

The Statement and Account Clause, the Obamacare Litigation and the FASAB's Unconstitutional Reporting Entity Proposal

Joseph H. Marren ⁽¹⁾ ⁽²⁾ ⁽³⁾
Concerned Citizen
July 3, 2013

- (1) The views expressed herein are solely Mr. Marren's and do not represent the views of KStone Partners LLC or any of its other Members.
- (2) Mr. Marren's biography: http://www.linkedin.com/profile/view?id=57346984&trk=nav_responsive_tab_profile
- (3) End notes for this "working draft" document have not been completed.

Table of Contents

- 1) Introduction
- 2) Exposure Draft
 - a. Current Law
 - b. Current Reporting
 - c. Proposed Rules
 - d. Summary Observation
- 3) The Statement and Account Clause
 - a. Historic Review
 - i. Constitutional Convention
 - ii. Federalist Papers
 - iii. Contemporaneous Statements
 - iv. Immediate Financial Reporting
 - v. U.S. v. Richardson
 - vi. Appropriations Clause
 1. The Miscellaneous Receipts Statute
 2. The Anti-Deficiency Act
 - vii. Tax and Spending Clause
 - b. Federal Financial Reporting
 - i. Legislative History
 1. Taft Commission and Prior Reform Efforts
 2. Impact of Woodrow Wilson
 3. Sixteenth Amendment
 4. Budget and Accounting Act of 1921
 5. Brownlow Committee
 6. Executive Reorganization Plan of 1939
 7. First Hoover Commission
 8. Joint Financial Management Improvement Program
 9. Accounting and Auditing Act of 1950
 10. Second Hoover Commission
 11. Amendments to 1921 and 1950 Acts
 12. President's Commission on Budget Concepts
 13. Executive Reorganization Plan of 1970
 14. Congressional Budget and Impoundment Act of 1974
 15. Arthur Andersen & Company Study

16. Prototype Consolidated Financial Statements
 17. Reaction by CBO to AA Report
 18. Title 2 of the GAO Policy and Procedure Manual for Guidance of Federal Agencies
 19. Managing the Cost of Government: Building An Effective Financial Management Structure
 20. Balanced Budget and Emergency Control Act of 1985
 21. Chief Financial Officers Act of 1990
 22. The Government Management Reform Act of 1994
 23. Federal Accounting Standards Advisory Board
 - a. Overview
 - b. Board Membership, AICPA Approval and Social Insurance
 - c. Accounting for Social Insurance
 - d. Flemming v. Nestor
 - ii. Accounting in the Private Sector
 - iii. Have Reporting Requirements Changed?
 - iv. Current Reporting
 1. Combined Statement
 2. President's Budget
 3. Financial Report
 4. Statement of Social Insurance
 5. Commentary
 - v. Psychological Factors
 - c. Impact on Private Rights
 - i. Right to Vote
 - ii. Freedom of Speech
 - iii. Due Process
 - iv. Equal Protection
 - v. Right to Financial Information
 - vi. Political Accountability
 - d. Antifraud Provisions of the Securities Laws
 - e. Congress' Plenary Power
- 4) Medicaid Expansion Issue in Obamacare Litigation
 - a. Federal Government's Inadequate Disclosures
 - b. State Government's Inadequate Disclosures
 - 5) Conclusion

SCHEDULES

1. The President's Budget
2. The Financial Reports
3. Financial Report Balance Sheet
4. Total Social Insurance Credit Card
5. Revised Financial Reports
6. Revised Financial Report Balance Sheet
7. Total Social Insurance Credit Card – Infinite Horizon
8. Infinite Horizon Balance Sheet

APPENDICES

- A. SEC v. State of New Jersey
- B. SEC v. State of Illinois

END NOTES

The Statement and Account Clause, the Obamacare Litigation and the FASAB's Unconstitutional Reporting Entity Proposal

1) Introduction

Does current financial reporting by the federal government comply with the requirements of the United States Constitution? This is a central question that Congress needs to address but will not. This memorandum attempts to answer that question.

It will surprise few that the conclusion reached in this memorandum is that the federal government's financial reporting falls far short of Constitutional requirements and that the proposed Exposure Draft does little more than maintain the current status quo with respect to fraudulent financial reporting by the federal government. The Exposure Draft reflects the fact that our political leaders have subverted the democratic process to protect their self interests. They have failed and continue to fail to comply with an important Constitutional check on power, the requirement for the publication of a complete and truthful statement and account.

Article I, Section 9 clause 7 of the United States Constitution provides 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.”

The first part is called the Appropriations Clause and the second part is called the Statement and Account Clause. The Tax and Spending Clause is found in Article I, section 8, Clause 1:

“The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.”

The inquiry into whether financial reporting violates the Constitution includes a review of a broad range of evidence from our nation's early history including the Articles of Confederation, statements by the Framers at the Constitutional Convention and at the state ratification conventions, government practices both

before and after enactment of the Constitution and the only court case to reach the Supreme Court regarding the Statement and Account Clause. A detailed analysis of the Appropriations Clause, the Statement and Account Clause and the Tax and Spending Clause is presented. This discussion is followed by a review of the legislative history affecting financial reporting from the late 1800s to the present day. An overview of current financial reporting by the federal government including detailed analysis of the President's Budget and the Financial Report follows. Included in the commentary of the Financial Report is an estimate of the federal government's actual financial results over the last decade. Also depicted is an estimated current balance sheet for the nation. The psychological factors that make it virtually impossible for the Legislative or Executive branches or state legislatures to correct the financial reporting problem are summarized. Finally, the question of whether reporting requirements have changed since the Constitution was ratified is addressed.

Why does financial reporting by the federal government matter? Based on Supreme Court decisions the deficient financial reporting violates numerous private rights conferred by our Constitution including the right to vote, freedom of speech, due process, equal protection, the right to financial information and the right to political accountability. In addition, the Supreme Court has ruled extensively on the meaning of the antifraud provisions of the securities laws. It appears that these principles are inherent in 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. This assertion will be reviewed and proven to be a false.

In addition to undermining private rights granted by the Constitution the deficient financial reporting by the federal government has led the Supreme Court of the United States to decide at least one case based on financial facts that are clearly untrue. 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.¹ The memorandum contains a discussion of 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.² Each of the opinions issued by the Court, Justice Ginsburg and the Dissenters (Justices Scalia, Kennedy, Thomas and Alito) contains economic and political accountability analyses that are seriously flawed.

Information submitted in merit briefs and orally to the Supreme Court included financial information published by the federal government that does not appear to comply with the Statement and Account Clause. 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.

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 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 & CEO of KStone Partners. Professor Sean Griffith, Director of the Fordham Law Corporate Center 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. A video of the conference as well as a transcript, all presentations and the conference brochure can be found at <http://law.fordham.edu/accountability>.

All figures used in the memorandum are taken or calculated directly from the federal government's reported financial results.

This memorandum is not intended to support either policy option (raising taxes or cutting spending) that are required to stabilize the nation's finances. 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. Furthermore, this memorandum does not attempt to assign blame for the current state of financial reporting. There is more than enough for both political parties.

In this memorandum the federal Government's Constitutional authority to suppress financial information related to national security matters is not being questioned. Also, Congress' authority to determine the amount of detail associated with its financial results is not being questioned. What is being asserted is that the federal Government is falsely reporting total receipts, total expenditures and the resulting deficit calculated by subtracting the second figure from the first. These three figures, it is asserted, are not subject to the plenary power of Congress.

2) Exposure Draft

a. Current Law

The determination as to which organizations and agencies will be included in the Financial Report of the United States Government ("Financial Report") is governed by Federal laws and is also based on guidance issued by the FASAB in their Statement of Federal Financial Accounting Concept No. 2 ("SFFAC 2"), Entity and Display³.

Conclusive Criteria according to SFFAC 2 is if an entity is included in the President's Budget, then it should be included in the reporting entity. Indicative Criteria are: 1) Exercises sovereign power, 2) Is owned by the federal government, 3) Carries out missions and objectives, 4) Is subject to direct or continuing control by the reporting entity, 5) Determines outcome of matters affecting the recipients of services, and 6) Has a fiduciary relationship with the reporting entity. However, no single criterion is determinative.

All SFFAC are not considered to be Generally Accepted Accounting Principles ("GAAP"). At present, the following hierarchy constitutes GAAP⁴:

1. Category A – Officially established accounting principles, consist of FASAB Statements and Interpretations, as well as American Institute of Certified Public Accountants ("AICPA") and Financial Accounting Standards Board ("FASB") pronouncements, specifically applicable to federal government entities by FASAB Statements and Interpretations.
2. Category B – consists of FASAB Technical Bulletins and, if specifically applicable to federal governmental entities by the AICPA and cleared by FASAB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.

3. Category C – consists of AICPA, Accounting Standards Executive Committee (“AcSEC”) Practice Bulletins if specifically applicable to federal governmental entities and cleared by FASAB, as well as Technical Releases of the Accounting and Auditing Policy Committee (“AAPC”) of FASAB.
4. Category D – includes implementation guides published by FASAB, as well as practices widely recognized and prevalent in the federal government.

Although Title 2 of the Government Accountability Office’s (“GAO”) Policy and Procedures Manual for the Guidance of Federal Agencies is not specifically mentioned in the above hierarchy, it is included in the fourth level of authority, as practices widely recognized and prevalent in the federal government. Moreover, the Handbook was based substantially upon Title 2. Accordingly, Title 2 is considered a proper reference for accounting principles and standards where it does not conflict with guidance provided for in the first three levels of the accounting hierarchy.

b. Current Reporting⁵

Fiscal Year 2012 Financial Statement Audit Results

The Government-wide Reporting Entity - The financial statements [in the Financial Report] cover the three branches of the Government (legislative, executive and judicial). Legislative and judicial branch reporting focuses primarily on budgetary activity. Executive branch entities, as well as certain legislative branch agencies are required, by law, to prepare audited financial statements. Some other legislative branch entities voluntarily produce audited reports.

A number of entities and organizations are excluded due to the nature of their operations, including the Federal Reserve System (considered to be an independent central bank under the general oversight of Congress), all fiduciary funds, and Government-Sponsored Enterprises, including the Federal Home Loan Banks, the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac). The Emergency Economic Stabilization Act (EESA) of 2008 gave the Secretary of the Treasury temporary authority to purchase and guarantee assets from a wide range of financial institutions through the Troubled Asset Relief Program (TARP). Following U.S. GAAP for Federal entities, the Government has not consolidated into its financial statements the assets, liabilities, or results of operations of any financial organization or commercial entity in which Treasury holds either a direct, indirect, or beneficial equity investment. Even though some of the equity investments are significant, the entities in which the Federal Government holds equity investments meet the criteria under

paragraph 50 of the SFFAC 2, which directs that the financial results of such entities should not be consolidated into the financial reports of the United States Government, either in part or as a whole. However, the investments in these entities and any related liabilities are recorded in the financial statements.

c. Proposed Rules⁶

“The principles herein are not intended to establish whether an organization is or should be considered a federal agency for legal or political purposes. Rather this exposure draft (ED) provides 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 (author’s note: the “Financial Report” for all practical purposes) for financial accountability purposes.

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.

The ED provides for determining the most appropriate means-consolidated financial statements or disclosures – to include information about these organizations in GPFFRs. Determining the most appropriate means requires an assessment of the degree to which the following characteristics are met: the organization is financed by taxes or other non-exchange revenue, is governed by the Congress and/or the President, imposes or may impose risks and rewards on the federal government, and/or provides goods and services on a non-market basis. Note, however, not all characteristics are required to be met to the same degree; classification is based on the assessment as a whole.

Generally, consolidated financial statements presenting the financial position and results of operation are appropriate for those organizations financed by the taxpayer, governed by elected officials, imposing risks and rewards on the federal government, and providing goods and services on a non-market basis....Organizations to be included in the consolidated financial statements within the GPFFR are referred to as “consolidation entities” and are subject to the hierarchy of generally accepted accounting principles (“GAAP”) established for “federal entities” in Statement of Federal Financial Accounting Standards 34.

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 operating results and financial position of the reporting entity. Instead, information about these types of discrete organizations should be disclosed in notes to the consolidated financial statements of reporting entities applying federal financial accounting standards....Organizations to be disclosed in the GPFFR are referred to as “disclosure organizations.”

d. Summary Observation

The proposed rules will largely continue current unconstitutional reporting practices with respect to the Federal Reserve System and Government Sponsored Enterprises such as Fannie Mae and Freddie Mac. They will not be consolidated in the Financial Report and hence, the government’s consolidated financial statements will remain substantially misleading. The concept of “consolidation entities” and “disclosure entities” is directly at odds with the Statement and Account Clause’s “all public Money” requirement.

3) The Statement and Account Clause

a. Historic Review

i. Constitutional Convention

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 states and the Continental Congress both incurred large debts during the War, and repaying those debts was a major issue. 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 1783.⁷

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.⁸ The inability to repay its debt was one of the principal reasons for calls for a stronger national government.⁹

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 “compleat power of taxation [was] the highest prerogative of supremacy . . . proposed to be vested in the National Govt.”¹⁰ Throughout the Convention, delegates focused on the “purse strings” or the “purse”.¹¹ —Every discussion was based on the premise that the protection of the people’s money is a legislative function.¹²

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.”¹³ 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.”¹⁴ Gerry's motion was defeated, by a margin of three states in favor and eight opposed.¹⁵

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.¹⁶ The Committee of Eleven presented its report to the Convention on July 5, 1787.¹⁷

The Committee of Eleven proposed the Great Compromise.¹⁸ 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.”¹⁹ 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.”²⁰

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.”²¹

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.”²²

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.²³ 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.²⁴

On August 6, John Rutledge, of South Carolina, delivered the Report of the Committee of Detail.²⁵ 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.”²⁶

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.”²⁷ 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.”²⁸

The delegates voted in favor of Pinckney’s motion by a margin of seven states in favor and four states against.²⁹ 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.³⁰

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.³¹ 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.”³²

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.”³³ Accordingly, “[i]t was improper therefore that it should tax the people.”³⁴ He concluded that “in all events he would contend that the purse strings should be in the hands of the Representatives of the people.”³⁵

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.”³⁶ He warned that “acceptance of the plan will inevitably fail, if the Senate be not restrained from originating Money bills.”³⁷

The vote in favor of restoring the origination restriction was defeated and the Origination Clause was to be stricken.³⁸

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.³⁹

The delegates postponed debate on the amendment without comment, by a vote of six to five.⁴⁰

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.”⁴¹ 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”⁴² 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.

“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.”⁴³ 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, Gouveneur 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.”⁴⁴ 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.”⁴⁵ 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.”⁴⁶

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.⁴⁷ 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.”⁴⁸ 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.⁴⁹

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.”⁵⁰ The remainder of the exchange between Madison and Mason was brief, and did not touch on secrecy of expenditures.⁵¹

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!”⁵² 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.⁵³ 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.⁵⁴

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.”⁵⁵

ii. Federalist Papers

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.”⁵⁶

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.”⁵⁷

Alexander Hamilton, in *Federalist No. 66*, stated that “[t]he exclusive privilege of originating money bills will belong to the House of Representatives,”⁵⁸ as an argument against concerns that the Senate would have too much power given its lack of proportional representation.

Hamilton in *Federalist No. 72* noted that the executive’s functions included “the application and disbursement of the public moneys in conformity to the general appropriations of the legislature.”⁵⁹

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”⁶⁰

iii. Contemporaneous Statements

In an early session of Congress, Madison stated “The constitution . . . places the power in the House of originating money bills.”⁶¹ 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].”⁶²

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.”⁶³

iv. Immediate Financial Reporting

By the second session of the 1st Congress, the Treasurer of the United States was providing quarterly accounts of public expenditures.⁶⁴ As early as 1791, the House provided by resolution⁶⁵:

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 earliest statements and accounts of public expenditures were not more specific than each “head of appropriation.”⁶⁶

Early State of the Union Messages reveal that presidents routinely reported national budgets-as well as statements and accounts of receipts and expenditures.⁶⁷ 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.”⁶⁸

v. U.S. 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.”⁶⁹ 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.⁷⁰

The Federal Government appealed to the Supreme Court and in July 1974, the nine Supreme Court Justices ruled in a 5-4 decision, that Richardson did not have 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*⁷¹ 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”⁷² “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.”⁷³ “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.”⁷⁴ “Secrecy was the evil at which Article I, Sec 9 Cl 7 was aimed.”⁷⁵

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.”⁷⁶

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)⁷⁷ 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.”⁷⁸

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.”⁷⁹

St. George Tucker’s comments are also instructive with respect to the Statement and Account Clause.⁸⁰ “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.”⁸¹

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.”⁸²

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?

vi. Appropriations Clause

The Appropriations Clause has been described as the single most important curb in the Constitution on Presidential power.⁸³ Control of government expenditures is among Congress' most important and immutable rights. It is also among Congress' indispensable duties. It means that no money can be paid out of the Treasury unless it has been appropriated by an act of Congress. The Constitution gives Congress the so-called "power of the purse" by providing that only it can appropriate money from the Treasury.⁸⁴

The "Appropriations" required by the Constitution are not only legislative specifications of money amounts, but also legislative specifications of the powers, activities and purposes-what we may call, simply, "objects"-for which appropriated funds may be used. As Alexander Hamilton 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.⁸⁵

There are two governing principles⁸⁶ 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.

Two framework statutes originally enacted in the 19th and early 20th centuries-the Miscellaneous Receipts statute⁸⁷ and the Anti-Deficiency Act⁸⁸ are especially important in ascertaining Congress' historical understanding and application of the appropriations requirement. Although the Anti-Deficiency Act as such was not enacted until the early 20th century, the rule against deficiencies was contained in several 19th century statutes.

1. The Miscellaneous Receipts Statute⁸⁹

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.

2. The Anti-Deficiency Act⁹⁰

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.

Congress may create permanent, substantive law through an appropriations bill only if it is clear about its intentions.⁹¹ 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.⁹²

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.⁹³ 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.

