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An Examination of the Government Accounting Standards Board

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AN EXAMINATION OF THE GOVERNMENT ACCOUNTING STANDARDS BOARD

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Table of Contents

Introduction

The reporting of financial results is among the most important activities conducted by any organization. Financial reporting provides a basis on which parties inside and outside an organization can judge the organization's effectiveness at conducting its core activities and determine its future financial viability. Donors use financial reports to examine whether not-for-profits efficiently use their donations; investors use financial reports to determine if a company is worthwhile place for their assets; voters use government financial reports to analyze whether they are receiving the services they expect for the tax dollars they are obligated to provide. The ability to perform such critical analysis is contingent on financial reporting that provides an accurate interpretation of the economic reality of organizations.

To maintain the efficacy and comparability of financial reporting in the United States, standards for accounting and financial reporting have been created and modified. These standards are typically called Generally Accepted Accounting Principles, better known by its acronym of GAAP (pronounced like gap). Standards such as GAAP were created to provide the most effective and accurate methods of communicating the financial results of an organization. Without such standards, entities would likely use many different standards, some of which might accurately reflect economic reality and provide comparability across entities, and some of which may not. Standards encompass topics such as what should be considered revenue for an organization, or how an organization properly communicates the cost of a building that it will use for 20 years. These standards provide the basis for comparability between organizations of the same type and allow one to determine that company A is more profitable than company B. These same standards may expose that indicate a high chance of bankruptcy in the near future, or show that a certain not for profit spends a higher portion of its donations on its core mission rather than administrative overhead, versus another.

To provide these standards, entities such as the Financial Accounting Standards Board, the Association of Certified Public Accountants, the Government Accounting Standards Board, the Public Company Accounting Oversight Board, and the Internal Revenue Service have been given some level of authority to determine what these standards should be for certain types of organizations. The organizations deliberate the merits of communicating the financial and economic activities of organizations in various ways, all with the purpose of ensuring that financial reporting is accurate and useful.

Periodically over the course of recent history, there have been times where the accuracy or efficacy of the accounting and reporting standards provided and the organizations providing those standards have come into question. After the collapse of Enron in 2001, there was crisis of confidence in our methods of financial reporting in the United States. Many wondered how such an immense fraud could be committed by a public company that must provide financial results to investors every quarter. Enron, as well as other corporate frauds committed around that period, contributed to the passing of the Sarbanes-Oxley Act of 2002 by the U.S. Congress, which completely changed the manner in which financial reporting of public companies in the United States is regulated. Because of Enron and Sarbanes-Oxley, there is now much more accountability around and awareness of the standards for public company financial reporting in the United States and the rest of the world.

While there has not been such a crisis yet, the world of government accounting standards is ripe with the possibility of disaster in the near future. According to the U.S. Bureau of Economic Analysis, state and local government spending totaled 12.5 percent of U.S. GDP in

2009, or around $1.77 trillion.[1] Although state and local spending is immense, the financial reporting standards for the public sector are not nearly as well developed as for public companies. The accounting and financial reporting standards for government entities are only semi-officially determined by the Government Accounting Standards Board (GASB). The GASB, unlike its private sector counterpart, is not the official standard setter for *all* public sector entities, but only ones which reside in states that have statutorily required government entities in their boundaries to follow the GASB's General Accept Accounting Principles[2]. Many other public sector organizations follow GASB's GAAP in spite of the fact that they are not required to do so.[3] Regardless, there does not exist nearly the same level of standards and comparability in public sector financial reporting as there does among publicly traded companies. This means that government financial reporting is not nearly as useful to its users, primarily ordinary citizens and municipal bond holders, as it can and should be. For example, the financial information available to judge the soundness of bonds for one municipality may not very comparable to other similar municipalities. Or if a resident of city was curious about the effectiveness of police spending in his city versus others, he or she would be disappointed to find that different cities may use entirely different standards to determine what those numbers are, making such analysis difficult if not impossible.

In addition to the issues of comparability and consistency across government entities that exists today, the way the GASB is structured and funded presents significant obstacles to it providing the most accurate and relevant financial reporting standards. The GASB is

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[1] "National Income and Product Accounts Table," Bureau of Economic Analysis, http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=5&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Year&FirstYear=2009&LastYear=2010&3Place=N&Update=Update&JavaBox=no#Mid11 November, 2010).

[2] D. S. Loyd and Michael A. Crawford, "GASB Research on the use of Generally Accepted Accounting Principles," *Governmental GAAP Update Service* 8, no. 12 (06/30, 2008), 1.

[3] ibid.

significantly underfunded as of late. The GASB also depends on sources of funds that are both inconsistent year-to-year and present significant potential conflicts of interest for the organization. Further, a majority of the members of the GASB have built in potential conflicts of interest because they serve on the board part-time while holding positions in state and local government. The presence of political officials on the board, as well as other factors, have meant that the GASB is very subject to political winds in its policies and has show hesitation in making tough decisions in the face of significant political opposition. All of this means that even if the GASB were to become the official source of GAAP for all state and local government entities, as it theoretically should, it would not have adequate resources and would not be properly aligned to meet that task.

A great example of the politics and difficulties the GASB has faced has revolved around the issue of properly accounting for future defined benefit retirement obligations, better known as pensions. Over the last couple of years, the board has been immersed in a significant debate about whether its current standards for pension accounting accurately reflect economic reality. This debate has become politically charged, with representatives and local government officials of all stripes weighing in against changes backed by economists and the board. The controversy and the arguably tempered changes currently proposed by the board indicate that that a thorough examination of the board's structure and role, as well as consideration of significant changes to the board are well justified.

In order to demonstrate the need for significant change to the GASB, this thesis will provide context as to the current structure and funding of the GASB and the history of its formation. In addition, this thesis will go into depth as to the recent debate around defined benefit pension accounting, and examine the potential scope of problems that exist in that area as well as the GASB's half-hearted attempt to shed light on those problems. Finally this thesis will endeavor to provide a path forward for the GASB that will set government accounting in the right direction. While this thesis will briefly address the recent history of accounting standards production for the Federal government, this thesis does not attempt to provide a thorough examination of that area nor provide recommendations that are pertinent to it. An argument could most certainly be made for Federal accounting standards setting to fall within the scope of the GASB, but the perceived urgency of the subject by the writer is not nearly as high as reforming the accounting standards and standard setting for state and local governments.

Chapter I: Current Structure and Funding of the FAF, FASB and GASB

A) The Financial Accounting Foundation (FAF)

The Financial Accounting Foundation (FAF) is a 501(c)(3) not-for-profit corporation that acts as the parent organization to both the Governmental Accounting Standards Board, and the Financial Accounting Standards Board.[1] The Foundation is managed by a Board of Trustees that is responsible for providing oversight, financial and administrative management for the Governmental and Financial Accounting Standards Boards and their respective Advisory Councils.[2] However, the Board is explicitly prohibited from involvement in the accounting standard making process, in order to preserve the independence of the boards' work. The by-laws of the FAF clearly articulate the independence of the standard setting boards relative to the foundation itself, "Trustees shall not, by or in connection with the exercise of their power of approval over annual budgets or their periodic review of such operating and project plans, direct the FASB or the GASB to undertake or to omit to undertake any particular project or activity or otherwise affect the exercise by the FASB or GASB of their authority, functions, and powers in respect of standards of financial accounting and reporting."[3] However, in fulfilling its oversight responsibilities, the Foundation's trustees are instructed to examine the short and long run goals of the Boards, as well as their effectiveness at meeting those goals.

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[1] *Financial Accounting Foundation 2009 Annual Report* (Norwalk, CT: Financial Accounting Foundation, 2010), 3.
[2] *By-Laws of the Financial Accounting Foundation* (Norwalk, CT: Financial Accounting Foundation, 2010), 2.
[3] ibid., 2

The Board of Trustees is made up of between fourteen and eighteen members, the number of which is decided upon by a majority vote of the trustees.[4] The members of the Trustees serve five year terms that are staggered so that every year a “class” consisting of at least one trustee finishes its term. The trustees are made up of two groupings: governmental trustees and at-large Trustees.[5] The governmental trustees, of which there are at least three, must have experience as an elected official or government financial officer, as determined by the sitting Trustees.[6] The at-large trustees may be anyone who has relevant experience from nearly any field, as determined by the Trustees. Nominations for the at-large Trustees may come from any interested party or group. Nominations for the Governmental Trustees must come from one of nine Governmental Organizations such as the National Governors Association and the National League of Cities.[7] A majority of the Trustees must not be currently associated with a public accounting firm, or have been associated with one in the prior two years.[8] The seven member Appointments and Evaluations Committee of the Trustees then considers the nominations and recommends nominees for approvals by the full board. If nominations from the governmental organizations for the Governmental Trusteeship are determined to not be suitable to the committee or the full board, they must notify the governmental organizations, which may then nominate alternative candidates for that position. The Appointments and Evaluations committee is also responsible for the evaluation and recommendation of potential board members for the FASB and the GASB.

