

**HEARING**

**On**

**STABILITY THROUGH SCANDAL: A REVIEW OF THE OFFICE OF  
THE CHIEF FINANCIAL OFFICER**

**Before the**

**Subcommittee on Oversight of Government Management, the Federal  
Workforce and the District of Columbia  
Committee on Homeland Security and Governmental Affairs  
U.S. Senate**

**The Honorable Daniel K. Akaka, Chairman**

**March 31, 2009, 10:00 a.m.  
Room 342, Dirksen Senate Office Building**



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

Good morning, Chairman Akaka, Senator Voinovich and members of the subcommittee. I am Natwar M. Gandhi, Chief Financial Officer for the District of Columbia. I am here to offer remarks about the progress the OCFO has made in financial management; how we respond to outside entities' recommendations; financial management challenges in the years ahead; and interagency cooperation with the Mayor's office and the Office of the Inspector General (OIG) to achieve efficiency and improve accountability.

### **Progress and Stability in Financial Management**

Mr. Chairman, since Congress created the independent CFO to work with the Mayor and the Council in 1995, the District has completed 12 consecutive balanced budgets, turned a cumulative \$550 million deficit into an impressive \$1.2 billion fund balance, and received a string of clean audit opinions from external auditors, and transformed a municipality with junk bond ratings into a financially credible jurisdiction with strong ratings.

Attachment 1 to my testimony is a chart showing a history of the annual budgetary surpluses and total General Fund balance since 1992. It tells the story of the District's successful return to fiscal solvency during the Control Board period, and later to a sound financial position evidenced by a General Fund balance of more than a billion dollars.

This turnaround did not happen accidentally, but rather it is a case study in a commitment to improve financial management and practices. Our General Obligation (GO) bond ratings have increased steadily, at what the rating agencies tell us was nearly unprecedented speed. They now stand at the A+ and A1 levels from all three rating agencies. These ratings are a clear indication to investors in

our bonds that the District of Columbia has indeed returned to a position of fiscal strength.

In addition, as you know, we were recently assigned ratings of AAA from Standard & Poor's and AA from Moody's Investors Service and Fitch Ratings on our inaugural issuance of Income Tax Secured Revenue Bonds. Had we not been carrying the strong A+/A1 GO ratings, it is questionable as to whether we would have been able to achieve the gilt-edged AAA rating from S&P, and the AA ratings from the other two agencies. These ratings enabled these bonds to be sold at such favorable interest rates that we expect the use of these bonds instead of GO bonds will lower the cost of borrowing by \$28 million over four years.

A significant area of financial improvement has been in the management of the debt burden. The Home Rule Act controls our GO borrowing by limiting GO debt service to 17 percent of revenues. However, bond rating agencies judge a municipality's creditworthiness by the amount of all its tax-supported debt, not just GO debt. Because bond rating agencies consider a tax-supported debt ratio in the 10-12 percent range to be high, in June 2007, I recommended to the Mayor and the Council that a hard cap of 12 percent be put into law. District law now contains this 12 percent cap, and the borrowing program in the Mayor's proposed FY 2010 budget and financial plan would stay within the new cap. Attachment 2 shows the District's debt burden since 1992.

### **Response to Tax Fraud**

On the morning of November 7, 2007 federal agents arrested two employees of the Office of Tax and Revenue (OTR); each was charged with ten felony counts of conspiracy and fraud. The employees worked in the division responsible for



issuing property tax refunds, an area that had not yet been upgraded to an automated system. The scheme involved persons both internal and external to OTR. These individuals were alleged to have conspired to defraud the District government through creating fraudulent real property tax adjustment refunds and directing them to “dummy” corporations. Inconsistent with best practices, these refunds were approved only by the manager of the tax office unit where they were initiated, regardless of the size of the check. This practice dated to the late 1980s and was in direct violation of directives.

This criminal enterprise was able to thrive over 20 years because of a failure of management oversight and internal controls at OTR. Not only were the correct processes not followed, but managers and others were not alert to behavior that might have provided signs of wrongdoing – such as overt displays of wealth and extravagant gift-giving. Internal controls rest on three legs – people, processes, and systems. We had to focus immediately on all three legs to ensure that no further fraud could be perpetrated.

Immediately following the discovery of the fraud:

- We strengthened both the automated and manual controls over the refund process at all levels.
- We removed the previous tax office management under whose supervision the fraud occurred.
- We removed employees who benefited from the fraud and failed to report suspicious activities.
- We established an independent audit committee comprised of distinguished professionals to provide financial advice and review the financial management and internal controls of the OCFO.

- We hired Stephen Cordi, a distinguished tax administrator, as Deputy Chief Financial Officer for the OTR, as well as other experienced and capable managers to oversee OTR's Real Property Tax and Revenue Accounting Administrations. Steve Cordi has been with us for over a year now, and has made significant progress in instituting change in OTR.

