PUBLIC BRIEFING
ON THE
COMPREHENSIVE ANNUAL FINANCIAL REPORT
(CAFR) FOR FISCAL YEAR 2010

Before the
Committee of the Whole
Council of the District of Columbia

The Honorable Kwame R. Brown, Chairman

February 8, 2011, 10:00 a.m.
Council Chambers

Testimony of
Natwar M. Gandhi
Chief Financial Officer
Government of the District of Columbia

Good morning, Chairman Brown and members of the Committee of the Whole. I am Natwar M. Gandhi, Chief Financial Officer of the District of Columbia Government. With me are Deputy Chief Financial Officers Anthony Pompa of the Office of Financial Operations and Systems and Stephen Cordi of the Office of Tax and Revenue. Also present are Deputy Chief Financial Officers Lasana Mack of the Office of Finance and Treasury, Fitzroy Lee of the Office of Revenue Analysis, and Gordon McDonald of the Office of Budget and Planning.

It is our pleasure to be here today to report on and discuss the Fiscal Year 2010 Comprehensive Annual Financial Report (CAFR).

Introduction

It is most important to begin by addressing the issues we face now and in the future. Although again this year, the District faces substantial challenges in its budget, I have every confidence that the challenges will be met in a fiscally responsible manner, and that we will continue to produce balanced budgets. That said, it will not be easy. Resources on which we have previously relied, such as the federal fiscal stimulus funding, received in 2009 and 2010 and which provided much needed relief, will no longer be available. Also, the accumulated fund balance on which we relied in the past few years is committed for specific purposes and not available to balance the budget.

Despite the problems we have faced as a result of the severe economic downturn, the District's financial condition remains far stronger than it was in the 1990s. Indeed, our turnaround from "junk bond" status to "A" category General Obligation bond ratings was faster than that of any other major city that has undergone a similar period of financial crisis, including New York, Philadelphia, Cleveland and Detroit. We have substantially improved our bond ratings and earned well-deserved respect in the financial markets. Let us remember this as we work to resolve the problems that face us.

CAFR Results

I am pleased to report that this year, for the 14th consecutive time, the District has received an unqualified, or “clean,” audit opinion on its annual financial statements. The CAFR shows that, for the year ending September 30, 2010, the District balanced its budget by limiting its expenditures to available revenues and other planned sources, such as use of accumulated fund balance.

Revenues combined with other sources exceeded expenditures by $58 million, or 1 percent of expenditures, on a budgetary basis. Of that amount, only $3 million, or less than one-tenth of a percent of expenditures, was attributable to Local sources. This budgetary surplus is reflected in the General Fund balance, all of which is either reserved or designated for specific purposes.

As presented in the CAFR, at the end of Fiscal Year 2010, the cumulative General Fund balance was $890 million, down from $920 million in Fiscal Year 2009. Although this $30 million decrease represents the third consecutive year of fund balance declines, the District’s General Fund balance position is better than that of many other state and local governments. The change was attributable to a combination of $138 million use of fund balance, offset by the $58 million noted above and several other items. (See Appendix, “General Fund Balance.”)

Again this year, the District has no unreserved and undesignated General Fund balance remaining.

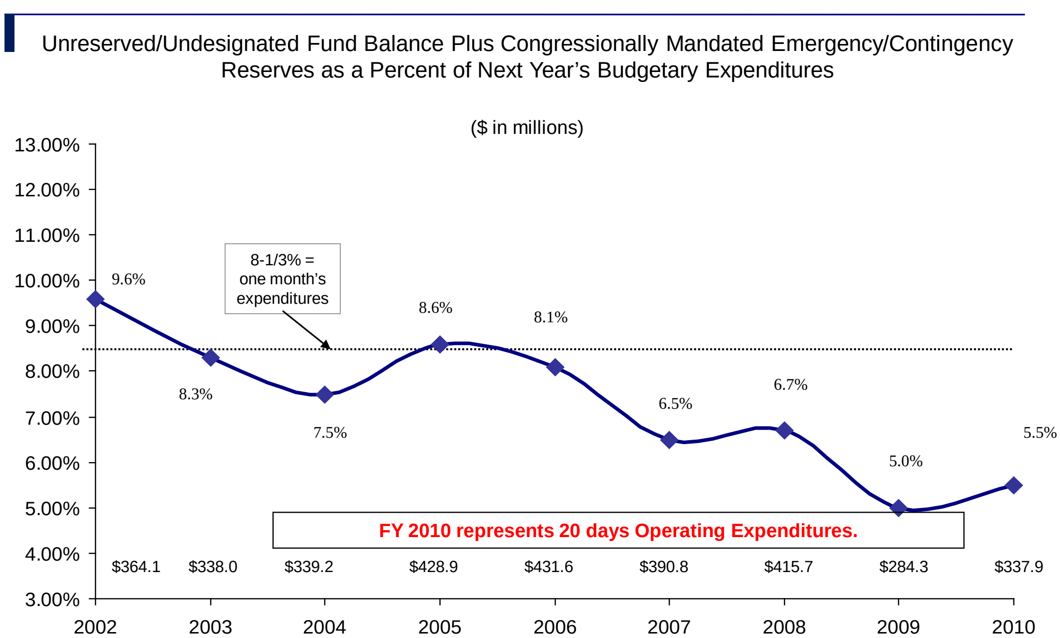
For some time, I have expressed my concerns about the depletion of our fund balance and the possible effect on our bond ratings. Later this week, you, Mr. Chairman, along with Mayor Gray, City Administrator Allen Lew and Chairman of the Council's Committee on Finance and Revenue Jack Evans will meet with the rating agencies to give assurances of the District's commitment to fiscal prudence and financial stability. This will be especially important given the recent report issued by Standard & Poor's (S&P) on December 14, 2010 on our General Obligation (GO) bonds in which S&P states that "…the District's financial position was, in our opinion, good but we expect it to weaken based on a trend of using reserves to offset revenue shortfalls."

It is imperative that the District adopt future budgets on the principle of current year spending not exceeding current year revenues. The Sustained Capital Investment and Fund Balance Restoration Act of 2010, adopted last year, was one important step in replenishing General Fund balance. Mr. Chairman, another step toward rebuilding fund balance would be adoption of your recent proposal to Mayor Gray to apply the proceeds of the sale of surplus assets towards that goal. Should the District receive proceeds from the sale of an asset, those funds should not be used to pay operating costs in a future budget, but rather should be applied to replenishing fund balance, Paygo capital, or other one-time spending purposes.

Although the duration and depth of the recession has taken a toll on the District's finances, in Fiscal Year 2010, revenues dropped only 2.4 percent from the original estimates, down from the 10 percent decline we saw in FY 2009. But again last year, budget balance was achieved only through planned reliance on monies in the General Fund balance to pay operating costs.