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.⁹⁴ 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.⁹⁵ 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.

In addition, although Congress holds the purse-strings, it may not exercise this power in a manner inconsistent with the direct commands of the Constitution.⁹⁶

vii. Tax and Spending Clause

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.

The Supreme Court has indicated that there are five restrictions on spending: 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.⁹⁷ A fifth restriction indicates 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.

b. Federal Financial Reporting

i. Legislative History

1. 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.

2. 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."⁹⁸ His views stand in sharp contrast to the importance of separation of powers as described by James Madison in Federalist No. 51.⁹⁹

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.

3. Sixteenth Amendment

The Sixteenth Amendment was ratified by the 36th 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%.

4. Budget and Accounting Act of 1921¹⁰⁰

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 Office of Management and Budget (“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.¹⁰¹

By the early 20th 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...”¹⁰² 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.¹⁰³ 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 Reserve¹⁰⁴ 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.¹⁰⁵

5. 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.

6. 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.

7. 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.

8. Joint Financial Management Improvement Program

The Joint Financial Management Improvement Program ("JFMIP") is a program authorized by the Budget and Accounting Procedures Act of 1950¹⁰⁶ 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.

9. Accounting and Auditing Act of 1950¹⁰⁷

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.¹⁰⁸

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.

10. 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.

11. Amendments to 1921 and 1950 Acts¹⁰⁹

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.

12. 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.

13. 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.

14. Congressional Budget and Impoundment Control Act of 1974 ¹¹⁰

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.

15. Arthur Andersen & Company Study¹¹¹

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.¹¹²

16. 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.

17. 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.¹¹³ 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.

18. 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.

19. 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.¹¹⁴ 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.

20. 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.

21. 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.¹¹⁵

22. 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.¹¹⁶

23. Federal Accounting Standards Advisory Board

a. Overview

In October 1990, three officials responsible for federal financial reporting established the FASAB (the “Board”) as a federal advisory committee. The officials were the Secretary of the Treasury, the Director of the Office of Management and Budget, and the Comptroller General of the United States (the “Sponsors”). The Sponsors created the FASAB to develop accrual accounting standards and principles for the United States Government.¹¹⁷ Please note that the 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”)¹¹⁸ cited the JFMIP and the Federal Advisory Committee Act, as amended (5 U.S.C. App) as the basis for establishing the Board. The creation of the FASAB does not appear to comply with the

Constitution's directive that Congress is responsible for publishing the Statement and Account. 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, it cannot outsource the determination of the proper accounting policies for the government to follow to a joint venture with the Executive branch. 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 MOU 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 OFFM, an office within OMB, decides upon new principles, standards and requirements for OMB after considering FASAB's recommendations.

b. Board Membership, AICPA Approval and Social Insurance

The membership of the Board 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).¹¹⁹ 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.¹²⁰ Veto power, however, was retained.¹²¹ AICPA said that if veto was ever used it would rescind FASAB's status.¹²² 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."¹²³

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 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.”¹²⁴

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.¹²⁵ 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.

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.

The ethical principles underlying the AICPA Code of Professional Conduct include the following: 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 the profession; Integrity – To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity; 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.

An argument can be made that the AICPA has violated both the Constitution and its ethical principles in recognizing the FASAB as the GAAP standards setter for the federal government under Rule 203. Has the AICPA aided and abetted in the publication of financial results that do not comply with the Constitution? Has the AICPA designated an unconstitutional entity, the FASAB, as the GAAP standard setter for the federal government? What public interest has been served by blessing a rule making body that assists in the publication of misleading/incomplete

financial results? What culpability does the AICPA have for the publication of financial statements 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? 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.

It is important to make one last observation regarding the role that the AICPA will likely play in the not-too-distant-future. When the Nation's finances finally go "off the cliff" and Treasury yields skyrocket Congress will do what it does best, search for someone or something to blame besides itself. It is fairly predictable that politicians will find that the AICPA fills that role perfectly.

Other examples of how the 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.¹²⁶

c. Accounting for Social Insurance

Historically, the FASAB has proclaimed the following 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 and their rationale. This can be accomplished through a review of the Preliminary Views document published after the contentious Board meetings in the summer of 2006.¹²⁷

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.¹²⁸ 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.¹²⁹

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.”¹³⁰

d. *Flemming v. Nestor*¹³¹

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.

ii. Accounting in the Private Sector¹³²

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.¹³³

iii. Have Reporting Requirements Changed?

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.

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.¹³⁴

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. This is true even if one assumes that there was no Congressional legislation on the matter. Arguably, a cash-based statement of receipts and expenditures was acceptable to fulfill the Statement and Account's Clause's required accountability 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 that created substantial future obligations, the federal government should have begun publishing accrual-based financial statements to meet its Constitutional responsibility.

iv. Current Reporting

One must review three reports in order to understand the federal government's financial reporting practices. These include the Combined Statement of Receipts, Outlays, and Balances¹³⁵ (the "Combined Statement") which is the "official" Statement and Account, the President's Budget¹³⁶ and the Financial Report.¹³⁷

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).¹³⁸

The federal government indicates that "Each year, the Administration issues two reports that detail financial results for the Federal Government: the President's Budget, which provides a plan for future initiatives and the resources needed to support them, as well as prior year fiscal and performance results; and th[e] Financial Report, which provides the President, Congress and the American people a broad, comprehensive overview of the cost on an accrual basis of the Government's operations, the sources used to finance them, its balance sheet and the overall financial outlook."¹³⁹

President's Budget – Prepared primarily on a 'cash basis'; Initiative-based and prospective: focus on current and future initiatives planned and how resources will be used to fund them. Receipts ("cash in"), taxes and other collections recorded when received. Outlays ("cash out"), largely recorded when payment is made.

Financial Report of the U.S. Government – "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.¹⁴⁰ Agency-based and retrospective – prior and present resources used to implement initiatives. Revenue: Tax revenue (more than 90 percent of total revenue) recognized on modified cash basis. Remainder recognized when earned, but not necessarily received. Costs: recognized when owed; but not necessarily paid.

Broadly, there are two adjustments required to make financial reporting reflect the nation's true financial results and financial position. The financial statements need to include:

- i. all entities that, by law, should be included in the government's consolidated financial results (e.g. Federal Reserve System, Fannie Mae , Freddie Mac),
- ii. the full cost of the nation's social insurance programs including Medicaid.

The first adjustment is easy to understand while the second requires some explanation. The Congress has enacted permanent appropriations and mandatory authorizing legislation that provides permanent and never ending appropriations for the entitlement programs.¹⁴¹ This means that absent anything short of a change in legislation these benefits will be paid. However, note that by law, Congress at any time can make any changes that it deems fit including terminating these programs. Furthermore, the Supreme Court has ruled that citizens do not have a contractual right to any entitlement benefit.¹⁴² No one has the right to expect payment or the coverage of benefits until they have met all eligibility requirements.

The Government takes the fact pattern described above and concludes that the only expense that should be recorded in any financial statement is that year's cash outlay plus the amount of any payments that are payable but which have not yet been processed (the "Due and Payable" approach).¹⁴³ No obligation beyond this is recorded in the financial statements. This approach does not accurately reflect the legal obligations of the federal government as reflected in the permanent appropriations and mandatory authorizing legislation coupled with the likelihood of payment. (Note that the government labels entitlement programs as "Mandatory Spending").

1. Combined Statement ¹⁴⁴

The Commissioner's Transmittal letter dated December 3, 2012 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, 2012. This statement presents budget results and the cash-related assets and liabilities of the Federal Government with supporting details."

The Preface states "Financial Management Service – The Financial Management Service (FMS), which is a bureau of the Department of the Treasury, performs a critical role in fulfilling Treasury's mission as the Government's financial manager.

In its role as Federal financial agent, FMS 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.”

The Combined States indicates that “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.”

The Combined Statement is virtually unknown by the general public and for good reason. 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 closest analogy of what role the report plays is that it is a cash disbursements summary journal book.

The government has clung to the practice of equating cash outlays with expenditures and continues to believe that the publication of the Combined Statement satisfies any obligation, assuming one exists, under the Clause.

2. 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 ii of "A Citizens Guide to the 2012 Financial Report of the U.S. Government" which is contained in the 2012 Financial Report of the United States Government.¹⁴⁵ It states "The Budget of the United States Government (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 compares receipts, or cash received by the Government, with outlays, or payments made by the Government to the public, to derive a budget surplus (excess of receipts over outlays) or deficit (excess of outlays over receipts). Receipts and outlays are measured generally based on when the Government receives or dispenses cash.

David Mosso, who was Chairman of the 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] understate[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."¹⁴⁶

Schedule 1 depicts the federal government's financial results for the last decade under budget accounting. (All Schedules can be found near the back of this memorandum.) Please note the nation's gross domestic product ("GDP") for 2012 was \$15.8 trillion. The Budget Deficit for the last four years has been relatively flat at \$1.1 to \$1.4 trillion.

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. Total outlays were \$29.4 trillion and total revenues were \$22.3 trillion so the long division yields a result of 1.32. Using budget accounting, the federal government has spent \$1.32 for every \$1 of revenue it has received.

3. Financial Report

A summary description of the Financial Report is found on page ii of A Citizens Guide to the 2012 Financial Report of the U.S. Government.¹⁴⁷ It states "The Financial Report of the United States Government (Report) focuses on the Government's revenues and costs (what came in and what went out), assets and liabilities (what it owns and owes), and other important financial information. It compares revenues (what the Government has collected and expects to collect, but has not necessarily received), with its costs (what the Government has incurred, but has not necessarily paid) to derive net operating cost.

Management's Discussion and Analysis – Introduction - The fiscal year (FY) 2012 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 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.¹⁴⁸

Pursuant to 31 U.S.C. sec 331 (e)(1), the Department of the Treasury (Treasury) must submit the Report, which is subject to audit by the Government Accountability Office (GAO), to the President and Congress no later than six months after the September 30 fiscal year end. To encourage timely and relevant reporting, the Office of Management and Budget (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.

As it has for the past fifteen years, GAO issued a "disclaimer" of opinion on the accrual-based, consolidated financial statements, for the fiscal years ended September 30, 2012 and 2011. GAO also issued disclaimers of opinion on the 2012,

2011 and 2010 Statements of Social Insurance (SOSI), following unqualified opinions on the 2008 and 2009 SOSI, and a disclaimer of opinion on the 2012 and 2011 Statement of Changes in Social Insurance Amounts (SCSIA).

Schedule 2 just adds to the Budget Deficit amounts accrued expenses for federal and veterans benefits that are payable in the future. The Financial Report over the last decade indicates that \$1.42 has been spent for every \$1.00 of revenue. The 2012 Financial Report's balance sheet as of September 30, 2012 on Schedule 3 indicates that the nation's reported net liability is about the size of the nation's GDP.

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.”¹⁴⁹

David Mosso, former Chairman of the FASAB commented about the Financial Report.

“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.”¹⁵⁰

4. Statement of Social Insurance

The Statement of Social Insurance (“SOSI”) shows the present values of estimated future revenues and expenditures for scheduled benefits over the next 75 years for the Social Security, Medicare, Railroad Retirement programs and through September 30, 2040 for the Black Lung program. The estimates are based on the economic and demographic assumptions presented in the Financial Report footnote on Social Insurance, in the relevant Social security and Medicare trustees' reports and in the agency financial report of HHS and in the relevant agency performance and accountability reports for SSA and RRB and the annual financial report for DOL. The projections are based on the continuation of program provisions contained in current law. The estimates in the consolidated SOSI of the open group measures

are for persons who are participants or eventually will participate in the programs as contributors (workers) or beneficiaries (retired workers, survivors, and disabled) during the 75-year projection period.

Actuarial present values of estimated future revenue (excluding interest) and estimated future expenditures for the Social Security, Medicare, and Railroad Retirement social insurance programs are presented for three different groups of participants: (1) current participants who have attained eligibility age, (2) current participants who have not attained eligibility age, and (3) future participants who are new entrants expected to become participants in the future. Current participants in the Social Security and Medicare programs form the “closed group” of taxpayers and/or beneficiaries who are at least 15 years of age at the start of the projection period. Since the projection period for the Social Security, Medicare, and Railroad Retirement social insurance programs consists of 75 years, the period covers virtually all of the current participants’ working and retirement years, a period that could be greater than 75 years in a relatively small number of instances. Future participants for Social Security and Medicare include births during the projection period and individuals below age 15 as of January 1 of the valuation year.

The present values of future expenditures in excess of future revenue are calculated by subtracting the actuarial present values of future scheduled contributions and dedicated tax income by and on behalf of current and future participants from the actuarial present value of the future scheduled benefit payments to them or on their behalf. To determine a program’s funding shortfall over any given period of time, the starting trust fund balance is subtracted from the present value of expenditures in excess of revenues over the period.

The financial projections for the Medicare program reflect substantial, but very uncertain, cost savings deriving from provisions of the ACA. The Medicare Board of Trustees, in their annual report to Congress, references an alternative scenario to illustrate when possible, the potential understatement of Medicare costs and projection results. This alternative scenario assumes that the productivity adjustments are gradually phased down during 2020 to 2034 and that the physician fee reductions are overridden. These examples were developed for illustrative purposes only; the calculations have not been audited; no endorsement of the illustrative alternative to current law by the Trustees, CMS, or the CMS 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 payments under Medicare and of the broad range of uncertainty associated with such impacts.

The SOSI became a principal financial statement of the Financial Report in 2006. The nominal rate used to discount future revenues and expenditures is roughly 2% for the next decade and 5.7% thereafter.

Schedule 4 only includes the net present value cost of Social Security and Medicare for the social insurance programs. The total net obligation per the SOSI as of January 1, 2012 is \$48.5 trillion. Please note that the GAO could not certify the 2010, 2011 and 2012 SOSI for Medicare so the trustees developed an alternate scenario for Medicare's future cost and this amount was reported in the notes to the Financial Reports for the applicable years.

Schedule 4 includes the alternate scenario amounts for Medicare for 2010, 2011 and 2012. Also, added to the schedule are all available net present cost figures that have been published for Medicaid. This brings the total net obligation for the three major entitlement programs to \$74.6 trillion. It is obvious that the increase in net obligations is overstated for 2010 as a result of the inclusion of Medicaid in the schedule.

The federal government believes that Medicaid and Medicare should be accounted for differently as Medicaid is a "general assistance" program and not a social insurance program like Medicare.¹⁵¹ An average accountant might react to the government's position with the observation the distinctions between the programs are without a difference from an accounting perspective. A cynical accountant might remark that treating the two programs differently is confusing to the public and intended only to obfuscate financial reality by significantly reducing the total amount of obligations that would otherwise appear on the SOSI.¹⁵² Furthermore, this approach has allowed the federal government to justify, to itself, not publishing any figure for the net present value cost of the federal government's share of the Medicaid program until the 2010 Financial Report and not prominently mentioning this inconvenient fact to the Supreme Court in the Obamacare litigation. From a political standpoint it is clear why the Administration did not want to have a net present value cost figure for Medicaid available both before and after enactment because this would prevent political posturing with respect to the cost of the Medicaid expansion component of the ACA.

The federal government has never reported the full costs of the Medicaid program in any of its primary financial reports since the program's inception. The only cost recorded by the federal government or any state in their financial statements for that matter is current year cash expenditures. The federal government published a \$24.2 trillion estimate of the present value of the future net cost of the program for the first time in the 2010 Financial Report.¹⁵³ 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.¹⁵⁴ However, the assumptions were so unrealistic that the Trustees of Medicare created an alternate scenario which indicated a cost of \$35.2 trillion. Medicare projections in the 2010 SOSI were based on full implementation of the provisions of the ACA including a significant decrease in the 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.

Legislation has been enacted that overrode the scheduled reductions in physician payments and reduced non-Medicare outlays by limiting a health insurance tax credit. The scheduled reductions in physician payments have been overridden since 2003. No alternate figure was published for Medicaid. The Medicaid figure reported in the 2011 Financial Report was \$24.0 trillion and this figure increased to \$26.1 trillion in the 2012 Financial Report.¹⁵⁵

The Medicaid figures for 2010, 2011 and 2012 are materially understated for two reasons. First, they are calculated based on assumptions that the Trustees of the Medicare fund continue to believe are unrealistic. The Trustees created alternate assumptions for purposes of calculating realistic estimates of the net present value obligation for Medicare for the years 2010, 2011 and 2012. Second, they are calculated based on a 75-year life which the government acknowledges significantly understates its obligations as permanent appropriations/mandatory authorizing legislation have an infinite time horizon.¹⁵⁶ It should be noted that all figures on Schedule 4 for Social Security, Medicare and Medicaid are based on a 75-year life.

As indicated on Schedule 4 the federal governments latest published estimate of the net present value cost of Medicare (alternate scenario) and Social Security is \$48.5 trillion.¹⁵⁷ Please note that the net present value cost that should be recorded in the federal government's books is limited to the amounts that have been appropriated by Congress. The fact that both programs will run out of appropriated funds in coming years is discussed below. However, the government provides no analysis of what this limitation would have on the net present value cost figures published in the SOSI. When the \$48.5 trillion amount is added to the unrealistically low Medicaid estimate it yields a total off-balance sheet obligation of \$74.6 trillion. See Schedule 4.

The 2012 Social Security Trustees Report indicates that the combined assets of the Old-Age and Survivors Insurance and Disability Insurance trusts will be exhausted in 2033. The two trust funds are often considered on a combined basis and are

designated as OASDI. Once the funds are exhausted, there will only be sufficient resources coming in to pay out about 75 percent of the scheduled Social Security benefits, unless changes are made to the program.¹⁵⁸

The 2012 Medicare Trustees Report indicates that the Medicare HI Trust Fund will be exhausted in 2024. Once the funds are exhausted, there will only be sufficient resources coming in to pay out unless changes are made to the program. The share of HI expenditures that can be financed with HI dedicated revenues is projected to decline slowly to 69 percent.¹⁵⁹

5. Commentary

Currently, it is impossible to determine the truth about the government's financial results as the “official” Statement and Account as well as the President’s Budget and the Financial Report individually and in the aggregate are grossly misleading. An accounting of “all public Money” is required, yet the Government continues to use the cash basis of accounting which equates expenditures with cash outlays. It knows that this approach is substantially misleading, yet uses it to prepare the Combined Statement and the President’s Budget.

