# It's Time to Mind the GASB

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## I. INTRODUCTION

Recurring news reports[1] about state and local governments facing unfunded public sector pension obligations raise concerns among policy makers,[2] scholars,[3] and the general public. The enormous pension deficits the public sector currently faces did not suddenly appear one day. Years and years of over-generous pension arrangements given to public servants,[4] accompanied by mismanagement and unsatisfactory funding, created today's mega-billion pension deficits.[5]

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1. *See, e.g.*, Ed Bachrach, Opinion, *Commentary: A Federal Solution to Chicago's Public Pension Mess*, CHI. TRIB. (Sept. 7, 2016, 7:01 PM), http://www.chicagotribune.com/news/opinion/commentary/ct-public-pensions-unfunded-police-chicago-perspec-0909-jm-20160907-story.html (reporting that Chicago's five major pension plans suffer from a $35 billion deficit of unfunded pensions); Aaron Kuriloff & Timothy W. Martin, *Connecticut, America's Richest State, Has a Huge Pension Problem*, WALL ST. J. (Oct. 5, 2015, 12:36 PM), http://www.wsj.com/articles/connecticut-americas-richest-state-has-a-huge-pension-problem-1443996813 (reporting on the current pension funding challenges that Connecticut faces); Mary Williams Walsh, *Dallas Stares Down a Texas-Size Threat of Bankruptcy*, N.Y. TIMES (Nov. 20, 2016), https://www.nytimes.com/2016/11/21/business/dealbook/dallas-pension-debt-threat-of-bankruptcy.html?_r=0 (reporting that Dallas Police and Fire Pension System asked the city for a one-time infusion of $1.1 billion, an amount roughly equal to Dallas's entire general fund budget).

2. *See, e.g.*, Public Employee Pension Transparency Act, H.R. 4822, 114th Cong. § 149A (2016) (amending the Internal Revenue Code to deny tax benefits relating to bonds issued by a state or political subdivision during any period in which such state or political subdivision is noncompliant with specified reporting requirements for state or local government employee pension benefit plans).

3. *See, e.g.*, Jack M. Beermann, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3, 3 (2013) (examining the "political environment within which public pension promises are made and funded," and whether "states could implement meaningful reforms without violating either state or federal law"); James Naughton & Holger Spamann, *Fixing Public Sector Finances: The Accounting and Reporting Lever*, 62 UCLA L. REV. 572, 572 (2015) (arguing "that partial responsibility for [the finances of many states and cities] lies with the outdated and ineffective financial reporting regime for public entities"); *Eminent Domain Path out of a Public Pension Crisis*, 37 CARDOZO L. REV. 307, 310 (2015) (considering whether and how a government could clear a path to reform by proactively asserting its power against the pensions promised to its current employees in exchange for just compensation).

4. *See* Beermann, *supra* note 3, at 16–26 (examining whether excessive promises of retirement benefits have been made to public employees and whether public pension plans are subject to abuse).

5. Estimated to be between $3.412 billion and $1.191 billion. *See infra* text accompanying note 243.

Why were these deficits not noticed before becoming a national problem? Recent voices criticize the distinctly non-business accounting methods used by public sector entities.[6] Primitive practices, so it is argued, implemented by the public sector, allowed billions of dollars in pension deficits to develop without being noticed by gatekeepers, the media, or the general public.[7]

Instead of focusing on specific perplexing or questionable accounting methods used by state and local governments,[8] this article directs attention to the institutional arrangements that created an inadequate disclosure regime for the public sector and hence prepared the ground for these deficits to develop. Responding to those seeking remedy through further expansion of practices already shared by the public sector and business sector accounting systems,[9] in other words, making the two systems more similar,[10] this article highlights necessary normative differences in the disclosure objectives of the two sectors. It also challenges the public sector's existing institutional arrangements for accounting standard setting, that is, the delegation[11] of

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6. *See* G. Eddy Birrer, *GASB Statement 68 on Pensions: A Solution to the Public*
GASB Statement 68 provides greater transparency, enabling legislators and others to make more informed pension-related decisions and to better understand the status of a governmental entity's financial condition); Naughton & Spamann, *supra* note 3, at 574.

7. The current discussion regarding public entities' accounting practices echo some ideas previously expressed in a discussion regarding the Social Security System. *Compare* Peter A. Diamond & Peter R. Orszag, *Accrual Accounting for Social Security*, 41 HARV. J. ON LEGIS. 173, 173 (2004) (objecting to Professor Jackson's proposal as granting too large a role for accrual based accounting in the federal budget), with Howell E. Jackson, *Accounting for Social Security and Its Reform*, 41 HARV. J. ON LEGIS. 59, 59 (2004) (raising objections to the current system of accounting for Social Security), and Kent Smetters, *The Inadequacies of Accrual Accounting for Social Security*, 41 HARV. J. ON LEGIS. 215, 215 (2004) (agreeing with Jackson's call for increased transparency regarding future obligations but nevertheless, arguing that accrual accounting fails to adequately reflect the current state of the Social Security System).

8. *See, e.g.*, Naughton & Spamann, *supra* note 3, at 581 (acknowledging the lack of reconciliation of accrual numbers with actual cash payments).

9. *E.g.*, *id.* at 572.

10. Among other things, by introducing SEC oversight over public entities' disclosures. *See id.* at 593.

11. As long as "Congress . . . 'lay[s] down . . . an *intelligible principle* to which the person or body authorized to act is directed to conform,'" then delegation of powers is seen as a legitimate transfer of semi-legislative powers from the legislator to a non-legislative agency, such as an administrative agency. ALPHEUS THOMAS MASON & GRIER STEPHENSON, AMERICAN CONSTITUTIONAL LAW: INTRODUCTORY ESSAYS AND SELECTED

standard-setting authority for disclosure requirements to private organizations (privatization)—an arrangement originally adopted from the business sector.[12]

Accordingly, this Article draws special attention to the institutional approach shared by the business and public sectors,[13] to theoretical difficulties this institutional approach creates within the context of the public sector, and to the dramatic consequences "on-the-ground" that this approach has already had on pension disclosures. This Article argues that the undetected inflation of current pension deficits resulted directly from inadequate disclosure standards for public entities, promulgated by the public sector's private standard-setter—the Governmental Accounting Standards Board, the "GASB."

On the conceptual level, this article further argues that delegation of the power to prescribe accounting practices transfers sovereign powers extending far beyond the mere regulation of financial reporting. Although such delegation can be justified[14] with respect to the business sector,[15] when it

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CASES 82 (Routledge 16th ed. 2015) (quoting J.W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 409 (1928)).

12. *See infra* notes 36–48 and accompanying text.

13. Under existing case law, promulgation of accounting and disclosure standards—recognized as generally accepted accounting principles for the purpose of the securities acts—are not considered as rules and therefore, do not constitute a delegation of the SEC's rule-making power. *See* Arthur Andersen & Co. v. SEC, No. 76C-2832, 1978 WL 1073, at *5 (N.D. Ill. Mar. 1, 1978) (characterizing the SEC recognition of some accounting standards promulgated by the AICPA as an evaluation method only, and not a substantive rule).

14. Mistretta v. United States, 488 U.S. 361, 372 (1989) ("[I]n our increasingly complex society, replete with ever changing and more technical problems, Congress simply cannot do its job absent an ability to delegate power under broad general directives."); *see also* Evan J. Criddle, *When Delegation Begets Domination: Due Process of Administrative Lawmaking*, 46 GA. L. REV. 117, 121 (2011) (arguing that the court should focus upon due process as the primary constitutional constraint on congressional delegation); George W. Liebmann, *Delegation to Private Parties in American Constitutional Law*, 50 IND. L.J. 650, 654–55 (1975) (arguing "that a per se doctrine precluding delegation of legislative powers to private persons is not needed and would have unfortunate results," and for "practical nonexistence of a per se rule against such delegations").

15. *See* ROBERT VAN RIPER, SETTING STANDARDS FOR FINANCIAL REPORTING: FASB AND THE STRUGGLE FOR CONTROL OF A CRITICAL PROCESS 9 (1994) (emphasizing the private sector's experience); William W. Bratton, *Private Standards, Public Governance: A New Look at the Financial Accounting Standards Board*, 48 B.C. L. REV. 5, 5 (2007); Douglas W. Hawes, *Whither Accounting and the Law? A Comparative Analysis of the Sources of Accounting Authority in the Light of International Developments*, 2 J. COMP. CORP. L. & SEC. REG. 195, 210 (1979) (arguing that governments operate too slowly in response to changes needed in accounting); Maurice C. Kaplan & Daniel M. Reaugh, *Accounting, Reports to Stockholders, and the SEC*, 48 YALE L.J. 935, 954 & n.78 (1939) (arguing that delegation is a device that preserves flexibility); Walter Mattli & Tim Büthe, *Global Private Governance: Lessons from a National Model of Setting Standards in Accounting*, LAW & CONTEMP. PROBS., Summer/Autumn 2005, at 225, 230–32 (emphasizing the private sector's highest levels of technical expertise). *But see* George Mundstock, *The Trouble*

comes to the public sector, delegation of accounting powers from the accountable and legitimate regulator to an unaccountable and self-agenda driven private organization leads to substantive difficulties, both in theory and in practice. Among other things, with respect to public entities, privatization has resulted in financial reporting that serves needs different than,[16] and partly contradictory to, the desire for efficient, effective, and accountable governance of public entities.[17]

According to this Article, the remedy for the public sector financial system is not found in increasing business properties in public sector disclosures,[18] but rather in further distinguishing public sector disclosures from those used in the business sector,[19] bringing state and local government disclosures more in line with those of the federal sector.

On the practical level, this Article proposes providing state and local governments with incentives to replace the current use of GASB-promulgated disclosure standards with more publicly oriented disclosure standards, such as those promulgated by the Federal Accounting Standards Advisory Board—"The Federal Advisory Board." The Federal Advisory Board is a federal disclosure standard setter that has successfully served the federal government during the same time the GASB provided state and local governments with inadequate disclosure requirements for pension liabilities that in part contribute to the creation of today's pension crisis.

To some extent, this article provides support for the "Public Employee Pension Transparency Act" (Transparency Bill).[20] The Transparency Bill, introduced in all 111th to 114th Congress—however not yet became

*with FASB*, 28 N.C. J. INT'L L. & COM. REG. 813, 816–24 (2003) (arguing against some of these justifications).

16. *See* Israel Klein, *The Gap in the Perception of the GAAP*, 54 AM. BUS. L.J. 581, 612 (2017) (arguing that "through the process of gathering a firm's information and expressing it in accounting terms," financial reporting serves some interests and not others).

17. *See* James Naughton et al., *Public Pension Accounting Rules and Economic Outcomes*, 59 J. ACCT. & ECON. 221, 223 (2015) (suggesting that the GASB approach "is associated with policy choices . . . that have the potential to exacerbate . . . fiscal stress").

18. For example, introducing Securities and Exchange Commission oversights. Naughton & Spamann, *supra* note 3, at 579 (citing U.S. SEC. & EXCH. COMM'N, REPORT ON THE MUNICIPAL SECURITIES MARKET, at iv (2012), https://www.sec.gov/news/studies/2012/munireport073112.pdf [https://perma.cc/5NQ2-3F8E]).

19. *See also* Klein, *supra* note 16, at 615 (discussing the difference between an investor's perspective and other perspectives used in financial accounting).

20. Public Employee Pension Transparency Act, H.R. 4822, 114th Cong. (2016); H.R. 1628 (S. 779) 113th Cong. (2013); H.R. 567 (S. 347), 112th Cong. (2011); H.R. 6484, 111th Cong. (2010).

law—proposes making tax benefits related to bonds issued by a state or political subdivision conditional upon compliance with specific reporting requirements, regarding post-employment financial liabilities, established by Congress.[21] However, and more importantly, the Article points to the fact that the Transparency Bill only deals with a symptom of a much deeper problem—the ability of public sector entities to "shop" their disclosures and therefore to avoid accountability and scrutiny.

This Article proceeds as follows: In Part II, I review the institutional arrangements currently governing disclosures both for the business sector and the public sector; the normative framework that established the Financial Accounting Standards Board, the "FASB," as the prominent accounting promulgator for the business sector; and the historical circumstances that led to the creation of the GASB as an alternative and almost equal authoritative standard setter for the public sector. In Part III, I discuss the existing justification supporting privatization of disclosure standard setting. I explain why these justifications, originally developed in the context of the business sector and the delegation of accounting standard setting powers from the SEC to the FASB, do not hold up in the case of the public sector. In Part IV, I discuss the implications for sovereignty of privatizing accounting standard setting for public entities. I explain how setting disclosure standards affects the ability of the public to control the public entity, its accountability, and the incentives given to the entity's executives to serve the public good. In Parts V and VI, after the full meaning of delegating accounting standard-setting powers and the lack of justification thereof are brought to light, I turn to discussing how the GASB, the current prominent private accounting standard-setter for the public sector, has exercised its delegated powers. I expose how the GASB acted differently than other accounting standard-setters such as the Federal Advisory Board—a difference that contributed to the development of the current pension crisis. In Part VII, the last section of the Article, I draw directly from the lessons learned from the development of the pension crisis and the lack of justifications for accounting privatization in the public sector and propose reducing the extent of privatization involved in setting accounting standards for the public sector. My proposal focuses on providing state and local governments with incentives for replacing voluntary use of GASB standards with compulsory use of those of the Federal Advisory Board.

21. *See* H.R. 4822 §§ 149A, 4980J; *infra* Section VII.3.

## II. THE PRIVATIZATION OF DISCLOSURE STANDARD-SETTING

Except as applied to federal entities,[22] financial reporting practices in the United States[23] are prescribed by private organizations.[24] For the business sector, reporting standards are set by the FASB; for the public sector, the standards are set by the GASB. Both the FASB and the GASB are private entities, organized as not-for-profit Delaware non-stock corporations.[25] Although the two organizations maintain high levels of transparency in their work and meticulously adhere to due process procedures,[26] they are still private organizations and, as such, are not subject to the administrative duties or obligations imposed by administrative law;[27] for example, compliance with the Administrative Procedure Act.[28] Nevertheless, the FASB and the GASB possess great administrative and regulatory power over the entire

22. *See infra* note 194 and accompanying text.

