and other market participants that can informally provide them with insights into the supply and demand, valuation, market sentiment, and other key pricing determinants with respect to individual municipal securities.

Although institutional investors vary widely in size and sophistication, the larger ones tend to have access to a variety of sources of municipal securities pricing information. This pricing information can include indicative quotes provided by their municipal bond dealer networks and post-trade transaction information provided by vendors and others. Institutional investors also may directly employ analysts, traders, and other professionals who are experienced in using the available informational tools and making independent pricing judgments.

Retail investors, on the other hand, have access to relatively little pricing information about municipal securities.

## 2. Transaction Costs

It is more expensive for investors to trade municipal securities than to trade corporate bonds or equity securities. For example, one study estimates that effective spreads on retail size trades of \$20,000 are 1.98% for municipal bonds, compared to 1.24% for corporate bonds and 0.4% for equities. Similar disparities are found for institutional-size trades. Studies of dealer markups have produced municipal security transaction-cost estimates of similar magnitude. These relatively higher transaction costs have been attributed to the lack of liquidity and price transparency in the municipal securities market.

Further, in the municipal securities market, transaction costs are generally higher, as a percentage of the par amount of the transaction, for retail investors than for institutional investors. Effective spreads and dealer markups are higher for retail-size trades than for institutional-size trades. The opposite is seen in the current U.S. equities market, where larger institutional-size trades tend to incur higher transaction costs than smaller retail-size trades.

As noted above, trading in the municipal securities market is heavily concentrated, with the top ten dealers accounting for more than 70% of customer trades by principal amount. Some data indicate that trading costs increase for municipal securities with the market power of the intermediating municipal bond dealer. Average markups tend to increase the greater the municipal bond dealer's market share. In addition, the significance of market power as a contributor to transaction costs is greater for smaller retail-size trades than for larger institutional-size trades.

### 3. Dealer Pricing Obligations to Customers

In general, MSRB rules require a municipal bond dealer effecting a transaction with a customer, whether as principal or agent, to trade at a fair price, and to exercise diligence in establishing the market value of the municipal security and the reasonableness of the compensation it receives. With certain limited exceptions discussed below, these duties extend to all customers, whether retail or institutional, but not to other dealers.

#### a. Fair Prices

MSRB rules require, among other things, that municipal bond dealers acting in a principal capacity with their customers purchase or sell municipal securities at a "fair and reasonable" price. Specifically, MSRB Rule G-30(a) prohibits a municipal bond dealer from purchasing municipal securities for its own account from a customer or selling municipal securities for its own account to a customer except at an aggregate price (including any markdown or mark-up) that is fair and reasonable. In determining the price, the dealer must take into consideration all relevant factors, including its best judgment as to the fair market value of the securities at the time of the transaction, the expense involved in effecting the transaction, the fact that the dealer is entitled to a profit, and the total dollar amount of the transaction. In addition, municipal bond dealers that charge excessive markups have been found to violate MSRB Rule G-17 which, among other things, requires them to deal fairly with their customers.

Similarly, MSRB Rule G-18 requires municipal bond dealers acting in an agency capacity to make a reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions. A dealer is expected to exercise the same level of care as it would if acting for its own account, including diligence in ascertaining prevailing market conditions. Although these agency duties do not generally apply to dealers acting in a principal capacity, the MSRB has explicitly extended this obligation to a broker's broker acting on behalf of another dealer. In addition, MSRB Rule G-30(b) prohibits municipal bond dealers from purchasing or selling municipal securities as agent for their customers for a commission or service charge in excess of a fair and reasonable amount, taking into consideration all relevant factors, including the availability of the securities involved in the transaction; the expense of executing or filling the customer's order; the value of the services rendered by the dealer; and the amount of any other compensation received by the dealer in connection with the transaction.

## V. RECOMMENDATIONS

### 1. Legislative

The following are possible legislative approaches that could provide the Commission authority to establish improved disclosures and practices in the municipal securities market.

- Authorize the Commission to require that municipal issuers prepare and disseminate official statements and disclosure during the outstanding term of the securities, including timeframes, frequency for such dissemination and minimum disclosure requirements, including financial statements and other financial and operating information, and provide tools to enforce such requirements.

This legislative approach would provide the Commission authority to establish disclosure requirements and principles, timeframes and frequency of dissemination of municipal securities offerings and continuing disclosures. This legislative approach would not entail any repeal or modification to the existing proscriptions on the SEC or the MSRB requiring any presale of disclosure documents, known as the “Tower Amendment.” Nor would this approach involve elimination of the exemptions for municipal securities under Section 3(a)(2) of the Securities Act or the exemptions under the Exchange Act. This legislative approach, however, would meaningfully enhance disclosure practices by municipal issuers and could be accomplished in a short period of time.

The Commission currently has limited authority over municipal issuers directly and providing enhanced authority with respect to municipal issuers’ disclosures in connection with their municipal securities offerings would enable the Commission to enhance municipal securities disclosures and practices for all market participants. This Report has identified a number of areas in which the limited Commission authority over municipal issuers has affected its ability to improve disclosures and practices in the municipal securities market.

Provision of this authority is not intended to replicate corporate registration or periodic reporting requirements or to mandate Commission review of municipal securities disclosure. It would allow the Commission to consider scaled or tiered disclosure content and frequency provisions based on, among other things, the size and nature of the municipal issuer, the frequency of issuance of securities, the type of municipal securities offered and the amount of outstanding securities. This recommendation is intended to enhance disclosure in a meaningful way. The legislative proposal does not envision detailed line item disclosure requirements such as those applicable to corporate issuers under Regulation S-K. Rather it is intended as a more principles-based approach. Further, it would allow the Commission to consider appropriate exemptions based on the type of purchaser. Under this approach, the Commission could determine the appropriate dissemination mechanism, whether through Internet posting, submission to the MSRB’s EMMA system or other electronic submission system. The Commission also could consider the appropriate disclosure policies and procedures that municipal issuers should have to assure that they will satisfy their primary and ongoing disclosure obligations.

- Amend the municipal securities exemptions in the Securities Act and Exchange Act to eliminate the availability of such exemptions to conduit borrowers who are not municipal entities under Section 3(a)(2) of the Securities Act, without differentiation based on the size of the financing due to

the continuing availability of other exemptions, including those available for small businesses, private offerings, and non-profit entities that take into account different types of offerings and issuers.

This legislative approach, which the Commission first recommended over 15 years ago, would subject companies and other entities that use municipal securities to finance their projects to the registration and disclosure provisions of the federal securities laws - the same registration and disclosure standards that would apply if they issued their securities directly (not using municipal issuers as conduits).

Currently conduit borrowers (those non-municipal entities receiving proceeds from municipal securities offerings) may be subject to the Securities Act or Exchange Act registration or disclosure requirements because they may not be considered to be offering their own securities at the time of the municipal securities offering. It is important that investors have information about the entities that are responsible for the monies necessary to make payments on municipal securities in order to be able to assess their investments. This is especially true in light of the relatively high default rate of conduit bonds. As discussed above, conduit bonds have represented approximately 70% of all municipal bond defaults despite representing a relatively small percentage of municipal bonds issued. In addition, many types of conduit municipal financings historically have been identified as providing substantially less continuing information than municipal securities not involving conduit borrowers. Moreover, as discussed in the Report, the significant reduction in the use of financial guarantee insurance (bond insurance) for municipal securities means that there is a greater need for more information on the underlying conduit borrower, so that investors have the ability to evaluate their investment and exposure to the conduit borrower.

This approach would not eliminate other available exemptions, such as those for nonprofit entities under Section 3(a)(4) of the Securities Act and other exemptions that are available to corporate issuers, such as the private offering exemption under Section 4(a)(2) of the Securities Act, without differentiation based on the size of the financing due to the continuing availability of other exemptions, including those available for small businesses, private offerings, and non-profit entities that take into account different types of offerings and issuers.

- Authorize the Commission to establish the form and content of financial statements for municipal issuers who issue municipal securities, including the authority to recognize the standards of a designated private-sector body as generally accepted for purposes of the federal securities laws, and provide the Commission with attendant authority over such private-sector body.

This legislative approach would provide explicit authority to the Commission to establish the form and content of financial statements used in municipal securities offerings and establish standards and designate a private-sector body as the GAAP standard setter for municipal issuer financial statements. As the Report notes, the Commission currently does not have authority to establish the form and content of financial statements of municipal securities issuers that are used in connection with primary offerings of municipal securities or provided on an ongoing basis in connection with outstanding municipal securities. Moreover, the Commission does not have direct authority over the standard setter for those financial statements. This authorization could be for purposes of the federal securities laws only, thereby allowing municipal issuers to continue to comply with other state accounting principles as applicable in the preparation of their financial statements. Most states already prepare their financial statements in accordance with GAAP as set by the GASB.

This approach recognizes the importance of having financial statements of different issuers that are prepared on the same basis, thereby allowing comparisons between municipal issuers and municipal securities.

This approach would further the interests of the Commission and market participants in improving the presentation of financial information. As noted above, many market participants believed that adherence to GASB standards promotes consistency and comparability of financial information between and among municipal issuers and differing types of municipal securities. In addition, many of the Commission's enforcement actions regarding materially misleading statements or omissions in official statements involved deficient financial statements provided by issuers or underlying obligors.

- Authorize the Commission, as it deems appropriate, to require municipal securities issuers to have their financial statements audited, whether by an independent auditor or a state auditor.

Improving the quality of financial reporting by municipal securities issuers would further the interests of the Commission and market participants. As the Commission stated in the 1994 Interpretive Release, an audit is a "reasonable expectation" for investors to have. Additionally, audited financial statements are referred to in Rule 15c2-12 and in GFOA's guidelines and the CAFR program. This legislative proposal could be a scaled or tiered requirement, beginning with the largest issuers.

## 2. Regulatory

- The Commission could consider issuing updated interpretive guidance regarding disclosure obligations of municipal securities issuers and others.

The Commission could consider updating the interpretive guidance the Commission previously provided to municipal securities market participants in the 1994 Interpretive Release. This guidance could recognize the significant improvements in municipal securities disclosure since the 1994 Interpretive Release and the adoption of amendments to Exchange Act Rule 15c212 and identify areas where the Commission thinks that improvement is still needed, based in part on the number of significant disclosure-related enforcement cases involving municipal securities brought since 1994, including, among other matters, financial statements and financial information, terms and risks of securities (including derivatives), and conflicts of interest and other relationships and practices. Updating the interpretive release would allow the Commission to provide further guidance through a means other than enforcement actions.

- The Commission could consider amendments to Exchange Act Rule 15c2-12 to further improve the disclosures made regarding municipal securities.

The Commission could consider further amendments to Exchange Act Rule 15c2-12 to improve the disclosures made with respect to municipal securities, both in primary offerings and on an ongoing basis. The Commission and market participants have identified a number of areas in which there could be improvements in the disclosure practices regarding municipal securities and where amendments to Rule 15c2-12 may be helpful. These amendments would not be needed, however, if the Commission receives direct authority over municipal issuer disclosures as discussed in the legislative recommendations above.

### 3. Municipal Market Initiatives

While we are encouraged by the existing guidelines and the willingness of industry groups to voluntarily discuss and generate a consistent way of measuring successful disclosure and accounting processes, we believe that industry participants should continue to refine these guidelines and explore new areas for guidance.

Voluntary industry initiatives would be useful in improving practices relating to the following areas:

- o disclosure policies and procedures for primary offering and ongoing disclosures, including issuer disclosure committees and training programs;



## V. Other Publications by the Author

*Joseph H. Marren - Conference Transcripts, Presentations and Video; FASAB Testimony, Presentation and Video and Articles*

A video of the entire Representation Without Accountability conference held on January 23, 2012 which was sponsored by the Fordham Corporate Law Center, a conference transcript, copies of PowerPoint presentations and the conference brochure can be found at:

<http://news.law.fordham.edu/jcfl/2012/01/24/representation-without-accountability/>  
[http://www.kstonepartners.com/docs/fordhamlaw\\_representationwithoutaccountability\\_brochure.pdf](http://www.kstonepartners.com/docs/fordhamlaw_representationwithoutaccountability_brochure.pdf)  
<https://thestudentbarassociation.wordpress.com/2012/01/23/>  
<http://law.fordham.edu/25031.htm>

Subsequent to the conference Mr. Marren wrote articles published in Barron's magazine, Jurist ([www.jurist.org](http://www.jurist.org)), the web-site for the University of Pittsburgh's School of Law and the Fordham Corporate Law Forum. These include:

- 1) *"Perpetuating Fraudulent Federal Financial Reporting"* published in the Fordham Corporate Law Forum on August 11, 2014 describes how recently proposed legislation in the House of Representatives is pernicious as it is based on the unconstitutional notion that the Comptroller General has the legal authority to prescribe accounting standards and principles for the federal government.
- 2) *"No Accounting for Government Cost"* published in Barrons magazine on January 4, 2014 describes how and why financial reporting by the federal government is fraudulent and violates the Constitution.  
<http://www.barrons.com/articles/SB50001424053111904227604579198062920358796>
- 3) *"Importance of Statement and Account Clause Cannot be Overlooked"* published in Jurist on October 23, 2012 describes the profound and unrecognized implications to recent Supreme Court decisions involving the antifraud provisions of the nation's securities laws. This article describes how these decisions are likely to ultimately force the Supreme Court to declare that federal financial reporting violates the Statement and Account clause of the United States Constitution, subverts the right to vote and the right to free speech and eliminates required political accountability.  
<http://www.jurist.org/sidebar/2012/10/joseph-marren-statements-accounts-accountability.php>
- 4) *"The Statement and Account Clause and Citizens United – Parts I, II, III and IV"* were published in Jurist on January 9, February 3, February 26 and March 13, 2013. Part I explains why the Statement and Account is political speech that is indispensable to decision-making in our democracy. The laws that have been enacted by Congress that have led to the publication of a false Statement and Account must be viewed in essentially the same manner as the Federal Election Commission's rules that were declared unconstitutional in *Citizens United*. Part II reviews the history of financial reporting to appreciate the extent of Congress' abdication of its constitutional responsibility and the unconstitutional takeover of financial reporting by the executive branch. Part III explores the history of FASAB and the Financial Report of the United States Government in an effort to make clear that the Supreme Court should not show deference to Congress with respect to financial reporting laws. Part IV addresses the issue of whether the AICPA has violated the U.S. Constitution and its ethical principles in designating FASAB as the GAAP standards setter for the federal government.

<http://www.jurist.org/sidebar/2013/01/joseph-marren-citizens-part1.php>,  
<http://www.jurist.org/sidebar/2013/02/joseph-marren-cu-part2.php>,  
<http://www.jurist.org/sidebar/2013/02/joseph-marren-citizens-part3.php>,  
<http://www.jurist.org/sidebar/2013/03/joseph-marren-citizens-part4.php>

- 5) “*The Statement and Account Clause and Caperton – Parts I and II*” were published in Jurist on April 8 and April 18, 2013. Based on the Supreme Court’s decision in *Caperton v. A.T. Massey Coal Co., Inc.* Congress should not be able to unilaterally determine whether it is complying with the Statement and Account clause. The Court indicated that no person is permitted to be a judge in his own case. Part II reviews the psychological factors that have led Congress to publish fraudulent financial statements. This analysis suggests that there are insurmountable barriers to fixing this problem through the normal legislative or election processes.  
<http://www.jurist.org/sidebar/2013/04/joseph-marren-sa-caperton-part1.php>,  
<http://www.jurist.org/sidebar/2013/04/joseph-marren-caperton-partII.php>
- 6) “*ACA Medicaid Decision is Judicial Malpractice*” was published on September 5, 2012 in Jurist. It was co-authored with Elizabeth M. Marren. The Supreme Court agreed that the Medicaid expansion in the ACA was unconstitutional. However, each of the opinions issued contain economic and political accountability analysis that is seriously flawed. All justices ignored important facts, and none addressed a directly applicable constitutional provision, the Statement and Account clause. Not surprisingly, the Court’s remedy is clearly in error.  
<http://www.jurist.org/sidebar/2012/09/marren-marren-medicaid-malpractice.php>
- 7) “*Financial Reporting Renders Health Care Reform Unconstitutional*” was published in Jurist on March 10, 2012. The article describes how one of the key questions in the then upcoming Affordable Care Act case is whether the requirement that states expand Medicaid eligibility or risk losing federal funds is unduly coercive. Federal financial reporting is coercive as it relates to Medicaid because it significantly overstates the federal government’s ability to continue providing funding.  
<http://www.jurist.org/hotline/2012/03/joseph-marren-government-finance.php>
- 8) “*ACA is Null and Void*” was written by “Fordham Publius” and published in the Fordham Corporate Law Forum in February 2015. The article consisted of ten parts. It no longer appears anywhere on the internet.