The President’s Budget is cash-based and 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 Financial Report is accrual-based yet has significant flaws. The Financial Report, a little-known alternative, does not consolidate numerous material government controlled entities or include the full costs of entitlement programs.

The only costs associated with the entitlement programs that are included in any of these reports are current cash outlays. The government calls this the Due and Payable approach.¹⁶⁰ Therefore, all three of the Government’s financial reports do not include the multi-trillion dollar annual increases in the net present value cost of our major entitlement obligations.¹⁶¹ 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 yearend balance. The government conveniently ignores the second half of the calculation. In addition the federal government does not consolidate in its cash-based or accrual-based financial statements material controlled enterprises.

No state records the full cost of its share of Medicaid costs in its “income statement” or records its share of the long-term obligation associated with Medicaid on its balance sheet. “Medicaid has long been the largest federal program of grants to the States.”¹⁶² Between 2005 and 2008 federal contributions toward the care of beneficiaries averaged 57% and States contributions averaged 43%.¹⁶³ Since the State portion of Medicaid contributions averaged 43% of total expenditures this means that, roughly speaking, based on the \$26.1 trillion federal obligation published in the 2012 Financial Report there is an additional aggregate \$19.7 trillion net present value obligation that should be recorded in total on the state’s balance sheets as of the end of fiscal 2012. Please note that the state’s calculation of its obligation may differ somewhat from the federal government’s calculation but for purposes of this memorandum it is a reasonable rough estimate of the enormous obligation that should be but is not recorded in the state’s financial statements.

Therefore, Medicaid in total is a \$45.8 trillion program (\$26.1 trillion federal net present value cost and \$19.7 state’s total net present value cost). The fact that none of the states are recording any expense or liability for the increase in the net present value cost of the program in their financial statements 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 and New Jersey in their respective settlements.¹⁶⁴ See Appendices A and B.

It is instructive to focus on the \$2.1 trillion increase in the net present value cost of Medicaid recorded by the federal government in 2012.¹⁶⁵ This staggering increase is equal to approximately 84% of all of the federal government’s revenue for the year. Even more astonishing, since it only represents 57% of the increase in the net present value cost increase for the Medicaid program states should have recorded in total an increase of approximately \$1.6 trillion. This amount represents approximately% of total state revenues for 2010. Please also note that the increase is likely significantly understated for reasons already discussed.

Schedule 5 depicts an estimate of the federal government’s actual financial results over the last decade. It records the full cost of Medicare, Social Security and Medicaid by adding the increase in the annual balance. No attempt has been made to adjust the financials for any of the material entities that should be consolidated in the financial statements (e.g. Federal Reserve System, Fannie Mae and Freddie Mac). The bottom line is that the federal government has spent approximately \$4.00 for every \$1.00 of revenue taken in.

The balance sheet in the 2012 Financial Report indicates that the federal government’s net liability is \$16.1 trillion.¹⁶⁶ When the \$74.6 trillion of off-balance sheet obligations is added the total obligation rises to approximately \$90.7 trillion.

See Schedule 6. This obligation represents a multiple of 36 times total revenue of approximately \$2.5 trillion¹⁶⁷ for 2012.

Schedule 7 depicts the total social insurance obligations under the infinite horizon for Social Security and Medicare. Please note that infinite horizon figures are not available for the alternate scenario so the schedule reflects costs under existing laws. Also, there are no infinite horizon figures available for Medicaid so the 75-year horizon figures are used. On balance, the infinite horizon figures portrayed in Schedule 7 are significantly understated. Schedule 8 merely adds the total social insurance obligations plus Medicaid to the government's reported net liability in the 2012 Financial Report.

For independent corroboration of the veracity of the analysis presented please read David Mosso's analysis presented at the Representation Without Accountability conference held at Fordham Law School on January 23, 2012. See <http://fordhamcorporatecenter.org/files/2012/01/David-Mosso-Conference-Remarks-1.23.122.pdf>.

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 and "Medicare by the Scary Numbers" written by John C. Goodman and Laurence J. Kotlikoff and published on June 24, 2013.

v. Psychological Factors¹⁶⁸

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 prejudice that the practice must be forbidden if the guarantee of due process is to be adequately implemented."¹⁶⁹

There are several important psychological factors that have influenced and continue to influence financial reporting for the federal government. This section attempts to explain how and why Congress has 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*.¹⁷⁰ 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.¹⁷¹ 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.”¹⁷² 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.¹⁷³

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.¹⁷⁴ Unfortunately, over the years there have never been any negative repercussions for any of the politicians responsible for the nation's deficient financial reporting.

The population's tendency to reciprocate favors and disfavours 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 nation's financial condition and making sure that the true state of the nation's finances is 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."¹⁷⁵ One of the most important factors 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 the Congress or the Administration is pointing out the fact that the government's financial reports fail to reflect economic reality this is social proof that the 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.¹⁷⁶ 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 and the Executive 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.¹⁷⁷ To a certain extent this explains some of the dysfunctional behaviors that our politicians exhibited in dealing with the fiscal cliff crisis and it is a precursor of more dysfunctional behavior to come with the 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 nation'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 and the Executive 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"¹⁷⁸

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."¹⁷⁹ In the case of financial reporting it is so because over the last 75 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.¹⁸⁰ 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."¹⁸¹ 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-Supreaction 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 benefits.

c. Impact on Private Rights

The federal government's grossly inadequate financial disclosure violates several private rights granted to citizens by the Constitution including the right to vote,¹⁸² free speech, due process, equal protection¹⁸³, right to financial information (not yet recognized by the Court but required by the Constitution) and political accountability. This violation of private rights is important and relevant in the context of the Medicaid expansion issue in the Obamacare litigation¹⁸⁴ as the Supreme Court has struck down spending conditions in *Legal Services Corp. v. Velasquez*¹⁸⁵ and *American Civil Liberties Union v. Moneta*¹⁸⁶ on First Amendment grounds.

The primary reason why our rights have been infringed upon is that the Legislative and Executive branches have an interest in expenditure amounts being under-reported. Both branches have controlled financial reporting and thereby public

opinion to minimize their accountability for spending. 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.

i. Right to Vote

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? When the government is spending at twice the level that it reports to its citizens? Three times? Four times?

In *Federal Election Commission (FEC) v. Akins*¹⁸⁷, 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.¹⁸⁸ 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.¹⁸⁹

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."¹⁹⁰

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

ii. Freedom of Speech¹⁹¹

On January 21, 2010, in *Federal Election Commission (FEC) v. Citizens United*¹⁹², 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.”

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 –vitaly 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.”

Given that the report is required by the Constitution, the Statement and Account is clearly “political speech.” Arguably, it is equal to or greater in importance than the President’s required State of the Union Address. It is inconceivable that the government’s current financial reporting can withstand strict scrutiny. The notion that cash-based accounting coupled with not consolidating material government-controlled entities furthers a compelling interest and is narrowly tailored to achieve that interest does not withstand even the slightest scrutiny as it is clear from the legislative history that it serves the re-election interests of politicians.

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 the publication of the Statement and Account to influence voters’ choices 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.

iii. Due Process¹⁹³

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.*¹⁹⁴, 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*¹⁹⁵. "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."¹⁹⁶

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.¹⁹⁷ Second, sums from the criminal fines were deposited in the village's general treasury fund for village improvements and repairs.¹⁹⁸

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."¹⁹⁹ 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."²⁰⁰

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.

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."²⁰¹

This concern was discussed in *Ward v. Monroeville*²⁰², 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."²⁰³ 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."²⁰⁴ 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."²⁰⁵

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 \$74.6 trillion of entitlement expenses 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.

In defining these standards the Court in Caperton 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.”²⁰⁶

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”.

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 Statement and Account Clause. 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.

iv. Equal Protection²⁰⁷

The Supreme Court in *South Dakota v. Dole*,²⁰⁸ 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.”²⁰⁹ 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.²¹⁰

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 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 operations would reveal this violation.

The Comptroller General recently stated "the federal government continues to face an unsustainable fiscal path."²¹¹ 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."²¹²

v. Right to Financial Information

Truthful financial reporting by our government is critical for the operation of our democracy. An informed electorate is the cornerstone 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. The right to financial information must exist if our democracy is to work properly. If we assume that citizens have no right to receive reasonably correct information about the nation’s finances this would limit or abrogate entirely citizens’ right to vote and freedom of speech and also violate their due process and equal protection rights. Finally, it eliminates required political accountability.

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.”²¹³

“If a nation expects to be ignorant and free, in a state of civilization, it expects what never was and never will be.”²¹⁴

“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.”²¹⁵

The Statement and Account Clause is found in Article I which defines the powers and limitations of Congress. Hence, Congress has the duty to produce the Statement and Account and the Executive Branch does not have any authority in defining the information required to be published. Using this analysis it is hard to understand why the FASAB exists except as an unconstitutional political accommodation. Furthermore, it is inconceivable that 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.

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.

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).”²¹⁶

Both the majority and dissenting Court of Appeals judges in the Richardson case referred to the right to financial information.²¹⁷ Justice Douglas focused on this fact

in his dissent when the case reached the Supreme Court. He thought that Chief Justice Burger's interpretation effectively read the Statement and Account Clause out of the Constitution.

Given the explicit language of the Statement and Account Clause the only reasonable interpretation is that citizens/voters have a right to financial information. This private right must 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.

Justice Rehnquist has famously characterized the implied private right of action under Rule 10b-5 of the securities laws as "a judicial oak which has grown from little more than a legislative acorn."²¹⁸ It would appear that the country would receive like benefits if the Court were to adopt a similar posture with respect to citizens' ability to challenge the federal government's financial reporting under the Statement and Account Clause. Recognizing a private right of action by citizens will result in the federal government most closely fulfilling its obligations under the Clause.²¹⁹

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, as will be discussed, the Court has already determined the relevant standard. 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 Statement and Account Clause.

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. 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. Furthermore, as previously noted, the lack of an interpretation of the Statement and Account Clause has dire implications for the right to vote, freedom of speech and equal protection. 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.

vi. Political Accountability

The Court in *New York v. United States*,²²⁰ sought to protect “the accountability of both state and federal officials” to their electorate.²²¹ 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 obligation's net present value cost of \$19.7 trillion 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.

James Madison was prescient. “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.”²²²

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.”²²³ 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.²²⁴ The Executive branch has 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.²²⁵ Given the CBO’s position it should be surprising if it does not file an objection to the Exposure Draft.

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 either permanent appropriations or mandatory authorizing legislation.²²⁶

Chief Justice Roberts in questioning General Verrilli in oral argument in the Obamacare case came close 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.

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.²²⁷

When you couple permanent appropriations or mandatory authorizing legislation 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.

Let’s not forget the role of the GAO, the federal government’s auditor. In every financial fraud or reporting failure in the private sector, the SEC always asks the question, “Where were the accountants?” All too often they find accountants and even outside auditors who, at best, closed their eyes to the problem and in some cases were even complicit. The GAO has refused to use its power to force the Executive branch to comply with its accounting directives. Furthermore, they were the key sponsor in setting up the FASAB.

The AICPA has also played an integral role in the massive accounting fraud that has been perpetrated on the American citizenry. It has designated two organizations (FASAB and the Governmental Accounting Standards Board (“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 and state governments’ publish financial statements are “U.S. GAAP compliant.” One can argue that there could be is no greater attempt by Congress at diminishing its accountability, degrading the competitiveness of the electoral process and protecting

incumbents than to have the accounting mess that it created be effectively blessed by the leading “independent” accounting entity.

d. Antifraud Provisions of the Securities Laws

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 1940.²²⁸ The broad goal of securities regulation and the Statement and Account Clause is the same, to ensure full and fair disclosure. 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.”²²⁹

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)²³⁰. The importance of the case is that the Court reaffirmed the traditional tests it laid out in *Basic, Inc. v. Levinson*²³¹ and *TSC Industries v. Northway, Inc.*²³² “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.”²³³ 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.”²³⁴

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.”²³⁵ 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.”²³⁶ 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.”²³⁷

Moreover, it bears emphasis that sec10(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.”²³⁸²³⁹

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.”²⁴⁰ 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.²⁴¹ Furthermore, materiality is a mixed question of law and fact, ordinarily determined by the fact finder.²⁴² It would seem that a reasonable citizen/voter standard and a fact-based approach to materiality with respect to meeting the 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. ²⁴³ 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.²⁴⁴

It is in this context that one need to examine the federal government's financial reporting. Prior to 2010 the government did not release any estimate of the net present value cost of Medicaid and starting in 2010 it released a single figure as a single line item in the Required Supplementary Information in the back of a roughly two hundred fifty page Financial Report. The net present value cost of Medicare and Social Security are included in a required financial statement, the Statements of Social Insurance, but this statement does not inter-relate with the government's consolidated financial statements. 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.²⁴⁵ 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.

If we apply the Court's logic in *FEC v. Akins* and the *Matrixx*, *Basic* and *TSC* securities law disclosure standard 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 2002²⁴⁶ requires registered companies to disclose "all material off-balance sheet transactions."²⁴⁷ A reasonable voter would require the government to follow this requirement because to not comply would render the financial statements misleading.

Given the unanimity on the Supreme Court with respect to the antifraud provisions of the securities laws it appears likely that the Court will ultimately rule that our securities laws antifraud provisions are inherent in the Statement and Account Clause. If a reasonable voter is not supplied with the information described it would appear that the voter does not have the political information required by the Constitution to properly evaluate candidates for public office.

e. Congress' Plenary Power

In its 1974 5-4 decision in *United States v. Richardson*,²⁴⁸ 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.”²⁴⁹ “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.”²⁵⁰

While these statements are clearly true as it relates 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 and expenditures.

The reference to “two centuries of acceptance” is hollow as the government’s finances have become exponentially more complex after the ratification in 1913 of the 16th amendment permitting income taxes and the Medicare and Medicaid programs are less than fifty years old.

4) Medicaid Expansion Issue in Obamacare Litigation²⁵¹

a. Federal Government’s Inadequate Disclosure

Does the federal government’s failure to properly advise the States or their citizens of its financial results and condition through the publication of an accurate and complete Statement and Account render acceptance of the Medicaid “contract” null and void as there could not be any meeting of the minds? Also, did the litigants in the case adequately represent the interests of the sovereign or did the legislative and executive branches and the states direct conflict of interest in not having expenditures reported correctly bias their entire approach to the case?

On June 28, 2012 the Supreme Court resolved constitutional challenges to two provisions of the ACA: the individual mandate and the Medicaid expansion.²⁵² The individual mandate requires most Americans to maintain a “minimum essential” health insurance coverage.²⁵³ For many this requires purchasing insurance.²⁵⁴ Those who do not comply must pay a penalty to the IRS.²⁵⁵ 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.²⁵⁶ 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.²⁵⁷ 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 Statement and Account Clause, a directly applicable Constitutional provision. Not surprisingly, the Court's remedy is clearly in error.

We will begin by summarizing certain facts highlighted by the Justices, the Court's analysis and remedy. "Medicaid has long been the largest federal program of grants to the States."²⁵⁸ 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. Between 2005 and 2008 federal contributions toward the care of beneficiaries averaged 57% and States contributions averaged 43%.²⁵⁹ 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)."²⁶⁰ "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."²⁶¹

"We have repeatedly characterized . . . Spending Clause legislation as 'much in the nature of a contract.'²⁶² 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."²⁶³ "In this case, the financial 'inducement' Congress has chosen is much more than 'relatively mild encouragement'— it is a gun to the head."²⁶⁴ "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."²⁶⁵

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."²⁶⁶ "When Congress compels the States to do its bidding, it blurs the lines of political accountability."²⁶⁷ 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."²⁶⁸

The Court believes 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.²⁶⁹

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."²⁷⁰ 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 future net cost of the program for the first time in the 2010 Financial Report.²⁷¹ 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.²⁷² 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 \$19.7 trillion present value obligation. Therefore, Medicaid in total is a \$45.8 trillion program. No State records the full cost of its share of Medicaid costs in its financials.

The government knows that it cannot possibly fund its existing entitlement programs. The Comptroller General stated in 2011 "the federal government continues to face an unsustainable fiscal path."²⁷³ 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."²⁷⁴ "... 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.”²⁷⁵

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 can 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?

Finally, the grossly inadequate disclosure violates several private rights granted to citizens by the Constitution including the right to financial information (not yet recognized by the Court but required by the Constitution), the right to vote,²⁷⁶ free speech and equal protection.²⁷⁷ This violation of private rights is important as the Court has previously struck down spending conditions in *Legal Services Corp. v. Velasquez*²⁷⁸ and *American Civil Liberties Union v. Moneta*²⁷⁹ on First Amendment grounds.

b. State Government’s Inadequate Disclosures

Does a state’s failure to properly advise their citizens of its financial results and condition through the publication of accurate and complete financial statements render acceptance of the Medicaid “contract” null and void as state representatives cannot accept the federal government’s offer because they were elected without the electorate being adequately informed about the existing financial implications of the program?

The quotes below summarize the massive nature of the impact of the ACA on both federal and state spending.

As the Dissenters have noted:

“Medicaid has long been the largest federal program of grants to the States. 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 47.¹⁴ *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.¹⁵ *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).”

State spending on Medicaid is not recorded in the States financial statements except for current cash outlays. The massive increases in the present value of future spending obligations for the States under the Medicaid program are not recorded anywhere. Given that the States obligation in total is \$19.7 trillion, this lack of reporting constitutes fraud under the securities laws as enforced by the Securities and Exchange Commission. See Appendices A and B for examples of SEC enforcement actions against the states of Illinois and New Jersey.

