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## Congress and Accounting Scandals: Is the Pot Calling the Kettle Black?

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# Congress and Accounting Scandals: Is the Pot Calling the Kettle Black?

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### I. Introduction

Not long ago, scandalous fraud and improper accounting practices in the private sector forced the collapse of several major corporations, including WorldCom,<sup>1</sup> Enron,<sup>2</sup> and Enron's accountant, Arthur Andersen.<sup>3</sup> Prosecutors have charged firms, as well as individual officers and executives, with criminal fraud, money laundering, conspiracy, and obstruction of justice in connection with the accounting scandals.<sup>4</sup>

1. Simon Romero & Riva D. Atlas, *WorldCom's Collapse: The Overview; WorldCom Files for Bankruptcy; Largest United States Case*, N.Y. TIMES, July 22, 2002, at A1 (reporting erosion of profits and accounting scandals leading to WorldCom's July 21, 2002 bankruptcy filing, the largest in United States history). The largest United States bankruptcy previous to WorldCom had been the Enron bankruptcy. See *infra*, note 2.
2. Richard A. Oppel, Jr. & Andrew Ross Sorkin, *Enron's Collapse: The Overview; Enron Corporation Files Largest U.S. Claim for Bankruptcy*, N.Y. TIMES, Dec. 3, 2001, at A1 (reporting Enron's December 2, 2001 filing for chapter 11 protection and reorganization in bankruptcy); see also, *In re Enron Corp.*, No. 01-16034, 2001 Bankr. LEXIS 1564 (Bankr. S.D.N.Y. Dec. 4, 2001) (Enron petition for postpetition financing to permit continuing operations during bankruptcy proceedings). For a brief summary of events leading to the Enron bankruptcy filing, see REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 2-3 (William C. Powers et al., eds., Feb. 1, 2002), available at <http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf> [hereinafter POWERS REPORT].
3. After its conviction on obstruction of justice charges on June 15, 2002, see *infra* note 4, Arthur Andersen informed the Securities and Exchange Commission that it would cease practicing before the commission by August 31, 2002. Kurt Eichenwald, *Andersen Guilty in Effort to Block Inquiry on Enron*, N.Y. TIMES, June 16, 2002, at A1.
4. In the first criminal charge ever brought against a major accounting firm, Arthur Andersen was indicted, and later convicted, on obstruction of justice charges. Kurt Eichenwald, *Andersen Charged With Obstruction in Enron Inquiry*, N.Y. TIMES, Mar. 15, 2002, at A1 (reporting Andersen indictment); Eichenwald, *supra* note 3 (reporting on Andersen conviction). Michael Kopper, a former En-

Led by Democratic Senator Paul Sarbanes of Maryland and Republican Representative Michael Oxley of Ohio, outraged legislators on both sides of the political aisle quickly responded by adopting the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, often referred to as the Sarbanes-Oxley Act.<sup>5</sup> The Act created an independent board to oversee the accounting industry, amended securities laws to require greater corporate responsibility, enhanced corporate financial disclosure requirements, and increased penalties for accounting fraud.<sup>6</sup>

Even from a Congress not known to be bashful about tough talk, public comments were especially vitriolic. Senator Chris Dodd, for example, reacted to the WorldCom accounting scandal stating, “[t]his wasn’t just cooking the books, this was marinating, sauteing, and garnishing.”<sup>7</sup> As he conducted hearings on the WorldCom accounting scandals, Representative Michael Oxley, Chair of the House Financial Services Committee, contrasted the evils of greedy corporate executives with the ideals of heroes of the American Revolution and the war on terrorism. The latter placed heroic virtues “above self-interest and

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ron managing director and aide to former Enron Chief Executive Officer, Andrew Fastow, pleaded guilty to money laundering and fraud charges. *The First Domino at Enron*, N.Y. TIMES, Aug. 22, 2002, at A22. Prosecutors subsequently charged Andrew Fastow, Enron’s former CEO, with fraud, money laundering, insider trading, and conspiracy charges as well. Alexei Barrionuevo, *Enron’s Fastow Charged With Fraud*, WALL ST. J., Oct. 3, 2002, at A3. Fastow recently pled guilty to two counts of conspiracy to commit fraud under an agreement providing for a minimum 10-year prison sentence. Kurt Eichenwald, *Couple Set to Plead Guilty in Enron Case*, N.Y. TIMES, Jan. 14, 2004, at C1; *Fastow Pleads Guilty*, BOSTON GLOBE, Jan. 15, 2004, at E2. In connection with the WorldCom scandal, prosecutors have indicted former chief financial officer, Scott D. Sullivan, and other high level executives. Carrie Johnson & Jonathan Krim, *Ex-Finance Chief, Colleague Indicted*, WASH. POST, Aug. 29, 2002, at A1 (reporting indictment of Sullivan along with Buford Yates, Jr., former director of general accounting). Yates has since pleaded guilty. Robert F. Worth, *Ex-Official of WorldCom Pleads Guilty to Fraud*, N. Y. TIMES, Oct. 8, 2002, at C9. WorldCom former comptroller, David Myers pled guilty to similar charges. Andrew Backover & Christine Dugas, *WorldCom Plea Could Help Feds’ Case*, USA TODAY, Sept. 27, 2002, at B1. Two additional WorldCom executives have since plead guilty as well. Carrie Johnson, *More Guilty Pleas from WorldCom Managers*, WASH. POST, Oct. 11, 2002, at E1 (reporting pleas from Betty L. Vinson, former director of management reporting, and Troy M. Normand, former director of legal entity accounting).

5. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) [hereinafter Sarbanes-Oxley Act].
6. Sarbanes-Oxley Act. §§ 101-109 (“Public Company Accounting Oversight Board”); §§ 301-308 (“Corporate Responsibility”); §§ 401-409 (“Enhanced Financial Disclosures”); §§ 801-807 (“Corporate and Criminal Fraud Accountability”); §§ 901-906 (“White-Collar Crime Penalty Enhancements”); §§ 1101-1107 (“Corporate Fraud and Accountability”).
7. Jonathan Karl, *Cooking the Books Is an Old Recipe for Uncle Sam*, WALL ST. J., July 22, 2002, at A14 (quoting Senator Dodd).

beyond the temptations of affluence, protecting others instead of themselves. Unfortunately, we must return to the people's House today to investigate a stark and outrageous contrast to those ideals, and yet another example of the decline of ethics in American culture during the 1990's."<sup>8</sup> Responding to the Enron scandal, Representative W.J. "Billy" Tauzin, House Energy and Commerce Committee Chair, commented that "[w]e have witnessed an incredible collection of not only miscreants and potential criminal behavior, but a series of accounting abuses . . . of the American public."<sup>9</sup>

Yet, as some journalists and commentators were quick to point out, Congress itself has been guilty of using accounting devices remarkably similar to those used by Enron, WorldCom and others to "cook the books" and to mislead the public with regard to government finances.<sup>10</sup> Comparisons of federal and private accounting standards are nothing new. As early as 1985, for example, Reagan Budget Director David Stockman, said that "[w]e have increasingly resorted to squaring the circle through accounting gimmicks, evasions, half-truths and downright dishonesty in our budget numbers . . . If the SEC had jurisdiction over the executive branches, many of us would be in jail."<sup>11</sup>

Private corporations, at least, bear the ultimate risk of bankruptcy in cases of extreme accounting shenanigans. This risk presumably provides some, however modest, check on corporate accounting gimmicks. The United States government, on the other hand, cannot go

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8. *Wrong Numbers: The Accounting Problems at WorldCom: Hearings on H.R. 3763 Before the House Comm. on Financial Services*, 107th Cong. 154 (2002) (prepared opening statement of Committee Chair, Rep. Michael Oxley).
  9. John Maggs, *Simply Shameless*, NAT'L J., Sept. 28, 2002, at 2777 (quoting Representative Tauzin). In a similar vein, Senate Majority Leader Thomas Daschle asked, "[w]ho's watching out for the stockholders, and who's watching out for the taxpayers?" *Id.*
  10. See, e.g., Martin Sullivan, *Now It's Time for Congress to Reform Its Own Accounting*, TAX NOTES, July 29, 2002, at 629; Karl, *supra* note 7; Maggs, *supra* note 9; Tom Raum, *Enron, Government Accounting Similar in Some Ways; 'Weird Economics': Relying on Overly Optimistic Projections Proves Faulty*, TELEGRAPH HERALD, Feb. 3, 2002; Tom Schatz, *Congress Worse than Enron*, SCRIPPS HOWARD NEWS SERVICE, July 10, 2002; Lance Gay, *Wanna See Shady Accounting Practices? Look at Congress*, SCRIPPS HOWARD NEWS SERVICE, Aug. 12, 2002.
  11. Karl, *supra* note 7. The General Accounting Office (GAO), which regularly reports on federal agency compliance with financial management systems and accounting standard requirements pursuant to the FEDERAL FINANCIAL MANAGEMENT IMPROVEMENT ACT OF 1996, Pub. L. No. 104-208, 110 Stat. 3009 (1996), has identified serious weaknesses and shortcomings. The GAO notes that "[w]hile much more severe at some agencies than others, the nature and seriousness of the problems indicate that, generally, agency management does not yet have the full range of information needed for accountability, performance reporting, and decision making." U.S. GENERAL ACCOUNTING OFFICE, PUB. NO. GAO-03-31, FINANCIAL MANAGEMENT: FFMIA IMPLEMENTATION NECESSARY TO ACHIEVE ACCOUNTABILITY 2 (Oct. 2002) [hereinafter FFMIA REPORT].

bankrupt. As a result, temptations for the government to engage in creative accounting may be even greater than those in the private sector.

Many budget commentators have complained about congressional gimmicks used to misstate or misrepresent the true state of the federal budget. To my knowledge, however, none of them has made an effort to compare the gimmicks used by Congress with those used by private-sector firms. One of the questions raised in this Article is the extent to which mere "gimmicks" in the hands of federal budget-makers might be considered accounting, tax, or securities fraud in the hands of the private sector. Further, if the gimmicks would be so considered, is the double standard justified? This question takes on added importance as Congress now seeks to hold the private sector to higher standards through recent corporate accountability legislation and as Congress considers proposals for budget reform.

The subject of federal accounting is complex and nuanced, requiring an understanding of distinctions between financial and budget accounting. Congress does, for example, require most federal agencies to comply with specified *financial* accounting standards.<sup>12</sup> This type of accounting for financial activities generally is a *backward-looking* process in which the agency reports its spending and receipts over a period of time, usually the preceding year. Congress also receives and disperses funds for its operations, and financially accounts for its use of federal funds. In contrast to federal agencies, however, Congress does not hold itself to particular accounting standards for purposes of these accounts.<sup>13</sup>

For purposes of this Article, the primary focus is not on congressional financial accounting for its day-to-day operations, but instead on congressional budgeting.<sup>14</sup> In contrast to financial accounting, *budget* accounting is a *forward-looking* process in which entities make plans regarding future receipts and expenditures. In the private sector, budget documents generally are internal and not subject to state and federal public disclosure rules otherwise applicable to accounting and tax documents. Government budget documents, on the other hand, are matters of public legislative record.

Recent private sector accounting scandals involved backward-looking financial accounting, whereas the congressional scandals on which this Article focuses involve forward-looking budget accounting. One might be tempted to object that this is effectively comparing apples to oranges. Not so. For one thing, modern budgeting and accounting

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12. See discussion *infra* notes 88-112 and accompanying text.

13. See discussion *infra* notes 125-129 and accompanying text.

14. While federal agencies also prepare budget reports, the focus of this Article is on congressional, as opposed to agency, budgeting. For a brief discussion of agency budgets, see *infra* notes 113-124 and accompanying text.

have become increasingly intertwined. Some uniformity of accounting practice is essential if one is to adequately assess and compare after-the-fact economic performance with before-the-fact planning and projections. In fact, as budget expert Allen Schick notes, “[a]n increasing number of state and local governments present their budgets on the basis of generally accepted accounting principles, as do a number of national governments. The United States government has not yet moved in this direction, but under the impetus of recent financial management reforms, it may do so.”<sup>15</sup> If budget information is to be usefully compared with actual performance, budget and financial documents should speak the same language. One illustration of the potential “disconnect” is the difficulty of comparing federal agency accounts to the federal budget given that the agencies use one method of accounting, while Congress uses another for purposes of federal budgeting.

Let me stress here that I have no political agenda. For some, Congress bashing has become an art, and many attacks on congressional handling of tax and budget matters are undertaken in a highly charged partisan atmosphere. I wish to distance myself from that environment. As in my prior writings, my concern is with what I label the “democracy-oriented goals of the budget process,” which include enforceability, accountability, transparency, openness, and durability.<sup>16</sup>

That Congress has adopted accounting standards applicable to others but not to itself may not be overly surprising. After all, Congress sometimes does make laws for others that it does not apply to itself. Part II of this Article explores the extent to which Congress might legitimately apply a double standard, using different accounting rules for itself in connection with the federal budget than those applicable to the private sector in connection with financial accounting. Part III considers differences between financial and budget accounting and provides analysis and comparison of accounting standards applicable to the private sector, government agencies, and to Congress itself.

Part IV contains the heart of the argument, comparing several major congressional accounting gimmicks with those used in private-sector accounting. In addition, Part IV considers congressional accounting gimmicks unavailable to the private sector. Among the most egregious congressional tricks is directed-scorekeeping, a device through which Congress simply ignores budget and revenue estimates that it does not like.<sup>17</sup> Using a big budget eraser, Congress uses di-

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15. ALLEN SCHICK, *THE FEDERAL BUDGET: POLITICS, POLICY, PROCESS* 261 (2000).

16. Cheryl D. Block, *Pathologies at the Intersection of the Budget and Tax Legislative Processes*, 43 B.C. L. REV. 863, 900-904 (2002) [hereinafter Block, *Pathologies*].

17. See discussion *infra* notes 421-451 and accompanying text.



irected-scorekeeping to sweep problems under the congressional balance sheet; it simply makes problems disappear with a wave of the congressional magic wand. This is one area in which Congress outdoes the private sector, which has no such magic wand at its disposal. In recent years, for example, Congress has avoided mandatory sequester provisions that would otherwise have been triggered by violations of budget procedures, simply declaring that the mandatory sequester amounts should be set to zero.<sup>18</sup> Democracy-oriented budget principles demand a careful examination of directed-scorekeeping.

Less obvious gimmicks can also have profound effects. For example, Congress uses cash method accounting for purposes of the federal budget even though generally accepted accounting practice calls for use of the accrual method.<sup>19</sup> The cash method takes only immediate expenses into account and does not account for future expenses. Some have argued that the disastrous savings and loan crisis of the 1980s was exacerbated by cash-based budgeting under which costs were not taken into account until banks had already failed and closed.<sup>20</sup>

Most of the federal budget accounting gimmicks described in this Article have been reported elsewhere. Many commentators, both inside and outside of Congress, have advocated changes and budget reforms addressing some of the federal budget accounting devices highlighted and critiqued in this Article. On the other hand, I was unable to find any comprehensive survey or analysis in the legal literature of particular federal budget accounting devices that distort the true economic picture and mislead the public and policymakers alike. One of the initial goals of this Article is to fill this gap by providing a comprehensive survey of federal budget accounting gimmicks. Many of these techniques closely parallel the corporate accounting gimmicks of which Congress has been so critical.

At the present time, Congress is operating without many of its former budget process rules, which expired at the end of 2002.<sup>21</sup> Congress now must decide whether to extend previous budget discipline procedures or to engage in more substantial budget reform. As it considers such reform, Congress should be mindful of the recent accounting scandals in the private sector and of its recent legislative efforts to combat such scandals. Congress itself can learn many lessons from this recent history. While laudable, major overhauls of the budget system and budget accounting procedures are not essential. As will be

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18. These budget procedures are briefly considered at *infra* notes 132-135 and accompanying text. For a fuller analysis, see Block, *Pathologies*, *supra* note 16, at 882-88.

19. See discussion *infra* notes 178-265 and accompanying text.

20. For a discussion of the budget's contribution to the savings and loan crisis, see *infra* notes 201-212 and accompanying text.

21. See discussion *infra* notes 132-136 and accompanying text.

discussed throughout this Article, improvements through incremental reform may be the appropriate first step towards future considerations of broader reform.

## II. Congressional Compliance with Its Own Laws

### A. Historical Background

One major tenet of United States constitutional history is that the laws made by Congress should be binding on everyone, including members of the legislative branch themselves. Members of Congress should not be above the law. Article I of the United States Constitution provides members of Congress with only two basic privileges: 1) freedom from arrest, with the exception of treason, felony, or breach of the peace cases; and 2) immunity from questioning about any speech or debate in the House or Senate.<sup>22</sup> Thomas Jefferson contrasted these two narrow privileges to the large number of privileges available to British Parliament members. He speculated that the United States framers' rationale for so dramatically limiting member privileges was to "provide that the *laws shall bind equally on all*, and especially that those who make them shall not exempt themselves from their operation."<sup>23</sup>

Framers of the United States Constitution were especially concerned that legislators might seek their own aggrandizement at the expense of the masses. A requirement that the *laws should bind equally on all* was among the structural checks designed by the Framers to prevent such degenerate oppressive measures. Thus, Federalist Paper 57 observes that representatives

*can make no law which will not have its full operation on themselves and their friends, as well as on the great mass of society.* This has always been deemed

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22. U.S. CONST. art. I, § 6, cl. 1 ("The Senators and Representatives . . . shall in all Cases, except Treason, Felony and Breach of the Peace, be privileged from Arrest during their Attendance at the Session of their respective Houses, and in going to and returning from the same; and for any Speech or Debate in either House, they shall not be questioned in any other Place."). The last part of clause 1 is generally referred to as the "Speech and Debate" clause. Although the constitutional privilege itself is narrow, the Supreme Court has interpreted the *scope* of the privilege rather broadly, noting that "throughout United States history, the privilege has been recognized as an important protection of the independence and integrity of the legislature." *United States v. Johnson*, 383 U.S. 169, 178 (1966). Citing Madison's FEDERALIST 48 concerning the need for the practical security of one branch against invasions from another, the Court in *Johnson* observed that "[t]he legislative privilege, protecting against possible prosecution by an unfriendly executive and conviction by a hostile judiciary, is one manifestation of the 'practical security' for ensuring the independence of the legislature." *Id.* at 179 (James Madison) (Edward Mead Earle ed., 1937).

23. THOMAS JEFFERSON, A MANUAL OF PARLIAMENTARY PRACTICE, *reprinted in* Constitution, Jefferson's Manual and Rules of the House of Representatives of the U.S., 106th Congress, H.R. Doc. No. 106-320, at 121, 125 (2001) (emphasis added).

one of the strongest bonds by which human policy can connect the rulers and the people together. It creates between them that communion of interests and sympathy of sentiments, of which few governments have furnished examples; but without which every government degenerates into tyranny.<sup>24</sup>

If the laws are to bind everyone, this constitutional legacy suggests that Congress generally should not exempt itself from its laws.

While recognizing that the laws generally should be equally binding on all, the Framers also understood that "power is of an encroaching nature, and that it ought to be effectually restrained from passing the limits assigned to it."<sup>25</sup> Each of the three branches of government is separate, but checks and balances were thought necessary to provide "some *practical security* for each, against the invasion of the others."<sup>26</sup> In order to preserve its independence and autonomy, the legislative branch should be free of invasive actions of the other branches. What emerges here is a tension between two conflicting values. On the one hand, fear of individual legislator aggrandizement at the expense of the people makes it important that the "laws shall bind equally on all."<sup>27</sup> On the other hand, independence and autonomy of the legislative branch is necessary to avoid encroachments by other departments of government. From time to time, it may be necessary for Congress to exempt itself from some of the laws imposed on others in order to preserve its independence and autonomy as a branch of government.

Not surprisingly, Congress does impose numerous rules upon the public and the executive branch that it does not impose upon itself. In each case, an appropriate question is the extent to which such congressional exemption can be justified by legislative branch needs for independence and autonomy or other legitimate reasons. Until recently, one of the most notorious of these congressional exemptions related to employment and the workforce. Prior to the Congressional Accountability Act of 1995 (CAA),<sup>28</sup> Congress exempted itself from federal anti-discrimination and other workforce protection laws. When Republicans took over control of the House in 1995, their first legislative act was passage of the CAA.<sup>29</sup> Quoting extensively from

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24. THE FEDERALIST No. 57, at 373 (Alexander Hamilton or James Madison) (Edward Mead Earle ed. 1937) (emphasis added).

25. THE FEDERALIST No. 48, at 321 (James Madison) (Edward Mead Earle ed. 1937).

26. *Id.* (emphasis added)

27. JEFFERSON, *supra* note 23.

28. Pub. L. No. 104-1, 109 Stat. 3 (1995) (codified as amended, at 2 U.S.C. §§ 1301-1438).

29. The Act extends coverage of eleven federal workplace laws to Congress. These include: The Fair Labor Standards Act of 1938, Title VII of the Civil Rights Act of 1964, The Americans with Disabilities Act of 1990, The Age Discrimination in Employment Act of 1967, The Family and Medical Leave Act of 1993, The Occupational Health and Safety Act of 1970, Chapter 71 of Title 5 (relating to Federal service labor-management relations), The Employee Polygraph Protection Act of

Federalist 57, Senator Grassley touted his own leadership in authoring the CAA and bringing this great congressional accomplishment to reality. He boasted:

I hold a strong belief that we, in Congress, are merely representatives of the people. We are not better than the people we represent and we are not, by definition and determination, different from the people we represent. We are, as representative government intends, the people themselves.

It is simply not fair, or good governance, for the Congress of the United States to enact laws for the American people, while exempting itself from compliance . . . This is a democracy, and therefore, we make laws for the people, and we, too, must follow these laws.<sup>30</sup>

Whether or not Congress should comply with its own laws is a complex question, raising both constitutional and political issues. The first major constitutional issue involves separation of powers. Laws made applicable to Congress would be enforced against Congress by the executive branch and reviewed by the judicial branch, arguably involving an inappropriate exercise of power by the latter two branches over the legislative branch.<sup>31</sup> The second major constitutional concern is that enforcement of federal laws against Congress might unconstitutionally question immunized activity under the speech and debate clause.<sup>32</sup>

Demanding that Congress comply with its own laws also raises political issues. One dominant concern is that Congress might be espe-

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1988, The Worker Adjustment and Retraining Notification Act, The Rehabilitation Act of 1973, and Chapter 43 of Title 38 (relating to veterans' employment and reemployment). 2 U.S.C. §1302(a)(1)-(11) (1995).

30. Senator Charles Grassley & Jennifer Shaw Schmidt, *Practicing What We Preach: A Legislative History of Congressional Accountability*, 35 HARV. J. ON LEGIS. 33, 34-35 (1998).
31. See, e.g., James J. Brudney, *Congressional Accountability and Denial: Speech or Debate Clause and Conflict of Interest Challenges to Unionization of Congressional Employees*, 36 HARV. J. ON LEGIS. 1, 6 (1999) ("Congressional reluctance to extend existing laws as written reflected in part a concern that Executive Branch enforcement and judicial review raised serious separation of powers issues."); see also Christina L. Deneka, Note, *Congressional Anti-Accountability and the Separation of Powers: A Survey of the Congressional Accountability Act's Problems*, 52 RUTGERS L. REV. 855, 860-70 (2000) (comparing functional and formalist separation of powers approaches to the CAA). In part, Congress addressed these separation of powers concerns by creating a quasi-independent agency for purposes of enforcing violations of workplace laws against Congress, 2 U.S.C. § 1381 (1996) (establishing the Federal Office of Compliance), and by enacting special rules for administrative and judicial disputes, 2 U.S.C. §§1401-1416 (1997).
32. See Brudney, *supra* note 31, at 21-56 (Section II: The CAA and Speech or Debate Clause Immunity). A partial response to the speech and debate clause concern in the CAA is that the respondent to a complaint and the defendant in a civil action is *the employing office* rather than the individual member. 2 U.S.C. §§1405(a), 1408(b) (1997). Thus, individual members are not liable under the CAA. A more detailed discussion of the particular constitutional issues raised by the speech and debate clause as applied to the CAA is beyond the scope of this Article.

cially vulnerable to politically motivated accusations.<sup>33</sup> After all, the executive branch is charged with enforcement or execution of the law. Particularly in a split government where the President is from one party and Congress is controlled by the other, the executive branch might be inclined to overly enforce laws against an opposition Congress. In addition, some have expressed concern that forcing congressional compliance with public laws might unduly divert members' attention away from public duties.<sup>34</sup>

In the end, deciding whether or not a particular species of laws should apply to Congress may not be as simple as it first appears. Constitutional constraints may *prohibit* the application of certain laws to Congress. At the same time, political concerns may require an assessment of costs and benefits to determine the extent to which Congress *should* apply statutory rules to itself.

## B. A Cost-Benefit Approach to Congressional Compliance Determinations

### 1. General Framework

Legal literature addressing congressional compliance with its own statutes is quite sparse. To date, most of the literature considers the extent to which individual members of Congress may be held personally liable for misconduct, focusing particularly on congressional compliance with federal laws regulating the workplace and employees.<sup>35</sup> Most of these articles were written between 1995 and 2000 in response to the Congressional Accountability Act of 1995.<sup>36</sup>

The leading article on congressional compliance was written by Professor Harold Bruff in 1995.<sup>37</sup> Professor Bruff developed both a series of cost-benefit considerations and a constitutional typology to assist in deciding when Congress should exempt itself from application of its own laws. As with the other articles from this period, Bruff's article largely focused on employment-related issues. Never-

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33. See, e.g., Grassley & Schmidt, *supra* note 30, at 36.

34. *Id.*

35. See, e.g., Brudney, *supra* note 31; Deneka, *supra* note 31; Grassley & Schmidt, *supra* note 30; James T. O'Reilly, *Collision in the Congress: Congressional Accountability, Workplace Conflict, and the Separation of Powers*, 5 GEO. MASON L. REV. 1 (1996).

36. See *supra* notes 30-32 and accompanying text. For considerations of the impact of the CAA, see Brudney, *supra* note 31; Deneka, *supra* note 31; Grassley & Schmidt, *supra* note 30; O'Reilly, *supra* note 35.

37. Harold H. Bruff, *That the Laws Shall Bind Equally on All: Congressional and Executive Roles in Applying Laws to Congress*, 48 ARK. L. REV. 105 (1995). Unlike many others, Professor Bruff's article does not focus on the Congressional Accountability Act, which passed just as his article went to press. Instead, Professor Bruff focuses on the larger picture, considering when Congress should or should not exempt itself from the burdens of its statutes.

theless, the analysis he adopts is useful in considering the wisdom of applying other types of statutory rules to the Congress itself. The sections in this Part that follow a brief description of Professor Bruff's general approach to congressional compliance issues will apply that approach to congressional budget and accounting rules.

## 2. *Advantages and Disadvantages of Congressional Compliance*

Early in our constitutional history, legislators tended to return to private life after a reasonably brief term of public service. In this climate, there may have been less concern that members be subject to the laws they enacted. After all, they would be subject to the laws soon enough upon their return to private life. Constitutional framers initially reasoned that representatives naturally would be discouraged from imposing inappropriate or unnecessary burdens on the public, because their return to private life would necessarily require them to live under the same burdens.

Today's legislators are much more likely to be career politicians serving for long periods of time in Congress.<sup>38</sup> Since those career members are no longer as likely to personally experience the burdens of their statutory demands, it is now more important that they experience those burdens during their tenure as members of Congress. Thus, one advantage of congressional compliance is ensuring that members live personally with and feel the impact of the laws they promulgate. If Congress is forced to "feel the force" of its laws, it will be in a better position to understand and appreciate them directly.<sup>39</sup>

A related advantage of congressional compliance is that it promotes higher levels of public confidence and morale. Surely, voters will have more confidence in a legislature that must live within the parameters of its laws than a legislature that exempts itself from such laws. In addition, congressional compliance may increase morale of executive branch officials and employees. Congress often imposes statutory constraints and burdens, such as conflict of interest and disclosure requirements, on those in public service in the executive branch. Failure to impose the same rules upon Congress itself may create "resentment and diminished moral imperative to comply."<sup>40</sup> If statutory rules do not apply to Congress, for example, the courts as a substitute might seek to create implied rights of action and to "at-

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38. One indication of this trend is reflected in the increasing number of representatives with over ten years seniority. From 1983 through 2001, for example, the number of House members with more than ten years seniority increased from 127 to 235 and the number of Senators with such seniority increased from 34 to 53. This data was derived from U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2002, ELECTIONS 247, tbl.382 (2002).

39. See Bruff, *supra* note 37, at 117.

40. *Id.* at 118-19.

tempt correctives, including unwise ones.”<sup>41</sup> An advantage of applying otherwise inapplicable statutory provisions to Congress might be to diminish this pressure.

If laws already apply to Congress, the executive and judicial branches have little incentive to creatively impose similar rules and correctives in unusual ways. This advantage, however, should be carefully balanced against separation of powers concerns and the possibility that when laws *do* apply to Congress, enforcement by the executive branch will be politically motivated. Overzealous executive officials or private parties might use litigation against Congress for inappropriate political reasons.<sup>42</sup>

In addition to this separation of powers balance, advantages of congressional compliance more generally must be balanced against various disadvantages. One concern is that required compliance would take significant time and effort away from important constitutional and public duties.<sup>43</sup> Another concern is that applications of laws to Congress might cause it to forfeit some of its independence and to instead develop an “unhealthy overcautiousness . . . due to overdeterrence.”<sup>44</sup> A final disadvantage of congressional compliance is that the statute may be a “[l]egal [m]isfit;” the details of the statute written for the general public may not be well-suited to the unique institution of Congress.<sup>45</sup>

### 3. *Classification of Congressional Actions*

For purposes of analyzing the propriety of requiring Congress to comply with otherwise private federal law, congressional activity can be broken into three distinct functions: 1) constitutional; 2) quasi-constitutional; and 3) proprietary.<sup>46</sup> Core constitutional functions include those specifically and exclusively delegated to the legislative branch. Most important among these, of course, is the legislative

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41. *Id.* at 118.

42. *See, e.g.*, Grassley & Schmidt, *supra* note 30, at 36 (“Members of Congress are particularly vulnerable to baseless accusations for political purposes and . . . careers can be hurt and even ended based on ill-timed charges.”); Bruff, *supra* note 37, at 120 (“If Congress subjects itself to enforcement activities of the other branches, an opportunity arises for one or both of them to harass members of Congress in retribution for their unrelated conduct of office.”).