#### Part I – King v. Burwell is a First Amendment Case

The prevailing legal wisdom is that *King v. Burwell* is a case about statutory construction. However, there are much larger issues at stake. The article will describe the facts, circumstances and law that should lead the Supreme Court to decide the case unanimously. The article will also explain how the Administration misjudged the states willingness to set up Health Insurance Exchanges.

#### Part II – Fraudulent State & Federal Financial Reporting - Summary of Arguments

Part II lays out the arguments describing how and why state and federal financial statements are fraudulent and violate the antifraud provisions of the nation’s securities laws and/or the Statement and Account and Appropriations Clauses.

#### Part III – Federal Government’s Fraudulent Financial Reporting

Part III reviews the details of the federal government’s fraudulent financial reporting. The fraud is primarily based on the creation of a different definition of a “liability” for financial

reporting purposes than for Appropriations law purposes. However, it also entails creating accounting rules that require that legal obligations for Appropriations law purposes that are not a “liability” as defined for financial reporting purposes shall not be recorded in the government’s financial statements.

#### Part IV – Federal Government’s Cover-up

Part IV reviews the federal government’s extensive efforts to cover-up its fraud.

#### Part V – State Governments’ Fraudulent Financial Reporting and Cover-up

Part V reviews the details of the state governments’ fraudulent financial reporting as well as their efforts to cover-up the fraud.

#### Part VI – The Financial Status of the Nation and Social Insurance Pre-ACA

This Part provides an overview of Medicare and describes the financial status of the nation and social insurance pre-enactment of the ACA. Seven schedules are attached to Part VI.

#### Part VII – The Financial Status of the Nation and Social Insurance Post-ACA

This Part provides a description of the financial status of the nation and Medicare post-enactment of the ACA. Eight schedules are attached to Part VII.

#### Part VIII – The Financial Status of Medicaid Pre- & Post-ACA

Part VIII describes the size and scope of the nation’s Medicaid program before and after passage of the ACA.

#### Part IX – Right of Free Speech and Right to Financial Information Have Been Violated

Part IX describes how the right of free speech and the right to financial information have been violated. It reviews important history prior to the Constitutional Convention that has been left out of legal discussions regarding the Statement and Account Clause and the Appropriations Clauses.

#### Part X – Conclusion

Part X describes the perpetual fraud on the Supreme Court that exists today, how the Administration misjudged the states willingness to set up exchanges and why the facts in the case dictate that the Supreme Court should rule unanimously in *King v. Burwell* that the ACA is null and void. One schedule is attached to Part X.

- 9) *“Brazil’s President Impeached: Could It Happen Here?”* was published in Jurist on September 5, 2016. The article indicates that on August 30, 2016 Brazil’s Senate voted to convict President Dilma Rousseff on charges that she used improper accounting to cover-up a growing budget deficit and illegal loans from state-owned banks. A recent WSJ editorial remarked that millions of Americans are probably wondering why they cannot impeach Washington politicians for similar offenses. The question was timely as elections were near. The correct answer is that federal politicians and certain executive officers can be impeached for publishing financial reports that do not adhere to the requirements of the United States Constitution. <http://www.jurist.org/hotline/2016/09/joseph-marren-brazil-president.php>

- 10) Mr. Marren submitted a memorandum to FASAB in July 2013 which commented upon the Board's proposed Reporting Entity exposure draft and he testified at the FASAB public hearing on August 28, 2013. The memorandum can be found at [http://www.fasab.gov/pdffiles/re\\_20\\_marren.pdf](http://www.fasab.gov/pdffiles/re_20_marren.pdf). A video of Mr. Marren's testimony can be found at <https://vimeo.com/76474319>.
- 11) Mr. Marren was interviewed by Larry Parks on September 21, 2014. Mr. Parks hosts a New York City cable TV show. See <https://vimeo.com/106757881>
- 12) Mr. Marren submitted a memorandum to FASAB on March 28, 2016 which commented upon the Board's proposed Insurance Programs exposure draft. The memorandum can be found at [http://files.fasab.gov/pdffiles/insprograms\\_7\\_marren.pdf](http://files.fasab.gov/pdffiles/insprograms_7_marren.pdf)
- 13) Mr. Marren submitted a memorandum to FASAB on September 13, 2016 which commented upon the Board's proposed Tax Expenditures exposure draft. The memorandum can be found at [http://files.fasab.gov/pdffiles/te\\_4\\_joseph\\_marren.pdf](http://files.fasab.gov/pdffiles/te_4_joseph_marren.pdf)

#### *Other Suggested Reading*

For independent corroboration of the veracity of the analysis contained in this memorandum please read David Mosso's analysis presented at the Representation Without Accountability conference. Also, please read Wall Street Journal op-ed pieces "Why \$16 Trillion Only Hints at the True U.S. Debt" written by Chris Cox and Bill Archer and published on November 26, 2012; "Medicare by the Scary Numbers" written by John C. Goodman and Laurence J. Kotlikoff and published on June 24, 2013; and "Heading Off the Entitlement Meltdown" written by Rob Portman and published on July 22, 2014.

## END NOTES

<sup>1</sup> Louis D. Brandeis, *Other People's Money and How the Bankers Use It* 92 (1914).

<sup>2</sup> <http://fordhamcorporatecenter.org/2012/01/24/representation-without-accountability-2/>

<sup>3</sup> <http://fordhamcorporatecenter.org/2012/01/24/representation-without-accountability-2/>

<sup>4</sup> Art. VI, sec 3 "Every state legislator and executive and judicial officer is solemnly committed by oath taken to support this Constitution."

<sup>5</sup> *Fed. Election Commission v. Akins*, 524 U.S. 11 (1998).

<sup>6</sup> *United States v. Hayes*, 515 U.S. 737 (1995).

<sup>7</sup> 2 *Annals of Congress* 302.

<sup>8</sup> See Stith, Kate, "Congress' Power of the Purse" (1988). Faculty Scholarship Series. Paper 1267.

[http://digitalcommons.law.yale.edu/fss\\_papers/1267](http://digitalcommons.law.yale.edu/fss_papers/1267); See also Office of the General Counsel – Principles of Federal Appropriations Law Second Edition Volume I July 1991 and Louis Fisher, *The Authorization-Appropriation Process Congress: Formal Rules and Informal Practices*, 29 *Cath U.L. Rev.* 51, 53-59 (1979).

<sup>9</sup> See *Reeside v. Walker*, 52 U.S. (11 How.) 272, 290-91 (1850); *Hart's Case*, 16 Ct. Cl. 459, 484 (1881) ("[A]bsolute control of money of the United States is in Congress, and Congress is responsible for its exercise of this great power only to the people."), *aff'd*, 118 U.S. 62 (1886); cf. *Baker v. Carr*, 369 U.S. 186, 217 (1962) (textually demonstrable constitutional commitment of the issue to a coordinate political department...")

<sup>10</sup> Stith, Kate, "Congress' Power of the Purse" (1988). Faculty Scholarship Series. Paper 1267.

[http://digitalcommons.law.yale.edu/fss\\_papers/1267](http://digitalcommons.law.yale.edu/fss_papers/1267).

<sup>11</sup> See *United States v. Lovett*, 328 U.S. 303, 313-14 (1946) (Congress cannot enact bills of attainder through appropriation legislation); see also 41 Op. Att'y Gen. 507 (1960); 41 Op. Att'y Gen 230 (1955); 4 Op. Off. Legal Counsel 731 (1980) (all stating that Constitution prohibits Congress from exercising appropriations power in a manner that violates other constitutional requirements); cf. *Buckley v. Valeo*, 424 U.S. 1, 132 (1976) (*per curiam*) (even where Congress has plenary legislative authority, it cannot exercise that authority so as to offend some other constitutional restriction).

<sup>12</sup> 531 U.S. 533 (2001).

<sup>13</sup> 319 F.Supp.2d 69 (D.D.C. 2004).

<sup>14</sup> *Matrixx Initiatives et al., v. Siracusano et al*, 563 U.S. (2011).

<sup>15</sup> 485 U.S. 224, 231-232 (1988)

<sup>16</sup> 426 U.S. 438, 449 (1976)

<sup>17</sup> 15 U.S.C. sec 78j(b).

<sup>18</sup> 17 CFR sec 240.10b-5(b).

<sup>19</sup> 426 U.S. at 449.

<sup>20</sup> See *United Paperworkers*, 985 F.2d at 1199 ("[E]ven information actually sent to shareholders need not be considered part of the total mix reasonably available to them if 'the true' is 'buried' in unrelated discussions.")

<sup>21</sup> *Werner v. Werner*, 267 F.3d 288, 297 (3d Cir. 2001) (quoting *Kas v. Fin. Gen. Bankshares, Inc.*, 796 F.2d 508, 516 (D.C. Cir. 1986)).

<sup>22</sup> *TSC Industries*, 426 U.S. at 450 (quoting *Johns Hopkins U. v. Hutton*, 422 F.2d 1124, 1129 (4<sup>th</sup> Cir. 1970)).

<sup>23</sup> FINANCIAL MANAGEMENT SERVICE: A BUREAU OF THE U.S. DEPARTMENT OF THE TREASURY, Overview: Combined Statement of Receipts, Outlays, and Balances of the United States Government (Combined Statement): Publications & Guidance: Financial Management Service, <http://www.fms.treas.gov/annualreport/overview.html>.

<sup>24</sup> U.S. Office of Management and Budget, *President's 2014 Fiscal Year Budget*, (2013).

<sup>25</sup> U.S. Gov't Accountability Office, *2012 Financial Report of the United States Government*, (2012).

<sup>26</sup> *Id.* at 168.

<sup>27</sup> 418 U.S. 166 (1974).

<sup>28</sup> *United States v. Richardson*, 418 U.S. 166 (1974). (Douglas, J., dissenting).

<sup>29</sup> *Id.* At 166, 198.

<sup>30</sup> *Id.* at 200.

<sup>31</sup> *Id.* at 201.

<sup>32</sup> *Id.* At 202.

<sup>33</sup> Brian Fitzpatrick's research at Vanderbilt focuses on class action litigation, federal courts, judicial selection and constitutional law. Professor Fitzpatrick joined Vanderbilt's law faculty in 2007 after serving as the John M. Olin Fellow at New York University School of Law. He graduated first in his class from Harvard Law School and went on to clerk for Judge Diarmuid O'Scannlain on the U.S. Court of Appeals for the Ninth Circuit and Justice Antonin Scalia on the U.S. Supreme Court. After his clerkships, Professor Fitzpatrick practiced commercial and appellate litigation for several years at Sidley Austin in Washington, D.C., and served as Special Counsel for Supreme Court Nominations to U.S. Senator John Cornyn. Before earning his law degree, Professor Fitzpatrick graduated summa cum laude with a bachelor's of science in chemical engineering from the University of Notre Dame. He has received the Hall-Hartman Outstanding Professor Award, which recognizes excellence in classroom teaching, for his Civil Procedure course.

<sup>34</sup> Joseph Marren, *The Statement and Account Clause and Citizens United*, JURIST - Sidebar, Jan. 9, 2013, <http://jurist.org/sidebar/2013/01/joseph-marren-citizens-part1.php>

<sup>35</sup>

<sup>36</sup> *Fed. Election Comm'n v. Akins*, 524 U.S. 11.

<sup>37</sup> James E. Pfander, *Triangulating Standing*, 53 *St. Louis U. L.J.* 829, 835 (2009)

<sup>38</sup> *Id.*

<sup>39</sup> *Fed. Election Comm'n v. Akins*, 524 U.S. 11, 21, 118 S. Ct. 1777, 1784, 141 L. Ed. 2d 10 (1998)

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<sup>41</sup> Joseph Marren & Elizabeth Marren, *ACA Medicaid Decision is Judicial Malpractice*, JURIST - Sidebar, Sept. 5, 2012, <http://jurist.org/sidebar/2012/09/marren-marren-medicaid-malpractice.php>

<sup>42</sup> Joseph Marren, *The Statement and Account Clause and Caperton: Part I*, JURIST - Sidebar, Apr. 8, 2013, <http://jurist.org/sidebar/2013/04/joseph-marren-sa-caperton-part1.php>

<sup>43</sup> 273 U.S. 510.

<sup>44</sup> THE FEDERALIST No. 10, p. 59 (J. Cooke ed. 1961)(J. Madison).

<sup>45</sup> Federal Accounting Standards Advisory Board, *FASAB Facts* (2009).

<sup>46</sup> *Carter v. Carter Coal Co.*, 298 U.S. 238, 311 (1936).

<sup>47</sup> *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2576 (2012)(Roberts, C.J.).

<sup>48</sup> Joseph Marren & Elizabeth Marren, *ACA Medicaid Decision is Judicial Malpractice*, JURIST - Sidebar, Sept. 5, 2012, <http://jurist.org/sidebar/2012/09/marren-marren-medicaid-malpractice.php>

<sup>49</sup> *Id.* at 2666 (Scalia, Kennedy, Thomas, and Alito, JJ., dissenting).

<sup>50</sup> *Id.* at 2602 (Roberts, C.J.)(quoting *Barnes v. Gorman*, 536 U.S. 181, 186 (2002)).

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at 2604.

<sup>53</sup> *Id.* at 2605.

<sup>54</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, 2010 FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT 140 tbl.1 (2010).

<sup>55</sup> *Id.* at 130-31, 222, 224, 226-28. *See also* U.S. GOV'T ACCOUNTABILITY OFFICE, 2011 FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT 134 (2011).

<sup>56</sup> RICO was enacted by section 901(a) of the Organized Crime Control Act of 1970 (Pub.L. 91-452, 84 Stat. 922, enacted October 15, 1970), and is codified at 18 U.S.C. ch. 96 as 18 U.S.C. §§ 1961-1968.

<sup>57</sup> THE WRITINGS OF JAMES MADISON 103 (Gaillard Hunt, ed. 1910).

<sup>58</sup> *Fed. Election Commission v. Akins*, 524 U.S. 11 (1998).

<sup>59</sup> *United States v. Hayes*, 515 U.S. 737 (1995).

<sup>60</sup> Jacob Soll, "The Reckoning" xii, (2014).

<sup>61</sup> "Accounting: Historical Perspectives: Encyclopedia of Business and Finance." *ENotes - Literature Study Guides, Lesson Plans, and More*. Web. 04 Sept. 2011. <<http://www.enotes.com/business-finance-encyclopedia/accounting-historical-perspectives>>.

<sup>62</sup> *See* 17 C.F.R. 210.4-01(a)(91)(2002) and Objectives of Financial Reporting by Business Enterprises, Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 1, paragraph 44.

<sup>63</sup> U.S. Government Accountability Office, 2012 Financial Report of the United States Government, x (2012).

<sup>64</sup> THE WRITINGS OF JAMES MADISON 103 (Gaillard Hunt, ed. 1910).

<sup>65</sup> Jacob Soll, *The Reckoning* (2014) page 5

<sup>66</sup> 2 Annals of Congress 302.

<sup>67</sup> 1 Annal of Congress 1031, 1061, 1141.

<sup>68</sup> *Halperin v. Cent. Intelligence Agency*, 629 F.2d 144, 162 (D.C. Cir. 1980)

<sup>69</sup> *See, e.g.*, Fourth Annual Message of Thomas Jefferson (Nov. 8, 1804), reprinted in 1 THE STATE OF THE UNION MESSAGES, *supra* note 62, at 77 ("Accounts of the receipts and expenditures of the last year, with estimates for the ensuing one, will as usual be laid before you").

<sup>70</sup> First Annual Message of George Washington (Jan. 8, 1790), reprinted in 1 THE STATE OF THE UNION MESSAGES, *supra* note 62, at 4.

<sup>71</sup> Walter Stahr, *John Jay* 105-108 (Hambledon 2005).

<sup>72</sup> Paul F. Figley & Jay Tidmarsh, *The Appropriations Power and Sovereign Immunity*, 107 Mich. L. Rev. 1207, 1253 (2009)

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at 1252-53.

<sup>75</sup> *Id.* at 1253.

<sup>76</sup> *Id.*

<sup>77</sup> Ronald J. Krotoszynski, Jr., *Reconsidering the Nondelegation Doctrine: Universal Service, the Power to Tax, and the Ratification Doctrine*, 80 Ind. L.J. 239, 250 (2005)

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at 251.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> *Id.* at 252.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at 253.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> *Id.* at 254.