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[4] ibid., 2
[5] ibid., 3
[6] ibid., 3
[7] ibid., 2
[8] ibid., 6

The Foundation's overall budget, inclusive of the activities of both standards boards, is around $48 million dollars.[9] The FASB, the GASB and the Foundation are all based out of the same facility located in Norwalk, Connecticut.

B) The Financial Accounting Standards Board (FASB).

Created in 1973, The Financial Accounting Standards Board is responsible for determining standards of financial accounting for non-governmental entities.[10] The FASB is recognized as the authoritative source of financial accounting standards for public companies by both the Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA).[11] The SEC is statutorily the ultimate arbiter of financial accounting and reporting standards for public companies in the United States by the Securities Exchange Act of 1934, but has traditionally mostly deferred to the FASB in determining what those standards should be.[12]

The FASB is made up of five full time board members that are appointed by the FAF Trustees to serve up to two five years terms. A staff of over sixty people currently supports the board in researching and determining standards. None of the current Board Members are associated with or employed by public accounting firms or public corporations.[13] Two of the board members served the FASB as technical staff for

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9 *Government Accounting Standards Board Statement of Budgeted Revenues and Expenses for the Year Ending December 31, 2010* (Norwalk, CT: Government Accounting Standards Board, 2009), 1.
10 *Financial Accounting Foundation 2009 Annual Report*, 1
11 "Facts about FASB," Financial Accounting Foundation, http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495 (accessed 23 November, 2010).
12 ibid.
13 "The Financial Accounting Standards Advisory Council," Financial Accounting Foundation, http://www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1218220137466 (accessed 23 November, 2010).

multiple years between leaving their positions as partners at major public accounting firms and joining the board.[14]

The board is also advised by a thirty six member Financial Accounting Standards Advisory Council (FASAC) that includes senior corporate executives, academics, institutional investors and partners at public accounting firm.[15] The council is tasked with serving as the proverbial "boots on the ground" for the FASB, by providing advice on potential priorities and agenda items from their current experiences in the private sector.[16] The makeup of the council is determined by the Trustees of the FAF.[17] Members serve one year terms, with a limit of four total terms.[18] The council holds quarterly meetings at the FASB offices with members of the FASB, FASB technical staff and the Chief Accountant of the SEC.[19]

C) The Governmental Accounting Standards Board (GASB)

The Governmental Accounting Standards Board is tasked with determining the financial accounting and reporting standards for all governmental entities that are not a part of the Federal Government. The GASB is made up of six part-time board members and one full-time chairman of the Board.[20] Unlike the FASB, members of the board can and frequently do serve on the GASB while also holding a full-time position in areas

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[14] *Facts about FASB*
[15] *The Financial Accounting Standards Advisory Council*
[16] ibid.
[17] ibid.
[18] ibid.
[19] ibid.
[20] *By-Laws of the Financial Accounting Foundation*, 16

such as state or local government and academia. Currently four of the seven members of the GASB hold public office or work in the public sector in a financial capacity.[21]

Members of the GASB are appointed by the FAF Trustees. The Appointments and Evaluations Committee of the FAF Trustees evaluate the nominations for the GASB and recommend them to the full board for approval.[22] Any FAF governmental trustees that do not serve on the Appointments and Evaluation Committee normally, ex-officio serve on the committee when considering appointments to the GASB.[23] Members of the GASB can only be removed by a two thirds vote of all the FAF trustees, and only because of: disability, malfeasance or alleged malfeasance, or "other cause deemed by such Trustees as reasonably evidencing conduct detrimental to the purposes or repute of the GASB."[24]

The GASB is generally considered the official source of Generally Accepted Accounting Principles (GAAP) for state and local government entities. A study of GAAP usage by government entities indicated that thirty six states have some level of regulation or statutes that requires that some or all governmental units utilize GAAP.[25] Also, about 26 percent of counties, localities and independents school districts are required to utilize gap in preparing their annual financial statements by virtue of statute or regulations.[26] For all types of governmental units, 67 percent actually utilize GAAP, whether required to or not.[27]

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[21] Michael Corkery, "Pension Dispute Ensnares A Board," *Wall Street Journal*, Oct 1, 2010.
[22] *By-Laws of the Financial Accounting Foundation*, 16
[23] ibid., 16
[24] ibid., 16
[25] D. S. Loyd and Michael A. Crawford, "GASB Research on the use of Generally Accepted Accounting Principles," *Governmental GAAP Update Service* 8, no. 12 (06/30, 2008), 1.
[26] ibid.
[27] ibid.

The GASB staff and board members are advised by the Government Accounting Standards Advisory Council (GASAC). The function of the GASAC is to provide suggestions as to the major technical issues that the GASB should devote its resources to, advise the GASB on its agenda, provide feedback to the GASB on technical exposure drafts and pronouncements its issues and to suggest priorities as to the issues before the board.[28] The GASAC is also tasked with helping to fundraise for the GASB and FASAC.[29]

Members are appointed to the GASAC by the FAF Trustees for two year terms, and while there are no explicit term limits, members "ordinarily serve no more than three consecutive terms."[30] Sixteen Organizations and the United States General Accounting Office are invited to nominate members to the council per the by-laws of the FAF.[31] The organizations include the American Accounting Association, the American Institute of Certified Public Accountants as well as the Association of Government Accountants and thirteen other governmental organizations. In addition, the by-laws instruct the FAF Trustees to seek "An individual who is knowledgeable in the municipal bond rating process, an individual knowledgeable in underwriting government securities offerings, and a user of the financial reports of state and local governmental entities (such as a bank or insurance company investment officer)."[32]

[28] *By-Laws of the Financial Accounting Foundation*, 22
[29] ibid., 21
[30] ibid., 21
[31] ibid., 21
[32] ibid., 21

D) Standard Setting Process

Both the GASB and the FASB follow the same general model for how they go about the process of forming accounting standards. The FASB and the GASB typically receive requests or suggestions to provide guidance in certain areas from various sources, such as their respective advisory boards or the public at large. Those ideas are researched and considered by the chairman and members of the relevant board. A board, in consultation with its staff and the Foundation trustees, may choose to add a project to its technical agenda.[33] Following placement on the technical agenda, the staff of the board researches and identifies major issues with respect to that area that the board then deliberates and considers at public meetings. The board then issues what is called an "Exposure Draft" that reveals potential technical accounting changes under consideration.[34] The exposure draft is debated at public forums with board members present, and comments are solicited and considered by the staff of the board. When the board has come to a decision, it either issues Accounting Standard Updates (FASB) or Statements and Interpretations (GASB) that describe the changed or new accounting standards.[35]

E) Funding Sources

The Government Accounting Standards Board and the Financial Accounting Standards board have different but intertwined sources of funding. As the designated private accounting standard setting organization recognized by the SEC under the

[33] *Financial Accounting Foundation 2009 Annual Report*, 2
[34] ibid., 2
[35] ibid., 2

authority given to it by the Sarbanes-Oxley Act of 2002, the FASB is able to collect an assessment from equity and investment company issuers in order to cover the expenses of determining and providing accounting standards.[36] The assessment is the primary source of funds for the FASB, and makes up 75% of the FAF's operating Revenue.[37] According to Section 109 of the Sarbanes-Oxley Act, the amount that the FASB may assess on equity issuers is not to exceed the "recoverable budget expenses of the standard setting body."[38] In the 2009 fiscal year, these fees totaled $28.9 million.[39]

The assessment is allocated to equity issuers who have a monthly average market capitalization greater than $25 million, or investment company issuers with an average market capitalization or net asset value great than $250 million. The allocation to each firm is based on the average monthly market capitalization of the firm during the 12 months immediately preceding the beginning of the FASB fiscal year, relative to the total market capitalization of all issuers during that period.[40] The purpose of the assessment according to Section 109 of the Sarbanes-Oxley Act is to provide an "Independent, stable source of funding" for the standard setting board.[41] The FASB delegates the collection of the assessment to the Public Company Accounting Oversight Board (PCAOB)[42], which is also authorized under Section 109 to collect such an assessment.[43]

In addition, Section 109 allows the SEC designated standard setting body to receive ancillary revenue such as earnings from publication sales in addition to the accounting

[36] ibid., 35
[37] ibid., 35
[38] *Sarbanes-Oxley Act of 2002, U.S. Statutes at Large* 116 (2002) 745
[39] ibid., 35
[40] Ibid.
[41] Ibid.
[42] ibid., 35
[43] Ibid.

support fee.[44] The publication revenue of the FASB totaled $12.49 million in 2009.[45] 68% of this revenue was from publication license fees received from publisher agreements, 13% from subscription fees for regular publications such as Accounting Standards Updates (ASUs), with the rest coming from miscellaneous forms of publication.[46]

The Government Accounting Standards Board is funded in a very different manner than its sibling institution. The GASB does not have an accounting support fee that it may assess in order to fund its work. In fact that GASB has very little direct revenue in order to cover its expenses. According to GASB's published budget for 2010, which also indicates its budgeted and actual results for 2009, the GASB had an excess of expenses over revenue of $3.82 million in fiscal year 2009.[47] More extraordinarily, the GASB budgeted an excess of expenses over revenue for the 2010 fiscal year of $4.46 million.