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.

5) Conclusion

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.

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 175–176.²⁸⁰

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. As a graduate of Fordham Law School I hope that readers 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.

SCHEDULES

1. The President's Budget
2. The Financial Reports
3. Financial Report Balance Sheet
4. Total Social Insurance Credit Card
5. Revised Financial Reports
6. Revised Financial Report Balance Sheet
7. Total Social Insurance Credit Card – Infinite Horizon
8. Infinite Horizon Balance Sheet

The President's Budget Under Budget Accounting \$1.32 Has Been Spent for Every \$1.00 of Revenue

(Trillions of Dollars)

Fiscal Year Ended 9/30	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
GDP <small>(Quarterly-Current Dollars per BEA)</small>	\$11.3	\$11.9	\$12.7	\$13.4	\$14.1	\$14.4	\$13.9	\$14.6	\$15.2	\$15.8
President's Budget										
Revenues	1.8	1.9	2.2	2.4	2.6	2.7	2.1	2.2	2.3	2.5
Outlays	2.2	2.3	2.5	2.7	2.7	3.1	3.5	3.5	3.6	3.5
Budget Deficit	(0.4)	(0.4)	(0.3)	(0.2)	(0.2)	(0.5)	(1.4)	(1.3)	(1.3)	(1.1)

Show \$1.42 Has Been Spent for Every \$1.00 of Revenue

(Trillions of Dollars)

Statements of Net Cost

Fiscal Year Ended 9/30	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
GDP (Quarterly-Current Dollars per BEA)	\$11.3	\$11.9	\$12.7	\$13.4	\$14.1	\$14.4	\$13.9	\$14.6	\$15.2	\$15.8
President's Budget										
Revenues	1.8	1.9	2.2	2.4	2.6	2.7	2.1	2.2	2.3	2.5
Outlays	2.2	2.3	2.5	2.7	2.7	3.1	3.5	3.5	3.6	3.5
Budget Deficit	(0.4)	(0.4)	(0.3)	(0.2)	(0.2)	(0.5)	(1.4)	(1.3)	(1.3)	(1.1)
Additional Accrued Expenses Recorded in Financial Report	(0.1)	0.2	0.4	0.2	0.1	0.6	(0.2)	0.8	0.0	0.2
Net Operating Cost	(0.3)	(0.6)	(0.8)	(0.4)	(0.3)	(1.0)	(1.3)	(2.1)	(1.3)	(1.3)

Financial Report Balance Sheet

Reported Net Liability is about the Size of the Nation's GDP

as of September 30, 2012

(Trillions of Dollars)

Assets	
Cash	\$0.2
Receivables	1.0
Inventories	0.3
Property, plant & equipment	0.9
Other	0.4
Total Assets	2.7

Liabilities	
Federal debt securities held by the public and accrued interest	(11.3)
Federal employee and veteran benefits payable	(6.3)
Other	(1.2)
Total Liabilities	(18.8)
Net Liability (Net Position)	(\$16.1)

Total Social Insurance Credit Card

Statements of Social Insurance Plus Medicaid

Present Value of Obligation as of January 1 for Open Group Alternative Scenario For Medicare for 2010, 2011 & 2012

(Trillions of Dollars)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Social Security	\$4.9	\$5.2	\$5.7	\$6.5	\$6.8	\$6.6	\$7.7	\$7.9	\$9.2	\$11.3
Medicare										
Part A	6.2	8.5	8.8	11.3	12.3	12.7	13.8	7.3	8.5	9.9
Part B	9.7	11.4	12.4	13.1	13.4	15.7	17.2	20.6	21.0	20.6
Part D		8.1	8.7	7.9	8.4	7.9	7.2	7.2	7.5	6.8
Total Medicare	15.8	28.1	29.9	32.3	34.1	36.3	38.1	35.2	37.0	37.2
Total Net Obligation Per SOSI	20.7	33.3	35.6	38.8	40.8	42.9	45.8	43.1	46.2	48.5
Medicaid								24.2	24.0	26.1
Total Social Insurance Net Obligation	\$20.7	\$33.3	\$35.6	\$38.8	\$40.8	\$42.9	\$45.8	\$67.3	\$70.2	\$74.6
Increase in Net Obligation (a)	\$2.9	\$12.5	\$2.3	\$3.2	\$2.1	\$2.0	\$2.9	\$21.5	\$2.8	\$4.5

Adjusted Financials Show the Feds Spent \$3.96 for Every \$1.00 of Revenue

Adjusted Statements of Net Cost

Open Group - (Alternative Scenario for Medicare for 2010, 2011 & 2012)

(Trillions of Dollars)

Fiscal Year Ended 9/30	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
GDP (Quarterly-Current Dollars per BEA)	\$11.3	\$11.9	\$12.7	\$13.4	\$14.1	\$14.4	\$13.9	\$14.6	\$15.2	\$15.8
President's Budget										
Revenues	1.8	1.9	2.2	2.4	2.6	2.7	2.1	2.2	2.3	2.5
Outlays	2.2	2.3	2.5	2.7	2.7	3.1	3.5	3.5	3.6	3.5
Budget Deficit	(0.4)	(0.4)	(0.3)	(0.2)	(0.2)	(0.5)	(1.4)	(1.3)	(1.3)	(1.1)
Additional Accrued Expenses Recorded in Financial Report	(0.1)	0.2	0.4	0.2	0.1	0.6	(0.2)	0.8	0.0	0.2
Net Operating Cost	(0.3)	(0.6)	(0.8)	(0.4)	(0.3)	(1.0)	(1.2)	(2.1)	(1.3)	(1.3)
Increase in Present Value of Social Insurance Obligations	2.9	12.5	2.3	3.2	2.1	2.0	2.9	21.5	2.8	4.5
Operating Deficit	(3.2)	(13.2)	(3.1)	(3.6)	(2.4)	(3.0)	(4.1)	(23.6)	(4.1)	(5.8)

Current Total Net Obligation is 5.7x the Size of Nation's GDP

Balance Sheet as of September 30, 2012

(Trillions of Dollars)

Assets	
Cash	\$0.2
Receivables	1.0
Inventories	0.3
Property, plant & equipment	0.9
Other	0.4
Total Assets	2.7

Liabilities	
Federal debt securities held by the public and accrued interest	(11.3)
Federal employee and veteran benefits payable	(6.3)
Other	(1.2)
Total Liabilities	(18.8)
Net Liability (Net Position)	(\$16.1)
Present Value of Social Insurance Obligations ⁽⁴⁷⁾	(74.6)
Total Net Obligation	(\$90.7)

Total Social Insurance Credit Card – Infinite Horizon

Statements of Social Insurance Plus Medicaid

Present Value of Obligation as of January 1 for Infinite Horizon
For Social Security and Medicare; 75 Year Horizon for Medicaid

(Trillions of Dollars)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Social Security		\$11.9	\$12.8	\$15.2	\$15.7	\$15.9	\$17.5	\$18.7	\$20.5	\$23.2
Medicare										
Part A		22.1	24.3	28.4	30.5	34.7	36.7	(0.3)	0.2	5.1
Part B		23.2	25.8	26.2	26.8	34.0	37.2	21.1	22.4	23.7
Part D		16.5	18.3	16.0	17.1	17.2	15.6	15.8	16.2	14.3
Total Medicare		61.8	68.4	70.6	74.4	85.9	89.5	36.6	38.8	43.1
Total Net Obligation Per SOSI		73.7	81.2	85.8	90.1	101.8	107.0	55.3	59.3	66.3
Medicaid								24.2	24.0	26.1
Total Social Insurance Net Obligation		73.7	81.2	85.8	90.1	101.8	107.0	79.5	83.3	92.4
Increase in Net Obligation (a)			\$7.5	\$4.6	\$4.3	\$11.7	\$5.2	(\$27.5)	\$3.8	\$9.1

Infinite Horizon Balance Sheet

Current Total Net Obligation is

6.9x the Size of Nation's GDP

Balance Sheet as of September 30, 2012

(Trillions of Dollars)

Assets	
Cash	\$0.2
Receivables	1.0
Inventories	0.3
Property, plant & equipment	0.9
Other	0.4
Total Assets	2.7

Liabilities	
Federal debt securities held by the public and accrued interest	(11.3)
Federal employee and veteran benefits payable	(6.3)
Other	(1.2)
Total Liabilities	(18.8)
Net Liability (Net Position)	(\$16.1)
Present Value of Social Insurance Obligations ⁽⁴⁷⁾	(92.4)
Total Net Obligation	(\$108.5)

APPENDICES

- a. SEC v. State of New Jersey
- b. SEC v. State of Illinois

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9135 / August 18, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14009

In the Matter of

STATE OF NEW JERSEY,

Respondent.

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”), against the State of New Jersey (the “State,” “New Jersey” or “Respondent”).

II.

In anticipation of the institution of these proceedings, the State has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, the State consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and the State’s Offer, the Commission finds that:

Summary

1. This matter involves New Jersey’s violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act in connection with the offer and sale of over \$26 billion in municipal bonds from August 2001 through April 2007. In 79 municipal bond offerings, the State misrepresented and failed to disclose material information regarding its under funding of New Jersey’s two largest

pension plans, the Teachers' Pension and Annuity Fund ("TPAF") and the Public Employees' Retirement System ("PERS"). More specifically, the State did not adequately disclose that it was under funding TPAF and PERS, why it was under funding TPAF and PERS, or the potential effects of the under funding.

2. In disclosure documents prepared in connection with each of the bond offerings, including preliminary official statements, official statements,¹ and Treasurer's Annual Reports² (collectively, "disclosure documents" or "bond offering documents"), the State made material misrepresentations and omissions regarding: (1) legislation adopted in 2001 (the "2001 legislation") which increased retirement benefits for employees and retirees enrolled in TPAF and PERS; (2) special Benefit Enhancement Funds ("BEFs") created by the 2001 legislation initially intended to fund the costs associated with the increased benefits; (3) the State's use of the BEFs as part of a five-year "phase-in plan" to begin making contributions to TPAF and PERS; and (4) the State's alteration and eventual abandonment of the five-year phase-in plan. These misrepresentations and omissions created the fiscal illusion that TPAF and PERS were being adequately funded and masked the fact that New Jersey was unable to make contributions to TPAF and PERS without raising taxes or cutting other services, or otherwise impacting the budget. Accordingly, disclosure documents failed to provide adequate information for investors to evaluate the State's ability to fund TPAF and PERS or the impact of the State's pension obligations on the State's financial condition.

Respondents and Related Entities

3. New Jersey possesses all powers, functions, rights, privileges and immunities authorized by the New Jersey Constitution and the State's laws, including the power to issue debt. The State has approximately 8.7 million residents, and is the second wealthiest State based on per capita personal income.

4. Teachers' Pension and Annuity Fund is a defined benefit plan³ operated by the

¹ An official statement is a document prepared by an issuer of municipal bonds that discloses material information regarding the issuer and the particular offering. A preliminary official statement is a preliminary version of the official statement which is used to describe the proposed new issue of municipal securities prior to the determination of the interest rate(s) and offering price(s). The preliminary official statement may be used to gauge interest in an issue and is often relied upon by potential purchasers in making their investment decisions.

² Treasurer's Annual Reports are continuing disclosures filed by the State with the Municipal Securities Rulemaking Board's Electronic Municipal Market Access system ("EMMA") under Rule 15c2-12 of the Securities Exchange Act of 1934 ("Exchange Act").

³ A defined benefit plan is a pension plan that specifies the amount of pension benefits to be provided at a future date based on various factors, including age, years of service, and compensation.

State to provide retirement, death, and disability benefits to its members.⁴ TPAF is the State's largest pension plan, and, as of June 30, 2009, had an actuarial value of assets of more than \$34 billion. As of June 30, 2009, TPAF had an active membership of 157,109 as well as 78,782 retirees and beneficiaries receiving annual pensions totaling more than \$2.8 billion.

5. Public Employees' Retirement System is a defined benefit plan operated by the State to provide retirement, death, and disability benefits to its members. PERS is the State's second largest pension plan, and, as of July 1, 2009, had an actuarial value of assets of more than \$28 billion. In addition to the State, local governments within New Jersey participate as employers. As of July 1, 2009, the State portion of PERS had assets of more than \$10 billion. As of July 1, 2009, PERS had an active membership of 316,849⁵ as well as 136,957 retirees and beneficiaries⁶ receiving annual pensions totaling more than \$2.2 billion.

State Law Requires Certain Annual Calculations and Measures of New Jersey's Pension Plans

6. State law regulates the administration of New Jersey's pension plans. The Division of Pensions and Benefits ("DPB"), a division of New Jersey's Department of the Treasury ("Treasury"), administers all aspects of TPAF and PERS, except the investment of pension plan assets. Plan assets consist of contributions by employers, including the State, contributions by TPAF's and PERS' members, and investment returns. Liabilities of the plans consist of pension benefits owed to current and retired TPAF and PERS members based on past years of service and the plans' administrative expenses.

7. State law requires that TPAF and PERS engage actuaries to conduct actuarial valuations at the end of each fiscal year – June 30. These valuations include calculating the "annual required contribution" and the "statutory contribution." While the annual required contribution is governed by industry standards,⁷ the statutory contribution is calculated in accordance with State law. According to State law and as disclosed in bond offering documents, employers are required to contribute to TPAF and PERS at an actuarially determined rate.

8. In addition to calculating both the annual required contribution and the statutory contribution, an actuarial valuation also calculates the actuarial accrued liability and the actuarial

⁴ Plan members include employees in active service, terminated employees who have accumulated benefits but are not yet receiving them, and retired employees and beneficiaries currently receiving benefits.

⁵ This includes 93,283 State employees and 223,566 employees from local employers.

⁶ This includes 43,764 State employees and 93,193 employees from local employers.

⁷ The annual required contribution is calculated in accordance with Statements 25 and 27 of the Governmental Accounting Standards Board ("GASB").

value of assets of each of the pension plans.⁸ The actuarial accrued liability estimates on the basis of demographic and economic assumptions the present value of pension benefits TPAF and PERS owe to their active and retired members based on past years of service. The actuarial value of assets is the value of cash, investments, and other property belonging to a pension plan using a five-year smoothing method that smoothes the difference between the market value of assets and the actuarial value of assets over a five-year period to prevent short-term fluctuations that may result from economic and market conditions. For each year, this method recognizes 20 percent of the investment gains or losses for the prior five years.

9. The actuarial valuations compare the actuarial accrued liability with the actuarial value of assets for TPAF and PERS and any excess of that liability over the assets forms an unfunded actuarial accrued liability (“UAAL”). The UAAL is the State’s unfunded obligation to TPAF’s and PERS’ members for past service. The actuarial valuations also express the percentages that the plans are funded through a “funded ratio” which represents the quotient obtained by dividing the actuarial value of assets of TPAF and PERS by the actuarial accrued liability of each plan. The trend in the funded ratio provides information as to whether the financial strength of a pension plan is improving or deteriorating over time. The financial strength of a pension plan is generally improving if the funded ratio is increasing. During the relevant time period, New Jersey’s funded ratio decreased significantly. As of June 30, 2001, TPAF had a funded ratio of 108 percent and the State portion of PERS had a funded ratio of 112.5 percent. As of June 30, 2009, TPAF had a funded ratio of 63.8 percent and an unfunded actuarial accrued liability of \$18.7 billion, and the State portion of PERS had a funded ratio of 56.4 percent and an unfunded actuarial accrued liability of \$8.2 billion.⁹

10. The statutory contribution for TPAF and PERS consists of two main components: (1) the normal cost, which represents the portion of the present value of pension benefits that are allocated to active members’ current year of service, and (2) an amortized portion of the UAAL. TPAF and PERS use a statutorily set closed 30-year amortization period¹⁰ for calculating the amount of the UAAL that is included in the statutory contribution.¹¹

⁸ The actuarial valuations calculate the actuarial accrued liability and actuarial value of assets in accordance with New Jersey statutes and Statements 25 and 27 of GASB.

⁹ Although contributions by State and local governments to PERS are invested together, PERS segregates the actuarial accrued liabilities between the State and local governments.

¹⁰ As of the June 30, 2006 actuarial valuations, the State used an open 30-year amortization period.

¹¹ The State’s amortization method amortizes the UAAL over a 30-year period as a level percentage of the projected payroll or “level percent of pay.” Under this method, the UAAL amortization payments are calculated so that they are a constant percentage of the projected payroll of active members over the 30-year period. Because the actuarial valuations assume a payroll growth rate of 4 percent each year, the amortization payments increase over time.

11. Although bond offering documents disclosed that the State was required to contribute to TPAF and PERS at an actuarially determined rate and discussed the budget process generally, bond offering documents did not adequately disclose that the amount actually contributed to the pension plans is subject to the Governor's budget request and annual appropriations by the State legislature. Each year, the Governor, based on recommendations received from Treasury, presents a budget request to the legislature, which may include a request for the State's pension contribution. Once the legislature adopts the budget, it is signed into law as the Appropriations Act for the coming fiscal year. In adopting the budget, the legislature is not required to follow the recommendations of the actuaries or the Governor in determining the State's contribution to the pension plans. The appropriations for the State contribution to the pension plans are credited to "Contingent Reserve Funds," existing funds within TPAF and PERS.

12. State law requires members of TPAF and PERS to contribute annually to the pension plans. Member contributions are based on a percentage of compensation. The State legislature must approve any changes to employer or member contributions. State law also provides that any changes in the pension benefits for TPAF's and PERS' members or any changes in the funding methods of the plans must be approved by the State legislature. In addition, each pension related bill submitted to the State legislature must be accompanied by a fiscal note stating the cost of the proposal.