23. In contrast to the Anglo-American approach for accounting standard-setting—as prevailing in the U.S. and U.K and other countries influenced by the U.S.—the Continental approach—as prevailing in many European countries and at the level of the European Union—establishes accounting standards through legislation. *Cf.* JOHN FLOWER, EUROPEAN FINANCIAL REPORTING: ADAPTING TO A CHANGING WORLD 76 (2004) (discussing the regulation of financial reporting in Europe with an emphasis on changes created by the adoption of international financial reporting standards (IFRS)).

24. Federal entities are implementing FASAB standards, which are set by a federal board. *See infra* notes 195–98.

25. The FASB and the GASB are held by a shared parent company, the Financial Accounting Foundation (FAF), which is another not-for-profit, non-stock Delaware corporation. *About the FAF*, FIN. ACCT. FOUND., http://www.accountingfoundation.org/cs/ContentServer?c=Page&pagename=Foundation%2FPage%2FFAFSectionPage&cid=1176157790151 [https://perma.cc/N9RW-MTGM].

26. *See GASB Standard Setting Process*, GOVERNMENTAL ACCT. STANDARDS BOARD, http://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1176156714545 [https://perma.cc/FYE6-YNGF]; *Standard-Setting Process*, FIN. ACCT. STANDARDS BOARD, http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1351027215692 [https://perma.cc/R8AV-RS9Q].

27. *Cf.* Omar Ochoa, *Accounting for FASB: Why Administrative Law Should Apply to the Financial Accounting Standards Board*, 15 TEX. REV. L. & POL. 489, 496 (2011) (noting that the SEC itself has stated "that FASB is not an agency").

28. Administrative Procedure Act (APA), Pub. L. No. 79-404, 60 Stat. 237 (1946) (codified as amended in scattered sections of 5 U.S.C.). The APA is a federal statute that, *inter alia*, governs the way in which administrative agencies of the federal government may propose and establish regulations or their rule-making power. *See also* Arthur Andersen & Co. v. SEC, No. 76C-2832, 1978 WL 1073, at *2 (N.D. Ill. Mar. 1, 1978) (a failed attempt to challenge ASR 150 (*infra* note 32) as unconstitutional).

U.S. financial reporting sphere.[29] Disclosure standards promulgated by these bodies have substantial effects on the economy[30] and, with respect to the FASB, warrant financial markets' attention, sometimes even that of the Congress.[31]

29. For hundreds of years the practices used in maintaining book records had developed by those who were, in practice, engaged in recording commerce transactions into accounts, and the records were designed for their own use. It was the merchant in his own store who was recording sales into accounts during business hours, employing practices which allowed him to know its daily profit, and restocking inventory to assure no shoplifting occurred. Accordingly, the guides for accounting practices were designed for the use of merchants. *Cf.* David E. Tinius & William L. Weis, *Introduction* to FRA LUCA PACIOLI, PARTICULARIS DE COMPUTIS ET SCRIPTURIS (Jeremy Cripps trans., 1995) (noting that Luca Pacioli's *Summa de Arithmetica, Geometria, Proportioni et Proportionalita*, published in 1498, is the first-ever known accounting codex). However, with the passage of time, book records became important for other purposes. Corporations started raising funds from the public, and disclosure requirements became a necessary tool in protecting investors. Book records, which were maintained in the past solely for the use of the owner, became important for the public as a whole. *See* Ben McClure, *The Importance of Corporate Transparency*, INVESTOPEDIA, https://www.investopedia.com/articles/fundamental/03/121703.asp [https://perma.cc/9CN3-B2XQ].

30. *Cf.* George J. Benston & Melvin A. Krasney, *The Economic Consequences of Financial Accounting Statements*, *in* ECONOMIC CONSEQUENCES OF FINANCIAL ACCOUNTING STANDARDS: SELECTED PAPERS 159, 159–60 (1978); Stephen A. Zeff, *The Rise of "Economic*
, at 56, 56.

31. One of the most famous issues that attracted a congressional intervention, though it did not result in a final effective statute, is the accounting treatment of stock options issued to company employees. In 1972, the Accounting Principles Board published the board's Opinion No. 25, "Accounting for Stock Issued to Employees," under which the issuing of stock options to employees generally resulted in recognition of no compensation cost to the employer—the company. ACCOUNTING PRINCIPLES BD., OPINION NO. 25: ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES (1972), https://dart.deloitte.com/resource/1/d02fdc63-3f36-11e6-95db-118fea65af4c [https://perma.cc/ZMN7-AM2B]; *see infra* text accompanying note 39. In 1993, the FASB, which replaced the AICPA Accounting Principles Board in 1973, then issued an exposure draft for a new standard to replace Opinion No. 25. In contradiction to the accounting treatment promulgated under Opinion No. 25, the proposed Standard required the expensing of employee stock options at fair value. The implications of the change were tremendous: While Opinion No. 25 incentivized companies to remunerate employees with stock options, as they were not recorded as expenses, the proposed Standard repealed that incentive and created a counter-incentive for issuing options to employees. Remuneration through stock options had to be recorded as an expense equal to the options' fair value, which many times forced the company to recognize expenses higher than the options' practical value for the employees—who could not sell them immediately. This change could heavily affect start-up companies in which the practice of remuneration by stock option in lieu of cash payments was very common. In response to industry pressure, Senator Joe Lieberman introduced a bill in the Senate that prohibited the SEC from requiring the issuer to recognize any expense in financial statements resulting from granting options to its employees in connection with the performance of services. Equity Expansion Act of 1993, S. 1175, 103d Cong. § 4. A similar bill was also introduced in the House of Representatives by Representative Lewis F. Payne, Jr. Equity Expansion Act of 1993, H.R. 2759, 103d Cong. In response to the intense political and industry pressure, the FASB modified its proposal to allow firms to substitute the proposed accounting treatment with

### *A. The Business Sector*

The FASB owes its status as the prominent accounting prescriber for the business sector to the SEC.[32] Although empowered with the authority to prescribe methods to be followed in the preparation of accounts, including the form and content of financial statements disclosed according to various legislation,[33] the SEC rarely exercises these powers.[34] Instead, the SEC historically looked to standard-setting bodies designated by the private market, specifically, the accounting profession, thus the FASB and its predecessors—

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those existing in Opinion No. 25, and the final version of the Standard allowed firms to continue reporting no expenses for issuing stock options to employees—nevertheless, companies were required to disclose the options' fair value in the notes to the financial statements. *See Summary of Statement No. 123*, FIN. ACCT. STANDARDS BOARD (Oct. 1995), http://www.fasb.org/summary/stsum123.shtml [https://perma.cc/9ASU-8ZE8]. The same story repeated itself in 2003 when corporate scandals in 2001 and 2002 encouraged the FASB to reopen the employee stock option debate by adding the subject to its agenda. Consequently, the Broad-Based Stock Option Plan Transparency Act and the Stock Option Accounting Reform Act were introduced. These prohibited the SEC from recognizing as GAAP any new standard on accounting for employee stock options and prevented the mandatory expensing of stock options granted to any employee, except a firm's chief executive officer and the four most highly compensated executive officers. Stock Option Accounting Reform Act, H.R. 3574, 108th Cong. (2004); Broad-Based Stock Option Plan Transparency Act of 2003, H.R. 1372, 108th Cong. Although the latter act passed the House of Representatives and was referred to the Senate, it faced a group of influential Senators who, along with others, such as Federal Reserve Chairman Alan Greenspan and Treasury Secretary John Snow, all supported the FASB's proposed accounting for stock options and opposed congressional intervention of the issue. The Bill was buried in the Senate and resulted in no effective statute. *See* David B. Farber et al., *Congressional Intervention in the Standard-Setting Process: An Analysis of the Stock Option Accounting Reform Act of 2004*, 21 ACCT. HORIZONS 1 (2007) (reviewing the political effort to block option expensing); Denise A. Jones & Kimberly J. Smith, *Employee Stock Options: A Standard Setting Saga*, 8 J. BUS. CASE STUD. 241, 244–51 (2012).

32. Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150, 3 SEC Docket 275 (Dec. 20, 1973) [hereinafter ASR No. 150] (recognizing accounting and reporting standards promulgated by the FASB as generally accepted accounting principles for the purposes of securities acts).

33. *See* Securities Act of 1933 § 19(a), 15 U.S.C. § 77s(a) (2012); Securities Exchange Act of 1934 § 13(b), 15 U.S.C. §§ 78m (2012) (noting the Commission's authority to prescribe the items or details to be shown in the balance sheet and the earnings statement and the methods to be followed in the preparation of such financial reports submitted to the Commission and published to investors).

34. *See* Zeff, *supra* note 30, at 57–59 (discussing all occasions up to 1978 in which the SEC intervened in accounting standard setting).

"to provide leadership in establishing and improving accounting principles" governing disclosure.[35]

In the 1930s, when the Securities Acts were enacted and, among other things, the SEC was created,[36] the accounting profession was already self-regulating the practices used in preparing financial statements.[37] At that time, these practices were seen as satisfactory,[38] and hence, the newly established SEC elected to continue the existing situation and have the private market continue its role in promoting accounting standards. In the 1970s, when the FASB was established as a full-time independent private body, replacing an existing part-time technical committee of the American Institute of Certified Public Accountants (AICPA)—the Accounting Principle Boards (APB)[39]—the SEC's practice of de facto empowering a private organization with administrative authorities[40] was challenged on constitutional grounds by accounting firms.[41] Although that attempt did not succeed,[42] in the years that followed, legal scholars heavily criticized the SEC's practice and the court's inadequate deliberation of the matter.[43] Eventually, among

35. ASR No. 150, *supra* note 32; *see* Donna M. Nagy, *Playing Peekaboo with*

975, 983–89 (2005); *see, e.g.*, Stephen A. Zeff, *The Evolution of U.S. GAAP: The Political Forces Behind Professional Standards*, CPA J., Feb. 2005, at 19, 19 (chronicling the rising importance of financial accounting standards and the resulting increased special-interest lobbying).

36. Securities Exchange Act of 1934, 15 U.S.C. § 78d (2016).

37. Mainly through the work of designated committees appointed by the American Institute of Certified Public Accountants, and before it, the American Institute of Accountants. *See* STEPHEN A. ZEFF, FORGING ACCOUNTING PRINCIPLES IN FIVE COUNTRIES: A HISTORY AND AN ANALYSIS OF TRENDS 119–40 (1972) (describing the AICPA committees engaged in accounting standards promulgation during the 1930s); Nagy, *supra* note 35, at 986.

38. *See* Stephen A. Zeff, *How the U.S. Accounting Profession Got Where It Is Today: Part I*, 17 ACCT. HORIZONS 189, 191 (2003) ("Federal agencies sought the advice of the organized accounting profession because of its growing reputation.").

39. The replacement of the APB with the FASB was a result of the SEC and the market losing confidence in the APB. *See* Stephen A. Zeff, *The Wheat Study on Establishment of Accounting Principles (1971–72): A Historical Study*, 34 J. ACCT. & PUB. POL'Y 146, 147 (2015).

40. ASR No. 150, *supra* note 32.

41. *See, e.g.*, Arthur Andersen & Co. v. SEC, No. 76C-2832, 1978 WL 1073, at *1 (N.D. Ill. Mar. 1, 1978); Nagy, *supra* note 35, at 987.

42. *Arthur Andersen & Co.*, 1978 WL 1073, at *4–5; Nagy, *supra* note 35, at 987.

43. *See, e.g.*, Ronald E. Large, Note, *SEC Accounting Series Release No. 150: A Critical Analysis*, 54 IND. L.J. 317, 320–21 (1979) (arguing that SEC recognition in the case should have been seen as a substantive rule); *see also* HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 153 (1979) ("The determination of what accounting should mean is the SEC's most important job—too important to be left to others."); Mundstock, *supra* note 15, at 827 ("The SEC has been composed primarily of lawyers. Lawyers do not want to be bothered by accounting, which they view as merely 'technical.' Hence, the SEC has been willing to leave accounting to

other changes the 2002 Sarbanes–Oxley Act[44] applied to the accounting profession, it explicitly approved the SEC's practice. Section 108 of the Sarbanes–Oxley Act explicitly allows the SEC to recognize[45] private organizations as standards promulgators for purposes of the securities laws.[46] In a policy statement[47] following the enactment, the SEC, after finding the organization satisfied all criteria stipulated in §108 of the Sarbanes–Oxley Act, reaffirmed the status of the FASB.

Accordingly, the FASB's financial accounting standards are recognized today as generally accepted for purposes of the federal securities laws, and companies subject to these acts are required to comply with those standards in the preparation of their financial statements, unless the SEC directs otherwise.[48]

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the accountants."); Nagy, *supra* note 35, at 983–1006 (discussing the accounting profession and the need for reform).

44. Sarbanes–Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified in scattered sections of the U.S. Code).

45. *Id.* § 108(b)(A), 15 U.S.C. § 77s(b)(1)(A) (2012).

46. However, the private organization must fulfill the criteria set in the act:

> In carrying out its authority . . . the Commission may recognize, as "generally accepted" for purposes of the securities laws, any accounting principles established by a standard setting body—
>
> (A) that—
>
> (i) is organized as a private entity;
>
> (ii) has . . . a board of trustees . . . ;
>
> (iii) is funded [by annual accounting support fees per 15 U.S.C. § 7219 (2012)] . . . ;
>
> (iv) has adopted procedures to ensure prompt consideration, by majority vote of its members, of changes to accounting principles necessary to reflect emerging accounting issues and changing business practices; and (v) considers, in adopting accounting principles, the need to keep standards current in order to reflect changes in the business environment . . . ;
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> . . . .

*Id.*

47. Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Securities Act Release No. 33-8221, 80 SEC Docket 139 (Apr. 25, 2003).