The GASB's two primary sources of revenue are the sales of publications and contributions. Net of the direct costs associated, the GASB had publication revenue of $1.45 million, of which 41% was from subscription fees from regular publications, 37% was from license fees from publishers, 17% was from bound editions and the rest from other miscellaneous publications.[48] Contributions to the GASB totaled $1.23 million in fiscal year 2009, 69% of which came from state governments, and 11% from local

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[44] Ibid.
[45] ibid., 36
[46] ibid., 36
[47] *Government Accounting Standards Board Statement of Budgeted Revenues and Expenses for the Year Ending December 31, 2010*, 1
[48] *Financial Accounting Foundation 2009 Annual Report*, 35

governments. In 2008, a voluntary municipal bond fee contributed 10% of GASB's revenue; however those contributions dropped to a negligible level in 2009.[49]

F) The Securities and Exchange Commission (SEC)

The SEC was created by the Securities Exchange Act of 1934 in order to properly regulate public company reporting and the securities industry.[50] The Sarbanes-Oxley Act gave the SEC the ability to recognize accounting standards coming from a standard setting entity as Generally Accepted for the purposes of securities laws if that entity meets certain criteria laid out in the act.[51] Since the act, it has recognized the Financial Accounting Standards Board as that entity.[52] Thus, when a public company runs afoul of GAAP as determined by the FASB and approved by the SEC, the SEC uses its civil enforcement powers to bring lawsuits in Federal court or civil administrative proceedings.

The SEC has never been given comparable authority over municipal entities, even those issuing securities. Municipal entities do not need to register any securities offerings with the SEC, as public companies must do, nor must they provide periodic financial reports.[53] Additionally, the SEC's power to determine the accounting and financial reporting standards under Section 19 of the Securities Act of 1933 and section 13(b) Securities Exchange Act of 1934 does not apply to issuers of municipal securities.[54]

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[49] ibid., 35
[50] *Securities Exchange Act of 1934, U.S. Statutes at Large 89* (1934) 74.
[51] Ibid.
[52] *Facts about FASB*
[53] Andrew Ackerman, "SEC Looks to Target Tower Amendment," *Bond Buyer*, May 13, 2009.
[54] ibid.

However, municipalities are subject to some of the anti-fraud provisions of those acts[55], and the SEC has recently used them to pursue a case against New Jersey for failing to properly report the health of its pension system.[56]

In addition to those prior exemptions, the Tower Amendment of 1975 amended the 1934 Securities Act to further prevent the SEC from becoming involved in the financial reporting requirements of municipal entities that issue securities.[57] The Tower Amendment prevents the SEC from requiring any filings from issuers of municipal securities before the sale of those securities.[58] As a workaround, the SEC has used the combination of anti-fraud provisions of the acts and Exchange Act Rule 15c2-12 –which requires broker-dealers to produce the issuer's official offering statement – in order to put the onus for disclosure requirements on the underwriters of the bonds.[59]

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55 ibid.

56 Zachary A. Goldfarb, "SEC Accuses New Jersey of Bond Fraud; First Time a State is Charged with Securities Violation," *The Washington Post*, August 19, 2010.

57 Ackerman, *SEC Looks to Target Tower Amendment*, 408

58 ibid.

59 ibid.

Chapter II: History of Government Financial Reporting Standards and the creation of the Governmental Accounting Standards Board (GASB)

A) Pre-GASB Government Accounting Standards

In 1906, the National Association of Comptrollers and Accounting Officers (NACAO) was formed to organize and guide government accounting standards and provide some semblance of comparability.[1] The NACAO would later become the Municipal Finance Officers Association (MFOA) in 1932 and became the Government Finance Officers Association (GFOA) in 1946.[2] In 1934, a GFOA predecessor formed the National Committee on Municipal Accounting (NCMA), which would become the National Committee on Government Accounting (NCGA) in 1949 and then the National Council on Government Accounting (NCGA) in 1973.[3] The NCGA produced accounting guidance from 1951-1973 in a publication called *Government Accounting, Auditing, and Financial Reporting* (GAAFR).[4] In 1974, the American Institute of Certified Public Accountants (AICPA) started providing additional guidance through a publication entitled *State and Local Government Industry Audit Guide*.[5] Around this time, people in the profession started to criticize the NCGA for not being representative of its users, not being independent of the profession it was setting standards for and for not having the adequate staff or financial resources necessary to do its job.[6] Also around this time, the

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1 Craig Foltin, "A Long and Winding Road," *CPA Journal* 80, no. 2 (02, 2010), 23.
2 ibid., 23
3 ibid., 23
4 ibid., 23
5 ibid., 23
6 James L. Chan, *Research in Governmental and Non-Profit Accounting*,: JAI Press Inc., 1985), 5.

defaults of New York City and Cleveland, Ohio served to highlight the growing need for better financial reporting relating to municipal securities.

In May of 1979, Senator Harrison Williams of New Jersey introduced a bill that would have amended the 1934 Securities Exchange Act to create a federal council of the Secretary of the Treasury, the Chairman of the SEC and the Comptroller General of the United States or representatives on their behalf.[7] This council would appoint 11 members to a private sector institute with a budget of $2 million that would determine accounting standards for state and local governments that would be nationally recognized.[8] Senator Paul Sarbanes, made famous twenty years later by a bill he co-sponsored with Senator Mike Oxley, was also a co-sponsor of the bill.[9] The prospect of Federal intervention in state and local government accounting led to discussions of the creation of an alternative to the NCGA in order to blunt potential federal intervention.

B) The Formation of the GASB

An important consideration to designing a new standards setting body, was AICPA Rule 203 of the Rules of Conduct of the Code of Professional Ethics. The rule does not allow a certified public accountant to express an audit opinion as to conformance with GAAP, if those statements contain a material difference from the standards created by FASB.[10] Since 1974, the Institute's Committee on Governmental Accounting and Auditing produced guides that reproduced and reconciled NCGA

[7] ibid., 8
[8] ibid., 8
[9] ibid., 8
[10] ibid., 9

standards, making them Rule 203 eligible.[11] In considering government standard setting organizations, the AICPA Board of Directors established that for any organization to produce standards that it would deem acceptable under Rule 203, the structure of the board and any supervisory foundation would have to be independent and not under the control of government representatives.[12]

In 1980, The Financial Accounting Foundation and the Financial Accounting Standards Board made some initial proposals that would bring some level of government financial reporting standards under the auspices of the Financial Accounting Standards Board (FASB), which provided standards for publically traded corporations.[13] However, the idea of the FASB setting government as well as private sector account standards was not popular with government officials who felt that the FASB would not duly appreciate what they believed the inherent differences required for government financial reporting.[14] In late 1979, the FAF decided against pursuing the idea of FASB as a government accounting standard setter, and instead started investigating the creation of a new standards board for government accounting under its auspices.[15] The FAF became concerned however with how the FASB and GASB would interact and about the amount of resources involved.[16] So instead, in 1980, the Financial Accounting Foundation came out in support of the idea restructuring the National Council on Governmental Accounting rather than the creation of a new entity.[17] The FAF proposed ways that the NCGA could become more professional, such as increasing its staff, separating from the

[11] ibid., 10
[12] ibid., 23
[13] ibid., 7
[14] ibid., 7
[15] ibid., 7
[16] ibid., 9
[17] ibid., 9

Municipal Finance Officers Association and the creation of an independent oversight organization of which the FAF would be a part of.