New Jersey Has Access to the National Public Markets through Municipal Bond Offerings

13. From August 2001 through April 2007, New Jersey issued over \$26 billion in municipal bonds in approximately 79 offerings. The State's preliminary official statements and official statements contained an appendix with several subsections, three of which provided information relating to the State's funding of TPAF and PERS (the "State Appendix"). Appendix I provided financial and other information relating to the State, including a section titled "Financing Pensions." The Financing Pensions section provided a description of the State's pension plans, a description of pension related legislation, a summary of the State's contributions to its pension plans for the current and upcoming fiscal years, and a table setting forth the actuarial accrued liability and the actuarial value of assets from the most recent actuarial valuations for each of the State's pension plans. Appendix I-A, which was an excerpt from the State's most recent Comprehensive Annual Financial Report ("CAFR"),¹² contained a footnote to the financial statements titled "Retirement Systems" that provided general information regarding the State's pension plans, including significant legislation and contribution requirements, as well as a table setting forth statistical information relating to the pension plans. Appendix I-D, an unaudited appendix found in the back of the State's disclosure documents, contained statistical tables for each of the State's three largest pension plans, including TPAF and PERS, that provided the actuarial value of assets and accrued liabilities, and the funded ratio for the previous six years.

14. Various divisions and offices within Treasury were responsible for the pension funding disclosures in the State Appendix. The updating of the pension funding sections generally

¹² The State's CAFR included audited financial statements prepared pursuant to standards established by GASB.

occurred three times a year – following the issuance of the Governor’s budget message, after the passage of the Appropriations Act, and following the issuance of the actuarial valuations. At these times, various divisions and offices within Treasury updated their sections of the State Appendix. They viewed the updating of the pension funding sections as a routine process, requiring the insertion of new numbers or facts into an existing document. The DPB updated the pension disclosures at the request of the Office of Public Finance (“OPF”), another office of the Treasury. The OPF inserted the new information into the State Appendix without verifying the information. The Office of Management and Budget (“OMB”) included in the State’s CAFR the pension fund related excerpts which were also found in the State Appendix.

15. Prior to the release of an official statement, the State Treasurer, or his designee, signed a Rule 10b-5 certification, certifying that the official statement did not contain any material misrepresentations or omissions. During the relevant time period, the Treasurers did not read official statements, and relied on their staff to ensure the accuracy of information contained in the documents.

16. Treasury had no written policies or procedures relating to the review or update of the bond offering documents. In addition, Treasury did not provide training to its employees concerning the State’s disclosure obligations under the accounting standards or the federal securities laws. Accordingly, the State’s procedures were inadequate for ensuring that material information concerning TPAF and PERS or the State’s financing of TPAF and PERS was disclosed and accurate in bond offering documents.

New Jersey Did Not Adequately Disclose the Creation of the BEFs

17. On June 29, 2001, the State legislature approved legislation (P.L. 2001, c. 133) that, effective November 1, 2001, increased retirement benefits for employees and retirees enrolled in TPAF and PERS by 9.09 percent. In order to fund the enhanced benefits, without increased costs to the State or taxpayers, the legislation revalued TPAF and PERS assets to reflect their full market value as of June 30, 1999, near the height of the bull market.¹³ Bond offering documents did not disclose the retroactive mark-to-market revaluation of the pension assets under the 2001 legislation until March 2003 or the reason for the reevaluation. More specifically, bond offering documents did not disclose that the State used the market value as of June 30, 1999 in order to make it appear that the State could afford the benefit improvements.

18. The legislation contemplated that the increased assets resulting from the retroactive mark-to-market revaluation would be used to offset the additional liabilities created by the increased benefits. The additional liabilities included the accrued liability resulting from providing the increased benefits to existing members and retirees as well as the normal cost to ensure that the future liability for the benefit enhancement was funded.

¹³ In the actuarial valuations as of June 30, 1999 for TPAF and PERS, the actuarial value of assets was replaced with the market value of assets. Subsequent actuarial valuations, including actuarial valuations as of June 30, 2000 and June 30, 2001, applied the five-year smoothing method.

19. The legislation created “benefit enhancement funds” or BEFs in TPAF and PERS to set aside a portion of the increased assets or “excess valuation assets”¹⁴ to pay the future annual normal cost associated with the enhanced benefits. After the increased assets were used to fund the accrued liability, a portion of the remaining excess valuation assets were placed in the BEFs to cover the future costs associated with the enhanced benefits. Bond offering documents did not disclose the creation of the BEFs until March 2003.

20. The BEFs were special accounts within TPAF and PERS. Each of the BEFs was credited with excess valuation assets, from the Contingent Reserve Funds, which are existing funds within TPAF and PERS used to hold employer contributions, which excess valuation assets resulted from the revaluation in 2001.

21. On July 11 and 13, 2001, approximately two weeks after the passage of the 2001 legislation, the Office of Legislative Services (“OLS”)¹⁵ issued fiscal notes analyzing the impact of the Assembly and Senate bills which had been adopted as the 2001 legislation. The fiscal notes acknowledged that valuing the pension assets as of June 30, 1999 did not reflect recent market losses in TPAF and PERS. The fiscal notes further acknowledged that, had the 2001 legislation revalued the pension assets as of April 30, 2001 rather than June 30, 1999, the remaining balance of excess assets in TPAF and PERS would have been \$2.4 billion less. Bond offering documents did not disclose the \$2.4 billion decline in the market value of the pension assets used to create the BEFs.

22. Bond offering documents did not disclose the reason for and impact of the retroactive mark-to-market revaluation of the pension assets. By revaluing TPAF and PERS assets and creating the BEFs to fund the ongoing costs of the benefit enhancements, the State gave the false appearance that it could afford the increased benefits. The revaluation of the pension assets to reflect their full market value as of June 30, 1999 resulted in a significant difference between the actuarial value and market value of assets in TPAF and PERS. Because the State’s contributions to TPAF and PERS are based on the actuarial value of assets, the revaluation created the false appearance that the plans were “fully funded” and allowed the State to justify not making contributions to the pension plans despite the fact that the market values of the plans’ assets were rapidly declining.

23. On May 25, 2005, the State’s Acting Governor created the Benefits Review Task Force to examine and make recommendations regarding employee benefits. On December 1, 2005, the New Jersey Benefits Review Task Force issued its final report (the “Benefits Review Task Force Report”) which offered strong criticism of the State’s pension funding practices. In particular, the report recommended that the State stop using actuarial and valuation “gimmicks,” like the State’s alteration of the valuation method in the 2001 legislation. The report advised that

¹⁴ Excess valuation assets is a term defined by New Jersey statute (P.L. 1997, c. 115), which refers to the difference between the valuation assets and the actuarial accrued liability, and other enumerated deductions.

¹⁵ OLS is a nonpartisan agency of the State legislature that provides support services to the legislature and its members.

“[m]ethodologies for determining pension fund values and contribution requirements should not again be changed in order to mask the true cost of benefit enhancements.” The Benefits Review Task Force Report also concluded that the State must regularly contribute to its pension plans and end its use of “pension holidays” – not contributing to its pension plans.

24. The Benefits Review Task Force Report was publicly available and published on the Benefit Review Task Force’s website. New Jersey, however, did not disclose the existence of, or the findings from, the Benefits Review Task Force Report in its bond offering documents.

New Jersey Faced Financial Challenges Due, in Part, to Its Historical Failure to Contribute to TPAF and PERS

25. During fiscal year 2002, the State learned from the actuaries for TPAF and PERS that New Jersey would be required to begin contributing to the State’s pension plans in fiscal year 2004 based on the actuaries’ calculations.¹⁶ Between fiscal years 1997 and 2003, the State had made no or only minimal contributions to TPAF and PERS because based upon the actuarial value of assets, both plans were fully or over funded prior to fiscal year 2003. From 1997 through 2003, the State did not contribute approximately \$916.4 million and \$487.4 million to TPAF and PERS, respectively. During this period and continuing through 2006, in the context of the State’s budgetary process, the State viewed monies not contributed to pension funds as “savings” in that any monies not contributed could be used for other budgetary purposes.

26. Beginning in fiscal year 2003, TPAF and PERS experienced a significant increase in each plan’s UAAL and a decrease in the funded ratios. TPAF and the State portion of PERS went from being over funded to having UAALs of \$2.7 billion and \$1.1 billion, respectively. TPAF’s funded ratio decreased from 103.9 percent in fiscal year 1997 to 92.7 percent in fiscal year 2003. The funded ratio for the State portion of PERS decreased from 105.8 percent in fiscal year 1997 to 90.7 in fiscal year 2003. The significant change in the financial health of TPAF and PERS was due to a variety of factors, including, the State’s failure to contribute to the plans since 1997, market declines, and the enactment of various benefit enhancements, including the 2001 legislation.

27. After a seven-year pension holiday, during which virtually no monies were appropriated in the State’s budget for pensions, the State recognized that it would have to begin contributing to TPAF and PERS. The State, however, now faced significant budget pressures which made it difficult for New Jersey to fund its pension plans absent cutting other programs and services, or raising taxes. Following Treasury’s recommendation, the Governor requested and the legislature provided in the annual Appropriations Act that the BEFs be used in lieu of the State contributing to TPAF and PERS.

¹⁶ Actuarial valuations of TPAF and PERS are completed approximately 6 to 8 months after the end of a fiscal year. Because of the delay, the statutory contribution calculated by the actuaries applies not to the fiscal year immediately following the fiscal year covered by the actuarial valuations, but to the second fiscal year. For example, the statutory contribution in the actuarial valuations as of June 30, 2003 applied to the fiscal year ended June 30, 2005.

**New Jersey Continued to Forego Making Contributions to
Its Pension Plans Through the Use of the BEFs and the Five-Year Phase-In Plan**

28. In 2003, while preparing the 2004 fiscal year budget, the State, faced with increased UAALs and declining funded ratios, had to choose between making contributions to the pension plans, or raising taxes or reducing spending in other areas. Accordingly, Treasury recommended, and the State announced, a five-year phase-in plan, in conjunction with using the BEFs, designed to gradually put New Jersey on track to making the State's full statutory contributions to its pension plans. Under the initial five-year phase-in plan, the State would contribute, subject to Constitutional provisions restricting each legislature's ability to mandate spending by future legislatures, 20 percent of the required statutory contribution to its pension plans in fiscal year 2004, 40 percent in fiscal year 2005, 60 percent in fiscal year 2006, 80 percent in fiscal year 2007, and 100 percent in fiscal year 2008. Beginning with fiscal year 2008, the State would be making the full statutory contribution to its pension plans.

29. Disclosures in bond offering documents regarding the State's five-year phase-in plan and use of the BEFs likely falsely led investors to believe that: (1) the State would be contributing to TPAF and PERS in fiscal years 2004, 2005, and 2006; (2) the State had a plan for making its full statutory contributions; and (3) the State would begin making full statutory contributions in fiscal year 2008.

30. Rather than making phase-in contributions to the pension plans, beginning in fiscal year 2004, the State began using the BEFs in conjunction with the five-year phase-in plan. The State continued to use the BEFs as part of the phase-in plan in fiscal years 2005 and 2006. As a result, the State did not contribute any monies to TPAF and PERS in fiscal years 2004 and 2005. In fiscal year 2006, the State did not contribute to PERS, but did contribute a minimal amount to TPAF to cover the portion of the State's contribution not covered by the BEF.

31. Bond offering documents did not disclose that the State was not contributing to TPAF and PERS during this time. When assets from the BEFs were used to fund the State's pension contributions in fiscal years 2004, 2005, and 2006, funds were transferred from the BEFs back to the Contingent Reserve Funds, the original source of the assets in the BEFs. These inter-fund transfers created the false appearance that the State was making contributions to TPAF and PERS, when no actual contributions were being made. Bond offering documents did not disclose that the BEFs allowed the State to forego making contributions to TPAF and PERS. Rather, disclosures in bond offering documents created the false impression that the BEFs were being used to make New Jersey's pension contributions even though no incremental funds were being received by TPAF and PERS. Disclosure documents misleadingly referred to the BEFs as "reserves" that were being utilized to fund the State's contributions to TPAF and PERS which created the misleading impression that the State was making cash contributions to its pension plans.

32. Although bond offering documents referenced the BEFs in connection with the State's contributions, they never disclosed what they were, how they were being used, or why they

were being used. Bond offering documents did not disclose that the State was using the BEFs in conjunction with a five-year phase-in plan because of significant budgetary constraints, and was unable to contribute to TPAF and PERS. In addition, bond offering documents did not disclose the impact of using the BEFs as part of the five-year phase-in plan. The State recognized that delaying the resumption of the State's contributions could result in substantially increasing the pension plans' unfunded liabilities in the future. The State also recognized that by depleting the BEFs, the State would now be faced with paying the normal costs of the enhanced benefits granted by the 2001 legislation. More than \$704.2 million was used from the BEFs to fund the State's fiscal year 2004, 2005, and 2006 pension obligations, and thus this amount was no longer available to offset the future costs of the benefit enhancement legislation.

33. By the end of fiscal year 2006, the State had depleted the BEFs. Bond offering documents did not disclose that the State, during each budget cycle, intended to forego making contributions to TPAF and PERS until it had exhausted the BEFs. By disclosing that the State had adopted a five-year phase-in plan, the bond offering documents gave the impression that the State would be contributing its full statutory contributions to TPAF and PERS by fiscal year 2008.

**New Jersey Altered and Then Abandoned
the Five-Year Phase-In Plan Because of Financial Difficulties**

34. Although New Jersey's bond offering documents referenced the five-year phase-in plan, the State treated the phase-in plan as a flexible plan that could be altered on a year-to-year basis depending on other budgetary demands. Because other budgetary priorities existed, the State's contributions to TPAF and PERS were reduced to 30 percent of the statutory contribution in fiscal year 2005 and 40 percent in fiscal year 2006. Bond offering documents did not disclose the changes to the phase-in plan or the reasons for the State's reduced contributions. These reduced contributions increased, in part, the UAALs for TPAF and the State portion of PERS by \$8.2 billion and \$3 billion, respectively.

35. Funding for TPAF and PERS was governed by the annual Appropriations Act. The Appropriations Act for fiscal years 2004, 2005, and 2006 also set forth the State's use of the BEFs. In fiscal year 2004, the Appropriations Act specified the amounts to be used from the BEFs in lieu of the State's contributions to TPAF and PERS. However, the Appropriations Act for fiscal years 2005 and 2006 did not identify the amounts to be used from the BEFs or the phase-in percentages. Rather, for those years, the Appropriations Act provided that the Treasurer would determine the amount to be used from the BEFs.

36. The language in the Appropriations Act for fiscal years 2005 and 2006 gave the Treasurer the flexibility to alter the amount of the BEFs to be used to cover the State's contributions to TPAF and PERS, up until the last day of the fiscal year when the contributions were due. In addition, this language gave the Treasurer the ability to alter the phase-in percentages under the phase-in plan. This was particularly important, since by adjusting the amount of the BEFs to be used in fiscal year 2005 and the phase-in percentage, the Treasurer was able to ensure that there were sufficient assets in the BEFs in fiscal year 2006 to cover all or almost all of the State's contributions to TPAF and PERS. In fiscal year 2005, the Treasurer exercised his authority

under the Appropriations Act by reducing the amount of the State's contributions to TPAF and PERS, and thus the phase-in percentage, following the enactment of the Appropriations Act. This change in the phase-in plan, however, was not disclosed in bond offering documents.

37. The State recognized that because of severe budgetary constraints, it would not be able to achieve full funding of its pension plans by fiscal year 2008 without cutting State services or finding other sources of revenue. In fact, the State only contributed 57.5 percent of the required statutory contribution to its pension plans in fiscal year 2007 and 50 percent in fiscal year 2008.

38. The State abandoned its five-year phase-in plan in approximately May 2006. Bond offering documents did not disclose that the State had abandoned the five-year phase-in plan. Rather, the State stopped using the term "five-year" when referring to the phase-in plan in disclosure documents. The State's continued use of the term "phase-in plan" gave the false impression that New Jersey still had a plan to achieve full statutory contributions. Moreover, bond offering documents did not disclose that New Jersey was unable to fully implement the five-year phase-in plan without causing New Jersey to suffer severe economic hardship.

New Jersey Failed to Provide Certain Present and Historical Financial Information Regarding Its Pension Funding

39. The State's bond offering documents contained inadequate information regarding the State's present and historical contributions to TPAF and PERS. Statistical tables for TPAF and PERS found in Appendix I-D set forth the amount of the State's contributions for the most recent fiscal year and the prior five fiscal years. This information, however, was misleading to investors because the amounts set forth included pension contributions, if any, as well as payments made by the State to members of TPAF and PERS for post-retirement medical benefits.¹⁷ This contribution information conflicted with other statistical information found in the Retirement Systems footnote of Appendix I-A, which showed the actual pension contributions made by the State, but did not include payments for post-retirement medical benefits, for the most recent fiscal year as well as the two prior fiscal years. In addition, the State's bond offering documents lacked sufficient information for investors to understand the State's historical failure – since 1997 – to contribute to TPAF and PERS.

40. Appendix I-A of the State's disclosure documents also excluded a key statistical table from the State's CAFR called the "Required Supplementary Information Schedule of Funding Progress" ("RSI Schedule"), which is defined by GASB. The RSI Schedule is designed to provide a long-term actuarial perspective on the State's funding of its pension plans. The RSI Schedule provided important financial information regarding TPAF and PERS for the three prior fiscal years, including the UAAL and the UAAL as a percentage of covered payroll.¹⁸ The ratio of

¹⁷ Under statutes for TPAF and PERS, the State's contributions for post-retirement medical benefits flowed through the pension plans.

¹⁸ Covered payroll includes all elements of compensation paid to active employees on which contributions to the pension plans are based.

UAAL to covered payroll is a measure of the significance of the UAAL relative to the capacity to pay it. The trend in the ratio provides information as to whether the financial strength of the pension plan is improving or deteriorating over time. The financial strength of a pension plan is generally improving if the ratio of UAAL to covered payroll is decreasing. In fact, from 2002 through 2007, the UAAL as a percentage of covered payroll steadily increased. The UAAL and the UAAL to covered payroll for TPAF and PERS is shown below.