43. *See, e.g.*, Grassley & Schmidt, *supra* note 30, at 36 (“involvement in litigation and other dispute resolution proceedings that might result from such liability would detract from the time [members] had to spend on their public duties”); Bruff, *supra* note 37, at 119 (discussing disadvantage of “[i]mpeding [p]erformance of [c]onstitutional [f]unctions”).

44. Bruff, *supra* note 37, at 120.

45. *Id.*

46. *Id.* at 120-23.

power.<sup>47</sup> Also included in the constitutional category is punishing members for misconduct in the course of legislative and related constitutional activities. Quasi-constitutional functions include investigative activities, some of which occur through formal committee and subcommittee hearings and others through more informal actions of members and staff.<sup>48</sup> Proprietary functions include housekeeping activities, such as hiring and supervising employees, purchasing supplies, and operating parking and cafeteria facilities.<sup>49</sup> Such proprietary activities are similar to those of private industry.

Rather than view constitutional, quasi-constitutional, and proprietary functions as entirely distinct, however, it may be more useful to think of a continuum, with constitutional activities at one end and proprietary functions of Congress at the other. Bruff argues that those "congressional functions nearest the constitutional core must be policed by Congress itself, and . . . activities far from that core may or must be policed by the executive."<sup>50</sup> Members engaged in core constitutional functions are fully protected by the speech and debate clause. In such cases, Congress generally should be free to adopt its own rules and to exempt itself from statutes applicable to others. Such independence is essential as a "practical security" to assure autonomy of the legislative branch.<sup>51</sup> Further removed from the constitutional core, Congress still has some need for independence and autonomy, although perhaps not as significant as in the case of the purely constitutional functions.

Workplace and employment issues fall into the proprietary category at the other end of the continuum. "When Congress performs its housekeeping functions of employment, police, and general services, it resembles the other two federal branches of state governments and private businesses."<sup>52</sup> As a matter of fairness and in keeping with cost-benefit analysis, Congress should not be exempted from adhering to its own rules when it is engaged in proprietary activities. At the same time, however, there may be constitutional separation of powers issues regarding executive branch enforcement of congressional proprietary functions.

At the end of the day, issues of congressional compliance arguably have less to do with *whether* statutes should apply to Congress than *how* they should apply.<sup>53</sup> In general, Congress *should not* exempt itself from its statutes. The question is how to provide for compliance

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47. U.S. CONST. art. I, § 1 ("All legislative Powers herein granted shall be vested in a Congress of the United States").

48. Bruff, *supra* note 37, at 122.

49. *Id.* at 123.

50. *Id.* at 120-21.

51. THE FEDERALIST No. 48, *supra* note 25 .

52. Bruff, *supra* note 37, at 140.

53. Bruff, *supra* note 37, at 114.



without creating constitutional separation of powers concerns. In other words, the key concern is with giving enforcement authority to the executive branch. In many cases, the answer may be to require congressional compliance, but to avoid entanglement of the executive branch by providing for enforcement through an independent regulatory commission.<sup>54</sup>

#### 4. *Cost-Benefit Approach to Compliance: Congressional Budgeting and Accounting*

To assess the extent to which Congress should apply its executive branch accounting requirements to itself, one should first determine where federal budgeting and accounting fall on the continuum from core constitutional to proprietary functions. Federal budgeting surely is not a proprietary activity at the private-resemblance end of the continuum. At the same time, it probably does not fall within the constitutional category at the other end. As budget observer Allan Schick notes:

The Constitution grants Congress the power to levy taxes and provides that money may be spent only pursuant to appropriations made by law. *It does not specify how those powers are to be exercised, nor does it provide for a federal budget. . . . In fact, the practice of budgeting was unknown when the Constitution was written.*<sup>55</sup>

Federal budgeting, then, arguably fits within the quasi-constitutional category. Given this placement, the distinct nature of the congressional enterprise should be recognized and respected. At the same time, since the function is not at the constitutional core, we should expect a higher degree of congressional compliance with the standards Congress imposes on other entities.

The general advantages of congressional compliance discussed above apply equally well, or perhaps even with greater force, in the accounting context. Many legislators hold office for long periods of time and do not personally experience the burdens imposed by their statutory pronouncements. Having to live with their strict accounting standards may cause members to think more carefully before imposing overly burdensome regulations upon others.<sup>56</sup> Moreover, members of Congress will better understand the general strengths and weaknesses of accounting rules that they are forced to live with themselves.

Indeed, the case for congressional compliance with regard to budget and accounting rules may be even stronger than it is for work-

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54. The Congressional Accountability Act of 1995, 2 U.S.C. §§ 1301-1438 (1995), for example, established an independent commission for purposes of enforcing workplace and employment laws against Congress.

55. SCHICK, *supra* note 15, at 9-10 (emphasis added).

56. See discussion *supra* note 39 and accompanying text.

place and employment rules. After all, accounting and budget rules are designed to increase reliability, transparency, and accountability. Financial investors are entitled to accurate accounting information with respect to private sector companies in which they invest. Since budget legislation determines overall amounts of government spending and receipts, the constituency of interested parties in budget legislation includes not just investors, but *all* citizens. Moreover, given the need for reliable and accurate empirical economic information necessary for wise budget legislation, increased reliability and transparency serves as a benefit to Congress itself. Assuming that accounting rules are well designed to serve the goals of reliability, transparency, and accountability, such rules should, *a fortiori*, apply to Congress.

Another advantage to congressional compliance is the diminishing pressure on the executive and judicial branches to overreach. When Congress exempts itself from rules imposed on others, the other branches might feel compelled to correct the legislative void in indirect and inappropriate ways.<sup>57</sup> Congressional compliance would serve prophylactically to avoid such potential overreaching. Given the existing tensions with the executive branch over budgeting, this benefit may well carry more weight in the budget and accounting context than in the workplace and employment setting.

With regard to costs, forcing congressional compliance with accounting rules would not seem to take too much time away from other public duties. After all, Congress must prepare a budget. If anything, more rigid accounting requirements might eliminate certain time-consuming game playing with gimmicks and ultimately lead to a more efficient process. To be sure, one must be concerned about overzealousness on the part of the executive branch if it is given enforcement authority over Congress. Moreover, giving such enforcement powers to the executive branch might violate constitutional separation of powers requirements. A solution to this dilemma, however, would be the use of an independent agency to assure congressional compliance with accounting standards.

A final concern is the question of "fit." If federal budgeting and accounting is significantly different from public company, executive department, or agency budgeting and accounting, then Congress might well claim exemption from rules applicable to these other entities. To be sure, there will be some budgeting and accounting issues that are unique to Congress. Perhaps Congress cannot simply extend all public company or executive branch accounting and management requirements to itself. Nevertheless, it should be possible to develop

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57. See discussion *supra* notes 40-41 and accompanying text.

specialized rules for Congress based upon the same underlying principles that drive private accounting standards.

### III. Accounting Rules

#### A. Introduction

##### 1. *Financial v. Budget Accounting*

When most of us think of accounting rules we tend to think of the financial accounting standards used by publicly-held companies to prepare their financial statements. In general, such financial documents are prepared for the use of shareholders and other outside parties concerned with the financial health of the business. One might refer to these financial statements as *external*. Annual business entity reports generally include three major financial statements. First, the *balance sheet* provides a single snapshot of assets and liabilities at a fixed moment in time, generally the close of the reporting year. Second, the *income statement* reflects receipts and expenses from business operations over the reporting year, resulting in a report of net profit or loss. Finally, as its name suggests, the *statement of cash flows* shows inflow and outflow of cash and cash-equivalent assets over the reporting period. Outflows include expenses for operating activities, interest on debt, and expenses for capital projects.<sup>58</sup> These financial reports are all backward-looking assessments of an earlier economic period in the life of the business entity.<sup>59</sup>

In the private sector, the forward-looking counterpart to financial accounting is *management* accounting, which uses economic information from the past in order to make business decisions for the future. Unlike financial accounting information, which is subject to extensive regulation and disclosure requirements, management accounting is for internal use only. Standards for internal management accounting are not generally regulated and "accounting information is generated for internal use in whatever form, and in whatever quantity, is most appropriate for the business."<sup>60</sup> Moreover, private sector budget documents generally are not available to the investing public.

That said, however, private sector companies that use formal budgets do tend to use generally accepted accounting principles in budget preparation. Although they may not be *required* to do so, private com-

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58. For a detailed discussion of the history and purposes of financial statements, see DAVID R. HERWITZ & MATTHEW J. BARRETT, *ACCOUNTING FOR LAWYERS*, 1-138 (3d ed. 2001).

59. CATHERINE GOWTHORPE, *BUSINESS & ACCOUNTING FINANCE FOR NON-SPECIALISTS*, 398 (2003) ("Conventional financial statements report events in the past; they do not tend to look forward into the future, and rarely contain any element of forecast information.")

60. *Id.* at 399.

panies also generally *choose* to use GAAP for budget purposes. This is perfectly sensible. After all, beyond establishing business objectives, one major function of a budget is to serve as a performance assessment tool. Management compares budget projections with financial statements to determine the extent to which business goals have been met. Budget makers use economic information from past financial statements to establish future business objectives. In order for a performance assessment to have much meaning, financial and budget documents ideally should use the same accounting principles.

Federal budget accounting is the public analogue to private management accounting. Like management accounting, federal budget accounting is forward-looking. The federal budget reflects public policy goals and objectives and decisions about future spending and receipts. Yet, Congress has no consistent set of accounting standards for purposes of preparing the federal budget.<sup>61</sup> If the public is to be in a position to assess the success or failure of federal budget goals, it must be able to compare the financial data from agencies with data in the budget. Congress should not only adopt specific budget accounting standards, but those standards should be consistent with the financial accounting standards imposed upon federal agencies.

## 2. *Need for Financial Accounting Standards*

There is no single set of rules that can necessarily claim to be the correct, or even the best way to account for the disclosure of financial information about companies and their transactions. At the same time, parties to economic transactions need to be able to rely upon financial statements and be in a position to compare the statements of one enterprise to another. Over time, the accounting profession has agreed upon accounting conventions to assure that parties to financial transactions generally speak the same language. These conventions are referred to as "generally accepted accounting principles" (GAAP). Despite this agreement on general conventions, "[f]inancial accounting is not a science. It addresses many questions as to which the answers are uncertain and is a 'process [that] involves continuous judgments and estimates.'"<sup>62</sup>

Virtually all public accountants now use GAAP rules, most of which are promulgated by the Federal Accounting Standards Board (FASB).<sup>63</sup> For companies regulated by the Securities and Exchange

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61. See *infra* notes 128-129 and accompanying text.

62. *Shalala v. Guernsey Mem'l. Hosp.*, 514 U.S. 87, 100 (1995) (quoting R. KAY AND D. SEARFOSS, *HANDBOOK OF ACCOUNTING AND AUDITING*, ch. 5, at 7-8 (2d ed. 1989)).

63. A detailed discussion of the history of the FASB and the development of GAAP appears *infra* notes 66-73 and accompanying text.

Commission (SEC), GAAP rules are mandatory.<sup>64</sup> Moreover, the American Institute of Certified Public Accountant's (AICPA) Code of Professional Conduct states that: "A member shall not . . . express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles . . . if such statements or data contain any departure from an accounting principle promulgated by bodies designated by the Council to establish such principles."<sup>65</sup> Thus, certified public accountants (CPAs) are obliged to use GAAP under rules of professional conduct, even for businesses *not* subject to SEC jurisdiction. In any event, small private entities not subject to SEC jurisdiction often will find that they must prepare financial statements in accordance with GAAP in order to be eligible for bank loans or other business programs.

## B. Accounting Rules Applicable to Public and Private Companies

### 1. Historical Development of Financial Accounting Standards

Accounting standards in the United States have been largely established by a private standard-setter.<sup>66</sup> From 1939 until 1973, the AICPA developed accounting principles for the private sector through its own internal committees.<sup>67</sup> In 1972, an AICPA committee chaired

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64. See *infra* notes 81-83 and accompanying text. SEC rules and interpretive releases supersede GAAP and FASB rules. In general, however, the SEC relies on principles developed by FASB and rarely promulgates its own specific accounting rules. See discussion *infra* notes 84-87 and accompanying text.

65. CODE OF PROFESSIONAL CONDUCT, Rule 203-1. (American Inst. of Certified Public Accountants 1988). For purposes of Rule 203, the AICPA "has designated the Financial Accounting Standards Board (FASB) as such a body and has resolved that FASB Statements of Financial Accounting Standards, together with those Accounting Research Bulletins and APB Opinions which are not superseded by action of the FASB constitute [such] accounting principles." CODE OF PROFESSIONAL CONDUCT, ET 203.03 (American Inst. of Certified Public Accounts 1993). For further discussion of the FASB, see *infra* notes 68-73 and accompanying text.

66. For a general critique of current accounting practices and an analysis of how private standard-setting contributed to recent accounting scandals, see George Mundstock, *The Trouble With FASB*, 28 N.C. J. INT'L L. & COM. REG. 813 (2003).

67. The AICPA created the Committee on Accounting Procedure (CAP) and the Committee on Accounting Terminology (CAT) in 1939 to develop formal accounting principles. These early principles appeared in the form of Accounting Research Bulletins (ARBs). In 1959, the AICPA replaced these committees with the Accounting Principles Board (APB), which issued accounting pronouncements in the form of APB Opinions. For a good general discussion of the historical development of financial accounting principles, see HERWITZ & BARRETT, *supra* note 58, at 152-54; Harold Dubroff, et al., *Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles*, 47 ALB. L. REV. 354, 366-74 (1983); Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL'Y 17, 75-84 (1998).

by former SEC Commissioner Francis M. Wheat recommended that accounting standards be promulgated by an independent and objective entity with broad-based public participation.<sup>68</sup> Hence, the FASB was established in 1973, taking over responsibility from the AICPA for developing standards for financial accounting and reporting. A non-profit organization, known as the Financial Accounting Foundation (FAF), selects members of the FASB and its advisory council. According to its mission statement, the FASB "is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information."<sup>69</sup> FASB promulgates both general objectives in the form of Statements of Financial Accounting Concepts (SFACs) and more specific Statements of Financial Accounting Standards (SFASs).

GAAP evolved over time from a variety of sources and now incorporates an intricate hierarchy for purposes of resolving conflicts among the various sources of accounting rules.<sup>70</sup> This combined hierarchy of sources effectively creates a sort of accounting "common law." The highest authority for GAAP rules is given to SFAS pronouncements by the FASB<sup>71</sup> and, if the FASB has not spoken on the issue, to the pronouncements of its predecessors, including Accounting Research Bulletins (ARBs) and Accounting Principles Board Opinions (APBs).<sup>72</sup> Next, GAAP rules look to pronouncements from groups of experts that deliberate in public forums and whose operating rules provide for public comment. For example, the AICPA may issue technical bulletins on subjects not otherwise covered or inadequately addressed by other sources. Third, GAAP rules include pronouncements from groups in the second order category that would have been entitled to second-order authority but for the absence of public comment mechanisms. The fourth category includes knowledgeable application of generally accepted pronouncements to specific circumstances<sup>73</sup> as well as recognized and prevalent practices in the accounting industry. Finally,

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68. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ESTABLISHING FINANCIAL ACCOUNTING STANDARDS (1972).

69. FINANCIAL ACCOUNTING STANDARDS BOARD, FASB FACTS 1 (2002), available at <http://www.fasb.org/facts/index.html> [hereinafter *FASB Facts*].

70. The following discussion of the five categories of sources for accounting principles is based on HERWITZ & BARRETT, *supra* note 58, at 168-72.

71. The SFAS "sets forth the actual standards, the effective date and method of transition, background information, a brief summary of research done on the project and the basis for the Board's conclusions, including the reasons for rejecting significant alternative solutions. It also identifies members of the Board voting for and against its issuance and includes reasons for any dissents." FASB FACTS, *supra* note 69, 6 (2002).

72. See *supra* note 67.

73. Examples include AICPA accounting interpretations and FASB questions and answers included in its implementation guides. See HERWITZ & BARRETT, *supra* note 58, at 169.

GAAP provisions incorporate other accounting literature such as FASB concept papers and AICPA issue papers.

## 2. *Securities and Exchange Commission ("SEC") Authority and Rules*

The Securities Act of 1933<sup>74</sup> and the Securities and Exchange Act of 1934<sup>75</sup> both include reporting and disclosure requirements for businesses covered by the act.<sup>76</sup> The SEC itself, established by the 1934 Act,<sup>77</sup> has the authority to promulgate accounting rules and standards for entities subject to its jurisdiction.<sup>78</sup> For example, for purposes of initial offerings under the 1933 Act, the SEC is empowered to make regulations as necessary, including regulations governing registration statements and prospectuses. More specifically, the SEC has authority "to prescribe the form or forms in which required information shall be set forth . . . and the methods to be followed in the preparation of accounts."<sup>79</sup> The SEC has similar authority to regulate forms of financial information and accounting principles for purposes of the 1934 Act.<sup>80</sup>

Despite this authority to promulgate its own accounting principles, the SEC usually follows GAAP and generally defers to the private rule-making of FASB. Under SEC rules, unless financial statements are prepared in accordance with accounting practices for which there is substantial authoritative support, they are presumed to be misleading.<sup>81</sup> When the FASB was established in 1973, the SEC announced that "principles, standards, and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such sup-

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74. 15 U.S.C. §§ 77a-77aa (1994).

75. 15 U.S.C. §§ 78a-78mm (1934).

76. The SEC's Regulation S-K integrates the disclosure requirements of both Acts, covering forms and information required for annual, periodic, and continuous reporting. 17 C.F.R. §§ 229.10-229.1016 (2003). Regulation S-B integrates an alternative set of reduced disclosure requirements under both statutes for qualifying small businesses. 17 C.F.R. §§ 228.10-228.702 (2003). In general, the 1933 Act covers new issues of stock while the 1934 Act governs day-to-day transactions in stock and the markets in which they occur.

77. Securities Exchange Act of 1934, 48 Stat. 885 (1934) (codified at 15 U.S.C. § 78d(a)) (1934).

78. Entities subject to SEC jurisdiction include "registrants" seeking to sell stock on a listed exchange or in the over-the-counter market, and, more generally, any "issuers" of stock. 15 U.S.C. § 78c(a)(8) ("The term 'issuer' means any person who issues or proposes to issue any security . . .")

79. 15 U.S.C. § 77s(a).

80. 15 U.S.C. § 78m(b)(1).

81. Administrative Policy on Financial Statements, Accounting Series Release No. 4, 11 Fed. Reg. 10,913 (Apr. 25, 1938).

port.”<sup>82</sup> Explaining its rationale for deferring to the FASB, the SEC observed that the FASB would:

provide an institutional framework which will permit prompt and responsible actions flowing from research and consideration of varying viewpoints. The collective experience and expertise of the members of the FASB and the individuals and professional organizations supporting it are substantial. Equally important, the commitment of resources to the FASB is impressive evidence of the willingness and intention of the private sector to support the FASB in accomplishing its task. In view of these considerations, *the Commission intends to continue its policy of looking to the private sector for leadership in establishing and improving accounting principles and standards through the FASB with the expectation that the body's conclusions will promote the interests of investors.*<sup>83</sup>

Although the SEC recognizes FASB as the authoritative source for establishing accounting principles, it may decide not to accept the FASB standard in rare cases.<sup>84</sup> In addition, GAAP sometimes fails to explicitly address accounting issues relevant to securities law disclosure requirements. Thus, the SEC has adopted Regulation S-X,<sup>85</sup> which focuses on the rare circumstances in which the SEC will not follow GAAP and on filling in details where “GAAP standards are not explicit and there is a need for an authoritative source.”<sup>86</sup> In many such cases, the SEC enacts gap-filling rules, which the FASB later adopts as its own.<sup>87</sup>

## C. Accounting Rules Applicable to the Federal Government

### 1. Federal Government Financial Accounting

The federal government has its own set of financial accounting rules. Although these rules tend to adopt generally accepted accounting principles, they also recognize and address particular issues unique to the federal government. Federal accounting rules and standards have developed incrementally, beginning with the Budget and Accounting Act of 1921, which simply directed the Comptroller General to prescribe forms, systems, and procedures for appropriations and accounting.<sup>88</sup> Amendments to the 1921 budget legislation clari-

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82. Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150, 39 Fed. Reg. 1260 (Dec. 20, 1973).

83. *Id.* (emphasis added).

84. Accounting Series Release No. 280, 20 S.E.C. Docket 1356 (Sept. 2, 1980).

85. 17 C.F.R. §§ 210.1-01-210.12-29 (2002).

86. Accounting Series Release No. 280, *supra* note 84.

87. STANLEY SIEGEL & DAVID A. SIEGEL, ACCOUNTING AND FINANCIAL DISCLOSURE: A GUIDE TO BASIC CONCEPTS 7 (1983) (“Often the SEC has acted as a gadfly, proposing or disseminating regulations that were later withdrawn after the accounting profession developed its own.”)

88. Pub. L. No. 67-13, §309, 42 Stat. 20 (1921) (codified as amended in scattered sections of 31 U.S.C.).



fied that agency heads should establish accounting procedures to assure full disclosure, provide adequate financial information, and control accountability for funds.<sup>89</sup> The Comptroller General was explicitly directed to prescribe “principles, standards, and related requirements for accounting to be observed by each executive agency.”<sup>90</sup> In 1949, the Comptroller General, the Treasury Secretary, and the Director of the Bureau of the Budget (now the Office of Management and Budget), signed an agreement to create a joint program to improve financial management of the federal government.<sup>91</sup> Statutory authority for the Joint Financial Management Improvement Program (JFMIP) was provided by the 1950 Budget Act.<sup>92</sup> Although standards were developed pursuant to the 1950 Act, the government did not insist on compliance and the standards were not uniformly used.<sup>93</sup>

Beginning in the 1980’s, Congress recognized the need to provide for more effective and efficient management of federal government operations and to provide greater accountability to the public. In response to these concerns, Congress first passed the Federal Managers’ Financial Integrity Act of 1982 (FIA)<sup>94</sup> to “strengthen internal controls and accounting systems throughout the federal government.”<sup>95</sup> Pursuant to the 1982 Act, the Comptroller General promulgated its *Standards for Internal Control in the Federal Government*.<sup>96</sup> Congress subsequently passed the Chief Financial Officers (CFO) Act of 1990,<sup>97</sup> which provided for modernization of federal financial management systems. This landmark legislation required specified federal executive agencies to provide annual, audited financial statements<sup>98</sup>

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89. Budget and Accounting Procedures Act of 1950, Pub. L. No. 81-784, §113(a), 64 Stat. 834, 836 (1950) (codified as amended at 31 U.S.C. § 3511 (1982)) [hereinafter 1950 Budget Act].

90. *Id.* at § 112.

91. JOINT FINANCIAL MANAGEMENT IMPROVEMENT PROGRAM, A BRIEF HISTORY OF JFMIP, at <http://www.jfmip.gov/jfmip/HISTORY.HTM> (last visited Dec. 20, 2003).

92. 1950 Budget Act, *supra* note 89, at § 111(f) (“The Comptroller General, the Secretary, and the President shall conduct a continuous program for improving accounting and financial reporting in the Government.”)

93. *See* S. REP. NO. 104-339, § 2 (1996).

94. Pub. L. No. 97-255, 96 Stat. 814 (1982) (codified at 31 U.S.C. §§3512(c),(d) (1982)).

95. FFMIA REPORT, *supra* note 11, at 6. The primary concern driving the amendments was “fraud, waste and abuse in government programs and services.” H. REP. NO. 97-38, at 2-3 (1982).

96. U.S. GEN. ACCOUNTING OFFICE, PUB. NO. GAO/AIMD-00-21.3.1, Standards for Internal Control in the Federal Government (Nov. 1999).

97. Pub. L. No. 101-576, 104 Stat. 2838 (1990).

98. 31 U.S.C. §3515 (1982) (“[T]he head of each executive agency identified in section 901(b) of this title shall prepare and submit to Congress and the Director of the Office of Management and Budget an audited financial statement for the preceding fiscal year, covering all accounts and associated activities of each office, bureau and activity of the agency.”).

and created a pilot program for auditing of overall agency operations. The Government Performance and Results Act of 1993<sup>99</sup> made the pilot programs permanent and made the CFO Act standards applicable to twenty-four executive agencies and departments.<sup>100</sup> The Comptroller General is also permitted to annually audit the consolidated financial statements of the entire executive branch.<sup>101</sup>

Private sector needs for uniform accounting rules had earlier led to the adoption of GAAP and the creation of an independent FASB to promulgate standards used in connection with GAAP.<sup>102</sup> In 1990, the Secretary of the Treasury, Director of the Office of Management and Budget, and the Comptroller General agreed to establish the Financial Accounting Standards Advisory Board (FASAB), an organization parallel to the FASB, to promulgate uniform accounting standards for the federal government.<sup>103</sup> The AICPA formally recognizes standards promulgated by the FASAB as generally accepted accounting practices for the federal government.

Despite the reforms adopted by the CFO, Congress returned to agency financial and management issues in 1996. A key concern was the absence of uniformity in federal accounting standards. The Committee on Governmental Affairs reported that

the financial management systems of the Federal government are inadequate . . . . The CFO Act . . . laid the groundwork for significant financial management reform through the appointment of agency chief financial officers and requirements for annual audited financial statements. Even with such reforms, however, federal agencies still lack many of the basic systems needed to provide uniform and reliable financial information. Without such systems, federal finances are still far from what American taxpayers have a right to expect.<sup>104</sup>

Building upon the CFO, Congress later enacted the Federal Financial Management Improvement Act (FFMIA) of 1996.<sup>105</sup> The FFMIA

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99. Pub. L. No. 103-62, 107 Stat. 285 (1993).

100. The covered agencies and departments are listed in 31 U.S.C. §901(b)(1990).

101. Pub. L. 103-356, 108 Stat. 3410, § 405(c) (1994) (codified as amended at 31 U.S.C. § 331 (e) (1), (2) (1994)).

102. See discussion *supra* notes 62-73 and accompanying text.

103. The FASAB was created as an advisory committee pursuant to the Federal Advisory Committee Act, Pub. L. No. 92-463, § 7, 86 Stat. 770 (1972). As described at its creation, the "Board, as a part of the effort under the Joint Financial Management Improvement Program to improve federal accounting and financial reporting, will consider and recommend accounting standards and principles to the Secretary of the Treasury, Director of the Office of Management and Budget, and the Comptroller General." 55 Fed. Reg. 52,322 (Dec. 17, 1990). Since its inception in 1990, the FASAB charter has been consistently renewed according to Federal Advisory Committee Act requirements, most recently in February, 2003. Renewal of FASAB Charter, 68 Fed. Reg. 7,789 (Feb. 10, 2003).

104. S. REP. 104-339, at 2 (1996).

105. Pub. L. No. 104-208, tit. VIII, 110 Stat. 3009-389 (1996) (codified as amended at 31 U.S.C. § 3512 (1997)).

requires federal agencies covered by the Act to implement and maintain financial management systems that substantially comply with: 1) federal financial management system requirements,<sup>106</sup> 2) applicable federal accounting standards, and 3) the U.S. Government Standard General Ledger.<sup>107</sup> In addition, FFMLA established audit requirements and provides for development of remediation plans for noncomplying agencies. Under FFMLA, federal agencies are expected to use the generally accepted accounting principles promulgated by the FASAB.<sup>108</sup>

Despite efforts toward reform and accountability, many federal agencies simply do not make the grade. In fact, twenty of the twenty-four agencies required to account under the Chief Financial Officers Act,<sup>109</sup> report that they do not substantially comply with FFMLA requirements.<sup>110</sup> As the GAO reported:

Many agencies still do not have reliable, useful, and timely financial information, including cost data, with which to make informed decisions and help ensure accountability on an ongoing basis. While agencies are undeniably making progress in addressing their financial management systems weaknesses, most agency systems are still not substantially in compliance with FFMLA's requirements.<sup>111</sup>

A recent GAO Report on federal accountability included inadequate reconciliation procedures, lack of accurate and timely recording of financial information, and failure to adhere to federal accounting standards as primary reasons for noncompliance.<sup>112</sup>

## 2. Budget Preparation and Accounting

Although the *formal* budget process for any fiscal year begins with the President's submission to Congress,<sup>113</sup> the *real* budget process begins approximately eight to ten months earlier.<sup>114</sup> During those

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106. Policies and standards are developed in OFFICE OF MGMT. AND BUDGET, FINANCIAL MANAGEMENT SYSTEMS, CIRCULAR No. A-127 (1993).

107. The Standard General Ledger was established in 1986 and published in the Treasury Department Financial Manual. It "promotes consistency in financial transaction processing and reporting by providing a uniform chart of accounts and pro forma transactions used to standardize federal agencies' financial information accumulation and processing throughout the year, enhance financial control, and support budget and external reporting, including financial statement preparation." FFMLA Report *supra* note 11, at 11.

108. Pub. L. No. 104-208, *supra* note 105, at § 802(a)(6). See discussion of FASAB at *supra* notes 103-104 and accompanying text.

109. See *supra* notes 97-100 and accompanying text.

110. FFMLA Report, *supra* note 11, at 2.

111. *Id.* at 15.

112. *Id.* at 17.

113. 31 U.S.C. §1105(a) (2000). This submission must be made no later than the first Monday in February of the preceding year. *Id.*

114. For a discussion of the federal executive agency's role in developing the President's budget, see SCHICK, *supra* note 15, at 30-31, 81-90.

months, individual agencies prepare their budget requests and submit them to the Office of Management and Budget (OMB), which is part of the Executive Office of the President.<sup>115</sup> Budget legislation requires each agency head to prepare and submit an appropriation request, but leaves to the President the form and timing of such agency submissions.<sup>116</sup>

The government *financial* accounting standards discussed in the previous section apply only to the backward-looking reports of prior agency activities. Thus, while the FASAB promulgates accounting standards for agency financial reporting purposes, its jurisdiction does *not* extend to budgeting.<sup>117</sup>

For purposes of budget accounting, there is no consistent and detailed set of accounting standards. Yet, agencies are instructed to follow certain general principles. For example, budget legislation requires agency appropriation requests to be developed from cost-based budgets.<sup>118</sup> Agencies are further instructed to maintain their accounts on an accrual basis in order to assist in preparing such cost-based budgets.<sup>119</sup>

Beyond this general instruction from Congress, agencies may develop their budget proposals free of statutory requirements. The OMB does, however, provide general budget preparation guidance to agencies through its Circular A-11 and through more customized "spring guidance memoranda."<sup>120</sup> Although they provide for substantial regulation of the budget preparation process, the guidelines offer a fair degree of latitude. For example, agencies are warned that the OMB *may* centrally calculate outyear policy estimates for long-term consequences of proposed programs, but offers agencies the opportunity to identify and justify deviations.<sup>121</sup> In any event, OMB guidelines can be changed at the whim of the executive, and executive budget accounting may differ from congressional budget accounting.