In 1980 an organization named the Government Accounting Board Organizing Committee (GASBOC) was created by the FAF, AICPA, MFOA and the National Association of State Auditors, Comptrollers, and Treasurers (NASACT) to hammer out a plan for a new government accounting standards organization[18]. For the next two years, the debate within the GASBOC would oscillate between the FAF assuming oversight responsibility for a new government standards organization, and forming a new organization called the Government Accounting Foundation (GAF), which would be similar in structure to the FAF.[19] Either way, the foundation charged would have oversight over the new Government Accounting Standards Board. The idea of creating a separate organization proved unpopular with the FAF, which was concerned that government representatives would have an effective veto over any standards created.[20] Additionally, some of the proposed sponsoring entities of the foundation did not agree with the proposal, leading the GASBOC to drop the idea in 1981.[21] Later in 1981, the GASBOC reached a tentative agreement that would request that the FAF oversee the GASB.[22] In November of 1982, the FAF and the government organizations reached an agreement as to the nature of the GASB, entitled “A Proposed Structure for a

[18] ibid., 10
[19] ibid., 11
[20] ibid., 23
[21] ibid., 12
[22] ibid., 12

Governmental Accounting Standards Board."[23] The FAF started to move forward but was somewhat stymied by the lack of endorsement by the "Public Interest Groups."[24]

The "Public Interest Groups" are seven associations of elected or appointed official members. They include the National Conference of State Legislators and National Governors Association.[25] The Public Interest Groups were unhappy that they were given a lone trustee representative on the FAF board.[26] Of the three additional trustees to be added to the FAF, the public interests groups were entitled to nominate one under the initial 1982 agreement, while the MFOA and the NASACT could nominate one as well.[27] To eventually win their backing, the MFOA and the NASACT agreed to drop their exclusive nomination ability over their respective trustee seats, and instead the nine organizations collectively became responsible for nominating the three government trustees.[28]

In 1984, one last issue held up the startup of the GASB: jurisdiction. The public interests groups wanted specific delineation of the comparative roles of the FASB and the GASB before the GASB could start its work.[29] In the agreement, the FAF was given responsibility for sorting out jurisdictional issues between the two boards.[30] GASB was charged with establishing the standards for state and local government entities, while FASB was given responsibility over all other entities.[31] A hierarchy was developed so that FASB pronouncements would also be applicable to government entities unless

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[23] ibid., 12
[24] ibid., 12
[25] ibid., 10
[26] ibid., 13
[27] ibid., 12
[28] ibid., 13
[29] ibid., 14
[30] ibid., 14
[31] ibid., 14

specific GASB pronouncements superseded them.[32] Also, provision was made that within certain parts of the public sector, FASB standards would still apply for separately issued financial statements.[33] The purpose of this was to allow government owned utilities, public authorities, hospitals and other entities to follow FASB for their specific financial statements.[34] For combined statements issued directly by state and local government entities, the GASB standards applied.[35]

In the first few years of the GASB's existence, the standards hierarchy that made FASB pronouncements applicable unless GASB had provided a relevant pronouncement caused the GASB some difficulty. In order to allow time to develop its own standards that were more tailored to state and local governments, the GASB had to issue so called "negative standards" that allowed governments to ignore FASB standards that the GASB thought would be onerous to temporarily follow.[36] After a fifth year review of the GASB in 1989 by the FAF trustees, and the issuance of *Statement of Auditing Standards No. 69* by the AICPA, the hierarchy was changed so that the GASB must affirmatively approve of any FASB standard before it applied to government financial reporting.[37]

Aside from difficulties it incurred in adjusting FASB standards, in its opening years the GASB focused on providing a conceptual framework, which would fall low on the accounting standards hierarchy, but would underlie all of its future technical statements. The GASB also addressed certain areas such as the financial reporting model,

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[32] ibid., 14
[33] ibid., 14
[34] ibid., 14
[35] ibid., 14
[36] D. Bean CPA, "A Look Back at 25 Years of High Quality Standards-Setting," *The Journal of Government Financial Management* 58, no. 3 (Fall, 2009), 28.
[37] ibid., 29

pensions and the reporting entity.[38] In May of 1987, the GASB issued Concepts Statement No. 1, *Objectives of Financial Reporting*, which was notable because it made clear that government financial statements needed to be relevant not only to the community of municipal securities investors, but also to the general public as a means hold governments accountable.[39]

The GASB encountered the biggest threat to its existence in its attempt to create performance based reporting, called Service Efforts and Accomplishments (SEA) starting in 1989. In attempting to create SEA reporting and incorporate it into the financial statements of governments, the members of the GASB wanted to provide a basis for citizens to analyze the effectiveness and efficiency with which governments used tax dollars.[40] In 2003, the GASB issued *Special GASB Report – Reporting Performance Information: Suggest Criteria for Effective Communication*, which detailed 16 possible criteria for performance measurement.[41] While government officials were somewhat annoyed by the publication of that report, GASB's addition of SEA reporting to its technical agenda in 2006 truly brought things to head.[42] The GFOA was so incensed at the prospect that it argued to the FAF trustees that such a project was outside of the jurisdiction of the GASB.[43] The FAF sided with the GASB, but the GFOA attempted to unite other government organizations in questioning GASB's standard setting status and encouraged that its role to be transferred to the FASB.[44] Some government groups

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[38] ibid., 29
[39] ibid., 29
[40] Foltin, *A Long and Winding Road,* 25
[41] ibid., 25
[42] ibid., 25
[43] ibid., 25
[44] ibid., 25

embraced SEA reporting, and the GASB stressed that the standards it was attempting to develop for SEA reporting were voluntary.[45] In June 2007, the chairman of the FAF made it clear that the GASB was here to stay by re-stating the impetus for GASB's initial creation. He argued, "There are fundamental differences between private and government entities that require specialized accounting and reporting standards… the GASB possesses the specialized expertise to set such standards for governmental entities."[46]

This past year, the Dodd-Frank Act of 2010 was enacted by Congress and the President in order to reform financial markets and attempt to prevent future economic crises comparable to the one experienced over the last few years. Among the many and wide-ranging provisions of the Dodd-Frank Act of 2010, were some less noticed ones relating to the GASB. Two important provisions relate to the funding of the GASB and a study of its importance. The first allows the SEC to require a "national securities association" to establish "a reasonable annual accounting support fee to adequately fund the annual budget of the Governmental Accounting Standards Board."[47] The second directs the Government Accountability Office (GAO) to examine the GASB's role and importance in municipal securities markets and the "manner and the level at which the Governmental Accounting Standards Board has been funded."[48] The GAO is required to submit this report to congress within six months of the passage of the act, which is

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[45] ibid., 26
[46] ibid., 26
[47] "Commissioner Walter Issues Remarks before 43rd Annual Securities Regulation Seminar," *US Fed News*, October 30, 2010.
[48] ibid.

January 21st, 2011.[49] The report could potentially lead to more attention and awareness of the GASB's role and its strengths and shortcomings.

C) Federal Government Accounting Standards

In 1990, Congress Enacted the Chief Financial Officers Act, which it subsequently amended in 1994 through the passage of the Government Management Reform Act of 1994.[50] The act required that the Federal government and each of reporting entities produce annual audited financial statements.[51] The act also created the position of Chief Financial Officer in each Federal government department and these individuals are responsible for developing systems for financial reporting and internal controls.[52] Following the passage of the Act in 1990, the Secretary of the Treasury, the Comptroller General of the United States (also known as the head of the Government Accountability Officer (GAO)), and the Director of the Office of Management and Budget created the Federal Accounting Standards Advisory Board (FASAB) to determine the standards for federal financial reporting.[53] The three associated agencies provide the funding necessary to operate the FASAB.[54] In 1999, the FASAB was restructured to make it more independent of the Federal Government. This was done in order to receive the endorsement of the AICPA of the FASAB as the official source of GAAP for Federal reporting entities,.[55] The board today is made up of three representatives chosen by the

[49] ibid.
[50] *FASAB Facts* (Washington D.C.: Federal Accounting Standards Advisory Board, 2010), 1, http://www.fasab.gov/pdffiles/fasab_facts_2010.pdf (accessed 24 November, 2010).
[51] ibid., 1
[52] ibid., 1
[53] ibid., 1
[54] ibid., 1
[55] ibid., 60

board's sponsoring agencies and six members of the public who are not Federal employees.[56]

[56] ibid., 1

Chapter III: GASB Standards Case Study: Defined Benefit Pension Accounting

Since its very creation, the politics and role of the Government Accounting Standards board has always been extremely complicated and controversial. Because GASB's standards directly impact many entities in which politics are inherently involved, the GASB's work will always be subject to being made into a broad political debate rather than a battle among policy wonks. However, for the GASB to live up to its mission, it must be able to separate itself from the purely political concerns of its actions, and determine the best way for governments to report "economic reality." In the recent debate and process to determine potential changes to defined benefit retirement plan accounting, the GASB has proven itself to be too willing to let its sails be pulled by political winds. It is abundantly clear to those outside of government that current accounting standards for such plans do not provide a clear or accurate enough picture of the difficulties that these plans will encounter over the next few decades, and allow these plans to appear healthier and better funded than they are. The lack of decisive and effective action to change the reporting requirements of the pension liabilities of government entities so that they reflect the true scope and state of those liabilities, is evidence that the GASB is not properly equipped to be a neutral arbiter of accounting standards for government in its current state.