Working capital grew slightly, from 5.0 percent to 5.5 percent, although again in FY 2010, this amount consisted entirely of the Congressionally-mandated Emergency and Contingency Funds, with no unreserved and undesignated funds adding to the working capital. At this level we now have 20 days of working capital, up from 18 days last year, but still below the equivalent of two month's spending, which is the Government Finance Officers Association's recommended "best practice."

Total Working Capital



The Independent Auditors' Report on Internal Control Over Financial Reporting (known as the Yellow Book report) which accompanies the CAFR again this year shows no material weaknesses, and five significant deficiencies, up from three last year. We regard these problems as serious matters and we are already working to resolve them. Later in this testimony, I will outline our continuing efforts to address these deficiencies.

Economy

Although the economy began to show signs of recovery in Fiscal Year 2010, the economic climate affected the District's revenue streams and presented significant budget challenges during the year. During the first quarter of Fiscal Year 2010, estimated revenues totaled $5.182 billion. By the end of the Fiscal Year, the revenue estimate decreased by $38 million to $5.144 billion. As the anticipated economic impact on the District's operations continued to worsen, the Mayor and the Council responded quickly to close the resulting budget gaps.

Although the District has been able to maintain financial stability and operate within budgetary constraints, the tenuous nature of the economy will continue to affect the District's financial condition in future Fiscal Years. Recognizing that fact, the OCFO will continue to be vigilant in its efforts to effectively manage and account for the District's financial resources. We are committed to improving business processes on an on-going basis, strengthening internal controls, and maximizing overall operational efficiency.

Near Term Outlook

The ability to effectively manage the District's finances depends on sound and reasonable revenue estimates. In December, my office released a new revenue letter showing no change from the September 2010 estimate in the current Fiscal Year and all subsequent years in the Financial Plan period.

Changes in Revenue Estimates ($Millions)
Changes Since June 2008, Local Source, General Fund Revenue Estimate

	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
June 2008 Budget	**$5,831.7**	**$6,099.2**	**$6,402.5**	**-**	**-**
Changes in revenue estimate since June 2008	**($1,032.6)**	**($1,432.1)**	**($1,614.6)**	**($347.3)**	**($81.5)**
Percent change from June 2008	*-17.7%*	*-23.5%*	*-25.2%*	-	-
Estimates as of December 2010 (excluding policy changes)	**$4,799.1**	**$4,667.2**	**$4,788.0**	**$4,941.4**	**$5,308.6**
Policy changes to address revenue decrease (Combination of spending cuts and revenue enhancements)	**$344.6**	**$363.5**	**$375.8**	**$363.8**	**$93.2**
Estimates as of December 2010	**$5,143.7**	**$5,030.7**	**$5,163.8**	**$5,305.2**	**$5,401.8**
Percent change over previous year	*1.8%*	*-2.2%*	*2.6%*	*2.7%*	*1.8%*

Later this month we will release a new revenue estimate and we are cautiously optimistic that we and the rest of the region have seen the worst of the recessionary effects, and may begin to see a turnaround in revenues.

Debt

The District has higher debt ratios than other states or large jurisdictions which limit our ability to borrow more to finance additional infrastructure. I again commend the elected leadership for adopting the 12 percent limitation on debt. This prudent action, which was well received by the rating agencies, has served us well in this period of economic and fiscal challenges as there has been, and will continue to be, a great deal of pressure on the remaining 88 percent of the budget that is available for providing services to residents.

In FY 2010, the District refunded approximately $828.7 million of its outstanding General Obligation bonds through the issuance of Income Tax Secured Revenue Refunding Bonds. The refunding, also considered a debt restructuring because it changed the amortization structure of the District's debt portfolio, reduced the District's debt service payments in FY 2010 and other years without extending the final maturity of any particular bond issue. The primary reason for doing this refunding/restructuring transaction was to allow the District to continue making important long-term investments in its infrastructure with on-going financing of its Capital Improvements Program, including Schools Modernization, while keeping annual debt service payments at levels that remain within the 12 percent debt cap throughout the financial plan period.

The District continued to enjoy strong ratings on both its General Obligation and Income Tax bonds. The District's Income Tax Secured Revenue Bonds are currently rated as follows: AA+ by Fitch Ratings; Aa1 by Moody's Investors Service; and AAA by Standard and Poor's Rating Service. All three rating agencies have assigned "stable" outlooks to the District's bonds. The credit rating agencies have also rated the District's General Obligation bonds favorably with current ratings as follows: AA- (Fitch Ratings); Aa2 (Moody's Investors Service); and A+ (Standard & Poor's Rating Service), all of which also carry "stable" outlooks.

Maintaining strong bond ratings has never been more important as the District continues to be affected by the economic decline of recent years. Measures must be taken to avoid practices that will compromise the District's bond ratings or present the risk of a downgrade in ratings; such actions would result in higher borrowing costs in the future. Accordingly, the District should make every effort to limit the use of reserves and other one-time sources to meet recurring operational needs or close budget gaps. The District must be prudent in its use of available financial resources.

Still, the District must attend to its infrastructure. In order to stay within the debt cap in the Financial Plan period, we will need to reduce planned borrowing levels by approximately $40 million a year, beginning in FY 2012. We will work with the Mayor and Council in developing a revised Capital Improvement Plan for the FY 2012 Budget and Financial Plan in an effort to prioritize the most important projects and postpone those projects that can wait until our revenue forecast is more positive.

Financial Management Improvements – Yellow Book Report

The "Independent Auditors Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards," commonly called the "Yellow Book" report, listed no material weaknesses and five significant deficiencies for FY 2010. Material weaknesses and, to a lesser degree, significant deficiencies reflect problems in the design or operation of internal controls over financial reporting. We take these findings seriously, both in areas under direct control of the CFO as well as in areas controlled by the Administration.

Following on the work of Kroll Associates, Inc., the Wilmer Hale report, and prior Yellow Book findings, OCFO and Office of Tax and Revenue (OTR) senior management and Chief Risk Officer Kathy Crader worked with outside consultants, through the use of stakeholder meetings, controls testing and other management analyses, to develop a robust risk inventory of key business practices. OTR is using this inventory to identify high risk areas and document and strengthen internal controls in these areas. OTR senior management and the Chief Risk Officer also established an Internal Control Core Team, which is a standing committee tasked with monitoring and documenting the implementation of internal controls that address risks. In addition to the risk identification and internal control work which grew out of the Wilmer Hale recommendations, OTR has completed a comprehensive effort to document policies and procedures down to the desk level, and has made this documentation a critical element in all ongoing control work.

I will now address each of the significant deficiencies contained in the Yellow Book, with particular attention to the areas over which the OCFO has direct control. A detailed management response to the auditors' findings is included in the Yellow Book report, and I am happy to answer questions about those responses. First let me address the significant weakness identified for controls at OTR.

Office of Tax and Revenue Controls Finding. These findings represent weaknesses in the District's control processes at the Office of Tax and Revenue. The findings generally speak to a failure to adhere to established internal controls. That is, the District has established policies and procedures in these areas; however, they are not being strictly followed. We take very seriously this finding, especially given the amount of time and resources we have devoted over the past several years to improving internal controls within the OCFO, and are fully committed to addressing successfully these deficiencies identified by KPMG.