48. As a general rule, corporations in America are not legally required to prepare financial statements or to file any other timely presentations of their financial position or operation results. Hence, unlike European corporations, which are legally required to prepare annual financial statements using accounting rules included in the civil code and filed with a state agency, U.S. corporations can choose whether to prepare financial statements, and according to what practices, if at all. *See generally* FLOWER, *supra* note 23, at 50, 56, 68–69 (discussing the financial reporting practices in Europe). A legal requirement for financial reporting is raised in cases only where a specific legal regime becomes applicable

With a contribution from the AICPA's Code of Professional Conduct Section 1.320—requiring AICPA members to follow FASB standards for all business entities[49]—FASB's SEC-recognized status with respect to the securities law also extends to business clusters in addition to those subject to securities regulations,[50] resulting in the FASB being the prominent standards promulgator for the entire business sector.[51]

### *B. The Public Sector*

Concern over affairs of local government and uniformity of financial reporting began in the 20th century when early reformers[52] attempted to develop uniform formats for reporting by municipalities.[53] However, public sector financials did not draw broad attention until the mid-1970s and the early 1980s, when big U.S. cities, among them New York and Chicago,[54] facing the risk of insolvency due to dubious financial management,[55] heightened public awareness of local government financial accounting[56] and disclosure practices, making it a national issue.[57]

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to the corporation, then a defined objective for the reporting is established which also determines the format and content of reporting; for example, once a corporation raises, or wishes to raise, capital from the public, it becomes subject to securities regulation and to its legal obligation for preparing and submitting financial statements that will provide information for investors. However, until a corporation elects to raise capital from the public, no legal obligations for financial reporting exist.

49. *See* AICPA CODE OF PROFESSIONAL CONDUCT (Am. Inst. of Certified Pub. Accountants 2014), http://pub.aicpa.org/codeofconduct/ethicsresources/et-cod.pdf [https://perma.cc/UUM8-GFYN].

50. Petro Lisowsky & Michael Minnis, *Accounting Choices and Capital Allocation: Evidence from Large Private U.S. Firms* 31 (Univ. of Chi. Booth Sch. of Bus., Working Paper No. 14-01, 2016), http://ssrn.com/abstract=2373498 (indicating a GAAP-use ratio of seventy-nine percent among private companies surveyed in the study).

51. *See* Klein, *supra* note 16, at 600 (describing the overall normative structure that governs the GAAP).

52. *See generally* William C. Rivenbark, *A Historical Overview of Cost Accounting in Local Government*, 37 ST. & LOC. GOV'T REV. 217, 217 (2005) (providing a historical overview of cost accounting development in local governments, including the contribution made by the progressive movement to the process).

53. Martin Ives, *The GASB: A Fresh Look at Governmental Accounting and Financial Reporting*, 8 J. Acct., Auditing, & Fin., 253, 257 (1985); *id.*

54. Chicago's financial system currently faces challenges. *See* Bachrach, *supra* note 1.

55. *See* Arthur Allen & George D. Sanders, *Financial Disclosure in US Municipalities: Has the Governmental Accounting Standards Board Made a Difference?*, 10
& MGMT. 175, 177 (1994); James L. Chan, *The Birth of the Governmental Accounting Standards Board: How? Why? What Next?*, 1 RES. GOVERNMENTAL & NON-PROFIT ACCT. 3, 6 (1985).

56. *See* Rivenbark, *supra* note 52, at 217.

57. Allen & Sanders, *supra* note 55, at 178.

Following Senate initiatives in 1979 and 1981[58] to place the development of standards for state and local governments under a federal governmental body,[59] local government executives and those organizations already holding stakes in prescribing accounting practices for the public sector[60]—for example, AICPA, which published its own auditing guide for local government accounts in 1974[61]—united in an effort to prevent the federal government from being involved in setting accounting standards for local governments.[62] Although the bill failed in the Senate, the credibility of the existing arrangement of standard setting—the National Council on Governmental Accounting (NCGA)[63]—continued to erode,[64] eventually forcing[65] all parties involved to accept a formula that those engaged either from the public sector or the private sector[66] could live with, and that would foster cooperation.[67] The

58. In 1979, Senator Harrison A. Williams introduced a bill to create a "State and Local Government Accounting and Financial Reporting Standards Council," comprised of the U.S. Secretary of the Treasury, Controller General of the United States, and the Chairman of the Securities and Exchange Commission, or their designees. Drafts of the bill had been circulated while interactions between involved parties continued, which lead, in part, to the establishment of a study group on the structure for setting state and local governmental accounting standards. Nonetheless, after complaining about "foot dragging," Senator Williams resurrected the bill in 1981. Chan, *supra* note 55, at 8 (describing the bill and its supporters); *see also infra* text accompanying note 211.

59. State and Local Government Accounting and Financial Reporting Standards Act of 1979, S. 1236, 96th Cong.; *see* Chan, *supra* note 55, at 7; Ives, *supra* note 53, at 253.

60. For the process of developing standards, and a look at those involved, see Allen & Sanders, *supra* note 55, at 177–78 and Chan, *supra* note 55, at 8.

61. Chan, *supra* note 55, at 9.

62. *See id.* at 10.

63. The NCGA was a council of volunteers, originally established in 1934 as the National Committee on Municipal Accounting by the Municipal Finance Officers Association of the United States and Canada (MFOA). The council met only two to four times a year, for two or three days. Frank L. Greathouse, *The History and Evolution of the National Council on Governmental Accounting*, PUB. BUDGETING & FIN., Summer 1985, at 23, 23–24.

64. Allen & Sanders, *supra* note 55, at 178 (citing Chan, *supra* note 55, at 6); *id.* at 24 (describing structural and procedural problems with the NCGA).

65. *See* Chan, *supra* note 55, at 9–15 (describing the grueling process that preceded the establishment of the GASB).

66. *See* Helen M. Roybark et al., *The First Quarter Century of the GASB (1984–2009): A Perspective on Standard Setting (Part One)*, 48 ABACUS 1, 11 (2012) ("The GASB was formed by agreement between the [FAF], the [AICPA], the Government Finance Officers Association, the National Association of State Auditors, Comptrollers and Treasurers, and the seven organizations representing state and local government officials.").

67. G. Robert Smith, Jr., *The Growth of GAAP*, *in* HANDBOOK OF GOVERNMENTAL ACCOUNTING 1, 9–10 (Frederic B. Bogui ed., 2009) (discussing the organizations that support the GASB).

formula included the establishment of a distinct and new standard-setting board engaged exclusively[68] in promoting public sector accounting; however, subject to the oversight of the existing[69] Financial Accounting Foundation (FAF),[70] which also oversaw and controlled the FASB.[71]

Unlike the FASB, which enjoys an authoritative status over business entities, supported by recognition of the SEC and the agency's cohesive power, the GASB's status results from its standards being voluntarily accepted by state and local governments.[72] Although the GASB is designated by the AICPA as the exclusive promulgator of Generally Accepted Accounting Principles (GAAP) for state and local government entities[73]—as the FASB is for business entities[74]—public entities are not legally obligated by Congress or any federal authority to implement GAAP, and therefore they

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68. *See also* Roybark et al., *supra* note 66, at 17–19 (discussing early conflicts over jurisdiction of the FASB).

69. A recommendation for the establishment of a new Governmental Accounting Foundation (GAF), with a majority of trustees associated with the public sector, was not accepted. *See* Chan, *supra* note 55, at 11.

70. The FAF is an independent, private-sector organization with responsibility for the oversight, administration, and finances of its standard-setting boards, the FASB and the GASB. It is a non-stock Delaware corporation that operates exclusively for charitable, educational, scientific, and literary purposes within the meaning of § 501(c)(3) of the Internal Revenue Code. *About the FAF*, FIN. ACCT. FOUND., http://www.accountingfoundation.org/cs/ContentServer?c=Page&pagename=Foundation%2FPage%2FFAFSectionPage&cid=1176157790151 [https://perma.cc/JEF6-ZCEH].

71. *See supra* notes 25–28 and accompanying text.

72. GOVERNMENTAL ACCOUNTING STANDARDS BD., GASB AT A GLANCE ¶ 8, http://www.gasb.org/facts/gasb_at_a_glance.pdf [https://perma.cc/UD3E-3B3D] ("The GASB is not a federal agency. The federal government does not fund GASB, and its standards are not federal laws or rules. The GASB does not have enforcement authority to require governments to comply with its standards.").

73. Section 1.310 of the AICPA Code of Conduct requires all AICPA members—over 400,000 accountants in 144 countries—to adhere to accounting standards set by the organizations endorsed by the Institute. *See* AICPA CODE OF PROFESSIONAL CONDUCT § 1.310.001.01 (Am. Inst. of Certified Pub. Accountants 2014), http://pub.aicpa.org/codeofconduct/ethicsresources/et-cod.pdf [https://perma.cc/UUM8-GFYN]; AICPA, FINANCIALS: 2014-15 ANNUAL REPORT 1 (2015), https://www.aicpa.org/content/dam/aicpa/about/annualreports/downloadabledocuments/2014-2015-annual-financials.pdf [https://perma.cc/2GJ7-DDZ4]. Similarly, § 1.320 prohibits an AICPA member from "express[ing] an opinion or stat[ing] affirmatively that the *financial statements* . . . are presented in conformance with generally accepted accounting principles . . . if such statements . . . contain any departure from an accounting principle promulgated by bodies designated by [AICPA Governing Council] to establish such principles . . . ." AICPA CODE OF PROFESSIONAL CONDUCT, *supra*, § 1.320.001.01. To date, only three organizations, besides AICPA itself, are endorsed by AICPA for the purpose of setting accounting standards for Institute members: The FASB, for setting standards used in for-profit reporting; the GASB, for state and local governmental entities; and the Federal Accounting Standards Advisory Board (FASAB), for establishing financial accounting principles for federal governmental entities. *Id.* § 1.320.040.01. Other organizations, such as the PCAOB and the IASB, are endorsed for other objectives. *Id.* at 156.

74. *Id.* § 0.400.10.

can choose[75] to use some *other comprehensive basis of accounting* (OCBOA) for their reports. Accordingly, while a significant number of states voluntarily adopted GASB standards,[76] a significant number of states and governments still use OCBOA instead of GAAP.[77]

Two recent research studies show the dominance of GASB standards in public sector reporting, and especially the lack of any other concrete alternative except for use of OCBOA, which is not systematically promulgated by any recognized accounting body but is, rather, the accounting method used de facto by the entity. The studies also provide a picture of the remaining terrain in which entities use OCBOA.

The first study, published by the GASB in 2008, reports that thirty-six states have actively adopted GASB standards, requiring by state law or regulation the implementation of GASB standards by political subdivisions.[78] The study estimates that 25.9% of all counties, localities, and independent school districts in the United States are required by state law or regulation to prepare GAAP financial statements.[79] With respect to actual implementation of GASB standards, regardless of whether there is a legal requirement to implement GASB standards or not,[80] the study estimates that 67.3% to

75. Vivian L. Carpenter & Ehsan H. Feroz, *Institutional Theory and Accounting Rule Choice: An Analysis of Four US State Governments' Decisions To Adopt Generally Accepted Accounting Principles*, 26 ACCT. ORGS. & SOC'Y 565, 588 (2001) (exploring how institutional pressures exerted on four state governments—New York, Michigan, Ohio, and Delaware—influenced the decision of these governments to adopt or resist the use of GAAP).

76. States endorse GASB standards for internal uses, such as budget preparation, and, many times, require local subdivisions, like counties, and state governed entities, like hospitals, to apply GASB standards. *See* James Chen & Xu Yunxiao, *Setting Government Accounting Standards: A Comparative Institutional Analysis of China and the United States*, *in* IMPLEMENTING REFORMS IN PUBLIC SECTOR ACCOUNTING 89, 102, 105–07 (Susana Jorge ed., 2008).

77. For a list of countries that use OCBOA, see *infra* note 86.

78. GOVERNMENTAL ACCOUNTING STANDARDS BD., RESEARCH BRIEF: STATE AND LOCAL GOVERNMENT USE OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR GENERAL PURPOSE EXTERNAL FINANCIAL REPORTING 3 (2008), http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176156726669 [https://perma.cc/D3GY-W96D].

79. *Id.* at 4.

80. In several states that do not require GAAP, "many [local] governments actually do follow GAAP." *Id.* at 8. "For instance, more than half of the localities in California received the Government Finance Officers Association's Certificate of Achievement for Excellence in Financial Reporting in 2005, which cannot be awarded without GAAP compliance." *Id.*

71.5% of the state and local governments included in the study[81] follow GAAP when preparing their annual financial statements. Hence, the remaining 32.7% to 28.5% of these public entities use OCBOA.

These findings are supported by another and more updated research study published in February 2016, focusing specifically on counties.[82] The 2016 research study reveals that counties in forty-five states use GASB standards for financial reporting.[83] "Thirty-two [] states require counties to follow GAAP and 295 counties in another [thirteen] states and the District of Columbia choose to" voluntarily file their financial reports according to GASB standards.[84] As a result, "almost three-quarters (71[%]) of [all] counties report[] their annual financial information" following GASB standards,[85] indicating an OCBOA use rate equal to 29% among counties.[86]

The data show that although the GASB did not receive wide recognition in its early years—during the 1980s[87]—it has been fueled by the support

81. "The estimation of GAAP compliance ranging from 67.3[%] to 71.5[%] relates only to the state and local governments included in the study and should not be construed as the proportion of *all* such entities in the United States. The estimated range—21,003 to 22,328 entities—relates to the largest 31,221 governments. These proportions should not be portrayed as the overall proportion of GAAP compliance in the United States." *Id.* at 7.

82. Emilia Istrate et al., *Counting Money: State & GASB Standards for County Financial Reporting*, NACO POL'Y RES. PAPER SERIES (Nat'l Ass'n of Countries, Wash., D.C.), Feb. 2016, at 1 http://www.naco.org/sites/default/files/documents/Counting%20Money_Executive%20Summary.pdf [https://perma.cc/3FBL-NELG]. "Counties provide essential services to more than 308 million residents across the country to keep communities prosperous, safe and secure. . . . [C]ounty governments operate in a constrained financial environment, conforming to state and federal mandates and limited by state caps on their ability to raise revenue." *Id.*

83. *Id.* at 2.