TPAF

Fiscal Year	UAAL	UAAL as a Percentage of Covered Payroll
2002	\$(1,654,591)	0.0%
2003	\$2,731,906,950	35.5%
2004	\$5,813,899,790	72.2%
2005	\$9,178,537,424	108.6%
2006	\$11,008,573,863	125.8%
2007	\$12,446,668,618	137.1%

PERS (State Portion)

Fiscal Year	UAAL	UAAL as a Percentage of Covered Payroll
2002	\$(312,599,482)	(8.9)%
2003	\$1,112,345,981	31.1%
2004	\$1,926,870,843	51.4%
2005	\$2,801,180,057	69.5%
2006	\$4,129,039,284	97.1%
2007	\$5,004,619,993	112.8%

41. The bond offering documents failed to provide information regarding the actuarial methodology used by the State to calculate the actuarial value of assets, and the impact of using this methodology on the State's funding of its pension plans. The bond offering documents did not disclose the effect of the State's use of a five-year smoothing method to measure the actuarial value of assets. As a result of the 2001 legislation and market declines, the actuarial value of assets exceeded the market value of assets for TPAF and PERS, resulting in net unsmoothed losses in both plans beginning in fiscal year 2002. The ratio of the actuarial value of assets to market value of assets for TPAF and PERS is shown below.

Actuarial Value as a Percent of Market Value

Fiscal Year	TPAF	PERS
2002	129.5%	126.8%
2003	131.0%	127.7%
2004	121.0%	118.3%
2005	117.4%	113.9%
2006	112.8%	106.7%

2007	104.7%	101.9%
------	--------	--------

Since the State's contributions to TPAF and PERS are based on the actuarial value of assets, the significant difference between the actuarial value of assets and the market value of assets reduced the State's statutory contributions to the pension plans.

42. The bond offering documents also failed to provide information regarding the actuarial methodology used by the State to calculate the actuarial accrued liabilities of TPAF and PERS, and the impact of using this methodology on the State's funding of its pension plans. The bond offering documents did not disclose the effect of the State's use of a closed 30-year amortization period¹⁹ based on a level percent of pay for measuring the actuarial accrued liability. Under this recognized actuarial method, the UAALs of TPAF and PERS will continue to rise indefinitely even if the State were to contribute the full statutory contribution to the pension plans. Under New Jersey statute, if the UAALs for TPAF and PERS increase from one year to the next, the actuarial valuations will continue to use the full 30-year amortization period. As a result, the State has been unable to and will continue to be unable to effectively amortize TPAF's and PERS' UAALs.

43. In addition, although available in actuarial reports for TPAF and PERS, the bond offering documents did not provide asset and funded ratio information on a market value basis. Because of the significant difference between the actuarial value and market value of assets in TPAF and PERS, the actuarial value did not accurately present the current value of the pension plans. Rather, the actuarial value of assets for TPAF and PERS provided a limited measure of the pension plans' financial health since they did not fully reflect the effects of the 2001 legislation or market declines. Investors lacked sufficient information to assess the current financial health of TPAF and PERS as a result of the absence of asset and funded ratio information on a market value basis. New Jersey's historical funded ratios using actuarial value of assets and market value of assets are shown below:

TPAF

Fiscal Year	Actuarial Value of Assets	Market Value of Assets	Funded Ratio (actuarial value)	Funded Ratio (market value)
2002	\$35,148,246,433	\$27,121,744,264	100.0%	77.2%
2003	\$34,651,825,932	\$26,447,330,285	92.7%	70.7%
2004	\$34,633,790,549	\$28,618,463,144	85.6%	70.8%
2005	\$34,789,389,875	\$29,610,249,605	79.1%	69.0%
2006	\$35,531,294,790	\$31,495,000,296	76.4%	69.3%
2007	\$36,714,578,745	\$35,070,757,170	74.7%	72.9%

¹⁹ As of the June 30, 2006 actuarial valuations, the State used an open 30-year amortization period.

PERS (State Portion)

Fiscal Year	Actuarial Value of Assets	Market Value of Assets	Funded Ratio (actuarial value)	Funded Ratio (market value)
2002	\$11,073,156,965	\$8,727,927,022	102.9%	81.1%
2003	\$10,829,953,189	\$8,479,326,527	90.7%	71.0%
2004	\$10,693,508,592	\$9,038,299,523	84.7%	71.6%
2005	\$10,631,348,826	\$9,325,929,009	79.1%	69.4%
2006	\$10,668,645,162	\$9,996,185,459	72.1%	67.6%
2007	\$11,024,255,608	\$10,817,111,560	68.8%	67.5%

New Jersey Enhances Its Pension Funding Disclosures

44. Subsequent to an April 2007 news article that raised questions regarding disclosures in the State's bond offering documents relating to New Jersey's funding of its pensions, the State hired disclosure counsel to advise the State on an on-going basis regarding its disclosure obligations under the federal securities laws. During 2007 and early 2008, the State, with the assistance of disclosure counsel, reviewed its bond offering documents and enhanced its disclosures.

45. With the assistance of disclosure counsel, the State has reviewed, evaluated, and enhanced its disclosure process by instituting formal, written policies and procedures. In its written policies and procedures, among other things, the State established a committee comprised of senior Treasury officials, representatives from the Attorney General's Office, and disclosure counsel to oversee the entire disclosure process and to review and make recommendations regarding the State's disclosures and disclosure practices. In addition, the State has implemented an annual mandatory training program conducted by disclosure counsel for the State's employees involved in the disclosure process to ensure compliance with the State's disclosure obligations under the federal securities laws.

Legal Discussion

46. Municipal securities represent an important part of the financial markets available to investors. At the end of 2009, individual investors held approximately 35 percent of outstanding municipal securities directly and up to another 34 percent indirectly through money market funds, mutual funds, and closed end funds. There is also substantial trading volume in the municipal securities market — almost \$3.8 trillion of long and short-term municipal securities were traded in 2009 in over 10 million transactions. Issuers of municipal securities have an obligation to ensure that financial information contained in their disclosure documents is not materially misleading. Proper disclosure allows investors to understand and evaluate the financial health of the state or local municipality in which they invest.

47. New Jersey, as an issuer of municipal securities, is subject to the antifraud provisions of the federal securities laws. In addition, the Commission has promulgated a broker-dealer rule, Exchange Act Rule 15c2-12, which in general limits market access for certain municipal securities issues to those offerings in which the issuer agrees to file annual disclosures of

specified financial and operating information as well as notices of certain events, if material, and notices of any failures to file with certain repositories designated by the Commission.²⁰ The antifraud provisions apply to such disclosure and to any other statements made to the market.

48. Section 17(a) of the Securities Act prohibits the making of any untrue statement of material fact or omitting to state a material fact in the offer or sale of securities. A fact is material if there is a substantial likelihood that its disclosure would be considered significant by a reasonable investor. Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1987); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Violations of Sections 17(a)(2) and (3) may be established by showing negligence. SEC v. Hughes Corp., 124 F.3d 449, 453-54 (3d Cir. 1997); SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992).

Violations

49. As a result of the negligent conduct described above, the State violated Sections 17(a)(2) and 17(a)(3) of the Securities Act. Specifically, the State made material misrepresentations and omissions in preliminary official statements, official statements, and continuing disclosures regarding the State's under funding of TPAF and PERS. TPAF and PERS represent a significant and growing obligation for New Jersey. The State's misrepresentations and omissions were material in that they failed, over the course of an almost six-year period, to provide investors with adequate information regarding the State's funding of TPAF and PERS as well as the financial condition of the pension plans. Information regarding the State's under funding of TPAF and PERS and their financial health was important to investors in evaluating New Jersey's overall financial condition and future financial prospects.

50. The State was aware of the under funding of TPAF and PERS and the potential effects of the under funding. However, due to a lack of disclosure training and inadequate procedures relating to the drafting and review of bond disclosure documents, the State made material representations and failed to disclose material information regarding TPAF and PERS in bond offering documents.

Remedial Efforts

51. In determining to accept the State's Offer, the Commission considered the cooperation afforded the Commission's staff during the investigation and remedial acts taken by the State, referenced in paragraphs 44 and 45.

²⁰ On December 5, 2008, the Commission amended Rule 15c2-12 to require issuers to agree to file annual disclosures of specified financial and operating information as well as notices of certain events, if material, and notices of any failures to file with the Municipal Securities Rulemaking Board. Issuers are no longer permitted to use other repositories. Rule 15c2-12 was further amended on May 27, 2010 to eliminate the materiality determination for certain types of events and to make other changes to improve the quality and timeliness of municipal securities disclosure.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in the State's Offer.

Accordingly, it is hereby ORDERED that pursuant to Section 8A of the Securities Act, the State shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act.

By the Commission.

Elizabeth M. Murphy
Secretary

Service List

Rule 141 of the Commission's Rules of Practice provides that the Secretary, or another duly authorized officer of the Commission, shall serve a copy of the Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), on the Respondent and its legal agents.

The attached Order has been sent to the following parties and other persons entitled to notice:

Honorable Brenda P. Murray
Chief Administrative Law Judge
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-2557

Elaine C. Greenberg, Esq.
Philadelphia Regional Office
Securities and Exchange Commission
701 Market Street, Suite 2000
Philadelphia, PA 19106

State of New Jersey
Marc-Philip Ferzan, Executive Assistant Attorney General
Robert M. Hanna, Director of the Division of Law
Office of the Attorney General
P.O. Box 080
Trenton, NJ 08625-0080

Carmen J. Lawrence, Esq.
Fried, Frank, Harris, Shriver & Jacobson LLP
One New York Plaza
New York, NY 10004
(Counsel for the State of New Jersey)

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9389 / March 11, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15237

In the Matter of

STATE OF ILLINOIS,

Respondent.

**ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT
TO SECTION 8A OF THE
SECURITIES ACT OF 1933, MAKING
FINDINGS, AND IMPOSING A CEASE-
AND-DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”), against the State of Illinois (the “State,” “Illinois,” or “Respondent”).

II.

In anticipation of the institution of these proceedings, the State has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, the State consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and the State’s Offer, the Commission finds that:

Summary

1. In connection with multiple bond offerings raising over \$2.2 billion from approximately 2005 through early 2009, the State of Illinois misled bond investors about the

adequacy of its statutory plan to fund its pension obligations and the risks created by the State's underfunding of its pension systems.¹

2. The State omitted to disclose in preliminary and final official statements material information regarding the structural underfunding of its pension systems and the resulting risks to the State's financial condition. Enacted in 1994, the Illinois Pension Funding Act (the "Statutory Funding Plan") established a pension contribution schedule that was not sufficient to cover both (1) the cost of benefits accrued in the current year and (2) a payment to amortize the plans' unfunded actuarial liability. This methodology structurally underfunded the State's pension obligations and backloaded the majority of pension contributions far into the future. The resulting systematic underfunding imposed significant stress on the pension systems and on the State's ability to meet its competing obligations.

3. During this same time period, the State also misled investors about the effect of changes to the Statutory Funding Plan, including substantially reduced pension contributions in 2006 and 2007 ("Pension Holidays"). Although the State's preliminary and final official statements disclosed the fact of the Pension Holidays and other legislative amendments to the plan, Illinois did not disclose the effect of those changes on the contribution schedule or on the State's ability to meet its pension obligations.

Respondent

4. Illinois possesses all powers, functions, rights, privileges, and immunities authorized by the United States Constitution, the Illinois Constitution, and the State's laws, including the power to issue debt.

Pension Funding in Illinois

5. The pension systems of Illinois currently are among the lowest-funded plans in the nation. As of 2011, the systems collectively were underfunded by \$83 billion, and system assets covered only 43 percent of system liabilities. The State's current funding deficit was created in significant part by the State's historical failure to fund its pension systems in a manner to avoid the growth of the unfunded liability.

6. The State of Illinois provides funding for five retirement systems that pay pension benefits upon retirement, death, or disability to public employees and their beneficiaries. The five systems are the Teachers' Retirement System of the State of Illinois, the State Universities Retirement System of Illinois, the State Employees' Retirement System of Illinois, the Judges' Retirement System of Illinois, and the General Assembly Retirement System, State of Illinois. Generally speaking, the systems are all defined-benefit plans that require contributions by employees and employers, with a significant portion funded by the State.

¹ These bonds are general obligation bonds, which are backed by the full faith and credit of the State.

7. Until 1981, the State funded pensions by covering the out-of-pocket costs associated with benefits as they came due. Employee contributions and investment income funded a reserve for future benefits. This approach had no relation to actuarial calculations of liability and was abandoned in 1982 during a period of fiscal stress. Without a remedial plan in place, state contributions were held relatively constant from 1982 to 1995. As a result of level contributions and rising costs, by 1995 the pension systems were significantly underfunded. In the aggregate, system assets covered only 50 percent of actuarial accrued liabilities, which had grown to approximately \$20 billion.

8. In an effort to address this imbalance, the Illinois General Assembly enacted the Statutory Funding Plan in 1994. Effective in 1995, this Statutory Funding Plan established a fifty-year schedule intended to achieve a 90 percent funded ratio for each system by 2045.² The Statutory Funding Plan called for the State to meet this target by contributing a level percentage of payroll each year sufficient to reach this goal. Under the level percentage of payroll method, amortization payments are calculated so that they are a constant percentage of the projected payroll of active plan members over a given number of years. Each year, actuaries for each pension system would use demographic and other data and various assumptions to calculate actuarial value of assets, actuarial accrued liability, and the State's contributions based on the statutory requirements and objectives. Rather than requiring the immediate funding of plan contributions calculated in this manner, the legislature phased in the State's contribution over a fifteen-year "ramp" period. During the ramp period, the Statutory Funding Plan required that the percentage of payroll increase each year such that, by 2010, the State would be contributing the level percentage of payroll required under the plan for 2011 to 2045. At the conclusion of the ramp period in 2010, the Statutory Funding Plan required the State to contribute a level percentage of state payroll in order to achieve the 2045 target.

9. Rather than controlling the State's growing pension burden, the Statutory Funding Plan's contribution schedule increased the unfunded liability, underfunded the State's pension obligations, and deferred pension funding. This resulting underfunding of the pension systems ("Structural Underfunding") enabled the State to shift the burden associated with its pension costs to the future and, as a result, created significant financial stress and risks for the State.

a. For the majority of the years under the Statutory Funding Plan, the State's annual required contributions were insufficient to prevent the growth of its unfunded liability. Specifically, the statutory contributions were not sufficient to cover both (1) the cost of pension benefits earned by public employees by virtue of their service in the current year ("the normal cost") and (2) a payment to amortize the accumulated amount of pension liabilities that have been deemed earned but are not funded (the unfunded actuarial accrued liability, or "UAAL") for an identified group of plan participants. The normal cost and amortization payment collectively are referred to as the actuarially required contribution ("ARC"). The State's pension contributions were calculated in accordance with State law, not in accordance with the ARC, and therefore the

² The funded ratio, which is one measure of the financial health of a pension plan, is the actuarial value of assets expressed as a percentage of the actuarial accrued liability. A 100 percent funded ratio means that existing assets cover the present value of future benefits to be paid by the systems.

Statutory Funding Plan deferred funding of the State's pension obligations and compounded its pension burden.

b. The 90 percent funding target allowed the State to amortize the UAAL in a manner that would not eliminate it entirely. By failing to amortize the UAAL completely, the State was able to lower its contributions. However, by assuring that some portion of the UAAL would remain outstanding, it also increased the economic cost of the pensions and delayed the cash outlays necessary to fulfill its pension obligations.

c. The State's plan also spread costs over fifty years, in contrast to the thirty-year amortization period adopted by the pension plans of most other states. The longer amortization period extended the amount of time required to pay down the UAAL, reducing the State's annual statutory contributions while increasing the real cost of the pensions over time.

d. The State's phased contributions during the fifteen-year ramp period accelerated the growth of the UAAL during this time period and amplified the burden and risk associated with the State's plan.

e. In contrast to the ARC, which typically is calculated using the closed group approach, contributions under the Statutory Funding Plan are calculated using an open group method, which spreads the cost of providing benefits over existing and new entrants. The Illinois approach requires actuaries to estimate pension benefits for employees to be hired far into the future, particularly given the State's use of a 2045 target date.

f. The State's use of the projected unit credit ("PUC") actuarial cost method compounded the risk of the Statutory Funding Plan. The PUC method, used by Illinois and a minority of states, allocates a higher portion of retirement costs closer to retirement, while the entry age normal ("EAN") method, used by a substantial majority of public sector plans, averages those same costs evenly over the pensioner's period of employment. Compared to an EAN approach, the PUC method results in less funding for active employees, accumulates assets more slowly, produces more volatile measures of contribution rates, and results in rising rather than level contribution rates.

10. From 1996 to 2010, the State's unfunded liability increased by \$57 billion. The State's insufficient contributions under the Statutory Funding Plan were the primary driver of this increase, outweighing other causal factors, such as market performance and changes in benefits. This Structural Underfunding created significant financial risks for the State:

a. Although the most significant effects of this Structural Underfunding materialize in the future, the pension shortfall already has imposed a severe strain on the finances of the Illinois government, and pension costs are affecting the State's ability to manage other significant obligations. In April 2012, the State acknowledged that the pension shortfall is "one of the most difficult problems that Illinois government has faced for more than three decades," and "[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."

b. The State understood that the Structural Underfunding put the plan at serious risk and that the State likely would not be able to afford the level of contributions required to reach

90 percent funding. As explained by one of the system's actuaries in 2009, "[t]he perpetual underfunding puts the plan at serious risk for ultimate exhaustion of the trust, leaving the responsibility for the payment of benefits elsewhere." He observed further that "[t]he plan is in significant funding peril unless the contributions recommended under the actuarially required contribution can be made." Similarly, a pension consultant retained by the Governor's Office of Management and Budget ("GOMB") wrote in August 2009 that "the Illinois pension system is now so underfunded that the State likely [would] never be able to afford the level of contributions required to ever reach 90 percent funding." Other documents generated by GOMB reflected serious concerns about the financial strain produced by the State's unfunded pension obligations. This information was not disclosed to bond investors in bond offering documents.

c. The Structural Underfunding of the pension systems and the State's increasing inability to afford contributions created the significant risk that the State would be unable to satisfy its competing obligations. This underfunding also compromised the creditworthiness of the State and increased the State's financing costs.