As Allen Schick reports, financial management of the federal government is highly fragmented. He observes that "[f]or decades, frag-

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115. 31 U.S.C. § 501 (2000).

116. 31 U.S.C. § 1108(b)(1) (2000).

117. FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD, ORIGINAL PRONOUNCEMENTS, STATEMENT OF FEDERAL FINANCIAL ACCOUNTING CONCEPTS No. 1: OBJECTIVES OF FEDERAL FINANCIAL REPORTING, at ¶ 190 (2002) [hereinafter FASAB, CONCEPT No. 1] ("The Board's authority does not extend to recommending budgetary standards or budgetary concepts, but the Board is committed to providing reliable accounting information that supports budget planning and formulation.")

118. 31 U.S.C. § 1108(b)(1).

119. 31 U.S.C. § 3512(e) (2000).

120. As a general matter, see OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, CIRCULAR No. A-11, PREPARATION, SUBMISSION, AND EXECUTION OF THE BUDGET app. B, § 30.1 (2003) [hereinafter OMB CIRCULAR No. A-11], and more specifically, 31 U.S.C. § 3512(e).

121. OMB CIRCULAR No. A-11 app. B, at § 30.2.

mentation resulted in weak coordination of budgeting and accounting, with each operating in its own sphere and having its own way of counting money."<sup>122</sup> In the past, individual agencies, and even bureaus within such individual agencies, used customized accounting systems designed for their particular needs. Although financial management reforms, including the Chief Financial Officers' Act, have made improvements,<sup>123</sup> the primary focus has been on improving financial management and agency performance. As Schick notes, the CFO Act did not give those holding the new position of chief financial officer a formal role in developing agency budgets.<sup>124</sup>

### 3. *Unique Position of Congress*

Just as federal agencies are required to provide financial reports, Congress itself must provide its own financial report. In fact, the Constitution requires that "a regular Statement and Account of Receipts and Expenditures of all public Money shall be published from time to time."<sup>125</sup> More specifically, legislation requires the Chief Administrative Officer of the House and the Secretary of the Senate to submit semi-annual financial reports to the House and Senate respectively and make them available to the public.<sup>126</sup> These financial reports simply treat Congress as a distinct financial entity, providing information regarding its expenses and receipts.

Although Congress demands that private companies and specified executive agencies comply with rigorous financial accounting standards,<sup>127</sup> it does not impose accounting standards upon itself.<sup>128</sup> Congress itself is not subject to FASAB federal government accounting rules. Moreover, neither the President's budget proposal nor the congressional budget resolution is prepared in accordance with GAAP.

At least with respect to *budget* accounting, the absence of standards might be explained by the distinct nature of budget as opposed to financial accounting. After all, GAAP rules are generally accepted *accounting* standards, not generally accepted *budgeting* standards. Although wise management practice suggests use of GAAP principles in preparing private sector budgets, such companies are not *required* to use them.

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122. SCHICK, *supra* note 15, at 256.

123. *See supra* notes 97-101 and accompanying text.

124. SCHICK, *supra* note 15, at 258.

125. U.S. CONST., art. I, § 9, cl. 7.

126. 2 U.S.C. § 104a (2000).

127. Although private companies have done a reasonable job of complying, those federal agencies that *are* bound by the various federal accounting and management requirements have failed to meet them. *See* discussion at *supra* notes 109-112.

128. Note, for example, that FFMI A accounting rules apply only to the 24 major departments and agencies covered by the Act. Each of these entities has a CFO Act agency inspector general (IG). *See supra* note 100 and accompanying text.

Even if one assumes that the financial v. budget information distinction justifies the preparation of private sector budget documents without required adherence to generally accepted accounting principles, the same logic does not extend to government. Government budget documents clearly serve a much more significant public function than private sector budget materials. Budget commentator Allen Schick observes, “[i]n business, the budget is an internal document that is not bound by accounting rules. In government, however, it is one of the principal means of communicating with citizens.”<sup>129</sup> The government budget is of critical importance to the public and receives substantial public scrutiny. If the budget is to provide citizens with information that they can understand, the information should be provided in accordance with some uniform accounting principles.<sup>130</sup> Moreover, if the budget is to provide useful information against which to assess achievement of public policy objectives, the budget should be written using similar accounting standards to those used for government financial reports.

#### IV. Congressional Budget Accounting

##### A. Introduction

Although Congress holds itself to no particular set of formal accounting standards and principles, it obviously uses *some* type of accounting principle to prepare federal budget documents. An initial concern then is identifying the accounting principles that Congress does use for purposes of the federal budget. Once those principles have been identified, one can compare the extent to which budget documents would differ if Congress used generally accepted accounting principles. A second and corollary question is whether adoption of generally accepted accounting principles would result in a better budget.

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129. SCHICK, *supra* note 15, at 259.

130. As Schick points out, “[a]n increasing number of state and local governments present their budget on the basis of generally accepted accounting principles, as do a number of national governments.” *Id.* at 261. See, e.g., CONN. GEN. STAT. §3-115(b) (2003) (“Effective with the fiscal year commencing July 1, 2003, the Comptroller is authorized to implement the use of generally accepted accounting principles, . . . , with respect to the preparation of the annual budget of the state.”); IDAHO CODE § 67-1101 (2003) (“It shall be the duty of the state controller to adopt and promulgate a uniform . . . classification of expenditures by function and object, which classifications shall be conformable to modern standards of accounting and reporting and shall be adapted to the requirements of the division of financial management for budget purposes.”); WASH. REV. CODE § 43.88.037(1) (2003) (“The director of financial management shall devise and maintain a comprehensive budgeting, accounting, and reporting system in conformance with generally accepted accounting principles applicable to state governments . . .”).

Another major accounting issue relates to congressional compliance. To the extent that Congress departs from generally accepted accounting principles, it uses a different set of standards for itself than those it imposes on private industry and on federal government departments and agencies. This departure is inconsistent with the increasing movement toward congressional compliance.<sup>131</sup> Here one must assess whether the differences between the goals of *financial accounting* as opposed to *federal budgeting* are sufficient to justify congressional use of different accounting approaches from those that it insists upon for others.

This question has added urgency for at least two reasons. First, many of the budgetary fiscal constraints introduced by the Budget Enforcement Act (BEA) in 1990 expired or “sunset” in 2002 for fiscal years 2003 and thereafter.<sup>132</sup> Under current budget procedure, the modern federal budget falls into two major categories, 1) discretionary spending, which requires annual appropriation and 2) mandatory spending for permanent programs, which includes tax legislation and entitlements.<sup>133</sup> Corresponding to each of these two major budget domains, the BEA previously imposed fiscal constraints. Spending caps applied to the discretionary spending in the first category and PAYGO restrictions applied to any new tax or entitlement legislation in the second.<sup>134</sup> Under PAYGO rules, any new legislation calling for an increase in direct spending or tax cuts had to be offset by other new legislation that decreased direct spending or increased taxes. Congressional failure to meet spending caps or PAYGO requirements

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131. See discussion *supra* notes 28-30 and accompanying text.

132. See Balanced Budget and Emergency Deficit Control Act of 1985, Pub. L. No. 95-177, 99 Stat. 1037, (providing for expiration of discretionary spending cap limits and deficit target enforcement provisions as of Sept. 30, 1991); see also 2 U.S.C. § 902 (a), (b) (2000) (providing for application of mandatory sequestration rules only to legislation enacted prior to Oct. 1, 2002). For sequestration purposes, however, the PAYGO rules continue to apply through 2006. See U.S. GEN. ACCOUNTING OFFICE, BUDGET ISSUES: BUDGET ENFORCEMENT COMPLIANCE REPORT 11, GAO-02-794, at 11 (June 2002) [hereinafter GAO, 2002 BUDGET COMPLIANCE] (“Although BEA expires in 2002, the sequestration procedure applies through 2006 to eliminate any projected net costs stemming from PAYGO legislation enacted through fiscal year 2002.”). For a detailed description of federal budget process and the application of PAYGO rules, see Block, *Pathologies*, *supra* note 16 at 870-88. Discussion of the sunset provisions and expiration of PAYGO rules appears in *id.* at 886-87.

133. See a description of the current budget structure in Elizabeth Garrett, *Rethinking the Structures of Decisionmaking in the Federal Budget Process*, 35 HARV. J. ON LEGIS. 387, 388 (1998).

134. Budget Enforcement Act of 1990, Pub. L. No. 101-508, tit. XIII, 104 Stat. 1388-573 (codified as amended at 2 U.S.C. § 902 (2000)). The President’s 2005 budget recently proposed reinstating caps on discretionary spending through 2009. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRES., BUDGET OF THE U.S. GOVERNMENT FISCAL YEAR 2005: ANALYTICAL PERSPECTIVES 215 (2004) [hereinafter 2005 ANALYTICAL PERSPECTIVES].

under the BEA triggered mandatory sequestration, which required the OMB to impose across-the-board cuts in federal programs.<sup>135</sup>

As the BEA fiscal disciplinary rules have sunset, Congress is left rudderless and must consider major federal budget reform.<sup>136</sup> More than ever, now is the appropriate time for Congress to carefully examine major problems with its budget accounting procedures. Added urgency also stems from recent accounting scandals in corporate America, which inspired congressional wrath and led to numerous accounting and securities law reforms.<sup>137</sup> Congress is concerned that many companies are using accounting practices and gimmicks that severely distort the true financial picture portrayed to interested shareholders. Particularly given such congressional accusations, the time is right to examine the extent to which Congress itself may be using similar accounting gimmicks that mislead the taxpayers. The following sections of this Article address these major issues.

## B. Cash v. Accrual Accounting in the Federal Budget

### 1. General Distinctions Between Cash and Accrual Accounting

Timing rules are among the major sources of federal budget accounting gimmickry. To understand the potential for timing tricks, one must first look at the underlying principles of cash and accrual

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135. The OMB had official sequestration enforcement responsibility and kept a sequester scorecard based upon OMB budget figures. 2 U.S.C. § 902(b). Certain programs were protected from mandatory cuts. For example, Social Security, was exempt from PAYGO sequester and Medicare could not be reduced by more than 4 percent. SENATE COMM. ON THE BUDGET, THE CONGRESSIONAL BUDGET PROCESS: AN EXPLANATION, S. REP. NO. 105-67, at 57 (1998) [hereinafter SENATE CONGRESSIONAL BUDGET EXPLANATION].

136. Congress temporarily extended PAYGO, S. Res. 304, § 2(b), 107th Cong. (2002) (enacted) (extending Senate PAYGO point-of-order rule to Apr. 15, 2003). The Senate retained a modified and weakened version of its *internal* PAYGO point of order rule in the Concurrent Budget Resolution for 2004. H.R. Con. Res. 95, 108th Cong., § 505 (2003). Senator Feingold subsequently proposed an amendment to H.J. Res 51, a joint resolution to increase the United States statutory debt limit, that would have extended *statutory* PAYGO and sequester rules, 149 CONG. REC. S7101-02 (daily ed. May 23, 2003). The PAYGO extension was rejected by the Senate. *Id.* at S7105. The President's 2004 budget indicated a willingness to work within PAYGO restrictions. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRES., BUDGET OF THE U.S. GOVERNMENT FISCAL YEAR 2004: ANALYTICAL PERSPECTIVES 315 (2003) [hereinafter 2004 ANALYTICAL PERSPECTIVES]. In an unusual and, to my mind, troubling proposal, the President's 2005 budget proposed "to extend the pay-as-you-go requirement *for mandatory spending only*. *Revenue legislation would not be subject to this requirement.*" 2005 ANALYTICAL PERSPECTIVES, *supra* note 134, at 216 (emphasis added). Under this proposal, any increase in entitlement programs would require an offsetting reduction in other programs. On the other hand, decreased revenue from tax cuts would not have to be "paid for" through increased revenue elsewhere in the budget.

137. See discussion *supra* notes 1-11 and accompanying text.



accounting methods in general and as applied to the budget in particular. In general, accounting methods focus on *timing*. Whether one is considering budget, finance, or tax, the essential accounting question is *when*; that is, determining the proper accounting period for reporting income from receipts and subtracting expenses for liabilities.<sup>138</sup> Although there is nothing especially magical about the year, and one might theoretically use some other time period for accounting purposes, the general period used for income tax and accounting has historically been the calendar year.<sup>139</sup>

The two most common methods of accounting for receipts and disbursements are the cash and the accrual methods. Unfortunately, these two methods of accounting do not have precise definitions. For federal budget purposes, the General Accounting Office defines the cash or cash-equivalent method as providing that "receipts are recorded when received and expenditures are recorded when paid, without regard to the accounting period in which the receipts are earned or the costs are incurred."<sup>140</sup> For federal income tax purposes, the cash method requires that "all items which constitute gross income . . . are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made."<sup>141</sup> Both GAO and Treasury Department definitions reflect the idea that the cash method generally follows cash flow;

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138. For example, the classic economic definition of personal income is "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between *the beginning and end of the period in question*." HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 50 (1938) (emphasis added).
139. FRANK C. MINTER, ET AL., *HANDBOOK OF ACCOUNTING AND AUDITING* A2-46 (2001) ("Precise financial information cannot be determined until a business has terminated and all its transactions are complete, but reporting at annual intervals has become accepted by custom and law because the users of financial information have been willing to sacrifice some precision for the sake of currentness."). For federal tax purposes, the Tax Code provides that income shall be computed on the basis of the taxpayer's "taxable year." I.R.C. § 441(a) (2000). This is generally the calendar year ending on December 31st, except that entities other than individuals may use a fiscal year. I.R.C. § 441(b) (2000). Since 1977, the federal government has operated on a fiscal year that begins on October 1 and ends on September 30. SENATE CONGRESSIONAL BUDGET EXPLANATION, *supra* note 135, at 55; see also STANLEY E. COLLENDER, *THE GUIDE TO THE FEDERAL BUDGET FISCAL 2000*, 203 (1999).
140. U.S. GEN. ACCOUNTING OFFICE, *A GLOSSARY OF TERMS USED IN THE FEDERAL BUDGET PROCESS: EXPOSURE DRAFT*, 19, GAO/AFMD-2.1.1 (Jan. 1993). [hereinafter GAO, GLOSSARY] "'Cash' generally refers to payment by cash, checks, or electronic funds transfers. 'Cash equivalent' refers to the use of an instrument or process that creates a substitute for cash. For example, when the government issues a debt instrument of any kind in satisfaction of claims, the transaction is recorded as simultaneous outlays and borrowing – the outlays when the debt instrument is issued, not when it is redeemed." *Id.*
141. Treas. Reg. § 1.446-1(c)(1)(i) (2002).

income is reported when cash is received and payments are reported when cash is paid out. As one tax commentator notes, the cash method “has the merit of simplicity . . . [b]ookkeeping and accounting duties are minimized; indeed, for most cash method taxpayers, all ‘accounting’ is done in the family checkbook.”<sup>142</sup> In its colorful opinion in *Knight-Ridder Newspapers, Inc. v. United States*, the Eleventh Circuit describes the cash method as “simple, plodding, elemental – stands firmly in the physical realm. It responds only through the physical senses, recognizing only the tangible flow of currency. Money is income when this raw beast actually feels the coin in its primal paw; expenditures are made only when the beast can see that it has given coins away.”<sup>143</sup>

In contrast to the cash method, GAO describes the accrual method as “the basis whereby transactions and events are recognized *when they occur*, regardless of when cash is received or paid.”<sup>144</sup> For federal tax purposes, regulations more specifically provide that “income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and . . . a liability is incurred . . . in the taxable year in which all the events have occurred that established the fact of the liability . . . and economic performance has occurred with respect to the liability.”<sup>145</sup> Under either of these definitions, the accrual method generally reflects items of income and expense *at the moment when rights and obligations arise*, rather than at the time of cash inflow or output.<sup>146</sup> The Eleventh Circuit compared the cash method to the accrual method, which

moves in a more ethereal, mystical realm. The visionary prophet, it recognizes the impact of the future on the present, and with grave foreboding or ecstatic anticipation, announces the world to be. When it becomes sure enough of its prophecies, it actually conducts life as if the new age has already come to pass. Transactions producing income or deductions spring to life in the eyes of the seer though nary a dollar has moved.<sup>147</sup>

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142. MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 267 (9th ed. 2002).

143. 743 F.2d 781, 787 (11th Cir. 1984).

144. GAO, GLOSSARY, *supra* note 140, at 19 (emphasis added). Elsewhere, the GAO defines accrual-based budget measurement as recording “revenues and expenses in the period the activity generating revenues, increasing liabilities or consuming resources occurs, regardless of when associated cash is actually received or paid.” U.S. GEN. ACCOUNTING OFFICE, ACCRUAL BUDGETING: EXPERIENCES OF OTHER NATIONS AND IMPLICATIONS FOR THE UNITED STATES 31, GAO/AIMD-00-57 (Feb. 2000) [hereinafter GAO, ACCRUAL BUDGETING]

145. Treas. Reg. § 1.446-1(c)(1)(ii) (as amended in 2002).

146. For federal income tax purposes, however, Congress and the courts have departed from traditional accrual accounting, instead requiring accrual method taxpayers under some circumstances to defer the reporting of an expense until the moment of “economic performance.” This is but one of several examples illustrating the point that tax and financial accounting do not always follow the same principles.

147. 743 F.2d at 787.

## 2. *Accrual Method Accounting*

### a) *The Concept of Matching: Tax v. Financial Accounting*

From an economic and accounting perspective, proper measurement of income requires matching *income* for particular accounting periods with the *costs* of generating that income attributable to the same accounting periods. In fact, the "matching" concept is so central to financial accounting that it is classified as a *pervasive principle* of accounting.<sup>148</sup> By this measure, the cash method fails miserably; it "makes no scientific effort either to 'time' or to 'match,' because under it the recognition of revenue and expense turns largely on the accidental factor of receipt or disbursement."<sup>149</sup> Cash method accounting is inconsistent with generally accepted accounting principles, which require use of the accrual method. For example, the FASB takes the position that "[i]nformation about enterprise earnings and its components measured by accrual accounting generally provides a better indication of enterprise performance than information about current cash receipts and payments."<sup>150</sup> As one major accounting handbook explains,

[a] statement of cash receipts and disbursements alone is not a useful indicator of future cash flows because it does not allow for relating current costs to the future revenues that they may produce. Accrual accounting makes allowances for the uneven timing of the actual payments and receipts of cash, and better enables financial statement users to judge the future earning power of the enterprise.<sup>151</sup>

Historically, taxpayers have been given a choice with respect to methods of accounting. According to the Tax Code, "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."<sup>152</sup> The two key options available under the Tax Code are the cash receipts and disbursements method and the accrual method.<sup>153</sup> Here again, the Court in *Knight-Ridder* adds a note of humor, observing that the "Code is possessed of great wisdom and tolerance. It knows that man must generally choose his own way. Therefore, it

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148. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING PRINCIPLES BOARD, STATEMENT NO. 4, BASIC CONCEPTS AND ACCOUNTING PRINCIPLES UNDERLYING FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES, at ¶ 27 (1970) (breaking accounting principles into three levels: 1) pervasive principles, 2) broad operating principles, and 3) detailed principles).

149. CHIRELSTEIN, *supra* note 142, at 275.

150. FEDERAL ACCOUNTING STANDARDS BOARD CONCEPT NO. 1, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 1: OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES, at ¶ 44.

151. MINTER, *supra* note 139, at A2-24.

152. I.R.C. § 446(a) (2000).

153. I.R.C. § 446(c) (2000).

leaves to the Taxpayer the original choice of which accounting method to use.”<sup>154</sup>

Taxpayer freedom to choose accounting methods under Internal Revenue Code provision I.R.C. § 446 is burdened with restrictions, however. For example, taxpayers engaged in the purchase and sale of inventories are required to use the accrual method.<sup>155</sup> In addition, I.R.C. § 448<sup>156</sup> prohibits use of the cash method for C corporations, partnerships that have a C corporation as a partner, and tax shelters. A 1984 Treasury Department report explained:

The cash method of accounting frequently fails to reflect the economic results of a taxpayer's business over a taxable year. The cash method simply reflects actual cash receipts and disbursements, which need not be related to economic income. Obligations to pay and rights to receive payment are disregarded under the cash method, even though they directly bear on whether the business has generated an economic profit or loss. *Because of its inadequacies, the cash method of accounting is not considered to be in accord with generally accepted accounting principles and, therefore, is not permissible for financial accounting purposes.*<sup>157</sup>

For federal income tax purposes, Congress and commentators often adopt the accounting profession's viewpoint that the accrual method “matching” principle generally results in a more accurate reflection of income.<sup>158</sup> The courts often express a similar preference for matching. In its landmark opinion in *INDOPCO, Inc. v. Commissioner*, for example, the Supreme Court stated: “the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.”<sup>159</sup>

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154. *Knight-Ridder Newspapers, Inc. v. United States*, 743 F.2d 781, 788 (11th Cir. 1984).

155. I.R.C. § 471 (2000); Treas. Reg. §1.446-1(c)(2)(i) (as amended in 2002).

156. I.R.C. § 448(a) (2000).

157. U.S. TREAS. DEP'T, 2 TAX REFORM FOR SIMPLICITY, SIMPLICITY, AND ECONOMIC GROWTH 215-16 (1984) (emphasis added); see also H.R. REP. NO. 99-426, at 605 (1985); JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 474-75 (Comm. Print 1987).

158. See, e.g., AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENT OF CONFORMITY OF TAX AND FINANCIAL ACCOUNTING (1971); B. Bernard Aidinoff & Benjamin B. Lopota, *Section 461 and Accrual-Method Taxpayers: The Treatment of Liabilities Arising From Obligations to be Performed in the Future*, 33 TAX LAW. 789, 796-97 (1980); Abraham M. Stanger, et al., *Prepaid Income and Estimated Expenses: Financial Accounting Versus Tax Accounting Dichotomy*, 33 TAX LAW. 403, 404-07 (1980); Laurie L. Malman, *Treatment of Prepaid Income – Clear Reflection of Income or Muddied Waters*, 37 TAX L. REV. 103, 146-47 (1981); John S. Nolan, *The Merit in Conformity of Tax to Financial Accounting*, 50 TAXES 761 (1972); REPORT OF THE PRESIDENT'S TASK FORCE ON BUSINESS TAXATION (Sept. 1970). Also, see a series of papers included in 2 Compendium of Papers on Broadening the Tax Base submitted to House Comm. on Ways & Means, 86th Cong. (1959).

159. 503 U.S. 79, 84 (1992). On the other hand, critics of the matching concept for tax purposes stress differences between tax and financial accounting. While es-

For individual taxpayers, the cash method seems to be a tolerable second-best, offering the advantage of greater simplicity. In support of the cash method for individual taxpayers, one might also add that the ultimate measurement of income is unlikely to be substantially different for individuals under either the cash or accrual method. Most individual taxpayers receive the bulk of their income from salary and generally do not have substantial amounts to be received in future time periods. At the same time, other than obligations for home mortgages, most individual taxpayers do not incur liabilities for payments to be made substantially in later time periods. Consequently, use of the cash method by most individual taxpayers is unlikely to generate major distortions. In contrast, the business financial picture often includes accounts receivable and accounts payable for future taxable years. Thus, under GAAP, businesses *must* use the more accurate accrual method.

Unlike tax accounting, *financial* accounting rules generally do *not* offer freedom to choose between cash and accrual methods. Since the accrual method is considered so superior as a measure of economic income, GAAP does not offer the option to use the cash-flow approach.<sup>160</sup> For purposes of financial accounting, for example, the SEC requires that businesses subject to its jurisdiction use the accrual method of accounting and otherwise comply with GAAP.<sup>161</sup>

In addition, the federal government itself adopts the accrual method of accounting for purposes of reporting the financial income of federal government departments and agencies. So, for example, FASAB rules require federal entities to report accounts receivable as income "when a federal entity *establishes a claim to cash or other assets* against other entities."<sup>162</sup> Moreover, liability is defined as a

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sentinal for financial accounting purposes, these critics argue that the matching concept does not always lead to appropriate policy results for tax accounting. *See, e.g.,* Geier, *supra* note 67; Alan Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1, 35 (1984) (arguing that "no one has ever advanced a reason for believing that matching should play a role in tax cases").

160. *See supra* notes 148-151 and accompanying text.

161. 17 C.F.R. § 210.4-01(a)(1) (2002) ("Financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided.")

162. FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD, ORIGINAL PRONOUNCEMENTS, STATEMENT OF FEDERAL FINANCIAL ACCOUNTING STANDARDS NO. 1: ACCOUNTING FOR SELECTED ASSETS AND LIABILITIES, at ¶ 41 (2002) (emphasis added) [hereinafter FASAB STANDARDS NO. 1]. Similarly, revenue from government sales of goods and services, referred to for FASAB purposes as "exchange revenues," are reported "when goods or services are provided to the public or another government entity at a price." FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD, STATEMENT OF FEDERAL FINANCIAL ACCOUNTING STANDARDS NO. 7: ACCOUNTING FOR REVENUE AND Other Financial Sources and Concepts for Reconciling Budgetary and Financial Accounting, ¶ 34 (2002) [hereinafter FASAB STANDARDS NO. 7].

“probable future outflow or other sacrifice or resource.”<sup>163</sup>

FASAB rules express their full support for accrual-based accounting as the most accurate measure for financial reporting purposes:

Accrual accounting recognizes the financial effects of transactions and events when they occur, whether or not cash changes hands at that time. *As it does with respect to exchange revenue, full accrual accounting for nonexchange revenue would enhance financial planning, control, and accountability.* Full accrual accounting could provide important data with respect to future cash flows and tax policy and could improve the ability to evaluate the performance of the collecting entities and the exercise of their custodial responsibilities.<sup>164</sup>

Although FASAB rules for the federal government generally track FASB and GAAP rules applicable to the private sector, there are some inherent limitations of the accrual method as applied to certain government activities. Reluctantly, FASAB provisions acknowledge that “the degree of accrual accounting that is practicable to perform for taxes and duties is limited by difficulties in ascertaining the amount of revenue arising from the underlying events and by the assessment processes used to manage the collecting functions.”<sup>165</sup> Given the practical difficulties of reporting revenues from taxes and duties under the accrual method, federal entities that collect such taxes or duties are entitled to use a modified cash method for such revenues.<sup>166</sup> Even these entities, however, are *permitted* to change to the accrual method “and make other changes that would result in a fuller and more complete application of accrual accounting.”<sup>167</sup>

*b) Present v. Face Value Accrual*

Although accrual accounting generally is better than cash accounting at matching income with expenses, one major difficulty is defining the precise moment at which rights and obligations arise and determining the proper amounts to be accrued. Under the accrual method, the *net present value* of income to be received in future time periods is less than the *actual face amount* of the receivable itself. Similarly, the net present value of a future payable is less than the actual face amount of the obligation itself. To most accurately reflect economic income or loss, then, accrued income and expense should be reported at its *net discounted present value*. This is the approach used for purposes of financial accounting under generally accepted accounting principles. While the concept of net present value itself is reasonably straight-forward, choice of an appropriate interest rate for purposes of

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163. FASAB STANDARDS No. 1, *supra* note 162, at ¶ 19 (emphasis added).

164. FASAB STANDARDS No. 7, *supra* note 162, at ¶ 168 (emphasis added).

165. *Id.* at ¶ 169.

166. *Id.* at ¶ 49.

167. *Id.*

discounting present values can be difficult and speculative absent a crystal ball displaying economic conditions into the future.<sup>168</sup>

Partly in response to these difficulties, Congress has chosen *not* to require accrual basis taxpayers to use traditional financial accrual accounting for future liabilities. Taxpayers using the accrual method historically have been permitted to deduct the full face value of future liabilities as long as all events have occurred that establish the fact of the liability and the amount of liability can be determined with reasonable accuracy.<sup>169</sup> In cases where actual obligations are deferred for many years, however, a full face value deduction can dramatically overstate the taxpayer's deductible expense. The most egregious case was that of *Mooney Aircraft*,<sup>170</sup> in which the aircraft manufacturing corporation issued \$1000 "Mooney Bonds" to its aircraft purchasers. Bearers of the bonds were entitled to a \$1000 payment upon retirement of the aircraft. In many cases, the aircraft were not likely to be retired for twenty or more years. Nevertheless, under the "all events" test for accrual accounting, Mooney Corporation argued that it had accrued the liability and should be permitted to deduct the full face value of the bonds at the time of issue. Unable to make a successful case against immediate deduction under the "all events" test itself, the government pulled out its next weapon. Under §446(b), the Commissioner is entitled to challenge the taxpayer's regular method of accounting if the Commissioner believes that the method used "does not clearly reflect income." Holding for the Commissioner, the Fifth Circuit agreed that the period of time between incurring and paying the obligation was simply too long.<sup>171</sup> If taxpayers simply were required to deduct the *net* discounted present value of future liabilities, as they do for financial accounting purposes, the overstatement issue in cases like *Mooney* would never arise.

By ignoring time value of money principles in connection with accrual basis accounting, Congress and the courts had created a monster.<sup>172</sup> One obvious solution to the problem would have been to bring

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168. GAAP standards do not have explicit rules for determining an interest rate to be used for discounting to present value, instead requiring the business enterprise to discount "expected cash flows at an appropriate discount rate that allows for the risk of the activities concerned." PAUL MUNTER & THOMAS A. RATCLIFFE, *APPLYING GAAP AND GAAS, PART II* § 21.02 (2003).

169. Treas. Reg. § 1.446-1(c)(1)(ii) (as amended in 2002). The regulation mentions no requirement that the liability amount deducted be discounted to net present value.

170. *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400 (5th Cir. 1969).

171. 420 F.2d at 409-11. Another case in which the Commissioner successfully used its § 446(b) authority to disallow a full face value deduction for a future liability is *Ford Motor Co. v. Comm'r*. 102 T.C. 87 (1994).

