PUBLIC BRIEFING

THE COMPREHENSIVE ANNUAL FINANCIAL REPORT (CAFR) FOR FY 2003

Before the

Committee of the Whole
Council of the District of Columbia

The Honorable Linda W. Cropp, Chairman

February 4, 2004, 10:00 a.m.
Council Chamber

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

Good morning, Chairman Cropp and members of the Committee of the Whole. I am Natwar M. Gandhi, the Chief Financial Officer of the District of Columbia Government. With me are my colleagues, the deputy chief financial officers, whom you know. It is my pleasure to be here today to discuss the District of Columbia's Fiscal Year 2003 Comprehensive Annual Financial Report (CAFR). Once again, this report is submitted on a timely basis, with an unqualified, "clean" opinion from the city's independent auditors, and reflects a balanced budget with a surplus.

Budget Surplus

For the fiscal year ended September 30, 2003, the District is reflecting a surplus in general funds (excluding federal and private sources) of $32 million. This means that from its local source revenues, District expenditures came within 0.7 percent of exactly matching revenue.

This outcome demonstrates that the financial assessments and forecasts our office made were on target. It also demonstrates the great seriousness of purpose exhibited by the Mayor and the Council in taking appropriate action to assure the District finished the year on-budget.

On the expenditure side, I am happy to report that with the prudent use of reserves, no District agency was anti-deficient in FY 2003.

Medicare/Medicaid Write-Offs

This budget surplus would have been larger had it not been necessary to write-off $99 million in Department of Mental Health Medicaid, Medicare, and federal beneficiary receivables from prior years. This write-off is part of our on-going effort to clean up the District's books, eliminating doubtful accounts. As with previous Medicaid write-offs, these are attributable to the inability of the District to adequately document charges in previous years. These write-offs were triggered by the completion in FY 2003 of federal Medicaid/Medicare audits, in some cases going back to FY 1992. Because of the considerable effort being placed on Medicaid recordation systems in all agencies receiving Medicaid funds, I am hopeful that, going forward, we will no longer see write-offs of this magnitude.

Revenue Actuals vs. Estimates

It is imperative that I, as your Chief Financial Officer, be realistically conservative in estimating revenues. In addition to the fiscal prudence required of all cities, a great many factors add to this imperative in the District including:

- the long lead-time between estimates and actual budget execution,
- the tight restrictions on the use of emergency and contingency reserve funds and the substantial difficulty in accessing them should the funds be needed, and
- the requirement that any used funds be repaid to the emergency and contingency reserves in the following fiscal year.

Were I not very careful in estimating revenues, the District could end the year with a deficit, and our hard-earned Home Rule could be imperiled.

In the summer of 2002, I alerted the Mayor and the Council to potential spending increases and a revenue shortfall that jeopardized our capability to execute the

FY 2003 budget as proposed. The Mayor and the Council took the necessary steps to bring the budget back into balance. That new FY 2003 budget was premised on tax and non-tax local revenues (excluding proprietary "O Type" revenues) of $3.626 billion, including $33 million in federal funds. Actual FY 2003 revenues as reported in the CAFR are $3.702 billion, a difference of $76 million or a 2-percent difference from the projection. Were it not for $56 million in one-time revenues that cannot be forecast, this margin would be $20 million, or about ½ of one percent.

A falloff in projected income tax receipts was the cause of our alert to you last year. Events have proven that alert to be correct. In May 2002, we estimated total income tax receipts at $1.340 billion. This amount was revised downward to $1.158 billion in the budget resubmitted to Congress in October 2002. Actual results show income tax revenues of $1.167 billion, a difference of $9 million or about ¾ of 1 percent off the September 2002 estimate. Our objective is to provide you with our best estimate of revenues consistent with maintaining the financial integrity and viability of the District. Attached to my testimony is a chart showing the evolution of our estimates for FY 2003.