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

- <sup>96</sup> *Id.*
- <sup>97</sup> *Id.*
- <sup>98</sup> *Id.* at 255.
- <sup>99</sup> *Id.*
- <sup>100</sup> *Id.*
- <sup>101</sup> *Id.*
- <sup>102</sup> *Id.*
- <sup>103</sup> *Id.* at 256.
- <sup>104</sup> *Id.*
- <sup>105</sup> *Id.*
- <sup>106</sup> *Id.*
- <sup>107</sup> The Founders' Constitution Volume 3, Article 1, Section 9, Clause 7, Document 1 [http://press-pubs.uchicago.edu/founders/documents/a1\\_9\\_7s1.html](http://press-pubs.uchicago.edu/founders/documents/a1_9_7s1.html) The University of Chicago Press
- <sup>108</sup> Farrand, Max, ed. *The Records of the Federal Convention of 1787*. Rev. ed. 4 vols. New Haven and London: Yale University Press, 1937.
- <sup>109</sup> *Id.* No. 72, at 403 (Alexander Hamilton).
- <sup>110</sup> *Id.* No. 78, at 433 (Alexander Hamilton).
- <sup>111</sup> The Federalist No. 48, at 278 (James Madison) (Clinton Rossiter ed., 1961).
- <sup>112</sup> *Id.* No. 58, at 327 (James Madison).
- <sup>113</sup> The Federalist No. 66, at 404 (Alexander Hamilton) (Clinton Rossiter ed., 1961).
- <sup>114</sup> Ronald J. Krotoszynski, Jr., *Reconsidering the Nondelegation Doctrine: Universal Service, the Power to Tax, and the Ratification Doctrine*, 80 Ind. L.J. 239, 258 (2005)
- <sup>115</sup> *Id.*
- <sup>116</sup> *U. S. v. Richardson*, 418 U.S. 166, 199-200, 94 S. Ct. 2940, 2958, 41 L. Ed. 2d 678 (1974)
- <sup>117</sup> 3 ST. GEORGE TUCKER, BLACKSTONE'S COMMENTARIES: WITH NOTES OF REFERENCE TO CONSTITUTION AND LAWS OF THE FEDERAL GOVERNMENT OF THE UNITED STATES AND OF THE COMMONWEALTH OF VIRGINIA (The University of Chicago Press 2000), available at [http://press-pubs.uchicago.edu/founders/print\\_documents/a1\\_9\\_7s3.html](http://press-pubs.uchicago.edu/founders/print_documents/a1_9_7s3.html).
- <sup>118</sup> *Id.*
- <sup>119</sup> 3 JOSEPH STORY, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES § 1342 (The University of Chicago Press 2000), available at [http://press-pubs.uchicago.edu/founders/documents/a1\\_9\\_7s4.html](http://press-pubs.uchicago.edu/founders/documents/a1_9_7s4.html).
- <sup>120</sup> 9 The Writings of James Madison 103 (Gaillard Hunt, ed. 1910)
- <sup>121</sup> 14 Writings of Thomas Jefferson 384 (Mem ed. 1903)
- <sup>122</sup> "John Adams, Dissertation on Canon and Feudal Law, 1765, From: Our Sacred Honor, Bennett, 253.
- <sup>123</sup> See Stith, Kate, "Congress' Power of the Purse" (1988). Faculty Scholarship Series. Paper 1267. [http://digitalcommons.law.yale.edu/fss\\_papers/1267](http://digitalcommons.law.yale.edu/fss_papers/1267); See also Office of the General Counsel – Principles of Federal Appropriations Law Second Edition Volume I July 1991 and Louis Fisher, The Authorization-Appropriation Process Congress: Formal Rules and Informal Practices, 29 Cath U.L. Rev. 51, 53-59 (1979).
- <sup>124</sup> See *Reeside v. Walker*, 52 U.S. (11 How.) 272, 290-91 (1850); *Hart's Case*, 16 Ct. Cl. 459, 484 (1881) ("[A]bsolute control of money of the United States is in Congress, and Congress is responsible for its exercise of this great power only to the people."), *aff'd*, 118 U.S. 62 (1886); cf. *Baker v. Carr*, 369 U.S. 186, 217 (1962) (textually demonstrable constitutional commitment of the issue to a coordinate political department...")
- <sup>125</sup> *Id.*
- <sup>126</sup> 31 U.S.C.A. § 3302 (b).
- <sup>127</sup> 31 U.S.C. § 1341-51.
- <sup>128</sup> Stith, Kate, "Congress' Power of the Purse" (1988). Faculty Scholarship Series. Paper 1267. [http://digitalcommons.law.yale.edu/fss\\_papers/1267](http://digitalcommons.law.yale.edu/fss_papers/1267).
- <sup>129</sup> Stith, Kate, "Congress' Power of the Purse" (1988). Faculty Scholarship Series. Paper 1267. [http://digitalcommons.law.yale.edu/fss\\_papers/1267](http://digitalcommons.law.yale.edu/fss_papers/1267).
- <sup>130</sup> Stith, Kate, "Congress' Power of the Purse" (1988). Faculty Scholarship Series. Paper 1267. [http://digitalcommons.law.yale.edu/fss\\_papers/1267](http://digitalcommons.law.yale.edu/fss_papers/1267).
- <sup>131</sup> See 19 ANNALS PF CONG. 1330-31 (1809) ([U]nless the House examine if the amount of appropriation is exceeded by the expenditure; or if it be misapplied, that is, if money appropriated for one object be expended for another; unless we do this sir, our control over the public purse is a mere name-an empty shadow.") (statement of Rep. J. Randolph); see also L. Wilmerding, *supra* note 4, at 199 *passim* ("the Effort to Control After Expenditure").
- <sup>132</sup> *Id.*
- <sup>133</sup> Stith, Kate, "Congress' Power of the Purse" (1988). Faculty Scholarship Series. Paper 1267. [http://digitalcommons.law.yale.edu/fss\\_papers/1267](http://digitalcommons.law.yale.edu/fss_papers/1267).
- <sup>134</sup> Kate Stith, *Rewriting the Fiscal Constitution: The Case of Gramm-Rudman-Hollings*, 76 Cal. L. Rev. 593, 607 n. 91-92 (1988); Permanent appropriations operate automatically to provide funding each year, without action by Congress. The major entitlement programs have permanent appropriations. Examples include social security, 42 U.S.C. §§ 401-433 (1982 & Supp. IV 1986), and federal retirement payments, 10 U.S.C. §§ 1201, 1202, 1204, 1205, 1275, 1315, 1331 (1982 & Supp. IV 1986); Some entitlement programs must be annually funded, including Medicaid, 42 U.S.C. § 1396 (1982 & Supp. IV 1986), Aid to Families with Dependent Children, 42 U.S.C. § 601 (1982), and various veterans benefits, 38 U.S.C. §§ 314, 503, 521 (1982 & Supp. III 1985), but these appropriations are treated as mandatory by Congress, like liquidating appropriations for contract authority.
- <sup>135</sup> *Id.*



- <sup>136</sup> *S. Dakota v. Dole*, 483 U.S. 203, 207-09 (1987); *Nevada v. Skinner*, 884 F.2d 445, 447 (9<sup>th</sup> Cir. 1989) cert. denied, 110 S. Ct. 1112.
- <sup>137</sup> See *United States v. Lovett*, 328 U.S. 303, 313-14 (1946) (Congress cannot enact bills of attainder through appropriation legislation); see also 41 Op. Att’y Gen. 507 (1960); 41 Op. Att’y Gen. 230 (1955); 4 Op. Off. Legal Counsel 731 (1980) (all stating that Constitution prohibits Congress from exercising appropriations power in a manner that violates other constitutional requirements); cf. *Buckley v. Valeo*, 424 U.S. 1, 132 (1976) (per curiam) (even where Congress has plenary legislative authority, it cannot exercise that authority so as to offend some other constitutional restriction).
- <sup>138</sup> 531 U.S. 533 (2001).
- <sup>139</sup> 319 F.Supp.2d 69 (D.D.C. 2004).
- <sup>140</sup> *Halperin v. Cent. Intelligence Agency*, 629 F.2d 144, 156 (D.C. Cir. 1980).
- <sup>141</sup> *Id.*
- <sup>142</sup> *Id.*
- <sup>143</sup> *Id.*
- <sup>144</sup> *Id.*
- <sup>145</sup> *Id.*
- <sup>146</sup> *Id.*
- <sup>147</sup> *Id.* at 156.
- <sup>148</sup> *Id.*
- <sup>149</sup> *Id.*
- <sup>150</sup> *Id.*
- <sup>151</sup> *Id.*
- <sup>152</sup> *Id.* at 159.
- <sup>153</sup> The six acts are: the Securities Act of 1933, 15 U.S.C. sec 77a-77aa (1994); the Securities Exchange Act of 1934, 15 U.S.C. sec 78a-78ll (1994); the Public Utility Holding Company Act of 1935, 15 U.S.C. sec 79-79z(6) (1994); the Trust Indenture Act of 1939, 15 U.S.C. sec 77aaa-77bbb (1994); the Investment Company Act of 1940, 15 U.S.C. sec 80a(1)-80(a)(64) (1994); and the Investment Advisers Act of 1940, 15 U.S.C. sec 80b(1)-80b(21) (1994).
- <sup>154</sup> *Matrixx Initiatives et al., v. Siracusano et al*, 563 U.S. (2011).
- <sup>155</sup> 485 U.S. 224, 231-232 (1988)
- <sup>156</sup> 426 U.S. 438, 449 (1976)
- <sup>157</sup> 15 U.S.C. sec 78j(b).
- <sup>158</sup> 17 CFR sec 240.10b-5(b).
- <sup>159</sup> Basic, 485 U.S., at 238. Under the private Securities Litigation reform Act of 1995 (PSLRA), when a plaintiff’s claim is based on an alleged misrepresentation or omissions of a material fact, “the complaint shall specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading,” 15 U.S.C. sec 78u-4(b)(1)
- <sup>160</sup> *Id.*, at 231-232 (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976))
- <sup>161</sup> 485 U.S., at 231 (quoting *TSC Industries*, 426 U.S., at 448-449).
- <sup>162</sup> 17 CFR sec 240.10b-5(b); see also Basic, 485 U.S., at 239, n. 17 (“Silence, absent a duty to disclose, is not misleading under Rule 10b-5”)
- <sup>163</sup> *Matrixx Initiatives, Inc., ET AL., Petitioners v. James Siracusano ET AL.* 563 U.S. (2011)
- <sup>164</sup> 426 U.S. at 449.
- <sup>165</sup> *Cione v. Gorr*, 843 F. Supp. 1199, 1202 (N.D. Ohio 1994). See also *Robinson v. Penn Cent. Co.*, 336 F. Supp. 655, 657 (E.D. pa. 1971) (“It may be that a sophisticated analyst, with knowledge of the corporate world, would ultimately deduce from the proxy material [the material information]. However, our concern is not the sophisticated analyst, but the reasonable stockholder...”).
- <sup>166</sup> See *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 317 (3d Cir. 1997).
- <sup>167</sup> See *United Paperworkers*, 985 F.2d at 1199 (“[E]ven information actually sent to shareholders need not be considered part of the total mix reasonably available to them if ‘the true’ is ‘buried’ in unrelated discussions.”)
- <sup>168</sup> *Werner v. Werner*, 267 F.3d 288, 297 (3d Cir. 2001) (quoting *Kas v. Fin. Gen. Bankshares, Inc.*, 796 F.2d 508, 516 (D.C. Cir. 1986)).
- <sup>169</sup> *TSC Industries*, 426 U.S. at 450 (quoting *Johns Hopkins U. v. Hutton*, 422 F.2d 1124, 1129 (4<sup>th</sup> Cir. 1970)).
- <sup>170</sup> FINANCIAL MANAGEMENT SERVICE: A BUREAU OF THE U.S. DEPARTMENT OF THE TREASURY, Overview: Combined Statement of Receipts, Outlays, and Balances of the United States Government (Combined Statement): Publications & Guidance: Financial Management Service, <http://www.fms.treas.gov/annualreport/overview.html>.
- <sup>171</sup> U.S. Office of Management and Budget, President’s 2014 Fiscal Year Budget, (2013).
- <sup>172</sup> U.S. Gov’t Accountability Office, 2012 Financial Report of the United States Government, (2012).
- <sup>173</sup> FINANCIAL MANAGEMENT SERVICE: A BUREAU OF THE U.S. DEPARTMENT OF THE TREASURY, Overview: Combined Statement of Receipts, Outlays, and Balances of the United States Government (Combined Statement): Publications & Guidance: Financial Management Service, <http://www.fms.treas.gov/annualreport/overview.html>.
- <sup>174</sup> *United States v. Richardson*, 418 U.S. 166 (1974).
- <sup>175</sup> U.S. Gov’t Accountability Office, 2012 Financial Report of the United States Government, (2012).
- <sup>176</sup> <http://fordhamcorporatecenter.org/2012/01/24/representation-without-accountability-2/>
- <sup>177</sup> <http://fordhamcorporatecenter.org/2012/01/24/representation-without-accountability-2/>
- <sup>178</sup> Under U.S. GAAP, most U.S. Government revenues are recognized on a ‘modified cash’ basis, or when they become measurable.
- <sup>179</sup> U.S. Gov’t Accountability Office, 2012 Financial Report of the United States Government, (2012).
- <sup>180</sup> U.S. Gov’t Accountability Office, 2012 Financial Report of the United States Government, (2012).
- <sup>181</sup> *Id.* at 168.
- <sup>182</sup> *Richardson v. United States*, 465 F.2d 844 (3d Cir. 1972) rev’d, 418 U.S. 166, 94 S. Ct. 2940, 41 L. Ed. 2d 678 (1974).
- <sup>183</sup> 418 U.S. 166 (1974).



