PUBLIC BRIEFING
ON THE
COMPREHENSIVE ANNUAL FINANCIAL REPORT
(CAFR) FOR FISCAL YEAR 2007

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

The Honorable Vincent C. Gray, Chairman

April 14, 2008, 3:00 p.m.
Council Chambers

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

Good afternoon, Chairman Gray 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 the OCFO's Deputy Chief Financial Officers with whom most of you are familiar: Anthony Pompa of the Office of Financial Operations and Systems, Robert Ebel of the Office of Revenue Analysis, Gordon McDonald of the Office of Budget and Planning, Lasana Mack of the Office of Finance and Treasury and Stephen Cordi of the Office of Tax and Revenue. In addition, joining me today is Robert Andary, Executive Director of the OCFO's Office of Integrity and Oversight. It is our pleasure to be here today to discuss the 2007 Comprehensive Annual Financial Report (CAFR).

As you know, this year, the CAFR was not filed by the February 1 deadline. The alleged tax fraud case in the Office of Tax and Revenue was cited by the District's independent auditing firm, BDO Seidman, LLP, in its request to the Office of the Inspector General for an extension to conduct an audit of OTR and other areas that could be exposed to potential fraudulent activity. We have worked closely with the auditors to ensure they had access to all information requested. As it has come to be expected, this report has an unqualified, "clean" audit opinion from the independent auditors, and we will discuss more on that conclusion shortly. What is most important is that once again, the District has achieved balanced financial operations and a budgetary surplus. This is the 11th consecutive year we have balanced our budget, and it is a tribute to our elected officials that we have achieved this exemplary record.

OVERVIEW OF THE FY 2007 CAFR

Mr. Chairman, the discovery of the alleged property tax fraud was certainly a low point for the District and the Office of the Chief Financial Officer. As I have said, it was devastating for me personally and I deeply regret it. I must emphasize, however, that the FY 2007 audit highlights the District's sound financial position despite losses sustained as a result of the alleged tax fraud. This alleged tax fraud must not be allowed to overshadow or diminish the District's financial accomplishments as evidenced by the District's 11^{th} consecutive balanced budget and a $281 million budgetary surplus.

Our strong financial standing is testimony to the steadfast commitment of the District's elected leaders to sound fiscal management, which has resulted in a nearly $2 billion turnaround in the cumulative General Fund balance since 1996, from a $518 million deficit to a $1.5 billion positive balance. (See Attachment 1.) It is important to note that of that $2 billion increase in fund balance, nearly half was accumulated in the post-Control period. Indeed, our turnaround from "junk bond" status was faster than any other major city that has undergone a similar period of financial crisis, including New York, Philadelphia, Cleveland and Detroit. We have a fund balance that is still among the highest in the nation – a far cry from a decade ago – substantially improved bond ratings, including upgrades in FY 2007 from both Moody's Investors Service and Fitch Ratings, and well-deserved respect in the financial markets. These measures of success are attributable to the strong fiscal leadership of the District's elected officials.

The Mayor and Council have made major strides in addressing some of the large capital needs in the District's infrastructure by providing funding authorization to begin work to bring substandard school buildings, roads, and bridges up to acceptable condition. More of these capital needs will be funded with proceeds of future general obligation bond issues, but even with those funds, our needs remain substantial. We have higher debt ratios than other states or large jurisdictions which, as I will discuss later, limit our ability to borrow more to finance additional infrastructure. These are hurdles that continue to challenge the District even in the course of profound financial achievement.

Local Fund Budget

The General Fund is composed of two sources – Local and Other. Of the $281 million General Fund budgetary surplus, $211 million is the result of operations in the $5 billion Local Source fund. (The remainder of the budgetary surplus – $70 million – resulted from Other Source revenues ($449 million) exceeding Other Source expenditures ($379 million). Please note that “Other Source funds” are dedicated monies to be used for special purposes such as the Housing Production Trust Fund and the Neighborhood Investment Fund. As a result, any surplus still remains available for the originally earmarked purpose.)

Composition of $281 million General Fund budgetary surplus

($ millions)

	Local	Other	Total
Actual revenues	5,338	449	5,787
Actual expenditures	5,127	379	5,506
Surplus	211	70	281
Surplus attributable to:			
Operating margin in revised budget, June 2007	24	126	150
Higher/(lower) revenues compared to revised budget	108	(206)	(98)
Lower than anticipated “bond fiscal charges"	24	0	24
Unspent appropriations and writeoffs	55	150	205
	211	70	281

Although we indeed had a $281 million budgetary surplus, none of that is available any longer for spending.

The table below shows the bridge between the budgetary surplus and the unreserved, undesignated General Fund balance.

	($ in millions)	
FY 2007 General Fund Surplus	$281	
Less: Non-Local Surplus	(70)	
FY 2007 Local Fund Surplus		$211
Fund balance release (Medicaid, DCPS - Blackman Jones, etc.) and other	(31)	
FY 2007 Surplus used in FY 2008 Supplemental	(99)	
Total Unreserved Undesignated General Fund Balance		**$81**

The unreserved undesignated fund balance proposed for use in FY 2009 has already been used.

On the expenditure side, the District ended the year with a small amount of unspent appropriations. Not including the "bond fiscal charge" supported entirely with bond proceeds, the unspent appropriation was $55 million, or only 1.1 percent of the revised $5.2 billion Local Source budget.

With respect to the revenue component of the surplus, the strong tax revenue growth experienced in FY 2004 and FY 2005 began to slow in FY 2006, but it picked up again in FY 2007. Compared to FY 2006, tax revenues (including earmarked revenues) grew by 14 percent in FY 2007. This reflected 6 percent growth in sales and use tax revenue, 26 percent growth in real property tax revenue, and 7 percent growth in individual income tax revenue. Deed taxes (including the economic interests tax) increased by 23 percent (in part, reflecting increased tax rates). The real property, deed, sales and the individual income taxes accounted for 80 percent of the additional tax revenue**.**

The District's economy showed considerable strength in FY 2007. Employment in D.C. grew by 6,300 (0.9 percent) and resident employment increased by 7,000 (2.3 percent).[1] The Census Bureau also reported that the District's July 2007 population of 588,292 was 2,833 (0.5 percent) more than a year earlier, the 4th year in a row of comparable population growth.[2]

The real property market changed in FY 2007. On the residential side, sales of single family houses declined by 9.4 percent while average sale prices rose by 7 percent. Condominium sales increased by 4.9 percent, by contrast, but average prices fell by 3.0 percent. All told, in FY 2007 the combined value of sales of both single family and condominium units declined by 1.2 percent.[3] In FY 2007 the amount of commercial office space increased by 4.0 percent and the vacancy rate declined — from 6.2 percent in FY 2006 to 5.8 percent in FY 2007.[4] The District's deed transaction records show that the value of all real property that changed hands increased by 11.9 percent in FY 2007.[5]

The District has revenue sources typically used by states as well as cities. State-type individual income taxes and the general sales taxes combined are 44 percent