A) Context of the Debate

In January of 2006, the board commissioned a research project to ascertain the sufficiency of GASB *Statements 25* and *27*, which are the existing standards for government defined benefit pension accounting.[1] Additionally, between the issuance of *25* and *27* and that time, GASB had come out with significant conceptual statements that govern the framework GASB uses to consider accounting standards. *Concepts Statement 3* came out in 2005 and concerned the different methods of financial statement communication (ex. notes versus recognition in the income statement, balance sheet, or statement of cash flows).[2] *Concepts Statement 4*, which came out in 2007, concerned conceptual characteristics and definitions of elements of financial statements.[3] The combination of framework changes and the staff's research project led the board to add pension accounting to its technical agenda in 2008.[4] In 2009, the GASB issued an invitation for interest parties to comment on pension accounting.

On June 16th, 2010, after taking into account the view presented during the comment period, the GASB released their "Preliminary Views… on major issues related to Pension Accounting and Financial Reporting by Employers."[5] The document quickly lit up a firestorm among government officials, economists, union leaders and actuaries, although its proposals are not nearly as drastic as they could have been. Many have suggested that proposal does not go far enough in shinning the light on the precarious situation of some pensions. The result has been that some observers are not only questioning the accounting standards involved, but the very structure and makeup of the GASB.[6]

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1 Government Accounting Standards Board, *Preliminary View on Major Issues Related to Pension Accounting and Financial Reporting by Employers* (Norwalk, CT: Financial Accounting Foundation, 2010), 1.
2 ibid.
3 ibid.
4 ibid.
5 ibid.
6 Michael Corkery, "Pension Dispute Ensnares A Board," *Wall Street Journal*, Oct 1, 2010.

B) Nature of Defined Benefit and Defined Contribution Retirement Plans

Defined benefit retirement obligations are more typically known as pensions. Employees who are entitled to the benefit are usually promised a monthly or yearly payment from the employee's retirement until the time of the employee's or the employees spouse's death. The size of that employee's pension is typically determined by factors such as the employee's tenure at the organization, his or her pay levels during that tenure and potentially other so called "sweeteners" that may occur, such as an early retirement incentive that artificially raises the organization's pension obligation. Pensions are called defined benefit retirement plans because the organization is then legally responsible for meeting the promised pension level. Typically organizations set aside funds and invest them in some way in order to provide for those future obligations. In the private sector, pension sponsors also pay a premium to a Federal corporation called the Pension Benefit Guaranty Corporation (PBGC), which provides insurance of the benefits for employees in the case of bankruptcy.[7] There is no comparable insurance organization for government employer sponsored pensions.

The alternative to pensions is typically a defined contribution retirement plan, typically a 401(k) plan or something similar. Instead of providing a fix level of benefits for a certain period, an organization only promises to provide a fixed contribution to the employees' plan. Employees typically then individually select investments for their plan based on the offering available in the plan. The employees bear all the risk for their plan's investment performance, and its ability to meet their post-employment needs. The

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[7] Edward A. Zelinsky, "The Defined Contribution Paradigm," *The Yale Law Journal* 114, no. 3 (Dec., 2004), 470.

vast majority of private sector organizations have switch from pension plans to 401(k) plans over the last few decades; however government organizations have been much slower to adopt 401(k) style plans.[8]

C) Calculation of Defined Benefit Obligations

In order to determine how much must be set aside to properly pay employees for their promised benefits, organizations must use actuaries to estimate certain assumptions for the pension plan, typically called Actuarial Assumptions.[9] These assumptions include factors such as how long employees are expected to remain at the organization, how their salary is likely to progress and how long they are expected to live. The goal of this is to determine the timing and magnitude of payments that the pension plan will be required to make in the future. However, these payments are future obligations, and must be discounted back using a discount rate in order to provide relevant present data to compare with plan assets. Because of discounting, small changes in the rate used to discount a plan's future payments can cause very wide swings in the size of the pension obligation involved, making the rate one of the most important factors involved.

For this reason, pension discount rates are very hotly debated, and it is at this point that corporate and government pension plan accounting standards typically start to defer. Until 2004, the SEC required corporations to discount their future pension

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8 "General FAQs about the PBGC," Pension Benefit Guaranty Corporation, http://www.pbgc.gov/about/wrfaqs.html#what_is (accessed November 20, 2010).

9 Nancy Y. Augustine et al., *The Trillion Dollar Gap; Underfunded State Retirement Systems and the Roads to Reform* (Washington, D.C.: Pew Center on The States, 2010), 53, http://downloads.pewcenteronthestates.org/The_Trillion_Dollar_Gap_final.pdf (accessed 19 November, 2010).

obligations by 120% of the rate of return of 30-year Treasury securities.[10] In 2004, Congress enacted the Pension Funding Equity Act, which was designed to ease the burden on hard hit industrial and transportation companies that because of their age have many more participants in their pension plans and much higher obligations.[11] The act allowed corporations to instead discount their obligations at the rate of a long term investment grade corporate bonds.[12] Because corporate bonds are considered to be riskier than treasury bonds which are backed by the full faith and credit of the Federal government, their interest rate is somewhat higher. As of late the rates have been around 6%.[13] Because higher discount rates lead to lower present values, the use of corporate bond rates causes a current pension obligation to appear lower. Usually this will also mean that an organization is then able to make smaller current contributions to its plan in order to adequately meet its obligations, which is why industrial and airline companies sought the change in 2004.

Government pension funds, according to current GASB GAAP, are able to use the fund's long run return on plan assets as a discount rate for their obligations.[14] This level for most plans is within a percentage point of 8%.[15]

D) The Discount Rate

[10] *Pension Funding Equity Act of 2004, U.S. Statutes at Large* 118 (2004) 596

[11] ibid.
[12] ibid.
[13] ibid.
[14] Mary Williams Walsh, "A New Plan for Valuing Pensions," *The New York Times*, June 25, 2010.
[15] Augustine et al., *The Trillion Dollar Gap; Underfunded State Retirement Systems and the Roads to Reform*, 35

The primary point of contention in the debate around accounting for pensions is what the proper discount rate for pension obligations should be. The June proposal included a significant change to how the discount rate is determined, but many of the more cautious people in the profession have suggested that the proposal does not nearly go as far as it should, while others have accused the GASB of attempting to design the standards in a way to force a policy outcome rather than for a financial reporting purpose.

GASB's opinion on the discount rate for future liabilities involves creating a new blended rate based on the differing risks to the fund's payments to pensioners. It is GASB's opinion that to the extent the fund is able to make future payments to pensioners from the projected plan assets that will result from projected returns and contributions to the fund, the fund may discount those liabilities at the fund's expected rate of return on its investments.[16] Then, for all pension liabilities that will fall after the fund's assets are projected to be depleted, those liabilities should be discounted using a high quality municipal bond index, which would almost always be a lower rate.[17] A combined discount rate then would be formed from those two values, and used to discount all of the fund's liabilities. The GASB justified this approach by saying "because the long-term rate of return is not relevant to an unfunded exchange of benefits for employee services."[18] In a sense, they are saying rate of return of the fund's assets does not matter if there are no assets available to achieve that rate of return.

The effect of GASB's proposed changes will likely balloon the current value of pension liabilities that have not been fully funded. For a states like New York, which was

[16] Government Accounting Standards Board, *Preliminary View on Major Issues Related to Pension Accounting and Financial Reporting by Employers,* 1
[17] ibid.
[18] ibid.

107% funded in fiscal year 2008[19], the change will likely not have any impact. States that are below 100% funded will most likely have to calculate the blended rate based on when they expect their fund to be depleted, which will raise their total liability, and decrease the fund's funding ratio. For a state like Illinois, which was 54% funded in 2008[20] and whose assets are projected to be depleted by 2018[21], the effect could be astronomical.

Some have questioned whether using the blended discount rate is designed to improve reporting, or if it is instead designed to influence the behavior of government entities by significantly highlighting their problems. The premise of the accusation is that by significantly increasing the size of projected liabilites of states that are not as well funded, that GASB is attempting to shame those states into increasing their funding. Jeremy Gold, who was formerly an advisor on a task force on pensions sponsored by the GASB, commented on what he believed the goal of the board was by enacting such a change, "I think they hope this will be the disciplinary tool that will get everybody funding at the actuarial rate."[22] Certainly, the effect of the change will have a much greater impact on governments that have more poorly funded their pension plans. Whether the discount rates changes is designed to influence behavior, or to better reflect the risk of the future pension liabilities is certainly an open question, however many economists would argue that the Board's proposal does not even go far enough towards recognizing the true risk of those liabilities.

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[19] Augustine et al., *The Trillion Dollar Gap; Underfunded State Retirement Systems and the Roads to Reform*, 56

[20] ibid., 56

[21] Joshua D. Rauh, "Are State Public Pensions Sustainable? Why the Federal Government should Worry about State Pension Liabilities," *SSRN eLibrary* (2010).