- <sup>184</sup> United States v. Richardson, 418 U.S. 166, 178 n.11 (1974)(Burger, C.J.).
- <sup>185</sup> *Id.*
- <sup>186</sup> United States v. Richardson, 418 U.S. 166 (1974). (Douglas, J., dissenting).
- <sup>187</sup> *Id.* At 166, 198.
- <sup>188</sup> *Id.* at 200.
- <sup>189</sup> *Id.* at 201.
- <sup>190</sup> *Id.* At 202.
- <sup>191</sup> Richardson v. United States, 465 F.2d 844 (3d Cir. 1972) rev'd, 418 U.S. 166, 94 S.Ct. 2940, 41 L. Ed. 2d 678 (1974).
- <sup>192</sup> 31 U.S.C. 3513(a)
- <sup>193</sup> *Id.*
- <sup>194</sup> Compare U.S. Const, Art I, Sec. 9, cl. 7 with Articles of Confederation, Art. IX, p 5 (requiring Congress to account to the states for "sums of money\*\*\*borrowed or emitted").
- <sup>195</sup> Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 14, 18, 28, and 29 U.S.C.).
- <sup>196</sup> 15 U.S.C. sec 78m(j) (2006)
- <sup>197</sup> Brian Fitzpatrick's research at Vanderbilt focuses on class action litigation, federal courts, judicial selection and constitutional law. Professor Fitzpatrick joined Vanderbilt's law faculty in 2007 after serving as the John M. Olin Fellow at New York University School of Law. He graduated first in his class from Harvard Law School and went on to clerk for Judge Diarmuid O'Scannlain on the U.S. Court of Appeals for the Ninth Circuit and Justice Antonin Scalia on the U.S. Supreme Court. After his clerkships, Professor Fitzpatrick practiced commercial and appellate litigation for several years at Sidley Austin in Washington, D.C., and served as Special Counsel for Supreme Court Nominations to U.S. Senator John Cornyn. Before earning his law degree, Professor Fitzpatrick graduated summa cum laude with a bachelor's of science in chemical engineering from the University of Notre Dame. He has received the Hall-Hartman Outstanding Professor Award, which recognizes excellence in classroom teaching, for his Civil Procedure course.
- <sup>198</sup> Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2576 (2012)(Roberts, C.J.).
- <sup>199</sup> F. Andrew Hessick, *Standing, Injury in Fact, and Private Rights*, 93 Cornell L. Rev. 275, 287 (2008). See Richard H. Fallon, Jr., *Individual Rights and the Powers of Government*, 27 Ga. L. Rev. 343, 351 (1993) (discussing private rights endowed by the Constitution and the interests those rights protect). Professor Bandes and then-Professor Nichol argue that all constitutional provisions should be cognizable. See Bandes, *supra* note 3, at 284-85; Gene R. Nichol, Jr., *Rethinking Standing*, 72 Cal. L. Rev. 68, 86 (1984).
- <sup>200</sup> Joseph Marren, *The Statement and Account Clause and Citizens United*, JURIST - Sidebar, Jan. 9, 2013, <http://jurist.org/sidebar/2013/01/joseph-marren-citizens-part1.php>
- <sup>201</sup>
- <sup>202</sup> Fed. Election Comm'n v. Akins, 524 U.S. 11.
- <sup>203</sup> James E. Pfander, *Triangulating Standing*, 53 St. Louis U. L.J. 829, 835 (2009)
- <sup>204</sup> *Id.*
- <sup>205</sup> *Fed. Election Comm'n v. Akins*, 524 U.S. 11, 21, 118 S. Ct. 1777, 1784, 141 L. Ed. 2d 10 (1998)
- <sup>206</sup> *N.Y. v. U.S.*, 505 U.S. 144, 112 S. Ct. 2408, 120 L. Ed. 2d 120 (1992).
- <sup>207</sup> Erwin Chemerinsky, *Protecting the Spending Power*, 4 Chap. L. Rev. 89, 100 (2001).
- <sup>208</sup>
- <sup>209</sup> Budget and Accounting-Amendment, Pub. L. No. 863 (1921), available at <http://www.usaid.gov/policy/ads/600/pl84-863.pdf>.
- <sup>210</sup> CBO's Budgetary Treatment of Fannie Mae and Freddie Mac.
- <sup>211</sup> Kate Stith, *Rewriting the Fiscal Constitution: The Case of Gramm-Rudman-Hollings*, 76 Cal. L. Rev. 593, 607 n. 91-92 (1988); Permanent appropriations operate automatically to provide funding each year, without action by Congress. The major entitlement programs have permanent appropriations. Examples include social security, 42 U.S.C. §§ 401-433 (1982 & Supp. IV 1986), and federal retirement payments, 10 U.S.C. §§ 1201, 1202, 1204, 1205, 1275, 1315, 1331 (1982 & Supp. IV 1986); Some entitlement programs must be annually funded, including Medicaid, 42 U.S.C. § 1396 (1982 & Supp. IV 1986), Aid to Families with Dependent Children, 42 U.S.C. § 601 (1982), and various veterans benefits, 38 U.S.C. §§ 314, 503, 521 (1982 & Supp. III 1985), but these appropriations are treated as mandatory by Congress, like liquidating appropriations for contract authority.
- <sup>212</sup> Joseph Marren & Elizabeth Marren, *ACA Medicaid Decision is Judicial Malpractice*, JURIST - Sidebar, Sept. 5, 2012, <http://jurist.org/sidebar/2012/09/marren-marren-medicaid-malpractice.php>
- <sup>213</sup> *S. Dakota v. Dole*, 483 U.S. 203, 107 S. Ct. 2793, 97 L. Ed. 2d 171 (1987).
- <sup>214</sup> *S. Dakota v. Dole*, 107 S. Ct. at 2794.
- <sup>215</sup> *Id.*
- <sup>216</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, 2011 FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT 32 (2011).
- <sup>217</sup> *Id.* at xiii.
- <sup>218</sup> Joseph Marren, *The Statement and Account Clause and Caperton: Part I*, JURIST - Sidebar, Apr. 8, 2013, <http://jurist.org/sidebar/2013/04/joseph-marren-sa-caperton-part1.php>
- <sup>219</sup>
- <sup>220</sup> 273 U.S. 510.
- <sup>221</sup> THE FEDERALIST No. 10, p. 59 (J. Cooke ed. 1961)(J. Madison).
- <sup>222</sup> 273 U.S. at 520.
- <sup>223</sup> *Id.* at 522.
- <sup>224</sup> *Id.* at 535.
- <sup>225</sup> *Ibid.*
- <sup>226</sup> *Withrow*, 421 U.S., at 47.
- <sup>227</sup> 409 U.S. 57 (1972).

<sup>228</sup> 409 U.S., at 60.

<sup>229</sup> *Ibid.*

<sup>230</sup> *Gibson v. Berryhill*, 411 U.S. 564, 579 (1973).

<sup>231</sup> *Withrow*, 421 U.S., at 47.

<sup>232</sup> Charles T. Munger, *Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger*, 390-446 (Peter D. Kaufman 2005).

<sup>233</sup> *Id.* at 401.

<sup>234</sup> THE FEDERALIST No. 72 at 257 (Alexander Hamilton (1788)).

<sup>235</sup> See "Setting Recusal Standards after *Caperton v. A.T. Massey Coal Company*

<sup>236</sup> *Id.* at 407.

<sup>237</sup> *Id.* at 409.

<sup>238</sup> *Id.* at 431-32.

<sup>239</sup> *Id.* at 435.

<sup>240</sup> Federal Accounting Standard Advisory Board, *Accounting for Social Insurance, Revised*, at 8 (2006).

<sup>241</sup> *Id.* at 434.

<sup>242</sup> *Id.* at 438.

<sup>243</sup> Munger, *Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger*, 425 (Peter D. Kaufman 2005).

<sup>244</sup> Federal Accounting Standards Advisory Board, *FASAB Facts* (2009).

<sup>245</sup> Memorandum of Understanding Among the Gov't Accountability Office, the Dep't. of the Treasury, and the OMB on the Federal Gov't Accounting Standards and a Federal Accounting Standards Advisory Board (Revised October 2009).

<sup>246</sup> James Patton & David Mosso, *Is the Federal Accounting Standards Advisory Board Independent? Can the Federal Accounting Standards Advisory Board Be More Independent?*, *Journal of Government Financial Management*, Fall 2009, at 61.

<sup>247</sup> *Id.*

<sup>248</sup> *Id.*

<sup>249</sup> *Id.*

<sup>250</sup> *Financial Reporting - AICPA Recognizes FASAB as GAAP Standard Setter*, *Journal of Accountancy*, Mar. 2000, at 1.

<sup>251</sup> James Patton & David Mosso, *Is the Federal Accounting Standards Advisory Board Independent? Can the Federal Accounting Standards Advisory Board Be More Independent?*, *Journal of Government Financial Management*, Fall 2009.

<sup>252</sup> Federal Accounting Standards Advisory Board, *FASAB News Federal Accounting Standards Advisory Board* (June/July 2010).

<sup>253</sup> Federal Accounting Standards Advisory Board, *Accounting for Social Insurance (Revised) Statement of Federal Financial Accounting Standards Preliminary Views* (Oct. 2006).

<sup>254</sup> *Id.* at 8.

<sup>255</sup> *Id.*

<sup>256</sup> Federal Accounting Standards Advisory Board, *FASAB News Issue 105*, at 5 (September/October 2007).

<sup>257</sup> James Patton & David Mosso, *Is the Federal Accounting Standards Advisory Board Independent? Can the Federal Accounting Standards Advisory Board Be More Independent?*, *Journal of Government Financial Management*, Fall 2009.

<sup>258</sup> Even scholars who would have sustained the one-House veto appear to agree with this ultimate conclusion. See Nathanson, *Separation of Powers and Administrative Law: Delegation, The Legislative Veto, and the "Independent" Agencies*, 75 Nw.U.L.Rev. 1064, 1090 (1981) ("It is not a case where the Congress has delegated authority to one of its components to take affirmative steps to impose regulations upon private interests—an action which would, I assume, be unconstitutional"). Cf. *Buckley v. Valeo*, 424 U.S. 1, 286, 96 S.Ct. 612, 728, 46 L.Ed.2d 659 (1976) (WHITE, J., dissenting) (expressing the opinion that a one-House veto of agency regulations would be unobjectionable, but adding that it "would be considerably different if Congress itself purported to adopt and propound regulations by the action of both Houses").

<sup>259</sup> As I have emphasized, in this case, the Comptroller General is assigned functions that require him to make policy determinations that bind the Nation. I note only that this analysis need not call into question the Comptroller General's performance of numerous existing functions that may not rise to this level. See ante, at 734-735, n. 9.

<sup>260</sup> The fact that Congress specified a joint resolution as the fallback provision has another significance as well. For it reveals the congressional intent that, if the Comptroller General could not exercise the prescribed functions, Congress wished to perform them itself, rather than delegating them, for instance, to an independent agency or to an Executive Branch official. This choice shows that Congress intended that the important functions of the Act be no further from itself than the Comptroller General.

<sup>261</sup> In considering analogous problems, our state courts have consistently recognized the importance of strict adherence to constitutionally mandated procedures in the legislative process. See, e.g., *State v. A.L.I.V.E. Voluntary*, 606 P.2d 769, 773, 777 (Alaska 1980) ("Of course, when the legislature wishes to act in an advisory capacity it may act by resolution. However, when it means to take action having a binding effect on those outside the legislature it may do so only by following the enactment procedures. Other state courts have so held with virtual unanimity...The fact that it can delegate legislative power to others who are not bound by Article II does not mean that it can delegate power to itself and, in the process, escape from the constraints under which it must operate"); *People v. Tremaine*, 252 N.Y. 27, 44, 168 N.E. 817, 822 (1929) ("If the power to approve the segregation of lump sum appropriations may be delegated to any one, even to one or two members of the Legislature, it necessarily follows that the power to segregate such appropriations may also be conferred by the committee chairmen. Such a delegation of legislative power would be abhor[r]ent to all our notions of legislation on the matter of appropriations").

<sup>262</sup> I have previously noted my concern about the need for a "due process of lawmaking" even when Congress has acted with bicameralism and presentment. See *Fullilove v. Klutznick*, 448 U.S. 448, 549, and n. 24, 100 S.Ct. 2758, 2811, and n. 24, 65 L.Ed.2d 902 (1980) (STEVENS, J., dissenting); *Delaware Tribal Business Committee v. Weeks*, 430 U.S. 73, 98, and n. 11, 97 S.Ct. 911, 916, and n. 11, 51 L.Ed. 173 (1977) (STEVENS, J., dissenting). When a legislature's agent is given powers to act without even the formalities of the legislative process, these concerns are especially prominent.

<sup>263</sup> See also Watson, *Congress Steps Out: A Look at Congressional Control of the Executive*, 63 Calif.L.Rev. 983, 1067, n. 430 (1975) (“A delegation which disperses power is not necessarily constitutionally equivalent to one which concentrates power in the hands of the delegating agency”); Ginnane, 66 Harv.L.Rev., at 595 (“It is a non sequitur to say that, since a statute can delegate a power to someone not bound by the procedure described in the Constitution for Congress’ exercise of the power, it can therefore ‘delegate’ the power to Congress free of constitutional restrictions on the manner of its exercise”).

<sup>264</sup> Justice BLACKMUN suggests that Congress may delegate legislative power to one of its own agents as long as it does not retain “tight control” over that agent. Post, at 779, n. 1. His suggestion is not faithful to the rationale of *Chadha* because no component of Congress, not even one of its Houses, is subject to the “tight control” of the entire Congress. For instance, the Congressional Research Service, whose primary function is to respond to congressional research requests, 2 U.S.C. sec 166, apparently would not fall within Justice BLACKMUN’S “tight control” test because Congress has guaranteed the Service “complete research independence and the maximum practicable administrative independence consistent with these objectives.” Sec 166(b)(2). I take it, however, that few would doubt the unconstitutionality of assigning the functions at issue in this case to the Congressional Research Service. Moreover, *Chadha* surely forecloses the suggestion that because delegation of legislative power to an independent agency is acceptable, such power may also be delegated to a component or an agent of Congress. Finally, with respect to Justice BLACKMUN’S emphasis on Presidential appointment of the Comptroller General, post, at 778-779, n. 1, as I have previously pointed out, other obvious congressional agents, such as the Librarian of Congress, the Architect of the Capitol, and the Public Printer are also appointed by the President, See n. 9, *supra*.

<sup>265</sup> Woodrow Wilson, *Congressional Government: A Study in American Politics* (Baltimore: John Hopkins University Press, 1981; orig. ed., 1885), pp. 27, 215.

<sup>266</sup> The Federalist No. 51, at xxx James Madison)(Clinton Rossiter ed., 1961).

<sup>267</sup> 31 U.S.C.A. 41

<sup>268</sup> 31 U.S.C. §702(a)

<sup>269</sup> 31 U.S.C.A. § 3511

<sup>270</sup> *Id.*

<sup>271</sup> 31 U.S.C. 714(b)

<sup>272</sup> Cornelius E. Tierney, Edward F. Kearney, & Roldan Fernandez, *Audit Federal Financial Controls: Sooner Rather Than Later?*, AGA CPAG Research Series: Report No. 1, Mar. 2005, at 5.

<sup>273</sup> 31 U.S.C. 65

<sup>274</sup> 31 U.S.C.A. 65; 31 U.S.C. §§3511-3515, 3521

<sup>275</sup> 31 U.S.C. 8351

<sup>276</sup> United States. Cong. *Budget and Accounting-Amendment*. 84th Cong., 2nd sess. <http://www.usaid.gov/policy/ads/600/pl84-863.pdf>.

<sup>277</sup> 31 U.S.C.A. §1301

<sup>278</sup> See Arthur Anderson & Co., *Sound Financial Reporting in the Public Sector: a Prerequisite to Fiscal Responsibility* (Sept. 1975); See also Arthur Andersen & Co., *Sound Fiscal Management in the Public Sector* (Oct. 1976).

<sup>279</sup> At the time of AA’s recommendation the Government computed two estimates of future liabilities for Social Security. These estimates were based on a present-value approach, taking into consideration future contributions and benefits which have been established by present laws. Beginning in 1972, benefits are automatically adjusted for changes in the consumer price index. The first estimate, usually referred to as the Official Actuarial Concept, indicates that the excess of benefits to be paid to present and future participants (defined years thereafter as the Open Group) over anticipated receipts for the next seventy-five years on a present value basis is \$1.312 trillion as of June 30, 1974. The second estimate, usually referred to as the Full-reserve Actuarial Concept, estimates that the excess of benefits to be paid to present participants over contributions by present participants (defined years thereafter as the Closed Group) on a present value basis is \$2.460 trillion as of June 30, 1974.

<sup>280</sup> Congressional Budget Office, *Federal Financial Reporting: Accrual Accounting and the Budget* (1977).

<sup>281</sup> U.S. Gov’t Accountability Office, GAO/AFMD-85-35-A, *Managing the Cost of Government: Building an Effective Financial Management Structure* (1985).

<sup>282</sup> § 307. Adoption of Capital Accounting Standards. PL 101–576, 1990 HR 5687

<sup>283</sup> § 3515. Financial statements of agencies, PL 103–356, 1994 S 2170

<sup>284</sup> “Social Security Online History Pages.” The United States Social Security Administration. Web. 02 Sept. 2011.

<<http://www.ssa.gov/history/nestor.html>>.

<sup>285</sup> Peter G. Peterson, *Running on Empty* 111 (Farrar, Straus and Giroux 2004).

<sup>286</sup> *Carter v. Carter Coal Co.*, 298 U.S. 238, 311 (1936).

<sup>287</sup> *Id.* at 2602 (Roberts, C.J.).

<sup>288</sup> *Id.* at 2660 (Scalia, Kennedy, Thomas, and Alito, JJ., dissenting).

<sup>289</sup> *Id.* at 2633 n.17 (Ginsberg, J., concurring in part and concurring in the judgment in part and dissenting in part).

<sup>290</sup> 15 U.S.C. sec 78o-3 (1970). See generally Nassau Sec. Serv. V. SEC, 348 F.2d 133 (2d Cir. 1965); Rutter, *The National Association of Securities Dealers*, 7 Vill. L. Rev. 611 (1962).

<sup>291</sup> *R.H. Johnson & Co. v. SEC*, 198 F.2d 690, 695 (2d Cir.), cert. denied, 344 U.S. 855 (1952).

<sup>292</sup> Louis D. Brandeis, *Other People’s Money and How the Bankers Use It* 92 (1914).

<sup>293</sup> *Nat’l Fed’n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2576 (2012)(Roberts, C.J.).

<sup>294</sup> Joseph Marren & Elizabeth Marren, *ACA Medicaid Decision is Judicial Malpractice*, JURIST - Sidebar, Sept. 5, 2012, <http://jurist.org/sidebar/2012/09/marren-marren-medicaid-malpractice.php>

<sup>295</sup> *Nat’l Fed’n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2576 (2012)(Roberts, C.J.).

<sup>296</sup> *Id.* at 2571.

<sup>297</sup> *Id.*

<sup>298</sup> *Id.*

<sup>299</sup> *Id.* at 2572-73.

<sup>300</sup> *Id.* at 2666 (Scalia, Kennedy, Thomas, and Alito, JJ., dissenting).

<sup>301</sup> *Id.* at 2663.

<sup>302</sup> *Id.* at 2632 (Ginsberg, J., concurring in part and concurring in the judgment in part and dissenting in part).