84. *Id.*

85. *Id.* at 6.

86. According to the study, state specific rules for financial reporting are the standard for about one-fifth of county governments. Nineteen percent of counties use a financial reporting format decided by their state and OCBOA. Nine states—Arkansas, Indiana, Kansas, Kentucky, Missouri, New Jersey, Oklahoma, Vermont, and Washington—ask counties to follow an alternative method of financial reporting and accounting to the GASB standard. "[T]he state determines the framework, including measurement, recognition, presentation and disclosure requirements of the county financial reports." *Id.* at 4.

87. Roybark et al., *supra* note 66, at 14.

of the FAF,[88] and conquered[89] the public sector, while winning the ongoing competition with OCBOA.[90]

This voluntarily-adopted dominance of the GASB in the public sector raises a number of questions: Has its rapid conquest of public sector accounting exacted a price at the standards level? In other words: Did GASB standards hold some special characteristics that appealed to state politicians and public entity executives?[91] Did efforts expended in becoming a prominent standard-setter like its older brother, the FASB, influence the GASB in designing reporting standards? Although a full historical analysis of GASB efforts to gain status and acceptance is beyond the scope of this Article, as further discussed in the next sections, the objectives GASB designated for financial reporting to fulfill, as well as repeal of specific pension disclosures,[92] all promulgated during the time the GASB was establishing

88. *Id.* at 12 (stating that the FAF supported, and the FASB contributed to, "achieving and maintaining its legitimacy as the recognized governmental accounting standard-setting body, at a time when a number of competing interest groups were unable to secure recognition as an alternative body to the GASB").

89. Nonetheless, in comparison with the 67.3% to 71.5% use rate of GASB standards in the public sector, in the business sector, FASB standards are used by 100% of public companies subject to SEC regulation, except foreign private issuers, and the majority of all other business entities. *See* Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP, Securities Act Release No. 33-8879, Exchange Act Release No. 34-57026, 73 Fed. Reg. 986 (Jan. 4, 2008) (codified at 17 C.F.R. pts. 210, 230, 239, 249); Lisowsky & Minnis, *supra* note 50, at 31 (reporting that almost 80% of the firms included in the study's sample use GAAP, meaning FASB standards, as the basis of accounting for their financial records).

90. Local governments may use OCBOA for several reasons. Small county governments, for example, might prefer OCBOA over GASB standards due to the lack of an actual contribution of accrual based accounting to small-scale budgetary and administrative decision-making. *See* Istrate et al., *supra* note 82, at 8. Preparing financial statements

track annual financial activities on a cash basis. *Id.*; *see also* Beermann, *supra* note 3, at 27 (listing additional reasons for local governments to use OCBOA).

91. "The decision to use GAAP for external financial reporting is an expensive one, involving many actors in the legislative and executive branches of state government who

Feroz, *supra* note 75, at 588.

92. *See* Beermann, *supra* note 3, at 27 (explaining how "unfunded pension promises benefit politicians in two ways": (1) "they allow current officials to provide services without requiring taxpayers to pay for them until much later"; and (2) "help politicians shore up support among government workers").

its accounting status while striving for leadership,[93] suggest some disturbing findings especially when compared with similar standards promulgated by other standard-setters such as the Federal Advisory Board and the NCGA, the GASB's predecessor.[94]

These questions become even more acute when the lack of actual justification for such delegation and privatization are exposed and the full implications of delegating accounting standard-setting powers, as described in the following two sections, are introduced into the discussion.

## III. THE INADEQUATE JUSTIFICATION FOR PRIVATIZATION IN THE PUBLIC SECTOR

As mentioned above, for both the business and public sectors, accounting standard-setting, and hence setting of disclosure practices, went private. During the years since this institutional approach was established, a number of justifications were suggested in support of such arrangements for disclosure standard-setting.[95] Nevertheless, legal contemplation[96] of the privatization of disclosure standard-setting had taken place in the context of business sector accounting and in particular, with the SEC's endorsement of FASB standards and its predecessors.[97] Accordingly, these justifications were never deliberated in the context of the public sector and the GASB. As explained below, although justification for disclosure standard-setting privatization might provide adequate reasoning in business sector accounting and reporting,[98] it does not in the case of the public sector.

### *A. Extrinsic Efficiency*

The most prominent justification for the privatization of accounting standard-setting focuses on the extrinsic benefits—that is, benefits seen as such from the standard setter's perspective—that result from utilizing specialization and expertise in the private market in lieu of establishing

93. *See also* Dale L. Flesher & Annette Pridgen, *The Development of Hospital Financial Accounting in the USA*, 25 ACCT. HIS. REV. 201, 208–09 (2015) (describing how states threatening to establish an alternative standard-setter, independent of the FAF, caused the FAF to change jurisdictional limitation between the GASB and the FASB).

94. *See* Greathouse, *supra* note 63, at 24.

95. *See* sources cited *supra* note 15.

96. *Cf.* KRIPKE, *supra* note 43, at 153 (arguing against the delegation and privatization of accounting standard-setting powers); Mundstock, *supra* note 15, at 817–24 ("[T]here is no apparent reason to be in favor of private setting of accounting standards, and many reasons to be opposed."); Nagy, *supra* note 35, at 983.

97. *See* sources cited *supra* note 15.

98. *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric,* Giving the SEC sole direct power could further politicize the standard-setting process.").

and developing these assets by the public agency. First, *ex ante*, when launching a regime that promotes cohesive uniformity in accounting practice, the use of existing private market knowledge is a substitute for "acquiring . . . expertise through lengthy and costly training" by the governmental authority.[99] Second, *ex-post*, maintenance of specialized expertise, as required in order to promote new and adapt existing standards, provided by a private agent is perceived to be "more efficient" and therefore also more likely to occur. The public servant uses the specialized expertise solely for the purpose of regulation, therefore making maintenance of "expertise more costly" than using private actors who "derive positive externalities from [their] expertise"—by utilizing it in other services provided to the private market, for example, consulting services.[100]

The positive externalities associated with private standard-setting not only make the private promulgation of accounting standards overall more cost-efficient, and therefore more desirable in broad social terms, they also create better incentives against stagnation.[101] Altering existing disclosure requirements creates expenses for the regulator and does not usually create any observable additional benefit for the regulator. New disclosures, keeping up with market changes, will not necessarily result in an observable improvement in regulatory work. In most scenarios it will only prevent deterioration of the regulatory function. Moreover, the regulator is not only required to invest resources in developing new standards and adjusting existing regulatory procedures to monitor the new disclosures, but also to bear the risk of failure of the new revised requirement. In contrast, a private agent derives additional benefits from altered disclosure requirements mainly by advising existing clients who now need to adapt practices. Although a risk of unnecessary opportunistic changes of the prevailing practice must be mitigated,[102] a private standard-setter is expected to be less in favor of unwanted stagnation.

99. Mattli & Büthe, *supra* note 15, at 230 (discussing general reasons for delegating governance functions to a private actor).
100. *Id.* at 230–31.
101. *See* Hawes, *supra* note 15, at 210.
102. The risk can be mitigated by having market firm representatives as members of the standard-setting board. This approach is adopted by private standard-setters, such as the FASB and the GASB.

## *B. Intrinsic Efficiency*

Another justification for placing accounting standard-setting out of reach of state agencies is the wish to keep accounting disclosures intrinsically efficient and without unnecessary political biases on reported numbers.[103]

When inadequate disclosure exists, investors will request an additional premium for their money due to the excessive risk engendered by sub-optimal disclosure because, for example, *ex-ante*, not enough information is provided in order to know whether a company is a washout or not; *ex-post*, there is not enough information to know how well the company is being managed.[104] So as to reduce their cost-of-capital, firms themselves will invest in producing better disclosures.[105] Because presumably efficient disclosure was already created by the market itself, non-market regulation, as levied by the SEC for example, would only serve to make disclosures less efficient.[106]

Another risk created by governmental regulation of disclosure is political sway over the content of the disclosure.[107] For example, a case in point, which required companies that received investment tax subsidies given as small yearly tax benefits, to report them as a one-time, larger sum.[108] Such

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103. *Cf.* David F. Hawkins, *The Saxe Lectures in Accounting: Financial Accounting, the Standards Board and Economic Development*, BARUCH C. (Nov. 12, 1973), http://www.baruch.cuny.edu/library/alumni/online_exhibits/digital/saxe/saxe_1973/hawkins_73.htm ("I believe that those responsible for determining accounting standards, such as the Financial Accounting Standards Board, should strive to set accounting standards that are technically and behaviorally sound *and that are not at variance with the national economic goals and the government's programs to achieve these goals*.").

104. *Cf.* George A. Akerlof, *The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 488 (1970) (knowing only average quality of cars being sold can result in non-functional market and no trades).

105. *See also* Ronald A. Dye, *Disclosure of Nonproprietary Information*, 23 J. ACCT. RES. 123, 142 (1985) (suggesting an explanatory disclosure model based on actual information availability); Robert E. Verrecchia, *Discretionary Disclosure*, 5 J. ACCT. & ECON. 179, 180 (1983) (suggesting an explanatory disclosure model based on disclosure-related costs).

106. *But cf.* Anat R. Admati & Paul Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities*, 13 REV. FIN. STUD. 479, 480 (2000) (arguing that the market will not always produce an optimal disclosure setting); BARUCH LEV & FENG GU, THE END OF ACCOUNTING AND THE PATH FORWARD FOR INVESTORS AND MANAGERS (2016) (reporting contemporary financial accounting disclosures' continuous deterioration in relevance to investors' decisions)

107. *Cf.* Hawkins, *supra* note 103 (suggesting that those responsible for determining accounting standards should strive to set standards that are not at variance with the national economic goals and the government's programs to achieve these goals).

108. *See, e.g.*, Maurice Moonitz, *Some Reflections on the Investment Credit Experience*, 4 J. ACCT. RES. 47, 47 (1966) (discussing accounting treatment of the investment tax credit and the government's struggle with the accounting profession's view of credit as income in the single year the credit is given, and not throughout the life period of the investment);

political influence makes reported numbers convey a different story and is not what statement users are seeking to learn—that is, the subsidies' actual effect on the prospective cash inflow: a small amount every year—again, resulting in sub-optimal or even distorted and misleading disclosures.

### *C. Extrinsic and Intrinsic Efficiency in the Public Sector*

Extrinsic and intrinsic efficiency justifications can support, to some extent, privatization of accounting standard-setting for the private market.[109] Nevertheless, when public sector accounting is considered, the support value of some of these justifications decreases substantially.

While business firms' financial statements are expected primarily to communicate information to investors making investment decisions and monitoring manager performance,[110] the public entities' financial statements are expected to fulfill the needs of a much larger group of users[111] engaged in activities other than making investments.[112] Among these users is the public entity itself, in fulfilling its duty to be publicly accountable for

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Zeff, *supra* note 30, at 57 (discussing governmental intervention in the accounting treatment of the investment tax credit).

109. *But cf.* Mundstock, *supra* note 15, at 814 (arguing against such justifications).

110. *See infra* text accompanying note 152.

111. GOVERNMENTAL ACCOUNTING STANDARDS BD., CONCEPTS STATEMENT NO. 1 OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD: OBJECTIVES OF FINANCIAL REPORTING, at i (1987) [hereinafter GASB CONCEPTS STATEMENT NO. 1] ("The Board has identified three groups as the primary users of external state and local governmental financial reports: the citizenry, legislative and oversight bodies, and investors and creditors."). *See generally* Chan, *supra* note 55, at 6 (mentioning how well-publicized financial crises in New York, Cleveland, and Chicago during 1974 to 1980 heightened public awareness of governmental finance);

actions and deliberations to illustrate some of the pressures the GASB faces).

112. GASB CONCEPTS STATEMENT NO. 1, *supra* note 111, at i ("Financial reports are used primarily to compare actual financial results with the legally adopted budget; to assess financial condition and results of operations; to assist in determining compliance with finance-related laws, rules, and regulations; and to assist in evaluating efficiency and effectiveness."); *see also* GOVERNMENTAL ACCOUNTING STANDARDS BD., GASB WHITE PAPER: WHY GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING IS—AND SHOULD BE—DIFFERENT, at ii (2017) [hereinafter GASB WHITE PAPER], http://gasb.org/cs/ContentServer?c=Document_C&pagename=GASB%2FDocument_C%2FDocumentPage&cid=1176169371273 [https://perma.cc/KKF8-7XVC] ("[M]ost governments do not operate in a competitive marketplace, face little or no threat of liquidation, and do not have equity owners. Consequently, measures of net income and earnings per share have no meaning to users of governmental financial reports. Instead, users need information to assess a government's stewardship of public resources . . . .").

monies raised through taxes and for their expenditure in accordance with appropriations laws;[113] the general public and the media, when evaluating the service efforts, costs, and accomplishments of the public entity; and, in assessing the impact on the country of the public entity's operations and investments and how, as a result, the entity's and the local government's financial condition has changed and may change in the future.

The information required for these activities is very different than the information required for capital investment decisions. For example, an investor in a county's bonds is indifferent as to whether the county budget is spent on a grandiose fireworks show for the Fourth of July celebrations, or on cleaning services provided for local schools; the county's residents, however, care a lot about what their taxes are spent on, and might even act according to that information when voting.