[22] Walsh, *A New Plan for Valuing Pensions*, 1

Economists argue that the discount rate of future liabilities should reflect the "riskiness" of those liabilities occurring.[23] Since state constitutions and other statutes often provide significant protections to accumulated public pension benefits, the payment of those benefits are, in a sense, risk free, and should be discounted as such.[24] Put another way, because there is no chance that payments to pensioners will not be made, because governments cannot back out of those payments, those payments should not be discounted using a rate that implies there is some chance to the occurrence of those payments. Ultimately, discounting those payments back will provide a sense of the current amount of funds required to meet those future payments, assuming the current funds will be invested in some way. Economic theory would suggest that the risk profile of that investment should be the same as the underlying cash flows that the investment will go towards. Otherwise, if the investment is too risky, the fund may not be able to meet its obligations, or if the investment has too little risk, that would require that the fund set aside more than funds than are necessary upfront. Since a pension fund has riskless obligations, economists suggest that those obligations be discounted by the US Government Treasury bond rate for the period of that obligation, which is generally considered to be risk-free. Thus, many economists have been critical of the GASB's proposal, suggesting that it does not go far enough in changing the discount rate to be used.[25]

In addition to considering the use of a risk-free discount rate, two other proposals that the GASB considered for the discount rate were to use the rate at which the plan

[23] ibid.
[24] ibid.
[25] Corkery, *Pension Dispute Ensnares A Board*, C.1

sponsor could issue high quality municipal bonds, and a rate determined by an index of high quality municipal bonds.[26] Using a rate from an index of high quality municipal bonds would be akin to what FASB has allowed public companies to use in determining their pension obligation. Public companies are allowed to use a rate from an index of high quality corporate bonds as their discount rate.[27] These proposals were all rejected by the GASB, which they justified by stating, "None of these alternatives was consistent with the view expressed above that the present value of projected benefit payments should reflect an expectation of the employer's projected sacrifice of resources, reduced by the expected return on investments."[28]

One possible consequence of the GASB's proposal is that pension funds may attempt to find ways to take more optimistic views about certain assumptions that underlie their pension liabilities, in order to avoid using the blended discount rate as much as possible. One area they might be able to do this is in their determination of the fund's long run rate of return, and thus their projected future returns. Another approach could be to project higher contributions to the fund from employees or plan sponsors. Boosting the projected fund returns or projected contributions to the plan would have the effect of making their current plan assets appear to last longer and go further towards funding their future obligation. Any reduction in the future liabilities that are not covered by current plan assets would reduce the extent that the funds have to use the much lower discount rate and would reduce the size of their projected liability.

[26] Government Accounting Standards Board, *Preliminary View on Major Issues Related to Pension Accounting and Financial Reporting by Employers*, 1
[27] ibid.
[28] ibid.

E) New Jersey

New Jersey has been ground zero for the public pension issue over the last couple of years. Two major events have turned the focus towards the Garden State: a civil suit by the SEC and the election of Governor Chris Christie. Both actions have brought additional scrutiny to New Jerseys pension practices over the past decade, and are continuing to cause significant repercussions.

In August of 2010, the SEC used what limited authority it has in the municipal finance area by accusing New Jersey of civil fraud for improperly communicating the funding status of its pension fund to bond investors.[29] Essentially the SEC accused New Jersey of improperly stating in financial disclosures related to bond offerings that the state was adequately funding its pension fund. During the time the SEC examined, from 2000 to 2007, New Jersey offered sweetened benefits to many of its employees, but did not properly fund those benefits and in fact did not adequately fund the benefits it had already promised.[30] Because pensions payments would have priority in a bankruptcy proceeding, and the additional payments required to meet pension obligations could in fact cause a bankruptcy in their own right, this created a risk to potential bondholders that was not properly disclosed in the view of the SEC. New Jersey settled the charges by saying they would make proper disclosures.[31] The SEC's actions opened the eyes of many in the field, as most people in the field believe that the SEC has very little authority to provide oversight in the area. Former SEC Chairman Arthur Levitt has urged the SEC

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[29] Zachary A. Goldfarb, "SEC Accuses New Jersey of Bond Fraud; First Time a State is Charged with Securities Violation," *The Washington Post*, August 19, 2010.
[30] ibid.
[31] ibid.

to continue pursuing this area, and for it to be more aggressive about the settlements it seeks in such cases.[32]

In addition to the SEC's actions, recently elected Governor Chris Christie has brought significant attention to New Jersey's pension benefits and obligations, and the financial soundness of its plans[33]. Governor Christie has been using the precarious state of New Jersey's pensions to urge for reform of pension benefits given to employees in the state, and has proposed that additional benefits given by the State Legislature in 2001 be rolled back.[34]

Over the past 10 years, New Jersey has had a horrendous record of making its necessary pension payments, and has essentially been using its funds as a semi-off-balance sheet borrowing tool. In 1998, New Jersey's pension fund was 106% funded.[35]Over the next 6 years, New Jersey consistently provided no more than 30% of the contribution required.[36] The result was that by 2008, New Jersey's pension system was no more than 73% funded[37], below the 80% level that most experts consider to be a barometer of a reasonably funded pension fund.[38] Each pension payment forgone would essentially require that New Jersey make that payment later, at a cost of the potential return that payment would have earned during the intervening period. This essentially makes the skipped payment a loan New Jersey has taken out with itself, albeit at the steep

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[32] Arthur Levitt and Lynn E. Turner, "Pension Shell Games Threaten Markets: Arthur Levitt, Lynn, Turner," 2010, .

[33] Adrienne Lu and Inquirer Trenton Bureau, "Christie to Announce Plan to Fix $46 Billion Shortfall in Public Pension System," *The Philadelphia Inquirer*, September 13, 2010.

[34] Goldfarb, *SEC Accuses New Jersey of Bond Fraud; First Time a State is Charged with Securities Violation*, A12

[35] Augustine et al., *The Trillion Dollar Gap; Underfunded State Retirement Systems and the Roads to Reform*, 25

[36] ibid., 25

[37] ibid., 25

[38] ibid., 46

rate of New Jersey’s expected rate of return of 8.25%[39] rather than the yield on recently issued municipal bonds of 2.94%.[40] It is easy to see why state legislators and the governor may tempted to take such steps, as borrowing from the states own pension fund is less complicated than using public markets. It also obscures the “borrowing” by placing it in the footnotes to the state’s financial statements rather than on the balance sheet, as normal debt would appear. However the cost to the state is immense, and further compounds the problems the state’s pension system currently has.

In 2010, New Jersey was supposed to make a $3.1 billion pension payment, of which $1.2 billion would have gone to cover current benefits and $1.8 billion would have gone towards meeting New Jersey’s unfunded actuarial accrued liability. [41] Unfortunately, New Jersey made no contribution at all.[42] According to analysis done by Professor Joshua D. Rauh at Northwestern University for the National Bureau of Economic Research, even using the 8% return on investment based discount rate that New Jersey currently uses, New Jersey could exhaust the assets in its fund by 2019, and that’s assuming that the state makes the required contributions for any new benefits accumulated between now and then.[43] In a separate study, Professor Rauh calculated that New Jersey would have a pension obligation of $147 billion if using a basket taxable municipal bonds as a discount rate, and $191 billion if using treasury bonds, compared

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[39] ibid., 35
[40] Dunstan McNichol and Brendan A. McGrail, "New Jersey Pays for Negative Outlook as Yield Widens on $669 Million Sale," *Bloomberg*, 30 September 2010, 2010, http://www.bloomberg.com/news/2010-10-01/new-jersey-pays-for-negative-outlook-as-yield-widens-on-669-million-sale.html (accessed 27 November).
[41] Lu and Bureau, *Christie to Announce Plan to Fix $46 Billion Shortfall in Public Pension System*, A01
[42] ibid.
[43] Rauh, *Are State Public Pensions Sustainable? Why the Federal Government should Worry about State Pension Liabilities*

with the State's stated obligation of $133 billion, using 2009 data[44]. Those numbers compare with New Jersey's pension assets of $67.2 billion.[45]

Over the next few years, New Jersey will have to make significant and difficult choices related to its pension system. New Jersey faces massive shortfalls in its pension plan; even when using current account methods that arguably understate the size of its obligation. In the state one of the highest relative tax burdens in the nation[46], residents of New Jersey are likely to reject using increased tax dollars to cover the unfunded pension obligations. Of advantage to the rest of the United States is that the increased focus in New Jersey on benefits promises made may encourage other states to take a more sober minded look at the costs of the benefits they have provided and could provide in the future.