<sup>303</sup> *Id.* at 2604 (Roberts, C.J.).

<sup>304</sup> *Id.* at 2572.

<sup>305</sup> *Id.* at 2602 (Roberts, C.J.)(quoting *Barnes v. Gorman*, 536 U.S. 181, 186 (2002)).

<sup>306</sup> *Id.*

<sup>307</sup> *Id.* at 2604.

<sup>308</sup> *Id.* at 2605.

<sup>309</sup> *Id.* at 2602 (Roberts, C.J.).

<sup>310</sup> *Id.* at 2660 (Scalia, Kennedy, Thomas, and Alito, JJ., dissenting).

<sup>311</sup> *Id.* at 2633 n.17 (Ginsberg, J., concurring in part and concurring in the judgment in part and dissenting in part).

<sup>312</sup> *Id.* at 2575 (2012).

<sup>313</sup> *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2576 (2012)(Roberts, C.J.).

<sup>314</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, 2010 FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT 140 tbl.1 (2010).

<sup>315</sup> *Id.* at 130-31, 222, 224, 226-28. *See also* U.S. GOV'T ACCOUNTABILITY OFFICE, 2011 FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT 134 (2011).

<sup>316</sup> *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2632 n.15 (2012)(Ginsberg, J., concurring in part and concurring in the judgment in part and dissenting in part).

<sup>317</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, 2011 FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT 32 (2011).

<sup>318</sup> *Id.* at xiii.

<sup>319</sup> Stith, Kate, "Congress' Power of the Purse" (1988). Faculty Scholarship Series. Paper 1267. [http://digitalcommons.law.yale.edu/fss\\_papers/1267](http://digitalcommons.law.yale.edu/fss_papers/1267).

<sup>320</sup> *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2576 (2012)(Roberts, C.J.).

<sup>321</sup> RICO was enacted by section 901(a) of the Organized Crime Control Act of 1970 (Pub.L. 91-452, 84 Stat. 922, enacted October 15, 1970), and is codified at 18 U.S.C. ch. 96 as 18 U.S.C. §§ 1961-1968.

<sup>322</sup> Rand Paul

<sup>323</sup> Chairman Greenspan presented identical testimony before the Committee on Financial services, U.S. House of Representatives, on February 12, 2003.

<sup>324</sup> The Federal Reserve Act requires the Board to order an annual independent audit of the financial statements of the Board and the twelve Reserve Banks. 12 USC 248b (1999).

<sup>325</sup> Comment Letter from the Board of Governors of the Federal Reserve System to Wendy Payne, Executive Director, Federal Accounting Standards Advisory Board, July 2, 2013.

<sup>326</sup> 418 U.S. 166 (1974).

<sup>327</sup> *United States v. Richardson*, 418 U.S. 166, 178 n.11 (1974)(Burger, C.J.).

<sup>328</sup> *Id.*

<sup>329</sup> The Exposure Draft would also require certain other organizations to be included in the government-wide GPFFR if excluding them would be misleading.

<sup>330</sup> These fees are not assessed and collected by the federal government, but are assessed and collected by the Public Company Accounting Oversight Board ("PCAOB") pursuant to a contractual arrangement between the FAF and the PCAOB.

<sup>331</sup> The independence of the FASB budget was critical to Congress. See 148 CONG. REC. S7355 (Jul. 25, 2002)(statement of Sen. Enzi): "We did something marvelous for the FASB. We made sure of its independence. One way we made sure of its independence, besides citing in the law, was to make sure FASB has independent funding. They will not have to come to Congress with a budget. And they will not have to go to corporate America for funding. They will get independent funding to be able to do the job they need to do. That will inhibit us from trying to change what they are doing in setting accounting standards."

<sup>332</sup> Although pursuant to Section 109 of SOX, the SEC is required to determine annually that the FASB accounting support fee is within the parameters prescribed by Congress, the SEC does not have authority, and is not required, to approve the FASB budget.

<sup>333</sup> The Budget of the U.S. Government: Analytical Perspectives-Supplemental Materials schedule entitled "Federal programs by Agency and Account" (Schedule 32-1); referring to the FASB as the "Standard Setting Body" (Account 527-00-5377)).

<sup>334</sup> It should be noted that notwithstanding the explicit statutory language providing that the accounting support fees do not constitute public monies or public funds, the OMB has determined that the FASB is subject to sequestration.

<sup>335</sup> The Exposure Draft also provides guidance regarding the circumstances when consolidated financial statements would be appropriate for an organization in the GPFFRs ("consolidation entities"), or when disclosure would be appropriate ("disclosure organizations").

<sup>336</sup> Although the Exposure Draft refers to inclusion in the Budget as a "principle," it appears to us to be more in the nature of a rule, requiring an entity to be included in the GPFFR if it is in the Budget.

<sup>337</sup> It seems anomalous to us that the FASB may not be entitled to rely on this exception (and therefore may be required to be included in the GPFFRs) precisely because it does not receive any form of federal financial assistance.

<sup>338</sup> We assume that, even were the FASB to be included in the GPFFRs, it would not be deemed to be a consolidation entity. As the Exposure Draft states, "Consolidation is not appropriate for organizations operating with a high degree of autonomy. Some organizations that meet the principles for inclusion are insulated from political influence and intended to be non-taxpayer funded. Presenting information about these discrete organizations in consolidated financial statements would obscure the operating results and financial position of the reporting entity." We also believe, though, that the FASB should not be considered to be a "disclosure organization," on the basis that the absence of any governmental ownership, or any operational governmental control, should not result in the FASB being within the scope of the GPFFRs in any

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manner. As the Exposure Draft states, “The Board recognizes that in rare instances it also may be misleading to include an organization that is administratively assigned to a reporting entity based on [inclusion] principles. In such cases, the organization may be excluded.” If there is no federal funds, there would be no justification for including the entity within the scope of the GPFFRs; indeed, to do so would be misleading. The proposed “misleading to include” criteria do not clearly reflect this consideration, and the Exposure Draft states without support that instances when organizations can be excluded are “rare.”

<sup>339</sup> We defer to the FASAB as to how an elimination of the “in the Budget” principle should be reflected. For example, the FASAB may determine that inclusion in the Budget is merely one of several factors to be considered in evaluating whether an organization should be included in the GPFFRs.

<sup>340</sup> The Exposure Draft includes twelve specific questions to which commentators are requested to respond. The comments set forth in this letter are intended to respond principally to questions Q1(a), (b) and, (d).

<sup>341</sup> Pub. L. No. 111-203, sec978(b), 124 Stat. 1376, 1925 (July 21, 2010).

<sup>342</sup> MSRB was established by Congress to promote a fair and efficient municipal securities market. MSRB makes rules regulating securities firms (but not issuers) in the municipal securities market. The Securities and Exchange Commission (SEC) is charged with oversight of MSRB.

<sup>343</sup> In this report, we use the term “stakeholder” to mean a person or group with an interest in GASB and its impact on the municipal securities market.

<sup>344</sup> For purposes of this work, the term “analysts” refers collectively to institutional or retail investors, rating agencies, and bond insurers—entities that employ professional staff who analyze the credit quality of municipal bonds—that we interviewed or participated in our roundtable. “Issuers” refers to those state and local governments and associations representing state and local governments and their finance officers that we interviewed or who participated in our roundtable. Where appropriate, we attribute the comments to subgroups.

<sup>345</sup> National Association of State Controllers, Time to Complete the States’ CAFRs, Fiscal Years 2005, 2006, 2007, 2008 and 2009. Received from the National Association of State Auditors, Comptrollers, and Treasurers via e-mail on November 19, 2010.

<sup>346</sup> Standard & Poor’s, For the U.S. Bond Insurance Market, There May Be No Turning Back, January 20, 2010.

<sup>347</sup> FASB, organized in 1973, establishes standards of accounting and reporting for private sector entities, including businesses and not-for-profit organizations. Like GASB, FASB is an operating component of the Foundation.

<sup>348</sup> In accordance with section 109 of the Act, FASB is funded by an annual accounting support fee allocated among securities issuers based on each issuer’s proportional market capitalization.

<sup>349</sup> If SEC exercised this authority, SEC said it would require the Financial Industry Regulatory Authority (FINRA), a registered national securities association under the Securities and Exchange Act of 1934, to establish the accounting support fee.

# The President's Budget

## 2000 to 2009

(Trillions of Dollars)

Fiscal Year Ended 9/30	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
<b>GDP</b> (Quarterly-Current Dollars per BEA)	\$10.4	\$10.6	\$11.0	\$11.6	\$12.4	\$13.2	\$13.9	\$14.6	\$14.8	\$14.4
<b>President's Budget</b>										
Revenues	\$2.0	\$2.0	\$1.9	\$1.8	\$1.9	\$2.2	\$2.4	\$2.6	\$2.5	\$2.1
Outlays	1.8	1.9	2.0	2.2	2.3	2.5	2.7	2.7	3.0	3.5
Budget Surplus (Deficit)	\$0.2	\$0.1	(\$0.2)	(\$0.4)	(\$0.4)	(\$0.3)	(\$0.2)	(\$0.2)	(\$0.5)	(\$1.4)

# *The Financial Report of the United States Government*

## Statements of Net Cost

(Trillions of Dollars)

Fiscal Year Ended 9/30	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
<b>GDP</b> (Quarterly-Current Dollars per BEA)	\$10.4	\$10.6	\$11.0	\$11.6	\$12.4	\$13.2	\$13.9	\$14.6	\$14.8	\$14.4
<b>President's Budget</b>										
Revenues	\$2.0	\$2.0	\$1.9	\$1.8	\$1.9	\$2.2	\$2.4	\$2.6	\$2.5	\$2.1
Outlays	1.8	1.9	2.0	2.2	2.3	2.5	2.7	2.7	3.0	3.5
Budget Surplus (Deficit)	\$0.2	\$0.1	(\$0.2)	(\$0.4)	(\$0.4)	(\$0.3)	(\$0.2)	(\$0.2)	(\$0.5)	(\$1.4)
Additional Accrued Expenses Recorded in Financial Report	0.2	0.6	0.2	(0.1)	0.2	0.4	0.2	0.1	0.6	(0.2)
<b>Net Operating Cost</b>	\$0.0	(\$0.5)	(\$0.4)	(\$0.3)	(\$0.6)	(\$0.8)	(\$0.4)	(\$0.3)	(\$1.0)	(\$1.2)

# ***The Financial Report of the United States Government Balance Sheet***

as of September 30, 2009

(Trillions of Dollars)

<b>Assets</b>	
Cash	\$0.4
Receivables	0.6
Inventories	0.3
Property, plant & equipment	0.8
Other	0.6
<b>Total Assets</b>	<b>\$2.7</b>

<b>Liabilities</b>	
Federal debt securities held by the public and accrued interest	(\$7.6)
Federal employee and veteran benefits payable	(5.3)
Other	(1.3)
<b>Total Liabilities</b>	<b>(14.1)</b>
<b>Net Liability (Net Position)</b>	<b>(\$11.5)</b>



# ***The Financial Report of the United States Government Statement's of Social Insurance***

Present Value of Obligations as of January 1 of each year and  
Increase in Present Value from the Prior January 1 Valuation  
Open Group

(Trillions of Dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Social Security	\$3.8	\$4.2	\$4.6	\$4.9	\$5.2	\$5.7	\$6.5	\$6.8	\$6.6	\$7.7
Medicare										
Part A	2.7	4.7	5.1	6.2	8.5	8.8	11.3	12.3	12.7	13.8
Part B	6.5	8.1	8.1	9.7	11.4	12.4	13.1	13.4	15.7	17.2
Part D					8.1	8.7	7.9	8.4	7.9	7.2
Total Medicare	9.2	12.8	13.3	15.8	28.1	29.9	32.3	34.1	36.3	38.1
Total Net Obligation Per SOSI	13.0	17.0	17.8	20.7	33.3	35.6	38.8	40.8	42.9	45.8
Increase in Net Obligation (a)		\$4.0	\$0.8	\$2.9	\$12.5	\$2.3	\$3.2	\$2.1	\$2.0	\$2.9

# ***Analysis of Appropriations and Unfunded Amounts for Social Insurance Figures Recorded in the 2009 SOSI***

	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Social Security</b>	\$2.4	\$5.3	\$7.7
<b>Medicare</b>			
Part A	0.3	13.4	13.8
SMI			
Part B	17.2	0.0	17.2
Part D	7.2	0.0	7.2
Total Medicare	24.7	13.4	38.1
<b>Grand Totals</b>	<b>\$27.1</b>	<b>\$18.7</b>	<b>\$45.8</b>

# ***The Financial Report of the United States Government Present Value and Increase in Present Value of Social Insurance Obligations – Infinite Horizon***

(Trillions of Dollars)

<b>Fiscal Year Ended 9/30</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
Social Security	11.9	12.8	15.2	15.7	15.9	17.5
Medicare						
Part A	\$22.1	\$24.3	\$28.4	\$30.5	\$34.7	\$36.7
Part B	23.2	25.8	26.2	26.8	34.0	37.2
Part D	16.5	18.3	16.0	17.1	17.2	15.6
Subtotal	61.8	68.4	70.6	74.4	85.9	89.5
	\$73.7	\$81.2	\$85.8	\$90.1	\$101.8	\$107.0
Increase in Present Value		\$7.5	\$4.6	\$4.3	\$11.7	\$5.2

# ***Analysis of Appropriations and Unfunded Amounts for Social Security and Medicare Figures Reported Under the Infinite Horizon Assumption for 2009***

	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Social Security</b>	2.4	15.1	17.5
<b>Medicare</b>			
Part A	0.3	36.4	36.7
SMI			
Part B	37.2	0.0	37.2
Part D	15.6	0.0	15.6
Total Medicare	<b>\$55.5</b>	<b>\$51.5</b>	<b>\$107.0</b>

# The President's Budget

## 2001 to 2010

(Trillions of Dollars)

Fiscal Year Ended 9/30	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
GDP (Quarterly-Current Dollars per BEA)	\$10.6	\$11.0	\$11.6	\$12.4	\$13.2	\$13.9	\$14.6	\$14.8	\$14.4	\$15.1
<b>President's Budget</b>										
Revenues	\$2.0	\$1.9	\$1.8	\$1.9	\$2.2	\$2.4	\$2.6	\$2.5	\$2.1	\$2.2
Outlays	1.9	2.0	2.2	2.3	2.5	2.7	2.7	3.0	3.5	3.5
Budget Surplus (Deficit)	\$0.1	(\$0.2)	(\$0.4)	(\$0.4)	(\$0.3)	(\$0.2)	(\$0.2)	(\$0.5)	(\$1.4)	(\$1.3)

# *The Financial Report of the United States Government*

## Statements of Net Cost

(Trillions of Dollars)

Fiscal Year Ended 9/30	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
GDP (Quarterly-Current Dollars per BEA)	\$10.6	\$11.0	\$11.6	\$12.4	\$13.2	\$13.9	\$14.6	\$14.8	\$14.4	\$15.1
<b>President's Budget</b>										
Revenues	\$2.0	\$1.9	\$1.8	\$1.9	\$2.2	\$2.4	\$2.6	\$2.5	\$2.1	\$2.2
Outlays	1.9	2.0	2.2	2.3	2.5	2.7	2.7	3.0	3.5	3.5
Budget Surplus (Deficit)	\$0.1	(\$0.2)	(\$0.4)	(\$0.4)	(\$0.3)	(\$0.2)	(\$0.2)	(\$0.5)	(\$1.4)	(\$1.3)
Additional Accrued Expenses Recorded in Financial Report	0.6	0.2	(0.1)	0.2	0.4	0.2	0.1	0.6	(0.2)	0.8
Net Operating Cost	(\$0.5)	(\$0.4)	(\$0.3)	(\$0.6)	(\$0.8)	(\$0.4)	(\$0.3)	(\$1.0)	(\$1.2)	(\$2.1)

# ***The Financial Report of the United States Government Balance Sheet***

as of September 30, 2010

*(Trillions of Dollars)*

<b>Assets</b>	
Cash	\$0.4
Receivables	0.8
Inventories	0.3
Property, plant & equipment	0.8
Other	0.6
<b>Total Assets</b>	<b>\$2.9</b>

<b>Liabilities</b>	
Federal debt securities held by the public and accrued interest	(\$9.1)
Federal employee and veteran benefits payable	(5.7)
Other	(1.6)
<b>Total Liabilities</b>	<b>(16.4)</b>
<b>Net Liability (Net Position)</b>	<b>(\$13.5)</b>

# ***The Financial Report of the United States Government Statement's of Social Insurance***

Present Value of Obligations as of January 1 of each year and  
Increase in Present Value from the Prior January 1 Valuation  
Open Group

*(Trillions of Dollars)*

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Social Security	\$4.2	\$4.6	\$4.9	\$5.2	\$5.7	\$6.5	\$6.8	\$6.6	\$7.7	\$7.9
Medicare										
Part A	4.7	5.1	6.2	8.5	8.8	11.3	12.3	12.7	13.8	2.7
Part B	8.1	8.1	9.7	11.4	12.4	13.1	13.4	15.7	17.2	12.9
Part D				8.1	8.7	7.9	8.4	7.9	7.2	7.2
Total Medicare	12.8	13.3	15.8	28.1	29.9	32.3	34.1	36.3	38.1	22.8
Total Net Obligation Per SOSI	17.0	17.8	20.7	33.3	35.6	38.8	40.8	42.9	45.8	30.8
Increase in Net Obligation (a)	\$4.0	\$0.8	\$2.9	\$12.5	\$2.3	\$3.2	\$2.1	\$2.0	\$2.9	(\$15.0)



# The Financial Report of the United States Government

## Comparison of Medicare Amounts Reported in 2010 SOSI To Managements' Illustrative Alternative Scenario

#9

Joseph Marren

Individual

<i>(in billions) (Unaudited)</i>	2010 Consolidated SOSI	Illustrative Alternative Scenario <sup>1,2</sup>
<b>Income</b>		
Part A	\$14,408	\$14,408
Part B <sup>3</sup>	4,836	7,684
Part D <sup>4</sup>	2,486	2,486
Total Income	\$21,730	\$24,578
<b>Expenditures</b>		
Part A	\$17,091	\$21,745
Part B	17,737	28,284
Part D	9,715	9,715
Total Expenditures	\$44,543	\$59,744
Part A	\$2,683	\$7,337
Part B	12,901	20,600
Part D	7,229	7,229
Excess of Expenditures over Income	\$22,813	\$35,166

1. These amounts are not presented in the 2010 Trustees' Report

2. At the request of the Trustees, the Office of the Actuary at CMS has prepared an illustrative set of Medicare Trust Fund projections that differ from current law. No endorsement of the illustrative alternative to current law by the Trustees, CMS, or the Office of the Actuary should be inferred.