Resulting from the difference between the two accounting systems, the type of already existing expertise in the private market does not necessarily make a positive contribution to establishing a better disclosure regime for public entities, nor is the private market better incentivized by unique opportunities to leverage expertise in other additional lucrative uses. Market participants, and more specifically, public entities, their bond holders, and accountants, do not necessarily know better what information is required by the state administration and general public in order to monitor public entities' spending, etc.[114] Similarly, market participants themselves—in this case, public entities and the general public—are not incentivized to further develop reporting standards. Although better disclosure regarding budget use by counties might reduce existing reluctance to pay local taxes, paying county taxes, unlike investing in stocks, is not subject to the taxpayer's discretion; hence, and although increased transparency might improve collection, on its own it would not incentivize increased disclosure—especially when other opportunistic reasons exist against such increased transparency.[115]

As far as support for privatization as a means to eliminate political influence over the content disclosed,[116] as mentioned, a public entity's reports are necessary for fiscal planning and monitoring by the local and state government. Thus, a political authority, at the level of the local government or beyond,

113. *See* FED. ACCOUNTING STANDARDS ADVISORY BD., *Statement of Federal Financial Accounting Concepts 1: Objectives of Federal Financial Reporting* [hereinafter SFFAC 1], *in* FASAB HANDBOOK OF FEDERAL ACCOUNTING STANDARDS AND OTHER PRONOUNCEMENTS, AS AMENDED 1, 16 (2016) [hereinafter FASAB HANDBOOK], http://files.fasab.gov/pdffiles/2016_fasab_handbook.pdf [https://perma.cc/3M8Y-RWPT].

114. *See also* Cotton, *supra* note 111, at 40 (arguing that public scrutiny of the FASAB process should serve as a much stronger control than the independence of FASAB's members).

115. *See* Akerlof, *supra* note 104, at 488.

116. *See* Hawkins, *supra* note 107.

must be able to adapt the disclosures so as to provide the information required for its fiscal and monitoring uses.[117]

All in all, the institutional approach currently governing accounting standard-setting both in the business sector and the public sector—that is, the privatization of accounting standard-setting—might[118] be justified for the business sector. However, advantages derived from private sector expertise and market optimization simply do not apply to disclosure standard-setting for public entities. As the following sections show, not only does the justification for delegation in the business sector not apply to the public sector, but, in fact, while disclosures made in the business sector serve consensual interests shared by all constituents—that is, to provide information useful for investment decision-making—much less uniformity exists in the case of public entity disclosures. In the context of public entities, serving investor's needs, in many cases, contradicts the interests of other constituents, such as state residents.

## IV. ACCOUNTING DELEGATION AS DELEGATION OF SOVEREIGNTY

Financial statements serve a social need for financial information regarding business entities such as companies, and public entities such as counties.[119] Meanwhile, as statements become the prominent information source regarding economic entities, the power to set the standards regulating disclosure also confers the power to determine what is known about the entities' financial actions and what is not; what actions are disclosed as income-generating and therefore are incentivized, and what actions are disclosed as generating expenses and are therefore disincentivized.[120] Overall, in privatizing accounting standard-setting for disclosures, there is the risk they are promulgated in

117. The risk of political manipulation of a statement's numbers does not exist, as the risk exists in a realm where users are distinct from the regulator of the reporting. Whereas in the case of public entities, prominent users, like the general public and the government, also regulate the reporting standards, through a public accounting standard-setter.

118. *See* Mundstock, *supra* note 15, at 814.

119. Klein, *supra* note 16, at 604 (explaining the social role reporting fulfills in providing financial understanding for abstract entities, e.g. companies, conducts).

120. *See* Allen & Sanders, *supra* note 55, at 175–76 (examining U.S. practices during

respond[ed] to discipline imposed by the capital markets and private standard setters").

a way that fulfills a private party's political aspiration,[121] at times at the expense of the good of the general public.[122]

### A. Whoever Controls the Standards, Controls Information

In order for economic entities to communicate financial information in an understandable, efficient, and effective manner, financial reporting implements consensual patterns of disclosure.[123] These patterns use defined expressions and phrases determined by accounting standards to communicate financial results. By following accounting standards, entities can communicate information to statement users who may not be fully familiar with every individual entity's actions, but are familiar with the standards and their financial definitions, and therefore they can digest information disclosed by any entity that follows the standards.[124]

Two examples of patterns used in accounting-based disclosures are the profit and loss report, which summarize the entity's operational results, and the balance sheet, which presents its overall financial status. A fundamental question in producing these reports is what should be disclosed and elaborated in the reports and what should be omitted? Communicating every tiny detail regarding an entity's conduct is impractical and highly inefficient. Therefore, not all information is presented in the reports. Many transactions that share common properties are communicated in aggregate numbers; for example, all expenses resulting from renovation of all highways during the reporting period are reported via a single number in the report. However, some information regarding highway renovation, for example, contracts not as yet executed, are generally not included in the aggregate numbers nor in any other part of the reports. That information is generally determined as not important enough to be included in the limited capacity of the report.[125]

121. *Cf.* Ross L. Watts & Jerold L. Zimmerman, *Positive Accounting Theory: A Ten Year Perspective*, 65 ACCT. REV. 131, 133 (1990); Ross L. Watts & Jerold L. Zimmerman, *Towards a Positive Theory of the Determination of Accounting Standards*, 53 ACCT. REV. 112, 114 (1978) (discussing political influences on standard setting in the private sector).

122. Klein, *supra* note 16, at 584–85.

123. *Id.* at 587.

124. For example, in business sector reports, financial statements include accounting parameters that describe investment returns on company shares, representing the company's profit for the accounting period divided by the number of outstanding shares: Earnings Per Share (EPS). The EPS parameter provides investors with useful information to evaluate investments, and is an additional method of evaluation alongside current prices on the stock market.

125. *Cf.* Kenneth W. Bond, *GASB 45: What It Means to Local Governments*, 39 URB. LAW. 723, 724 (2007) (analyzing GASB 45, which requires the accrual of some future payment

The disclosure standard-setter generally makes the decisions regarding what information to disclose and what to leave out of the reports, what to disclose as a separate item, and what to disclose as part of aggregate numbers. When defining the consensual pattern used for disclosures, accounting standards define the different items that have to be reported and the form to use in reporting the numbers. For example, for signed contracts not yet executed, accounting standards stipulate that although a legal mutual contractual obligation exists, its current economic consequences are not substantive enough and therefore should not be recognized and disclosed in the reports.[126]

Deciding what to disclose and in what form has two far-reaching consequences. First, it affects the ability to control the entity and to monitor its conduct; second, it affects the entity's systems and control. Disclosures constitute what we know about the financial conduct of the entity and its executive; therefore, the information disclosed and the way it is presented directly affects the ability to control and hold the entity and its executives accountable. For example, presenting all the county's administrative expenses in a single figure, without providing a separate disclosure of executive compensation, prevents information regarding the compensation from being publicly available and therefore shields executives from criticism.

Beyond determining what is known about the entity, accounting standards affect systems and control procedures: Fulfilling disclosure requirements mandates provision of reliable information that can be confirmed by the entity's external auditor—as generally mandated by federal and state legislation.[127] Therefore, disclosure actually forces the entity to develop systematic procedures to collect the information. These procedures then create control and enhance monitoring both by insiders, such as the entity's comptroller, and outsiders, such as the entity's auditor. Thus, to a certain extent, disclosure requirements determine which operations will be monitored and systematically managed and which operations will be left unsupervised —at least at the level of the comptroller and the external auditor. An effective

126. *See, e.g.*, FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 6, ¶ 25 (2008), http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220132831&acceptedDisclaimer=true ("Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." (footnote omitted)).

127. The Single Audit Act of 1984 requires most governmental recipients of federal assistance to have organization-wide financial and compliance audits on an annual basis. Pub. L. No. 98-502, 98 Stat. 2327 (codified as amended at 31 U.S.C. § 7501 (2012)).

way to restrain unwanted expenses in public entities, for example, overspending on entertainment such as expensive season basketball tickets by a public entity's executives, is to require a disclosure of these expenses.

System and control procedures created by disclosure requirements should not be taken lightly. In fact, creating system and control procedures was the main reason mentioned when Congress decided to insist on the demand that the Department of Defense invest over $100 million to create a valuation system,[128] used only for reporting the value of existing—that is, already purchased—weapons systems held by the U.S. military, and was not willing to be satisfied with reports only on new weapons purchases, which would not have required the establishment of such an expensive information system.[129]

### *B. The Additional Control over Incentives*

Beyond the decision in principle about whether to require information to be disclosed or not, the decision how to classify the information disclosed —that is, whether to describe it as generating income for the entity or as an expense[130]—is a decision that determines the effect the disclosure will have on the entity's conduct.

For accounting disclosure purposes, many of the public entity's transactions can be classified either as generating an expense or as generating an asset.[131] For example, payments made by a county's administration for construction of a new highway can be expensed fully upon payment and accordingly be disclosed as use in-full of the current year's budget. In the alternative, they be capitalized as an asset and expensed in small amounts during the years the road is used and thus disclosed as smaller expenditures of future budgets.

Whether to expense or capitalize affects incentives: Entities, and more specifically, managers and executives, are measured and evaluated based on performance as deduced through financial statements. In the same way that corporate management that leads a company to report heavy losses will probably be replaced by shareholders, a mayor that causes a city's budget deficit might not be elected for another term. Therefore, executives and managers in public companies and political subdivisions alike prefer statements to project earnings and increased savings. And so, the decision regarding which transaction and under what circumstances are disclosed

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128. Cotton, *supra* note 111, at 38.

129. *Id.*

130. *See* Klein, *supra* note 16, at 592–93 (discussing the problem of a single set of factual circumstances that can result in contradictory disclosures as a function of the accounting standards used).

131. *Id.*

as generating expenses—or liabilities—and which are disclosed as generating income—or assets—presents executives with incentives and disincentives.[132]

To a certain extent, the decision whether to renovate California State Route 1 and make congested two-lane segments into a new multiple-lane freeway is affected by the way this expensive construction work will be presented in California's financial statements. If the highway's renovation costs are expensed in full the year they occur, then a governor of a deficit state would probably be advised by the state comptroller to avoid having such a heavy negative effect on the state's financials; however, if such expenses are capitalized as an asset, and are only expensed during the useful life of the road until next expected renovation—that is, five to ten years—and cash required for the construction can be raised by loans, for which interests payments will also be capitalized with the construction assets, then the road will probably be renovated—among other things, increasing local employment, etc. All in all, whoever controls information, controls, or at least, substantially affects, the conduct.[133]

### *C. The Effect of Voluntary Adoption*

The challenges that emerge with the delegation of sovereign powers are further heightened by the fact that state and local governments can choose whether to adopt GASB standards or not.[134] Remember, state and local governments are not obligated to use GASB standards and can use OCBOA. Hence, not only can the GASB be incentivized to relax stringent disclosure requirements in order to induce adoption, but public entities themselves can opt for selective adoption of the standards, creating "opportunistic adoption." For example, adopting GASB standards only in periods when the resulting disclosures fulfill current political objectives. Accordingly, in troubled times, public entities can opt-out and adopt other standards,

132. Zeff, *supra* note 30, at 56 (discussing the "economic consequences"—the incentives and disincentives—created by financial accounting).

133. The question of recognition goes beyond the over-simplified debate, whether an expense should be recognized on an accrual basis—when the liability to pay is generated, even if no payment is yet made—or, on a cash basis. The fundamental question is which transactions that involve an exchange of an entity's resources, such as money or manufactured goods, for other resources, such as services, are considered negative for the entity, and therefore, as generating an expense; and which are considered positive, and therefore as generating an asset or even income.

134. *See* Carpenter & Feroz, *supra* note 75, at 565.

including OCBOA.[135] Or, local governments can adopt the standards for only certain and stronger sectors—for example, those expected to result in favorable disclosures, such as local tax collection departments—and not for other weaker sectors—in financial terms—for example, fire departments.[136] It should be mentioned that the principle problem with opportunistic adoption by states results from the states being a sovereign entity. Although that issue cannot be fully resolved by replacing one dominant set of disclosure standards with another set of standards, some improvement can be achieved by providing incentives for states to commit themselves, even for a pre-defined period, to a single set of standards.[137]

## V. THREE STANDARD-SETTERS: TWO DIFFERENT DISCLOSURE OBJECTIVES; ONE PENSION CRISIS

The question of whether to expense in full or to capitalize, and many other similar questions concerning the recognition and classification of transactions under financial accounting, are fundamental and unavoidable for all accounting systems. If the last fifty years of modern accounting research has taught us anything, it is that answers to disclosure dilemmas—whether to expense or to capitalize, to recognize a liability or to obscure the information, etc.—are never self-evident, and are conceptually dependent on social, normative preferences—that is, they are subjective.[138]

At the end of the day, the preferences implemented in the disclosure are those dictated by the accounting standard-setter who controls disclosure specifications.[139] Once the power to set accounting standards is delegated

135. *See supra* notes 75–77 and accompanying text.

136. In contrast to revenue collection departments, like parking departments, which are characterized by revenue generation and low expenses on labor and equipment, fire departments are generally characterized by excessive salaries and equipment expenses.

137. *See infra* Part VII.

138. *See* WILLIAM H. BEAVER, FINANCIAL REPORTING: AN ACCOUNTING REVOLUTION 16 (1981) ("[T]he selection of a financial reporting system is a social choice."); Joel S. Demski, *The General Impossibility of Normative Accounting Standards*, 48 ACCT. REV. 718, 718–23 (1973) (proving that accounting cannot be neutral and must be pre-defined by an exogenous political objective); *see also* Peter Miller, *Accounting as Social and Institutional Practice: An Introduction*, *in* ACCOUNTING AS SOCIAL AND INSTITUTIONAL PRACTICE 1, 13–15 (Anthony G. Hopwood & Peter Miller eds., 1994) (noting that the method adopted to calculate profits reflects a policy choice by the standard setter) .

139. The answer to this question, as to many other similar questions regarding transaction recognition under accounting, is not self-evident; rather, it is provided, or more accurately, dictated, by the accounting standards and according to the objective chosen for financial reporting by the accounting standard-setter. Different objectives infer different recognition rules. Klein, *supra* note 16, at 613–14. If financial statements are designed to allow investors better investment decision-making, then a profit will be recognized if it contributes to future cash inflow to shareholders. However, if the statements are designed to allow citizens to monitor the activity of the administrative division, then a profit will be defined

and further placed in private hands, the public no longer controls what information is disclosed by public entities, and in consequence, the extent of accountability and internal control created by the disclosure.