KPMG did recognize the effective compensating controls which OTR has put in place which include (1) verifying refunds against a data warehouse to prevent the issuance of refunds to anyone other than intended taxpayers, (2) a post-filing season comparison of data in electronically filed returns reported by taxpayers with that reported by employers, and (3) IRS corrections of reported income figures provided to us through the CP 2000 program and revenue agent reports. OTR will follow up with KMPG on the specifics of the further corrective actions it concluded are needed to ensure that we are following, effectively and consistently, our policies and procedures on internal controls. Additionally, the comment regarding the monitoring of the lockbox vendor will be largely addressed by the Treasurer specifying in his new contract with a lockbox provider that an SAS 70 type II report will be required.

Other significant weaknesses are:

General Information Technology Controls Finding. These findings represent weaknesses in the information technology control environment of various systems of the District (payroll, procurement, etc.).

Procurement and Disbursement Controls Finding. These findings represent weaknesses in the District's control process over procuring and paying for goods and services.

Accounting for Non-Routine Transactions Finding. These findings represent weaknesses in the District's controls over non-routine transactions processed at various agencies and component units of the District government (UDC, Convention Center, Unemployment Compensation Trust Fund, Disability Compensation Fund, United Medical Center).

Human Resources and Employee Compensation Controls Finding. These findings represent weaknesses in the District's control processes over maintaining employee human resources information as well as employee compensation.

For all these weaknesses the common theme is failure to adhere to established internal controls. That is, the District has established policies and procedures in these areas; however, they are not being strictly followed. The OCFO will work with the appropriate units to find a means to resolve the problems that led to these findings.

Additional information concerning the history of the Yellow Book report is contained in the Appendix.

CONCLUSION

In summary, despite the current challenges, I continue to believe the District has the ability to sustain all that it has accomplished in the past decade. In many respects, I see a bright future. This financial report presents the results of the collaborative efforts of the Mayor, Council, Agency Directors, and others throughout the District to maintain financial stability in Fiscal Year 2010, even as the District continued to experience the effects of the national economic downturn. We have continued to function under the constraints of a limited tax base, which goes to the heart of our budgetary challenges. Due to the District's disciplined financial management practices, we have weathered the economic storm relatively well in comparison with many other jurisdictions.

I want to take this opportunity to thank the many District government employees, from both the financial and program areas, who have worked long and hard to ensure the successful closure of the District's books and the maintenance of the high-quality records required for an unqualified audit opinion. In particular, I commend Tony Pompa, the District's Controller, his deputy, Bill Slack, and the rest of the team at the Office of Financial Operations and Systems, for their hard work and dedication. I also thank the rest of my senior management team and their staff: Gordon McDonald, Lasana Mack, Fitzroy Lee, Stephen Cordi, Cyril Byron, Mohamed Mohamed, George Dines, Deloras Shepherd, Angelique Hayes, Rumman Dastgir, Bill Divello, and Kathy Crader.

I also thank the public accounting firm of KPMG, who were assisted by Bert Smith and Company, for their efforts throughout the audit engagement. Their highly professional staffs worked equally long and hard during the past few months to successfully complete this audit. In particular, I commend Jack Reagan, Chuck Kozlik and Abdool Akhran for their efforts.

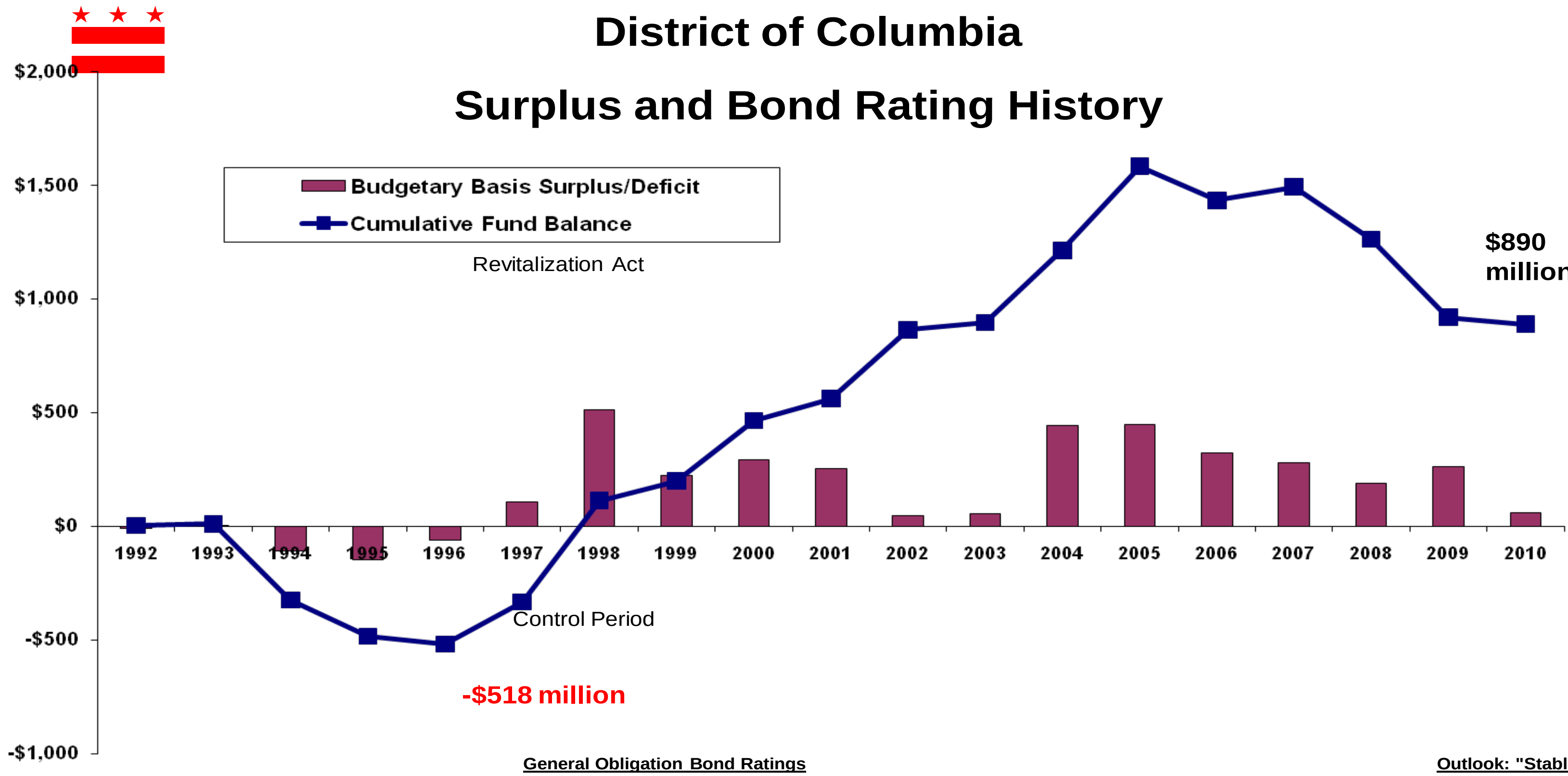
Thanks also go to Inspector General Charles Willoughby and to Ron King, the chair of the CAFR oversight committee. Their independent oversight is critical to the integrity of this process.