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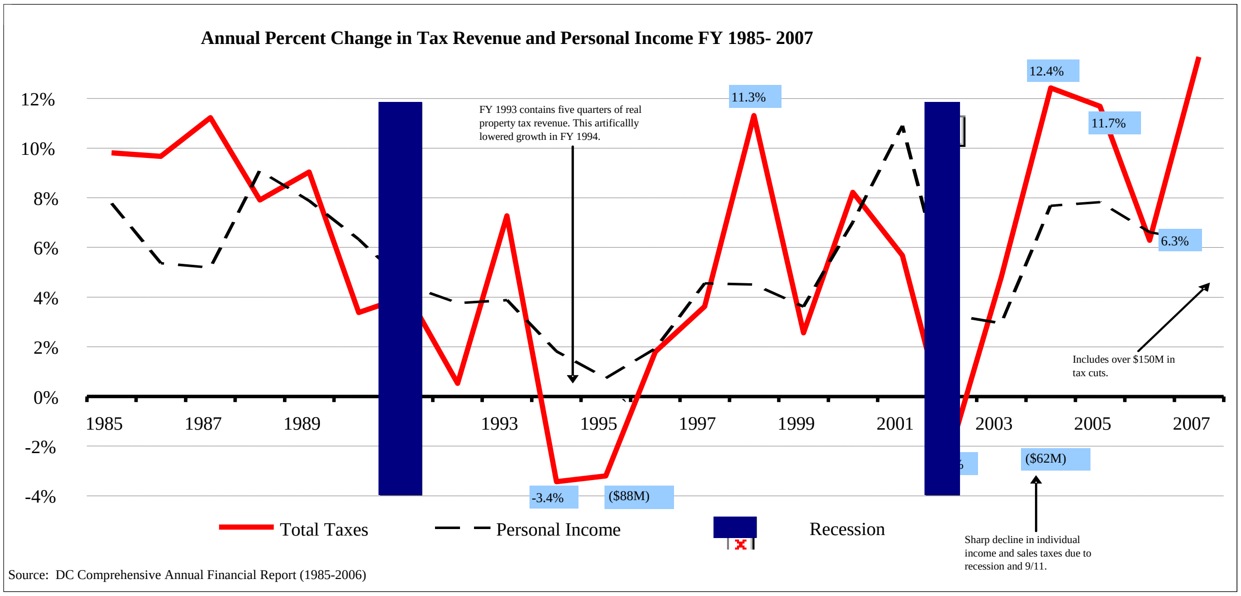
[1] U.S. Bureau of Labor Statistics, employment and labor force data as of December 2007.
[2] U.S. Bureau of the Census population estimate for the District of Columbia and all States as of July 1, 2007.
[3] Sales data for single family and condominium units are from the Metropolitan Regional Information System (MRIS), accessed through the Greater Capital Area Association of Realtors (GCAAR).
[4] Delta Associates, December 2007.
[5] Office of Tax and Revenue, calculated from collections of the Deed Transfer Tax and the Economic Interest Tax.

of total tax revenue (including dedicated taxes) in FY 2007. These revenues are particularly sensitive to economic and external effects and thus make the District's tax revenues volatile. Local governments typically derive 72 percent of their tax revenues from the historically more stable property tax[6]. In the District, this source accounts for only 33 percent of total tax revenue.

The potential downside –and one that we must track with great care when we are observing, as now, a "turning point" in the macro-economy -- is that from our perspective as a municipality, we are more vulnerable than other cities to the inherently volatile income and sales taxes (See chart below and Attachment 7).

The following chart shows the percent changes of individual income tax collections since 1984. Note that the fluctuations in this revenue source have been significant.

[6] U.S. Census Bureau, State and Local Government Finance Data, FY 2005.



The February 2008 revenue estimates illustrate the nature of this uncertainty. In just the past two months, the national and the District of Columbia economy have slowed down. Indeed, some external financial observers are predicting a recession in the near term. We have observed the slowing in District home sale activity as well as the stock market and the overall pace of economic activity. This slow down, in combination with recent legislative changes, has resulted in an estimate of total revenues less than we expected as of last December. Similarly, for our May revenue estimate we are closely monitoring April tax collections and the evolving economic picture for any signs that the revenues are growing even more slowly.

The District's unique mix of revenue sources and the resulting volatility calls for realistically conservative revenue estimates to ensure a balanced budget throughout each fiscal year. (See Attachment 2.)

As I have said before, the District's revenue estimates must be somewhat conservative as a matter of both necessity and good financial management. As already noted, the national economy is showing signs of a significant downturn, and our local economy is beginning to slow. Having successfully completed one financial control period, the District's elected leadership is very clear about not risking a second. Financial control, 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 Other Source revenues and expenditures (see Attachments 3 and 4). Total General Fund revenue was $5.8 billion in FY 2007, exceeding revised revenue estimates by $52 million or 0.9 percent. General Fund expenditures were $228 million (3.9 percent) lower than the revised budget, with $149 million attributable to Other Source expenditures.

As presented in the FY 2007 CAFR, the District ended the year with a General Fund Balance of $1.5 billion (see Attachment 1). This means that since the beginning of FY 1997, when the General Fund Balance was a negative $518 million, the District's General Fund Balance has increased by $2 billion, an average of about $180 million per year. This fund balance clearly indicates the healthy financial position of the District.

However, it is important that we truly understand the components of the fund balance (see Attachment 5). The principal components are $327 million for bond debt service, $309 million for the Congressionally-mandated emergency and contingency cash reserves and $185 million in other reserves mandated by accounting rules. These three categories -- reserves mandated by accounting rules, Congressional requirements and our bond covenants -- together make up about 55 percent of the fund balance.

The remaining $673 million, or 45 percent of fund balance, is controllable by the Mayor and Council. This includes $592 million that has been reserved or designated for subsequent years' expenditures, Paygo capital spending, a reserve for retiree health benefits, and various other special purposes like the Neighborhood Investment Fund (see Attachment 6), and $81 million which was unreserved and undesignated at the end of FY 2007.

Cash Reserves

In the past, credit rating agencies cite the District's Emergency/Contingency Cash Reserves as a positive factor in their analysis and decision to upgrade the District's ratings (see Attachments 7 and 8). The District currently enjoys $309 million in these cash reserves. As you can see from Attachment 6, these reserves along with the $81 million undesignated and unreserved fund balance dropped in FY 2007, to an amount that is less than one month's spending. Furthermore, as noted earlier, the $81 million has already been proposed for Fiscal Year 2009 expenditures. It is generally considered prudent financial management to hold at least one month's spending in reserve, and I am concerned that we have allowed this level to drop below the minimum recommended level. Indeed, according to the Government Finance Officers Association, "best practices" recommend that municipal governments maintain a cushion equivalent to one to two months' expenditures. Should revenues prove to be higher than currently expected, I strongly urge the Mayor and Council to provide for a higher level of spendable reserves in order to meet unforeseen spending needs in the future, particularly in light of the downturn in the national economy and its potential effect on our local revenues.

As to the likelihood of realizing additional revenues this fiscal year, I must caution Mayor and Council not to expect the pattern of growth we have seen in the past several years. The trend of adding revenues to the forecast is not likely to continue, and must not be relied upon for spending needs. The economic outlook, although better than our neighbors, is still far slower than in recent years. Indeed, if additional spending pressures emerge, we will have to look for ways to cut spending in other areas of the budget.

Bond Ratings

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. These improved ratings help reduce the District's borrowing costs. We estimate that the effect of the many upgrades we have achieved since the District dropped below investment grade in 1995 is an annual savings of more than $15 million in debt service and fees.

FINANCIAL MANAGEMENT IMPROVEMENTS

Yellow Book Report

The delay in the CAFR allowed the independent auditors additional time to conduct in-depth studies of the way the District does business, not just in the Office of Tax and Revenue where the alleged fraud case arose, but in all areas of the government. Accordingly, we now have a more detailed report than in previous years. The findings can be found in the "Independent Auditors Report on Compliance and on Internal Control over Financial Reporting and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards". This document, commonly called the "yellow book" report, lists three material weaknesses and six reportable conditions for

Fiscal Year 2007. Material weaknesses and, to a lesser degree, reportable conditions are significant deficiencies in the design or operation of internal control over financial reporting.

Mr. Chairman and Members of the Council, I want to stress that these findings should in no way diminish the remarkable accomplishments that the District has achieved since the end of the control period. Rather, they should be viewed as an opportunity for all of us – managers and elected officials alike – to focus on the areas that most need improvement. The findings will be a valuable tool for managers throughout the District to improve financial management.

It is imperative that we correct the problems cited by the auditors. While part of the reason for these findings is attributable to changes in the standards used by all auditing firms, most of the responsibility lies with the District government, and it is up to us collectively to see that the problems are corrected. If unattended, these problems could lead to more serious measures in next year's CAFR.