In this respect, a critical decision left to the discretion of the private standard-setter is what objectives are disclosures intended to fulfill. Disclosures in the business sector classically aim to fulfill the information needs of those invested in the corporation but who, nevertheless, are not part of the inner circle—and are therefore dependent on the information disclosed.[140] In contrast, disclosures in the public sector are seen as also serving needs other than those of investors,[141] among them, and as discussed above,[142] the need of the local government to fulfill its "duty to be publicly accountable for monies raised through taxes" and for their expenditure in accordance with appropriations laws,[143] and the general public "in evaluating the service efforts, costs, and accomplishments of the [public] entity."[144] Meanwhile, it is impossible to provide information in any one report sufficient to meet all the needs of all users. Moreover, in some cases, fulfilling some users' information needs contradicts with fulfilling the needs of other users.[145] For example, investors ultimately care about future cash inflows, generated to serve debt and interest payments on the public entity's bonds; hence, increased investments in non-income-generating infrastructure—for example, paving new non-toll highways—is seen by them as negative spending as it uses resources for purposes not benefitting bond holders. In contrast, the public is mainly interested in the services provided by the entity and

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as resulting only from circumstances that contribute to a citizen's overall quality of life. *Id.* at 612.

140. *See, e.g.*, ELDON S. HENDRIKSEN & MICHAEL F. VAN BREDA, ACCOUNTING THEORY 198–226 (5th ed. 1992) (discussing the role information plays in corporations).

141. *See* GASB WHITE PAPER, *supra* note 112, at 1 ("Governments are fundamentally different from for-profit business enterprises in several important ways. Their organizational purposes, processes of generating revenues, stakeholders, budgetary obligations, and propensity for longevity differ. These differences require separate accounting and financial reporting standards in order to provide information to meet the needs of stakeholders to assess government accountability and to make political, social, and economic decisions."); SFFAC 1, *supra* note 113, at 1–2 (mentioning budgetary integrity, operating performance, stewardship and systems, and control as the four objectives of federal financial reporting).

142. *See supra* Section III.3.

143. SFFAC 1, *supra* note 113, at 1.

144. FED. ACCOUNTING STANDARDS ADVISORY BD., *Statement of Federal Financial Accounting Standards 17: Accounting for Social Insurance*, *in* FASAB HANDBOOK, *supra* note 113, at 6.

145. *See* Klein, *supra* note 16, at 587.

hence interest payments for bond holders are seen as negative spending. In contrast, investments in improving infrastructure—and keeping it toll-free—are seen as a positive use of funds. Thus, a profit accounted and disclosed under the investors' perspective is not necessarily a profit under the general public's perspective, and vice-versa.[146]

The question of whose objective do disclosures serve—that is, the perspective used when accounting for and disclosing transactions—affects information availability and the incentives to which the disclosures give rise. If the investor perspective is used, then investors are those who mainly enjoy the information disclosed by the state, and all other stakeholders—the media, state residents, etc.—must invest their own resources in gathering the information they require. However, if the general public's perspective is adopted in disclosures then, the public gets the information for free—that is, at the state's expense—and investors are those left to incur the costs involved in retrieving the information they need. The same analysis also applies with respect to the incentives created by disclosure and accountability—the use of the investors' perspective incentivizes actions that promote investors' interests while gearing disclosure toward public interest incentivizes promotion of the public's interest.

Private standard-setters are aware of the important role the objective of reporting plays in disclosure of information and its determinist effect on the information provided and interests promoted, and therefore approach this question in their conceptual framework—established to include the principles applied when standards are developed.

The FASB, which designates the standards to be used in the business sector, adopts an exclusive objective based on investors' needs. The FASB's Conceptual Framework for Financial Reporting explicitly defines its goal:

> The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. . . .
>
> . . . .
>
> Other parties, such as regulators and members of the public other than investors, lenders, and other creditors, also may find general purpose financial reports useful. However, those reports are not primarily directed to these other groups.[147]

In contrast to the FASB's catering to the investor perspective, the Federal Advisory Board—known as the FASAB—which sets disclosure standards

146. *Id.* at 619.

147. FIN. ACCOUNTING STANDARDS ADVISORY BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 8, ¶¶ OB2, OB10 (2010) [hereinafter FASAB ACCOUNTING CONCEPTS NO. 8] (footnote omitted)

for the federal government, adopts a perspective that leans towards the general public:

> The FASAB and its sponsors believe that any statement of objectives of federal financial reporting must be based on the needs of those who use the reports. Those users include citizens, Congress, federal executives, and federal program managers. Current and potential users of federal financial information want information to help them assess how well the government is doing . . . .[148]

Although the federal government raises capital from public investors, as a matter of fact, to a much greater extent than any other publicly traded company including Apple, Amazon, and Google all together—as of September 30, 2016, the U.S. federal debt held by investors was equal to $14,173 billion[149]—financials at the federal level are accounted and disclosed using a non-investor perspective, *inter alia*, in order to achieve broad public-concern objectives, among them to "provide information that helps the reader to determine . . . whether government operations have contributed to the nation's current and future well-being."[150]

What perspective did the GASB adopt? While the FASB took a straightforward approach that adheres to the investor perspective over any other perspective,[151] and the Federal Advisory Board serves the general public perspective,[152] the GASB, perhaps in an effort to please both investors and the public,[153] both state politicians[154] and the federal administration,[155] decided to hold the rope at both ends: "Governmental financial reporting

148. SFFAC 1, *supra* note 113, at 5.

149. U.S. GOV'T ACCOUNTABILITY OFFICE, FINANCIAL AUDIT: BUREAU OF THE FISCAL SERVICE'S FISCAL YEARS 2016 AND 2015 SCHEDULES OF FEDERAL DEBT 1, 17 (2016), https://www.treasurydirect.gov/govt/reports/pd/feddebt/feddebt_ann2016.pdf [https://perma.cc/WZT3-4FAL].

150. FED. ACCOUNTING STANDARDS ADVISORY BD., *Statement of Federal Financial Accounting Standards 6: Accounting for Property, Plant, and Equipment*, *in* FASAB HANDBOOK, *supra* note 113, at 9 n.16.

151. "Other parties, such as regulators and members of the public other than investors, lenders, and other creditors, also may find general purpose financial reports useful. However, those reports are not primarily directed to these other groups." FASAB ACCOUNTING CONCEPTS NO. 8, *supra* note 147, ¶ OB10.

152. *See* FASAB HANDBOOK, *supra* note 113, at 1.

153. *See* Smith, Jr., *supra* note 67, at 9 (discussing how the need to fulfill contradictory objectives was approached by the organizations that preceded the GASB).

154. *See* Carpenter & Feroz, *supra* note 75, at 588.

155. *See* Roybark et al., *supra* note 66, at 1 (noting that the GASB was established under an agreement of parties from the private, public, and federal sectors).

should provide information to assist users in (a) assessing accountability and (b) making economic, social, and political decisions."[156]

Nonetheless, the GASB is aware of the tradeoff between these two different and sometimes contradictory objectives,[157] and therefore finds a creative solution in which the lowest common denominator approach to disclosed information is employed:

> Users of state and local governmental financial reports are diverse; their needs may be equally diverse. As a result, it may be impossible to provide information in any one report sufficient to meet all the needs of all users. Consequently, the type and amount of information provided in general purpose financial reports generally should be based on the common needs of users.[158]

And, in another place, the GASB acknowledges:

> The Board intends to maintain a broad perspective of the meaning and implications of accountability reporting. At the same time, it recognizes that information considered important by some users is not important to others. Excessive detail may confuse rather than clarify. Cost-benefit relationships will be carefully considered by the Board, during its research and due process, when establishing individual standards.[159]

All in all, while the FASB adopted a business objective suitable for the business sector, and the Federal Advisory Board a public objective for the federal sector, the GASB adopted a mixed objective that focuses on providing information based on ambiguous shared interests constrained by cost-benefit considerations that sought to serve as many constituents as possible.

Although at the time this extremely broad, two-sided objective was adopted, it satisfied all those involved, both from the investor and general public standpoints[160]—and was possibly the only one pragmatically feasible at the time[161]—it later turned out to have some devastating consequences.

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156. GASB CONCEPTS STATEMENT NO. 1, *supra* note 111, ¶ 76.

157. Klein, *supra* note 16, at 587.

158. GASB CONCEPTS STATEMENT NO. 1, *supra* note 111, ¶ 72. For an elaboration on how these objectives are met, see *id.* ¶¶ 13–17.

159. *Id.* ¶ 73.

160. *See* Carpenter & Feroz, *supra* note 75, at 588; Roybark et al., *supra* note 66, at 14–17 (describing surveys created by the GASB and indicating that constituents think that the GASB performs most of its activities in an outstanding fashion).

161. *See* Roybark et al., *supra* note 66, at 10 (describing the controversies and the different interest-groups involved in the process preceding the establishment of the GASB).

## VI. THE (NON-)DISCLOSURE OF PUBLIC SECTOR PENSION DEFICITS

During the 1990s, it was claimed that the pension disclosures of important public entities were imprecise[162] and therefore confusing and misleading[163] to the majority of users whose objectives GASB standards are designed to serve. Consequently, in a standard issued in the mid-1990s, the GASB repealed these disclosure requirements, thus allowing local governments to increase benefits[164] without triggering disclosure that could have drawn public scrutiny and criticism or created control and accountability over those benefits. This left the general public to face potentially disastrous consequences that became apparent and fully understood only when these once repealed disclosure requirements were reintroduced five years ago.[165]

### *A. GASB Statement No. 25*

GASB Statement No. 25,[166] issued by the GASB in 1994, reestablished financial reporting standards for defined benefit pension plans[167] and for the notes to the financial statements of defined contribution plans of state and local governmental entities.

For defined benefit pension plans, GASB Statement No. 25 required financial statements to include only a statement of net assets and a statement

162. GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 25: FINANCIAL REPORTING FOR DEFINED BENEFIT PENSION PLANS AND NOTE DISCLOSURES FOR DEFINED CONTRIBUTION PLANS 25 (1994) [hereinafter GASB STATEMENT NO. 25].

163. "Based on the results of a survey and comments received on the ED, the Board believes that a standardized measure is not useful to the majority of users, would be confusing to them, and might mislead them." *Id.* at 23 (explaining why GASB Statement No. 25 is repealing the requirement to disclose a standardized measure of the pension obligation, which is used to assess pension plan status and make comparisons among plans under NCGA Statement No. 6).

164. *See* Beermann, *supra* note 3, at 8.

165. The same partially occurred in 2007 when the GASB issued Statement No. 50: Pension Disclosures—an amendment of GASB Statements No. 25 and No. 27. *See generally* GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 50 OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD: PENSION DISCLOSURES (2007) (requiring the disclosure of actuarial based pension liability in the notes to financial statements).

166. GASB STATEMENT NO. 25, *supra* note 162.

167. In general, a defined benefit pension plan is a plan that "provides retirement income and also may provide other types of postemployment benefits, including disability benefits, death benefits, life insurance, healthcare benefits, and other ancillary benefits." *Id.* ¶ 12. GASB Statement No. 25 specifically excluded postemployment healthcare benefits from the definition of benefit pension plan because these benefits are specifically accounted and disclosed according to a separate statement. *Id.*

of changes in net assets.[168] It did not require a disclosure in the body of the basic financial statements of any information concerning the net status of the entity's pension obligations or changes in these obligations.[169] Although it did require a disclosure of actuarially determined information from a long-term perspective, that information focused on the progress being made in funding the program[170] and not on providing information regarding the overall status of the entity's pension obligation.[171] In addition, that information was only disclosed as supplementary information, presented after the notes to the financial statements[172] and hence beyond the auditor's auditing scope, which is generally focused on the body of the statement. And, above all, an exemption included in the standard could easily bypass a requirement for such a disclosure.[173]

Crucial to the analysis is the fact that by not requiring a disclosure of the net status of the entity's pension obligations, or changes in these obligations,[174] GASB Statement No. 25 overturned the prevailing accounting

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168. *See* ROBERT L. CLARK ET AL., A HISTORY OF PUBLIC SECTOR PENSIONS IN THE UNITED STATES 1–10 (2003) (describing the evolution of public pensions).

169. GASB STATEMENT NO. 25, *supra* note 162, at 24–25.

170. "The Board has concluded that plan financial statements should provide current information about the *stewardship* (custody and management) of the *assets* held in trust for plan members. *The Board does not intend the asset values reported in the financial statements to be used for comparisons between assets and a plan's actuarial accrued liability (assessments of funded status and funding progress)* . . . ." *Id.* ¶ 79; *see also* GOVERNMENTAL ACCOUNTING STANDARDS BD., NEW GASB PENSION STATEMENTS TO BRING ABOUT MAJOR IMPROVEMENTS IN FINANCIAL REPORTING 1 (2013) [hereinafter NEW GASB PENSION STATEMENTS], www.gasb.org/cs/ContentServer?c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160140567 [https://perma.cc/FC5T-K8UL] ("While there has been a close relationship between how governments fund pensions and how they account for and report information about them until now, the new guidance [GASB Statement No. 67] establishes a decided shift from the *funding-based* approach to an *accounting-based* approach.").

171. GASB STATEMENT NO. 25, *supra* note 162, at i–ii (requiring a statement of plan net assets, a statement of changes in plan net assets, a schedule of funding progress and a schedule of employer contributions; however, no statement of the present changes in the liabilities of the plan); *see also* Naughton et al., *supra* note 17, at 224 (arguing that in contrast to the FASB's approach, designed to provide an estimate of the cost of settling the obligation to pay pension benefits, the GASB's approach supports a pension liability calculation that is primarily useful in setting a reasonable contribution schedule).

172. GASB STATEMENT NO. 25, *supra* note 162, ¶ 18.

173. *Id.* ¶ 34 ("When a cost-sharing or agent plan's financial statements are included in an employer's financial report (pension trust fund), the employer is not required to present schedules of required supplementary information for that plan if (a) the required schedules are included with the plan's financial statements in a publicly available, stand-alone plan financial report and (b) the employer includes in its notes to the financial statements information about how to obtain the stand-alone plan financial report.").