The Fund Balance

The Fund Balance in the CAFR is the net difference between the District's assets and liabilities as of the end of the fiscal year. At the General Fund level, the FY 2003 Fund Balance is $ 897.4 million. It is large; however, we cannot look to the Fund Balance as an easy way to solve our financial problems. Of the General Fund Balance, $813.2 million, or 91 percent, is reserved for specific uses, principally $213.2 million for debt service and $253.8 million in congressionally mandated cash reserves. This cash reserve requirement, which totals 7 percent of the operating budget, is among the highest for government jurisdictions nationwide. This leaves $84.2 million, or 9 percent, unreserved and undesignated.

In general, there is little advantage to having an ever-growing Fund Balance, which is why the District requested and Congress approved in the FY 2004 appropriations bill limited access to the Fund Balance with prior congressional approval. In other jurisdictions, unrestricted cash is used in various ways in following years to pay down debt, rebate taxes, or meet necessary, one-time expenditures, not to mention as working capital.

Cash Reserve Requirements in Other Jurisdictions

If I may, I would like to briefly summarize cash reserve requirements elsewhere as a reminder of how noteworthy the District's performance is in this area.

No other major city has a cash reserve requirement except Denver, which is required to have 3 percent of general fund expenditures in a reserve.

Among states, most have some form of cash reserve or "rainy day" fund. Further,

- the approximate average size of these funds is 5 percent of budget;
- 25 states are required to contribute to the reserve fund when there is a budget surplus at the end of a fiscal year, and another 11 states require contributions to the reserve fund when tax receipts or economic growth exceeds certain specified levels;
- most states have no replenishment requirement, but 6 states require the funds to be replenished over the course of 2, 3, or 5 years; and

- in 21 states, the reserve funds can be used when the state faces a deficit for any reason, and in most other states the funds can be used in the event of a revenue shortfall.

As you can see from this information, by comparison the District:

- has an exceptionally strong reserve position, maintaining its rainy day reserves at 7 percent of its operating budget – only one state exceeds it;
- always has reserves in liquid assets, to be easily available;
- has access to these funds only in declared major emergencies or serious revenue contingencies; and
- has an onerous requirement that requires replenishment in the following year.

Cash Perspective

A key point to keep in mind as we study this CAFR is that it presents an accounting picture of our assets and liabilities as of the end of the year. In many respects, our position looks very positive and, compared to many other jurisdictions, it is very good indeed. However, both financial managers and policy makers need to keep in mind that we run on a day-to-day basis in paying our bills – approximately $575 million in cash outflows a month – and, in this regard, cash is king. Cash management is further complicated by the more than $400 million in real property cash payments that are due in the last half of the last month of the fiscal year. We must either carry over large amounts of cash from the prior year or conduct short-term borrowing just to make cash-ends meet under a balanced budget. There are seven requirements that we have to fulfill at all times to prevent the return of the control board. All seven relate to the District being unable to meet its cash obligations.

While I foresee no immediate problem with our cash situation at this time, we need to monitor this area carefully and be very circumspect in taking any action that would reduce the flow of funds or radically alter the pattern by which funds are received.

Grants Administration

In FY 2003, the District spent over $1.6 billion in federal grants, and had approximately $2.4 million, or 0.15 percent, lapse. The comparable lapse figures for FY 2001, just two years ago, were $4.3 million and 0.33 percent, so grant lapse has been cut by almost half during this period. To help reduce lapse even more, the Office of Budget and Planning (OBP) is sending letters to agency staff as grants approach their expiration dates, to remind them to fully expend the funds or seek extension letters. As recent Council hearings have shown, the Office of the City Administrator and my office are working closely to implement additional improvements in the overall grants administration process.