The table below shows a history of the yellow book findings since FY 2001. Please note that Medicaid and Disability Compensation have appeared in the yellow book in five of the past seven years. Human Resources and Unemployment Compensation have appeared in four of the past seven years, and DCPS has appeared three times in that period.

YELLOW BOOK FINDINGS FY 2001 - FY 2007

	Material Weaknesses	Reportable Conditions
FY 2001	DCPS Accounting & Fin Reporting UDC Accounting & Fin Reporting Medicaid Provider Accounting	Cash/Bank Reconciliation Human Resource/Payroll Process Mgmt 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 Medicaid Provider Accounting	Human Resource/Payroll Process Mgmt Monitoring of Exp Against Open Procurements Disability Comp Claims Mgmt
FY 2003	Health Care Safety Net Contract Mgmt Medicaid Provider Accounting	Human Resource/Payroll Process Mgmt 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 Management of the Medicaid Program District of Columbia Public Schools	Investment Reconciliations and Activities NCRC and the AWC Management of Grants Compensation Management of Disability Compensation Program Management of Unemployment Comp. Program

As you know, following the discovery of the alleged fraud in the Office of Tax and Revenue, I established an independent Audit Committee to Review Financial Management and Internal Controls to advise the OCFO on how to swiftly and effectively address the problems that led to the alleged fraud. (See Attachment 11.) This group, chaired by Sheldon Cohen, former Commissioner of the U.S. Internal Revenue Service, has provided invaluable advice and direction, and the OCFO is grateful for the time and effort contributed by this group. Indeed, we have already made great headway in improving the way the OCFO does business, but much remains to be done. The Committee will report quarterly and the first of those reports is due at the end of this month. Judge Stanley Sporkin, former U.S. District Judge for the District of Columbia, has also provided his expertise and guidance to the OCFO, for which we are also very grateful.

Material Weaknesses

I will first address each of the three material weaknesses and summarize steps already taken and planned to remediate the problems outlined. 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.

I. Office of Tax and Revenue – Refund Process

As I testified last Wednesday, the Yellow Book finds that the refund process in the Office of Tax and Revenue is a material weakness. This was, of course, the area where the alleged fraud occurred, in manual property tax refunds.

Last fall, the tax refund process, specifically manual tax refunds, was identified as an area of particular concern. Since November, we have overhauled that process by establishing and enforcing procedures for preparation and review of refund requests. We have a new head of OTR, Stephen Cordi, who is a highly accomplished professional with an established record of sound tax management. We are also currently reevaluating and strengthening our anti-fraud programs, not just in OTR but throughout the OCFO.

In response to the auditor’s findings on refunds:

- To reduce the need for manual refunds, when OTR encounters a problem processing a refund in ITS, we are making systemic solutions our priority rather than resorting immediately to manual processes.
- Procedures are in place for higher-level reviews of and internal controls over manual refunds. All tax refunds over certain thresholds are reviewed, and a new signature approval process has been developed, employees have been trained and the process is being followed. Thus the problem of inadequate documentation has been remedied. The auditor sampled 134 manual refunds and validated most, but they were severely hampered by inadequate documentation. This must not and will not recur.
- The practice of allowing checks to be “held for pickup” has been virtually eliminated with the guidelines promulgated by Office of Finance and Treasury.
- The system of authorization and approval of manual tax refunds has been revised to address separation of duties, roles and responsibilities.

- We reviewed all the automated tax refunds found by the auditor to lack adequate documentation; there are no fraudulent payments among these refunds.
- Checks issued from SOAR and ITS since November 2007 are formally reconciled and compared to the General Ledger on a monthly basis.
- Business processes have been implemented to improve the legibility of scanned documents.

II. Management of the Medicaid Program

This finding reflects the ongoing problems about which I have been speaking for several years. Indeed, it has been elevated from a reportable condition in the FY 2006 CAFR to a material weakness, an indication that we have not made enough progress in improving this area. While the District no longer has the kind of write-offs we experienced in previous years due to poor billing practices, we still have a long way to go. The Inspector General has also publicly pointed out for years the problems in Medicaid administration. The new Department of Health Care Finance, combined with a competent and effective contractor, is key to solving this issue once and for all. Again, it is essential that we make the resources available to correct this situation and remove this from the list of weaknesses.

III. District of Columbia Public Schools (DCPS)

The last material weakness is the DC Public Schools. Following last year's CAFR, we established a team, working with DCPS officials, to remedy the personnel, procurement and Medicaid issues that led to the "material weakness" finding. Through the development of policies and procedures, employee training programs and the imaging of documents, significant progress was made to improve the performance in these areas. This hard work began last February after the CAFR was issued, and I commend the progress that was made between February and the end of the Fiscal Year. Unfortunately, there was simply too much to accomplish in too little time, and as a result, the FY 2007 CAFR findings continue to cite DCPS as a material weakness. The District is at a disadvantage, of course, due to the "high-risk" designation by the U.S. Dept of Education. Accordingly, I have decided NOT to disband the special forces team I assembled at DCPS in order to address this year's "material weakness".

Reportable Conditions

In addition to the three material weaknesses outlined above, the auditors identified six additional areas that need management attention. Again, it is imperative that we work together to improve these areas.

IV. Investment Reconciliation and Activities – Like the discovery of new shortcomings at DCPS, I am very disappointed with outside auditors' findings of shortcomings at the Office of Finance and Treasury. This branch of the OCFO was cited for deficiencies in the area of investment reconciliation activity and in the area of contributions to retiree health benefits accounts. Timely reconciliations of investment activities and the proper accounting of retiree health benefits must and will occur.

V. National Capital Revitalization Corporation and the Anacostia Waterfront Corporation – The report addresses the District's failure to ensure a transition of the financial operations of the NCRC and AWC to the District. As you know, both of these organizations have been dissolved, and this finding will not recur.

VI. Management of Grants – The report states that the District has not been timely in collecting outstanding receivables, effectively causing the General Fund to make temporary loans to grant programs. Clearly, if the District provides a service under a grant, it needs to be sure it can document the transactions and get reimbursed with the grant funds. Routine recordkeeping must become just that – "routine". Management is reviewing corrective action plans to prevent this in the future, including OCFO oversight on grants accounting issues.

VII. Compensation – There were discrepancies between time and attendance records and overtime payments to employees; deficient documentation of bonus payments; and payment of health benefits after termination of employees. The FY 2006 management letter addressed ineligible overtime payments (DCHR). In this finding as well as others, new auditing standards are a factor – if there has been no improvement, the level of the comment is elevated. There will be additional training of timekeepers and review of timesheets to ensure compliance. The Peoplesoft payroll system, effective

October 2007, allows for the automatic termination of health benefit payments after an employee is terminated. Office of Pay and Retirement System will do what is required to ensure that all bonuses and retroactive payments are sufficiently documented.

VIII. Management of Disability Compensation Program – This area, along with Unemployment Compensation, has been a problem on and off for several years. The report recommends that the District create and maintain internal controls over new disability claims and assess previous claims. This program is now managed by a third party administrator. This area will require management attention in order to ensure effective operations in the future.

IX. Management of Unemployment Compensation Program – the Department of Employment Services (DOES) has had difficulty completing the requisite number of audits required by the U.S. Department of Labor. There is also evidence that inadequate controls have resulted in some suspicious claims that have been referred to the Office of the Inspector General for investigation. DOES is also cited for inadequate procedures for processing employer refunds and needed improvements to allow the unemployment tax assessment system to interact with SOAR. DOES will increase the number of auditors this year, improve software capability to improve efficiency and take other steps to eliminate these problems quickly.

Debt Burden

We still face challenges in catching up from many years of neglect or inability to fund capital improvements. It is very tempting to address these substantial needs through additional borrowing. To borrow too much 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 $10,000 per capita for all tax supported debt at the beginning of the current fiscal year, New York City's is less than $7,000, Chicago's is $4,400, Boston's is $1,800 and Baltimore's is $1,200. What is also important is our goal to keep the percentage of our budget that goes to pay debt service at a manageable level. Our debt service at the beginning of the current fiscal year was around 9.1 percent of expenditures, and with currently planned amounts of future borrowing, that percentage is projected to rise to 12.1 percent by the end of FY 2010, just above the firm cap of 12 percent recommended by the OCFO and above the Moody's median of 11.5 percent for large cities.

