PUBLIC OVERSIGHT HEARING
ON THE FY 2010 AND FY 2011
SPENDING AND PERFORMANCE
OF THE OFFICE OF
THE CHIEF FINANCIAL OFFICER (OCFO)

Before the
Committee on Finance & Revenue
Council of the District of Columbia

The Honorable Jack Evans, Chairman

March 7, 2011
Council Chamber, John A. Wilson Building

Testimony of
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Good morning, Chairman Evans and members of the Committee on Finance and Revenue. I am Natwar M. Gandhi, Chief Financial Officer of the District of Columbia. I am here for your annual oversight hearing to testify on the FY 2010 performance and FY 2011 plans of the Office of the Chief Financial Officer (OCFO).

Our deputy chief financial officers have also prepared testimonies and are here to help address specific issues or answer questions as needed. With me are Stephen Cordi, Deputy CFO for the Office of Tax and Revenue (OTR), Anthony Pompa, Deputy CFO for the Office of Financial Operations and Systems (OFOS); Lasana Mack, Deputy CFO for the Office of Finance and Treasury (OFT); and Fitzroy Lee, Deputy CFO for the Office of Revenue Analysis (ORA). Also here to answer questions is Gordon McDonald, Deputy CFO for the Office of Budget and Planning (OBP), whose oversight hearing before the Committee of the Whole is scheduled for March 18. In addition, Buddy Roogow, executive director of the DC Lottery, is here and testified earlier today on behalf of the Lottery. Please see Attachment 1 for an organizational chart of the entire OCFO.

BACKGROUND AND CURRENT ENVIRONMENT

I have testified many times before this Council and the Congressional committees responsible for District oversight and appropriations about the extraordinary turnaround the District has achieved since the 1990s. The journey from junk bond status to the highest possible rating of AAA on our income-tax secured bonds, is indeed a remarkable story, and one of which we can all be proud. The story that is more relevant to today's hearing, however, is how we have weathered the worst economic crisis since the Great Depression.

The presence of the federal government has always provided the District a measure of protection from economic downturns. The lengthy recession of the past three years had a far less negative effect on District finances than it did on most other states and large municipalities. But, we did suffer.

Since the June 2008 Budget, estimated or expected revenues in FY 2011 and FY 2012 dropped by $1.4 billion and $1.6 billion, respectively. This represents declines of 23.5 percent and 25.2 percent in those years – a significant drop in what we expected to receive in revenues. In order to continue funding critical programs, we used a substantial portion of our cumulative general fund balance, which was $1.5 billion in FY 2007, prior to the recession. Now, the fund balance stands at $890 million at the close of FY 2010. As I have noted many times before, this is why governments need to build and keep sizable reserves in fund balance – to cover needs in times of economic downturns.

In the midst of the recession, the District enacted two key pieces of legislation that codified sound financial practices. First, spending on debt service was capped at 12 percent of General Fund spending, thereby ensuring that at least 88 percent of spending would go to providing services to District residents. Rating agencies and investors in District bonds consider this a significant positive step that will help ensure the continued credit worthiness of the District. Second, the Sustainable Capital Investment and Fund Balance Restoration Act of 2010 was enacted. It established requirements for a Pay-as-you-go Capital Account, whereby greater amounts of future budgets will go toward funding our Capital Improvement Plan with cash rather than borrowing. It also established a Fiscal Stabilization Reserve Account and a Cash Flow Reserve Account for the purpose of rebuilding our General Fund balance and reducing or eliminating entirely the need to borrow from external sources for cash flow purposes.

I commend Mayor Gray and the members of the Council for taking these actions, which the Rating Agencies acknowledged favorably on our recent visit with them. By taking these measures and adhering to sound fiscal policies, our remarkably improved bond ratings and well-deserved respect in the financial markets will likely continue.