174. "Plan liabilities for benefits and refunds should be recognized when due and payable in accordance with the terms of the plan." *Id.* ¶ 26. "The difference between total plan

practice at the time. That practice, which indeed required such disclosures, was adopted in 1983 by NCGA Statement No. 6, "Pension Accounting and Financial Reporting."[175]

GASB Statement No. 25's repeal of NCGA Statement No. 6's disclosure requirements and the lack of a requirement for a straightforward disclosure of the entity's net pension liability—however, requiring the disclosure of net pension assets, if they exist[176]—were prominent reasons one of the five board members, Mr. James F. Antonio—the former Missouri State Auditor,[177] holding appointment as the chairman of the GASB board—objected to the statement;[178] the standard was nevertheless adopted, though not unanimously.[179]

With respect to the decision not to require disclosure of the entity's net pension obligations, the GASB justified its decision "by expressing concern about the preciseness of the actuarial estimates and about the accounting nature of the pension obligation and the unfunded obligation."[180] They claimed that these repealed disclosures and other disclosures required by the superseded NCGA Statement No. 6 were not useful to the majority of users and therefore would only be confusing and misleading.[181] Remember, the lowest common denominator of all users approach for deciding disclosure was being employed.[182]

### *B. GASB Statement No. 67*

Following the 2008 recession, state and municipal defined benefit programs received increased public scrutiny,[183] as did the accounting treatment of

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assets and total plan liabilities at the reporting date should be captioned *net assets held in trust for pension benefits*." *Id.* ¶ 27.

175. NAT'L COUNCIL ON GOVERNMENTAL ACCOUNTING, STATEMENT 6 PENSION ACCOUNTING AND FINANCIAL REPORTING: PUBLIC EMPLOYEE RETIREMENT SYSTEMS AND STATE AND LOCAL GOVERNMENT EMPLOYERS ¶ 35 (1983) [hereinafter NCGA STATEMENT 6].

176. GASB STATEMENT NO. 25, *supra* note 162, ¶ 7.

177. Smith, Jr., *supra* note 67, at 10.

178. GASB STATEMENT NO. 25, *supra* note 162, at 24–25.

179. *Id.* at 21.

180. *Id.* at 25.

181. *See supra* text accompanying note 163.

182. *See* GASB CONCEPTS STATEMENT NO. 1, *supra* note 111, ¶¶ 72–73.

183. John W. Mortimer & Linda R. Henderson, *Measuring Pension Liabilities Under GASB Statement No. 68*, 28 ACCT. HORIZONS 421, 422 (2014); *see also* Olivia S. Mitchell, *The Future of Public Employee Retirement Systems*, *in* THE FUTURE OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS 1, 1 (Olivia S. Mitchell & Gary Anderson eds., 2009) (discussing other reasons for increased scrutiny of public employee retirement systems).

these plans and their associated disclosures.[184] Following the re-examination of pension standards,[185] in June 2012, the GASB board unanimously approved a new accounting and disclosure standard: GASB Statement No. 67, Financial Reporting for Pension Plans.[186]

Superseding the old 1994 standard—GASB Statement No. 25—the new standard introduced a substantive change to the pension disclosure framework: It now required defined benefit pension plans to disclose a net pension liability equal to the amount of the unfunded portion of the pension, based on actuarial estimations.[187] In addition, following that change in the disclosure of program statements, the board also approved another new standard[188] that required state and local governments that participate in defined benefit pensions to disclose in their own statements a net pension liability in the amount[189] of the unfunded portion of the pension.[190]

Overall, the standards promulgated in 2012 ended nearly twenty years—1994–2012—of undisclosed pension deficits.[191] The dramatic results of which

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184. *See* NEW GASB PENSION STATEMENTS, *supra* note 170, at 1.

185. *Id.*

186. GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 67: FINANCIAL REPORTING FOR PENSION PLANS 24 (2012) [hereinafter GASB STATEMENT NO. 67].

187. "When the total pension liability exceeds the pension plan's net assets (now referred to as plan net position) available for paying benefits, there is a *net pension liability*. Governments will now be required to report that amount as a liability in their accrual-based financial statements . . . ." NEW GASB PENSION STATEMENTS, *supra* note 170, at 2; *see also id.* at 52, 78 (explaining the reasons why the new requirements were adopted and providing an example of the required disclosure).

188. GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 68: ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS, at i (2012) [hereinafter GASB STATEMENT NO. 68]. Prior to the issuance of GASB Statement No. 68, factual payments were seen as the obligating event for state and local governments' defined benefit financial reporting; in addition, net pension liability was relegated to footnote disclosure. Mortimer & Henderson, *supra* note 183, at 424. Under GASB Statement No. 68, an obligating event occurs in the current period, as benefits are seen as part of service compensation, and so the unfunded portion of the pension liability is disclosed in the main statement of the net position. *Id.*

189. *See* Mortimer & Henderson, *supra* note 183, at 424 (discussing how the standard under GASB Statement No. 68 implements a statistical model to illustrate the reportable net pension liabilities and other accounting parameters).

190. *Id.*

191. During these years, programs were required to present partial information regarding progress in the funding of the program—which, in many instances, was required by law. Since 2005–2007, programs were also required to disclose the actuary information underlying the funding calculations. *See, e.g.*, *Summary of Statement No. 50*, GOVERNMENTAL ACCT. STANDARDS BOARD (May 2007), http://www.gasb.org/cs/Satellite?c=Pronouncement_C&cid=1176156701402&pagename=GASB%2FPronouncement_C%2FGASBSummaryPage [https://perma.cc/TJN6-X5R9]. However, these disclosures allowed flexibility in measuring the actuary liability and emphasized disclosure of progress in fulfilling funding obligations rather than providing a complete, comprehensive picture of the program's financial status. GASB Statement No. 67 forced the programs to disclose the overall financial status of the program, using strict measuring procedures, while pushing information on funding

are seen these days when more and more local governments recognize the need to settle these deficits, to avoid becoming insolvent,[192] and, for some local governments, to prevent bankruptcy.[193]

### *C. Statement of Federal Financial Accounting Standards No. 5: Accounting for Federal Government Liabilities*

In the year following the GASB repeal of disclosure requirements for pension deficits, in 1995, the Federal Advisory Board promulgated standards requiring federal agencies whose employees are enrolled in a defined benefits program, and federal entities that manage those programs, to disclose pension deficits based on long-term actuarial calculations.[194]

Five years after being established to set accounting standards for the federal entities,[195] in December 1995, the Federal Advisory Board released

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progress to the supplementary part of the reports. *See, e.g.*, *Summary of Statement No. 67*, GOVERNMENTAL ACCT. STANDARDS BOARD (June 2012), http://www.gasb.org/jsp/GASB/Pronouncement_C/GASBSummaryPage&cid=1176160219444&pf=true [https://perma.cc/2CXA-M983].

192. *See* Jack M. Beermann, *Resolving the Public Pension Crisis*, 41 FORDHAM URB. L.J. 999, 1002 (2014) (provoking a wider discussion of the normative issues surrounding pension reform by asking if "pension claimants [should] be treated like any other unsecured creditor . . . or is there a case for treating them as victims of a fiscal disaster beyond their control").

193. *See generally* Clayton P. Gillette, *Dictatorships for Democracy: Takeovers of*
"takeover boards,"
which are used by states when less intrusive forms of assistance fail to bring stability to fiscally distressed municipalities).

194. *See* NEW GASB PENSION STATEMENTS, *supra* note 170, at 2.

195. *History of FASAB*, FED. ACCT. STANDARDS ADVISORY BOARD, http://www.fasab.gov/the-history-of-fasab/ [https://perma.cc/B9B3-KRK8]. "On October 10, 1990, then Secretary of the Treasury Nicholas Brady, Director of OMB Richard Darman, and Comptroller General Charles Bowsher jointly agreed to create and sponsor the Federal Accounting Standards Advisory Board (FASAB) by signing a 'Memorandum of Understanding (MOU) Among the General Accounting Office, the Department of the Treasury, and the Office of Management and Budget on Federal Government Accounting Standards and a Federal Accounting Standards Advisory Board.' FASAB would consider and recommend the appropriate accounting standards for the federal government." *Id.*; *see also* Memorandum of Understanding between the Government Accountability Office, the Department of the Treasury, and the Office of Management and Budget on Federal Government Accounting Standards and a Federal Accounting Standards Advisory Board 1–4 (Oct. 2009) [hereinafter FASAB Memorandum of Understanding], http://files.fasab.gov/pdffiles/OUR_MEMORANDUM_OF_UNDERSTANDING_03_2011-1.pdf [https://perma.cc/NPH3-VX8V].

an official Federal Advisory Board standard, "FFAS No. 5,"[196] which, among other issues, deals with the recognition and disclosure of federal entities' actuarial pension obligations.[197] With respect to the administrative entities—that is, the entities that administer federal pension plans—FFAS No. 5 requires accounting and reporting of pension liabilities to be performed according to the present actuarial value of all future benefits based on projected salaries and total projected service, less the present actuarial value of future normal cost contributions that would be made for and by the employees under the plan.[198] The resulting pension liability must then be reported on the administrative entity's financial statements. In comparison, GASB Statement No. 25 did not require disclosure of a net pension liability—only a net pension asset resulted in disclosure on financial statements, if such exists—that is, the program is more than 100 percent funded.[199] In a similar fashion, actuarial information was only disclosed as supplementary unaudited information under GASB Statement No. 25.[200]

In addition, FFAS No. 5 also requires that the pension liability and all other associated expenses for pensions and other retirement benefits—including health care—be recognized by the federal employer at the time the employee's services are rendered.[201] In comparison, the parallel contemporaneous GASB standards' general approach[202] required such prospective costs to be expensed only when actually paid[203] or amortized over a prolonged period of time.[204] Hence, while Federal Advisory Board standards introduced full disclosures, GASB standards postponed recognition and disclosure on the employer's statements, and did not require recognition or disclosure of the actuarial pension liability by the programs.[205]

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196. FED. ACCOUNTING STANDARDS ADVISORY BD., *Statement of Federal Financial Accounting Standards 5: Accounting for Liabilities of the Federal Government*, *in* FASAB HANDBOOK, *supra* note 113.

197. *See id.* ¶¶ 62–99.

198. *Id.* ¶ 71.

199. *See* GASB STATEMENT NO. 25, *supra* note 162, ¶ 7.

200. *Id.* ¶ 76.

201. FED. ACCOUNTING STANDARDS ADVISORY BD., *Statement of Federal Financial Accounting Standards 4: Managerial Cost Accounting Standards and Concepts*, *in* FASAB HANDBOOK, *supra* note 113, ¶ 95.

202. GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 27: ACCOUNTING FOR PENSIONS BY STATE AND LOCAL GOVERNMENTAL EMPLOYERS, at ii–iii (1994) [hereinafter GASB STATEMENT NO. 27].

203. Mortimer & Henderson, *supra* note 183, at 424; *see* GASB STATEMENT NO. 68, *supra* note 188, ¶ 90.

204. *See* GASB STATEMENT NO. 27, *supra* note 202, at 21, 24 (discussing the reasons for Mr. Antonio's dissenting opinion).

205. "Financial statement recognition would not be required for either the plan's unfunded actuarial liability according to the actuarial cost method in use or the unfunded pension benefit obligation (PBO) calculated in accordance with Statement 5." *Id.* ¶ 50.

## VII. PREVENTING THE NEXT CRISIS FROM DEVELOPING

Would pension disclosures in the critical years preceding the pension crisis have been different if accounting standards for the public sector were promulgated by an entity other than the private GASB? Examining the disclosure standards promulgated at that time by the public Federal Advisory Board suggests an affirmative answer to this question. While the private GASB repealed the requirement to disclose full actuarial pension liabilities, the public Federal Advisory Board launched new standards for federal entities that required these very disclosures.

These findings evoke some acute and very disturbing questions. Was the 1994 repeal of the 1983 NCGA Statement No. 6 requirement motivated by reasons other than the public good? Was the private standard-setter easing stringent reporting requirements in order to induce voluntary adoption?[206] As mentioned above, a full historical analysis of the GASB's motives is beyond the scope of this Article; nevertheless, the dramatic consequences of undisclosed pension liabilities, taken in the broader perspective of the GASB's declared dual reporting objectives and the board's need to achieve voluntary adoption over OCBOA, suggest some insights. These insights, taken together with the implications privatization of public sector accounting standard-setting have on sovereignty, and coupled with the lack of actual reasoning for such delegation,[207] lead to questions concerning the fitness of current public sector institutional arrangements of disclosure standard-setting.

206. *See, e.g.*, *id.* at 21, for the reasons provided for Mr. Antonio's dissenting opinion to GASB Statement No. 27:

> In keeping with the intent of the 1990 ED, Mr. Antonio believes an appropriate reaction to the respondents' comments would have been a slight adjustment of the proposed constraints. Instead, the Board has chosen to remove virtually all of those constraints on funding approaches when used for employer pension accounting measurements. Mr. Antonio is not surprised that a majority of respondents to this Statement's ED agreed with the Board's approach, given the flexibility provided.

207. *See* discussion *supra* Part III.

### *A. Moving to Compulsory Standards*

Unsatisfactory functioning of the FASB's predecessor, the APB,[208] caused the business and professional community to advocate for its replacement,[209] and similarly, dissatisfaction with NCGA[210] resulted in the public sector community, as indicated by Congress in 1978 and 1981,[211] advocating for the replacement of the NCGA with a new federal-level public board. Nonetheless, historical circumstances, including those personally related to the sponsor of the Senate initiative,[212] caused the institutional arrangement already established in the business sector to be duplicated in the public sector.

However, as explained in previous sections, public sector disclosures fulfill user needs that extend beyond financial investments in municipal bonds. At the same time, financial statements cannot serve all needs[213] and compromise must be made between the different, and to some extent, contradictory, uses. Since 1984, compromises have been drafted by a private organization—the GASB—which, as part of the efforts to satisfy rival information needs, adopted a twofold, almost-impossible objective for public entity financial reporting.[214] The repeal of critical pension disclosures stands out as an example of a disclosure compromise implemented in order to appeal to the lowest common denominator of all users of public entities' reports. Non-disclosure enabled public entity executives to offer[215] public

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208. *See generally* Zeff, *supra* note 39 (discussing the crisis in standard setting that led up to the appointment of the Wheat Study).