Underfunding of the State's Pension Obligations

11. In its bond offering documents from 1995 to 2010, the State disclosed that Illinois funded its pension obligations through the Statutory Funding Plan, which according to the State provided for funding "necessary" or "sufficient" to achieve 90 percent funding of liabilities in 2045. Specifically, official statements disclosed that the Statutory Funding Plan "created a 50-year funding schedule of the Retirement Systems which requires the State to contribute each year, starting with Fiscal Year 2011, the level percentage of payroll sufficient to cause the assets of the Retirement Systems to equal 90 percent of the total accrued liabilities by the end of Fiscal Year 2045. In Fiscal Years 1997 through 2010, contributions as a percentage of payroll are increased each year such that by Fiscal Year 2010, the contribution rate is at the same level as required for years 2011 through 2045."

12. The State also disclosed statistics regarding the systems' assets and liabilities and other information. Among other things, the State provided, for an historical five-year period, the actuarial assets and liabilities for each of the pension systems, as prescribed by state law; the UAAL, which is one measure of the funded status of pension plans; the funded ratio, which is the actuarial value of assets as a percentage of the actuarial accrued liability; and summary financial statements for each of the pension systems. The State's official statements also reviewed recent legislation affecting pension funding and demographic data for participants in the pension systems.

13. The State did not disclose that contributions required by the Statutory Funding Plan significantly underfunded the State's pension obligations and deferred pension funding into the future.

a. The State did not disclose in its official statements its failure to contribute to the full amount of the ARC and the consequences of not funding the full amount of the ARC.³

³ The State's comprehensive annual financial reports ("CAFRs"), which the official statements incorporated by reference, compared the calculation of the contribution under the

b. The State also did not disclose that multiple aspects of the Statutory Funding Plan deferred pension contributions and increased the burden associated with the pension plans. For instance, the State did not explain the implications of its decision to spread costs over fifty years, the fifteen-year ramp period, and 90 percent funding target.

c. The State did not inform investors that other aspects of the State's funding method, such as the State's use of the PUC method, delayed contributions and increased the unfunded liability.

d. In its official statements, the State cited a number of factors that, in the past, contributed to the increase in unfunded pension liability, such as statutory benefit enhancements and market performance, but did not disclose that the State's insufficient contributions were the primary driver of the increase.

e. The State disclosed that its UAAL could increase in the future by virtue of a variety of factors, such as a decrease in the performance of investments and changes in legislation, actuarial assumptions, inflation, benefits, or the State's contribution rate. However, the State misleadingly omitted to disclose the primary driver of the increase—the insufficient contributions mandated by the Statutory Funding Plan.

14. The State also failed to disclose the risks created by the Structural Underfunding.

a. The State failed to disclose the effect of its unfunded pension systems on the State's ability to manage other obligations. The State also did not inform investors that rising pension costs could continue to affect its ability to satisfy its commitments in the future. In contrast, the State included multiple metrics to assist potential investors' evaluation of the burden associated with the State's bond offerings and obligations.

b. Although the State understood that the Structural Underfunding could risk the eventual exhaustion of the pension systems' funds and that the State likely would not be able to afford the level of contributions required by the Statutory Funding Plan, it did not disclose that the State's inability to make its contributions increased the investment risk to bondholders. The State did not identify or discuss how this underfunding compromised the State's creditworthiness or increased its financing costs.

Failure to Adhere to the Statutory Funding Plan

15. As described above, the Statutory Funding Plan set contribution requirements at a level that failed to control the growth of the unfunded liability until the latter years of the plan. Nevertheless, the State did not meet the requirements of the plan as enacted in 1995. Beginning in 2005, the State amended the Statutory Funding Plan, lowering these already deficient contributions, or borrowed to cover its payments. This modification to the original Statutory

Statutory Funding Plan to a contribution calculated in accordance with generally accepted accounting principles. However, the CAFR disclosures did not describe the risks and implications of the Statutory Funding Plan and deviations from that plan.

Funding Plan created further risk to the pension systems and the financial condition of the State. The State misled investors about the effect of these changes on the State's financial condition and, in particular, the impact of the Pension Holidays instituted in 2006 and 2007.

16. On June 1, 2005, the State legislatively enacted Pension Holidays, lowering the contribution in 2006 and 2007 by 56 and 45 percent, respectively. The Pension Holidays had the dual effect of increasing the UAAL and further delaying payment of the deferred portion of the contribution to a future fiscal year.

17. Contrary to the State's CAFRs, which stated that the Pension Holidays would be offset by increased contributions from 2008 to 2010, the 2005 amendment to the Statutory Funding Plan did not require increased contributions in 2008 through 2010 to offset the reduced contributions in 2006 and 2007. Instead, the statute required contributions from 2008 to 2010 to be "increased in equal annual increments from the required State contribution for State fiscal year 2007." In other words, the Illinois legislature mandated a resumption of the ramp period from the reduced 2006 and 2007 levels, not an increase in the 2008, 2009, and 2010 contribution levels to offset those reduced contributions.

18. Although the State disclosed the basic fact of these reduced contributions, the State did not disclose that each of these deviations exacerbated the Structural Underfunding, deferred contributions further into the future, impaired the ability of the State to meet its pension obligations, and negatively impacted the State's creditworthiness.

19. Due to the State's failure to adhere to the original Statutory Funding Plan prior to the conclusion of the ramp period, the State should have known that it likely would have significant difficulty making the required contributions in the future. In addition, the State should have known that its disclosures regarding the Structural Underfunding and the related risks were inadequate.

Significance to Potential Investors

20. The funding of pension obligations is a significant aspect of the State's budget and financial status. Reasonable investors would have considered information regarding the State's Structural Underfunding of its 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 financial condition and the State's future financial prospects. Such information allows investors to weigh and price the risk associated with the State's debt obligations.

21. Concern about the State's pension financing was a significant factor prompting downgrades of the State's credit rating from 2010 to 2012. For example, on June 4, 2010, Moody's lowered the State's general obligation bond rating based on the State's increased reliance on non-recurring measures. A significant factor cited by Moody's was the fiscal pressure caused by the State's pension funding burden, and, for the first time, Moody's provided additional detail regarding the State's funding challenges and difficulty complying with its pension law in recent years.

22. Certain events ultimately revealed the State's Structural Underfunding of pensions and the risks associated with the underfunding. For example, on January 21, 2011, the State included enhanced pension disclosures released in a preliminary official statement for a general obligation offering on February 11, 2011. Following this event and others, the risk premium associated with Illinois bonds rose, causing the spread between the yield on Illinois bonds relative to other AAA-rated municipal bonds to widen.

Institutional Failures

23. The State's misleading disclosures resulted from, among other things, various institutional failures. The State failed to adopt or implement sufficient controls, policies, or procedures designed to ensure that material information was assembled and communicated to individuals responsible for disclosure determinations, to train personnel involved in the disclosure process adequately, or to retain disclosure counsel. As a result, the State lacked proper mechanisms to identify and incorporate into its official statements relevant information held by the pension systems and other bodies within the State.

24. GOMB, which managed the issuance of debt for the State, coordinated the drafting, review, and revision of the bond disclosure documents, including the section regarding pension funding. GOMB's procedures were inadequate for ensuring that material information concerning State Pension Funds or the State's financing of State Pension Funds was disclosed and accurate in bond offering documents. The State failed to implement sufficient policies and procedures, to conduct adequate training, or to consult securities disclosure counsel to ensure adequate disclosure. Relying on prior "carryover" disclosures and "page-turn" reviews during group conference calls, the State and its advisors did not scrutinize the institutionalized description of the Plan adequately and made little affirmative effort to collect potentially pertinent information from knowledgeable sources—in particular, actuaries for the pension systems and the State's Commission on Government Forecasting and Accountability ("COGFA").

25. Within GOMB, the team responsible for managing the disclosure process purported to rely on its consultants, underwriters, underwriter's counsel, and bond counsel to identify and evaluate the need for additional disclosures. Those parties, however, relied on the State to do the same. The result was a process in which no one person fully accepted responsibility for identifying and analyzing potential pension disclosures.

Remedial Measures

26. The State has taken significant steps to correct these process deficiencies and enhance its pension disclosures. Among other things, the State issued enhanced disclosures; retained disclosure counsel; instituted written policies and procedures, disclosure controls, and training programs; and designated a disclosure committee.

a. In the State's April 2009 bond offering documents, the State provided a hyperlink to a February 2009 COGFA monthly briefing in which COGFA provided certain negative information regarding, among other things, the decline in the State's pension system assets.

b. In June 2009, the State commissioned a Pension Modernization Task Force to evaluate the benefit structure, costs, and funding of the State's pension systems. The task force

met from June to November 2009 and issued a report in November 2009. The report contained detailed information about the history of pension investments, benefits, and funding and reflected the views of various experts. In its official statement for the January 2010 offering, the State included a hyperlink to the task force report in the pension section.

c. In late 2009, the State made a series of personnel changes in the GOMB, including in its most senior positions. These new officers worked to formalize the disclosure and underwriting process.

d. In March 2010, COGFA produced a report on the funded status of the pension systems as of June 30, 2009. The report contained certain historical and projected information regarding the State's funding of its pensions.

e. Promptly following the Commission's settled action against the State of New Jersey in August 2010,⁴ the State began to implement a series of remedial measures. The State retained disclosure counsel, significantly enhanced disclosures in the pension section of its bond offering documents, developed training materials, and added formal disclosure controls regarding pension disclosures. The State also designated a disclosure committee responsible for collecting information from relevant sources, evaluating the State's disclosure obligations, and approving bond offering disclosures. Prior to dissemination of official statements, the committee ensures that the disclosures are reviewed by the pension systems, COGFA, the Office of the Comptroller, the Office of the Treasurer, and the Office of the Illinois Attorney General.

f. These steps culminated with significant corrective disclosures in connection with an offering in February 2011, the State's first offering since the Commission's settled action against the State of New Jersey. In particular, the State disclosed contrasts between contributions determined under the Illinois Statutory Funding Plan and the costs implied by standard actuarial methods and assumptions and Government Accounting Standards Board ("GASB") Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*. The State also discussed the effect of such deviations on the State's ability to meet its pension obligations and included the projected funded status of the pension systems. Finally, the State disclosed the effect of amendments to its Statutory Funding Plan on its ability to fund its pension obligations and the State's financial condition. The State's disclosures also included an extensive discussion of the background of the pension systems, history of contributions to the pension systems, the financial condition of the plans, projections of funded status, substantive references to additional sources of information, and a discussion of disclosure policies and procedures.

Legal Discussion

27. Issuers of municipal securities are responsible for the accuracy of their disclosure documents. Proper disclosure allows investors to understand and evaluate the financial health of the municipality in which they invest. The Commission has repeatedly emphasized that disclosure

⁴ *In re State of New Jersey*, Securities Act Release No. 33-9135 (Aug. 18, 2010).

in municipal debt offerings may be rendered materially misleading due to the omission of other material facts.

28. The antifraud provisions of Section 17(a) of the Securities Act prohibit fraudulent or deceptive practices in the offer or sale of securities by the issuers of municipal securities. Section 17(a) of the Securities Act prohibits obtaining money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. A fact is material if there is a substantial likelihood that a reasonable investor would have viewed the information as “having significantly altered the ‘total mix’ of information available.” *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). To the extent the omitted information relates to contingent future events, materiality depends upon “a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of circumstances.” *Basic, Inc. v. Levinson*, 485 U.S. 224, 238 (1988). Negligence is sufficient to prove violations of Section 17(a)(2) or (3) of the Securities Act. *Aaron v. SEC*, 446 U.S. 680, 696-97 (1980).

Violations

29. As a result of the negligent conduct described above, the State violated Sections 17(a)(2) and 17(a)(3) of the Securities Act. Specifically, in numerous bond offerings from approximately 2005 through March 2009, the State misled bond investors by omitting to disclose information about the adequacy of its statutory plan to fund its pension obligations and the risks created by the State’s Structural Underfunding of its pension obligations. During this same time period, the State also misled bond investors about the effect of changes to that plan, including the Pension Holidays in 2006 and 2007.

30. The State was aware of the Structural Underfunding and the potential effects of the underfunding. However, due largely to institutional failures, the State misled investors by omitting to disclose material information, rendering certain statements misleading, in bond offering documents regarding the State’s ability to fund its pension obligations or the impact of the State’s pension obligations on the State’s financial condition.

Remedial Acts

31. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by the State, as described in Paragraph 26, and cooperation afforded the Commission staff during the investigation.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in the State's Offer.

Accordingly, it is hereby ORDERED that, pursuant to Section 8A of the Securities Act, the State of Illinois shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act.

By the Commission.

Elizabeth M. Murphy
Secretary

END NOTES

¹ Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2576 (2012)(Roberts, C.J.).

² Id. At 2666 (Scalia, Kennedy, Thomas and Alito, JJ., dissenting).

³ Executive Office of the President, Statement of Federal Financial Accounting Concepts No. 2: Entity and Display, at 75 (2010).

⁴ Federal Accounting Standards Advisory Board, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board Statement of Federal Financial Accounting Standards 34* (July 2009).

⁵ GAO, 2012 Financial Report of the United States Government, 217 (2012). The following entities are not part of the Governmentwide reporting entity based on an assessment of these entities in accordance with the indicative criteria stated in SFFAC No. 2, Entity and Display. However, this list is not inclusive of all entities excluded from these statements. American International Group (AIG), Board of Governors of the Federal Reserve System (Including the Federal Reserve Banks), Citigroup, Federal Home Loan Banks, Freddie Mac, Fannie Mae, Thrift Savings Fund, The Financing Corporation, GMAC Financial (Ally Financial), Amtrak, Public-Private Investment Funds, Resolution Funding Corporation and Student Loan Marketing Association.

⁶ Exposure Draft excerpts.

⁷ Walter Stahr, *John Jay* 105-108 (Hambledon 2005).

⁸ Paul F. Figley & Jay Tidmarsh, *The Appropriations Power and Sovereign Immunity*, 107 Mich. L. Rev. 1207, 1253 (2009)

⁹ Id.

¹⁰ Id. at 1252-53.

¹¹ Id. at 1253.

¹² Id.

¹³ 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)

¹⁴ Id.

¹⁵ Id. at 251.

¹⁶ Id.

¹⁷ Id.

¹⁸ Id.

¹⁹ Id. at 252.

²⁰ Id.

²¹ Id.

²² Id.

²³ Id. at 253.

²⁴ Id.

²⁵ Id.

²⁶ Id.

²⁷ Id.

²⁸ Id.

²⁹ Id. at 254.

³⁰ Id.

³¹ Id.

³² Id.

³³ Id.

³⁴ Id. at 255.

³⁵ Id.

³⁶ Id.

³⁷ Id.

³⁸ Id.

³⁹ *Id.* at 256.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Halperin v. Cent. Intelligence Agency*, 629 F.2d 144, 156 (D.C. Cir. 1980).

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.* at 156.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.* at 159.

⁵⁶ The Federalist No. 48, at 278 (James Madison) (Clinton Rossiter ed., 1961).

⁵⁷ *Id.* No. 58, at 327 (James Madison).

⁵⁸ The Federalist No. 66, at 404 (Alexander Hamilton) (Clinton Rossiter ed., 1961).

⁵⁹ *Id.* No. 72, at 403 (Alexander Hamilton).

⁶⁰ *Id.* No. 78, at 433 (Alexander Hamilton).

⁶¹ 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)

⁶² *Id.*

⁶³ *U. S. v. Richardson*, 418 U.S. 166, 199-200, 94 S. Ct. 2940, 2958, 41 L. Ed. 2d 678 (1974)

⁶⁴ 1 Annal of Congress 1031, 1061, 1141.

⁶⁵ 2 Annals of Congress 302.

⁶⁶ *Halperin v. Cent. Intelligence Agency*, 629 F.2d 144, 162 (D.C. Cir. 1980)

⁶⁷ 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”).

⁶⁸ First Annual Message of George Washington (Jan. 8, 1790), reprinted in 1 THE STATE OF THE UNION MESSAGES, supra note 62, at 4.

⁶⁹ *Id.* at 168.

⁷⁰ *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).

⁷¹ *United States v. Richardson*, 418 U.S. 166 (1974). (Douglas, J., dissenting).

⁷² *Id.* At 166, 198.

⁷³ *Id.* at 200.

⁷⁴ *Id.* at 201.

⁷⁵ *Id.* At 202.

⁷⁶ *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).

⁷⁷ 31 U.S.C. 3513(a)

⁷⁸ *Id.*

⁷⁹ 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”).

⁸⁰ 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.

⁸¹ Id.

⁸² 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.

⁸³ See Stith, Kate, “Congress’ Power of the Purse” (1988). Faculty Scholarship Series. Paper 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).

⁸⁴ 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) (texturally demonstrable constitutional commitment of the issue to a coordinate political department...)”

⁸⁵ Stith, Kate, “Congress’ Power of the Purse” (1988). Faculty Scholarship Series. Paper 1267. http://digitalcommons.law.yale.edu/fss_papers/1267.

⁸⁶ Id.

⁸⁷ 31 U.S.C.A. § 3302 (b).

⁸⁸ 31 U.S.C. § 1341-51.

⁸⁹ Stith, Kate, “Congress’ Power of the Purse” (1988). Faculty Scholarship Series. Paper 1267. http://digitalcommons.law.yale.edu/fss_papers/1267.

⁹⁰ Stith, Kate, “Congress’ Power of the Purse” (1988). Faculty Scholarship Series. Paper 1267. http://digitalcommons.law.yale.edu/fss_papers/1267.