172. The House Report accompanying statutory reforms explained that under the current all events test, "an accrual basis taxpayer generally can deduct the face amount of an accrued expense." H.R. REP. NO. 98-432, at 1252 (1984); *see also*

tax accounting more in line with financial accounting, thus requiring accrual method taxpayers to reflect future liabilities at their net present value. Concerns were raised, however, that moving to a present value deduction approach for future liabilities would be too complex and subject to manipulation.<sup>173</sup> Congress instead responded by adding a new provision, which simply disallows the accrual deduction altogether until the moment of "economic performance."<sup>174</sup> Critics complained that, rather than improving the economic accuracy of tax accounting, the new provision essentially turned accrual basis into cash basis taxpayers only for purposes of deductions.<sup>175</sup>

Clearly, many tax accounting principles adopted by Congress are inconsistent with accounting and financial notions of economic matching. Rules such as the § 461(h) "economic performance" test prohibit accrual taxpayers from deducting expenses so as to appropriately offset such prepayment income. As another example, taxpayers are required under *tax* accounting rules to report any prepayments of income entirely in the year of receipt even though the receipts may be attributable to income in future tax years.<sup>176</sup> For federal income tax purposes, Congress has adopted an inconsistent and oddly hybrid assortment of cash and accrual principles. Given these inconsistencies, Congress should look to *financial* accounting standards rather than

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JAMES S. EUSTICE, THE TAX REFORM ACT OF 1984: A SELECTIVE ANALYSIS ¶ 2.03[2] (1984) ("[T]he courts had consistently allowed taxpayers to accrue a deduction currently even if the liability was in fact incurred in the current taxable year even though payment or performance would occur in the future. Since the courts ignored time value [of money] principles and allowed the full amount of the liability to be accrued, the deduction was economically overstated."); Noël B. Cunningham, *A Theoretical Analysis of the Tax Treatment of Future Costs*, 40 TAX L. REV. 577, 577 (1985) (Cunningham describes a "congressional response to transactions that were structured to take advantage of rules that did not properly account for the time value of money. These transactions were perceived as abusive, and Congress reacted with a vengeance.")

173. See *Hearings Before the Senate Finance Subcommittee on Oversight of the I.R.S.*, 98th Cong. (1983) (statement of Robert G. Woodward, Acting Treas. Dep't Tax Legis. Counsel) ("Because of uncertainty as to the proper discount rate to be employed in determining the present value of future liabilities, we are concerned that a rule allowing deductions for the present value of future expenses could be subject to manipulation."); see also Cunningham, *supra* note 172, at 588 ("Treasury opposed adopting such a rule, however, because it thought the rule would be an administrative nightmare. Since the proper amount of the deduction would not be easily ascertainable, the rule would be plagued with uncertainty and complexity, and would be an easy target for manipulation and abuse.")
174. I.R.C. § 461(h)(1) (2000), added by the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 678, § 91(a) (1984) (providing that "the all events test shall not be treated as met any earlier than when economic performance . . . occurs.")
175. See, e.g., Cunningham, *supra* note 172, at 585.
176. *Schlude v. Comm'r*, 372 U.S. 128 (1963); *American Automobile Assoc. v. United States*, 367 U.S. 687 (1961); *Automobile Club of Michigan v. United States*, 353 U.S. 180 (1957).



tax accounting standards for guidance in preparing the federal budget. Unless otherwise indicated, future references to accrual basis accounting in this Article will be to *financial* accrual rules as opposed to *tax* accrual rules.

3. *Federal Budget Accounting Methods: Cash and Obligation-Based Budgeting with a Hint of Accrual*

a) *General Description of Federal Budget Accounting Rules*

Although the choice of accounting for budget purposes may appear to be a highly technical matter, the fact is that such choices “represent much more than technical means of cost measurement; they reflect fundamental choices about the uses and functions of the budget.”<sup>177</sup> As previously noted, cash and accrual are the two major alternative approaches for tax and financial accounting. For *budget* accounting, a third alternative is obligation-based budgeting. Under this approach, “financial transactions involving the use of funds are recorded in the accounts primarily when goods and services are *ordered*, regardless of when the resources acquired are to be received or consumed.”<sup>178</sup> In fairness, federal budget accounting is most accurately described as a hybrid system using cash basis accounting as its background default rule, but which sometimes uses obligation-based or accrual-based methods. This is precisely the opposite of federal government financial accounting, which is perhaps most accurately described as a hybrid process with an *accrual* basis default rule.

Under the cash method, the cost of goods would be reflected when *payment* for the goods was made. Recall that under the accrual method, the same cost would generally be reflected when the *liability* for the cost was established, most likely at the moment of delivery of the goods, which often occurs before payment is made.<sup>179</sup> In contrast, cost of goods under the obligation-based method is reported when goods are *ordered*. Of course, an order for goods will occur before actual payment is made and before delivery of the goods. Thus, obligation-based budgeting generally results in the most rapid up-front reporting of the cost of goods purchased. Some contend that obliga-

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177. GAO, ACCRUAL BUDGETING, *supra* note 144, at 31.

178. GAO, GLOSSARY, *supra* note 140, at 19 (emphasis added); *see also* GAO, ACCRUAL BUDGETING, *supra* note 144, at 32 (“[O]bligation-based budgeting focuses on the legal obligations entered into during a period regardless of when cash is paid or received and regardless of when resources acquired are to be received or consumed.”).

179. The Tax Code sometimes restricts accrual method taxpayers, requiring them to wait to deduct expenses until “economic performance” occurs with respect to those expenses. I.R.C. § 461(h) (2000). In such cases, the deduction for a cost may be delayed until payment, thus effectively placing the taxpayer on the cash method for purposes of deducting such expenses. *See supra* notes 174-175 and accompanying text.

tion-based budgeting is the best method for providing up-front control over budget spending.<sup>180</sup>

Despite general agreement that accrual methods of accounting more accurately reflect financial income and despite the federal government's general adoption of accrual method accounting for federal government department and agency *financial* reporting,<sup>181</sup> Congress generally still uses the cash method for most government activities reflected in the federal budget.<sup>182</sup> Moreover, the bottom-line assessment of deficit or surplus is determined based upon cash receipts and outlays.<sup>183</sup> Although Congress generally uses cash method budget accounting, individual agency requests submitted to and included in the President's budget generally are cost or accrual based. This unfortunate discrepancy can lead to difficulty in interpreting government budget information and performance.

Although cash accounting is the general default rule, *some* specific government obligations and outlays are reflected in the federal budget under obligation-based accounting.<sup>184</sup> Thus, costs of goods purchased may be reflected when the government enters into a legally binding obligation to pay for them. Under this approach, costs generally are reflected even sooner than they otherwise would be under the cash or the accrual method. Under another exception to cash method accounting rules, Congress uses the accrual method for *some* budget items. For example, the federal budget uses accrual accounting to record interest on public debt.<sup>185</sup> In 1990, Congress moved to accrual-based federal budget accounting for federal credit program outlays.<sup>186</sup> Under cash-flow budgeting, direct loan outlays had been reflected as expenses, even though many of the loans were likely to be repaid and,

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180. GAO, ACCRUAL BUDGETING, *supra* note 144, at 33 (“[C]ontrol over spending is greatest if the budget recognizes the complete cost at the time the decision is made . . .”).

181. See discussion *supra* notes 148-151, 161-164, and accompanying text.

182. GAO, GLOSSARY, *supra* note 140, at 19 (“As a general rule, budget receipts and outlays are on a cash or cash equivalent basis . . .”).

183. GAO, ACCRUAL BUDGETING, *supra* note 144, at 32.

184. *Id.*

185. See, e.g., 2004 ANALYTICAL PERSPECTIVES, *supra* note 136, at 302 (“Treasury securities held by the public are measured as the par value less the unamortized discount or premium . . .”). see also, *id.* at 300, n.1; GAO, GLOSSARY, *supra* note 140, at 19; U.S. GEN. ACCOUNTING OFFICE, BUDGET ISSUES: BUDGETING FOR FEDERAL INSURANCE PROGRAMS, GAO/AIMD-97-16, 22 n.1 (1997) [hereinafter GAO, BUDGETING FOR FED. INSUR. PROGRAMS]

186. Federal Credit Reform Act of 1990, Pub. L. No. 101-508, § 13201(a), 104 Stat. 1388-610 (1990) (codified at 2 U.S.C. § 661 (2000)). Military and civilian retirement benefit costs are also now reflected in the federal budget on an accrual basis. Since the retirement benefit expense to the federal employer is paid into government retirement trust funds, the accrual accounting issues for retirement costs are different. They are discussed *infra* at notes 290-318 and accompanying text.

thus, did not reflect a real economic cost to the government. At the same time, the cost of federal loan *guarantee* programs was not reflected in the budget until the government was called upon to make payments in the event of the primary obligor's default. In connection with its 1990 budget accounting reforms, Congress reported that the cash method approach "overstates the real economic cost of direct loan programs and understates the real economic cost of loan guarantee programs in the year loans are made."<sup>187</sup> Under the revised provisions, "'cost' means the estimated long-term cost to the Government of a direct loan or loan guarantee . . . calculated on a net present value basis, excluding administrative costs and any incidental effects on government receipts or outlays."<sup>188</sup> Thus, the federal budget now accounts for estimated recoveries from borrowers and estimated expenses from defaults on a present value accrual basis.

b) *Prevalence of Cash Method Accounting in the Federal Budget*

If accrual method accounting is thought to result in the most accurate reflection of economic income and if the private companies and the federal government both use accrual accounting for *financial* purposes, one might appropriately question why accrual basis accounting is not generally used for *budget* purposes. The question is even more appropriate given that cash method budget accounting seems to invite timing gimmicks. Under the cash-flow method, for example, Congress can authorize a new program with substantial long-term costs, but not reflect those costs in the budget until payments are later made.<sup>189</sup> These timing gimmicks can result in dramatic understatement of fed-

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187. H.R. REP. NO. 101-964 at 1161 (1990).

188. 2 U.S.C. § 661a(5)(A) (2000). Direct loan costs are now reflected in the budget based upon the combined net present value of loan disbursements, repayments of principal, and payments of interest "over the life of the loan after adjusting for estimated defaults, prepayments, fees, penalties, and other recoveries." *Id.* Loan guarantees are now reflected based upon the combined net present value of (i) estimated payments by the Government to cover defaults and delinquencies, interest subsidies, or other payments and (ii) the estimated payments to the Government including origination and other fees, penalties, and recoveries. *Id.*

189. See Block, *Pathologies*, *supra* note 16, at 864-65 ("With regard to accounting, Congress uses cash-flow, rather than present value accounting. This permits Congress not to take future costs into account until they are actually paid-out, as opposed to assessing the present value of anticipated future costs."); Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process*, 65 U. CHIC. L. REV. 501, 527-28 (1998); Theodore P. Seto, *Drafting a Federal Balanced Budget Amendment That Does What it is Supposed to Do (And No More)*, 106 YALE L. J. 1449, 1481 (1997) ("timing of cash flows can easily be manipulated"); *Id.* at 1484 ("The potential for avoidance created by this inaccuracy of the cash method arises any time the government incurs an obligation that it does not immediately pay.").

eral budget deficits or an overstatement of surpluses, giving the public a rosier economic picture than appropriate.<sup>190</sup>

One major objective of the budget process surely is to provide accurate information of long-term budget impact.<sup>191</sup> When the budget is maintained on a cash-flow basis, huge future liabilities are not reflected, resulting in a highly inaccurate picture of the government's financial health. As one commentator noted, "Congress may obligate the government in ways that ensure financial catastrophe. As long as no actual payment is made, however, the cash method will report that all is well."<sup>192</sup> In addition to this "information" objective, the federal budget process should incorporate what I have earlier referred to as the "democracy-oriented" goals of accountability and transparency.<sup>193</sup> By allowing distortion and manipulation, a federal budget based upon cash method accounting arguably violates these principles. Reports from other countries that have adopted accrual-based budgeting suggest accountability and transparency advantages to the accrual approach. For example, proponents of the new accrual approach in New Zealand report that private sector accrual accounting standards are better accepted and understood by practitioners, thus "helping to ensure that the budget is understood and subject to greater public scrutiny than was possible when the budget was cash-based."<sup>194</sup> Officials in New Zealand and the United Kingdom also saw advantages in providing greater consistency between financial and budget accounting. Under their previous cash-based budget systems, these officials noted that "differing budgeting and reporting standards generally provided conflicting signals to decision makers and could lead to the failure to adequately focus on results and performance. They viewed the alignment of the basis of budgetary measurement with that used in financial accounting standards, i.e. accrual, as providing a consistent basis with which to make comparisons."<sup>195</sup>

In fairness, one should observe that cash method budgeting does offer some advantages. For one thing, it is easy to measure and easy to track. As a practical matter, the GAO points out that the time between the underlying transaction and the cash flow for many government activities, such as salary and grant payments, is relatively short

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190. See discussion *infra* notes 201, 203, 226-34, 379-94 and accompanying text.

191. GAO, 2002 BUDGET COMPLIANCE, *supra* note 132, at 37.

192. Seto, *supra* note 189, at 1483. The most significant future government obligation not now reflected in the budget is Social Security. *Id.* at 1484 ("The largest budgetary time bomb now waiting to go off is Social Security, which involves massive future payments that Congress has obligated the government to make but which, under the cash method, have no current budgetary impact."). For further discussion of Social Security issues, see *infra* notes 292-312 and accompanying text.

193. Block, *Pathologies*, *supra* note 16, at 900-04.

194. GAO, ACCRUAL BUDGETING, *supra* note 144, at 80.

195. *Id.*

in any event.<sup>196</sup> Consequently, results under accrual-based budgeting for these activities would not significantly differ from those under cash-based budgeting. Nor is there universal agreement that a move to accrual-based budgeting would necessarily improve transparency. Many accrual-based judgements require estimates, assumptions, and projections that could make budget computations more complicated.

While there are admittedly some advantages to the cash method of budgeting, the huge budget distortions resulting from the failure to appropriately reflect future liabilities from activities such as employee pension programs, retirement health programs, Social Security, and environmental clean-up simply cry out for reform. Such calls for reform date at least back to a 1967 report of the presidential budget commission, which recommended that "budget expenditures and receipts be reported on an accrual basis instead of the present cash basis."<sup>197</sup> More recently, the Director for Federal Budget Analysis noted that "[w]hile there are significant estimation and implementation challenges, accrual-based budgeting has the potential to improve budgetary information and incentives . . . by providing more accurate and timely recognition of the government's costs and improving the information and incentives for managing insurance costs."<sup>198</sup>

As previously noted, until 1990, cash-flow approaches to federal budgeting severely understated the costs of federal direct loan and loan guarantee programs, resulting in a rosier budget picture than would be reported under an accrual approach. Congress responded by switching to accrual-based budgeting for such programs.<sup>199</sup> Precisely the same concerns arise with respect to federal insurance programs, including deposit insurance. As the GAO noted, the "mismatch is most obvious for programs in which the government's commitment extends for many years into the future, such as for life insurance and pension guarantees."<sup>200</sup> In fact, some have argued that the savings and loan crisis in the 1980s was exacerbated by the shortcomings of cash-flow budgeting.<sup>201</sup> With respect to the savings and loan crisis, the GAO noted that

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196. *Id.* at 35.

197. U.S. PRESIDENT'S COMM. ON BUDGET CONCEPTS, REPORT OF THE PRESIDENT'S COMMISSION ON BUDGET CONCEPTS 7, 36-46 (1967) [hereinafter PRESIDENT'S COMMISSION REPORT].

198. *Hearings Before the House Budget Comm.*, 107th Cong. (2002) (statement of Susan J. Irving, Dir. for Fed. Budget Analysis).

199. See discussion *supra* notes 186-88 and accompanying text.

200. GAO, BUDGETING FOR FED. INSUR. PROGRAMS, *supra* note 185, at 7. The report went on to observe that "[e]ven for programs in which the insurance commitment is short term, cash-based reporting may not be adequate because some risks insured by the government - e.g., flood and crop damage - result in losses that although predictable are nevertheless variable on an annual basis." *Id.*

201. *Id.* at 3.

corrective action was delayed and the government's ultimate cost increased. The cash-based budget provided little incentive to address the growing problem because it did not recognize the costs until institutions were closed and depositors paid. This delayed budget recognition obscured the program's, as well as the government's, underlying fiscal condition and limited the budget process as a means for the Congress to assess the problem.<sup>202</sup>

**The President's 1992 budget made similar observations:**

Proper measurement of deposit insurance subsidies over the last decade would have shown that thrifts and banks were depending more heavily on deposit insurance guarantees. Without them, firms would quickly have lost the ability to fund themselves and continue to operate. The costs of deposit insurance thus would have been shown to be growing at an alarming rate. Recording this increase in exposure as part of the budget might have encouraged more timely action to reform the system and limit losses.<sup>203</sup>

Despite similar concerns for federal loan and federal insurance program budget accounting, the 1990 switch to accrual accounting for federal *credit* programs explicitly did *not* extend to federal *insurance* programs.<sup>204</sup> Recognizing, however, that similar issues were at stake, Congress directed the OMB and Congressional Budget Office (CBO) to study "whether the accounting for Federal deposit insurance programs should be on a cash basis on the same basis as loan guarantees, or on a different basis."<sup>205</sup> Reports generated pursuant to this congressional study mandate concluded that federal deposit, life, pension, and other insurance *should* be treated for budgetary purposes on an accrual basis.<sup>206</sup> Despite several legislative proposals to switch to accrual-based accounting for federal insurance programs, none has yet been enacted. For example, a proposal included in President Bush's Fiscal Year 1992 budget led to introduction of the Pension Security Accounting Act,<sup>207</sup> which would have moved federal pension and re-

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202. *Id.*

203. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE U.S. GOV, FISCAL YEAR 1992, 214-15 (1991)

204. 2 U.S.C. § 661e(a) (2000).

205. 2 U.S.C. §661e(b) (2000).

206. See CONGRESSIONAL BUDGET OFFICE, BUDGETARY TREATMENT OF DEPOSIT INSURANCE: A FRAMEWORK FOR REFORM (May 1991); OFFICE OF MGMT. & BUDGET, BUDGETING FOR DEPOSIT INSURANCE (June 1991); see also GAO, BUDGETING FOR FED. INSUR. PROGRAMS, *supra* note 185 (1992 testimony of Comptroller General and the CBO); *Hearings Before the House Budget Comm.*, 108th Cong. (2002) (statement of Susan J. Irving, Dir. for Fed. Budget Analysis, U.S. Gen. Accounting Office) (repeating that "in 1997 we reported that the current cash-based budget generally provides incomplete information on the costs of federal insurance programs. The ultimate costs to the federal government may not be apparent up front because of time lags between the extension of the insurance, the receipt of premiums, and the payment of claims. While there are significant estimation and implementation challenges, accrual-based budgeting has the potential to improve budgetary information and incentives . . . for managing insurance costs.")

207. Enhanced Economic Growth and Job Creation Act of 1992, H.R. 4200, 102d Cong., tit. II (1992).

tirement benefit insurance programs to accrual-based budgeting similar to that adopted for federal direct loans and loan guarantees in 1990.<sup>208</sup> The federal insurance issue resurfaced in the 105th Congress, in which the Budget Committee formed the Task Force on Budget Process Reform.<sup>209</sup> After Task Force hearings in 1998, Representatives Nussle and Cardin introduced the Comprehensive Budget Process Reform Act of 1998, which was referred to the Budget Committee, but never acted upon.<sup>210</sup> They reintroduced a similar measure in the 106th Congress as the Comprehensive Budget Process Reform Act of 1999.<sup>211</sup> Included among the proposed reforms was a provision requiring Congress and the President to switch from cash to accrual-based budgeting for federal insurance programs.<sup>212</sup>

One explanation for the less than enthusiastic response to proposed federal insurance budgeting reforms may be the tempered reaction of expert witnesses testifying on the issue before the House Budget Committee. Few would question that cash-based budgeting for federal insurance programs provides a distorted and misleading picture of the federal government's financial position.<sup>213</sup> In fact, witnesses before the Budget Committee all agreed that the cash-flow approach to federal insurance was fundamentally flawed. For example, one witness testified that

cash-based budgeting for insurance programs presents several problems. Its focus on single period cash flows can obscure the program's cost to the government and thus may (1) distort the information and incentives presented to policymakers, (2) skew the recognition of the program's economic impact, and (3) cause fluctuations in the deficit unrelated to long-term fiscal balance.<sup>214</sup>

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208. While stating their general support for such a change, both the GAO and the CBO objected to the administration's specific proposals in 1992, arguing in part that the "selective application of the accrual concept reinforces the notion that the change was proposed more for particular policy purposes rather than for improved financial management." U.S. GEN. ACCOUNTING OFFICE, ACCRUAL BUDGETING, GAO/AFMD-92-49R, at 4 (Feb. 1992) (letter from Gen. Charles A. Bowsher, Comptroller, to Senate Comm. on Governmental Affairs with enclosed letter from Robert D. Reischauer, Dir. of CBO to Senate Budget Comm.).
209. H.R. 105-844, Activities and Summary Report of the Comm. on the Budget during the 105th Cong., at 15 (1999).
210. H.R. 4837, 105th Cong., tit. V (1998).
211. H.R. 853, 106th Cong., tit. V (1999).
212. *Id.* at § 603.
213. As a matter of terminology, the FASAB distinguishes between "financial position" and "financial condition." The concept of financial position is a balance-sheet type notion that provides "a 'point-in-time' snapshot of an entity's economic resources and the claims on those resources." FASAB, CONCEPT NO. 1, *supra* note 117, ¶¶ 177-82. "Financial condition," on the other hand, is "broader and more forward-looking." For the U.S. government, the additional data could include financial and nonfinancial information about current conditions and reasonable expectations regarding the national and even the global society." *Id.* ¶ 180.
214. *Hearings Before the House Budget Comm.*, 105th Cong. (1998) [hereinafter *1998 House Budget Hearings*] (statement of Susan J. Irving, Assoc. Dir., Budget Is-

Witnesses before the Budget Committee praised the 1990 budget reforms applicable to federal loans and loan guarantees and noted that the same accounting issues are raised in the context of federal insurance.<sup>215</sup>

At the same time, however, the witnesses acknowledged major implementation challenges to accrual-based budgeting for federal insurance programs. Most important, they noted, were the difficulties in estimating or forecasting future insured losses. In most instances of federal government insurance protection, the private sector has refused to provide insurance because of its inability to adequately assess the probability of highly uncertain risks. Surely, the federal government will face the same challenges as it attempts to estimate the extent of future liabilities. As Susan Irving observed, "when underlying conditions are not fully understood, estimates are said to be made under uncertainty. This is the case for most federal insurance programs due to the nature of the risks insured, program modifications, and other changes in conditions that affect potential losses."<sup>216</sup> In addition to obligations resulting from actual federal insurance programs, the government sometimes is called upon to bailout state or local governments, or even private industry, in cases of emergency.<sup>217</sup> Esti-

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sues, GAO, Accounting and Information Mgmt. Div.); *see also id.* (statement of Marvin Phaup, CBO Deputy Ass't Dir., Spec. Studies Division) ("[C]urrent cash basis of accounting used in the federal budget provides policymakers with neither the information nor the incentives to control the cost of government insurance programs."); *id.* (statement of Rudolph G. Penner, Senior Fellow, Urban Institute) (Budget accounting for federal government's insurance programs "can give a totally misleading picture of the financial health of such programs."); *see also Hearing on H.R. 853 Before House Budget Comm.*, 106th Cong. (1999) [hereinafter *1999 House Budget Hearings*] (statement of Dan L. Crippen, Dir., CBO) ("Although [the] budgetary picture makes PBGC [Pension Guarantee Guaranty Corporation] appear to be a moneymaker for the U.S. government, cash-based accounting does not acknowledge the liabilities that the agency has accrued but has yet to pay and does not address taxpayers exposure from the insurance commitments."); *Hearings Before the Comm. on Rules*, 106th Cong. (1999) [hereinafter *1999 House Rules Comm. Hearings*] (statement of Susan J. Irving, GAO Assoc. Dir., Budget Issues, Accounting and Information Management Division) ("The budget was not designed to and does not provide complete information on long-term cost implications stemming from some of the government's commitments when they are made. We have long advocated that policymakers need information on the long-term cost consequences of today's commitments.").

215. *See, e.g., 1998 House Budget Hearings, supra* note 214 (statement of Rudolph G. Penner) ("Although analysts also face formidable difficulties in making the estimates necessary to implement the Credit Reform Act of 1990 (CRA), I believe that it has been extremely successful.").

216. *Id.* (statement of Susan J. Irving).

217. *See, e.g., Chrysler Corporation Loan Guarantee Act of 1979*, Pub. L. No. 96-185, 93 Stat. 1324 (1980); *Emergency Loan Guarantee Act of 1979*, Pub. L. No. 92-70, 85 Stat. 178 (1971) (legislation motivated by financial problems of the Lockheed Aircraft Corporation); *New York City Loan Guarantee Act of 1978*, Pub. L. No. 95-339, 92 Stat. 460 (1978); *New York City Seasonal Financing Act of 1975*, Pub.



mates of such long-term risks are even more difficult than risk estimates for formal programs such as deposit and pension insurance.

One can argue that the government confronts similar issues in estimating future costs from direct loans that will never be repaid and loans that it is called upon to pay pursuant to a loan guarantee when the obligor defaults. Despite these difficulties, Congress manages to make reasonable estimates for accrual-based budgeting of loans and loan guarantees. Yet, two differences arguably make the estimation problems far more difficult in the context of federal insurance programs. First, although the probability of risk may be uncertain, at least the *amount* of potential risk exposure is generally limited and measurable in the context of federal government loans and loan guarantees. Second, since loans generally have fixed terms, the *time period* of risk exposure generally is limited and measurable in the loan context.<sup>218</sup> In contrast, the magnitude and timing of federal government insurance programs, particularly for deposit insurance and pension guarantees is much more difficult to forecast.<sup>219</sup>

A small, but significant, change in the 1999 proposal for switching to accrual-based budgeting for federal insurance should have made the proposal more palatable to those with administrative feasibility concerns based on estimation challenges. The reform version introduced in the 106th Congress would have delayed full implementation of accrual budgeting until fiscal year 2006.<sup>220</sup> In his testimony on the provision, CBO Director Dan Crippen took the position that the "lengthy transition is appropriate and would give agencies with operating responsibilities for insurance programs - as well as the OMB and the CBO - some time to collect the relevant data, develop and test financial models of those processes, and display the results in the budget documents on a trial basis."<sup>221</sup> At the same hearing, however, another witness praised the delayed date for moving to the accrual-based approach, but complained that the proposed legislation also provided for a sunset after only two years. This was viewed as problematic because "the knowledge that the numbers would only be used in the budget for two years could reduce the pressure to do the hard work necessary to develop good estimates . . . and changing the basis of budget numbers for only 2 years is likely to be both burdensome and confusing."<sup>222</sup>

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L. No. 94-143, 89 Stat. 797 (1975). For a comprehensive discussion of the many different types of federal bailouts, see Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L. J. 951 (1992).

218. See *1998 House Budget Hearings*, *supra* note 214 (statement of Marvin Phaup).

219. Estimates of risk exposure might be slightly less complicated in the case of shorter-term programs, including federal flood and crop insurance.

220. H.R. 853, §§ 602-603, 106th Cong. (1999).

221. *1999 House Budget Hearings*, *supra* note 214 (statement of Dan L. Crippen).

222. *Id.* (statement of Susan J. Irving).

The time has come for Congress finally to act. Cash-based budget accounting for federal insurance programs results in substantial distortions. Given the greater accuracy of accrual accounting, Congress now insists that taxpayers use the accrual method for inventories and requires many businesses to adopt accrual-based accounting for tax purposes.<sup>223</sup> Congress should similarly impose more accrual-based rules upon itself. Despite an ongoing discussion of the problem and repeated task force and departmental studies since at least 1992,<sup>224</sup> little movement has occurred. All seem to be agreed that the switch to accrual-based accounting must be made and that the sticking point is establishing the appropriate methodology and resources for estimating future government obligations. A delayed switch without the two-year sunset provision would put feet to the fire and perhaps move the estimation methodology process along.

A compromise approach suggested by one witness was to make present value estimates informational,

unless the gap between the present value of receipts and outlays on the stock of outstanding insurance exceeded some threshold, say 5 percent of the present value of premiums. At that point, an appropriation could be required to create a sufficient reserve to bring the subsidy value under the threshold or the law could require an increase in premiums or a reduction in benefits. This approach would mean that the Congress would not be beholden to uncertain estimates of present values each and every year, but would be forced to take action if things were getting severely out of line.<sup>225</sup>

Another compromise would be to move ahead with respect to those federal insurance programs for which estimating techniques can be developed more quickly. For example, better historical and actuarial data is available with respect to flood and crop insurance than for deposit and pension insurance. Congress has already adopted a partial and incremental approach toward accrual-based budget accounting by providing for such accounting with respect to some items and not others. Administrative problems regarding estimation for some federal insurance programs should not hinder the movement to accrual-based accounting for other insurance programs with respect to which estimation concerns are not as great.

*c) Cash Method Budget Accounting – Potential for Timing Gimmicks*

*(i) Delayed Outflows: Advance Appropriations and Related Budget Devices*

A rather crass motive unfortunately may explain the congressional reluctance to switch to accrual-based budgeting for more budget

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223. See discussion *supra* at notes 156-57 and accompanying text.

224. See discussion *supra* at notes 207-12 and accompanying text.

225. 1999 House Budget Hearings, *supra* note 214 (statement of Rudolph G. Penner).

items. Cash method accounting offers many opportunities to manipulate the timing of receipts and expenses for budget purposes and such budget gimmicks are often simply too difficult for legislators to resist. One common congressional timing gimmick repeatedly used under cash method budget accounting is to delay outflows until periods outside the budget window.<sup>226</sup> This technique was especially popular in the world of spending caps and PAYGO budget limitations, which required that spending increases be offset with increased revenue.<sup>227</sup> Budget expert, Allen Schick, notes that the “easiest way to remove a spending increase from the score is to schedule it to take effect beyond the period covered by the baseline” so that it will never be scored as a spending increase.<sup>228</sup> Another observer similarly remarked that “[f]iddling with the fiscal year – either to put an expenditure in an earlier or later accounting period, depending on which will help the most – is a pure (if that word may be used) gimmick. Defense salaries may be paid a day earlier or later, thus saving billions for the next fiscal year. Medicare miraculously lived on an 11-month year in 1980 and 13-month year in 1981.”<sup>229</sup>

One common method for delaying outflows is to provide for advance appropriations or to phase in program expansions over a period of years beyond the budget window. Under budget scorekeeping rules, advance appropriations are “scored as new budget authority in the fiscal year in which the funds become newly available for obligation, not when the appropriations are enacted.”<sup>230</sup> Despite repeated efforts, and some successes, in limiting advance appropriations, the technique is still popular with congressional budget makers.<sup>231</sup> Enron appar-

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226. Historically, Congress has adopted a five-year window for purposes of federal budgeting, the statutory minimum pursuant to 2 U.S.C. §632(a) (1974) (“The concurrent resolution shall set forth appropriate levels for the fiscal year beginning on Oct. 1 . . . and for at least each of the 4 ensuing fiscal years . . .”). More recently, however, Congress has moved to a ten-year period. See discussion in Block, *Pathologies*, *supra* note 16, at 875; see also Garrett, *supra* note 189, at 527. President Bush’s Fiscal Year 2004 budget, however, suggested a return to the five-year budget window. 2004 ANALYTICAL PERSPECTIVES, *supra* note 136.