Let me also extend my deepest thanks to all who helped make this possible, several of whom were a part of the process in a different capacity including the Mayor; and you, Chairman Brown, as well as City Administrator Allen Lew. Also thanks go to Mr. Evans and the rest of the Council for their guidance, support and oversight of the process over the past few months. Their leadership and commitment to fiscal prudence was an essential part of this successful endeavor.

Mr. Chairman, there is an extensive Appendix attached to my testimony which has been given to each Councilmember. This concludes my remarks. I would be pleased to answer any questions you may have.

District of Columbia

Surplus and Bond Rating History



General Obligation Bond Ratings

Outlook: "Stable"

S&P:	A-	A-	A-	BBB-	B	B	BB	BBB	BBB	BBB+	BBB+	A-	A	A+	A+	A+	A+	A+	A+
Moody's:	Baa	Baa	Baa	Ba	Ba	Ba2	Ba1	Ba1	Baa3	Baa3	Baa1	Baa1	A2	A2	A2	A1	A1	Aa2	Aa2
Fitch:		A-	BBB+	BB	BB	BB	BB+	BB+	BBB	BBB	BBB+	A-	A-	A	A	A+	A+	AA-	AA-

Income Tax Secured Revenue Bonds: S&P: AAA Moody's: Aa1 Fitch: AA+ (All "Stable" Outlooks)

Government of the District of Columbia
Office of the Chief Financial Officer
Natwar M. Gandhi, Chief Financial Officer

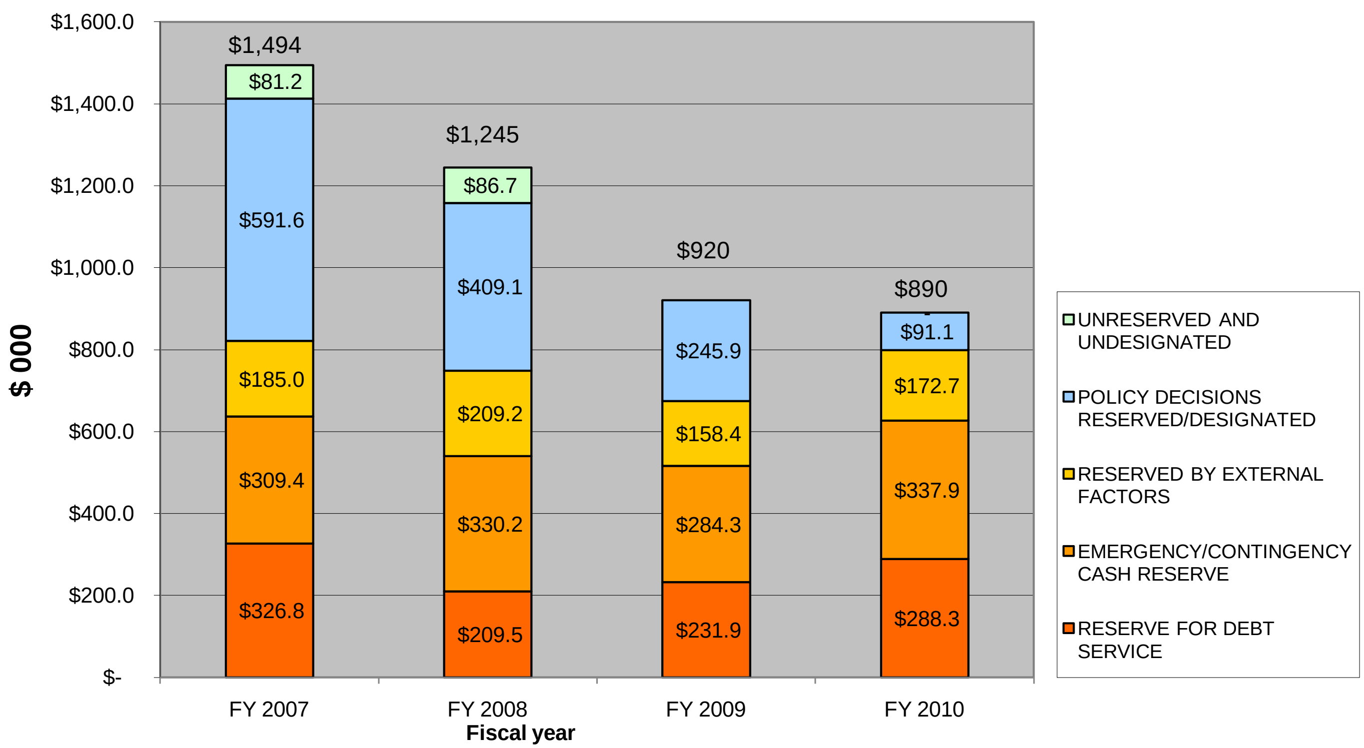
FY 2010 CAFR

Attachment 2

Composition of General Fund Balance

FY 2007 – FY 2010

($ in millions)



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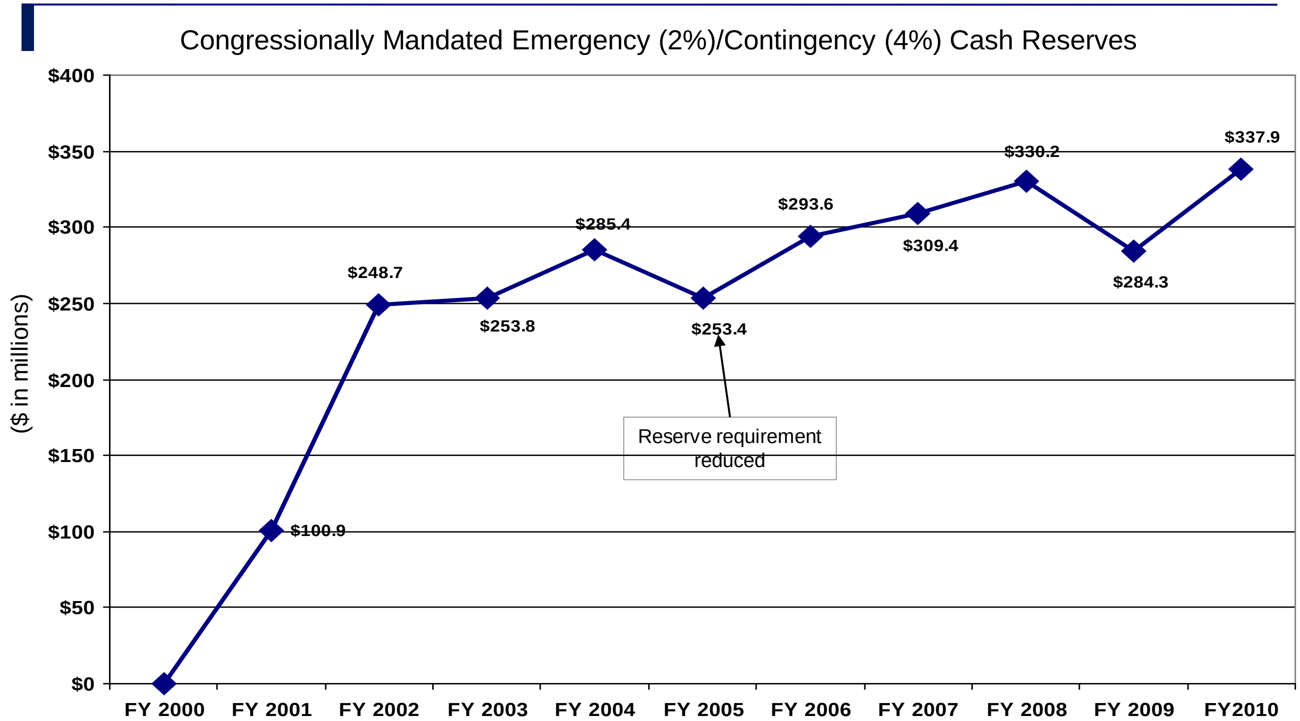
FY 2010 CAFR