Let me take this opportunity to again address the issue of variable rate debt that was raised at the FY 2009 budget presentation last week. Auction Rate Securities and variable rate demand obligations, far from being "exotic," are a common form of variable rate debt that resets interest rates periodically. The District has about $900 million of Auction Rate Securities and other variable rate bonds insured by bond insurers that have been downgraded (FGIC, MBIA and XL Capital). In addition, we have about $325 million of variable rate and auction rate securities insured by companies that have not been downgraded.

The average interest rate on auction rate/variable rate securities in FY 2007 was 3.63 percent. Historically, interest rates on variable rate bonds are 150 to 200 basis points below fixed rates. Short-term variable rates in the past few years have been very low – sometimes below 2 percent and for a very brief period, even below 1 percent. Thus, compared to a fixed rate of interest, the District has saved about $15 million per year on its portfolio of $1.2 billion of variable rate bonds. Over the past seven years, this amounts to over $100 million of savings.

The market disruption led to failed remarketing/auctions over the past several weeks, leading to higher interest rates. Interest rates have been reset as high as 15%, the maximum allowed by law or the bond documents. The District is moving quickly to take action to replace some or all of the Auction Rate Securities and variable rate bonds that are currently, or may be, exposed to higher than average short term interest rates. We are working with our financial advisors, bond attorneys and underwriters to determine the best economic outcome for the District. We now plan to refinance these bonds with another form of variable rate debt with credit enhancement from a bank Letter of Credit. We expect to close by the end of May.

There has been a great deal of focus on our debt levels recently, which is indicative of the importance of this element to the District's overall financial condition. As we are all aware, the District performs more functions than most governments, including that of a state, a county, a city and a school district. It has been suggested that we should therefore carry a greater percentage of our budget in the form of debt service. This premise, however, suggests that we can afford to allot a smaller percentage of the budget to all other functions, including the delivery of services to our residents. The nature of debt service is that it is for the most part an inflexible expenditure that lasts for a very long time – as much as thirty years or more. We must look to the future with an eye to protect fiscal flexibility, and therefore I am re-emphasizing my recommendation to target no more than ten percent of the budget for debt service, with a firm cap of 12 percent. The District has made extraordinary improvements in its fiscal position, and we should not lose the ground we have gained by taking the easy way of funding capital projects by burdening future taxpayers with a heavy debt service load. (See Attachment 9.)

Continuing Financial Stability

In summary, I continue to believe the District has the ability to sustain all that it has accomplished in the past nine years (see Attachment 10). In many respects I see a very bright future. The City's elected leadership possesses a steadfast commitment to fiscal responsibility that has become widely recognized, most notably in the financial markets where the District is enjoying its highest bond ratings ever.

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 19.4 percent and child poverty rate of 32.5 percent are significantly higher than the U.S average (13.2 and 18.3 percent) and neighboring counties including Arlington (6.8 and 8.1 percent), Fairfax (4.6 and 5.0 percent), Montgomery (4.4 and 3.7 percent), and Prince George's (8.3 and 11 percent). Unlike other urban jurisdictions, the District cannot pool resources across 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 123 percent above the national average for public services, and the capital costs (primarily buildings) are 1.65 times 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 had to spend 131 percent of 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 imply that our residents must share a disproportionate share of the costs of public services, while the benefits generated by the city are shared by a much larger community. It also implies that under slower revenue growth scenarios, District services could become severely impaired.

CONCLUSION

I want to take this opportunity to thank the many District government employees, from both the financial and program areas, who have worked so 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 want to commend Tony Pompa, the DC 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 would also like to thank the rest of my senior management team and their staff: Gordon McDonald, Lasana Mack, Robert Ebel, Stephen Cordi, Cyril Byron, Mohamed Mohamed, George Dines, Deloras Shepherd, Angelique Hayes, and Robert Andary. The District owes them its thanks.

I also want to thank the public accounting firm of BDO Seidman, LLP who were assisted by Bert Smith and Company and Thompson, Cobb, Bazilio and Associates 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 want to commend Wayne Berson, Jim Nesbitt, Bill Eisig and Abdool Ahkran for their efforts.

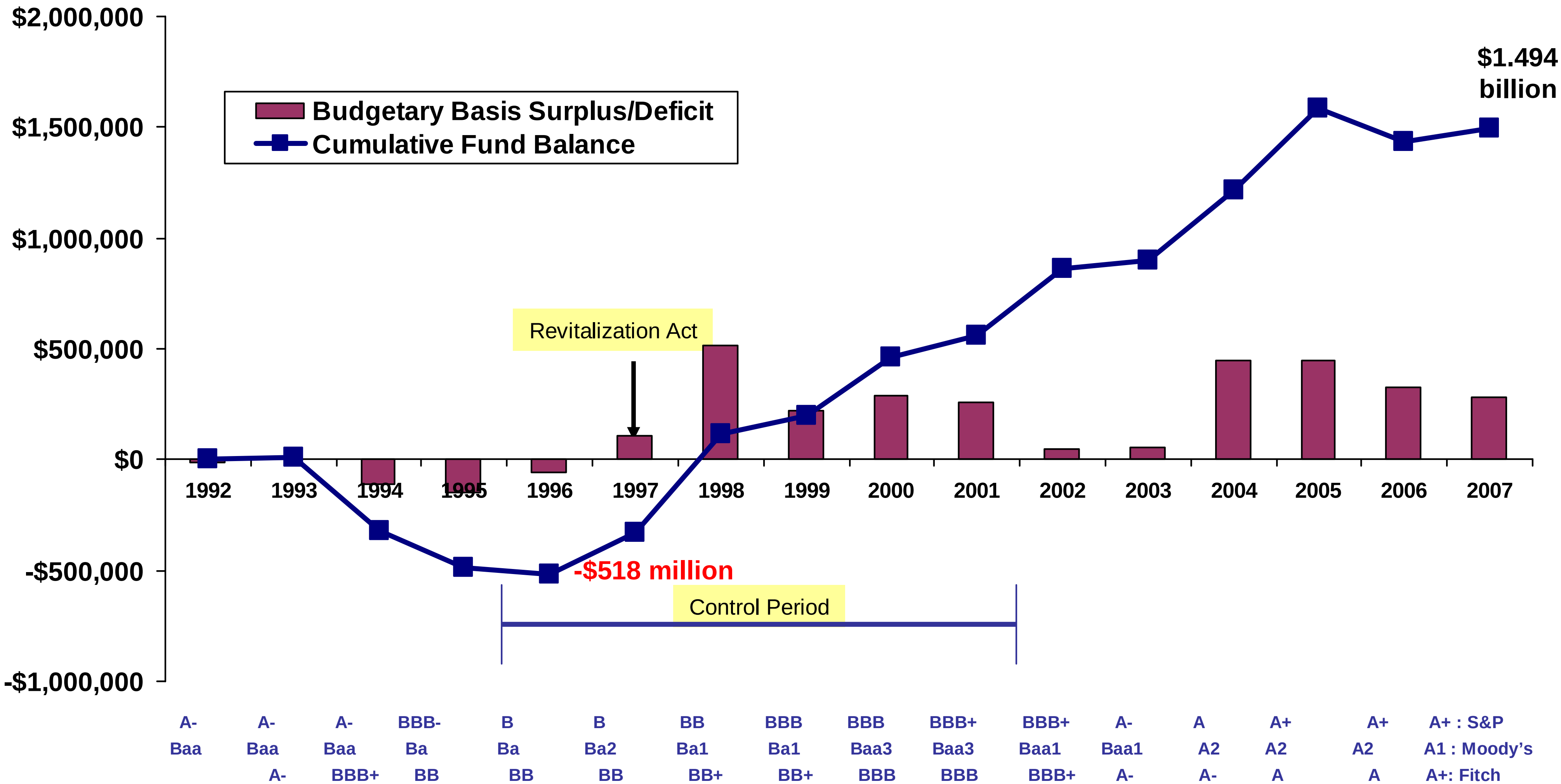
Thanks also go to Inspector General Charles Willoughby and to Bill Divello, the chair of the CAFR oversight committee. Their independent oversight is critical to the integrity of this process.