227. Spending caps and PAYGO rules of the Budget Enforcement Act recently expired. See discussion *supra* notes 132-37 and accompanying text; see also Block, *Pathologies*, *supra* note 16, at 868-69.

228. SCHICK, *supra* note 15, at 68.

229. AARON WILDAVSKY & NAOMI CAIDEN, *THE NEW POLITICS OF THE BUDGETARY PROCESS* 121-22 (4th ed. 2001).

230. OMB CIRCULAR NO. A-11, *supra* note 120, app. A, at para. 2 (2002). As Wildavsky and Caiden discuss, this rule enabled Congress to make appropriations in one year but to have money scored against the caps for a later year. WILDAVSKY & CAIDEN, *supra* note 229, at 333-34.

231. In an apparent effort to curb advance appropriations, the President’s 2004 budget proposal argued that the advance appropriation practice “distorts the debate over Government spending and misleads the public about spending levels . . .” Thus, it proposed freezing “all advance appropriations at their 2002 levels, except for

ently engaged in similar activities, “using energy contracts called ‘pre-pays,’ which provided Enron a large advance payment to deliver natural gas or other energy products.”<sup>232</sup>

Also under cash method budgeting, Congress can manipulate budget figures by arbitrarily shifting the pay date from one fiscal year to another. Using this technique, Congress takes advantage of the distinction between budget *authority* and budget *outlays*. While Congress votes to *authorize* appropriations for government activity, measurement of the fiscal surplus or deficit is based upon actual *outlays*.<sup>233</sup> Thus, it can reduce this year’s apparent deficit by simply shifting outlays to a different fiscal year. As an example, this particular device saved just over \$2 billion from the fiscal year 1999 budget by simply moving the payday for substantial military salary from September 30, 2000 to October 1, 2000, thus moving the outlay into fiscal year 2000.<sup>234</sup>

(ii) *Delayed Revenue Losses: Phase-Ins and Sunsets*

In a related technique known as “back-loading,” tax cuts or other loss producing programmatic changes can also be phased in over a long period of time so that revenue losses occur outside of the budget window, resulting in a rosier economic budget picture. Such phase-ins were used on a massive scale in the Economic Growth and Tax Relief Reconciliation Act of 2001 in order to push budget costs into subsequent years.<sup>235</sup> Rather than implement an immediate, one-time tax

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those that should be reduced or eliminated for programmatic reasons.” 2004 ANALYTICAL PERSPECTIVES, *supra* note 136, at 317; *see also* SCHICK, *supra* note 15, at 66. In its recent fiscal year 2004 Concurrent Budget Resolution, Congress created self-imposed restrictions on advance appropriations, but immediately exempted itself with respect to certain accounts specifically labeled as “Accounts Identified for Advance Appropriations.” H. Con. Res. 95, 108th Cong., § 501 (2003).

232. STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., 1 REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS, JCS-3-03, at 70 (2003).

233. For a general discussion of the distinction between authorization and outlays, see COLLENDER, *supra* note 139, at 2-5 and WILDAVSKY & CAIDEN, *supra* note 229, at 7-9.

234. Dept. of Labor, Health and Human Services, and Education, and Related Agencies Appropriations Act, 2000, Pub. L. No. 106-113, 113 Stat. 1501, tit. III, Fiscal Year 2000 Offsets and Rescissions, § 305 (1999) (providing that “the basic pay and allowances that accrues to members of the Army, Navy, Marine Corps, and Air Force for the pay period ending on September 30, 2000 shall be paid, . . . no earlier than October 1, 2000”).

235. Pub. L. No. 107-16, 115 Stat. 38, § 101(a) (2001) (phased-in reduction in income tax rates through 2006); *id.* at § 501 (delayed repeal of the estate and generation-skipping transfer taxes until 2010); *id.* at § 511 (phased-in reduction of maximum estate tax rates through 2009); *id.* at § 521 (phased-in increase of unified credit exempt amount for estate tax purposes through 2010). Another example of the

cut, Congress provided for a gradual reduction in rates to begin with a retroactive rate reduction of the lowest bracket for the 2000 tax year and a table of subsequent reductions for the remaining tax brackets to occur from June 30, 2001 through January 1, 2006.<sup>236</sup>

On the flip side, by “front-loading,” Congress sometimes deliberately enacts tax breaks with expiration dates, anticipating that the provision will be extended into future years once the initial provision expires. The “sunset” clause reduces anticipated future costs of the provision for budget purposes. Historically, sunset clauses were used for relatively minor tax provisions as opposed to across-the-board changes in tax rates. For example, Congress has authorized special provisions for qualified research expense credits,<sup>237</sup> work opportunity credits,<sup>238</sup> and other similar business credits, with built-in automatic expiration dates. Sometimes referred to as “extenders,” these tax provisions require legislation to extend their effective dates.<sup>239</sup>

The Economic Growth and Tax Reconciliation Act of 2001 ushered in a new “sunsetting” era, for the first time using expiration dates for sweeping general tax rate reductions. In addition to the phased-in rate cuts effective through 2006, the Act included a bizarre expiration date worthy of the Mad Hatter in Alice in Wonderland. First, the statute provides that all of its provisions expire after December 31, 2010.<sup>240</sup> Thereafter, the Tax Code is to be applied as if the statute “had never been enacted.”<sup>241</sup> In other words, in 2011 the tax rates are to magically revert to their pre-2001 levels. Although Congress recently accelerated the pace of the 2001 Act rate reductions, the statutory amendments remain subject to the 2011 “sunset” provision.<sup>242</sup>

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phase-in budget technique used to delay reflection of budget losses is the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, § 501 (1997) (phased-in increase of unified credit exempt amount for estate tax purposes through 2006).

236. The table provided that the then 28%, 31%, 36%, and 39.6% brackets would be gradually reduced, respectively, to 25%, 28%, 33%, and 35%. Pub. L. No. 107-16, *supra* note 238, at § 501. *See also supra* note 233. Congress recently accelerated the pace of the phased-in reductions so that the rates originally scheduled to take effect in 2006 will be effective for taxable years beginning after Dec. 31, 2002. The Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752, § 105(a) [hereinafter Jobs & Growth Act].
237. I.R.C. § 41 (2000).
238. I.R.C. § 51 (2000).
239. *See, e.g.*, Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, 113 Stat. 1031, tit. V, Tax Relief Extension Act of 1999 § 502(a) (1999) (extending the research credit through 2004); *see also* Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21, tit. VI, Extensions of Certain Expiring Tax Provisions (2002).
240. Pub. L. No. 107-16, 115 Stat. 38, tit. IX, § 901(a)(1) (2001).
241. *Id.* at § 901(b).
242. Jobs & Growth Act, *supra* note 236, at § 107 (“Each amendment made by this title shall be subject to title IX of the Economic Growth and Tax Relief Reconcilia-

Such gimmickry was designed solely for the purpose of complying with congressional budget procedures.<sup>243</sup>

Obvious gimmickry appears again in the recent 2003 Tax Act. For example, the legislation accelerates expansion of the low ten-percent bracket, but only for 2003 and 2004.<sup>244</sup> From 2005 through 2008, the income levels required for the 10-percent bracket revert to pre-2003 levels, to increase again in 2008, only to revert to pre-2001 levels in 2010.<sup>245</sup> The 2003 Tax Act also reduced tax rates on “qualified dividend income,”<sup>246</sup> but provides that the reduction will expire or sunset for taxable years beginning after December 31, 2008.<sup>247</sup> Former Congressional Budget Director Robert Reischauer, refers to the 2003 amendments as “Cinderella’ provisions because seven of the bill’s eight tax cuts turn into pumpkins between 2004 and 2008.”<sup>248</sup> Most troubling to many, the administration and others pretend “that tax cuts it fully expects Congress to extend are just temporary.”<sup>249</sup> If, in fact, the tax cuts simply are to be reenacted as soon as they expire, the budget cost is obviously much greater than that reflected in the current budget. The CBO recently concluded that “[i]f all expiring tax provisions (except some related to the alternative minimum tax) were extended and a Medicare prescription drug benefit was provided at the cost assumed in the Congressional budget resolution, the baseline budget outlook projected for 2013 would *change from a surplus of \$211*

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tion Act of 2001 to the same extent and in the same manner as the provision of such Act to which such amendment relates.”).

243. Under a special Senate budget procedural rule, popularly known as the “Byrd Rule,” Senators may raise a point of order against a provision “if it decreases, or would decrease, revenues during a fiscal year after the fiscal years covered by . . . [a] reconciliation bill or reconciliation resolution, and such . . . decreases . . . are greater than . . . revenue increases resulting from other provisions in such title in such year. . . .” 2 U.S.C. § 644(a)(1)(E) (2000). The 2001 budget resolution covered a ten-year period. If the rate reductions in the 2001 Act had continued beyond this ten-year period, they would have violated the Byrd Rule and thus been subject to a point of order. With a remarkable degree of candor, the Senate entitled Title IX of the Act, providing for expiration of the tax cuts after ten years, “Compliance with Congressional Budget Act,” making it clear that the sunset provision was entirely designed as a budget gimmick.
244. Jobs & Growth Act, *supra* note 236, at § 104; *See also* explanation in H.R. REP. No. 108-126, at 11 (2003).
245. *See* Jobs & Growth Act, *supra* note 236, at § 104. The provision calling for expansion of the ten-percent bracket in 2008 and disappearance of the bracket expansion in 2010 were part of the Economic Growth and Tax Reconciliation Act of 2001, *see supra* notes 240-42 and accompanying text.
246. Jobs & Growth Act, *supra* note 236, at § 302(a).
247. *Id.* at § 303, (“Sunset of Title”).
248. Steven Mufson, *Of Sunsets and Pumpkins*, WASH. POST, June 1, 2003, at B2 (quoting former Budget director, Robert Reischauer).
249. *Id.*; *see also* William G. Gale & Peter R. Orszag, *Sunsets in the Tax Code*, 99 TAX NOTES 1553, 1557 (2003) (“Policymakers supporting sunsets have every intention of trying to make the policies permanent.”).

*billion to a deficit of \$324 billion.*<sup>250</sup> A former I.R.S. Commissioner refers to the sunset provisions as a “joke,” commenting on the “artificial sunset provisions designed by lawmakers to make the packages appear less costly than they really are . . . .”<sup>251</sup> A study by the co-directors of the Tax Policy Center at the Brookings Institution concludes that:

[u]sing sunsets in this manner – to avoid the constraints imposed by the budget rules and raise the underlying annual size of a tax cut within a given multi-year budget total – is a serious problem. It pushes the nation farther down an already unsustainable fiscal path. It elevates expectations that the tax cuts will indeed be continued, even if they are ultimately unaffordable given the nation’s long-term fiscal gap. *It is gapingly hypocritical and poorly timed, given the crackdown on fraudulent corporate accounting practices.*<sup>252</sup>

Going even further, another commentator observed that “the increasing reliance on gimmicks is putting the federal budget on a path toward ‘Enron-style accounting,’ in which the official budget projections are ‘universally seen as unreliable and even fraudulent because they are based on assumptions everyone knows to be false, such as that various major tax cuts will simply be allowed to expire.”<sup>253</sup> Congress is in a poor position to be so vitriolic in its attack on corporate accounting scandals when Congress itself engages in similar budget accounting gimmicks.

(iii) *Cash v. Accrual Accounting in the Tax Expenditure Budget*

When federal income tax provisions provide deductions or credits to taxpayers for items that would not ordinarily be subtracted under ideal economic measures of income, the foregone revenue is a type of indirect federal spending. Beginning with the Congressional Budget and Impoundment Act of 1974,<sup>254</sup> Congress recognized the need to account for this type of indirect spending by requiring the federal budget to include information about lost revenue from tax expenditures.<sup>255</sup>

250. CONGRESSIONAL BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: AN UPDATE (Aug. 2003). Another study estimated that “[i]f all the temporary provisions in the conference agreement were extended, the total revenue loss through 2013 would amount to \$1.09 trillion, *more than three times the official \$350 billion revenue estimate.*” Gale & Orszag, *supra* note 249, at 1553.

251. Tom Herman, *Tax Plan Takes Shape: Income, Dividend Effects of Tax Bill Come Into Focus – House, Senate Bills Would Trim Marginal Rates, Life Child Credit and Ease the Marriage Penalty*, WALL ST. J., May 19, 2003, at C1 (quoting former I.R.S. Commissioner, Mortimer Caplin).

252. Gale & Orszag, *supra* note 249, at 1557-58 (emphasis added).

253. Press Release, Center on Budget and Policy Priorities, Senate Appears Poised to Approve Tax Cut with Actual Cost of \$660 Billion (May 15, 2003) (*available at* <http://www.cbpp.org/5-15-3tax-pr.htm>).

254. Pub. L. No. 93-344, 88 Stat. 297 (1974) (codified at 2 U.S.C. § 632(e)(2)(E) (1997)).

255. “Tax expenditures” are statutorily defined to include “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, ex-

Although the notion of a tax expenditure budget itself is not especially controversial, disagreements can arise over which expenditures should be included. Some deductions are designed to provide a more refined or accurate reflection of taxpayers' true economic income. Such deductions or credits should not be included in the tax expenditure budget. On the other hand, other deductions or credits are designed to provide tax breaks to particular economic activities or incentives to stimulate particular kinds of economic or social behavior. The latter types of deductions or credits should be incorporated into the tax expenditure budget. Disagreements over items in the tax expenditure budget generally stem from differing views on whether a particular deduction or credit belongs in the former or the latter category.

As a general rule, the tax expenditure budget uses the same cash-based accounting approach that is used for the federal budget generally.<sup>256</sup> As with the general budget, cash-based reporting presents a distorted image of the real economic picture. The President's budget concedes as much, stating that "[a]lthough [cash-based] estimates are useful as a measure of cash flows into the Government, they do not accurately reflect the true economic cost of these provisions."<sup>257</sup> As a complement to cash-basis estimates, the President's budget also reports discounted present values for some provisions involving long-term deferrals or revenue effects. The budget report noted that such present value estimating was conceptually similar to the accrual-based budgeting now used to report the budgetary effect of credit programs.<sup>258</sup> Interestingly, the provisions selected for present value analysis include the revenue lost from the exclusion of employer-provided and other pension contributions, but not for the partial exclusion of Social Security benefits from the tax base.<sup>259</sup> Such selective

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emption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." 2 U.S.C. § 622(3) (2000). The "tax expenditure budget" is simply "an enumeration of such tax expenditures." *Id.*

256. For example, the President's budget for fiscal year 2004 reports that the "annual value of tax expenditures is . . . reported on a cash basis . . . . Cash-based estimates reflect the difference between taxes deferred in the current year and incoming revenues that are received due to deferrals of taxes from prior years." 2004 ANALYTICAL PERSPECTIVES, *supra* note 136, at 102.

257. *Id.*

258. *Id.* ("Discounted present value estimates of revenue effects are presented in Table 6.4 for *certain* provisions that involve tax deferrals or other long-term revenue effects. These estimates compliment the cash-based tax expenditure estimates presented in other tables.") (emphasis added). Table 6-4 appears at *id.* at 112.

259. The *cash-based* estimates from Table 6-1 for employer, 401(k), IRAs, and Keogh retirement contribution exclusions, *id.* at 104, total \$128.2 billion as contrasted with total *present value* estimates of \$191.5 billion for the same expenditures in Table 6-4, *id.* at 112. Clearly, the cash-based method severely understates the cost of retirement tax expenditures.



and inconsistent use of present value analysis may further distort the tax expenditure budget and diminish its value.

Not only does the use of cash-based accounting distort the true economic tax expenditure picture, but inconsistent applicability of the cash method itself and inconsistent use of present value analysis results in yet further distortion. The methodology used to estimate cash flows associated with pension plan tax expenditures<sup>260</sup> differs from the methodology used to estimate cash flows from Social Security tax expenditures.<sup>261</sup> The benefit-based cash flow method used to estimate Social Security tax expenditure underestimates its true cost.<sup>262</sup> This underestimation surely distorts policymakers views of Social Security reform. In addition, however, the inconsistent methodology applied to pensions and Social Security results in much higher tax expenditure estimates for the former and often places pension-related tax benefits near the top of the rank ordered list of the largest items in the tax expenditure budget.<sup>263</sup>

Reformers often look to the tax expenditure budget as evidence of excessive tax breaks for certain privileged groups or activities. When pressures build to increase the fairness and horizontal equity of the Tax Code, reformers often look to the tax expenditure budget as a place to broaden the tax base by eliminating special tax advantages. Moreover, in the pre-2003 PAYGO budget world that required any decrease in revenues from tax cuts to be offset by increased revenues, interest groups advocating new tax breaks became "funding predators" looking for target programs to cut in exchange for new benefits.<sup>264</sup> Here again, the tax expenditure budget is the place that such predators looked for victim programs. An estimation methodology that places pension programs at the top of the list, while leaving Social Security programs much lower further distorts the process. So,

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260. See Dallas L. Salisbury, *The Costs and Benefits of Pension Tax Expenditures in Pension Funding & Taxation: IMPLICATIONS FOR TOMORROW* 85, 88 (Dallas L. Salisbury & Nora Super Jones eds., 1994).
261. STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., *ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2000-2004*, JCS-13-99 (Comm. Print 1999).
262. For a good description of the difference in tax expenditure estimation methodology and its implications, see Jonathan Barry Forman, *Comparing Apples and Oranges: Some Thoughts on the Pension and Social Security Tax Expenditures*, 5 *EMPL. RTS. & EMPLOY. POL'Y J.* 297, 311-14 (2001).
263. For example, for fiscal year 2004, net exclusion of pension contributions and earnings from employer plans ranked third on the list of largest federal tax expenditures. 2004 *ANALYTICAL PERSPECTIVES*, *supra* note 136, at 110, tbl.6-3. For fiscal years 2001 and 2002, employer pension plan provisions ranked first. OFFICE OF MGMT AND BUDGET, EXEC. OFFICE OF THE PRES., *BUDGET OF THE U.S. GOVERNMENT: FISCAL YEAR 2002, ANALYTICAL PERSPECTIVES*, at 117, tbl.5-3 (2001); OFFICE OF MGMT AND BUDGET, EXEC. OFFICE OF THE PRES., *BUDGET OF THE U.S. GOVERNMENT: FISCAL YEAR 2001, ANALYTICAL PERSPECTIVES*, at 71, tbl.5-3 (2000).
264. See Garrett, *supra* note 189, at 515-21; see also Block, *Pathologies*, *supra* note 16, at 917-19.

for example, one commentator notes that there is “more pressure to curtail the special tax benefits for pensions and less pressure to curtail the special tax benefits for Social Security.”<sup>265</sup>

### C. The “Off-Budget” Device

#### 1. *On v. Off Budget: Introduction*

Pursuant to federal budget law, certain federal entities and programs have been excluded from the federal budget. Such an entity is referred to as an “off-budget federal entity,” defined to include “[a]ny Federal fund or trust fund whose transactions are required by law to be excluded from the totals of the President’s budget submission and Congress’ budget resolution, despite the fact that these are part of the government’s total transactions.”<sup>266</sup> The Budget Enforcement Act of 1990, for example, explicitly provided that the budget should *not* include outlays and revenues from old age, survivors, and disability insurance programs under Title II of the Social Security Act in surplus or revenue totals.<sup>267</sup> In addition, receipts and disbursements of the Postal Service are explicitly excluded from federal budget totals and exempt from general budget limitations.<sup>268</sup> Congress noted that its reason for severing its budgetary ties with the Postal Service was “to ensure that the receipts and disbursements from the [Postal] Fund cannot be used for purposes of artificially affecting the computations of the federal budget deficit. . . .”<sup>269</sup> Although such motivations are laudable, the movement of items from on- to off-budget itself has potential to game the system. As one key budget observer noted, “[t]here is no standard list of reasons why a program is off budget; the decision is almost always political and can be changed depending on the year and situation.”<sup>270</sup>

One obvious similarity between private sector and federal budget accounting gimmicks is the use of off-budget activities. Enron and the

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265. Forman, *supra* note 262, at 321.

266. SENATE CONGRESSIONAL BUDGET EXPLANATION, *supra* note 135, at 56; *see also* COLLENDER, *supra* note 139, at 206 (more simply defining “off-budget” as including “[p]rograms and agencies whose transactions have been excluded by law from the unified federal budget.”)

267. Pub. L. No. 101-508, 104 Stat. 1388, § 13,301, tit. XIII (1990) (codified at 2 U.S.C. § 632(a) (2000)); *see also* 2 U.S.C. § 655(a) (2000); 42 U.S.C. § 911 (2000). For further discussion of Social Security and related programs, *see supra* notes 288-308 and accompanying text.

268. Congress created a revolving Postal Service Fund and declared that receipts and disbursements from the fund would not be included in budget totals. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106, tit. IV, Civil Service and Postal Service Programs, § 4001(a) (1989) (codified at 39 U.S.C. § 2009a (2000)).

269. H. REP. NO. 101-247, at 873 (1989).

270. COLLENDER, *supra* note 139, at 12.

federal government, for example, faced at least one common problem; that is, large expenses for items not expected to generate significant earnings over the short term.<sup>271</sup> For Enron, the concern was substantial losses on balance sheets relied upon by investors. For the U.S. government, the related concern is substantial federal deficits that can reduce public confidence in the economy. Both Enron and the federal government sometimes turned to a similar device – structuring transactions to result in off-balance sheet treatment.<sup>272</sup> In some cases, Enron created joint ventures.<sup>273</sup> In others, Enron used independent special-purpose entities (SPEs).<sup>274</sup> Enron’s use of joint ventures and off-budget SPEs parallels the federal government’s use of off-budget government-sponsored enterprises (GSEs).<sup>275</sup>

## 2. Trust Funds and Other Specially Earmarked Budget Accounts

### a) Budget Terminology

Use of the term “off-budget” can sometimes be inconsistent and confusing. Technically speaking, the term “off-budget” is used to refer *only* to the two Social Security programs and the postal service trust fund that are *statutorily* excluded from the budget. The major significance of declaring these items “off-budget” was to isolate and protect them from the spending restrictions under the Budget Enforcement Act.<sup>276</sup> In addition to the formally designated off-budget entities, the federal budget incorporates a tremendous number of accounts that are earmarked for special purposes. These include trust funds and special funds.<sup>277</sup>

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271. For a description of Enron’s concerns, see POWERS REPORT, *supra* note 2, at 36.

272. *See id.* at 37.

273. *Id.*

274. POWERS REPORT, *supra* note 2, at 5. Enron, however, did not properly follow accounting rules for creating a legitimate SPE entitled to off-balance sheet treatment. *See id.* at 7, 47-50. This, in part, led to Enron’s downfall when it was required to retroactively consolidate its balance sheets, thus showing a substantial loss. *Id.* at 7.

275. *See* discussion *infra* notes 271-75 and accompanying text.

276. SCHICK, *supra* note 15, at 44-45.

277. The federal budget actually incorporates five types of funds in addition to the general fund: special funds, public enterprise funds, intragovernmental funds, nonrevolving trust funds, and revolving trust funds. U.S. GEN. ACCT. OFF., FEDERAL TRUST AND OTHER EARMARKED FUNDS: ANSWERS TO FREQUENTLY ASKED QUESTIONS, GAO-01-199SP, 8 (Jan. 2001) [hereinafter GAO, EARMARKED FUNDS]. Nonrevolving trust funds and special funds are substantially similar. In both cases, the entity is financed by specific tax receipts and other earmarked revenues. Revolving trusts and public enterprise funds also are substantially similar. These entities are both financed through their own business-type activity. *Id.* at 10. The GAO reports that even for similar kinds of programs, “there is no consistency in whether they are funded by earmarked receipts or general fund appropriations.” *Id.* In addition, the use of six different types of funds further

Prior to 1969, the administrative federal budget excluded trust funds from its computations. Beginning with the fiscal year 1969 budget, however, the President began to report a unified or consolidated budget,<sup>278</sup> which included federal funds<sup>279</sup> and the previously excluded trust funds in its computation.<sup>280</sup> Congress followed suit by requiring the report of a unified budget in the Congressional Budget and Impoundment Control Act of 1974.<sup>281</sup> As currently used, the unified budget is the “form of the budget of the federal government in which receipts and outlays from federal funds and trust funds are consolidated into a single total.”<sup>282</sup> Even though Social Security is technically considered an off-budget item, it is still included for purposes of the unified budget.<sup>283</sup> Despite the technical statutory definition of off-budget, many administrators and legislators continue to loosely refer to trust and special funds as “off-budget.”

Adding to the complexity of the budget regime, the federal budget uses at least three sets of figures for purposes of assessing the extent of federal government deficit or surplus. In addition to the already mentioned unified budget surplus or deficit, budget figures also include the on-budget surplus or deficit as well as the federal funds surplus or deficit. The on-budget figures simply exclude the three officially off-budget entities.<sup>284</sup> The federal funds budget is compara-

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complicates an already enormously complicated budget process. The GAO suggests that “transparency could be increased by recognizing the similarity between non-revolving trust funds and special funds and between revolving trust funds and public enterprise funds. Do we really need four fund types when two might suffice?” *Id.* at 38-39.

278. Although “unified budget” is the term most frequently used to refer to the total federal budget, the term “consolidated budget” is often used interchangeably. See COLLENDER, *supra* note 139, at 86, n. 4.

279. See SCHICK, *supra* note 15, at 44-46.

280. The move to a unified budget was based upon concerns that budget reporting was incomplete and inaccurate. The proposal originated with a recommendation from a presidential budget commission. See PRESIDENT’S COMMISSION REPORT, *supra* note 197.

281. Pub. L. No. 99-177, 99 Stat. 1037, § 406 (1985) (amending Pub. L. No. 93-344, 88 Stat. 297) (codified at 2 U.S.C. § 566(a)) (“Notwithstanding any other provision of law, budget authority, credit authority, and estimates of outlays and receipts for activities of the Federal budget which are off-budget immediately prior to the date of enactment of this section . . . shall be included in . . . a concurrent resolution on the budget.”)

282. COLLENDER, *supra* note 139, at 209.

283. *Id.*; see also 2004 ANALYTICAL PERSPECTIVES, *supra* note 136, at 475 (“The budget combines the on- and off-budget totals to derive unified or consolidated totals for Federal activity.”); SENATE CONGRESSIONAL BUDGET EXPLANATION, *supra* note 135, at 58 (defining the unified budget as “a comprehensive display of the Federal budget. This display includes all revenues and all spending for all regular programs and trust funds.”); SCHICK, *supra* note 15, at 45 (“Social Security is almost always included in governmental and media reports on the budget.”).

284. See discussion *supra* notes 267-68 and accompanying text.

ble to the pre-1969 administrative budget, which excluded all trust funds from the budget totals.<sup>285</sup>

*b) How Congress Uses Trust and Related Funds*

Over the years, Congress has increasingly turned to the use of trust funds and other earmarked funds for federal budgeting purposes. In part, this trend can be explained by constituent pressures. After all, a specially earmarked fund offers a level of comfort to those interested in the particular federal government activity. Unfortunately, however, the federal trust notion may lull the public into a misguided sense of comfort since federal trust funds do not carry the same fiduciary protections ordinarily provided by trusts in the private sector. As the term is used for federal budget purposes, “the federal government both owns the assets . . . and can, through legislation, raise or lower the fund’s collections or payments, or alter the purposes of the trust fund.”<sup>286</sup>

Perhaps more important, the increasing use of trust and other specially earmarked funds has enabled Congress to play additional games with numbers and mask the true extent of federal deficits. To understand the reason, it is important first to observe that, unlike other federal budget accounts, the majority of earmarked funds take in more than they currently need. Viewed as independent entities, they operate on a “surplus.”<sup>287</sup> Although the surpluses technically belong to the special funds, the government can and does use the surplus to fund other activities. For budget purposes, the surplus or “balance” is reflected as an *asset* belonging to the earmarked fund, but a liability from the perspective of the general fund. By way of these intragovernmental accounts, the general fund effectively becomes a borrower and

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285. SCHICK, *supra* note 15, at 46.

286. *Hearings Before the House Comm. on Appropriations, Subcomm. on Transp. & Related Issues*, 106th Cong. (1999) [hereinafter *1999 Transportation Hearings*] (statement of Susan J. Irving, GAO Assoc. Dir., Budget Issues, Accounting and Information Management Division); see also SCHICK, *supra* note 15, at 40-41; GAO, EARMARKED FUNDS, *supra* note 277, at 14 (“Although for trust, special, and public enterprise funds, the earmarking of receipts by law indicates the government’s intent to restrict the use of those funds to the specified purpose, the government can always change this restriction by changing the law.”)

287. See GAO, EARMARKED FUNDS, *supra* note 277, at 16 (“The vast majority of earmarked funds take in more than their current needs. On an annual basis, this is often described as having a ‘surplus.’”). For example, virtually all earmarked funds analyzed in the GAO report had a surplus for fiscal year 1999. *Id.* at 45-74 (App. II: Description of Selected Earmarked Funds); *Id.* at 75-87 (App. III: List of Funds’ Reserves, Gross Outlays, and Balances for Fiscal Year 1999). The CBO cautions that the overall trust fund surplus “balance is somewhat misleading, however, because trust funds receive much of their income in the form of transfers from other parts of the budget.” CONGRESSIONAL BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2005 TO 2014, 22 (Jan. 2004) (footnote omitted) [hereinafter 2005-2014 BUDGET AND ECONOMIC OUTLOOK].

the earmarked fund becomes a lender. This result is achieved through the earmarked funds' investment in U.S. Treasury securities on which the general fund is obligated to pay interest.<sup>288</sup> The interest thus credited to trust and special fund accounts is referred to as a "general fund transfer." The special funds actually reflect *additional income* to the earmarked funds. The additional income increases the trust fund surplus and income can make a deficit appear smaller.<sup>289</sup>

In addition to whatever legitimate purposes they may serve, one suspects that the President and Congress may increasingly turn to specially earmarked funds as a way to mask the true extent of any federal deficit. As one witness commented, trust and special fund surpluses "are commingled with other revenues and used to finance other governmental activities. While all of these general fund transfers were instituted for a purpose – often to better allocate costs – the fact remains that they are *intragovernmental* transfers. Without such transfers, the trust funds as a whole would run a deficit."<sup>290</sup>

### 3. *Social Security, Medicare, and Retirement Trust Funds*

#### a) *Introduction*

Since federal Social Security, Medicare, and military and civilian employee retirement programs are funded through federal trusts, they raise many of the same issues raised in the preceding section addressing trusts and other specially earmarked accounts.<sup>291</sup> Because of the size and political importance of these programs, however, they have somewhat unique characteristics and raise additional budget accounting issues, particularly regarding the projected size of any surplus or deficit. As the baby boom generation in the United States ages, the revenue demands upon the federal government for Social Security and Medicare programs increase dramatically. Substantial economic and political controversy swells around questions of the future health and solvency of these social programs. Potential reforms to address these questions appear to be constantly under discussion. Despite the importance of such issues, this section of the Article is limited to discussing specific issues related to federal budgeting ac-

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288. For a description of the mechanics of this intragovernmental debt, see SCHICK, *supra* note 15, at 41; see also GAO, EARMARKED FUNDS, *supra* note 277, at 18; 1999 *Transportation Hearings*, *supra* note 286 (statement of Susan J. Irving). Further discussion of these transfers appears *infra* at notes 303-05, 317-22, and accompanying text.