Rainy Day Funds

($ in millions)

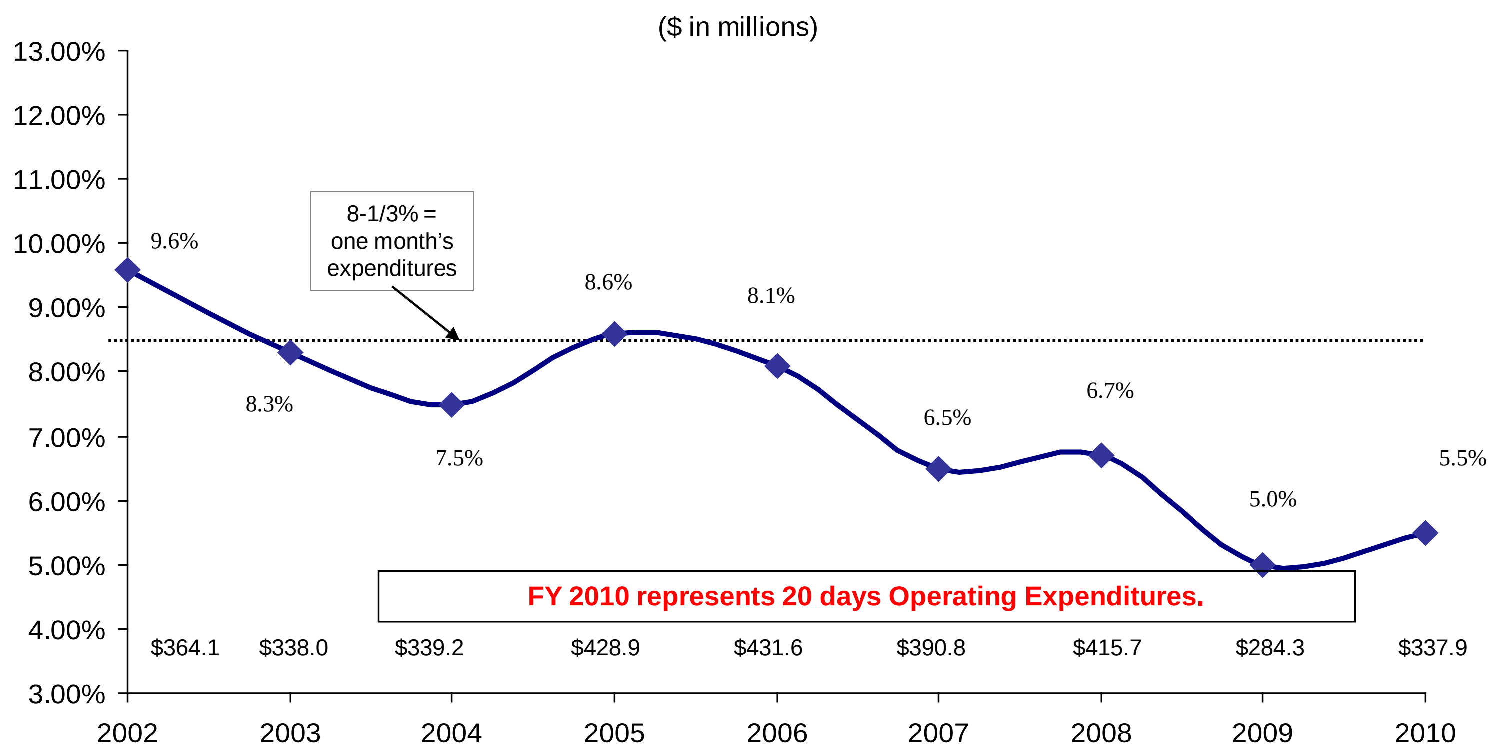


Government of the District of Columbia
Office of the Chief Financial Officer
Natwar M. Gandhi, Chief Financial Officer

FY 2010 CAFR

Total Working Capital

Unreserved/Undesignated Fund Balance Plus Congressionally Mandated Emergency/Contingency Reserves as a Percent of Next Year's Budgetary Expenditures



Attachment 5

FY 2010 GENERAL FUND

					Actual vs. Revised		Actual vs. Original	
	Original	Revised	Actual		$	Percent	$	Percent
Revenues:								
Taxes	4,964.9	5,045.0	4,903.9		(141.1)	-2.8%	(61.1)	-1.2%
Non Taxes	869.9	774.8	778.1		3.3	0.4%	(91.8)	-10.6%
Fund balance release	129.0	214.9	138.4		(76.4)	-35.6%	9.4	7.3%
All other GF Sources	84.3	106.2	96.1		(10.1)	-9.5%	11.8	14.1%
Total Revenues	6,048.2	6,140.9	5,916.5		(224.3)	-3.7%	(131.6)	-2.2%
Less Fund Balance release	**5,919.1**	**5,926.0**	**5,778.1**		**(147.9)**	**-2.5%**	**(141.0)**	**-2.4%**
Expenditures:								
FY 2010	$ 5,993.2	$ 5,967.2	$ 5,722.7		$ (244.4)	-4.1%	$ (270.5)	-4.5%
FY 2011 Advance to Public Education	-	135.6	135.6		-	0.0%	135.6	
Total Expenditures	$ 5,993.2	$ 6,102.8	$ 5,858.4		$ (244.4)	-4.0%	$ (134.8)	-2.2%
Revenues vs. Exp	**54.9**	**38.1**	**58.1**		**20.1**		**3.2**	
Surplus as % of Revenues	0.91%	0.62%	0.98%					