3. Excludes \$12,901 billion and \$20,600 of General revenue Contributions from the 2010 Consolidated SOSI projection and the Illustrative Alternative Scenario's projection, respectively, i.e., to reflect Part B income on a consolidated Government-wide basis.

4. Excludes \$7,229 billion of General Revenue Contributions from both the 2010 Consolidated SOSI projection and the Illustrative Alternative Scenario's projection, respectively, i.e., to reflect Part D income on a consolidated Government-wide basis.

# ***Analysis of Appropriations and Unfunded Amounts for Social Insurance Figures Recorded in the 2010 SOSI***

	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Social Security</b>	\$2.5	\$5.4	\$7.9
<b>Medicare</b>			
Part A	0.3	2.4	2.7
SMI			
Part B	12.9	0.0	12.9
Part D	7.2	0.0	7.2
Total Medicare	20.4	2.4	22.8
<b>Grand Totals</b>	<b>\$23.0</b>	<b>\$7.8</b>	<b>\$30.8</b>

# ***The Financial Report of the United States Government Present Value and Increase in Present Value of Social Insurance Obligations – Infinite Horizon***

(Trillions of Dollars)

	2004	2005	2006	2007	2008	2009	2010
Social Security	11.9	12.8	15.2	15.7	15.9	17.5	18.7
Part A	\$22.1	\$24.3	\$28.4	\$30.5	\$34.7	\$36.7	\$6.6
Part B	23.2	25.8	26.2	26.8	34.0	37.2	31.1
Part D	16.5	18.3	16.0	17.1	17.2	15.6	21.0
Subtotal	61.8	68.4	70.6	74.4	85.9	89.5	59.2
	\$73.7	\$81.2	\$85.8	\$90.1	\$101.8	\$107.0	\$77.9
Increase in Present Value		\$7.5	\$4.6	\$4.3	\$11.7	\$5.2	(\$29.1)

# ***Analysis of Appropriations and Unfunded Amounts for Medicare Figures Reported Under the Infinite Horizon Assumption for 2010***

	Funds Appropriated	Unfunded Amounts	
<b>Social Security</b>	\$2.5	\$16.2	\$18.7
<b>Medicare</b>			
Part A	0.3	6.3	6.6
SMI			
Part B	31.6	0.0	31.6
Part D	21.0	0.0	21.0
<b>Total Medicare</b>	<b>\$55.4</b>	<b>\$22.5</b>	<b>\$77.9</b>

# ***Ballpark Estimate of Each State's Net Present Value Cost Obligation for Medicaid Based on the 2010 State Expenditure Report Examining Fiscal 2009 -2011 State Spending***

Published by National Association of State Budget Officers  
Table 28 Medicaid Expenditures

2010 State Expenditure Report Actual Published Figures for Fiscal 2010					Calculation of Each State's Estimated Obligation					
( \$ in millions)	General Fund	Federal Funds	Other State Funds	Total	Col. 1 + Col. 3 Adjusted Total State Spending	Estimated Adjust- ments	Estimated Adjusted Total State Spending	% of Total State Spending	Aggregate State Net Present Value Cost	State Net Present Value Cost Obligation for Medicaid
	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8	Col. 9	Col. 10
<b>California</b>	\$10,319	\$27,968	\$738	\$39,025	\$11,057		\$11,057	8.81%	\$18,256,140	<b>\$1,609,124</b>
<b>New York</b>	6,296	26,057	4,672	37,025	10,968		10,968	8.74%	18,256,140	<b>1,596,172</b>
<b>Massachusetts</b>	9,462	0	0	9,462	9,462		9,462	7.54%	18,256,140	<b>1,377,004</b>
<b>Ohio</b>	8,611	3,024	658	12,293	9,269		9,269	7.39%	18,256,140	<b>1,348,916</b>
<b>Pennsylvania</b>	5,697	12,678	1,776	20,151	7,473		7,473	5.96%	18,256,140	<b>1,087,545</b>
<b>Texas</b>	6,701	16,086	86	22,873	6,787		6,787	5.41%	18,256,140	<b>987,711</b>
<b>Florida</b>	2,823	11,984	3,817	18,624	6,640		6,640	5.29%	18,256,140	<b>966,318</b>
<b>Illinois</b>	3,327	8,397	2,571	14,295	5,898		5,898	4.70%	18,256,140	<b>858,335</b>

# 2010 State Expenditure Report Actual Published Figures for Fiscal 2010

## Calculation of Each State's Estimated Obligation

(\$ in millions)	General Fund	Federal Funds	Other State Funds	Total	Col. 1 + Col. 3 Adjusted Total State Spending	Estimated Adjustments	Estimated Adjusted Total State Spending	% of Total State Spending	Aggregate State Net Present Value Cost	State Net Present Value Cost Obligation for Medicaid
	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8	Col. 9	Col. 10
<b>New Jersey</b>	\$3,925	\$6,120	\$130	\$10,175	\$4,055		\$4,055	3.23%	\$18,256,140	<b>\$590,124</b>
<b>Washington</b>	3,754	3,870	108	7,732	3,862		3,862	3.08%	18,256,140	<b>562,036</b>
<b>North Carolina</b>	2,319	8,113	1,364	11,796	3,683		3,683	2.94%	18,256,140	<b>535,987</b>
<b>Michigan</b>	1,451	8,435	1,683	11,569	3,134		3,134	2.50%	18,256,140	<b>456,091</b>
<b>Minnesota</b>	2,745	4,748	67	7,560	2,812		2,812	2.24%	18,256,140	<b>409,230</b>
<b>Virginia</b>	2,590	3,963	1	6,554	2,591		2,591	2.07%	18,256,140	<b>377,068</b>
<b>Missouri</b>	1,422	6,196	1,168	8,786	2,590		2,590	2.06%	18,256,140	<b>376,922</b>
<b>Maryland</b>	1,997	4,185	557	6,739	2,554		2,554	2.04%	18,256,140	<b>371,683</b>
<b>Colorado</b>	1,120	2,533	1,115	4,768	2,235		2,235	1.78%	18,256,140	<b>325,259</b>
<b>Connecticut</b>	3,855	0	1,145	5,000	5,000	(\$2,768)	2,232	1.78%	18,256,140	<b>324,823</b>
<b>Wisconsin</b>	1,367	4,742	759	6,868	2,126		2,126	1.69%	18,256,140	<b>309,397</b>
<b>Arizona</b>	1,187	5,608	868	7,663	2,055		2,055	1.64%	18,256,140	<b>299,064</b>
<b>Georgia</b>	1,663	5,832	389	7,884	2,052		2,052	1.64%	18,256,140	<b>298,627</b>
<b>Tennessee</b>	1,632	6,227	322	8,181	1,954		1,954	1.56%	18,256,140	<b>284,365</b>
<b>Indiana</b>	1,186	4,554	432	6,172	1,618		1,618	1.29%	18,256,140	<b>235,467</b>
<b>Alabama</b>	315	3,957	1,037	5,309	1,352		1,352	1.08%	18,256,140	<b>196,756</b>

## 2010 State Expenditure Report Actual Published Figures for Fiscal 2010

## Calculation of Each State's Estimated Obligation

(\$ in millions)	General Fund	Federal Funds	Other State Funds	Total	Col. 1 + Col. 3 Adjusted Total State Spending	Estimated Adjustments	Estimated Adjusted Total State Spending	% of Total State Spending	Aggregate State Net Present Value Cost	State Net Present Value Cost Obligation for Medicaid
	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8	Col. 9	Col. 10
<b>Louisiana</b>	\$798	\$5,634	\$484	\$6,916	\$1,282		\$1,282	1.02%	\$18,256,140	<b>\$186,569</b>
<b>Oregon</b>	808	3,037	404	4,249	1,212		1,212	0.97%	18,256,140	<b>176,382</b>
<b>Kentucky</b>	811	4,499	383	5,693	1,194		1,194	0.95%	18,256,140	<b>173,763</b>
<b>Iowa</b>	602	2,165	522	3,289	1,124		1,124	0.90%	18,256,140	<b>163,576</b>
<b>Oklahoma</b>	739	2,586	360	3,685	1,099		1,099	0.88%	18,256,140	<b>159,937</b>
<b>South Carolina</b>	529	3,521	546	4,596	1,075		1,075	0.86%	18,256,140	<b>156,445</b>
<b>Mississippi</b>	139	3,199	849	4,187	988		988	0.79%	18,256,140	<b>143,784</b>
<b>Kansas</b>	713	1,860	70	2,643	783		783	0.62%	18,256,140	<b>113,950</b>
<b>Arkansas</b>	602	3,209	179	3,990	781		781	0.62%	18,256,140	<b>113,659</b>
<b>Rhode Island</b>	715	1,234	7	1,956	722		722	0.58%	18,256,140	<b>105,073</b>
<b>New Mexico</b>	567	2,683	113	3,363	680		680	0.54%	18,256,140	<b>98,960</b>
<b>Nevada</b>	465	944	107	1,516	572		572	0.46%	18,256,140	<b>83,243</b>
<b>New Hampshire</b>	385	797	180	1,362	565		565	0.45%	18,256,140	<b>82,224</b>
<b>Maine</b>	383	1,801	175	2,359	558		558	0.44%	18,256,140	<b>81,206</b>
<b>Nebraska</b>	532	1,095	22	1,649	554		554	0.44%	18,256,140	<b>80,624</b>

## 2010 State Expenditure Report Actual Published Figures for Fiscal 2010

## Calculation of Each State's Estimated Obligation

(\$ in millions)	General Fund	Federal Funds	Other State Funds	Total	Col. 1 + Col. 3 Adjusted Total State Spending	Estimated Adjustments	Estimated Adjusted Total State Spending	% of Total State Spending	Aggregate State Net Present Value Cost <sup>(4)</sup>	State Net Present Value Cost Obligation for Medicaid
	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8	Col. 9	Col. 10
<b>Hawaii</b>	\$499	\$957	\$0	\$1,456	\$499		\$499	0.40%	\$18,256,140	<b>\$72,619</b>
<b>Delaware</b>	481	777	0	1,258	481		481	0.38%	18,256,140	<b>70,000</b>
<b>West Virginia</b>	252	2,100	211	2,563	463		463	0.37%	18,256,140	<b>67,380</b>
<b>Utah</b>	229	1,370	185	1,784	414		414	0.33%	18,256,140	<b>60,249</b>
<b>Idaho</b>	288	1,069	111	1,468	399		399	0.32%	18,256,140	<b>58,066</b>
<b>Vermont</b>	147	834	229	1,210	376		376	0.30%	18,256,140	<b>54,719</b>
<b>Alaska</b>	341	823	7	1,171	348		348	0.28%	18,256,140	<b>50,644</b>
<b>South Dakota</b>	225	604	0	829	225		225	0.18%	18,256,140	<b>32,744</b>
<b>Montana</b>	137	728	65	930	202		202	0.16%	18,256,140	<b>29,397</b>
<b>Wyoming</b>	196	363	0	559	196		196	0.16%	18,256,140	<b>28,524</b>
<b>North Dakota</b>	193	467	2	662	195		195	0.16%	18,256,140	<b>28,378</b>
	<b>\$97,540</b>	<b>\$233,633</b>	<b>\$30,674</b>	<b>\$361,847</b>	<b>\$128,214</b>	<b>(\$2,768)</b>	<b>\$125,446</b>	<b>100.00%</b>		<b>\$18,256,140</b>



# The President's Budget

Under Budget Accounting the Federal Government has Spent \$1.30 for every \$1.00 of Revenue

(Trillions of Dollars)

Fiscal Year Ended 9/30	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
GDP (Quarterly-Current Dollars per BEA)	\$13.9	\$14.6	\$14.8	\$14.4	\$15.1	\$15.6	\$16.2	\$16.7	\$17.5	\$18.1
<b>President's Budget</b>										
Revenues	\$2.4	\$2.6	\$2.5	\$2.1	\$2.2	\$2.3	\$2.5	\$2.8	\$3.0	\$3.3
Outlays	2.7	2.7	3.0	3.5	3.5	3.6	3.5	3.5	3.5	3.7
Budget Deficit	(\$0.2)	(\$0.2)	(\$0.5)	(\$1.4)	(\$1.3)	(\$1.3)	(\$1.1)	(\$0.7)	(\$0.5)	(\$0.4)

# The Financial Report of the United States Government Statements of Net Cost

Under Accrual Accounting the Federal Government has Spent \$1.38 for every \$1.00 of Revenue

(Trillions of Dollars)

Fiscal Year Ended 9/30	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
GDP (Quarterly-Current Dollars per BEA)	\$13.9	\$14.6	\$14.8	\$14.4	\$15.1	\$15.6	\$16.2	\$16.7	\$17.5	\$18.1
<b>President's Budget</b>										
Revenues	\$2.4	\$2.6	\$2.5	\$2.1	\$2.2	\$2.3	\$2.5	\$2.8	\$3.0	\$3.3
Outlays	2.7	2.7	3.0	3.5	3.5	3.6	3.5	3.5	3.5	3.7
Budget Deficit	(0.2)	(0.2)	(0.5)	(1.4)	(1.3)	(1.3)	(1.1)	(0.7)	(0.5)	(0.4)
Additional Accrued Expenses Recorded in Financial Report	0.2	0.1	0.6	(0.2)	0.8	0.0	0.2	0.1	0.3	0.1
Net Operating Cost	(\$0.4)	(\$0.3)	(\$1.0)	(\$1.3)	(\$2.1)	(\$1.3)	(\$1.3)	(\$0.8)	(\$0.8)	(\$0.5)

# Reconciliation from Net Operating Cost to Budget Deficit

(Billions of Dollars)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Net Operating Cost	(\$449.5)	(\$275.5)	(\$1,009.1)	(\$1,253.7) )	(\$2,080.3)	(\$1,312.6)	(\$1,316.3)	(\$805.1)	(\$791.3)	(519.7)
<b>Change In</b>										
Federal Employee and Veterans Benefits Pay	187.2	90.1	549.8	(35.2)	503.1	71.9	481.8	264.3	134.3	46.7
Environmental and Disposal Liabilities	45.4	36.8					(2.2)	(41.7)	18.4	(15.6)
Property Upward/(Downward) Credit Reform Subsidy Re-estimates, Net								(23.1)	22.9	(26.8)
Other Liabilities									7.3	38.6
Other, Net	(10.0)	(11.6)	4.5	(128.1)	283.1	(57.9)	(252.7)	(84.8)	105.0	(4.6)
Subtotal-Net Difference	201.6	112.7	554.3	(163.3)	766.2	14.0	226.9	124.8	307.9	60.6
Budget Deficit	(\$247.7)	(\$162.8)	(\$454.8)	(\$1,417.0) )	(\$1,294.1)	(\$1,298.6)	(\$1,089.4)	(\$680.3)	(\$483.4)	(\$438.9)