In 2009, Standard & Poor's awarded its highest possible rating of "AAA" to the District's Income Tax Secured Revenue Bonds. This was the first time that any of the District's bonds have been rated AAA. Recently, S&P reaffirmed its AAA rating, and Moody's and Fitch also reaffirmed their respective Aa1 and AA+ ratings, all with "stable" outlooks. Furthermore, the District's General Obligation bonds have received ratings of A+, Aa2 and AA- from S&P, Moody's and Fitch, respectively, also with "stable" outlooks. These ratings are a testament to the sound economic and financial policies that the District has followed for the past dozen years and the sound financing structure that we have created for the Income Tax bonds. However, as I pointed out in my letter of January 5, 2011 to the Mayor and the Council Chairman, S&P, in its latest credit report on our general obligation bonds, raised serious concerns about the continued depletion of our fund balance and the possible negative effects on our bond ratings. These concerns were echoed by all three rating agencies during our most recent visits. As a result, at those meetings, the city's elected leadership made the commitment to construct an FY 2012 budget and financial plan that does not include the use of reserves.

All of this demonstrates the important fact that we manage our financial operations well and take care of emergencies as they arise. Attachment 2 depicts this history through FY 2010 in terms of annual budgetary surpluses, cumulative fund balances, and bond ratings.

The financial management infrastructure of the District is strong and functions well in support of the District's elected leaders, who demonstrate a strong commitment to maintaining fiscal balance.

As an agency, we are also very serious about our responsibility to operate cost-effectively to protect the District's financial integrity and preserve and enhance its revenue stream. The OCFO has progressively become a leaner organization since FY 2000. Starting in FY 2004, there were increases to our authorized FTE level, primarily as a result of Council-imposed tax compliance initiatives and legal mandates. By FY 2009, the total authorized FTEs reached 1,078. (See Attachments 3, 4, and 5)

In response to the economic downturn and severe budget constraints, we reduced our FTEs in FY 2010 by 149, or 14 percent. In FY 2011, an additional 24 FTEs (2.6%) were eliminated. Among these, for example, was a judicious cut of 15 FTEs in OTR (all vacant positions). Non-personal services cuts in OTR have sharply reduced the funding available for filing season staff, forms printing, and mailings, but we believe that the continued emphasis on electronic filing will make these cuts manageable. In FY 2010 individual income tax returns filed electronically increased by 8.5 percent over the FY 2009 level. We strongly encourage District taxpayers to file and pay electronically, which cuts down on processing errors and dramatically increases the speed with which we can process refunds.

Despite the very substantial cuts that our organization has taken, I am determined to maintain the effectiveness of the OCFO in FY 2011 and beyond, and believe we will continue to be successful despite the budget reductions.

To further this goal, we are maximizing our investments in technology. For example, the tax office, our most labor intensive unit, is becoming more and more automated, as evidenced by higher electronic filing, robust fraud prevention programs, and internal-control enhancements. In addition, information technology investments comprise our capital budget and current capital request– replacing SOAR in FY

2013, replacing the Real Property Tax System by 2013 and ITS, subject to approval of our capital funding request, by FY 2015.

As you review the performance of the OCFO and prepare for the FY 2012 budget review, we ask the committee to keep this record of fiscal prudence and efficiency in mind. It is imperative for the District to maintain its capability to perform core financial functions: keeping track of the books, financing its operations, and collecting the maximum amount of revenue that it is due. I fully understand the problems that we face, and we are working closely with the Mayor's budget team to provide assistance and expertise in the formulation of a fiscally responsible budget for FY 2012. I know that every agency has to share the collective pain and take reductions in order to achieve a balanced budget. The OCFO is fully committed to contributing its share. However, if the OCFO is called upon to cut too deeply, it is likely to hurt our tax compliance and collection efforts, which could negatively affect the District's overall revenue outlook.

OCFO OVERARCHING GOALS

As the Chief Financial Officer, my objective is to preserve and enhance the overall financial stability of the District by reliably estimating revenues, exercising control of the budget, and scrutinizing and improving internal controls, all of which help maintain and strengthen the District's standing with our residents, the financial community and Congress.

It is our intent to present to this committee, the Mayor and the Council, the minimum OCFO resource request consistent with attaining our goals. In each case, I believe the achievement of these goals is absolutely necessary to maintain and strengthen the District's financial viability.

The Deputy CFOs will speak at length about the accomplishments and plans of their offices. I will give a brief summary of the highlights here.