The District's independent auditors, BDO Seidman, LLP delayed the release of the Comprehensive Annual Financial Report (CAFR) for Fiscal Year 2007 in order to allow additional time to review internal controls and determine the areas of weakness that allowed the tax fraud to occur. In the audit released March 31, 2008, the auditors gave us a "clean" audit opinion, but they found the manual refund process in OTR to be a material weakness. These findings were helpful in guiding our actions over the past year to improve internal controls. In the just-released CAFR for FY 2008, BDO Seidman reduced the severity of the finding on OTR from "material weakness" to "significant deficiency," and again gave us a "clean" audit opinion. Further, we continue to improve that record in FY 2009.

Other outside parties also reviewed the processes at the tax office. The Council of the District of Columbia authorized the WilmerHale law firm to conduct a special investigation of the real property tax fraud. WilmerHale, with the assistance of PricewaterhouseCoopers, conducted a year-long investigation into this matter. Both organizations donated their services on a pro bono basis to the District. The results of this inquiry are contained in a Report of Investigation that was released on December 15, 2008, and we are working diligently to fully implement its recommendations. In collaboration with our independent audit committee, we have engaged the services of Deloitte Financial Advisory Services to assist us in completing this work.



In sum, notwithstanding the difficulties we faced in the wake of the tax fraud, we emerged from this episode as a stronger and more resilient organization. We are maintaining our vigilant efforts to improve our internal controls and financial management review processes. One important measure of the strength of the District's financial operations is the esteem with which we are held on Wall Street – not only did we not suffer a downgrade of our bond issues, but Standard & Poor's gave our recent income tax revenue bond issue a AAA rating, the highest in the District's history. Finally, I strongly believe that our success in crisis management, reflected in the significant improvements we have made to our internal controls and financial management, is as important as the crisis itself.

#### **OCFO Relations with Auditors and OCFO Efforts with Mayor's Office and OIG to Achieve Efficiency and Improve Accountability**

As demonstrated by our response to the tax fraud, we welcome the review by outside entities of our policies and practices, and we take their recommendations seriously.

#### *Government Accountability Office (GAO)*

Only two weeks ago, my staff and I met with representatives of the GAO regarding how we will track and report the District's participation in the federal Stimulus Plan. The District has been chosen by GAO along with 16 states they will track as to how the stimulus funds are being used. We will work closely with them to ensure that they are receiving complete and accurate reporting on the way funds are spent. In order to facilitate the accountability for and transparency in financial reporting of the stimulus funds, we have established special stimulus budget and accounting codes to track the use of these funds.

### *External auditors*

Each year the OIG contracts with an external auditor to audit the District's financial statements and internal controls. The annual Independent Auditors' Report on Internal Control over Financial Reporting and on Compliance and Other Matters, commonly known as the "Yellow Book," contains detailed analyses of areas of financial management that need improvement, both within the OCFO and in various agencies of the District government such as the Medicaid program. Attachment 3 shows the history of the findings in these Yellow Book reports.

The FY 2006 report highlighted the DCPS as a material weakness. In response, we worked with the school administration to take remedial action. We assembled a multi-agency task force to focus on deficiencies found in human resources, procurement, and Medicaid cost reporting within DCPS. DCPS remained a material weakness in FY 2007 because of additional findings, but the severity was reduced to significant deficiency in the FY 2008 report.

In FY 2007 the number of material weaknesses and significant deficiencies increased to three material weaknesses and six significant deficiencies, as a result of the additional review of the tax fraud as well as more stringent auditing standards that were being instituted nationwide. In the just-released CAFR for FY 2008, the number of findings was reduced to two material weaknesses and four significant deficiencies. An audit today would find one of the material weaknesses (Treasury functions) eliminated.

We are committed to reducing the number of findings in the FY 2008 Yellow Book by correcting our practices in those areas. Some areas identified in the FY

2008 report are currently being fixed, while other problem areas may take additional time to address completely. We will continue to work with the City Administrator's office and agency directors, the OIG, and our independent auditors to identify reasonable approaches to each problem, and see that they are implemented effectively.

#### *The Office of the Inspector General (OIG)*

We work closely with the Inspector General. The contract for the annual audit of the CAFR is managed by IG, so we work closely with his office on that process all year long. The various IG audits and reports have findings and recommendations that pertain to the executive or our office or both. We take each finding and recommendation that pertains to our office very seriously, respond fully, and if we concur with the recommendation we implement corrective action.

#### **OCFO Internal Reviews and Permanent Improvements in Controls**

We value the perspectives of external entities, but we have never waited for their reviews to make improvements. When I joined the District government in 1997 I established an internal audit function at the tax office. That function was expanded to cover all of the OCFO when I became CFO in 2000. Over the years we have instituted improvements such as:

- Background checks of all new employees,
- Integrity probes of the various OCFO operating areas,
- A comprehensive written code of conduct, and
- The elimination of "dummy accounts" in the integrated tax system.