209. Resulting in the establishment of the FASB: In 1971, a public committee, publicly known as the Wheat Committee, was formed to study the establishment of accounting principles and to make recommendations for improving the process. *See* AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, ESTABLISHING FINANCIAL ACCOUNTING STANDARDS: REPORT OF THE STUDY ON ESTABLISHMENT OF ACCOUNTING PRINCIPLES 9 (1972); Richard Vangermeersch, *Wheat Committee*, *in* THE HISTORY OF ACCOUNTING: AN INTERNATIONAL ENCYCLOPEDIA 607, 607–08 (Michael Chatfield & Richard Vangermeersch eds., 1996); Zeff, *supra* note 39.

210. *See* Greathouse, *supra* note 63, at 25.

211. *See* Chan, *supra* note 55, at 5.

212. Sponsor of the Senate initiative Senator Harrison A. Williams faced a criminal investigation and eventually had to resign from the House in 1982. *See* Joseph F. Sullivan, *Williams Quits Senate Seat as Vote To Expel Him Nears; Still Asserts He Is Innocent*, N.Y. TIMES (Mar. 12, 1982), http://www.nytimes.com/1982/03/12/nyregion/williams-quits-senate-seat-vote-expel-him-nears-still-asserts-he-innocent-text.html?pagewanted=all.

213. *See supra* notes 140 and accompanying text.

214. *See About the GASB*, GOVERNMENTAL ACCT. STANDARDS BOARD, http://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1176168081485 [https://perma.cc/838G-XRUF].

215. *See* Beermann, *supra* note 3, at 27–31 (explaining how unfunded pension promises benefit politicians).

servants compensation that could not be financed in the long run—without triggering public scrutiny or other accountability requirements.

While similar difficulties with private promulgation of accounting and reporting standards in the business sector are arguably successfully mitigated[216] —in part, due to the fact that companies are legally required to comply with FASB standards—and therefore the FASB is not incentivized to relax reporting standards to induce compliance, the GASB faces a much more complex situation:[217] Public entity executives, including elected politicians, need reasons to adopt and adhere to GASB standards.[218]

Compelling public entities to irrevocably accept the obligation to adhere to the standards can reduce the need of the standard setter—GASB or others—to relax disclosure requirements in order to induce voluntary adoption. In addition, moving to mandatory use would prevent opportunistic adoption by public entities.[219] Therefore, the first part of improving the public sector's disclosure regime is to incentivize state and local governments to commit themselves to ongoing implementation of a single set of disclosure standards.

### *B. What Standards? The Advantages of the Federal Advisory Board over the GASB*

Policy reasons for favoring compulsory adoption of Federal Advisory Board standards over those of the GASB extend beyond the mere factual historical success of the Federal Advisory Board in providing adequate pension disclosures. The Federal Advisory Board has systemic advantages that make it more suited to fulfilling public expectations of public sector disclosures.[220]

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216. *Cf.* Mundstock, *supra* note 15, at 816–23 (criticizing the business sector's private accounting standard setting, following the accounting scandals of the early 2000s, for example, Enron and WorldCom).

217. With respect to funding, § 978(a) of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 grants authority to the SEC to require stock exchanges to establish annual accounting support fees to adequately fund the annual budget of the GASB. Pub. L. No. 111–203, § 978, 124 Stat. 1924 (2010) (codified as amended at 15 U.S.C. § 77s (2012)). Accordingly, "[t]he GASB is funded primarily by accounting support fees paid by brokers and dealers who trade in municipal bonds." *What We Do: GASB*, FIN. ACCT. FOUND., www.accountingfoundation.org/jsp/Foundation/Page/FAFSectionPage&cid=1351027541296 [https://perma.cc/T6DW-PTGV]. However, the same section also includes a non-interference clause, which states: "Nothing in this subsection shall be construed to impair or limit the authority of a State or local government to establish accounting and financial reporting standards." 15 U.S.C. § 77s.

218. *See* Carpenter & Feroz, *supra* note 75, at 588.

219. *See supra* Section IV.3.

220. *See supra* notes 14–18 and accompanying text.

Among these advantages is the successful integration of non-federal board members—who also constitute a majority[221]—while simultaneously maintaining federal oversight due to the ability of the director of Office of Management and Budget (OMB) or the Comptroller General[222] to veto new standards.[223] As a result, the government cannot abuse the process by initiating politically-biased standards but can veto standards that are undesirable from a public good perspective.

More importantly, the reporting objectives implemented in the Federal Advisory Board standards are not ambiguous or twofold. The Federal Advisory Board is committed to promulgating standards that serve the general public good[224] and accordingly sets the standards to require disclosure that first and foremost serve the public interest—with an emphasis on control over, and accountability of, the public entity.[225]

An example that emphasizes the enhanced control and accountability implemented by the Federal Advisory Board standards is the fact that these standards require entities to recognize the full amount of the liability and disclose contingent liabilities as soon as their chances of realization reach a threshold of 50%—that is, every liability that is *more likely than not* to materialize must be disclosed and accounted for—at 100% of the amount.[226] This practice currently leads federal entities to disclose liabilities before state and local governments do. In contrast, by following the FASB's recognition threshold of *likely to occur*, GASB standards require recognition of contingent liabilities at only an 80% threshold[227]—that is, only when the chances of realization are greater than 80%—is an entity employing GASB standards required to disclose a contingent liability.

The two different approaches to liability recognition stem from the different DNA of the two standard sets. GASB standards, as a private market product, prefer sub-disclosure that must be preserved in order to prevent disclosure

221. FED. ACCOUNTING STANDARDS ADVISORY BD., FASAB FACTS 2 (2012), http://www.fasab.gov/pdffiles/fasab_facts.pdf [https://perma.cc/W47S-G4B8]. To gain recognition under the AICPA Rule 203, the ratio of federal officials and non-federal members was reversed from 6:3 to 3:6 in 2003. Professor James L. Chan, American Government Accounting: Institutions, Concepts, and Standards, Lecture Series at the University of Cagliari 10 (2008), http://jameslchan.com/papers/ChanCagSem3.pdf [https://perma.cc/VME6-R3FQ].

222. The Comptroller General is the director of the Government Accountability Office. *Office of the Comptroller General*, U.S. GOV'T ACCOUNTABILITY OFF., https://www.gao.gov/about/workforce/ocg.html [https://perma.cc/B75X-NBTP].

223. FASAB Memorandum of Understanding, *supra* note 195, § 4.

224. *See* SFFAC 1, *supra* note 113, at 1.

225. FASAB Memorandum of Understanding, *supra* note 195, § 4.

226. Cotton, *supra* note 111, at 34–35.

227. *Contingencies: Key Differences Between U.S. GAAP and IFRSs*, DELOITTE, http://www.iasplus.com/en-us/standards/ifrs-usgaap/contingencies [https://perma.cc/3GS4-BAXZ] (elaborating on the difference between U.S. GAAP and IFRSs contingencies recognition).

from becoming a "self-fulfilling prophecy" in the market, causing statement users—for example, debtors—to act prematurely against the entity.[228] Federal Advisory Board standards, in contrast, as a governmental product, prefer accountability and over-disclosure of contingent liabilities, even at the cost of immature actions from the debtors' side.

Getting state and local governments to replace the use of GASB standards with those of the FASAB will improve public sector disclosures, accounting practice, and accountability. As another example, it will apply required changes in the disclosures, those indicated as problematic by existing research;[229] among them, reconciliation of accrual numbers of actual cash payments, a prominent disclosure lacking in current reporting practices of public entities, but implemented according to Federal Advisory Board standards.[230] Therefore, the second part in improving the public sector disclosure regime—beyond just incentivizing state and local governments to commit themselves to ongoing implementation of a single set of disclosure standards—is to incentivize state and local governments to use the Federal Advisory Board standards instead of those of the GASB.

### *C. The Transparency Bill: Good, but with Extensive Room for Improvement*

The discussion conducted in the previous sections regarding the accountability effects of disclosure requirements supports the Transparency Bill,[231] as do the arguments made with reference to the inadequate disclosure regime currently established under the existing institutional arrangement used in disclosure standard setting for the public sector.[232]

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228. Over-disclosure of liabilities can cause creditors to act against the entity to a much greater extent than necessary.

229. *See* Naughton & Spamann, *supra* note 3, at 593–97.

230. Hiroyuki Kohyama & Allison Quick, *Accrual Accounting in Federal Budgeting: Retirement Benefits for Government Workers* (Harvard Law Sch. Fed. Budget Policy Seminar, Briefing Paper No. 25, 2006), http://www.law.harvard.edu/faculty/hjackson/RetirementBenefits_25.pdf [https://perma.cc/U3HT-KYSW] ( "In the Financial Report, the Treasury includes a table detailing the reconciliation of net operating cost (based on the calculations in the financial report [accrual based]) and the unified budget deficit (based on the Presidential/Congressional budget [cash based]). Most of the differences between the net operating cost and the budget deficit are attributable to military employee benefits, civilian employee benefits, and veterans' compensation.").

231. Public Employee Pension Transparency Act, H.R. 4822, 114th Cong. § 2 (2016).

232. *See supra* Part IV.3 (discussing opportunistic adoption of disclosure standards by states and local governments).

Nonetheless, as the Transparency Bill focuses on post-employment—pension—obligations only, and in solving disclosure malfunction by enacting specific and elaborate disclosure requirements,[233] it does not deal with the core of the problem and does not affect the systemic arrangements that allowed such a malfunctioning disclosure regime to exist. To the contrary, a move to compulsory use of Federal Advisory Board standards, as suggested by this Article, will not only solve the current non-disclosure problem but will also end the current arrangement that allows states to tailor and shop their standards with a private standard setter.

In this respect, the same means proposed by the Transparency Bill—that is, making tax benefits related to bonds issued by a state or political subdivision conditional upon compliance with disclosure requirements—can be used to accomplish the suggested institutional change: Incentivize state and local governments to commit themselves to the Federal Advisory Board standards in order to maintain bond-related tax incentives.

At the outset, it can be mentioned that such federal influence on states' "domestic issues"[234] is not extraordinary under the federalism theory[235] and doctrine,[236] and rests on sound and substantive legal doctrines.[237] A famous example of a similar action is the 1984 National Minimum Drinking Age Act[238] in which Congress required[239] states to make changes in their regulation so as to prohibit persons under 21 years of age from purchasing alcoholic beverages, as a condition of receiving state highway funds.

233. For example, the bill requires the disclosure of the number of participants in every . "A statement of the number of participants who are each of the following—(i) those who are retired or separated from service and are receiving benefits, (ii) those who are retired or separated and are entitled to future benefits, and (iii) those who are active under the plan." H.R. 4822 § 4980J.

234. "[T]he selection of a financial reporting system is a social choice." BEAVER, *supra* note 138, at 16.

235. *See generally* MALCOLM M. FEELEY & EDWARD RUBIN, FEDERALISM: POLITICAL IDENTITY AND TRAGIC COMPROMISE 69–90 (2008) (reviewing different theories of federalism).

236. *See generally id.* at 124–43 (reviewing the judicial doctrine of federalism).

237. *See, e.g.*, Sarah F. Liebschutz, *The National Minimum Drinking-Age Law*, 15 PUBLIUS 39, 43 (1985) (evaluating the constitutional basis for federal intergovernmental regulation in a policy area dominated by states); Richard J. Pierce, Jr., *Regulation, Deregulation, Federalism, and Administrative Law: Agency Power to Preempt State Regulation*, 46 U. PITT. L. REV. 607, 613–14 (1985) (quoting LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW 319 (1978)) (discussing how state-imposed regulations, which advance states' interests at the expense of national interests, should be addressed).

238. 23 U.S.C. § 158 (2012).

239. More accurately, forced: "The Secretary shall withhold 10 per centum of the amount required to be apportioned to any State [for highway funds] . . . on the first day of each fiscal year . . . in which the purchase or public possession in such State of any alcoholic beverage by a person who is less than twenty-one years of age is lawful." *Id.* § 158(a)(1)(A).

All in all, the Transparency Bill clearly indicates a new understanding that "accounting has become too important to be left to the accountants"[240] even at the state level;[241] nonetheless, there is still an acute need to address the systemic issue in order to prevent the next financial crisis.

## VIII. CONCLUSION

During the last quarter of a century, state and local governments have taken on the obligation to provide pension benefits to approximately 20,000,000 Americans who are active employees of these entities, and an additional 7,000,000 retirees and their dependents.[242] In recent years, these public entities have been facing difficulties in financing this obligation. Enormous amounts of unfunded pension liabilities, estimated to be between $3,412 billion—Congress's estimates—and $1,191 billion—the programs' officially disclosed numbers[243]—threaten the financial stability of many local governments.

This Article argues that today's pension crisis is only a symptom of the systemic weaknesses existing in state and local governments' disclosure regimes. Public entities' freedom to choose whether or not to adopt disclosure standards promulgated by a private organization, combined with the resulting need of the private promulgator to promote their own standards by relaxing stringent disclosure requirements, add up to an inadequate disclosure regime.

The Transparency Bill, introducing specific disclosure requirements with respect to post-employment liabilities of state and local governments, is one welcome step towards improving public sector disclosures. Nonetheless, it only deals with one symptom—that is, the current specific lack of adequate disclosures regarding pension liabilities—and does not address the institutional source of the problem. This Article, in contrast, suggests incentivizing state and local governments to improve their disclosure conduct entirely—that is, to replace voluntary adoption of privately promulgated GASB disclosure standards with compulsory use of disclosure standards promulgated by the Federal Advisory Board.

The transformation from voluntary adoption of privately promulgated standards, which implement inadequate reporting objectives not focused

240. JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 94 (1975).
241. At the national level, see Jones & Smith, *supra* note 31, at 244.
242. Public Employee Pension Transparency Act, H.R. 4822, 114th Cong. § 2 (2016).
243. *Id.*

on control and accountability, to compulsory use of federal-based standards, which are more conservative and emphasize control and accountability, is expected to contribute to minimizing the chances for the next public sector financial crisis to develop due to inadequate disclosure.