289. So, for example, CBO reports that trust fund surpluses can be "misleading . . . because trust funds receive much of their income in the form of transfers from other parts of the budget. CONGRESSIONAL BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2004-2013, 20 (Jan. 2003) [hereinafter 2003 BUDGET AND ECONOMIC OUTLOOK].

290. 1999 *Transportation Hearings*, *supra* note 286 (statement of Susan J. Irving).

291. See discussion *supra* notes 276-85 and accompanying text.

counting for Social Security and Medicare. As such, the ongoing debate on general Social Security and Medicare reform is beyond the scope of this Article, except to the extent that such issues overlap with budget considerations.

*b) Structure of Social Security and Medicare Programs*

The Social Security system is made up of two accounts created on the books of the Treasury entitled the "Federal Old-Age and Survivors Insurance Trust Fund" and the "Federal Disability Insurance Trust Fund."<sup>292</sup> Both of these trusts are funded by special payroll contributions from employers and employees.<sup>293</sup> The Medicare program is similarly made up of two nonrevolving trust accounts entitled the "Federal Hospital Insurance Trust" (HI Trust) and the "Federal Supplementary Medical Insurance Trust" (SMI Trust). Unlike the two Social Security trusts, each of these Medicare trusts is funded differently. Similar to the Social Security trusts, the HI Trust is funded through special payroll tax contributions.<sup>294</sup> The SMI Trust, on the other hand, is a voluntary program funded through premiums paid by participants, with the remaining funds coming from general federal revenues.<sup>295</sup> In addition to special trusts used to fund Social Security and Medicare, the federal government maintains trusts to fund retirement obligations to civilian and military employees. Included among these trusts are the "Thrift Savings Fund,"<sup>296</sup> which provides retirement benefits to civilian employees covered by either the Civil Service Retirement System (CSRS)<sup>297</sup> or the Federal Employees' Retirement System (FERS)<sup>298</sup> and the "Department of Defense Military Retirement Fund,"<sup>299</sup> which provides similar benefits to military retirees.

Although Social Security, Medicare, and federal employee retirement accounts are referred to as "trusts" and are earmarked for special purposes, there is no "trust" in the legal sense. There is no trustee

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292. 42 U.S.C. § 401(a), (b) (2000). These are both nonrevolving trust accounts. GAO, *EARMARKED FUNDS*, *supra* note 277, at 67.

293. *Id.* Individual employees are required to contribute 6.2% of wages, as defined in 26 U.S.C. §3121(a) (2000), and their employers are required to contribute an additional 6.2% of wages, similarly defined, toward the payroll tax for old-age, survivors, and disability insurance. 26 U.S.C. §§ 3101(a), 3111(a) (2000).

294. Individual employees are required to contribute an additional 1.45% of wages and their employers are required to contribute another 1.45% of wages toward the payroll tax for hospital insurance. 26 U.S.C. §§3101(b), 3111(b). The fund also receives a portion of federal income taxes paid on Social Security benefits. See GAO, *EARMARKED FUNDS*, *supra* note 277, at 57.

295. GAO, *EARMARKED FUNDS*, *supra* notes 277, at 58.

296. 5 U.S.C. § 8437 (2000).

297. 5 U.S.C. §§ 8331-8351 (2000).

298. 5 U.S.C. §§ 8401-8479 (2000).

299. 10 U.S.C. § 1461 (2000).

and there are no formal fiduciary obligations to manage the trust on behalf of beneficiaries. Writing about the top ten myths of Social Security, Professor Richard Kaplan observes that

[t]here is probably no single, more enduring myth among Americans than the existence of some separately constituted Social Security Trust fund. . . . Rather, it is simply a bookkeeping entry, recording the fact that the federal government has taken the currently generated surplus and has given obligations that are essentially tantamount to government IOU's.<sup>300</sup>

c) *Social Security, Medicare, and the Budget*

Consistent with the tendency for trust and earmarked accounts generally to operate at a surplus,<sup>301</sup> the two Social Security trust funds also are expected to run large and increasing annual surpluses over at least the next ten years.<sup>302</sup> For bookkeeping purposes, these surpluses belong to the Social Security trust funds. At the same time, however, they are federal revenues that the government can tap for alternate uses. Surpluses are thus effectively commingled with general federal revenue and used to fund other federal government activity.<sup>303</sup> This is not to suggest that the federal government simply takes these surpluses without accounting for them. Instead, the surpluses are invested in nonmarketable U.S. Treasury securities.<sup>304</sup> In effect, the trust funds "lend" money to the general fund and, in return, generate interest income from the intragovernmental debt. As reported by the GAO in 2001, this intragovernmental debt represents over a third of gross federal debt. Moreover, the debt obligation "does not appear on the government's consolidated financial statements because it rep-

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300. Richard L. Kaplan, *Top Ten Myths of Social Security*, 3 ELDER L. J. 191, 192-93 (1995).

301. See GAO, EARMARKED FUNDS, *supra* note 277, at 16; see also discussion *supra* notes 287-89 and accompanying text.

302. THE BD. OF TRUSTEES OF THE FED. OLD-AGE & SURVIVORS INS. & DISABILITY INS. TRUST FUNDS, 2002 ANNUAL REPORT 3 (2002). These figures are based upon an "intermediate" set of demographic, economic, and program-specific assumptions. See also *id.*, at 11, tbl.II.D. The Board used three alternative sets of assumptions to show a range of possible outcomes, but believes that the intermediate set of assumptions reflect the "best estimates" of future experience." *Id.* at 1. The first deficits for the Social Security funds under the intermediate assumptions are projected to begin in 2017. *Id.* at 12. The CBO projects that "federal spending for Social Security, Medicare, and Medicaid combined . . . [will] increase (even under moderate growth assumptions) by more than two-thirds as a share of the economy - from more than 8 percent of GDP in 2004 to over 14 percent in 2030 and almost 18 percent in 2050." 2005-2014 BUDGET AND ECONOMIC OUTLOOK, *supra* note 287, at 8.

303. See 1999 *Transportation Hearings*, *supra* note 286 (statement of Susan J. Irving).

304. Most trust funds are required to invest their surplus in such securities. See 31 U.S.C. § 9702 (2002) ("amounts held in trust by the United States Government (including annual interest earned on the amounts) - (1) shall be invested in Government obligations; and (2) shall earn interest at an annual rate of at least 5 percent.").



resents internal debt – amounts that one part of the government owes to another part of the government.”<sup>305</sup>

One major accounting concern with respect to Social Security is the way in which its surpluses should be reflected in the federal budget. Under a unified budget concept, which includes all trust funds in one consolidated statement, the Social Security surplus can be large enough to offset what would otherwise be a deficit in other federal programs. Over the years, many raised concerns that “the availability of the Social Security surpluses makes the unified budget deficit smaller than it otherwise would appear. Thus, some accused policy-makers of using Social Security surpluses to hide the true size of the budget deficit.”<sup>306</sup> On three separate occasions, Congress responded by enacting legislation to remove Social Security from the budget.<sup>307</sup>

The official budget rules now explicitly exclude receipts and disbursements of the Social Security trust funds from presidential and congressional budget totals<sup>308</sup> and further provide that Social Security outlays and revenues shall not be included in any surplus or deficit totals.<sup>309</sup> Under these rules, the unified budget should not use *off-budget* surpluses from Social Security to offset *on-budget* deficits. Nevertheless, both the President and Congress ignore these rules. The President’s budget routinely includes Social Security surpluses in computing the unified budget.<sup>310</sup> For example, President Bush’s fiscal year 2004 budget documents explain that “[t]he unified budget deficit in [2004] is \$307 billion – a \$482 billion on-budget deficit partly offset by a \$175 billion off-budget surplus. The off-budget surplus is virtually the same as the Social Security surplus.”<sup>311</sup> The President can

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305. GAO, EARMARKED FUNDS, *supra* note 277, at 18.

306. William G. Dauster, *Protecting Social Security and Medicare*, 33 HARV. J. ON LEGIS. 461, 479 (1996).

307. Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65, § 346 (1983) (removing Social Security and Medicare hospital fund from budget totals beginning in fiscal year 1993); Balanced Budget and Emergency Deficit Control Act of 1985, Pub. L. No. 99-177, 99 Stat. 1037, tit. II, Part C (1985) (removing Social Security from budget totals beginning in fiscal year 1986, but including Social Security for purposes of estimating overall deficits); Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, § 13301 (1990) (codified at 2 U.S.C. § 632 (2000) (taking Social Security off-budget for all calculations of budget totals). For a discussion of these three attempts, see David STUART KOITZ, CONGRESSIONAL RESEARCH SERVICE, SOCIAL SECURITY AND THE FEDERAL BUDGET: WHAT DOES SOCIAL SECURITY’S BEING “OFF BUDGET” MEAN? C.R.S. REP. NO. 98-422, at 2-3 (2001) [hereinafter KOITZ REPORT]; see also Dauster, *supra* note 305, at 489-96.

308. 42 U.S.C. § 911 (2000).

309. 2 U.S.C. § 632(a) (2000).

310. See, e.g., 2004 ANALYTICAL PERSPECTIVES, *supra* note 136, at 30, tbl.2-4; *id.* at 301, tbl.13-2 (President Bush’s fiscal year 2004 prominently features unified budget totals, which include off-budget Social Security figures.).

311. *Id.* at 400.

get away with violating the off-budget rules regarding Social Security since the President may constitutionally submit any messages to Congress that he or she judges necessary or expedient.<sup>312</sup> Although the President may have the constitutional freedom to include off-budget Social Security figures in his or her budget message, one would expect Congress itself to abide by its budget rules. The off-budget rules have simply complicated the process, resulting in budget documents that showed unified totals as well as on-budget and off-budget totals.

Dual and conflicting concerns may explain Congress' schizophrenic treatment of off-budget items. On the one hand, Congress wants to appear to protect the Social Security surplus, which is of tremendous political concern to constituents. At the same time, the temptation to use the Social Security surplus to reduce the deficit and otherwise pay for programs is almost irresistible in difficult economic times. With multiple sets of books, Congress can effectively have it both ways. In addition to these conflicting policy considerations, a Congressional Research Service report adds that:

The continued reflection of aggregate budget figures in [budget] documents is largely driven by economic considerations. Those who are interested in the aggregate financial flows on the Treasury and the impact those flows have on the economy . . . continue to examine the financial affairs of the government on a unified budget basis, which means they count Social Security in computing revenue and spending totals. It is the difference between the government's total receipts and total spending, including Social Security's, that determines how much the government needs to borrow from the markets or can repay.<sup>313</sup>

In addition to the specific statutory provisions taking Social Security off-budget, Congress provided in the Social Security Amendments of 1983 that the Federal Hospital Insurance Trust Fund should also be excluded from the federal budget.<sup>314</sup> Here again, Congress often includes the HI Trust in budget totals and fails to provide a separate report of off-budget Medicare HI trust balances, simply ignoring its own budgetary rules. As one commentator notes, "[a]lthough this presentation may have the virtue of simplicity, it shows little respect for the Social Security Act or the philosophy of separate treatment of Medicare that it embodied."<sup>315</sup> As Congress points fingers at the private sector for using "off-budget" entities and transactions to dupe investors, it should consider the extent to which current budget accounting rules for "off-budget" Social Security and trust and earmarked fund surpluses have similar potential to mislead the public.

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312. U.S. CONST., art. II, § 3; *see also* Dauster, *supra* note 306, at 495.

313. KOITZ REPORT, *supra* note 307, at 3.

314. Pub. L. No. 98-21, 97 Stat. 65, § 710 (1983) (codified at 42 U.S.C. § 911(a)(1), amended by Pub. L. No. 105-33 (1997) (current version codified at 42 U.S.C. § 911 (2000)).

315. Dauster, *supra* note 306, at 496-97.

d) *Federal Employee Retirement Trusts*

Despite many similarities, Social Security and Medicare differ in many respects from federal employee retirement trust funds. Perhaps most important, the latter have not been statutorily excluded from the budget. In addition, Social Security and Medicare represent general federal government obligations to taxpayers whereas the retirement trusts represent federal government obligations to its own employees. Some might argue that the use of "on-budget" federal employee retirement fund surpluses as an offset against deficits elsewhere in the budget is less objectionable than similar use of "off-budget" Social Security and Medicare surpluses. The opportunities for playing games with budget numbers may not appear to be as great with federal employee retirement trust funds as they are with Social Security and Medicare. Nevertheless, if for no other reason, the sheer size of these funds and their potential budget impact suggest that policymakers should be careful to adopt consistent budget accounting rules for federal employee trusts that more accurately reflect the true economic status of these funds.<sup>316</sup>

In general, federal trust and other earmarked account administrators invest fund "surpluses" in U.S. Treasury securities, thus effectively "lending" the surplus back to the general fund and earning interest on the securities.<sup>317</sup> Since this intragovernment transfer is viewed as "borrowing" that must be repaid by the general fund, the budget does not reflect any income or expense to the general fund. At the same time, however, the trusts will actually *increase* their "surplus" by the interest income paid on the Treasury securities. Since the funds are "on-budget," these artificial surpluses can more readily be used to distort the true economic picture. In this respect, the federal employee retirement trust funds are similar to other federal trusts and earmarked funds.

Despite some apparent improvements in budget accounting for retirement, federal retirement trust-type intragovernment transfers still present a particularly stark illustration of budget distortions that may result from such transfers. When a government agency or department makes retirement contributions, it transfers funds from its agency or department account to the appropriate federal employee retirement trust fund. In a sense, the government simply moves funds from its left-hand to its right-hand pocket. The agency or department's financial statements will "deduct" this intragovernment transfer as an expense, and the trust's financial statements will include the

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316. The civilian and retirement trust funds are, by far, the largest of the federal trust funds after Social Security and Medicare. See 2003 BUDGET AND ECONOMIC OUTLOOK, *supra* note 289, at 19 (Table 1-5).

317. See *supra* notes 287-89 and accompanying text.

same amount as income.<sup>318</sup> This financial accounting makes sense, and may even improve the accuracy of financial accounting and allocation of budget resources for the federal government in the aggregate.

Perhaps more significant, the government has switched to accrual-based budget accounting at the *department* or *agency* level for most civilian and military retirement expenses.<sup>319</sup> This too makes sense and is consistent with reforms moving slowly in the direction of accrual-based budgeting.<sup>320</sup> The more accurate reflection of retirement costs provided by accrual accounting arguably gives the public a far more accurate picture of the government's financial health, since the budget reflects department-level expense for federal employers' retirement obligations at their discounted net present values.

Nevertheless, current budget accounting methods continue to distort the true economic picture and allow Congress to play budget number games. First, while the accrual-method may make the department-level deficit appear deeper, the intragovernment transfer simultaneously makes the retirement trust's "surplus" appear larger to the same extent. This extra surplus expands the opportunity to play the "lending game," in which the trust purchases U.S. Treasury securities, which in turn provide interest income to the trust.<sup>321</sup> Second, and more important, even though the department-level budget uses accrual-based reporting, the federal government still uses cash method accounting for the trust funds themselves. Thus, the "on-budget" trust funds will show the actual payments to retirees on a cash basis.<sup>322</sup> In the end, although the original intragovernment transfer from the agency or department *increased* the trust's income by the *full net present value of all future retirement expenses*, the trust's income is only *decreased* for the *current payments* to retirees. In general, accrual-based budgeting is thought to increase the eco-

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318. FASAB, CONCEPT NO. 1, *supra* note 117, at STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 5: ACCOUNTING FOR LIABILITIES OF THE FEDERAL GOVERNMENT ¶¶ 56-78. For *financial* accounting purposes, both the employing agency and the trust fund use accrual method accounting with respect to the transfer. *Id.* at ¶¶ 64, 71.

319. GAO, ACCRUAL BUDGETING, *supra* note 144, at 40 ("[I]n 1985, budgeting for military retirement costs was moved to an accrual basis *at the program level* by reflecting the government's expected costs for retirement benefits as they are earned. Similarly, since 1987, accruing retirement costs not covered by employee contributions have been charged to employing agencies for civilian employees covered by the Federal Employees Retirement System.") (emphasis added)

320. See *supra* notes 186-88 for a discussion of the flaws of cash-based budgeting and description of accrual-based reforms regarding federal loan and loan guarantees. See also *supra* notes 185-88 and accompanying text.

321. See *supra* notes 287-89 and accompanying text.

322. See, e.g., GAO, ACCRUAL BUDGETING, *supra* note 144, at 40 ("because the retirement systems themselves are within the budget, total outlays, and thus the deficit/surplus, include only cash outlays to current retirees.").

conomic accuracy of the budget. In this case, however, it may be that the switch to accrual accounting at the department level actually exacerbated the problem. Cash method accounting at the trust level only for actual payments to retirees rather than the full discounted present value of the total expected payments dramatically reduces the apparent government retirement obligation and artificially improves the budget bottom line.<sup>323</sup> There is danger in the selective use of accrual budget accounting.

#### 4. *Federal Budgetary Use of Corporations*

##### a) *Categories of Government Corporations*

Government corporations typically fall into one of three major structural patterns: wholly-owned, mixed-ownership, and government sponsored enterprises (GSEs). Unlike the first two categories, government-sponsored corporations, commonly referred to as GSEs, are entirely privately owned. This section will consider the first two categories of government corporation, leaving discussion of the privately-owned GSEs for separate treatment in subsequent sections.<sup>324</sup>

##### b) *Wholly-Owned Government Corporations*

From its inception, the U.S. Congress has chartered government corporations to serve special public needs.<sup>325</sup> Simply put, government corporations “are generally federally chartered entities created to serve a public function of a predominantly business nature.”<sup>326</sup> By the end of World War II, the use of government corporations had proliferated without appropriate standards for federal control and accountability, thus leading Congress to enact the Government

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323. Although the parallels are not precise, there are some similarities here to Enron's controversial accounting for non-qualified employee stock options through which Enron took an up-front tax deduction for the “bargain element” of the option, but did not reflect the costs on its *financial* statements, thus artificially improving its bottom line. For a brief discussion of the stock option issues, see Anthony J. Lupino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L.REV. 35, 87-108 (2003).

324. See discussion *infra* notes 364-78 and accompanying text.

325. The earliest government corporations were national banks. The first government corporation, the Bank of North America, was chartered by the Continental Congress in 1871. See LAWRENCE LEWIS, JR., A HISTORY OF THE BANK OF NORTH AMERICA (1882). For a good discussion of general and constitutional history of government corporations, see A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543, 549-57, 561-77.

326. U.S. GEN. ACCOUNTING OFFICE, GOVERNMENT CORPORATIONS: PROFILES OF EXISTING GOVERNMENT CORPORATIONS, GAO/GGD-96-14, at 1 (Dec. 1995) [hereinafter GAO, 1995 GOVERNMENT CORPORATIONS].

Corporation Control Act.<sup>327</sup> In addition to incorporating new audit and budgetary control mechanisms, the Control Act required termination of government corporations unless reincorporated by Congress before June 30, 1948.<sup>328</sup> President Truman's 1948 Budget Message to Congress clearly expressed his views regarding the appropriate use of such government entities:

While the general role of the Government corporation has been accepted in the laws of this country for more than 30 years, the standards for use of this instrument are not fully developed and will be subject to many refinements. Experience indicates that the *corporate form of organization is peculiarly adapted to the administration of governmental programs which are predominantly of a commercial character—those which are revenue producing, are at least potentially self-sustaining, and involve a large number of business-type transactions with the public.*

In their business operations such programs require greater flexibility than the customary type of appropriation budget ordinarily permits. As a rule the usefulness of a corporation lies in its ability to deal with the public in the manner employed by private business for similar work.<sup>329</sup>

Today, government corporations are still generally considered appropriate for commercial, self-sustaining activities that, while important to the public interest, might be more efficiently run through corporate form rather than a government agency.<sup>330</sup> To permit the greater operational flexibility that President Truman was referring to, most government corporations enjoy freedoms denied to regular federal agencies. For example, they may be exempt from civil service rules, federal procurement requirements, "use it or lose it" budgetary constraints, and other contract and budget restrictions.<sup>331</sup>

Although there are no precise statutory definitions, the National Academy of Public Administration defines a wholly-owned government corporation as "a corporation pursuing a government mission assigned in its enabling statute, financed by appropriation, with assets owned by the government and controlled by board members or an administrator appointed by the President or a department secretary."<sup>332</sup> Wholly-owned government corporations<sup>333</sup> are subject to reasonably

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327. Pub. L. No. 79-248, 59 Stat. 597 (1945) (codified at 31 U.S.C. §§ 1105, 9101-9109 (2000)).

328. *Id.* at § 304(b), 59 Stat. at 602.

329. President Truman's Budget Message to Congress, 1947 U.S.C.S. 1750, 1788 (emphasis added).

330. *See, e.g.*, GAO, 1995 GOVERNMENT CORPORATIONS, *supra* note 326, at 3.

331. For an overview of the mix of powers granted to government corporations, see Froomkin, *supra* note 325, at 553-54.

332. NATIONAL ACADEMY OF PUBLIC ADMINISTRATION, REPORT ON GOVERNMENT CORPORATIONS (1981) [hereinafter NAPA REPORT] (describing the wholly-owned corporation as one in which "the federal government holds 100% of the equity and exercises 100% of the votes on the board of directors or other governing body").

333. Examples of wholly-owned government corporations include: Commodity Credit Corp., 15 U.S.C. § 714 et. seq., 31 U.S.C. § 9101(3)(A) (2000); Federal Crop Insurance Corp., 7 U.S.C. § 1503 et. seq., 31 U.S.C. § 9101 (3)(D); Pension Benefit

strict controls and are included within the presidential and congressional budget.<sup>334</sup> In many respects, they operate like federal agencies. Even though wholly-owned corporations are technically part of the federal budget, their financial information cannot be effectively incorporated with regular budget schedules because they adopt commercial accounting standards as opposed to the financial standards used for federal agencies pursuant to FASAB rules.<sup>335</sup>

c) *Mixed-Ownership Government Corporations and Related Entities*

A mixed-ownership government corporation is "a corporation with both government and private equity, with assets owned and controlled by board members selected by both the President and private stockholders, usually intended for transition into the private sector."<sup>336</sup> Mixed-ownership government corporations are less accountable to Congress than agencies and wholly-owned corporations.<sup>337</sup> Moreover, they are not included with the federal budget.<sup>338</sup>

Wholly-owned and mixed-ownership government corporations generally are authorized by an explicit act of Congress. More recently, however, certain federal agencies have been granted authority to enter into public/private ventures without further explicit Congressional approval. One major example is the privatization initiative on military housing. Under Congressional authority granted in 1996, the Defense Department may "make investments in an eligible entity carrying out projects for the acquisition or construction of housing units suitable for use as military . . . housing."<sup>339</sup>

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Guaranty Corp., 29 U.S.C. § 1301 et. seq., 31 U.S.C. § 9101(3)(J); Tennessee Valley Authority, 16 U.S.C. § 831 eq seq., 31 U.S.C. § 9101(3)(N).

334. 31 U.S.C. §§ 9103, 9104 (2000).

335. See discussion in SCHICK, *supra* note 15, at 42.

336. NAPA REPORT, *supra* note 332; see also Froomkin, *supra* note 325 (defining a mixed-ownership entity slightly differently suggesting that the government does not necessarily have a direct equity interest in every mixed-ownership government corporation); *id.* at 555 ("In *mixed-ownership federal corporations* . . . the United States may own some or none of the equity. [Its] charter often guarantees that the President will appoint at least a minority of the directors even if the federal government does not own any shares.").

337. Examples of mixed-ownership corporations include: Federal Deposit Insurance Corp., 31 U.S.C. § 9101(2)(B) (2000); Federal Home Loan Banks, *id.* § 9101(2)(C); Financing Corp., *id.* § 9101(2)(I); Resolution Trust Corp., *id.* § 9101(2)(J).

338. See Froomkin, *supra* note 325, at 559 & n. 81.

339. 10 U.S.C. § 2875(a) (2000). This provision was included along with a number of others designed to provide broad general authority to the Defense Department to privatize acquisition and construction of military housing. National Defense Authorization Act for Fiscal Year 1996, Pub. L. No. 104-106, §§ 2801-2802, 110 Stat. 544, tit. XXVIII, subtit. A (Military Housing Privatization Initiative).

Proper budget treatment of Defense Department expenses in connection with its public/private housing ventures has been a matter of dispute. Since such ventures do not require explicit legislative authority, “[c]ongressional scoring plays a limited role in determining the budgetary treatment of individual public/private ventures.”<sup>340</sup> Under OMB guidelines, the Defense Department is able to record each individual contractual provision as a separate transaction without taking the overall government commitment into account. According to a recent CBO report, the Defense Department is thus able “to obtain on-base family housing without recording large budgetary obligations up front.”<sup>341</sup>

The CBO report expresses concern that:

A growing number of public/private ventures and leases are being structured to avoid the requirement for recognizing the costs of government investments up front. That trend could reduce the budget’s ability to encourage cost-effective investment decisions and to make agencies’ commitments visible to the Congress and the public. In some cases, those commitments could challenge Congressional control over federal finances.<sup>342</sup>

Budgetary accounting procedures for wholly-owned and mixed-ownership government corporations and related public/private ventures cry out for reform. Although the federal budget makes information about wholly-owned government corporations available, the information is difficult to assess and use since such entities do not use FASAB government accounting standards. Any major budget reform should address these inconsistencies. Far worse, federal expenses related to mixed-ownership government corporations generally are not reflected in the budget at all. Changes should be made to require some accounting for such enterprises in the federal budget. Finally, by failing to account for many expenses up front, budget accounting for many public/private ventures vastly understates the extent of the government’s financial commitment to such enterprises.

*d) Special Purpose and Related Entities*

*(i) Government-Sponsored Enterprises (GSEs)*

A third type of entity used to conduct governmental activities is the government-sponsored enterprise. Each GSE is created by Congress through a federal charter, but Congress has not provided a precise statutory definition of GSE. Although technically private, their fed-

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340. CONGRESSIONAL BUDGET OFFICE, U.S. CONG., *THE BUDGETARY TREATMENT OF LEASES AND PUBLIC/PRIVATE VENTURES* 39 (Feb. 2003) [hereinafter CBO, *BUDGETARY TREATMENT OF LEASE*].

341. *Id.* For example, CBO reports that budgetary treatment of an Army limited partnership interest with a private partner for housing at Fort Hood will reflect an up-front budget obligation of only \$52 million for on-base housing units worth approximately \$273 million. *Id.* at 42.

342. *Id.* at 49.



eral charters provide GSEs certain privileges and subject them to certain limitations that do not apply to the ordinary privately-owned corporation. The GAO explains that "Congress established GSEs as federally chartered, but privately owned and operated corporations, limited their activities to certain economic sectors deemed worthy of public support, and gave them certain advantages to help accomplish their public purposes."<sup>343</sup>

Although each GSE federal charter may differ, GSEs tend to share a number of important characteristics. They are all 1) federally chartered for a particular public purpose; 2) privately owned and operated; 3) subject to restrictions and obligations that would not ordinarily apply to a private corporation;<sup>344</sup> 4) offered advantages, such as tax exemption, exemption from SEC registration requirements, and access to Treasury Department lines of credit, that would not ordinarily be available to a private corporation;<sup>345</sup> and 5) benefitted by investor perceptions of federal government guarantee in the event of default on their obligations.<sup>346</sup>

Of these characteristics, the most controversial and difficult to measure are the benefits that a GSE receives by virtue of the *explicit* tax exemption, preferred lines of credit, and the like, as well as the *implicit* advantage from investor perceptions that the government is prepared to bailout the failed enterprise. These benefits and advantages effectively provide the GSE with federal subsidies at taxpayer expense. Perhaps the most well-known GSEs are those engaged in housing and mortgage lending activities, including Fannie Mae, Fred-

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343. U.S. GEN. ACCOUNTING OFFICE, GSEs: RECENT TRENDS AND POLICY, GAO/T-OCE/GGD-97-76, at 1 (July 1997). In its report on government corporations, the GAO distinguishes GSEs from wholly-owned and mixed-ownership entities. "GSEs are federally established, privately owned corporations designed to increase the flow of credit to specific economic sectors. GSEs typically receive their financing from private investment . . . . GSEs issue capital stock and short-and long-term debt instruments, issue mortgage-backed securities, fund designated activities, and collect fees for guarantees and other services. GSEs generally do not receive government appropriations." GAO, 1995 GOVERNMENT CORPORATIONS, *supra* note 326, at 4 n.9.

344. For example, Fannie Mae and Freddie Mac are housing GSEs, whose charter limits their activities primarily to the financing of conforming mortgages. CONGRESSIONAL BUDGET OFFICE, U.S. CONG., FEDERAL SUBSIDIES AND THE HOUSING GSEs 10 (May 2001) [hereinafter CBO, HOUSING GSEs STUDY].

345. GSEs may also receive additional advantages from court rulings holding that certain GSEs have sovereign immunity and promissory estoppel against claims based upon employee conduct. See, e.g., *Mendrala v. Crown Mortgage Co.*, 955 F.2d 1132 (7th Cir. 1992); *McCauley v. Thygerson*, 732 F.2d 978 (D.C. Cir. 1984).