# ***Reported Net Liability is about the Size of the Nation's GDP Balance Sheet***

as of September 30, 2015

(Trillions of Dollars)

<b>Assets</b>	
Cash	\$0.3
Receivables	1.3
Inventories	0.3
Property, plant & equipment	0.9
Other	0.4
<b>Total Assets</b>	<b>\$3.2</b>

<b>Liabilities</b>	
Federal debt securities held by the public and accrued interest	(\$13.2)
Federal employee and veteran benefits payable	(6.7)
Other	(1.6)
<b>Total Liabilities</b>	<b>(21.5)</b>
<b>Net Liability (Net Position)</b>	<b>(\$18.2)</b>

# ***The Financial Report of the United States Government Statement's of Social Insurance***

Present Value of Obligations as of January 1 of each year and  
Increase in Present Value from the Prior January 1 Valuation  
Open Group

(Trillions of Dollars)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Present Value of Social Insurance Programs										
Social Security	\$6.5	\$6.8	\$6.6	\$7.7	\$7.9	\$9.2	\$11.3	\$12.3	\$13.3	\$13.4
Medicare										
Part A	11.3	12.3	12.7	13.8	2.7	3.3	5.6	4.8	3.8	3.2
Part B	13.1	13.4	15.7	17.2	12.9	13.9	14.8	15.7	17.9	17.5
Part D	7.9	8.4	7.9	7.2	7.2	7.5	6.8	6.9	6.8	7.3
Subtotal	32.3	34.1	36.3	38.1	22.8	24.6	27.2	27.3	28.5	27.9
Total Social Insurance Obligations	\$38.8	\$40.8	\$42.9	\$45.8	\$30.8	\$33.7	\$38.5	\$39.6	\$41.8	\$41.4
Increase in Net Obligation	\$3.2	\$2.1	\$2.0	\$2.9	(\$15.0)	\$3.0	\$4.7	\$1.1	\$2.2	(\$0.4)

# Analysis of Illustrative Scenarios and Related Appropriations 2010 - 2015

(Trillions of Dollars)

	2010	2011	2012	2013	2014	2015
Excess of Expenditures Over Income						
Part A	\$7.3	\$8.5	\$9.9	\$9.2	\$8.3	\$7.9
SMI -Part B	20.6	21.0	20.6	20.1	20.0	21.5
SMI -Part D	7.2	7.5	6.8	6.9	6.9	7.4
	\$35.2	\$37.0	\$37.2	\$36.2	\$35.2	\$36.8
Increase in Present Value Cost		\$1.8	\$0.2	(\$1.0)	(\$1.0)	\$1.6
Appropriations						
Part A	\$0.3	\$0.3	\$0.3	\$0.3	\$0.3	\$0.3
SMI -Part B	20.6	21.0	20.6	20.1	20.0	21.5
SMI -Part D	7.2	7.5	6.8	6.9	6.9	7.4
	\$28.1	\$28.8	\$27.7	\$27.3	\$27.2	\$29.2

# Analysis of Appropriations and Unfunded Amounts for Medicare Figures Reported in SOSI

#9

Joseph Marren

Individual

2006	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$11.0	\$11.3
SMI – Part B	13.1	0.0	13.1
SMI – Part D	7.9	0.0	7.9
<b>Medicare Total</b>	<b>21.3</b>	<b>11.0</b>	<b>32.3</b>

2007	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$12.0	\$12.3
SMI – Part B	13.4	0.0	13.4
SMI – Part D	8.4	0.0	8.4
<b>Medicare Total</b>	<b>22.1</b>	<b>12.0</b>	<b>34.1</b>

2008	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$12.4	\$12.7
SMI – Part B	15.7	0.0	15.7
SMI – Part D	7.9	0.0	7.9
<b>Medicare Total</b>	<b>23.9</b>	<b>12.4</b>	<b>36.3</b>

2009	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$13.4	\$13.8
SMI – Part B	17.2	0.0	17.2
SMI – Part D	7.2	0.0	7.2
<b>Medicare Total</b>	<b>24.7</b>	<b>13.4</b>	<b>38.1</b>

2010	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$2.4	\$2.7
SMI – Part B	12.9	0.0	12.9
SMI – Part D	7.2	0.0	7.2
<b>Medicare Total</b>	<b>20.4</b>	<b>2.4</b>	<b>22.8</b>

# Analysis of Appropriations and Unfunded Amounts for Medicare Figures Reported in SOSI

#9

Joseph Marren

Individual

2011	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$3.0	\$3.3
SMI – Part B	13.9	0.0	13.9
SMI – Part D	7.5	0.0	7.5
<b>Medicare Total</b>	<b>21.6</b>	<b>3.0</b>	<b>24.6</b>

2012	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.2	\$5.3	\$5.6
SMI – Part B	14.8	0.0	14.8
SMI – Part D	6.8	0.0	6.8
<b>Medicare Total</b>	<b>21.8</b>	<b>5.3</b>	<b>27.2</b>

2013	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.2	\$4.6	\$4.8
SMI – Part B	15.7	0.0	15.7
SMI – Part D	6.9	0.0	6.9
<b>Medicare Total</b>	<b>22.7</b>	<b>4.6</b>	<b>27.3</b>

2014	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.2	\$3.6	\$3.8
SMI – Part B	17.9	0.0	17.9
SMI – Part D	6.8	0.0	6.8
<b>Medicare Total</b>	<b>24.9</b>	<b>3.6</b>	<b>28.5</b>

2015	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.2	\$3.0	\$3.2
SMI – Part B	17.5	0.0	17.5
SMI – Part D	7.3	0.0	7.3
<b>Medicare Total</b>	<b>25.0</b>	<b>3.0</b>	<b>27.9</b>



# ***The Financial Report of the United States Government Present Value and Increase in Present Value of Social Insurance Obligations – Infinite Horizon***

(Trillions of Dollars)

<b>Fiscal Year Ended 9/30</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
Social Security	\$15.2	\$15.7	\$15.9	\$17.5	\$18.7	\$12.4	\$23.2	\$25.8	\$27.7	\$28.5
Medicare										
Part A	28.4	30.5	34.7	36.7	6.6	0.2	5.1	3.7	2.1	0.3
Part B	26.2	26.8	34.0	37.2	31.6	22.4	23.7	25.1	31.5	28.3
Part D	16.0	17.1	17.2	15.6	21.0	16.2	14.3	14.4	14.2	14.9
Subtotal	70.6	74.4	85.9	89.5	59.2	38.8	43.1	43.2	47.8	43.5
Social Security and Medicare	85.8	90.1	101.8	107.0	77.9	51.2	66.3	69.0	75.5	72.0
Increase in Present Value	\$4.6	\$4.3	\$11.7	\$5.2	(\$29.1)	(\$26.7)	\$15.1	\$2.7	\$6.5	(\$3.5)

# ***Analysis of Appropriations for Social Security – Infinite Horizon***

Appropriated Amounts Unchanged From Amounts Identified in the Analysis of SOSI Figures

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Social Security Infinite Horizon	\$15.2	\$15.7	\$15.9	\$17.5	\$18.7	\$12.4	\$23.2	\$25.8	\$27.7	\$28.5
Appropriated Funds	1.9	2.0	2.2	2.4	2.5	2.6	2.7	2.7	2.8	2.8
Unfunded Obligations	13.3	13.7	13.7	15.1	16.2	9.8	20.5	23.1	24.9	25.7

# Analysis of Appropriations and Unfunded Amounts for Medicare Figures Reported Under the Infinite Horizon Assumption

2006	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$28.1	\$28.4
SMI – Part B	26.2	0.0	26.2
SMI – Part D	16.0	0.0	16.0
<b>Medicare Total</b>	<b>42.5</b>	<b>28.1</b>	<b>70.6</b>

2007	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$30.2	\$30.5
SMI – Part B	26.8	0.0	26.8
SMI – Part D	17.1	0.0	17.1
<b>Medicare Total</b>	<b>44.2</b>	<b>30.2</b>	<b>74.4</b>

2008	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$34.4	\$34.7
SMI – Part B	34.0	0.0	34.0
SMI – Part D	17.2	0.0	17.2
<b>Medicare Total</b>	<b>51.5</b>	<b>34.4</b>	<b>85.9</b>

2009	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$36.4	\$36.7
SMI – Part B	37.2	0.0	37.2
SMI – Part D	15.6	0.0	15.6
<b>Medicare Total</b>	<b>53.1</b>	<b>36.4</b>	<b>89.5</b>

2010	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$6.3	\$6.6
SMI – Part B	31.6	0.0	31.6
SMI – Part D	21.0	0.0	21.0
<b>Medicare Total</b>	<b>52.9</b>	<b>6.3</b>	<b>59.2</b>

# Analysis of Appropriations and Unfunded Amounts for Medicare Figures Reported Under the Infinite Horizon Assumption

2011	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$-0.1	\$0.2
SMI – Part B	22.4	0.0	22.4
SMI – Part D	16.2	0.0	16.2
<b>Medicare Total</b>	<b>38.9</b>	<b>-0.1</b>	<b>38.8</b>

2012	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$4.8	\$5.1
SMI – Part B	23.7	0.0	23.7
SMI – Part D	14.3	0.0	14.3
<b>Medicare Total</b>	<b>38.3</b>	<b>4.8</b>	<b>43.1</b>

2013	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$3.4	\$3.7
SMI – Part B	25.1	0.0	25.1
SMI – Part D	14.4	0.0	14.4
<b>Medicare Total</b>	<b>39.8</b>	<b>3.4</b>	<b>43.2</b>

2014	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$1.8	\$2.1
SMI – Part B	31.5	0.0	31.5
SMI – Part D	14.2	0.0	14.2
<b>Medicare Total</b>	<b>46.0</b>	<b>1.8</b>	<b>47.8</b>

2015	Funds Appropriated	Unfunded Amounts	SOSI Obligation Reported
<b>Medicare</b>			
Part A	\$0.3	\$0.0	\$0.3
SMI – Part B	28.3	0.0	28.3
SMI – Part D	14.9	0.0	14.9
<b>Medicare Total</b>	<b>43.5</b>	<b>0.0</b>	<b>43.5</b>

# ***Statement of Long-Term Fiscal Projections and Required Supplementary Information - Federal Government's Portion of Net Present Value Cost of Medicaid***

*(All Figures in Trillions of Dollars)*

	2010	2011	2012	2013	2014	2015
<b>Medicaid's Net Present Value Cost</b>	\$24.2	\$24.0	\$26.1	\$25.2	\$26.0	\$27.3
<b>Increase in Net Present Value Cost</b>	\$24.2	(\$0.2)	\$2.1	(\$0.9)	\$0.8	\$1.3

# ***Ballpark Estimate of Each State's Net Present Value Cost Obligation for Medicaid Based on the 2015 State Expenditure Report Examining Fiscal 2013 -2015 State Spending***

Published by National Association of State Budget Officers  
Table 28 Medicaid Expenditures

2015 State Expenditure Report Estimated Published Figures for Fiscal 2015					Calculation of Each State's Estimated Obligation			
(\$ in millions)	General Fund	Federal Funds	Other State Funds	Total	Col. 1 + Col 3 Adjusted Total State Spending	% of Total State Spending	Aggregate State Net Present Value Cost	State Net Present Value Cost Obligation for Medicaid
	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8
<b>California</b>	\$16,599	\$52,658	\$5,699	\$74,956	\$22,298	11.43%	\$16,778,510	<b>\$1,918,473</b>
<b>Ohio</b>	14,861	7,541	1,925	24,327	16,786	8.61%	16,778,510	<b>1,444,232</b>
<b>New York</b>	11,161	29,393	5,114	45,668	16,275	8.35%	16,778,510	<b>1,400,267</b>
<b>Texas</b>	11,381	22,197	3,983	37,561	15,364	7.88%	16,778,510	<b>1,321,886</b>
<b>Pennsylvania</b>	8,298	12,996	2,849	24,143	11,147	5.72%	16,778,510	<b>959,065</b>
<b>Florida</b>	5,294	13,799	4,487	23,580	9,781	5.02%	16,778,510	<b>841,537</b>
<b>Illinois</b>	4,445	9,921	3,235	17,601	7,680	3.94%	16,778,510	<b>660,771</b>
<b>Massachusetts</b>	7,120	6,704	171	13,995	7,291	3.74%	16,778,510	<b>627,302</b>

**2015 State Expenditure Report**  
**Estimated Published Figures for**  
**Fiscal 2015**

**Calculation of Each State's Estimated Obligation**

(\$ in millions)	General Fund	Federal Funds	Other State Funds	Total	Col. 1 + Col 3 Adjusted Total State Spending	% of Total State Spending	Aggregate State Net Present Value Cost	State Net Present Value Cost Obligation for Medicaid
	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8
<b>North Carolina</b>	\$3,594	\$8,752	\$1,435	\$13,781	\$5,029	2.58%	\$16,778,510	<b>\$432,685</b>
<b>New Jersey</b>	3,869	8,912	1,068	13,849	4,937	2.53%	16,778,510	<b>424,769</b>
<b>Michigan</b>	2,797	12,494	2,029	17,320	4,826	2.47%	16,778,510	<b>415,219</b>
<b>Minnesota</b>	4,533	6,187	164	10,884	4,697	2.41%	16,778,510	<b>404,120</b>
<b>Missouri</b>	1,778	4,511	2,419	8,708	4,197	2.15%	16,778,510	<b>361,101</b>
<b>Virginia</b>	4,114	4,123	0	8,237	4,114	2.11%	16,778,510	<b>353,960</b>
<b>Wisconsin</b>	2,650	4,969	1,259	8,878	3,909	2.00%	16,778,510	<b>336,322</b>
<b>Maryland</b>	2,922	5,688	951	9,561	3,873	1.99%	16,778,510	<b>333,225</b>
<b>Tennessee</b>	3,316	6,673	370	10,359	3,686	1.89%	16,778,510	<b>317,136</b>
<b>Connecticut</b>	3,496	3,483	0	6,979	3,496	1.79%	16,778,510	<b>300,789</b>
<b>Georgia</b>	3,052	5,943	329	9,324	3,381	1.73%	16,778,510	<b>290,894</b>
<b>Colorado</b>	2,312	4,557	735	7,604	3,047	1.56%	16,778,510	<b>262,158</b>
<b>Arizona</b>	2,279	8,040	602	10,921	2,881	1.48%	16,778,510	<b>247,875</b>
<b>Louisiana</b>	1,610	4,588	1,216	7,414	2,826	1.45%	16,778,510	<b>243,143</b>
<b>Indiana</b>	2,009	6,476	677	9,162	2,686	1.38%	16,778,510	<b>231,098</b>
<b>Washington</b>	2,008	5,285	180	7,473	2,188	1.12%	16,778,510	<b>188,251</b>

**2015 State Expenditure Report**  
**Estimated Published Figures for**  
**Fiscal 2015**

**Calculation of Each State's Estimated Obligation**

(\$ in millions)	General Fund	Federal Funds	Other State Funds	Total	Col. 1 + Col 3 Adjusted Total State Spending	% of Total State Spending	Aggregate State Net Present Value Cost	State Net Present Value Cost Obligation for Medicaid
	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8
<b>Oklahoma</b>	\$1,417	\$2,930	\$717	\$5,064	\$2,134	1.09%	\$16,778,510	<b>\$183,605</b>
<b>Kentucky</b>	1,501	7,517	504	9,522	2,005	1.03%	16,778,510	<b>172,506</b>
<b>Oregon</b>	728	6,683	1,260	8,671	1,988	1.02%	16,778,510	<b>171,043</b>
<b>Iowa</b>	1,268	2,846	691	4,805	1,959	1.00%	16,778,510	<b>168,548</b>
<b>Alabama</b>	685	4,155	1,192	6,032	1,877	0.96%	16,778,510	<b>161,493</b>
<b>Kansas</b>	1,281	1,689	578	3,548	1,859	0.95%	16,778,510	<b>159,944</b>
<b>South Carolina</b>	1,023	4,359	640	6,022	1,663	0.85%	16,778,510	<b>143,081</b>
<b>Arkansas</b>	898	4,568	593	6,059	1,491	0.76%	16,778,510	<b>128,283</b>
<b>Mississippi</b>	640	3,633	635	4,908	1,275	0.65%	16,778,510	<b>109,698</b>
<b>New Mexico</b>	862	4,036	238	5,136	1,100	0.56%	16,778,510	<b>94,642</b>
<b>Rhode Island</b>	1,067	1,482	30	2,579	1,097	0.56%	16,778,510	<b>94,384</b>
<b>Maine</b>	753	1,510	270	2,533	1,023	0.52%	16,778,510	<b>88,017</b>
<b>West Virginia</b>	520	2,610	400	3,530	920	0.47%	16,778,510	<b>79,155</b>
<b>Hawaii</b>	888	1,160	0	2,048	888	0.46%	16,778,510	<b>76,402</b>
<b>Nebraska</b>	850	968	37	1,855	887	0.45%	16,778,510	<b>76,316</b>
<b>Utah</b>	400	1,614	467	2,481	867	0.44%	16,778,510	<b>74,595</b>