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 Gray; as well as City Administrator Tangherlini. 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.

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

Attachment 1

Surplus and Bond Rating History



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

Fiscal Year	Individual Income Tax Collections ($000s)	Percent Change
1984	386,635	
1985	417,509	8.0%
1986	444,824	6.5%
1987	513,201	15.4%
1988	592,828	15.5%
1989	603,469	1.8%
1990	637,910	5.7%
1991	615,746	-3.5%
1992	620,208	0.7%
1993	589,521	-4.9%
1994	650,660	10.4%
1995	643,676	-1.1%
1996	689,408	7.1%
1997	753,475	9.3%
1998	861,505	14.3%
1999	952,156	10.5%
2000	1,077,346	13.1%
2001	1,098,188	1.9%
2002	949,175	-13.6%
2003	928,968	-2.1%
2004	1,042,309	12.2%
2005	1,160,074	11.3%
2006	1,233,602	6.3%
2007	1,313,826	6.5%

FY 2007 Local Fund Surplus

($ in millions)

	Revised Budget	Actual	Actual vs. Revised	Percent Variance
Taxes	$ 4,505.1	$ 4,787.8	$ 283	6.3%
Non Taxes	337.6	423.9	86.3	25.6%
Fund Balance Release	261.3	39.5	(221.9)	-84.9%
All Other General Fund Sources	102.1	86.6	(15.5)	-15.2%
	$ 5,206.1	$ 5,337.7	$ 132	2.5%
Expenditures				
FY 2007	$ 5,120.6	$ 5,041.6	$ (79)	-1.5%
FY 2008 Advance to Public Education	85.0	85.0		
Revenues vs. Expenditures	$ 0.5	$ 211.0		

FY 2007 General Fund Surplus

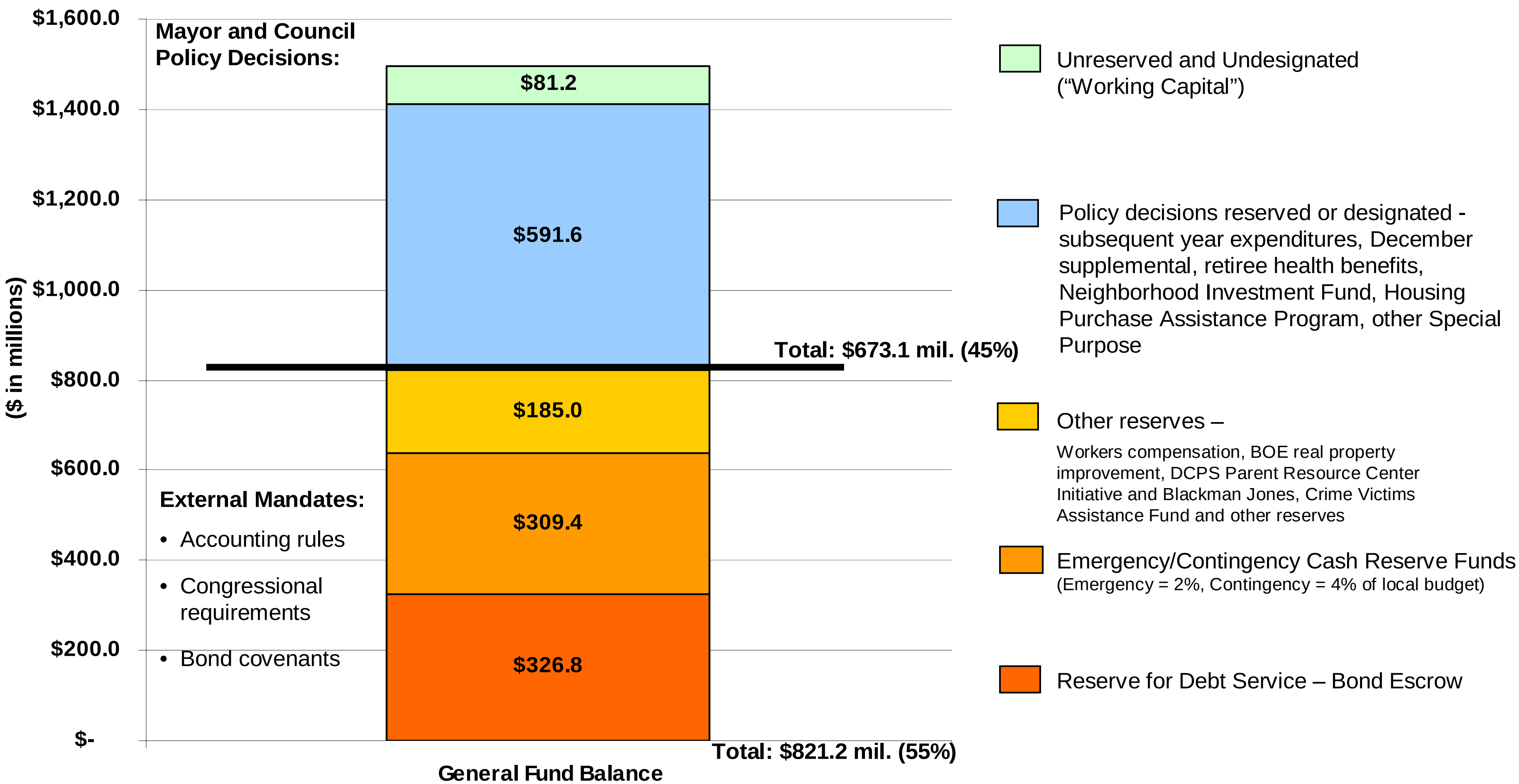
($ in millions)

	Revised Budget		Actual		Actual vs. Revised	Percent Variance
Taxes	$	4,505.1	$	4,787.8	$ 283	6.3%
Non Taxes		783.8		790.4	6.7	0.9%
Fund Balance Release		344.3		122.4	(221.9)	-64.4%
All Other General Fund Sources		102.1		86.6	(15.5)	-15.2%
	$	5,735.3	$	5,787.2	$ 52	0.9%
Expenditures						
FY 2007	$	5,649.7	$	5,421.3	$ (228)	-4.0%
FY 2008 Advance to Public Education		85.0		85.0		
Revenues vs. Expenditures	$	0.5	$	280.9		

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

FY 2007 General Fund Balance

Total as of September 30, 2007: **$1,494 million**



Explanation of General Fund Balance Chart (bottom up):
($ in thousands)

EXTERNAL MANDATES

Reserve for Debt Service -- Bond Escrow		**326,768**	22%
Emergency/Contingency cash reserve funds		**309,383**	21%
Other reserves:			
Long term assets:			
State Education	3,500		
Home Purchase Assistance Program (HPAP)	3,204		
Total Long term assets		**6,704**	
Inventory		**15,998**	
Budget:			
DCPS - Parent Resource Center Initiative and Blackman Jones	12,373		
Disability compensation fund	10,412		
Student Census Audit and OSSE-Geneva	10,246		
Commercial revitalization tax rebate	4,952		
FY 02 Workforce Investment	2,517		
8 other items under $1 million (incl. Craig, Medicaid, Verizon litigation, other)	2,505		
Total Budget		**43,005**	
Purpose restrictions:			
Workers Compensation Special Fund and Administration	21,083		
BOE--Real Property Improvement/Maintenance Fund	12,652		
Crime Victims Assistance Fund	11,531		
Unemployment Administrative Assessment	8,562		
Storm water	7,673		
Charter School Credit Enhancement	6,634		
Rent (deposits on District-owned properties)	3,472		
Natural Gas Trust Fund (NGTF)	3,414		
Land Acquisition for Housing Development Opportunities (LAHDO)	3,043		
Condo Conversion (fees from landlords for relocation assistance for tenants)	2,601		
41 other items less than $2 million	14,249		
Total Purpose restrictions		**94,914**	
Capital lease payment--reserved for payment of St. Elizabeths lease		**16,822**	
Charter school enrollment fund		**7,577**	
Total Other reserves		**185,020**	12%
TOTAL EXTERNAL MANDATES ($ AND %)		**821,171**	55%