Financial Management Improvements

The District has made great strides in financial management. One of the major improvements is the enactment of a local anti-deficiency law, which is intended to prevent overspending by District agencies by providing sanctions for violators. Another improvement is the implementation of CFO$ource, an online reporting tool that was first introduced in FY 2003. The development of the CFO$ource executive-level “dashboard” takes financial and performance reporting one step further, by providing operational budget, contract, performance, and other management information to agency directors, finance personnel, and executives, so they can more effectively manage their budgets. This capability helps alert agencies to potential overspending so that corrective actions can be taken to avoid deficiencies.

The implementation of performance-based budgeting (PBB) allows us to provide the Mayor and the Council with detailed information on agency budgets by program and activity. In FY 2004, the Phase 2 implementation will bring to 33 the number of District agencies using PBB, and in FY 2005 nearly all District agencies will have completed the transition to PBB. Additionally, the development of a new District-wide budget system based on Hyperion software will allow agencies to accurately formulate, execute, and report on their finances by fund and by PBB structure. It also will allow agencies to report their performance against key result measures.

Final Thoughts

With the issuance of this CAFR, the District has confirmed that the process is now routine, with little concern over its timeliness or securing a clean opinion. The issuance of this CAFR also confirms that the financial infrastructure is rebuilt and functioning well in support of the District's leaders as they make timely decisions. Their dedication to balanced budgets and fiscal responsibility is a national model, and the District is getting recognition for it in the form of a bond rating upgrade to an A- and a positive outlook from the bond rating agencies. This is the first time in 10 years that the District has had such a rating, and we will do everything in our power to protect and further enhance these gains.

But even though we were able to close FY 2003 successfully, and the outlook for 2004 seems steady, I foresee fiscal challenges ahead as we struggle to find remedies to its inherent structural imbalance. The May 2003 General Accounting

Office (GAO) report on the structural imbalance, which confirmed an imbalance of between $470 million and $1.143 billion, makes it clear that we must guard our tax base closely.

The District's structural imbalance includes a prohibition on taxing federal real property, which comprises 42 percent of the District's property value, and other non-municipal tax-exempt property, such as universities, which comprise an additional 11 percent. Further constraining the District's tax base are restrictions on taxing income at source, which means that the District can tax just 34 percent of the income earned within its borders. The District also provides state-like functions such as human services, mental health, and higher education estimated at $500 million annually.

Thank You/Congratulations

Now, I want to take this opportunity to thank the many employees, from financial and program areas, who have worked so long and so hard to ensure both 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, deputy chief financial officer for the Office of Financial Operations and Systems, and his staff for their hard work and dedication. I would also like to recognize and thank the rest of my senior management team and their staff: Bert Molina, Dr. Julia Friedman, Anthony Calhoun, Phil Brand, Barbara Jumper, Henry Mosley, Deloras Shepherd, Pamela Graham, Steward Beckham, and John Musso. The District owes them its thanks.

I also want to thank the accounting firm of KPMG, whose highly professional staff worked equally long and hard during the past few months to successfully complete this audit. In particular, I want to commend Karyn Molnar and Jack Reagan for their efforts.

Let me also extend my deepest thanks to the Mayor; to you, Mrs. Cropp; to Mr. Evans; to the Council; and to the Inspector General 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 CAFR.

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

Comparison of Certified Revenues to Actual Revenues

(Dollars in Millions)

	Estimate[1]
May 2002 Revenue Certification	3,621.0
Federal Project Funds	33.0
May Revenue Enhancements, Adopted	130.2
Total	3,784.2
Revision to Revenue Estimate	(285.2)
September 2002 Revenue Certification	3,499.0
September Revenue Enhancements, Adopted	126.9
Total	3,625.9
Actual Revenue	3,702.3
Actual Revenue Compared to September 2002 Certification	**76.4**
Actual Revenue from One-Time Sources[2]	55.8
Actual-to-Certification Comparsion Excluding One-Time Revenues	**20.6**

Note 1: Revenue comparison provided for general fund revenues, plus the original federal project fund estimate and excluding O-type revenues.

Note 2: One-time sources include funding from the Washington Center on Aging and the MCI Arena Bond Fund, among other sources.