1. Protect and Enhance District Revenues

OTR must efficiently process all tax returns voluntarily remitted and aggressively pursue enforcement action to both increase revenue and reduce the rate of noncompliance each year. OTR has implemented a variety of automated initiatives to increase revenue – the CP2000 federal matching program, offering payment plans to every delinquent taxpayer it bills (excluding real property), contracts with collection agencies, and an automated fraud detection program. In FY 2010, OTR successfully executed a Tax Amnesty Program which yielded collections in excess of $20 million. Additionally in FY 2011, OTR will implement an automated DC vendor offset program, an automated sales and withholding tax delinquency control program, and the federal vendor offset program. The District would further benefit from the enactment of streamlined bank attachment legislation adopted in a number of states which would require banks to report the existence of bank balances of tax delinquents so that they can be attached. This legislation, if enacted, would ultimately enhance tax collections by $10 million per year for the foreseeable future.

2. Maintain Financial Controls and Safeguard Assets

Protecting District assets requires the maintenance of internal checks and balances, effective internal audits, and the maintenance of systems to record and check financial transactions. Written policies and procedures are also an important element of a well-designed and effective system of internal controls, as they provide management the opportunity to establish workflows and processes that address potential risks. Since FY 2008, substantial progress has been made in the revision and development of the District's financial policies and procedures. An OCFO cross-agency project team updated the District-wide financial policies and procedures manual, and developed manuals for each cluster and central agency.

In FY 2010, the Office of Tax and Revenue was cited in the "yellow book" for weaknesses in its financial reporting process. To address this finding, we have developed a detailed corrective action plan designed to further strengthen and institutionalize our internal controls in this area. Mr. Cordi will speak in further detail about this during his testimony. I would like to emphasize that much work has been done to date to strengthen the control structure at OTR and throughout the OCFO. Starting in FY 2008, three firms – Kroll Associates, Deloitte Financial Advisory Services, and Ernst & Young – assessed processes and systems in OTR and OFT, on a pro bono basis, to assist us in enhancing and promoting a culture of fraud prevention, detection, and deterrence. During FY 2009, the OCFO engaged the services of Deloitte Financial Advisory Services to build on that work through the development of a comprehensive internal control improvement initiative and to assist OCFO management in the development and full implementation of a system of internal controls consistent with OMB Circular 123 and Sarbanes Oxley.

In June 2009, I appointed a Chief Risk Officer (CRO), Kathy Crader. Building on the work accomplished in FY 2008 and FY 2009, the CRO has designed a formal Internal Controls Program and its documentation tool, the Risk Control Matrix. Working with the staff in each business unit, the CRO is creating robust risk inventories and assessments, controls inventories and assessments, and control tests. In 2010, the CRO developed detail for the Internal Controls Program in OTR, and continues to roll out the Program to other areas across the OCFO as well. The OCFO Audit Committee to Review Financial Management and Internal Controls, which I established in December 2007, to advise the OCFO on how to strengthen our organization's internal controls and financial management, continues to provide us with recommendations on how to further strengthen the District's control structure.

3. Produce Reliable Revenue Estimates

Conservative estimates are at the heart of a balanced budget and adequate cash flow. A conservative revenue estimating philosophy recognizes that economic forecasting is an inexact science and that the economic environment can change very quickly, so even during boom years our revenue estimate errs on the side of avoiding a deficit in an economic downturn. Regular revision of the revenue estimates enables the District to adjust its budget during the fiscal year in response to changing economic circumstances. Starting just before the beginning of fiscal year 2010, we revised the fiscal year 2010 revenue estimate downward four times, reducing the estimate by a total of $952.4 million. (See Attachments 6 and 7)

The revenue estimate issued last Monday, which increased the revenue estimate for FY 2012 by $105 million, is based on an improving economy, in particular, a resurgent commercial real property sector. Because of the stronger economy and revenue-raising initiatives enacted by D.C. policymakers over the last 2 years, local fund revenues are now projected to reach the FY 2008 peak in FY 2012 rather than FY 2013 as previously forecast.