346. This list of common characteristics is derived from GAO *Testimony: Hearings on the Growing Role of GSEs in the Nation's Credit Markets Before the House Subcomm. on Capital Markets, Securities, and Gov't. Sponsored Enterprises, Comm. on Banking and Financial Services*, 106th Cong. 7-30 (1997) (statement of James L. Bothwell, GAO, Chief Economist).

die Mac, and the Federal Home Loan Bank. These housing GSEs were "created to provide liquidity and stability in the home mortgage market, thereby increasing the flow of funds available to mortgage borrowers."<sup>347</sup>

In a careful study, the CBO attempted to quantify the extent of federal subsidies provided to housing GSEs through direct and indirect government benefits. For example, the CBO estimated a combined value of about \$1.2 billion for the year 2000 from exemptions from state and local income taxes, exemption from SEC registration, and the lower cost of credit rating for debt and mortgage-backed securities.<sup>348</sup> These estimates quantify *direct* monetary saving from special legal status given to housing GSEs, but not offered to other shareholder-owned corporations. Additional direct government costs arise from contingent liabilities in the event that the federal government ultimately decides to bailout a GSE. Even though statutory disclaimers and disclosures on the typical GSE prospectus state that its obligations are *not* backed by the U.S. government,<sup>349</sup> investor perception of an implicit federal government guarantee is hard to break.<sup>350</sup> Such perceptions certainly were bolstered by the 1987 bailout of the Farm Credit System, a GSE for which the federal government had not formally provided its backing or a guarantee.<sup>351</sup> Another potential direct cost to the federal government arises because, "treasury borrowing costs may increase due to the perception that GSE debt is a relatively good substitute (substitution cost)."<sup>352</sup>

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347. CBO, HOUSING GSEs STUDY, *supra* note 344, at 1. This report is an update, requested by the House Committee on Financial Services, of an earlier CBO study. CONGRESSIONAL BUDGET OFFICE, U.S. CONG., ASSESSING THE PUBLIC COSTS AND BENEFITS OF FANNIE MAE AND FREDDIE MAC (May 1996).

348. CBO, HOUSING GSEs STUDY, *supra* note 344, at 15-16. Although potentially substantial, the CBO did not attempt to directly estimate the value of additional savings to housing GSEs from special legal provisions permitting them to use the Federal Reserve as a fiscal agent or giving them special Treasury Department lines of credit. *Id.*

349. *See, e.g.*, description of typical Fannie Mae prospectus disclosure in CBO, HOUSING GSEs STUDY, *supra* note 344, at 14, n. 2.

350. Some have even observed that GSEs "are regarded by most people who lend them money as the government in disguise." MARCIA STIGUM, THE MONEY MARKET 358 (1990) (emphasis added). Others have observed that even the statutory disclaimer of government backing itself, *see, e.g.* 12 U.S.C. § 4503 (2000), is written in neutral language that seems to hint at the special federal relationship. Thus, the disclaimer fails to impress investors who continue to behave as if such government backing does exist. *See* Richard Scott Carnell, *Federal Deposit Insurance and Federal Sponsorship of Fannie Mae and Freddie Mac: The Structure of Subsidy*, in SERVING TWO MASTERS, YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC 56, 75 n.5 (Peter J. Wallison, ed., 2001) [hereinafter WALLISON, SERVING TWO MASTERS].

351. Agricultural Credit Act of 1987, Pub. L. No. 100-233, 101 Stat. 1568 (1988).

352. Froomkin, *supra* note 325, at 599-600.

According to the CBO, the largest part of the federal government subsidy to GSEs is the "reduction in borrowing rates on the GSEs general obligation debt securities." Investors are prepared to accept lower rates of interest from GSEs based on their stubborn perception of an implicit guarantee from the federal government. The CBO estimated the value of this aspect of federal subsidy to Fannie Mae, Freddie Mac, and FHLBs at \$8.8 billion for the year 2000.<sup>353</sup> Another subsidy stemming from implicit federal government backing is the advantage to GSE mortgage-backed securities from reduced costs for providing credit guarantees. The CBO notes that "the market requires greater capital backing for a fully private guarantee, and providing that capital is costly to private firms. Consequently, Fannie Mae and Freddie Mac have the latitude to charge fees in excess of guarantee costs."<sup>354</sup> The CBO here estimated the value of the federal subsidy to Fannie Mae and Freddie Mac for the year 2000 at \$3.6 billion.<sup>355</sup> In the end, the CBO estimated that total direct and indirect federal subsidies to the three housing GSEs amounted to \$13.6 billion for the year 2000.<sup>356</sup> Moreover, the CBO concluded that a substantial portion of the federal subsidy actually is passed on to GSE shareholders and stakeholders.<sup>357</sup> In other words, the federal government is providing these benefits to private shareholders at taxpayer expense.<sup>358</sup>

GSEs are completely excluded from the presidential budget and the congressional budget resolution; they simply are not reported in

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353. CBO, HOUSING GSEs STUDY, *supra* note 344, at 21 tbl.5 (including estimates for the years 1995 through 2000).

354. *Id.* at 22.

355. *Id.* at tbl.6 (providing estimates for years 1995 through 2000).

356. *Id.* at 24.

357. *Id.* at 25.

358. To be sure, the CBO findings were controversial and challenged by the GSEs themselves. *See, e.g.*, FANNIE MAE, SETTING THE RECORD STRAIGHT: AN ANALYSIS OF CBO'S 2001 REPORT ON FANNIE MAE AND FREDDIE MAC (2001); JAMES C. MILLER & JAMES E. PEARCE, FREDDIE MAC, RESPONSE TO CBO'S DRAFT REPORT: FEDERAL SUBSIDIES AND HOUSING GSEs (2001); *see also* Robert Van Order, *The Economics of Fannie Mae and Freddie Mac* in WALLISON, SERVING TWO MASTERS, *supra* note 348, at 41 ("Whether the GSEs get a subsidy has been a source of controversy. . . . The size of the gross benefit has been [overstated]."). Robert Van Order was chief economist at Freddie Mac. *Id.* at ix. On the other hand, Robert Seiler, Office of Federal Housing Enterprise Oversight, Manager of Policy Analysis, concluded that, if anything, the CBO study had *understated* federal subsidies to housing GSEs. Robert S. Seiler, Jr. *Estimating the Value and Allocation of Federal Subsidies* in WALLISON, SERVING TWO MASTERS, *supra* note 348, at 8, 33. Defending itself against claims of flawed methodology, the CBO argues that "[d]espite the fact the GSEs claim our analytical framework is fundamentally 'flawed,' it is only the GSEs and their paid consultants who make that assertion. This methodology has been widely reviewed in and out of government, including by participants in 'the market.'" Letter from Dan L. Crippen, Dir., CBO, to Richard H. Baker, Chair, U.S. House Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises 1 (July 11, 2001).

either the on-budget or the off-budget figures.<sup>359</sup> Although GSEs were originally designed to serve a public purpose, they can easily be used as a budget accounting gimmick to reduce the size of apparent deficits. As one commentator notes, “a few GSEs were created as little more than accounting devices designed to allow the federal government to borrow funds without appearing to increase the deficit.”<sup>360</sup> Although the early vision of a GSE was a commercial entity that could be self-sustaining,<sup>361</sup> an economic reporter with the Wall Street Journal in 1989 complained that the later GSEs were not necessarily expected to earn profits. Instead, he then argued, “GSEs could become the budget gimmick of the 1990s.”<sup>362</sup> Just as Enron used off-budget entities as an accounting gimmick to mask the true nature of its economic situation, Congress uses completely off-budget GSEs to enlarge surpluses or mask the true size of deficits. To make matters worse, since GSEs are private, they are not subject to lobbying restrictions that apply to federal agencies and wholly-owned federal corporations. Thus, special interest groups that benefit from federal advantages granted to the GSE can protect their positions. Opposition from competing interest groups may be muted since the federal subsidies and taxpayer costs with respect to GSEs are not reflected in the federal budget.<sup>363</sup>

(ii) *Private Sector Special-Purpose Enterprises (SPEs) as a Parallel to Public Sector GSEs*

Government use of GSEs to keep certain activities off-budget for federal budget purposes is strikingly parallel to private sector use of special-purpose enterprises (SPEs) to keep certain activities off private entity consolidated financial statements. Enron, for example, extensively used such SPEs in order to keep certain investment

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359. For example, the President's budget for fiscal year 2004 reports that “[n]either the on-budget nor the off-budget totals include transactions of Government-sponsored enterprises, such as the Federal National Mortgage Association (Fannie Mae).” 2004 ANALYTICAL PERSPECTIVES, *supra* note 136, at 463. Nevertheless, the President concedes the importance of GSEs to the government and its finances. The budget statement goes on to note that “[f]ederal laws established these enterprises for public policy purposes, but they are privately owned and operated corporations. Because of their close relationship to the Government, the budget discusses them and reports their financial data in the Appendix to the budget and in some detailed tables.” *Id.*

360. Froomkin, *supra* note 325, at 559. Froomkin cites the Federal Financing Bank as an example of an entity with a deficit from borrowing that was counted on the federal books as an account receivable asset. “[B]ecause the Bank is off-budget, . . . , [the deficit] is not considered part of the national debt – instead the ‘asset’ reduces the national debt.” *Id.* at 559 n.83.

361. See discussion *supra* notes 325-31 and accompanying text.

362. William G. Gale, *The Budget Gimmick of the 1990s?*, WALL ST. J., May 3, 1989, at A18.

363. See, e.g., discussion in Froomkin, *supra* note 325, at 596.

activities “off-balance sheet” and “to present itself more attractively as measured by the ratios favored by Wall Street analysts and rating agencies.”<sup>364</sup> Just as there is no precise statutory definition for GSEs used by the federal government, there also is “no generally accepted definition of SPEs to distinguish them from other legal entities.”<sup>365</sup> The notion of an SPE, however, is an independent entity in which the investor has a substantial interest and whose “activities and powers are significantly limited by their charter or other contractual arrangement.”<sup>366</sup>

Corporations often will isolate a particular business or investment activity in a separate corporation in which they hold a controlling interest. The controlled corporation, usually referred to as a subsidiary, is considered part of the larger corporate family controlled by the parent corporation. For *tax* accounting purposes, the parent corporation may *elect* to file a consolidated tax return in lieu of separate returns for each business entity within the corporate group.<sup>367</sup> For *financial* accounting purposes, on the other hand, consolidated statements are usually required. In fact, FASB Accounting Research Bulletin No. 51 has established a presumption that consolidated financial statements are more meaningful than separate statements.<sup>368</sup>

Under this presumptive financial consolidation rule, if a business uses multiple distinct entities to conduct its activities, its financial statement should reflect the *aggregate* profit and loss from all related entities. Without such a rule, the business could “isolate” loss activities in one entity, making the others appear more profitable. One challenge presented by the consolidation rule is defining which entities are sufficiently “related” as to require their inclusion in an aggregate statement. For *corporate* entities, the challenge is reasonably easy to meet. A corporation is related to another if it owns more than a specified percentage of the other corporation’s stock.<sup>369</sup>

For many SPEs, however, the investor’s interest does not take the form of traditional voting stock, but instead involves contractual agreements regarding the sharing of assets, liabilities, and the risk of loss. Depending upon the contractual arrangement, an investor might well bear the same risk of loss that a controlling shareholder would otherwise bear. Under prior financial accounting rules, an investor was required to include the SPE’s activities in its consolidated financial statement under the presumptive consolidation rule only if the

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364. POWERS REPORT, *supra* note 2, at 37.

365. *Id.* See *supra* notes 346-48 (describing the common characteristics of GSEs).

366. POWERS REPORT, *supra* note 2, at 37-38.

367. 26 U.S.C. § 1501-1563 (2000) (Consolidated Returns).

368. Federal Accounting Standards Board, Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (1959) [hereinafter FASB Bulletin No. 51].

369. For example, the benchmark used for tax purposes generally is 80%. I.R.C. § 1504(a) (definition of affiliated group for purposes of consolidated reporting).

SPE was a subsidiary in which the investor had a controlling financial interest, usually interpreted to mean a majority *voting* interest.<sup>370</sup> An SPE investor could overcome the presumption if another independent owner or owners of the SPE made a substantial capital investment and that investment had substantive risks and rewards of ownership.<sup>371</sup> In addition, the independent owner or owners had to exercise some control over the SPE.<sup>372</sup> In other words, an investor could avoid including an investment on its own consolidated financial statement as long as there was another independent investor with some significant interest in the SPE. Through several investments in limited partnerships, Enron Corporation clearly took advantage of the loose nature of these accounting requirements to keep losses from SPE investments off of its balance sheets.<sup>373</sup>

In response to Enron accounting scandals, the FASB reconsidered its accounting rules regarding the proper treatment of SPEs, issuing new rules in January, 2003. The new FASB rule now refers to special-purpose and related entities as "variable interest entities" (VIEs).<sup>374</sup> According to the FASB, previous rules were "fragmented and incomplete" since they generally required consolidation for controlled subsidiaries, but not for VIEs with which the investor has a similar relationship.<sup>375</sup> New FASB rules require existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved.<sup>376</sup> In other words, if the other parties do not bear a substan-

370. FASB Bulletin No. 51, *supra* note 366, at ¶ 2.

371. At least according to SEC interpretation, this independent investor could have as little as 3% of total capital. *See* discussion in POWERS REPORT, *supra* note 2, at 39.

372. The notion of control was a subjective standard, not solely based upon voting interests. *Id.*

373. *See, e.g.*, discussion of Enron's relationship with Chewco Investments L.P. in POWERS REPORT, *supra* note 2, at 41-67. In fairness, some attribute a large measure of the blame for misleading financial statements to lax FASB accounting standards. *See, e.g.*, William H. Beaver, Symposium, *Enron: Lessons and Implications: What Have We Learned From the Recent Corporate Scandals That We Did Not Already Know?* 8 STAN. J.L. BUS. & FIN. 155, 164 (2002) ("Recent events have triggered a number of criticisms of financial reporting standards and have raised concerns that the current standards may be a part of the problem . . . . Certainly, the accounting for Special Purpose Entities (SPEs) that was at the heart of the problems with Enron's financial reporting is being revisited and rightly so.")

374. *See Consolidation of Variable Interest Entities: An Interpretation of ARB No. 51*, FINANCIAL ACCOUNTING SERIES: FASB INTERPRETATION NO. 46 (2003) [hereinafter FASB INTERPRETATION NO. 46].

375. *Id.*

376. FASB INTERPRETATION NO. 46, *supra* note 374. The new FASB interpretation has been controversial and the FASB has both delayed its effective date and proposed modifying the interpretation itself. *Exposure Draft Proposed Interpretation: Consolidation of Variable Interest Entities: A Modification of FASB Interpretation No. 46*. FINANCIAL ACCOUNTING SERIES: FASB INTERPRETATION NO. 46 (2003) (Finan-

tial risk, the primary investor must report SPE activities on its own financial statements. United States financial accounting standards have historically tended to be rule-oriented, leaving open possibilities for exploitation of the rules. Some analysts suggest "an approach placing greater emphasis on meeting the spirit of key budgetary principles and less emphasis on satisfying specific quantitative criteria."<sup>377</sup> The new FASB rules for VIEs adopt a more principles-based approach, thus moving closer to international accounting standards.<sup>378</sup> As the FASB tightens its rules to require that more related-entity activities be brought "on-budget," the federal government should similarly tighten its own rules.

#### D. Long-Term Leasing

##### 1. Budgetary Treatment of Government Leases

An increasingly common technique used to avoid up-front budgetary reporting of government expenses for capital assets and to keep such expenses effectively "off-budget" is the government lease. Since the government does not actually *own* the property, the budget will not reflect the full capital expense. A recent CBO report found that the current budget treatment of leases and public/private ventures is inconsistent with two fundamental budget principles: 1) recognizing financial commitments when they are made; and 2) providing a comprehensive budget that captures all federal government finances.<sup>379</sup> More than simply misleading the public, the current budget treatment of government leases may actually *encourage* federal managers to make inefficient choices regarding major government expenses, thus spending unnecessary taxpayer dollars. As the CBO reports,

A budgetary treatment inconsistent with those principles could deny the Congress and the Administration the information needed to over-see federal spending. Moreover, unless the costs of asset purchases financed through leases and public/private ventures appear up front in the federal budget, in the same way as the costs of assets purchased directly by the government, federal managers will be more likely to rely on such financing techniques even though they are inherently more costly.<sup>380</sup>

Prior to 1991, government leases were scored for budget purposes on an annual basis with each year's budget reflecting only the annual lease payment for that year. Concerns were raised that this type of

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cial Accounting Standards Board of the Financial Accounting Foundation, Norwalk, Conn.). The details of the new VIE rules will not be considered in this Article.

377. CBO, BUDGETARY TREATMENT OF LEASES, *supra* note 340, at 52.

378. *Id.*; see also Jenny Wiggins, *Markets Assess Impact of FASB: New Rules Could Hamper the Structured Finance Business*, FINANCIAL TIMES (London), Jan. 21, 2003, at 30.

379. CBO, BUDGETARY TREATMENT OF LEASES, *supra* note 340, at vii-viii.

380. *Id.* at viii.

budget treatment for long-term leases was flawed in numerous ways beyond the simple failure to adequately reflect the government's overall financial commitment to the enterprise.<sup>381</sup> When the federal government engages in a direct acquisition of a capital asset, the budget immediately reflects the full cost of the asset purchased. Under prior budget controls, such capital spending was subject to deficit limits and spending caps.<sup>382</sup> If only a small portion of the expense of the capital asset was reflected in the budget year, such budget controls were easier to satisfy. Thus, many federal agencies turned to long-term leases as a device to avoid the impact of budget controls. In addition, reporting only a portion of the expense in a given budget year allowed agencies to avoid facing the full cost, thus providing a potential incentive to make acquisitions that were not cost-effective. Moreover, the overall costs of a lease-purchase following a long-term lease were often far higher than the cost of a direct purchase. The budget treatment of long-term leases thus actually raised the costs of some government investments.<sup>383</sup>

Responding directly to these concerns, new guidelines for the budget treatment of government leases were developed in 1991 through a joint effort of the House and Senate Budget Committees, the CBO and the OMB. These guidelines break government leases into three major categories: 1) capital leases; 2) lease-purchases; and 3) operating leases.<sup>384</sup>

Capital leases and lease-purchases both effectively provide the government with ownership of the asset being leased. In the case of a capital lease, the lease term is so long that the government consumes the value of the lease property over the lease term, leaving little or no value at the end of the term to be returned to the lessor. In the case of a lease-purchase, the government actually purchases the property at the end of the lease term.<sup>385</sup> Both capital leases and lease-purchases clearly are substitutes for direct acquisition. Consequently, the 1991 guidelines require that "budget authority will be scored in the year in which the authority is first made available in the amount of the net

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381. For a general discussion of these concerns, see CBO, BUDGETARY TREATMENT OF LEASES, *supra* note 340, at ix, 14-15.

382. For a discussion of these budget controls see *supra* notes 132-136 and accompanying text.

383. "For example, according to a 1990 internal CBO analysis of the lease-purchase of the Federal Judiciary Building and of the National Archives facility, in each case the approach was about 10 percent more costly, in present discounted terms, than a direct purchase would have been." CBO, BUDGETARY TREATMENT OF LEASES, *supra* note 340, at 15.

384. OMB CIRCULAR NO. A-11, *supra* note 120, at para. 3.

385. A lease-purchase is defined as "a type of lease in which ownership of the asset is transferred to the government at or shortly after the end of the lease term." *Id.*; see also discussion of lease types in CBO, Budgetary Treatment of Leases, *supra* note 340, at viii.



present value of the Government's total estimated legal obligations over the life of the contract."<sup>386</sup> In contrast to capital leases and lease-purchases, an operating lease provides government access to the leased property for a limited time and is not tantamount to a purchase.<sup>387</sup> Under the new guidelines, only such operating leases are eligible for annual scoring of budget authority as lease payments are made.<sup>388</sup> From a federal agency's perspective, an operating lease can be appealing since the full up-front costs expected to be incurred over the lease term need not be reflected in the budget. In order to assure that only the proper types of leases are treated under the annual as opposed to up-front scoring rules, OMB guidelines include strict criteria that an operating lease must meet.<sup>389</sup>

Unfortunately, rather than improving the budget treatment of government leases, the 1991 scoring guidelines for government leases simply provided impetus to federal managers to find new and creative techniques to bypass or avoid the guidelines. The CBO recently reported that such techniques have become prevalent. For example, the General Services Administration is increasingly substituting the short-term operating lease method for acquiring federal office space over direct purchase and lease-purchase.<sup>390</sup> Federal government ex-

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386. OMB CIRCULAR No. A-11, *supra* note 120, app. B, at para. 1.

387. CBO, BUDGETARY TREATMENT OF LEASES, *supra* note 340, at viii.

388. *Id.*; OMB CIRCULAR No. A-11, *supra* note 120, at app. B, para. 1.

389. Such criteria include the following: 1) ownership of the asset must remain with the lessor and not be transferred to the government; 2) the lease must not have a bargain-purchase option; 3) the lease term must not exceed 75% of the estimated economic life of the asset; 4) the present value of the minimum lease payments must not exceed 90% of the fair market value of the asset; 5) the asset must be a general purpose asset not built to unique government specification; 6) there must be a private sector market for the asset. OMB CIRCULAR No. A-11, *supra* note 120, at app. B, para. 3 (defining the term "operating lease"). These criteria are strikingly similar to those adopted by the FASB for private venture leases. FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING No. 13, ACCOUNTING FOR LEASES, ¶ 7 (1976) [hereinafter FASB, STANDARD No. 13] (defining the term "capital lease" using the mirror image of the OMB "operating lease" criteria). Further discussion of private sector leases appears at *infra* notes 394-412 and accompanying text.

390. CBO, BUDGETARY TREATMENT OF LEASES, *supra* note 340, at 19-20. A report concerning the extent to which this reliance on short-term leases was increasing costs and hampering GSA's ability to fund other important programs was inconclusive. See U.S. GEN. ACCOUNTING OFFICE, BUDGET SCORING: SCORING AFFECTS SOME LEASE TERMS BUT THE FULL EXTENT IS UNCERTAIN, GAO-01-929 (Aug. 2001). A similar earlier report found that "[a]lthough construction was almost always estimated by GSA to be the least costly approach for meeting long-term space needs, it was not always the approach proposed." U.S. GEN. ACCOUNTING OFFICE, GENERAL SERVICES ADMINISTRATION: COMPARISON OF SPACE ACQUISITION ALTERNATIVES-LEASING TO LEASE-PURCHASE AND LEASING TO CONSTRUCTION, GAO/GGD-99-49R, at 1 (Mar. 12, 1999). The GAO reported budget scorekeeping rules as the major non-economic factor influencing the acquisition decision. *Id.* at 2.

pense for short-term lease of an asset may well be greater than the expense of acquiring access to that asset through direct purchase, long-term lease, or lease-purchase. Thus, government reliance on short-term leases may result in more expense and higher deficits.<sup>391</sup> An additional device used to bypass the lease scoring guidelines is to contract out capital-intensive tasks and simply to postpone acquisition of needed capital assets.<sup>392</sup> In addition, CBO reports that federal managers are responding to the lease scoring guidelines by increasingly resorting to incremental budgeting in which “Congress appropriates funds for part of a project even though that part has no value as a stand-alone project” and advance appropriations in which “Congress authorizes and appropriates funds for an entire project, but the appropriations do not become available for obligation until later.”<sup>393</sup> Both of these techniques decrease transparency of the budget by reducing the visibility of government costs.

## 2. *Private Sector Synthetic Leasing as a Parallel to Government Leasing*

Both the federal government and private industry have generally used separate entities, such as GSEs and SPEs, as devices to keep certain activities off-budget, thus masking the true extent of government or business expenses.<sup>394</sup> The long-term lease technique is similar. A *purchase* of property results in large up-front expenditures, which are reflected in the federal budget or private enterprise’s financial statements. In contrast, a long-term *lease* of the same property may serve as an effective equivalent to actual ownership and, at the same time, mask the true financial picture shown to taxpayers and investors. Although the federal government has made some improvements with its scoring guidelines for lease transactions, loopholes remain and the long-term lease technique survives.<sup>395</sup>

In the private sector, the parallel to long-term government leasing is synthetic leasing, which offers business entities the best of two worlds. In a carefully structured transaction, a business may be treated as the *owner* of property for *tax* purposes and still be regarded

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391. For example, the CBO provided an assessment in 2002 of alternative methods for modernizing the Air Force’s tanker aircraft fleet. It concluded that the overall costs of pursuing a ten-year operating lease option would well exceed the cost of a direct purchase. See Letter from Dan L. Crippen, Dir., CBO, to Sen. John McCain (May 7, 2002). For further discussion of the Air Force leasing controversy, see *infra* notes 402-12 and accompanying text.

392. CBO, BUDGETARY TREATMENT OF LEASES, *supra* note 340, at 20-22.

393. *Id.* at 22. For a discussion of the use of advance appropriations as a budget gimmick, see *supra* notes 230-32 and accompanying text.

394. See *supra* notes 343-78 and accompanying text.

395. See *supra* notes 386-93 and accompanying text.

as the *lessee* for *book* or financial purposes.<sup>396</sup> If a business lease meets the definition of an “operating lease” for financial accounting purposes, acquisition of the property is not included on the business’s balance sheet.<sup>397</sup> The business often will create an SPE for purposes of the lease transaction and arrange for the SPE to buy the property. The SPE, in turn, leases the property back to the business. A major advantage of this classification is that

the corporation need not charge annual depreciation expenses against its financial statement earnings for any buildings constructed on the property underlying the lease. Certainly, a stronger bottom line, or at least the impression thereof, tends to boost the investment profile of publicly traded companies, which face intense daily scrutiny from Wall Street analysts and investors.

Thus, the business can simultaneously show a stronger bottom line for investors and decrease federal tax liability.<sup>398</sup>

Regardless of the lease-like *form* of the transaction, a lease will be treated as a mortgage for tax purposes if the economic substance suggests that the nominal lessee has an ownership-like interest.<sup>399</sup> If a business is viewed as an owner for tax purposes, its purported “rental” payments will be treated as debt service in connection with a purchase. As owner, the taxpayer is entitled to deductions for the portion of the “rent” attributable to interest on the mortgage and for depreciation on buildings on the property.

One synthetic lease that received significant attention in connection with recent accounting and tax scandals involved Enron, which purchased its Houston headquarters building through an SPE created for purposes of the acquisition and then leased the headquarters from the SPE.<sup>400</sup> Although it was not the primary focus of congressional

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396. For good a description and discussion of synthetic leasing, see Luppino, *supra* note 323, at 49-68; H. Peter Nesvold, *What Are You Trying to Hide? Synthetic Leases, Financial Disclosure, and the Information Mosaic*, 4 STAN. J. L. BUS. & FIN. 83 (1999); Donald J. Weidner, *Synthetic Leases: Structured Finance, Financial Accounting and Tax Ownership*, 25 J. CORP. L. 445 (2000). The “tax-sheltering” opportunities presented by such leasing are usefully and succinctly described in George Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657, 685-86 (1985).

397. FASB, STANDARD NO. 13, *supra* note 389. This FASB standard provides criteria used to define a “capital lease” that would *not* result in generally favorable off-balance financial treatment. The parallel budget scoring guidelines, which undoubtedly were derived from FASB Standard No. 13, use the mirror image of these criteria to define an “ordinary lease” that *would* effectively lead to off-budget treatment. See *supra* note 389.

398. Nesvold, *supra* note 396, at 93.

399. For a good discussion of this federal tax law “substance over form” doctrine as applied to synthetic lease transactions, see Weidner, *supra* note 396, at 465-88.

400. See POWERS REPORT, *supra* note 2, at 37; see also Diana B. Henriques, *The Brick Stood Up Before. But Now?*, N.Y. TIMES, Mar. 10, 2002, §3, at 1 (describing SPE set up by Enron to purchase the company’s Houston headquarters and lease it back to the company).

activity, synthetic lease abuse did receive some attention at hearings leading up to passage of the Sarbanes-Oxley Act.<sup>401</sup>

Despite congressional and public concern over the misuse of synthetic leases to artificially improve the bottom line, the federal government continues to try the same off-budget special-entity lease gimmick used by the private sector. A recent and controversial illustration is the arrangement through which the Air Force has proposed to use a newly created special-purpose entity to lease aerial refueling aircraft from Boeing.<sup>402</sup> Congress first provided authority for the Secretary of the Air Force to establish a “multi-year program for leasing general purpose Boeing . . . aircraft.”<sup>403</sup> The Air Force itself lobbied rather heavily for this authority and was clearly motivated, at least in part, by its desire to acquire the aircraft without having to include the full up-front acquisition cost in the budget.<sup>404</sup> To get this preferred budget treatment, Congress required the Air Force to lease the aircraft in a transaction that would meet OMB criteria for “operating lease” classification.<sup>405</sup> The stakes here are high. The CBO concluded that if the originally proposed lease of 100 aircraft

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401. See *supra* notes 5-6; see, e.g. *Hearings Before the House Energy and Commerce Committee*, 107th Cong. (2002) (prepared statement of Bala G. Dharan, Professor of Accounting, Rice Univ.) (describing synthetic lease transactions as designed to “structure the purchase or use in such a way that it does not result in a financial liability on the balance sheet”); *Hearings Before the Senate Banking, Housing, and Urban Affairs Committee*, 107th Cong. (2002) (prepared statement of Lynn Turner, Chief Accountant, United States Securities and Exchange Commission) (structured transactions permit “hundreds of billions of dollars in synthetic lease financing off balance sheet liabilities to be hid from the eyes of investors; . . . permit companies to avoid consolidation of special purpose entities . . . They are better described as a chapter from Grimm’s Fairy Tales.”).
402. Senator John McCain, for example, described the special entity created for purposes of the lease transaction as “an Enron entity run by the Air Force” and complained that the government would be “asking the taxpayers to pay \$5 million in additional funds with a shell game Enron-like entity, funneling the money through . . .” *The Proposed Lease of 100 KC-767 Aerial Refueling Tanker Aircraft by the Air Force: Hearings Before the Senate Comm. on Armed Services*, 108th Cong. (2003) [hereinafter *Proposed Lease Hearings*] (remarks of Senator McCain).
403. Department of Defense and Emergency Supplemental Appropriations for Recovery From and Response to Terrorist Attacks on the U.S. Act, 2002, Pub. L. No. 107-117, §8159, 115 Stat. 2230, 2284 (2002) (not formally codified, but referenced at 10 U.S.C.A. §2401a (West Supp. 2003) (Historical and Statutory Notes)) [hereinafter 2002 Defense Appropriations Act].
404. See *Proposed Lease Hearings*, *supra* note 402 (statement of James Roche, Sec. of the Air Force) (“The dominant reason for proposing a lease is the advantage it affords for quickly delivering needed tankers . . . without requiring significant up-front funding.”) (emphasis added).
405. 2002 Defense Appropriations Act, *supra* note 403, at §8159(c)(5). The Act further required the Air Force to report to Congress on the terms and conditions of proposed leasing contracts and to describe the savings, if any, of a lease as compared with an outright purchase program. *Id.* at §8159(c)(7). Subsequent legislation

is recorded as a purchase, budget authority over the first five years would total \$17.3 billion, and outlays would sum to \$10.1 billion. If the transaction is recorded as an operating lease, only \$1.5 billion in budget authority would be shown over the first five years, and outlays during that period would also total only \$1.5 billion, because most of the aircraft would not be available for leasing until 2009.<sup>406</sup>

After reaching an agreement with Boeing in May 2003, the Air Force reported to Congress that the proposed lease transaction would qualify as an operating lease under OMB criteria. While conceding that the lease option would cost more than an outright purchase, the Air Force still held to its view that leasing was the preferred approach.<sup>407</sup> The CBO disagreed with the Air Force's classification of the lease and concluded that the Air Force had dramatically underestimated the extra cost of leasing as opposed to outright purchase of the aircraft. In contrast to the Air Force estimate of \$150 million in extra cost, the CBO concluded that the lease proposal would cost \$1.3 to \$2 billion more than the purchase alternative.<sup>408</sup> One suspects that Air Force efforts to avoid up-front budget reporting of the full aircraft cost resulted in a substantially inefficient choice regarding a major government expenditure.<sup>409</sup>

Conceding that "the proposal is right at the margin," the executive branch of the OMB nevertheless sided with the Air Force and agreed to classify the lease as an operating lease under its guidelines. Justifying this conclusion, the OMB observed: "[i]n light of the Air Force's conviction that these planes are needed to meet an urgent military need and in light of clear congressional intent to support a lease, as expressed in legislation, the OMB believed it appropriate to resolve ambiguities in favor of classifying this transaction as an operating lease."<sup>410</sup>

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further mandated that the Air Force not enter into any lease pursuant to §8159 without first submitting a report to Congress and receiving authorization and appropriation of funds or new start reprogramming notification for necessary funds. Bob Stump National Defense Authorization Act for Fiscal Year 2003, Pub. L. No. 107-314, 116 Stat. 2608, div. A, tit. 1, §133 (not formally codified, but referenced at 10 U.S.C.A. §2401a (West Supp. 2003)(Historical and Statutory Notes). The OMB criteria for "operating lease" classification are listed at *supra* note 389.