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Attachment 6

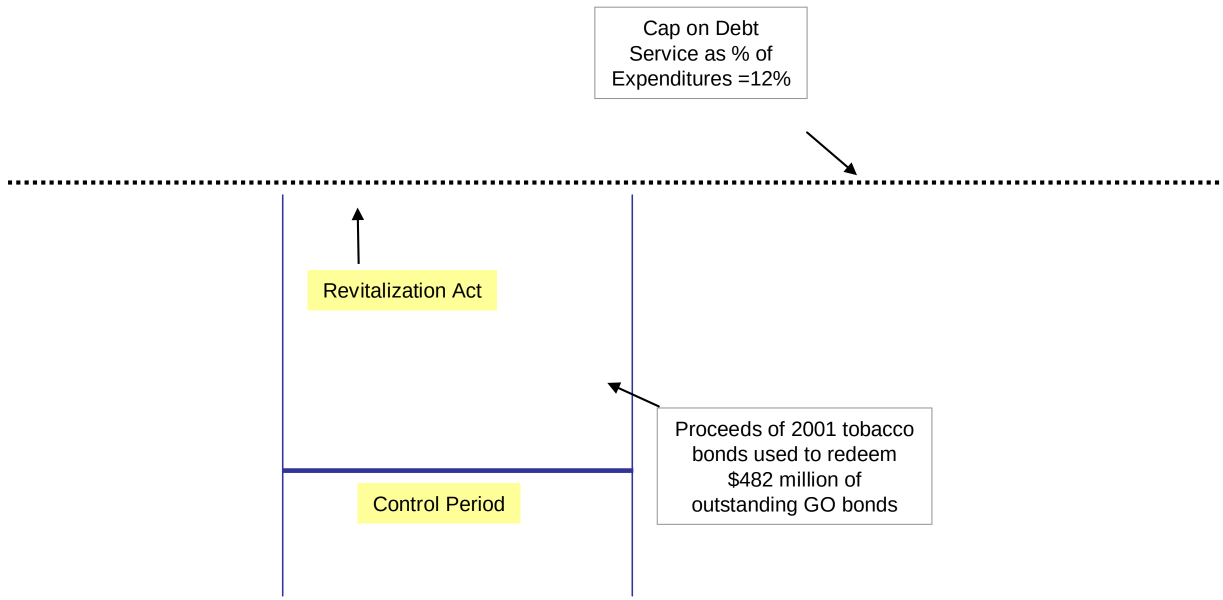
FY 2010 LOCAL FUND

	Original	Revised	Actual		Actual vs. Revised $	Actual vs. Revised Percent	Actual vs. Original $	Actual vs. Original Percent
Taxes	$ 4,964.9	$ 5,045.0	$ 4,903.9		$ (141.1)	-2.8%	$ (61.1)	-1.2%
Non Taxes	409.3	334.3	338.2		3.9	1.2%	(71.1)	-17.4%
Fund balance release	60.3	131.3	117.9		(13.4)	-10.2%	57.6	95.5%
All other GF Sources	84.3	106.2	96.1		(10.1)	-9.5%	11.8	14.1%
	$ 5,518.8	$ 5,616.8	$ 5,456.1		$ (160.8)	-2.9%	$ (62.8)	-1.1%
Less Fund Balance release	**$ 5,458.5**	**$ 5,485.5**	**$ 5,338.2**		**$ (147.3)**	**-2.7%**	**$ (120.3)**	**-2.2%**
Expenditures:								
FY 2010	$ 5,463.9	$ 5,443.1	$ 5,317.1		$ (126.1)	-2.3%	$ (146.9)	-2.7%
FY 2011 Advance to Public Education	-	135.6	135.6		-	0.0%	135.6	
Total Expenditures	$ 5,463.9	$ 5,578.8	$ 5,452.7		$ (126.1)	-2.3%	$ (11.2)	-0.2%
Revenues vs. Exp	**54.9**	**38.1**	**3.4**		**(34.7)**		**(51.6)**	
Surplus as % of Revenues	1.00%	0.68%	0.06%					

Growing Debt Burden

Debt Service as % of Expenditures

(as of September 30 of each fiscal year)



Government of the District of Columbia
Office of the Chief Financial Officer
Natwar M. Gandhi, Chief Financial Officer

APPENDIX

OVERVIEW OF THE FY 2010 CAFR

The FY 2010 audit highlights the District's sound financial position as evidenced by the District's 14th consecutive balanced budget and a markedly improved record of financial management.

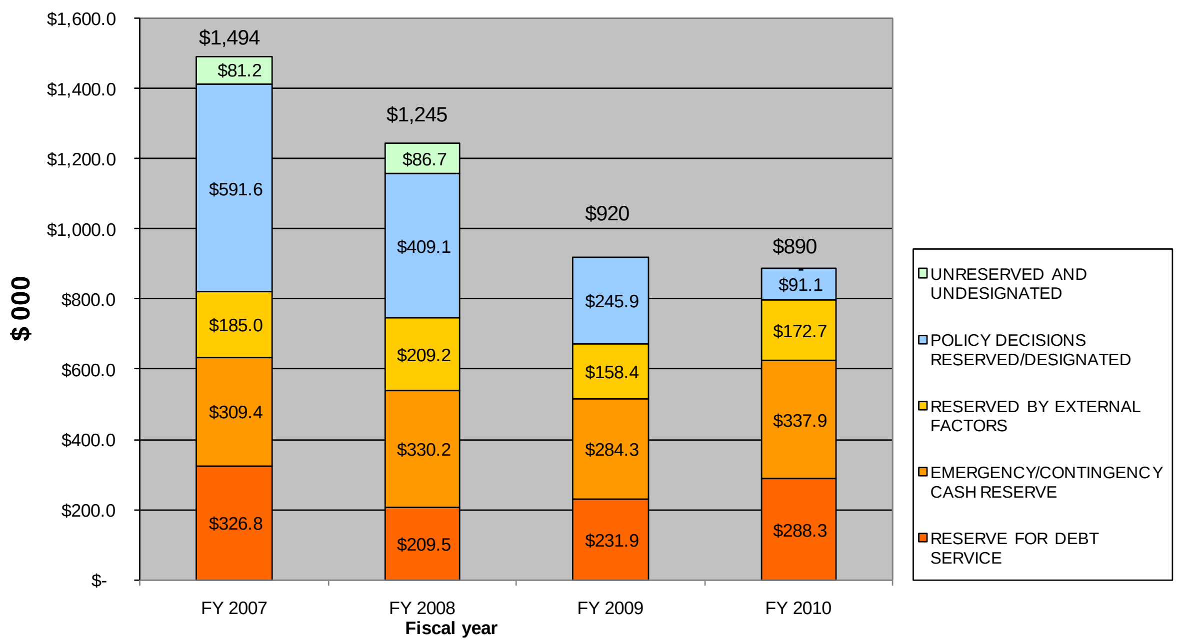
The cumulative General Fund balance now stands at $890 million, $30million below the FY 2009 level but $1.4 billion above where it was at the low point in Fiscal Year 1996, when the District had a $518 million deficit. (See Attachment 1.)