F) The Magnitude of the Problem: the other 49 States

It is important to recognize also, that even without reforms that will likely boost pension liabilities for government entities across the board, many state pension funds are in dire positions as is. A report published by the Pew Center on the States in February of 2010, estimated the aggregate underfunding of pension plans across all 50 States, aggregate underfunding being the difference between their present-value-discounted liabilities and their assets, is $452 billion.[47]Additionally, the report said that 21 states

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[44] Robert Novy-Marx and Joshua D. Rauh, "Public Pension Promises: How Big are they and what are they Worth?" *SSRN eLibrary* (2010).
[45] ibid.
[46] *Special Report; State and Local Burdens as Income Growth Outpaces Tax Growth* (Washington, D.C.: Tax Foundation, 2008), 2, http://www.taxfoundation.org/files/sr163.pdf (accessed 20 November, 2010).
[47] Augustine et al., *The Trillion Dollar Gap; Underfunded State Retirement Systems and the Roads to Reform*, 3

have pension funds that are below the 80% threshold.[48] However the report gives many caveats to its findings that would suggest the magnitude of the problem could be significantly worse. The first is that the report used data as of the end of fiscal year 2008, which for most governments ended on June 30th. This means that the significant investment losses incurred by most funds in 2008 are not fully reflected, especially in states that allow for investment gain or loss smoothing over a period of multiple years.[49] The second important caveat is that the present value of each funds' liabilities was calculated using the discount rate that the fund currently uses, typically its historical rate of investment returns.[50] As mentioned above, there is significant debate as to the validity of using that number as the discount rate. There are currently no existing estimates as to what the unfunded liabilities may look like nationwide under the proposed new GASB standards, however there are estimates for other discount rates. Professor Rauh, after standardizing other actuarial assumptions, estimated that the present value of the pension liabilities of all 50 states exceed current plan assets by $1.26 trillion if using a taxable municipal bond index rate as a discount rate, and $2.49 trillion if using a treasury bond discount rate.[51]

The underfunding of pensions can be an issue that literally compounds on itself. Some pension funds, suffering from underfunding, have become tempted to attempt to boost returns in order to "grow" out of the problem.[52] To boost returns, those funds can start investing in areas in which they have not previously, and potentially take on greater

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[48] ibid., 3
[49] ibid., 1
[50] ibid., 54
[51] Novy-Marx and Rauh, *Public Pension Promises: How Big are they and what are they Worth?*, 5
[52] G. Crawford, "2 Approaches to 1 Problem," *Pensions & Investments* 38, no. 5 (Mar 8, 2010), 1.

risk. That greater risk can frequently come back to harm those funds during market downturns by putting the fund in an even worse position than it would have had it not taken the risk. For example, CALPERS, the pension fund for state and local government employees in California was burned by private equity and real estate investments it started to make following the burst of the tech bubble in 2000.[53] Typically those investments were made instead of safer but much lower returning investments.[54] In fiscal year 2009, CALPERS real estate portfolio lost 37% of its value.[55] To be sure, some of the movement into high risk areas by pension funds would have resulted regardless of their funding status, because of the envy that exists of the high returns earned at other large institutional investors such as Yale University's endowment. But just as a blackjack player down significantly to the house starts to double his bets to make up for lost ground, pension funds often make riskier bets to attempt to make up for insufficient funding, and frequently suffer for it.

G) Other Considerations

One common reason would-be pension accounting reformers have pushed for better recognition of pension obligations, is to get voters and other interested parties focused on the issue of municipal compensation. Former SEC Chairman Arthur Levitt has argued that there is a significant disconnect between the retirement benefits that are offered to public employees and the cost to fund those obligations.[56] In a sense he argues

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[53] Michael Corkery et al., "Risky, Ill-Timed Land Deals Hit Calpers," *Wall Street Journal,* Dec 17, 2008.
[54] ibid.
[55] A. Jacobius, "System does some Real Estate Housecleaning," *Pensions & Investments* 38, no. 21 (Oct 18, 2010), 5.
[56] Levitt and Turner, *Pension Shell Games Threaten Markets: Arthur Levitt, Lynn, Turner*

that the present decisions of politicians to provide larger pensions does not adequately cause some well understood short term financial or political cost that might make them hesitate in their decision. Instead the financial cost is opaque enough and delayed enough, that politicians do not have to spend or lose any of their “political capital” to provide those benefits, but instead significant political capital from being generous to a significant political constituency. Levitt proposes that politicians only be able to provide additional benefits only if they agree to fund them fully, in a sense “pay as you go”.[57] Such a requirement is outside the scope of the GASB’s purview, as accounting is just the means to report such discrepancies, not a provider of public policy implications. However the thinking goes that greater and more accurate disclosure of pension obligations will lead voters and the markets to have the information they need to be better able to hold public pension funds and the politicians responsible for them and accountable for the decisions they make.

[57] ibid.

Chapter IV. Policy Implications

As it currently stands, a the Government Accounting Standards is in many regards not adequately positioned and structured to provide the accounting and financial reporting guidance that capital providers and the public at large need to be critical examiners of government performance and financial health. There are three primary areas where the GASB is due for significant reforms: the GASB's organizational structure, regulatory role, and funding sources.

A) Organizational Changes

The makeup of the GASB and its structure is not adequate for the performance of its role as the determiner of financial reporting standards. In many ways it is best to compare the structure of GASB too its sibling organization, the FASB, since they perform very similar roles but over different areas of the economy. The first change the GASB should make is to require that serving on its board be a full-time job. The financial reporting standards of governments are no less complicated than that of public companies and the debates around those standards are no less fraught. GASB board members should be devoting comparable time and effort to the development of those standard by serving the board full-time, instead of part-time as they currently do.

A further change to the board should be a requirement that board members not hold a concurrent role that may cause, or at the very least create the appearance of a conflict of interest in determining financial reporting standards. Four of the seven board members at present work full-time as elected officials or government finance officials.

There exists a high likelihood that the board could examine reporting issues that would make life more difficult or directly harm the careers of people working in state or local government. For example, as mentioned previously, a change in the discount rate used for pension liabilities has a significant effect on the present value size of that liability. If the size of that liability grows because of a decrease in the discount rate used, that would likely force sponsoring government entities to contribute additional assets to the plan, in order for the plan to be properly funded. By making higher contributions to its pension plan, a sponsoring entity will likely not be able devote as much funds to other things that are more popular to the voting public, like government services or a tax cut. Taxes may even need to be raised to support the additional contributions. Cutting popular programs or increasing taxes to fund the benefits of retired employees may be difficult to explain to the voting public and not politically palatable. An elected official who serves on the GASB may be unwilling to make a decision to set a more appropriate discount rate if they have to deal with electoral repercussions locally. In a sense, the process of the board's determination of the way to properly reflect economic reality could be impeded by the natural self-interest of its members.

In the accounting profession, the mere appearance of any potential conflict of interest, regardless of whether there is a conflict in fact, is held to be extremely problematic if not worse. Sarbanes-Oxley banned public accounting firms from providing non-audit services to audit clients, because of the conflicts of interest that could result in competing to provide other services to clients with whom the firms are supposed to be independent.[1] For the board tasked with determining accounting standards –which should

[1] "A Conflict of Interest ?; Accountancy Firms," *The Economist*, October 16, 2010, .

theoretically be the leading example for the profession– to have members with direct potential conflicts makeup the majority of its board is very nearly an embarrassment to the profession.

The frequently provided justification for having government members serve on the board, is that they are most familiar with the difficulties, unique aspects and processes of government financial reporting.[2] They are correct in suggesting that the GASB should contain members who are experts in government finance. However, it is clearly not the case that those members must concurrently serve in roles that provide that expertise. They could be retired from prior roles, or work for firms that interact with or assist government entities that prepare financial statements. Members of the FASB must be independent of the people and companies that they affect; it seems both logical and necessary that GASB members should be as well.

B) Funding Changes

The above mentioned potential reforms for the GASB come at a likely come at some expense. The total expenses incurred by the GASB in 2009 were $7.22 million, compared with $29.14 million in "recoverable expenses" by the FASB during that year.[3] While it does not seem likely that that the GASB size and expense would approach that of the FASB, it is certainly reasonable to expect that the gap between the two will narrow. To achieve the aforementioned reforms, additional funds will be necessary.

[2] Michael Corkery, "Pension Dispute Ensnares A Board," *Wall Street Journal*, Oct 1, 2010.
[3] *Financial Accounting Foundation 2009 Annual Report* (Norwalk, CT: Financial Accounting Foundation, 2010), 3.

In addition to the additional resources necessary for the implementation of organization reforms to the GASB, the GASB's current funding is fairly tenuous and questionable as is. In the first place, GASB's direct revenue does not cover the entirety of its annual expenses[4], which is not a sustainable method of funding the organization. Additionally, half the GASB's current revenue comes from state and local government contributions, which undermines the GASB's mission by creating the appearance of a conflict of interest by relying on funds from the entities its standards are likely to impact, either positively or negatively. The other half of its revenue comes from publications that have shown significant cyclicality over the last few years, and do not appear to be stable enough source of funds for the core operations of the GASB.