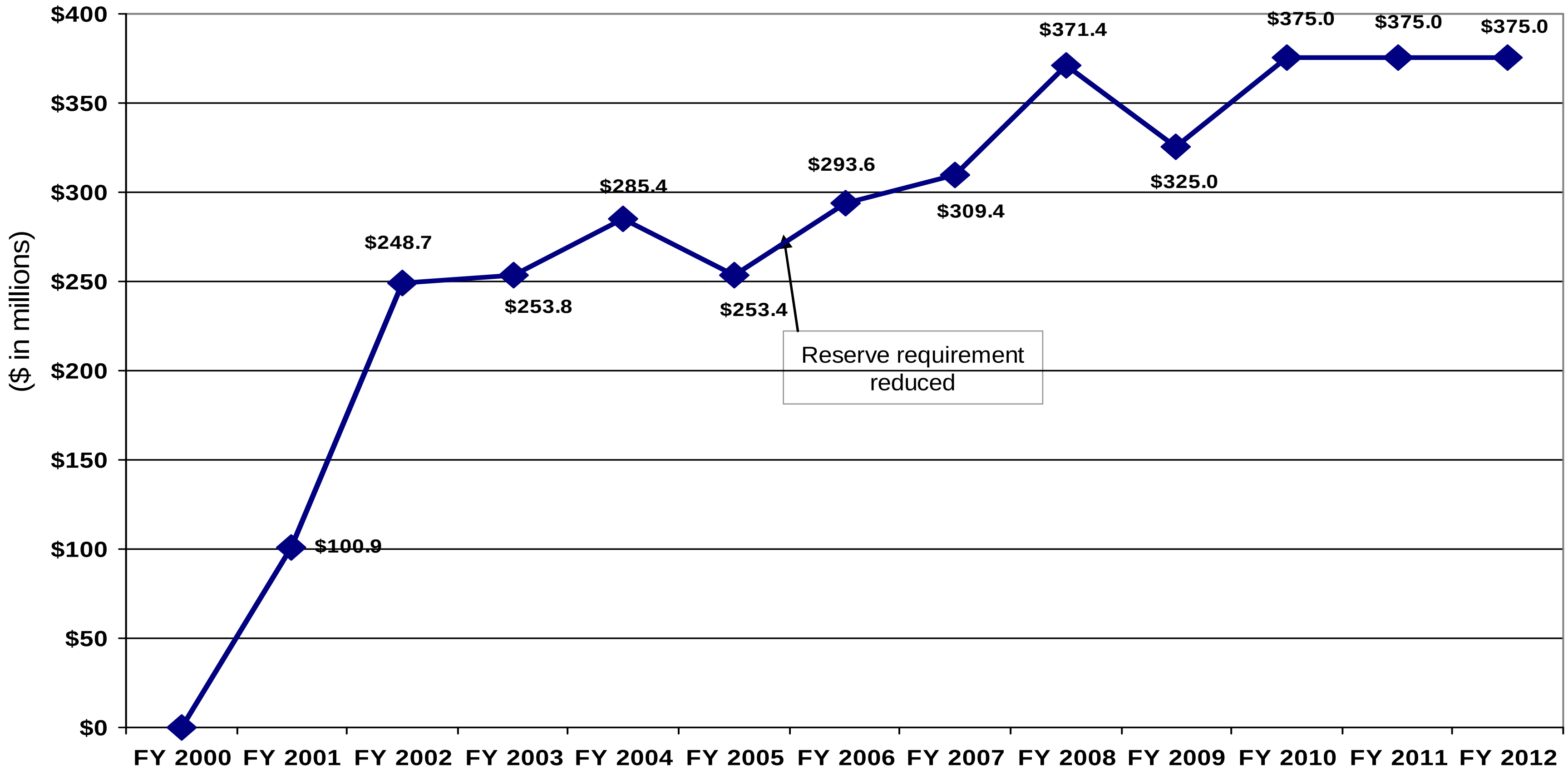
POLICY DECISIONS

Retiree health benefits (OPEB)			
Reserved	34,906		
Unreserved, designated	13,288		
Total retiree health benefits:		**48,194**	
Subsequent years expenditure: Amount needed to balance budget as result of use of Sales Tax for School Modernization		**246,233**	
Purpose restrictions:			
Nursing Facility Quality of care	21,501		
Recorder of Deeds Surcharge	6,534		
Pepco	5,114		
Total purpose restrictions		**33,149**	
Integrated Service Fund		**6,009**	
Budget Support Act		**12,194**	
December Supplemental		**99,498**	
Fixed cost		**4,137**	
Designated -- Other Special Purposes			
Neighborhood Investment Fund	24,204		
Housing Purchase Assistance Program - Repay	17,509		
DDOT Operating Fund	8,972		
Compliance & Real Property Tax Admin Fund	6,675		
General "O" Type Revenue Sources	6,285		
Cable Franchise Fees	6,076		
ABC - Import and Class License Fees	5,565		
Industrial Revenue Bond Program	5,534		
Master License Fee-Special Account	4,896		
Child Support - TANF/AFDC Collections	4,419		
Nuisance Abatement Fund	3,758		
Rehab Repay	3,431		
R-E Guar. & Education Fund	3,103		
Soil Erosion/Sediment Control	2,723		
SSI PayBack	2,670		
DC General Collections	2,613		
Pesticide Product Registration	2,520		
911 & 311 Assessments	1,998		
Nuisance Abatement	1,951		
Consumer Protection Fund	1,857		
Vital Records Revenue	1,683		
Other Funds	1,634		
Enterprise Fund Account	1,546		
Motor Vehicle Inspection Station	1,516		
Board of Medicine	1,515		
Antifraud Fund	1,263		
Construction/Zoning Compliance	1,224		
Food Handlers Certification	1,192		
OPLA - Special Account	1,162		
90 other items under $1 million	12,679		
Total Designated - Other Special Purpose		**142,173**	
Total policy decisions reserved or designated:		**591,587**	40%
Unreserved and undesignated		**81,242**	5%
TOTAL POLICY DECISIONS ($ AND %)		**672,829**	45%
TOTAL FUND BALANCES		**1,494,000**	