General Fund Balance

Change in General Fund Balance, FY 2009 to FY 2010		
($ in millions)		
General Fund Balance, FY 2009		**$ 920**
Less:		
Use of Fund Balance	$ 138	
		$ 782
Plus:		
FY 2010 Budgetary Surplus	$ 58	
Transfer from Community Healthcare Fir	15	
Transfer from Tax Increment Financing F	10	
Receivable from hospital	26	
Accounting adjustments	(1)	
	$ 108	
General Fund Balance, FY 2010		**$ 890**

COMPOSITION OF GENERAL FUND BALANCE

FY 2007 – FY 2010



Local Fund Budget

The General Fund is composed of two sources – Local and Other ("O Type"). In FY 2010, there was a budgetary basis excess of $58 million in the General Fund, $3 million of which is the result of operations in the $5.5 billion Local Source fund. The remainder of the budgetary excess – $55 million – resulted from O Type revenues ($460 million) exceeding O Type expenditures ($405 million). Please note that "O Type" funds are dedicated monies to be used for special purposes such as nuisance abatement or the crime victims' assistance fund. As a result, the remaining excess is available only for the originally earmarked purpose.

The revised budget allotted $214 million of General Fund balance to be released from restrictions and used as a funding source along with annual taxes and other revenues, but only $138 million was actually used ($118 million of which was Local and $20 million of which was O Type).

TABLE 1

General Fund budgetary results *

($ millions)

	Local	**Other**	**Total**
Actual revenues and other sources	5,456	460	5,916
Actual expenditures	5,453	405	5,858
Excess	3	55	58
Compared to budget, excess attributable to:			
Operating margin in revised budget	38	0	38
Higher/(lower) revenues, other than use of fund balance	(147)	(1)	(147)
Lower use of fund balance	(13)	(63)	(76)
Lower spending	126	118	244
Actual Operating Margin	3	55	58

* Details may not add to totals due to rounding.

Although we indeed had a $3 million Local Source budget left over in FY 2010, there is nothing available for appropriation because substantial sums have already been committed to future budgets or are designated to remain available until spent.

On the expenditure side, the District ended the year with a small amount of unspent appropriations representing just over one percent of the revised Local source budget. Not including $8.5 million of under spending for "bond fiscal charges" supported entirely with bond proceeds, the unspent appropriation was $117.6 million, or only 2.1 percent of the revised $5.6 billion Local Source budget.

With respect to revenues, for the Fiscal Year that ended September 30, 2010, tax revenues (including earmarked revenues) grew slightly, by 1.0 percent, compared to a 5 percent decline the previous year. This reflected a nearly 16 percent increase in sales and use tax revenue, offset by 0.6 percent decline in real property tax revenue, and a 3 percent decline in individual income and business franchise tax revenue, and a 7.3 percent decrease in gross receipts and other taxes.

Economic Conditions and Effect on Revenues

The District's economy showed mixed results in FY 2010 compared to prior years. During FY 2010 employment in D.C. grew by 6,100 (0.9 percent), due to increases in federal employment. This growth is in sharp contrast to the 1.7 percent decline in employment nationally. On the other hand, D.C. resident employment fell by 2,900 in FY 2009 (-1.0 percent). The Census Bureau also reported that the District's July 2010 population of 610,589 was 10,614 (1.7 percent) more than a year earlier, the 7th year in a row of population growth.[1]

The real property market showed some signs of recovery in FY 2010. Residential sales of single family houses increased by 18.9 percent. Average sale prices, however, fell by 3.4 percent. Condominium sales increased by 9.8 percent in FY 2010, and average prices increased by 1.9 percent. All told, in FY 2010 the combined value of sales of both single family and condominium units increased by 13.8 percent.[2]

In FY 2010 the amount of commercial office space increased by 3.5 percent, and the vacancy rate decreased from 10.2 percent in FY 2009 to 9.1 percent in FY 2010.[3] The District's deed transaction records show that the value of all real property that changed hands increased by 41.5 percent in FY 2010.[4]

The District has revenue sources typically used by states as well as cities. Despite having a broad portfolio of revenue sources, the tax system of the District of Columbia is quite volatile. The volatility of a tax system is the degree to which tax revenue fluctuates from one year to the next. By one measure of volatility the District's tax system is one of the most volatile in the nation – the volatility of the District's tax system is topped only by that of Alaska, Hawaii, and Wyoming.

The volatility of the District's tax system calls for realistically conservative revenue estimates to ensure a balanced budget throughout each Fiscal Year. The District economy is forecasted to continue a slow recovery from the 2009 recession. Having successfully emerged from one financial control period, the District's elected leadership is very clear about not risking a second. Federal

[1] U.S. Bureau of the Census preliminary population estimate for the District of Columbia and all States as of July 1, 2010.
[2] Sales data for single family and condominium units are from the Metropolitan Regional Information Systems (MRIS), accessed through the Greater Capital Area Association of Realtors (GCAAR).
[3] Delta Associates. The vacancy rate percentage includes space for sublet.
[4] Office of Tax and Revenue, calculated from collections of the Deed Transfer Tax and the Economic Interest Tax.

oversight, however well-intentioned, still means the loss of basic freedoms granted under Home Rule. Realistically conservative estimates are at the heart of a balanced budget and adequate cash flow and, hence, at the heart of avoiding a second control period. The District must end every Fiscal Year with a balanced budget.

General Fund and Fund Balance

The General Fund results reflect the favorable Local Source results, as well as all O Type revenues and expenditures (see Attachments 6 and 7). Total General Fund revenues and sources was $5.9 billion in FY 2010, which was lower than revised revenue estimates by $224 million or 3.7 percent. Second, O Type revenues other than fund balance came in as expected while fund balance released from restrictions was $63 million less than expected, for a net result of revenues and sources $63 million (13.7 percent) lower than expected. Total General Fund expenditures (including write-offs) were $244 million (4.0 percent) lower than the revised budget, with $118 million attributable to O Type expenditures.

As presented in the FY 2010 CAFR, the District ended the year with a General Fund Balance of $890 million (see Attachment 1). This drop of $30 million from last year was the result of a planned drawdown of fund balance for one-time spending as well as operating purposes, offset by a budgetary surplus of $58 million plus certain accounting adjustments

However, it is important that we truly understand the components of the fund balance (see Attachment 2). The principal components are $288 million for bond debt service and capital lease reserves, $338 million for the Congressionally-mandated emergency and contingency cash reserves and $173 million in other reserves mandated by accounting rules. These three categories – reserves mandated by legal requirements and accounting rules, Congressional requirements and our bond covenants – together make up about $799 million or 90 percent of the fund balance.

The remaining $91 million, or 10 percent of fund balance, is controlled by the Mayor and Council. These are funds that have been designated for specific purposes, the majority of which are in Special Purpose Revenue funds like the AWC and NCRC Development fund, 911 and 311 assessments, and Child support/TANF funds. This year, there is again no unreserved and undesignated fund balance.