406. CONGRESSIONAL BUDGET OFFICE, ASSESSMENT OF THE AIR FORCE'S PLAN TO ACQUIRE 100 BOEING TANKER AIRCRAFT 6 (2003) [hereinafter CBO, AIR FORCE ASSESSMENT]

407. See *Proposed Lease Hearings*, *supra* note 402 (statement of James Roche).

408. The CBO presented its findings to Congress in testimony before several committees. See, e.g., *Proposed Lease Hearings*, *supra* note 402 (statement of Robert A. Sunshine, Ass't Dir. for Budget Analysis).

409. For a discussion of the inefficient choice problem with regard to government leasing in general, see *supra* notes 380-83 and accompanying text.

410. *Proposed Lease Hearings*, *supra* note 402 (remarks of Joel Kaplan, Deputy Dir., OMB).

Over the institutionally more neutral CBO objections, Congress sided with the Air Force and the OMB, authorizing the Air Force to go forward with its multi-year lease contract for no more than twenty tanker aircraft.<sup>411</sup> In the end, the Air Force deal with Boeing was placed on hold pending investigation of wrongdoing against Boeing in connection with bidding for the contract and conflict of interest claims regarding Boeing's alleged employment offers to federal employees involved in negotiating the lease transaction.<sup>412</sup> The ongoing debate over the Air Force lease deal with Boeing simply highlights the extent to which Congress continues to play the same games with numbers that it finds so troubling in the private sector. This budget gamesmanship goes on even in the post-Gramm-Rudman world that no longer includes formal discretionary spending caps and PAYGO budget restrictions. As the Boeing investigation proceeds, Congress should use the opportunity to consider provisions that would limit private entity attempts to reduce taxes while simultaneously improving the financial bottom line. Congress should also use this opportunity to look inward and consider provisions restricting its own use of special entities and long-term leases to improve the budget bottom line. Government use of these devices is especially egregious when transactions result in far greater overall expenditure of taxpayer dollars than an outright purchase or more straight-forward transaction structure.

### E. Declaration of Emergencies That Aren't

Under the Budget Enforcement Act, any discretionary spending or new direct spending or receipts legislation declared as an emergency by the President and Congress was exempt from spending caps for appropriations and PAYGO restrictions for new tax and entitlement legislation.<sup>413</sup> With regard to appropriations, Congress can provide emergency funding through regular annual appropriations, contingent emergency appropriations, or emergency supplemental appropriations.<sup>414</sup> The GAO reports that Congress increasingly has been

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411. National Defense Authorization Act for Fiscal Year 2004, div. A, tit. 1, §135, Pub. L. No. 108-136, 117 Stat. 1392 (2004) (Procurement of Tanker Aircraft). Congress even provided authority to initiate or continue a multiyear lease "for any fiscal year for which sufficient funds are available to pay the costs of such contract for that fiscal year, *without regard to whether funds are available to pay the costs of such contract for any subsequent fiscal year.*" *Id.* at §135(b)(4) (emphasis added).

412. See David Bowermaster, *Stonecipher Puts New Twist on the Status of Tanker Deal*, SEATTLE TIMES, Feb. 7, 2004, at C1.

413. 2 U.S.C. § 901(b)(2) (2000) (discretionary spending cap emergencies); 2 U.S.C. § 902(e) (2000) (PAYGO emergencies).

414. U.S. GEN. ACCOUNTING OFFICE, BUDGETING FOR EMERGENCIES: STATE PRACTICES AND FEDERAL IMPLICATIONS, GAO/AIMD-99-250, at 6 (1999) [hereinafter GAO, BUDGETING FOR EMERGENCIES].

using emergency spending designations as a strategy to exceed spending limitations.<sup>415</sup> More significantly, emergency appropriations increasingly are being used for “broader purposes.”<sup>416</sup> This is simply the GAO’s polite way of saying that Congress has been taking advantage of the emergency designation under the Budget Enforcement Act to bypass budget enforcement. Perhaps the most extreme example is the emergency declaration of \$4.5 billion in the fiscal year 2000 budget for Census preparation, surely an anticipated expenditure that few would be seriously willing to label as an emergency appropriation.<sup>417</sup> Not only were emergency classifications loopholes permitting Congress to avoid pre-2003 spending caps, but they also arguably caused Congress to provide inadequate insurance or otherwise attempt to reduce the potential costs of future disasters.<sup>418</sup>

Unfortunately, the statute itself, however, offers no definition of emergency, leading one witness to testify before the House Budget Committee that “[u]nder current procedures . . . , emergency spending is whatever the Congress and the President deem it to be.”<sup>419</sup> Responding to a request from Congress that it propose guidelines for classifying “emergencies,” the OMB in 1991 proposed five criteria:

- (1) the expenditure was “necessary,”
- (2) the situation requiring the emergency appropriations was “sudden,”
- (3) the situation was “unforeseen,”
- (4) the need for emergency appropriations was “urgent,” and
- (5) the situation requiring the emergency appropriations was “not permanent.”<sup>420</sup>

Despite several proposed bills, Congress has yet to codify the OMB guidelines.

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415. GAO, 2002 BUDGET COMPLIANCE, *supra* note 132, at 34.

416. *Id.*

417. Consolidated Appropriations Act of 2000, Pub. L. No. 106-113, 113 Stat. 1501 (1999).

418. *CBO Testimony on Budgeting for Emergency Spending: Hearing Before the House Task Force on Budget Process, Comm. on the Budget*, 105th Cong. 12 (1998) (statement of James L. Blum, Deputy Dir., CBO) (“Some also claim that excessive emergency aid discourages the purchase of adequate insurance or the incentive to take actions that would mitigate the cost of natural disasters.”).

419. *Id.*, at 2; *see also* SENATE CONGRESSIONAL BUDGET EXPLANATION, *supra* note 135, at 55.

420. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, REPORT ON COSTS OF DOMESTIC AND INTERNATIONAL EMERGENCIES AND ON THE THREATS POSED BY THE KUWAITI OIL FIRES (June 1991), *cited in* GAO, BUDGETING FOR EMERGENCIES, *supra* note 414, at 22-23 & n. 30. The President recently included these proposals in his 2005 budget. 2005 ANALYTICAL PERSPECTIVES, *supra* note 134, at 217.

## F. Directed Scoring and Directed Scorekeeping

### 1. Directed Scoring

Perhaps the most egregious form of playing games with numbers is the use of directed scoring and directed scorekeeping. The term “directed scoring” is used with some frequency and can be found in the budget literature.<sup>421</sup> Directed scoring as a phenomenon is made possible by the existence of multiple federal budget scorekeepers. Within the executive branch, the OMB is responsible for providing budget estimates for the President’s budget and for purposes of applying budget sequester rules under pre-2003 discretionary spending cap and PAYGO budget limitations of the Budget Enforcement Act of 1990.<sup>422</sup> Congress, on the other hand, established the CBO in 1974 to generate a separate set of estimates for congressional use in preparation of the concurrent budget resolution.<sup>423</sup> In addition to the CBO, Congress gave authority to yet another entity, the Joint Tax Committee (JTC), to provide revenue estimates and distributional effect information for any pending or enacted revenue legislation enacted by Congress.

The staffs of the three different scoring entities do not always agree on working assumptions or methodology. As a result, the same budget proposals or programs may be given three different scores.<sup>424</sup> As would be expected, Congress generally relies upon its own CBO figures in preparing its concurrent budget resolution and considering the impact of any new legislation. Periodically, however, Congress decides that the CBO figures do not suit its purposes; they simply direct the CBO to adopt OMB figures instead of its own. As Schick reports, Congress sometimes “picks and chooses between OMB and CBO assumptions, taking from each those that score its appropriations as less costly.”<sup>425</sup> “Directed scoring” is the term generally used to refer to this particular congressional budget committee direction to the CBO to use OMB figures.<sup>426</sup> For fiscal year 2000, for example, the CBO

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421. See, e.g., SCHICK, *supra* note 15, at 63.

422. See discussion *supra* notes 133-137 and accompanying text; see also Block, *Pathologies*, *supra* note 16, at 885-86.

423. Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 297 (1974). The CBO is responsible for providing Congress with its own set of general budget numbers and baselines. 2 U.S.C. § 601(f) (2000). As budget expert, Allen Schick explains, both the “OMB and CBO prepare baseline projections for budget aggregates . . . , particular categories of the budget, and for particular programs or accounts.” SCHICK, *supra* note 15, at 57. Schick further reports that the “CBO tends to use more cautious assumptions than [the] OMB.” *Id.* at 63.

424. For an excellent discussion of the different scoring and estimating techniques used by the CBO, JCT, and OMB, see Michael J. Graetz, *Paint By Numbers Tax Lawmaking*, 95 COLUM. L. REV. 609 (1995).

425. SCHICK, *supra* note 15, at 63.

426. On the one hand, some will loosely use the terms “directed scoring” and “directed scorekeeping” interchangeably. Some use the term “directed scorekeeping” to re-



reported that it was directed by Congress to use estimates approximating OMB's calculations for defense, receipts from the auction of spectrum licenses, and student loans.<sup>427</sup> Based upon CBO estimates, the congressional budget resolution for fiscal year 2000 would have violated the 1990 Budget Act spending cap restrictions, thus triggering the mandatory sequester rules.<sup>428</sup> House Armed Services Committee Chairman Floyd Spence was quite open about using directed scoring with respect to the defense appropriation budget for fiscal year 2000. Forced to choose between directed scoring and spending reductions, he would clearly choose the former. As he noted, "[i]f it becomes necessary, I [sic] recommend a similar solution this year, and could not support any solution to an outlay-scoring problem that requires a reduction to the President's defense budget request."<sup>429</sup>

Congress can use this directed scoring to play games with the numbers, choosing to use its own figures when such figures work to its advantage and turning to the executive department numbers at whim when the latter make the budget figures come out better. This random application of scoring rules seems inconsistent with the tone of corporate accountability that Congress has recently taken with respect to private business enterprises. In fairness to Congress, however, it is conceivable that there are occasions when it might make policy sense to depart from CBO estimates. On such unusual occasions, Congress should carefully explain its rationale for rejecting CBO in favor of OMB estimates and should not be free to simply choose the score it likes best.

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fer to what most budget treatises and what I prefer to call "directed scoring." See, e.g., David Baumann, *Begin the Endgame*, 15 NAT'L J. 1126, 1126-27 (2000) (referring to House and Senate Budget Committee directions to CBO to adopt OMB scoring as "directed scorekeeping"); James P. Lucier, *Candidates Clash; Congress Toils*, 16 INSIGHT MAG., Mar. 27, 2000, at 8, 9 (referring to Republican's use of "OMB's fuzzier numbers because they looked better" as "directed scorekeeping"). On the other hand, some use the term "direct scoring" to refer to what really should be called "directed scorekeeping." See, e.g., 147 CONG. REC. S12,341 (daily ed. Dec. 4, 2001) (statement of Sen. Domenici) ("Don't ask the Congressional Budget Office and then say, regardless of their answer, which we are supposed to follow, we are going to determine and declare that we are not going to follow it. That is called directed scoring - telling them how to score things contrary to the rules, contrary to reality, and contrary to the way we have been doing it."); see also discussion, *infra* notes 411-412 and accompanying text for an attempt to clarify the two terms.

427. CONGRESSIONAL BUDGET OFFICE, U.S. CONG., *THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2001-2010*, 77 (2000).

428. For a brief discussion of these budget rules, see *supra* notes 135-137 and accompanying text. For a fuller discussion, see Block, *Pathologies*, *supra* note 16, at 882-88.

429. Baumann, *supra* note 426, at 1127 (quoting Senator Spence).

## 2. *Directed Scorekeeping*

“Directed scorekeeping,” unlike “directed scoring,” does not appear to be a common term. Although federal budget process experts often use the phrase, one cannot find it in the index to any of the major treatises on the budget process.<sup>430</sup> Unfortunately, to the extent that the term is applied, it is often used interchangeably with “directed scoring,” thus leading to the impression that the two concepts are one and the same. One of the objectives in this Article is to raise awareness of the distinction between directed scoring and directed scorekeeping and to make sure that “directed scorekeeping” does not remain the dirty little secret of budget experts on Capitol Hill. In addition, this Article urges the terms be used accurately to describe two different types of scoring adjustments.

In the case of directed scoring, Congress chooses a set of budget figures from two possible sets, both of which presumably were prepared by experts. To be sure, estimating economic baseline projections and other relevant budget figures is a complex process about which reasonable minds may differ. When Congress chooses to use OMB numbers rather than its own, it is at least choosing plausible figures prepared by expert economists and policymakers. When Congress uses what I refer to as “directed scorekeeping,” on the other hand, it simply directs the CBO to use figures other than the CBO’s own estimates.<sup>431</sup> Since the CBO is the official scorekeeper for Congress, Congress departs from its own budget practices when it requests “scoring adjustments” from the CBO. This might be referred to as *internal* directed scorekeeping. Gaming the numbers in this way arguably permits politicians to be dishonest, particularly about the extent to which Congress is borrowing from the Social Security surplus in order to fund other federal government activities. As at least one reporter observed in 1999, in order to avoid appearing to steal money from the Social Security surplus, Congress simply directed the CBO to recompute its calculations and, “this time, to subtract several billion dollars from the result so that the numbers would come out right. (This is called ‘directed scorekeeping; essentially, Congress has the le-

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430. See, e.g., COLLENDER, *supra* note 139; SCHICK, *supra* note 15; WILDAVSKY & CAIDEN, *supra* note 229.

431. Another possible way to distinguish directed scoring and directed scorekeeping would be to say that the former applies to *internal* directions from Congress for CBO to use figures other than its own. Directed scorekeeping, on the other hand, might be said to refer to congressional instructions to the OMB to use figures other than its own for enforcement purposes. This usage gives the terms slightly different meanings from those that I adopt in the text. From my perspective, the better distinction is one used in the text.

gal right to make the CBO do anything it wants, even if that means pretending certain budget items do not really exist).<sup>432</sup>

If one looks closely at CBO computations of on-budget surplus, for example, one can find an entry somewhat euphemistically labeled "scoring adjustment."<sup>433</sup> When asked to explain, CBO Director Dan Crippen routinely answered, "we include the effects of various scorekeeping directives and adjustments made by the budget committees, which would have the effect of reducing outlays attributed to appropriations bills . . . In total, these adjustments come to about \$17 billion for the House and \$16 billion for the Senate."<sup>434</sup> Professional CBO economists work hard to provide reasonable and accurate budget figures for Congress. Yet, as one journalist reports, "these number-crunchers live in two budgetary worlds: the real one, based on the CBO's generally respected economic projections, and the fake one, based on politicians' fantasies, a little like the bits of cake in 'Alice in Wonderland' that magically make things shrink or grow."<sup>435</sup>

One recent example of controversial directed scorekeeping involves the Railroad Retirement and Survivors' Improvement Act of 2001.<sup>436</sup> The Act increased retirement benefits for railroad employees, reduced payroll taxes previously used to finance those benefits, and generally restructured the railroad retirement system.<sup>437</sup> One of the major restructuring devices was to create a new National Railroad Retirement Investment Trust (RRIT) as a privately-owned government-sponsored enterprise.<sup>438</sup> Unlike regular government trusts, this new railroad retirement trust is authorized to invest in non-federal assets; it is not limited to investing its surplus in U.S. Treasury obligations. In the process of restructuring, the balance held in the old Rail Industry Pension Fund was transferred to the new RRIT, which would be authorized to invest the balance in a diversified portfolio, including corporate

432. Jonathan Chait, *The GOP Gets One Right, Sort Of*, THE NEW REPUBLIC, Nov. 22, 1999, at 16, 17.

433. CONGRESSIONAL BUDGET OFFICE, COMPUTATION OF ON-BUDGET SURPLUS FOR FISCAL YEAR 2000. CBO Senior Analyst, Susan Tanaka, reported that "by definition," if CBO labels something as a "scoring adjustment," it means that CBO does not agree with it. Ann Scott Tyson, *The Numerical Wizardry Behind the Budget*, CHRISTIAN SCIENCE MONITOR, Oct. 25, 1999, at 1.

434. Letter from Dan L. Crippen, Dir. CBO, to Rep. John M. Spratt, Jr., Ranking Dem. Member, House Budget Comm. (Aug. 26, 1999), reprinted in TAX NOTES TODAY 177 (1999).

435. Tyson, *supra* note 433, at 1.

436. Pub. L. No. 107-90, 115 Stat. 878, 887 (2001) [hereinafter Railroad Retirement Act of 2001].

437. HOUSE COMM. ON WAYS & MEANS, REPORT ON THE LEGISLATIVE AND OVERSIGHT ACTIVITIES OF THE COMMITTEE ON WAYS AND MEANS DURING THE 107TH CONGRESS, H. R. REP. 107-801, at 3-4, 56-57 (2003) (description of Railroad Retirement and Survivors' Improvement Act of 2001).

438. Railroad Retirement Act of 2001, *supra* note 436, at § 105(a), 115 Stat. at 882-86 (codified at 45 U.S.C. § 231n(j) (2003)).

stocks and bonds.<sup>439</sup> In what might appear on the surface as a reasonably innocuous provision, Congress included a financing detail providing that for purposes of budget computations and federal financial accounting, “the purchase or sale of non-Federal assets . . . by the National Railroad Retirement Investment Trust shall be treated as a means of financing.”<sup>440</sup>

The significance of this declaration was to effectively declare, contrary to CBO estimates and GAO practice, that the transfer of federal funds to the RRIT was not a budget outlay. The CBO had estimated a total cost of \$14.9 billion for the measure over the years 2001-2010. On the Senate floor, Senator Nickles stated that he was embarrassed and horrified that the Senate could incorporate such a provision. He complained: “Hocus pocus—write a check, and it doesn’t count. That really bothers me.”<sup>441</sup> Concerned about the selective use of directed scorekeeping and the troubling precedent that it might establish in the context of Social Security, Senator Domenici proposed a floor amendment to strike the direct scorekeeping provision.<sup>442</sup> Describing the directed scorekeeping as “pathetic,” Senator Domenici pleaded with his colleagues not to ask for CBO cost estimates “and then say, regardless of their answer, which we are supposed to follow, we are going to determine and declare that we are not going to follow it.”<sup>443</sup> He further commented that bending the rules in the private sector “creates confusion for the same reason [and] we should not bend the accounting rules of the Federal Government to suit our purpose. Doing so reduces transparency and misleads the public.”<sup>444</sup>

To be fair, even the CBO acknowledged that the proper budget treatment of trust fund investments in non-Federal assets was unsettled.<sup>445</sup> Under conventional budget treatment, the transfer of funds to RRIT should be treated as an outlay, since cash is physically leaving the Treasury. On the other hand, since the outlay is invested in securities, as opposed to other goods and services, an argument might be made that the outlay should simply be viewed as a non-scoreable means of financing.<sup>446</sup>

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439. See description in H.R. REP. NO. 106-777, pt. 1, at 16-17 (2000).

440. Railroad Retirement Act of 2001, *supra* note 436, § 105(c), 115 Stat. at 887 (referenced at 45 U.S.C.A. § 231n(e) (West Supp. 2003) (Historical and Statutory Notes)).

441. 147 CONG. REC. S12,118 (daily ed. . Nov. 29, 2001) (statement of Sen. Nickles).

442. Amendment No. 2202 to amend. No. 2170 to H.R. 10, 107th Cong., 147 CONG. REC. S12,340 (daily ed. Dec. 4, 2001) (amendment to strike provision related to directed scorekeeping).

443. 147 CONG. REC. S12,341 (daily ed. Dec. 4, 2001) (statement of Sen. Domenici).

444. *Id.*

445. H.R. REP. 106-777, *supra* note 439, pt. 2, at 20-23.

446. The House Committee on Transportation and Infrastructure considered both alternatives as applied to the new railroad retirement trust fund and concluded,

Congress has also turned to a broader form of directed scorekeeping in recent years in order to bypass pre-2003 mandatory sequestration that would otherwise have resulted from PAYGO violations. For purposes of enforcing fiscal restraints imposed by the Budget Enforcement Act, the OMB was required to impose mandatory sequestration of certain federal programmatic funds. The OMB maintained its own PAYGO scorecard for purposes of this sequestration enforcement. When Congress directs the OMB to ignore the OMB scorecard and instead to substitute a figure created by Congress, it engages in directed scorekeeping. This type of *external* directed scorekeeping, however, is quite different from the informal process used when congressional budget committees simply direct CBO to substitute alternate budget figures of Congress' choosing.

Unlike *internal* directed scorekeeping through congressional directives to CBO, *external* directed scorekeeping must be done by statute. Remarkably, for fiscal years 2000 through 2002, Congress directed the OMB to set its PAYGO scorecard to zero, thus avoiding mandatory sequestration.<sup>447</sup> The OMB has complied with these directed scorekeeping directives from Congress. For example, in response to the fiscal year 2001 directive, the OMB's sequester report simply ends with: "NOTE: Pursuant to P.L. 106-554, the pay-as-you-go balances that would result in a sequester for FY 2001 will be set to zero."<sup>448</sup> One must wonder how Congress could simply tell the OMB to erase whatever PAYGO figures it had on its scorecard and substitute a zero.<sup>449</sup> Alice in Wonderland immediately comes to mind. One wonders also whether this can possibly be constitutionally appropriate. Why did the OMB not raise separation of powers objections?<sup>450</sup> Per-

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contrary to CBO, that the "alternative budget treatment is more appropriate than the conventional budget treatment." *Id.*, pt. 1, at 17.

447. Department of Defense and Emergency Supplemental Appropriations for Recovery from and Response to Terrorist Attacks on the United States Act, 2002, Pub. L. No. 107-117, div. C, § 102, 115 Stat. 2230, 2342-43 (2001) (setting PAYGO sequester to zero for 2001 and 2002); Consolidated Appropriations Act, 2001, Pub. L. No. 106-554, § 2(b), 114 Stat. 2763, 2763-64 (2000) (setting PAYGO sequester to zero for 2001); Consolidated Appropriations Act, 2000, Pub. L. No. 106-113, § 1001(c), 113 Stat. 1501, 1537 (1999) (setting PAYGO sequester to zero for 2000). For an interesting case study regarding the evolution of fiscal year 2002 directed scorekeeping to the OMB, see Block, *Pathologies*, *supra* note 16, at 888-98.
448. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, OMB COST ESTIMATE FOR PAY-AS-YOU-GO CALCULATIONS, OMB REP. NO. 550 (Jan. 12, 2001).
449. Without success, Congress has tried to discipline itself with regard to directed scorekeeping. For example, the 2001 fiscal year budget included a provision making it out of order in the House "to consider any reported bill or joint resolution, or amendment thereto or conference report thereon, that contains a directed scorekeeping provision." H.R. Cong. Res. 290, 106th Cong. § 31, at 53-54 (2000) (enacted).
450. Former OMB Director, Richard Darman, at least hinted of separation of powers concerns in 1991 testimony before the House Budget Committee. After noting

haps the explanation is that Congress itself created the mandatory sequester process through the Budget Enforcement Act, giving the OMB its sequestration powers in the first place. Since the direction to the OMB took the form of a statute, duly enacted and signed by the President, one might say that Congress simply repealed the Budget Act sequestration provision, at least for that particular year. Constitutional considerations aside, the directed scorekeeping technique is surely a gimmick largely hidden from public view. Although Congress may not have violated the Constitution, to my mind, it surely has violated transparency and accountability, democratically-oriented principles that should drive the federal budget process.<sup>451</sup> For the moment, the directed scorekeeping aimed at the OMB is no longer an issue, given the recent sunset of spending caps, PAYGO, and sequesters. The issue will re-emerge, however, if such budget constraints are re-enacted. Either way, the external directed scorekeeping examples above provide dramatic illustration of the extent to which Congress plays games with numbers.

#### V. Conclusion

Congress has spent considerable time over the past several years focusing on issues of corporate accountability – and rightly so. Public confidence in the economy and the stock market has been severely eroded by the seemingly endless reports of major U.S. corporate accounting, tax, and financial scandals. Coincidentally, the past year also happens to be the year in which budgetary fiscal constraints built into the Budget Enforcement Act of 1990 expired. Sadly, Congress itself is guilty of using accounting and financial gimmicks to comply with budget procedural rules, to reduce the apparent federal deficit and to paint a rosier picture of the economy to the American public. Unless Congress cleans up its own house, public confidence in the economy and the stock market will suffer.

Although I think that Congress should do so, this Article has not focused upon the policy question of whether Congress should extend recently expired Budget Enforcement Act discretionary spending caps and PAYGO procedures. Surely, Congress must address these issues as it considers budget reform. For the moment, however, my concern is narrower, focusing particularly on the accounting rules that Congress uses for purposes of the federal budget. Far from being simply a

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that congressional directed scorekeeping violates the enforcement provisions of the BEA, he stated that "these sections of the BEA designate *OMB* as the 'scorekeeper' of the budget effect of legislation for purposes of calculating whether a spending limit has been exceeded or the pay-as-you-go requirement has been violated." *Hearings Before the House Budget Comm.*, 103d Cong. 8 (July 17, 1991) (statement of Richard G. Darman, Dir. OMB).

451. See Block, *Pathologies*, *supra* note 16, at 898-904.

technical matter, budget accounting has a dramatic impact not only on budget formation and budget policy, but also on public policy more generally. If Congress now limits its budget reform debate to addressing just the fiscal discipline issues, it will have lost a precious opportunity.

From time to time, proposals have emerged regarding one budget gimmick or accounting device or another. Now is the time for Congress to take a careful look at the entire budget picture and review all of its major budget accounting provisions. Perhaps the first task should be for Congress to prepare a comprehensive set of federal budget accounting rules comparable to the FASB rules applicable to the private sector and the FASAB rules applicable to federal government agencies and departments. Much of congressional budget accounting is considered in a piecemeal fashion and there are many inconsistencies as approaches have developed incrementally over time. Although a complete move to accrual-based accounting may be premature, Congress at a minimum should address the inconsistent use of accrual-based methods in the current budget. The logic that moved Congress to adopt accrual-based budgeting with respect to federal credit programs as well as some civilian federal and military employee retirement programs should similarly move Congress to adopt accrual-based budgeting for other retirement programs and activities with similar long-term cost implications.

Over the years, the number of off-budget mixed-ownership and government-sponsored enterprises has proliferated. Particularly as it slings arrows at the off-budget entities used by Enron and others to disguise financial information, Congress must assess its use of off-budget government corporations and develop a consistent policy regarding appropriate use of such enterprises. Once and for all, Congress also needs to stop being schizophrenic about its treatment of Social Security. There certainly are reasonable arguments for and against the off-budget status of Social Security, but Congress cannot have it both ways. Whatever budget accounting position Congress chooses should be consistently applied. Many federal programs, including Medicare, have similar policy underpinnings and budgetary concerns. Although Social Security is among the largest of these programs, whatever treatment Congress decides upon for Social Security should be extended to other comparable programs.

Over the past decade, Congress has displayed an increasing commitment to the notion that the laws shall bind equally on all. The Congressional Accountability Act of 1995 showed a willingness on the part of Congress to subject itself to the same workplace and employment regulations that it imposed on the private sector. To make the provision work, Congress had to be somewhat creative in overcoming logistical and procedural hurdles. Separation of powers concerns, for

example, made it impossible to simply extend the private sector rules to Congress. Instead, Congress had to devise an enforcement structure that would not involve the executive branch in enforcing employment laws against the legislative branch. Similarly, Congress cannot simply vote to apply the same accounting rules for federal budget purposes that it imposes on the private sector. Congress recently created the Public Company Accounting Oversight Board to oversee accounting and auditing practices in the private sector.<sup>452</sup> Past experience shows that, despite the best of intentions, Congress has considerable difficulty sticking to its guns when it comes to budget discipline. Perhaps one solution would be for Congress to create its own independent oversight board.

To be sure, federal budget accounting has unique objectives and may require different rules than those used for purposes of private sector financial accounting. At the same time, it also might not be sensible for Congress to simply extend to itself the *federal* government financial accounting rules that it imposes on federal agencies and departments. Surely, Congress must also recognize the unique issues relevant to budget as opposed to financial accounting. That said, however, Congress should come closer than it has to date to adopting federal budget accounting standards that conform to private sector and federal government accounting principles. When Congress departs from those principles, it has an obligation to explain more fully the grounds for its departure. Absent such an explanation, the public may be justified in accusing Congress of a double standard. When Congress accuses the private sector of accounting gimmickry and fraud, the pot may well be calling the kettle black.

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452. Sarbanes-Oxley Act, *supra* note 5, at § 101(a).