Rainy Day Fund

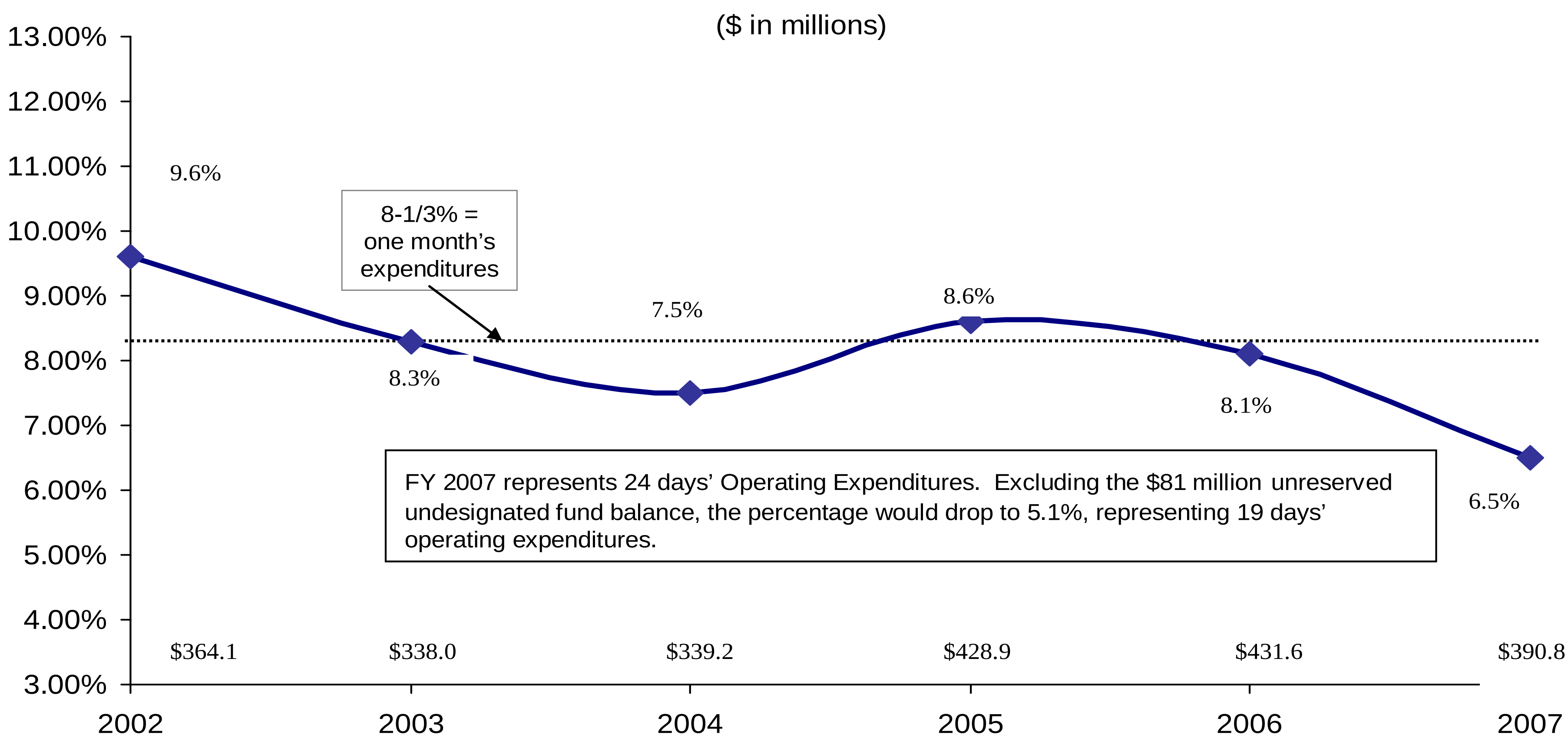
Congressionally Mandated Emergency (2%)/Contingency (4%) Cash Reserves

(FY 2008-2010 Projected; includes operating cash reserves through FY 2008 only)



Total Working Capital

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



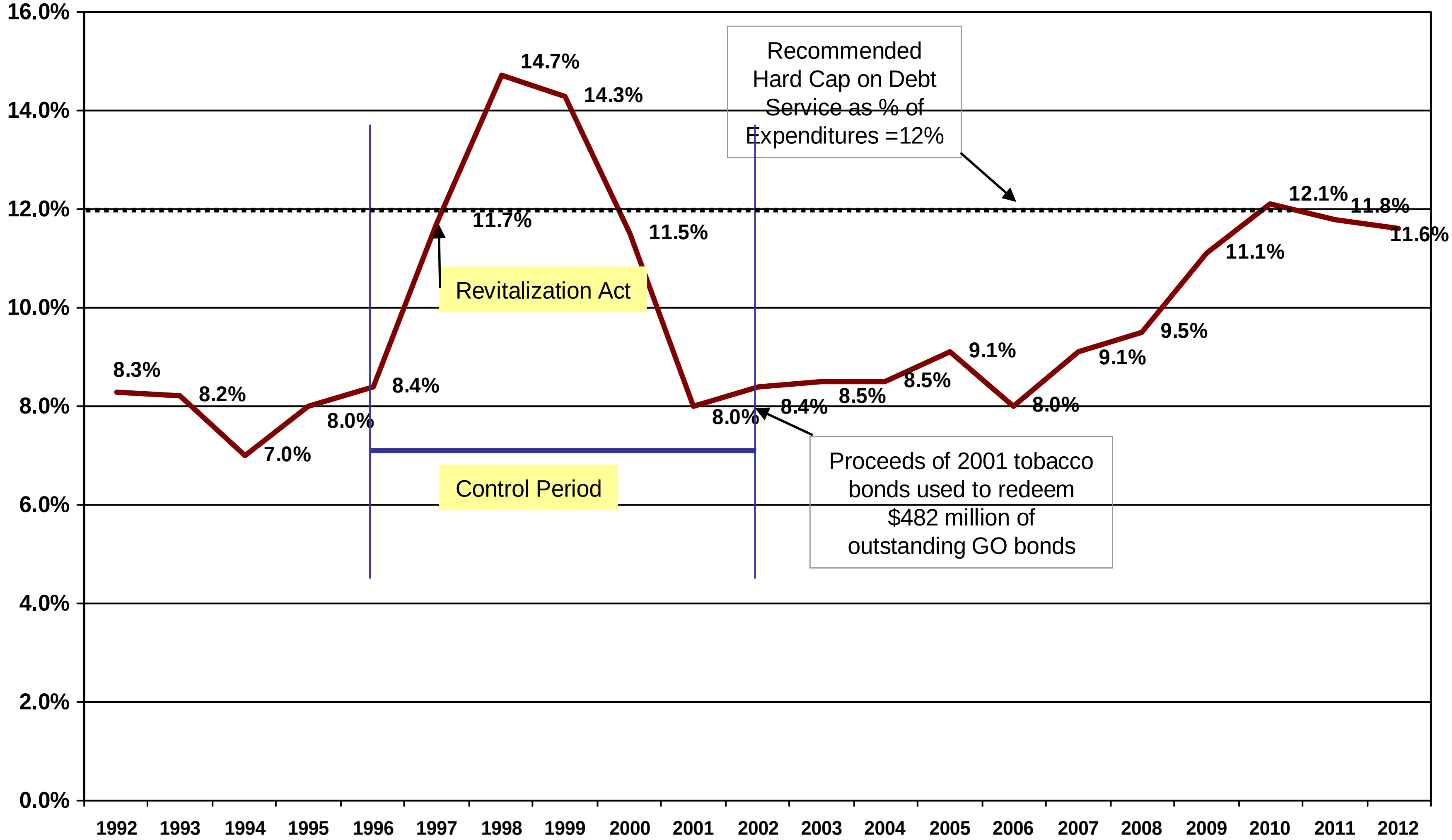
Government of the District of Columbia
Office of the Chief Financial Officer
Natwar M. Gandhi, Chief Financial Officer

Attachment 9

Growing Debt Burden

Debt Service as % of Expenditures

(as of September 30 of each fiscal year)



General Fund Financial Plan

(Budgetary Basis, $ in millions)

		FY 2007 Actual (as of 3-20-08)	FY 2008 Adjusted	FY 2009 Proposed	FY 2010 Projected	FY 2011 Projected	FY 2012 Projected
	Revenues						
1	Total Resources	$ 5,787	$ 6,540	$ 6,444	$ 6,574	$ 6,854	$ 7,162
	Program Expenditures						
2	General Program Expenditures	$ 5,324	$ 6,206	$ 6,204	$ 6,342	$ 6,524	$ 6,760
3	Cash Reserve/Budgeted Contingency	-	50	50	55	60	65
4	School Modernization Fund		68	-	-	-	-
5	Paygo Capital	118	-	29	-	-	-
6	Transfer to Post Employment Benefits	5	111	81	87	93	99
7	Transfer to HPTF and Baseball Revenue Fund	59	84	76	65	62	64
8	**Total General Fund Expenditures**	$ 5,506	$ 6,519	$ 6,440	$ 6,549	$ 6,739	$ 6,988
9	**Operating Margin, Budget Basis**	$ 281	$ 21	$ 4	$ 25	$ 115	$ 174
10	**Beginning General Fund Balance**	$ 1,435	$ 1,494	$ 1,021	$ 844	$ 848	$ 943
11	Operating Margin, Budget Basis (line 9)	281	21	4	25	115	174
12	Projected accounting adjustments, net	(100)	(20)	(20)	(20)	(20)	(20)
13	Fund Balance Use	(122)	(474)	(162)	-	-	-
14	**Ending General Fund Balance**	$ 1,494	$ 1,021	$ 844	$ 848	$ 943	$ 1,097
15	**Cash Reserves ((Operating (FY07 and FY 08 only), Emergency and Contingency))**	$ 309	$ 371	$ 325	$ 375	$ 375	$ 375