To provide stable and adequate funds, the GASB should be funded using a method similar to that of the FASB, where the necessary expenses to implement standard setting are determined, and then are assessed in a non-voluntary way on the entities for which the standards are set. As mentioned above, the Dodd-Frank Act of 2010 gives the SEC the ability to require that another financial regulatory organization enact this. The non-voluntary aspect of this assessment is important for two reasons: it will reduce the cyclicality of the funds the GASB needs to perform its role and it removes the appearance of conflict of interest in receiving funds from the entities that its standard affect. This is accomplished by removing the ability of those entities to withhold funds should they not be pleased with how the GASB's standards affect them.

The difficult aspect of this fee assessment is in determining which entities must be subject to the fee, and what basis should be used to distribute the contributions to the

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[4] *Government Accounting Standards Board Statement of Budgeted Revenues and Expenses for the Year Ending December 31, 2010* (Norwalk, CT: Government Accounting Standards Board, 2009), 1.

government entities. With public companies, weighting by the market capitalization of a company versus the market capitalization of the market for public companies is a simple and logical way to divide the expenses. For government entities this becomes more difficult because the governments do not have a similar measure of value, and because many government entities do not issue securities of any kind, making it more difficult in practice to justify requiring them to contribute to the GASB. Additionally, there are hundreds of thousands of relatively small government entities, from small townships and public authorities to school boards. It could be potentially very difficult and overly expensive to implement a method of calculating and receiving payment from all of those entities.

One intriguing possibility for a fee to fund GASB is to assess it at the state level rather than at a more local level. The state is the foundational building block for all government entities in the United States, from the Federal Government to the smallest public authority. The states gives rise to local government entities such as school boards, public authorities and cities, and is the ultimate the authority on whether they are permitted exist or not. It would then follow that states should take responsibility for the cost of providing adequate financial reporting for all of the entities they have given birth to. If the states wanted to, they could then come up with a method of allocating and collecting their respective fee responsibility from the entities within their boundaries, but the GASB or an agent of it would not be responsible for such potentially difficult determinations. The question then becomes how to divide the fee proportional to each state. One method could be to determine the total spending by all entities within a state, and then weight each state's fee assessment by its proportion of total state and local government spending in the United States. However, due to the immense number of government entities in the United States, such data might be difficult to attain and its accuracy may be questionable. A very simple and logical way to divide the expense would be based on the proportional population located within a state. While population likely does not directly correlate with the number of entities within a state, and thus the demand it implicitly places on the GASB, it would be a relatively fair and easy way to calculate the allocation. Whichever way chosen, the burden would not be significant in the scale of state budgets. For example, if the "recoverable cost" were to be $25.00 million, California, which has the largest population share at 12.03% of US Population in 2009[5], it would be responsible for approximately $3 million in fees, out of a state general fund budget in 2009 of over $119 billion.[6]

While it is likely that states would be resistant to paying even such a minor fee, there is a method that should be used to ensure the proper participation by all the states. The Federal government, through Congressional legislation, should make the release of any or some portion of the funds dispersed from it to a state contingent on the state having paid its bill to the GASB. The precedent for this is The National Minimum Drinking Age Act of 1984, which required states to set their drinking age to 21 or face a 10% reduction in highway funds from the Federal Government.[7] In addition, since the states will be required to pay the fees in order to insulate the GASB from the power of the

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[5] "California QuickFacts from the US Census Bureau," US Census Bureau, http://quickfacts.census.gov/qfd/states/06000.html (accessed 27 November, 2010).

[6] Adam Nagourney, "Schwarzenegger and Legislators Reach Deal on Long-Delayed California Budget," *The New York Times*, October 8, 2010.

[7] Steven R. Weisman, "Reagan Signs Law Linking Federal Aid to Drinking Age," *The New York Times*, July 18, 1984.

purse, there would not be any incentive for the GASB to tailor its standards any way or show any favoritism towards larger states that may be providing higher fees.

Having the Federal government indirectly require the payment of fees to the GASB is also very appropriate considering that the Federal government should be very concerned with the accounting standards used by the states and localities that it is providing funds to. While the Federal government already has significant reporting standards of its own for states that utilize its funds, the Federal government still has an interest in the financial reporting that states and local governments use on an everyday basis accurately reflect economic reality.

It is worth mentioning another method of funding that has been somewhat implemented currently but is not a viable long-term option: a voluntary assessment on municipal bonds. The first major problem with funding the GASB through this method is that it is extremely problematic that the assessment is voluntary, since that makes its funding subject to the financial health of the parties involved in the municipal bond transactions. This is evidenced by the fact that between 2008 and 2009, there was an approximately 92% drop in the funds provided to the GASB from Voluntary Municipal Bond Fee Assessment Program.[8] In addition, the voluntary funds would allow organizations to choose to pay the fee or not as a way of attempting to influence the GASB. Regardless, if the fees on the municipal bonds were to be made involuntary, municipal bond activity varies enough to make a fee tied to it not an adequate source of stable funds for the organization’s activities. The immense need for the GASB to be a strong standard setter exists regardless of the economy and the bond market’s current

[8] *Financial Accounting Foundation 2009 Annual Report*, 3

position, so its source of funds should not determine its activity so much as its activities should determine how much funding it needs, within reason and subject to supervision

Allowing the GASB to assess a fee on the states based on relative population and its "recoverable expenses" would provide the GASB with a secure and consistent source of funds that is resistant to political influence. The state assessment would enable GASB to gain additional credibility by ensuring that it is both adequately funded to meet the goals of its mission as well ensure that it has the financial stability to continue to be a going concern. Without such a source of funds, the GASB is in danger of coming under increasing political influence and its influence would be undermined by the consistent doubts as to its financial stability.

C) Regulatory Role Changes

Changes to the regulatory structure surrounding the determination of accounting standards for governments is an important element of making the GASB more effective and more accountable. Regulatory changes that should be made primarily revolve around giving the SEC increased regulatory authority around the issuance of municipal securities. The SEC was created with the specific purpose of protecting investors by creating and enforcing standards of disclosure for the issuance of securities. While municipal securities and their borrowing entities may have many unique characteristics to them compared to their private sector counterparts, their distinctiveness should not allow those issuers to have less oversight.

In order to provide the proper regulation of the municipal securities market, Congress should amend the Securities Act of 1933 to remove the Tower Amendment and allow the SEC to require that municipal securities issuers provide issuance documents, rather than requiring the issuer's underwriters to provide them. In addition, Congress should remove the exemption from registration and periodic reporting requirements for municipal issuers in the Securities Act of 1933 and the Securities Exchange Act of 1934. The combination of these two changes would allow the SEC to create a financial disclosure regulatory structure similar to what exists for corporate equity and debt issuances. Removing the exemptions would bring municipal securities fully under the provisions of the 1933 and 1934 laws meaning that SEC could then require that municipal security issuance documents conform to GAAP, of which the SEC is the final arbiter. In addition, because of the explicit authority given to the SEC to delegate accounting standard setting to an independent board under Sarbanes-Oxley's modification of the 1933 and 1934 acts[9], it could substantially delegate standard setting to the GASB, as it currently does with the FASB, elevating its role. Giving the SEC these powers would also allow it to step up its enforcement of government entities that do not meet accounting standards provided by the GASB, ensuring further adherence and emphasizing that governments will be held accountable for their financial reporting.

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[9] *Sarbanes-Oxley Act of 2002, U.S. Statutes at Large* 116 (2002) 745

Conclusion

Despite being a little known organization outside those who work in or around government finance, the Government Accounting Standards Board has an important role to play for a significant portion of the economic activity that occurs in the United States. The GASB can be a key tool to provide comparability in financial reporting across different government entities. The GASB is relied upon by the municipal securities markets as a neutral arbiter of the accounting and reporting standards that will allow market participants to make informed investment decisions. Without it, people would hold much less confidence in the municipals market, risk and thus interest rate would be higher, and much more significant information asymmetries would exist than currently do. The GASB is also relied upon by the public at-large, albeit without their knowledge, to provide comparability in such a way that they can be informed and critical readers government of the financial reports.

The GASB's role is so important, that much more attention needs to be paid to it by the general public, the SEC and Congress. The debate around defined benefit pension accounting, and the insufficient action that the board is proposing, has revealed the weaknesses of the GASB. All of its stakeholders must consider reforms in how it is structured, its regulatory environment, and how it will be funded in order to maintain this role. The GASB's structure is such that its members can be a part of it while holding positions with government entities that may impair their ability to be impartial arbiters. This potentially undermines the standard creation process, as well as the board's credibility. The GASB should also be put in a stronger regulatory position by removing exemptions that currently exist for municipal securities, and allowing them to fall under existing regulatory powers provided to the SEC for public companies. Giving the SEC regulatory oversight would give the GASB a much more definitive position as the standard-setter for governments, and give the GASB a strong ally in enforcing its provisions. Finally the GASB needs a permanent source of funding that will allow it to fulfill its role without any hesitation or doubts as to its longevity and bias.

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