**2015 State Expenditure Report**  
**Estimated Published Figures for**  
**Fiscal 2015**

**Calculation of Each State's Estimated Obligation**

(\$ in millions)	General Fund	Federal Funds	Other State Funds	Total	Col. 1 + Col 3 Adjusted Total State Spending	% of Total State Spending	Aggregate State Net Present Value Cost	State Net Present Value Cost Obligation for Medicaid
	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8
<b>Idaho</b>	\$475	\$1,304	\$250	\$2,029	\$725	0.37%	\$16,778,510	<b>\$62,377</b>
<b>New Hampshire</b>	548	917	166	1,631	714	0.37%	16,778,510	<b>61,431</b>
<b>Alaska</b>	694	951	5	1,650	699	0.36%	16,778,510	<b>60,140</b>
<b>Delaware</b>	668	1,193	14	1,875	682	0.35%	16,778,510	<b>58,678</b>
<b>Nevada</b>	564	2,225	114	2,903	678	0.35%	16,778,510	<b>58,334</b>
<b>Vermont</b>	283	824	335	1,442	618	0.32%	16,778,510	<b>53,171</b>
<b>North Dakota</b>	441	697	7	1,145	448	0.23%	16,778,510	<b>38,545</b>
<b>South Dakota</b>	364	484	0	848	364	0.19%	16,778,510	<b>31,318</b>
<b>Montana</b>	271	748	91	1,110	362	0.19%	16,778,510	<b>31,146</b>
<b>Wyoming</b>	272	309	23	604	295	0.15%	16,778,510	<b>25,381</b>
	<b>\$144,859</b>	<b>\$317,302</b>	<b>\$50,154</b>	<b>\$512,315</b>	<b>\$195,013</b>	<b>100.00%</b>		<b>\$16,778,510</b>

# Analysis of Medicare Amounts Reported in SOSI, Alternative Scenario and Infinite Horizon that have Appropriations

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
<b>Amounts Reported in SOSI</b>										
Part A	\$0.3	\$0.3	\$0.3	\$0.3	\$0.3	\$0.3	\$0.2	\$0.2	\$0.2	\$0.2
Part B	13.1	13.4	15.7	17.2	12.9	13.9	14.8	15.7	17.9	17.5
Part D	7.9	8.4	7.9	7.2	7.2	7.5	6.8	6.9	6.8	7.3
Total Medicare in SOSI	21.3	22.1	23.9	24.7	20.4	21.6	21.8	22.7	24.9	25.0
<b>Amounts Reported in Alternate Scenario</b>										
Part A					0.3	0.3	0.3	0.3	0.3	0.3
Part B					20.6	21.1	20.6	20.1	20.0	21.5
Part D					7.2	7.5	6.8	6.9	6.9	7.4
Total Medicare – Alternate Scenario					28.1	28.8	27.7	27.3	27.2	29.2
<b>Amounts Reported Under Infinite Horizon</b>										
Part A	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Part B	26.2	26.8	34.0	37.2	31.6	22.4	23.7	25.1	31.5	28.3
Part D	16.0	17.1	17.2	15.6	21.0	16.2	14.3	14.4	14.2	14.9
Total Medicare – Infinite Horizon	42.5	44.2	51.5	53.1	52.9	38.9	38.3	39.8	46.0	43.5
<b>Change in Infinite Horizon</b>	\$1.9	(\$1.7)	(\$7.3)	(\$1.6)	\$0.2	\$14.0	\$0.6	(\$1.5)	(\$6.2)	\$2.5

# ***Social Security, Medicare and Medicaid Amounts that are Fully Funded with Appropriations***

Social Security Appropriations Limited to Amounts in the Trust Fund

Medicare Amounts Based on the Infinite Horizon Assumption

Medicaid Amount Based on the Figures Appearing in the Statement of Long-Term Fiscal Projections and  
Required Supplementary Information

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Social Security	\$1.9	\$2.0	\$2.2	\$2.4	\$2.5	\$2.6	\$2.7	\$2.7	\$2.8	\$2.8
Medicare										
Part A	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
SMI -Part B	26.2	26.8	34.0	37.2	31.6	22.4	23.7	25.1	31.5	28.3
SMI - Part D	16.0	17.1	17.2	15.6	21.0	16.2	14.3	14.4	14.2	14.9
Total Medicare	42.5	44.2	51.5	53.1	52.9	38.9	38.3	39.8	46.0	43.5
Net SOSI Obligation with Appropriations	44.3	46.2	53.7	55.5	55.4	41.5	41.0	42.5	48.7	46.3
Medicaid					24.2	24.0	26.1	25.2	26.0	27.3
Total SOSI & Medicaid Obligations with Appropriations	\$44.3	\$46.2	\$53.7	\$55.5	\$79.6	\$65.5	\$67.1	\$67.7	\$74.7	\$73.6
Increase (Decrease) in Net Obligations	(\$1.7)	\$1.9	\$7.5	\$1.8	\$24.1	(\$14.1)	\$1.6	\$0.7	\$7.0	(\$1.2)

# The Financial Report of the United States Government Adjusted Statements of Net Cost

Includes the Increase or Decrease in the Net Present Value Cost Of Social Security, Medicare and Medicaid to the Extent that they are Fully Funded with Appropriations

(Trillions of Dollars)

Fiscal Year Ended 9/30	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
GDP (Quarterly-Current Dollars per BEA)	\$13.9	\$14.6	\$14.8	\$14.4	\$15.1	\$15.6	\$16.2	\$16.7	\$17.5	\$18.1
<b>President's Budget</b>										
Revenues	\$2.4	\$2.6	\$2.5	\$2.1	\$2.2	\$2.3	\$2.4	\$2.8	\$3.0	\$3.2
Outlays	2.7	2.7	3.0	3.5	3.5	3.6	3.5	3.5	3.5	3.7
Budget Surplus (Deficit)	(\$0.2)	(\$0.2)	(\$0.5)	(\$1.4)	(\$1.3)	(\$1.3)	(\$1.1)	(\$0.7)	(\$0.5)	(\$0.4)
Plus: Expenses Recorded in Financial Report	0.2	0.1	0.6	(0.2)	0.8	0.0	0.2	0.1	0.3	0.1
Financial Report – Net Operating Cost	(0.4)	(0.3)	(1.0)	(1.2)	(2.1)	(1.3)	(1.3)	(0.8)	(0.8)	(0.5)
<b>Increase (Decrease) in NPV Cost</b>										
Social Security	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.0	0.0
Medicare	(1.9)	1.7	7.3	1.6	(0.2)	(14.0)	(0.6)	1.5	6.2	(2.5)
Medicaid					24.2	(0.2)	2.1	(0.9)	0.8	1.3
Net Change	(1.7)	1.9	7.5	1.8	24.1	(14.1)	1.6	0.7	7.0	(1.2)
Adjusted Net Operating Cost	\$1.3	(\$2.2)	(\$8.5)	(\$3.0)	(\$26.2)	\$12.8	(\$2.9)	(\$1.5)	(\$7.8)	\$0.7

19 Joseph Maier Individual

# ***The Financial Report of the United States Government Adjusted Balance Sheet Reported Net Liability is about 5.1x the Size of the Nation's GDP***

as of September 30, 2015

(Trillions of Dollars)

<b>Assets</b>	
Cash	\$0.3
Receivables	1.3
Inventories	0.3
Property, plant & equipment	0.9
Other	0.4
<b>Total Assets</b>	<b>\$3.2</b>

<b>Liabilities</b>	
Federal debt securities held by the public and accrued interest	(\$13.2)
Federal employee and veteran benefits payable	(6.7)
Other	(1.6)
<b>Total Liabilities</b>	<b>(21.5)</b>
<b>Net Liability (Net Position)</b>	<b>(18.2)</b>
Net Present Value Cost of Social Insurance and Medicaid obligations funded with Appropriations	(73.6)
<b>Total Net Obligations</b>	<b>\$91.8</b>

# ***REVISED Ballpark Estimate of Each State's Net Present Value Cost Obligation for Medicaid Based on the 2015 State Expenditure Report Examining Fiscal 2013 -2015 State Spending***

Published by National Association of State Budget Officers  
Table 28 Medicaid Expenditures

2015 State Expenditure Report Estimated Published Figures for Fiscal 2015					Calculation of Each State's Estimated Obligation			
(\$ in millions)	General Fund	Federal Funds	Other State Funds	Total	Col. 1 + Col. 3 Adjusted Total State Spending	% of Total State Spending	Aggregate State Net Present Value Cost	State Net Present Value Cost Obligation for Medicaid
	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8
<b>California</b>	\$16,599	\$52,658	\$5,699	\$74,956	\$22,298	11.43%	\$34,110,158	<b>\$3,900,193</b>
<b>Ohio</b>	14,861	7,541	1,925	24,327	16,786	8.61%	34,110,158	<b>2,936,077</b>
<b>New York</b>	11,161	29,393	5,114	45,668	16,275	8.35%	34,110,158	<b>2,846,697</b>
<b>Texas</b>	11,381	22,197	3,983	37,561	15,364	7.88%	34,110,158	<b>2,687,351</b>
<b>Pennsylvania</b>	8,298	12,996	2,849	24,143	11,147	5.72%	34,110,158	<b>1,949,747</b>
<b>Florida</b>	5,294	13,799	4,487	23,580	9,781	5.02%	34,110,158	<b>1,710,817</b>
<b>Illinois</b>	4,445	9,921	3,235	17,601	7,680	3.94%	34,110,158	<b>1,343,326</b>
<b>Massachusetts</b>	7,120	6,704	171	13,995	7,291	3.74%	34,110,158	<b>1,275,285</b>

**2015 State Expenditure Report**  
**Estimated Published Figures for**  
**Fiscal 2015**

**Calculation of Each State's Estimated Obligation**

(\$ in millions)	General Fund	Federal Funds	Other State Funds	Total	Col. 1 + Col. 3 Adjusted Total State Spending	% of Total State Spending	Aggregate State Net Present Value Cost	State Net Present Value Cost Obligation for Medicaid
	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8
<b>North Carolina</b>	\$3,594	\$8,752	\$1,435	\$13,781	\$5,029	2.58%	\$34,110,158	<b>\$879,634</b>
<b>New Jersey</b>	3,869	8,912	1,068	13,849	4,937	2.53%	34,110,158	<b>863,542</b>
<b>Michigan <sup>(3)</sup></b>	2,797	12,494	2,029	17,320	4,826	2.47%	34,110,158	<b>844,126</b>
<b>Minnesota</b>	4,533	6,187	164	10,884	4,697	2.41%	34,110,158	<b>821,563</b>
<b>Missouri</b>	1,778	4,511	2,419	8,708	4,197	2.15%	34,110,158	<b>734,107</b>
<b>Virginia</b>	4,114	4,123	0	8,237	4,114	2.11%	34,110,158	<b>719,589</b>
<b>Wisconsin</b>	2,650	4,969	1,259	8,878	3,909	2.00%	34,110,158	<b>683,732</b>
<b>Maryland</b>	2,922	5,688	951	9,561	3,873	1.99%	34,110,158	<b>677,435</b>
<b>Tennessee</b>	3,316	6,673	370	10,359	3,686	1.89%	34,110,158	<b>644,726</b>
<b>Connecticut</b>	3,496	3,483	0	6,979	3,496	1.79%	34,110,158	<b>611,493</b>
<b>Georgia</b>	3,052	5,943	329	9,324	3,381	1.73%	34,110,158	<b>591,378</b>
<b>Colorado</b>	2,312	4,557	735	7,604	3,047	1.56%	34,110,158	<b>532,958</b>
<b>Arizona</b>	2,279	8,040	602	10,921	2,881	1.48%	34,110,158	<b>503,922</b>
<b>Louisiana</b>	1,610	4,588	1,216	7,414	2,826	1.45%	34,110,158	<b>494,302</b>
<b>Indiana</b>	2,009	6,476	677	9,162	2,686	1.38%	34,110,158	<b>469,814</b>
<b>Washington</b>	2,008	5,285	180	7,473	2,188	1.12%	34,110,158	<b>382,708</b>

**2015 State Expenditure Report**  
**Estimated Published Figures for**  
**Fiscal 2015**

**Calculation of Each State's Estimated Obligation**

(\$ in millions)	General Fund	Federal Funds	Other State Funds	Total	Col. 1 + Col. 3 Adjusted Total State Spending	% of Total State Spending	Aggregate State Net Present Value Cost	State Net Present Value Cost Obligation for Medicaid
	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8
<b>Oklahoma</b>	\$1,417	\$2,930	\$717	\$5,064	\$2,134	1.09%	\$34,110,158	<b>\$373,263</b>
<b>Kentucky</b>	1,501	7,517	504	9,522	2,005	1.03%	34,110,158	<b>350,699</b>
<b>Oregon</b>	728	6,683	1,260	8,671	1,988	1.02%	34,110,158	<b>347,726</b>
<b>Iowa</b>	1,268	2,846	691	4,805	1,959	1.00%	34,110,158	<b>342,653</b>
<b>Alabama</b>	685	4,155	1,192	6,032	1,877	0.96%	34,110,158	<b>328,310</b>
<b>Kansas</b>	1,281	1,689	578	3,548	1,859	0.95%	34,110,158	<b>325,162</b>
<b>South Carolina</b>	1,023	4,359	640	6,022	1,663	0.85%	34,110,158	<b>290,879</b>
<b>Arkansas</b>	898	4,568	593	6,059	1,491	0.76%	34,110,158	<b>260,794</b>
<b>Mississippi</b>	640	3,633	635	4,908	1,275	0.65%	34,110,158	<b>223,013</b>
<b>New Mexico</b>	862	4,036	238	5,136	1,100	0.56%	34,110,158	<b>192,403</b>
<b>Rhode Island</b>	1,067	1,482	30	2,579	1,097	0.56%	34,110,158	<b>191,879</b>
<b>Maine</b>	753	1,510	270	2,533	1,023	0.52%	34,110,158	<b>178,935</b>
<b>West Virginia</b>	520	2,610	400	3,530	920	0.47%	34,110,158	<b>160,919</b>
<b>Hawaii</b>	888	1,160	0	2,048	888	0.46%	34,110,158	<b>155,322</b>
<b>Nebraska</b>	850	968	37	1,855	887	0.45%	34,110,158	<b>155,147</b>
<b>Utah</b>	400	1,614	467	2,481	867	0.44%	34,110,158	<b>151,649</b>



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**Calculation of Each State's Estimated Obligation**

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	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8
<b>Idaho</b>	\$475	\$1,304	\$250	\$2,029	\$725	0.37%	\$34,110,158	<b>\$126,811</b>
<b>New Hampshire</b>	548	917	166	1,631	714	0.37%	34,110,158	<b>124,887</b>
<b>Alaska</b>	694	951	5	1,650	699	0.36%	34,110,158	<b>122,264</b>
<b>Delaware</b>	668	1,193	14	1,875	682	0.35%	34,110,158	<b>119,290</b>
<b>Nevada</b>	564	2,225	114	2,903	678	0.35%	34,110,158	<b>118,590</b>
<b>Vermont</b>	283	824	335	1,442	618	0.32%	34,110,158	<b>108,096</b>
<b>North Dakota</b>	441	697	7	1,145	448	0.23%	34,110,158	<b>78,361</b>
<b>South Dakota</b>	364	484	0	848	364	0.19%	34,110,158	<b>63,668</b>
<b>Montana</b>	271	748	91	1,110	362	0.19%	34,110,158	<b>63,318</b>
<b>Wyoming</b>	272	309	23	604	295	0.15%	34,110,158	<b>51,599</b>
	<b>\$144,859</b>	<b>\$317,302</b>	<b>\$50,154</b>	<b>\$512,315</b>	<b>\$195,013</b>	<b>100.00%</b>		<b>\$34,110,158</b>