GOVERNMENT OF THE DISTRICT OF COLUMBIA
OFFICE OF THE CHIEF FINANCIAL OFFICER

AUDIT COMMITTEE APPOINTEES
BRIEF BIOGRAPHIES

Sheldon Cohen, Chairman

The Honorable Sheldon S. Cohen, Esq. is currently a Director at Farr, Miller & Washington, LLP and a professional lecturer at the George Washington Law School. Mr. Cohen retired as a partner in the law firm of Morgan, Lewis & Bockius in 2005. Mr. Cohen served in the Internal Revenue Service on several different occasions. During the period 1952-1956, he served as a legislative draftsperson during the drafting of the 1954 Code and Regulations. In the period from January 1964 through January 1969, Mr. Cohen served as Chief Counsel for one year and then as Commissioner of the Internal Revenue Service for four years. He was the youngest person to ever serve in that position. He has also served as an officer and Trustee of the National Academy of Public Administration and has served as a panel member of several studies dealing with the administrative aspects of the Internal Revenue Service. He served as a consultant to the United Nations Development Program assisting developing countries with tax administration. He is the Chair of the Audit Advisory Committee of the GAO.

Donald H. Chapin

Mr. Chapin has been a consultant on accounting, auditing, and financial management issues from 1997 to date. He is a member of the Audit and Review Committee of the Smithsonian. He has advised the New York City District Attorney on Tyco related auditing issues and law firms on Enron related accounting issues, auditor independence issues and the application of accounting standards in a dispute. He evaluated the external and internal audit functions of a major telecommunications company and advised on related financial management issues. He also aided a law firm to evaluate an audit failure by a major accounting firm. He is a recent former member of the Standing Advisory Group (SAG) of the Public Company Accounting Oversight Board (PCAOB) and prior to his appointment consulted with the PCAOB staff. He served on the NASDAQ Listing and Hearing Review Council where he was Chairman of its committee on Accounting and Audit Committees. He also served on the Federal Accounting Standards Advisory Board, the Government Auditing Standards Advisory Council, the Loan Loss Accounting Task Force of the AICPA and the Public Sector Committee of the International Federation of Accountants. From 1989 to September 30, 1996, Mr. Chapin was employed by the GAO, ending his service as the Assistant Comptroller General for Accounting and Information Management responsible for GAO’s financial and systems audits of federal agencies and corporations and for its reports and Congressional testimonies on financial management issues.

John Hill

Mr. Hill is Chief Executive Officer of the Federal City Council, with more than 28 years of experience in federal, state, local, and private sector entities. He formerly served as director of state and local government consulting services for Arthur Andersen, LLP, and was the founding executive director of the Washington, D.C. Financial Control Board. Mr. Hill has also served as a director in the U.S. General Accounting Office, director of audits with the Marriott Corporation, and audit manager for Coopers and Lybrand and Price Waterhouse.

James L. Hudson

Mr. Hudson served as the Vice-Chair of the National Capitol Revitalization Corporation and is currently involved in real estate and venture capital development. He was the Special Legislative Counsel for the cities of Detroit, New Orleans, Oakland and Kansas City where he provided legal and executive department support on city finance and economic development plans. In addition, he served as principal liaison with the U.S. Congress and the U.S. Departments of Housing and Urban Development, Labor and Transportation. Mr. Hudson also served as Finance Counsel for the District of Columbia government from 1974 to 1982.

Irving Pollack

Mr. Pollack was a former Commissioner and Director of the Divisions of Enforcement and Market Regulation for the U.S. Securities and Exchange Commission, Mr. Pollack is serving as Of Counsel to Fulbright & Jaworski L.L.P. He has consulted for numerous governmental and private institutions, including the World Bank, the International Finance Corporation (World Bank affiliate), the International Organization of Securities Commissions (IOSCO), the National Association of Securities Dealers, the Ontario and Quebec Securities Commissions and Merrill Lynch Pierce Fenner & Smith, Inc., Edward Jones, and the U.S. Synthetic Fuels Corporation. Mr. Pollack has rendered expert services for Dow Jones, the New York Stock Exchange, and other organizations. He recently served as a Director of ML Life Insurance Co. of New York and a member of its Audit & Compensation Committee.

GOVERNMENT OF THE DISTRICT OF COLUMBIA
OFFICE OF THE CHIEF FINANCIAL OFFICER

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Audit Committee to Review Financial Management and Internal Controls Organizational Summary

Overview

Historically, the Chief Financial Officer (CFO) has appointed several advisory boards to advise the office on a variety of matters. These boards, such as the CFO Advisory Council, Business Advisory Council, Real Estate Advisory Council, Revenue Estimating Technical Review Committee, and Tax Advisory Council, provide substantive expertise and recommendations to the CFO on an ongoing basis.

Audit Committee Mission

The CFO is establishing a new advisory board, the Audit Committee to Review Financial Management and Internal Controls (Audit Committee), to assist the CFO in reviewing internal control structures and compliance with established policies and procedures for the District's financial management operations.

Audit Committee Appointees

The CFO will be appointing the following individuals to serve on the Audit Committee, each for a three-year term ending December 31, 2010 (see brief biographies, below):

- Sheldon Cohen (Chair)
- Donald H. Chapin
- John Hill
- James Hudson
- Irving Pollack

The Executive Office of the Mayor, the District Council, and the Inspector General will each have a liaison to the Audit Committee:

- Executive Office of the Mayor – Peter Nickles, General Counsel
- District Council – TBD
- Inspector General -- TBD

Guidelines

The Audit Committee will be guided by the advice published in 1995 in OMB Circular A-123, Management Accountability and Control, which set forth eight principles for control standards in a mature organization:

.(i) Compliance With Law;

.(ii) Reasonable Assurance and Safeguards;

(iii) Integrity, Competence, and Attitude;

.(iv) Delegation of Authority and Organization;

.(v) Separation of Duties and Supervision;

.(vi) Access to and Accountability for Resources;

(vii) Recording and Documentation; and

(viii) Resolution of Audit Findings and Other Deficiencies.

These eight principles apply to management controls in general, in any sort of program. The Audit Committee will assist the CFO by reviewing its programs, processes, and systems for financial management and controls throughout the District, for their conformance with the eight principles, and will recommend corrective actions where needed.

The Audit Committee will also be guided by the section 404 of the Public Company Accounting Reform and Investor Act of 2002, also known as the "Sarbanes-Oxley Act of 2002," which sets forth standards of review for the assessment of the adequacy of internal controls for financial reporting of publicly traded companies.

Initially, the Audit Committee will be charged with review of the financial operations of Office of the Chief Financial Officer (OCFO). It will then move on to the financial operations of all other District government agencies, including the financial operations of the Office of Contracts and Procurement, the Department of Health, and, if it is enacted, the proposed Department of Health Care Finance.

The Audit Committee will meet on a monthly basis, commencing in December, 2007, and concluding in December, 2010, subject to renewal by the Chief Financial Officer. It will hire staff and, if necessary, contract with an accounting firm to carry out its mission, supported from the budget of the OCFO.

The Audit Committee will report to the CFO on a quarterly basis, with its final report due no later than March 31, 2011. The quarterly and final reports will be posted timely on the CFO's website. The Audit Committee will also provide quarterly briefings on its findings for the Mayor and the Council