The District of Columbia is at the heart of a regional economy powered by the federal government. The DC metro area weathered the longest and deepest recession since the 1930s better than any other region in the country because of the federal government expansion during the recession. There were 24,000 (3.4 percent) more persons working in the District of Columbia in December 2010 than in December 2007 when the recession began. The latest indicators point to a DC economy in recovery. D.C. residents are gaining jobs once more, and although the D.C. unemployment in December 2010 was still at a high rate of 9.7 percent it is down from the 12 percent rate at the beginning of 2010. The vacancy rate in commercial office property stood at 8.5 percent in December 2010, down from a high of over 10 percent during the depths of the recession and well below the regional average of 11.9 percent. Home prices are rising once more and personal income growth has picked up.

Going forward there are still some risks. Although recent economic indicators point to a more robust recovery in the national economy, the persistently high national unemployment rate adds a degree of uncertainty as to the sustainability of the recovery. Because of the large role that the federal government plays in the District of Columbia, and the entire metropolitan area, we will be closely monitoring developments in the federal sector. In particular, a prolonged shut-down of the federal government could affect revenues in the short-term. Additionally, plans by the new Congress to cut federal spending could have a detrimental impact on the economy of the District of Columbia. We will continue to monitor the national and local economic environment and will alert you to any development that threatens the District's finances.

4. Assure Balanced Budgets

Budgets built on quality analysis that include all foreseeable costs ensure the smoothest possible execution of programs approved by the Mayor and Council. The budgeting process continues to be very challenging. Due to revised revenue estimates in FY 2010, OBP worked with the Mayor and the Council to balance the budget and produce the FY 2010 Revised Budget. This was done concurrently with the development of the FY 2011 budget that was presented to Council on April 1, 2010. Due to updated revenue estimates, the FY 2011 budget was then revised in the first quarter of FY 2011. So in short, we have produced three budgets in a 15 month period. ORA prepares fiscal impact statements on bills, contracts and regulations, and all fiscal impact statements prepared by the OCFO since May 2001 are retrievable on the OCFO Web site at *www.cfo.dc.gov*.

Constant monitoring of expenses helps to control costs and spots operations that are off-course. The major tool used to monitor agency spending is the quarterly Financial Review Process (FRP) report, prepared by the agency fiscal officers and submitted through the agency directors to OBP for review and analysis. During the past few years, we have also built online capacity (CFO$olve, and the Agency Operational Dashboard) and made these resources available to Executive and Council staff to provide optimum service and transparency to District agencies and elected officials.

5. Prepare Audited Comprehensive Annual Financial Reports (CAFRs)

Our ability to record financial transactions timely and accurately is critical to our ability to produce audited financial statements on time and maintain and improve the District's bond ratings. This year, again, the annual closing process was uneventful in that there were no "surprises" and no serious threats to the schedule or calendar. Intense monitoring of the interim and annual closes proved to be very effective in producing a more efficient FY 2010 year-end close.

DEBT MANAGEMENT and BOND RATINGS

In FY 2010, we restructured approximately $840 million of debt, which lowered debt service costs in FY 2010 by approximately $100 million and produced substantial reductions in debt service over the financial plan period. This transaction allowed the District to continue to make important long-term investments in infrastructure. Mr. Mack will provide more details of this in his testimony.

Starting in FY 2009, the District has funded its Capital Improvements Program through the issuance of Income Tax Secured Revenue Bonds, which are rated AAA, the highest possible rating, by Standard and Poor's, Aa1 by Moody's and AA+ by Fitch. These ratings are the result of strong financial management and will result in debt service savings of an estimated $20 million over the course of the financial plan period. This represents quite an accomplishment for the District. As I emphasized earlier in my testimony, rating agencies have indicated that the District's continued use of fund balance to help balance its annual budget could result in negative ratings action. The commitments made by the elected leadership during the recent rating agency visits to produce and execute structurally balanced budgets in FY 2012 and beyond, and to replenish our fund balance, if realized, will go a long way in alleviating their concerns and sustaining our current ratings.

CONCLUSION

The continuing leadership provided by the Mayor, by you, Mr. Evans, and the Council has enabled the District to weather the recent economic crisis and provided a sound foundation to meet the challenges that lie ahead. The OCFO is committed to doing everything it can to support continued financial improvements in the city in FY 2011 and beyond.

This concludes my remarks. I would be pleased to answer any questions you may have.