⁹¹ Stith, Kate, “Congress’ Power of the Purse” (1988). Faculty Scholarship Series. Paper 1267. http://digitalcommons.law.yale.edu/fss_papers/1267.

⁹² 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.

⁹³ Id.

⁹⁴ 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”).

⁹⁵ Id.

⁹⁶ 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).

⁹⁷ *S. Dakota v. Dole*, 483 U.S. 203, 207-09 (1987); *Nevada v. Skinner*, 884 F 2nd 445, 447 (9th Cir. 1989) *cert. denied*, 110 S. Ct. 1112.

⁹⁸ Woodrow Wilson, *Congressional Government: A Study in American Politics* (Baltimore: John Hopkins University Press, 1981; orig. ed., 1885), pp. 27, 215.

⁹⁹ The Federalist No. 51, at xxx James Madison)(Clinton Rossiter ed., 1961).

¹⁰⁰ 31 U.S.C.A. 41

¹⁰¹ 31 U.S.C. §702(a)

¹⁰² 31 U.S.C.A. § 3511

¹⁰³ *Id.*

¹⁰⁴ 31 U.S.C. 714(b)

¹⁰⁵ 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.

¹⁰⁶ 31 U.S.C. 65

¹⁰⁷ 31 U.S.C.A. 65; 31 U.S.C. §§3511-3515, 3521

¹⁰⁸ 31 U.S.C. 8351

¹⁰⁹ United States. Cong. *Budget and Accounting-Amendment*. 84th Cong., 2nd sess.

<http://www.usaid.gov/policy/ads/600/pl84-863.pdf>.

¹¹⁰ 31 U.S.C.A. §1301

¹¹¹ 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).

¹¹² 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.

¹¹³ Congressional Budget Office, *Federal Financial Reporting: Accrual Accounting and the Budget* (1977).

¹¹⁴ U.S. Gov't Accountability Office, GAO/AFMD-85-35-A, *Managing the Cost of Government: Building an Effective Financial Management Structure* (1985).

¹¹⁵ § 307. Adoption of Capital Accounting Standards. PL 101-576, 1990 HR 5687

¹¹⁶ § 3515. Financial statements of agencies, PL 103-356, 1994 S 2170

¹¹⁷ Federal Accounting Standards Advisory Board, *FASAB Facts* (2009).

¹¹⁸ 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).

¹¹⁹ 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.

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Financial Reporting - AICPA Recognizes FASAB as GAAP Standard Setter*, *Journal of Accountancy*, Mar. 2000, at 1.

¹²⁴ 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.

¹²⁵ Federal Accounting Standards Advisory Board, *FASAB News Federal Accounting Standards Advisory Board* (June/July 2010).

¹²⁶ 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.

¹²⁷ Federal Accounting Standards Advisory Board, *Accounting for Social Insurance (Revised) Statement of Federal Financial Accounting Standards Preliminary Views* (Oct. 2006).

¹²⁸ *Id.* at 8.

¹²⁹ *Id.*

¹³⁰ Federal Accounting Standards Advisory Board, *FASAB News Issue 105*, at 5 (September/October 2007).

¹³¹ "Social Security Online History Pages." The United States Social Security Administration. Web. 02 Sept. 2011. <<http://www.ssa.gov/history/nesstor.html>>.

¹³² "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>>.

¹³³ 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.

¹³⁴ U.S. Government Accountability Office, 2012 Financial Report of the United States Government, x (2012).

¹³⁵ 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>.

¹³⁶ U.S. Office of Management and Budget, President's 2014 Fiscal Year Budget, (2013).

¹³⁷ U.S. Gov't Accountability Office, 2012 Financial Report of the United States Government, (2012).

¹³⁸ *United States v. Richardson*, 418 U.S. 166 (1974).

¹³⁹ U.S. Gov't Accountability Office, 2012 Financial Report of the United States Government, 6 (2012).

¹⁴⁰ Under U.S. GAAP, most U.S. Government revenues are recognized on a 'modified cash' basis, or when they become measurable.

¹⁴¹ Kate Stith, *Rewriting the Fiscal Constitution: The Case of Gramm-Rudman-Hollings*, 76 Cal. L. Rev. 593, 607 n. 91-92 (1988).

¹⁴² "Social Security Online History Pages." The United States Social Security Administration. Web. 02 Sept. 2011. <<http://www.ssa.gov/history/nesstor.html>> (citing *Flemming v. Nestor*, 363 U.S. 603, 80 S. Ct. 1367, 4 L. Ed. 2d 1435 (1960)).

¹⁴³ Federal Accounting Standards Advisory Board, *Accounting for Social Insurance Statement of Recommended Accounting Standards Number 17* (August 1999).

¹⁴⁴ 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>.

¹⁴⁵ ¹⁴⁵ U.S. Gov't Accountability Office, 2012 Financial Report of the United States Government, (2012).

¹⁴⁶ <http://fordhamcorporatecenter.org/2012/01/24/representation-without-accountability-2/>

¹⁴⁷ U.S. Gov't Accountability Office, 2012 Financial Report of the United States Government, (2012).

¹⁴⁸ U.S. Gov't Accountability Office, 2012 Financial Report of the United States Government, (2012).

¹⁴⁹ Peter G. Peterson, *Running on Empty* 111 (Farrar, Straus and Giroux 2004).

¹⁵⁰ <http://fordhamcorporatecenter.org/2012/01/24/representation-without-accountability-2/>

¹⁵¹ Federal Accounting Standards Advisory Board, *Accounting for Social Insurance Statement of Recommended Accounting Standards Number 17*, 8, 22 (August 1999).

¹⁵² There are several key definitions and concepts one needs to be familiar with when reviewing the SOSI. The **Closed Group** includes a) participants who have attained eligibility and b) participants who have not attained eligibility. The **Open Group** adds future participants to the Closed Group.

¹⁵³ U.S. GOV'T ACCOUNTABILITY OFFICE, 2010 FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT 140 tbl.1 (2010); However, please note that this projection is based on a fiscal year starting on October 1, 2010.

¹⁵⁴ *Id.* at 141-142. Assumptions Used and Relationship to Other Financial Statements – A fundamental assumption underlying the projections in Table 1 is that current Federal policy – as defined below – does not change...The following summarizes the assumptions used for key categories of receipts and spending presented in Table 1 and in the related analysis....**Medicare:** Current law Medicare spending is based on incurred expenditures from the 2010 Medicare trustees' report, which reflect the changes in Medicare that resulted from passage of the Affordable Care Act (ACA), and, therefore, projects lower costs than in previous reports. However, some adjustments are required to convert these amounts to Medicare spending as measured by the budget. Medicare Part B and D premiums, as well as State contributions to Part D, are subtracted from gross spending in measuring Part B and Part D outlays in the budget.⁶ (Footnote 6 – Medicare Part B and D premiums and State contributions to Part D are subtracted from the Part B and D spending displayed in Table 1. The total 75-year present value of these subtractions is \$7.7 trillion, or 0.9 percent of GDP.) The budget treats these premiums as “negative spending” rather than receipts, since they represent payment for a service and in that sense “business like.” Government receipts are defined as payments obtained through the Government's sovereign power to tax. With these adjustments, Medicare spending net of administrative costs corresponds to Medicare spending in the budget. The long-term fiscal projection uses historical budget data from FY2010 for Medicare spending and Part A payroll tax revenues, with both growing at growth rates presented in the trustees' report. Also, as discussed in Note 26, there is uncertainty about whether the projected reductions in health care cost growth will be fully achieved. Note 26 includes an alternate projection to illustrate the uncertainty of projected Medicare costs. **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).⁷ (Note 7 Christopher J. Truffer, John D. Klemm, E. Dirk Hoffman, and Christian J. Wolfe, 2008 Actuarial Report of the Financial Condition for Medicaid, Office of the Actuary, Centers for Medicare and Medicaid Services, United States Department of Health and Human Services.) As projections in this 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.

¹⁵⁵ *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) AND 2012 FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT, 131-138, 155-156 (2012).

¹⁵⁶ U.S. Gov't Accountability Office, 2012 Financial Report of the United States Government, 188 (2012). ...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.

¹⁵⁷ U.S. GOV'T ACCOUNTABILITY OFFICE, 2012 FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT 21 tbl.8 (2012).

¹⁵⁸ "Trustees Report Summary." *Social Security Online Actuarial Publications*. USA Social Security Administration. Web. 04 Sept. 2011. <<http://www.ssa.gov/oact/trsum/index.html>>.

¹⁵⁹ *Id.* at 2.

¹⁶⁰ Federal Accounting Standards Advisory Board, *Accounting for Social Insurance Statement of Recommended Accounting Standards Number 17* (August 1999).

¹⁶¹ See U.S. Gov't Accountability Office, 2001-2012 Financial Reports of the United States Government (2001-2012) for Statements of Social Insurance included therein.

¹⁶² *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2663 (2012). Ginsberg, J., concurring in part and concurring in the judgment in part and dissenting in part).

¹⁶³ *Id.* at 2632.

¹⁶⁴ See Appendices A and B.

¹⁶⁵ See Schedule 4.

¹⁶⁶ U.S. Gov't Accountability Office, 2012 Financial Report of the United States Government, at 11 tbl.5 (2012).

¹⁶⁷ *Id.* at 42.

¹⁶⁸ Joseph Marren, *The Statement and Account Clause and Caperton: Part II*, JURIST - Sidebar, Apr. 18, 2013, <http://jurist.org/sidebar/2013/04/joseph-marren-caperton-partII.php>.

¹⁶⁹ *Withrow*, 421 U.S., at 47.

¹⁷⁰ Charles T. Munger, *Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger*, 390-446 (Peter D. Kaufman 2005).

¹⁷¹ *Id.* at 401.

¹⁷² THE FEDERALIST No. 72 at 257 (Alexander Hamilton (1788)).

¹⁷³ See "Setting Recusal Standards after *Caperton v. A.T. Massey Coal Company*

¹⁷⁴ *Id.* at 407.

¹⁷⁵ *Id.* at 409.

¹⁷⁶ *Id.* at 431-32.

¹⁷⁷ *Id.* at 435.

¹⁷⁸ Federal Accounting Standard Advisory Board, *Accounting for Social Insurance, Revised*, at 8 (2006).

¹⁷⁹ *Id.* at 434.

¹⁸⁰ *Id.* at 438.

¹⁸¹ Munger, *Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger*, 425 (Peter D. Kaufman 2005).

¹⁸² *Fed. Election Commission v. Akins*, 524 U.S. 11 (1998).

¹⁸³ *United States v. Hayes*, 515 U.S. 737 (1995).

¹⁸⁴ *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2576 (2012)(Roberts, C.J.).

¹⁸⁵ 531 U.S. 533 (2001).

¹⁸⁶ 319 F.Supp.2d 69 (D.D.C. 2004).

¹⁸⁷ *Fed. Election Comm'n v. Akins*, 524 U.S. 11.

¹⁸⁸ James E. Pfander, *Triangulating Standing*, 53 St. Louis U. L.J. 829, 835 (2009)

¹⁸⁹ *Id.*

¹⁹⁰ *Fed. Election Comm'n v. Akins*, 524 U.S. 11, 21, 118 S. Ct. 1777, 1784, 141 L. Ed. 2d 10 (1998)

¹⁹¹ 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>

¹⁹²

¹⁹³ 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>

¹⁹⁴

¹⁹⁵ 273 U.S. 510.

¹⁹⁶ THE FEDERALIST No. 10, p. 59 (J. Cooke ed. 1961)(J. Madison).

¹⁹⁷ 273 U.S. at 520.

¹⁹⁸ *Id.* at 522.

¹⁹⁹ *Id.* at 535.

²⁰⁰ *Ibid.*

²⁰¹ *Withrow*, 421 U.S., at 47.

²⁰² 409 U.S. 57 (1972).

²⁰³ 409 U.S., at 60.

²⁰⁴ *Ibid.*

²⁰⁵ *Gibson v. Berryhill*, 411 U.S. 564, 579 (1973).

²⁰⁶ *Withrow*, 421 U.S., at 47.

²⁰⁷ 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>

²⁰⁸ *S. Dakota v. Dole*, 483 U.S. 203, 107 S. Ct. 2793, 97 L. Ed. 2d 171 (1987).

²⁰⁹ *S. Dakota v. Dole*, 107 S. Ct. at 2794.

²¹⁰ *Id.*

²¹¹ U.S. GOV'T ACCOUNTABILITY OFFICE, 2011 FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT 32 (2011).

²¹² *Id.* at xiii.

²¹³ 9 *The Writings of James Madison* 103 (Gaillard Hunt, ed. 1910)

²¹⁴ 14 *Writings of Thomas Jefferson* 384 (Mem ed. 1903)

²¹⁵ “John Adams, *Dissertation on Canon and Feudal Law*, 1765, *From: Our Sacred Honor*, Bennett, 253.

²¹⁶ *Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2576 (2012)(Roberts, C.J.).

²¹⁷ 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).

²¹⁸ *Blue Chip Stamps*, 421 U.S. at 737.

²¹⁹ *Cf. Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (noting that the Supreme Court has repeatedly emphasized that “private actions provide ‘a most effective weapon in the enforcement’ of the securities laws and are ‘a necessary supplement to [SEC] action’” (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964))).

²²⁰ *N.Y. v. U.S.*, 505 U.S. 144, 112 S. Ct. 2408, 120 L. Ed. 2d 120 (1992).

²²¹ Erwin Chemerinsky, *Protecting the Spending Power*, 4 *Chap. L. Rev.* 89, 100 (2001).

²²² 9 *THE WRITINGS OF JAMES MADISON* 103 (Gaillard Hunt, ed. 1910).

²²³

²²⁴ Budget and Accounting-Amendment, Pub. L. No. 863 (1921), available at <http://www.usaid.gov/policy/ads/600/pl84-863.pdf>.

²²⁵ CBO’s Budgetary Treatment of Fannie Mae and Freddie Mac.

²²⁶ 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.

- ²²⁷ Stith, Kate, “Congress’ Power of the Purse” (1988). Faculty Scholarship Series. Paper 1267. http://digitalcommons.law.yale.edu/fss_papers/1267.
- ²²⁸ 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).
- ²²⁹ Louis D. Brandeis, *Other People’s Money and How the Bankers Use It* 92 (1914).
- ²³⁰ *Matrixx Initiatives et al., v. Siracusano et al*, 563 U.S. (2011).
- ²³¹ 485 U.S. 224, 231-232 (1988)
- ²³² 426 U.S. 438, 449 (1976)
- ²³³ 15 U.S.C. sec 78j(b).
- ²³⁴ 17 CFR sec 240.10b-5(b).
- ²³⁵ *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)
- ²³⁶ *Id.*, at 231-232 (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976))
- ²³⁷ 485 U.S., at 231 (quoting *TSC Industries*, 426 U.S., at 448-449).
- ²³⁸ 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”)
- ²³⁹ *Matrixx Initiatives, Inc., ET AL., Petioners v. James Siracusano ET AL.* 563 U.S. (2011)
- ²⁴⁰ 426 U.S. at 449.
- ²⁴¹ *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...”).
- ²⁴² See *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 317 (3d Cir. 1997).
- ²⁴³ 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.”)
- ²⁴⁴ *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)).
- ²⁴⁵ *TSC Industries*, 426 U.S. at 450 (quoting *Johns Hopkins U. v. Hutton*, 422 F.2d 1124, 1129 (4th Cir. 1970)).
- ²⁴⁶ Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 14, 18, 28, and 29 U.S.C.).
- ²⁴⁷ 15 U.S.C. sec 78m(j) (2006)
- ²⁴⁸ 418 U.S. 166 (1974).
- ²⁴⁹ *United States v. Richardson*, 418 U.S. 166, 178 n.11 (1974)(Burger, C.J.).
- ²⁵⁰ *Id.*
- ²⁵¹ 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>
- ²⁵² *Nat’l Fed’n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2576 (2012)(Roberts, C.J.).
- ²⁵³ *Id.* at 2571.
- ²⁵⁴ *Id.*
- ²⁵⁵ *Id.*
- ²⁵⁶ *Id.* at 2572-73.
- ²⁵⁷ *Id.* at 2666 (Scalia, Kennedy, Thomas, and Alito, JJ., dissenting).
- ²⁵⁸ *Id.* at 2663.
- ²⁵⁹ *Id.* at 2632 (Ginsberg, J., concurring in part and concurring in the judgment in part and dissenting in part).
- ²⁶⁰ *Id.* at 2604 (Roberts, C.J.).

²⁶¹ *Id.* at 2572.

²⁶² *Id.* at 2602 (Roberts, C.J.)(quoting *Barnes v. Gorman*, 536 U.S. 181, 186 (2002)).

²⁶³ *Id.*

²⁶⁴ *Id.* at 2604.

²⁶⁵ *Id.* at 2605.

²⁶⁶ *Id.* at 2602 (Roberts, C.J.).

²⁶⁷ *Id.* at 2660 (Scalia, Kennedy, Thomas, and Alito, JJ., dissenting).

²⁶⁸ *Id.* at 2633 n.17 (Ginsberg, J., concurring in part and concurring in the judgment in part and dissenting in part).

²⁶⁹ *Id.* at 2575 (2012).

²⁷⁰ Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2576 (2012)(Roberts, C.J.).

²⁷¹ U.S. GOV'T ACCOUNTABILITY OFFICE, 2010 FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT 140 tbl.1 (2010).

²⁷² *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).

²⁷³ U.S. GOV'T ACCOUNTABILITY OFFICE, 2011 FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT 32 (2011).

²⁷⁴ *Id.* at xiii.

²⁷⁵ 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).

²⁷⁶ Fed. Election Commission v. Akins, 524 U.S. 11 (1998).

²⁷⁷ United States v. Hayes, 515 U.S. 737 (1995).

²⁷⁸ 531 U.S. 533 (2001).

²⁷⁹ 319 F.Supp.2d 69 (D.D.C. 2004).

²⁸⁰ Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2576 (2012)(Roberts, C.J.).