Cash Reserves

In the past, credit rating agencies cited the District's Emergency/Contingency Cash Reserves as a positive factor in their analysis and decision to upgrade the District's ratings (see Attachment 3). The District currently holds $338 million in these cash reserves. As you can see from Attachment 4, the working capital grew in FY 2010 compared to FY 2009, attributable largely to repayments to the Contingency Fund for prior draws.

Bond Ratings and Debt Burden

At the beginning of 1997, the ratings the District received from the three major bond rating agencies were B, Ba and BB. These were below investment grade, or "junk bond", ratings. Today, the ratings are A+, A1 and A+ from Standard & Poor's, Moody's, and Fitch, respectively. In the past, these improved ratings helped reduce the District's borrowing costs. Then, in FY 2009, the District introduced to the capital markets a new type of bond secured by the District's income and franchise taxes. These bonds received ratings of AAA from Standard & Poor's, and double-A ratings from Moody's and Fitch. These are the highest ratings ever achieved by a District security. From the use of income tax secured bonds, we estimate that the effect of the savings we achieved in FY 2010 debt issues alone to be approximately $20 million over the next four Fiscal Years. The Build America Bonds program, which was part of the Stimulus package, resulted in the lowest interest rates ever achieved on a District bond offering. The program, which provided a subsidy from the federal government equal to 35 percent of the interest cost, expired on December 31, 2010. Savings from that program will result in estimated savings of $15 million over the next four Fiscal Years.

We still face challenges in catching up from many years of neglect or inability to fund capital improvements. While it is very tempting to address these substantial needs through additional borrowing, too much debt could mean reversing the District's hard-earned gains. The District already has the highest per capita debt of any large city in the nation. Compared to the District's approximately $11,895 per capita for all tax supported debt at the beginning of the current Fiscal Year, New York City's is approximately $8,300, Chicago's is $5,300, Boston's is $1,900 and Baltimore's is $1,900. (Since the close of the FY2010 Fiscal Year, the District has issued additional debt resulting in a new per capita debt number of $13,079.) As noted earlier, the enactment of the 12 percent cap on debt service will help us avoid burdening future generations with heavy debt payments. (See Attachment 7.)

FINANCIAL MANAGEMENT IMPROVEMENTS

Yellow Book Report

Last year, the "Independent Auditors Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards", commonly called the "Yellow Book" report, listed no material weaknesses and three significant deficiencies for FY 2009. Material weaknesses and, to a lesser degree, significant deficiencies reflect problems in the design or operation of internal controls over financial reporting. For FY 2010, there were again no material weaknesses and five significant deficiencies.

The table below shows a history of the Yellow Book findings since FY 2001. Please note that Medicaid has appeared in the Yellow Book seven of the past nine years and DCPS has appeared five times. It is notable that neither Medicaid nor DCPS appear in the Yellow Book for FY 2010. Compensation, however, has appeared a total of six times and is again noted as a significant deficiency.

YELLOW BOOK FINDINGS FY 2001 - FY 2010

	Material Weaknesses	Reportable Conditions/Significant Deficiencies*
FY 2001	DCPS Accounting & Fin Reporting	Cash/Bank Reconciliation
	UDC Accounting & Fin Reporting	Human Resource/Payroll Process Mgmt
	Medicaid Provider Accounting	Accounting - Non-Routine Transactions
		Monitoring of Exp Against Open Procurements
		Disability Comp Claims Mgmt
		Reporting of Budgetary Revisions
FY 2002	Health Care Safety Net Contract Mgmt	Human Resource/Payroll Process Mgmt
	Medicaid Provider Accounting	Monitoring of Exp Against Open Procurements
		Disability Comp Claims Mgmt
FY 2003	Health Care Safety Net Contract Mgmt	Human Resource/Payroll Process Mgmt
	Medicaid Provider Accounting	Unemployment Comp Claimant File Mgmt
FY 2004	**NONE**	Unemployment Comp Claimant File Mgmt
		Management of Disability Comp Program
FY 2005	**NONE**	Management of Disability Comp Program
		Management of Unemployment Comp Trust Fund
FY 2006	District of Columbia Public Schools	Management of the Medicaid Program
FY 2007	Office of Tax and Revenue - Refund Process	Investment Reconciliations and Activities
	Management of the Medicaid Program	NCRC and the AWC
	District of Columbia Public Schools	Management of Grants
		Compensation
		Management of Disability Compensation Program
		Management of Unemployment Comp. Program
FY 2008	Treasury Functions	Compensation
	Management of the Medicaid Program	Office of Tax and Revenue
		District of Columbia Public Schools
		Management of the Postretirement Health and Life Insurance Trust
FY 2009	**NONE**	District of Columbia Public Schools
		Management of the Medicaid Program
		Office of Tax and Revenue
FY 2010	**NONE**	Information Technology
		Procurement and Disbursement
		Stand-alone reports -- Unemployment Compensation, UDC, WCSA, UMC, Office of Risk Management and Dpt. Of Human Resources
		Office of Tax and Revenue
		Personnel Management and Compensation

* "Significant Deficiency" used starting FY 2007

	Material Weakness	Reportable Condition/Significant Deficiency
Medicaid	FY 2001, FY 2002, FY 2003, FY 2007, FY 2008	FY 2006, FY 2009
DCPS	FY 2001, FY 2006, FY 2007	FY 2008, FY 2009
Compensation		FY 2001, 2002, 2003, 2007, 2008, 2010

High Needs and Restricted Tax Base

The District, as the central urban location of a large metropolitan area, houses a disproportionately large share of the very poor and needy population. The District's overall poverty rate of 16 percent and child poverty rate of 23 percent are significantly higher than the U.S average and that of neighboring counties including Arlington, Fairfax, Montgomery, and Prince George's. Unlike other urban jurisdictions that are part of states, District resources cannot be pooled with those from suburban areas to serve its urban poor. Yet, it must provide state-level services such as healthcare, housing and welfare largely through its own resources.

The District's service problems are exacerbated by the higher costs of service delivery. Labor costs in the District are 23 percent above the national average for public services, and the capital costs are 65 percent above the national average. This combination of a needy population and high costs of service delivery result in high expenditure needs for the District. Specifically, if the District were to offer a basket of public services that prevail as "average" among all the state and local governments, it would have to spend 31 percent more than the national average to deliver it.

In this environment of high expenditure needs, the District's tax base has been externally restricted through federal actions. First, the federal government prohibits the taxation of federal real property and does not provide a Payment in Lieu of Taxes to compensate for the revenue forgone from this prohibition. Second, the Home Rule Act prohibits the District from taxing nonresident income. In the District, this is a significant reduction in the income tax base as about 70 percent of the workers in the District are nonresidents.

These restrictions on our revenue collections result in District residents shouldering a disproportionate share of the costs of public services, while the benefits generated by the city are shared by a much larger community. This disparity also implies that under slower revenue growth scenarios, District services could become severely impaired.