These improvements have all served the District well, and I am proud of them. But the uncovering of the tax fraud in 2007, as painful as it was, led us to make deeper



improvements. In December 2007, I established the OCFO Audit Committee to Review Financial Management and Internal Controls to advise us on how to strengthen our organization's internal controls and financial management, especially in light of the fraud. The Committee is composed of leading figures in accounting, public finance and the law. The Committee, which met regularly throughout FY 2008, is chaired by Sheldon Cohen, former Commissioner of the U.S. Internal Revenue Service.

During 2008, the internal controls of two areas of the OCFO – the tax office and the treasurer's office – were reviewed by outside firms that generously provided their services on a pro bono basis. Kroll Associates reviewed the tax office, and Deloitte Financial Advisory Services and Ernst & Young facilitated a fraud risk assessment of specific business processes within the Office of Finance and Treasury. The assessments in both these areas were important proactive steps in enhancing and promoting a culture of fraud prevention, detection, and deterrence and should serve as a model for use throughout the District.

As mentioned earlier, in 2008, we engaged the services of Deloitte Financial Advisory Services to assist us in completing this work. So far we have:

- Conducted OCFO-wide risk assessments, and based on those findings are drilling down to address potential exposures within the OCFO divisions, including the tax office, the treasurer's office, and the comptroller's office.
- Made significant progress in the development, implementation, and documentation of an internal controls system that is consistent with OMB Circular 123/Sarbanes Oxley.
- Established the position of Chief Risk Officer within the OCFO and are actively recruiting to fill it. See our organization chart in Attachment 4,

including this position, which reports directly to me and is responsible for identifying, reporting and mitigating risks throughout the OCFO agency.

- Enhanced the existing integrated tax system (ITS) to strengthen internal controls by limiting user profiles and appropriately segregating duties, and
- Assigned four of our internal auditors to conduct audits on-site in the tax office.

In addition:

- We are gathering the requirements for the procurement of both a new ITS and Real Property Tax System that will automate manual processes, provide greater security, and further guard against fraud, and
- We are changing the work environment throughout the agency through:
  - Promoting a culture that has “zero tolerance” for fraud and misconduct,
  - Enhancing integrity/accountability training,
  - Instituting periodic background investigations for all employees,
  - Establishing a 24-hour hotline operated by an independent third party so that employees may report fraud and mismanagement without fear of retribution,
  - Conducting periodic surprise cash-counts at our various locations where our cashiers conduct transactions, and
  - Increasing communication and coordination between administrations.

While we have made significant progress in these areas, much work remains. The OCFO has committed its full attention and available resources to successfully completing this most important project.

## **Financial Management Challenges in the Years Ahead**

You have also asked that we address the District's projected revenue shortfalls, and the steps the OCFO plans to take to address those challenges. Like most other states, the District of Columbia has felt the effects of the current recession in the form of falling revenues. Certainly the biggest challenge facing the District today is the drop in projected revenues. Attachment 5 shows the dramatic reduction in the revenue estimates since last June.

As you know, the primary tool that the OCFO has to ensure balanced fiscal operations is to provide conservative revenue estimates. Over the years, this has proved to be key to protecting the District's hard-earned financial recovery. I will continue to exercise sound, well researched and conservative revenue estimating policies in order to retain our solid financial standing throughout this very challenging economic period.

The economic outlook for the District of Columbia has changed dramatically from that of a year ago when the previous budget was submitted to the Council. The current forecasts assume that economic conditions will continue to deteriorate as employment and wages edge downward, commercial property vacancies rise, real property transfers slow further, and construction projects are delayed. Even with this grim outlook, we are in relatively better fiscal shape than other states and cities that are projecting deficits into the billions.

On the negative side, a significant portion of our population is not well educated or trained to fill jobs in the growing employment areas and the services they will need and that we must provide will continue to tax our resources at increasing levels. On the plus side, we are fortunate to be a center for three growth areas –



government, education and health. And, even though our revenues are shrinking, the diversity of our tax base will help us to pull through these times in better shape than many other states and localities.

The Mayor has taken the opportunity of the current economic crisis to re-think how the government does business. In previous years, the District looked for ways to spend rising revenues creatively and effectively. This year the job is to provide the services our people need at the levels of quality they have come to expect. Mayor Fenty and City Administrator Tangherlini should be commended for their work to produce a balanced, workable budget and financial plan that bends the curve.

In addition, we have maintained a “rainy day fund” – the emergency and contingency cash reserves -- of at least \$360 million throughout the four year plan. And in our capital budget, we have been prudent in our borrowing by observing our debt cap limits.

Looking ahead, we must continue the sound fiscal policies that have produced balanced budgets that provide quality services to all of our people. I am often accused of being overly pessimistic, but at this time I believe that the record we have established gives us the right to be optimistic that we will come through this period with a record of responsibility and service that will be a point of pride for all of us.

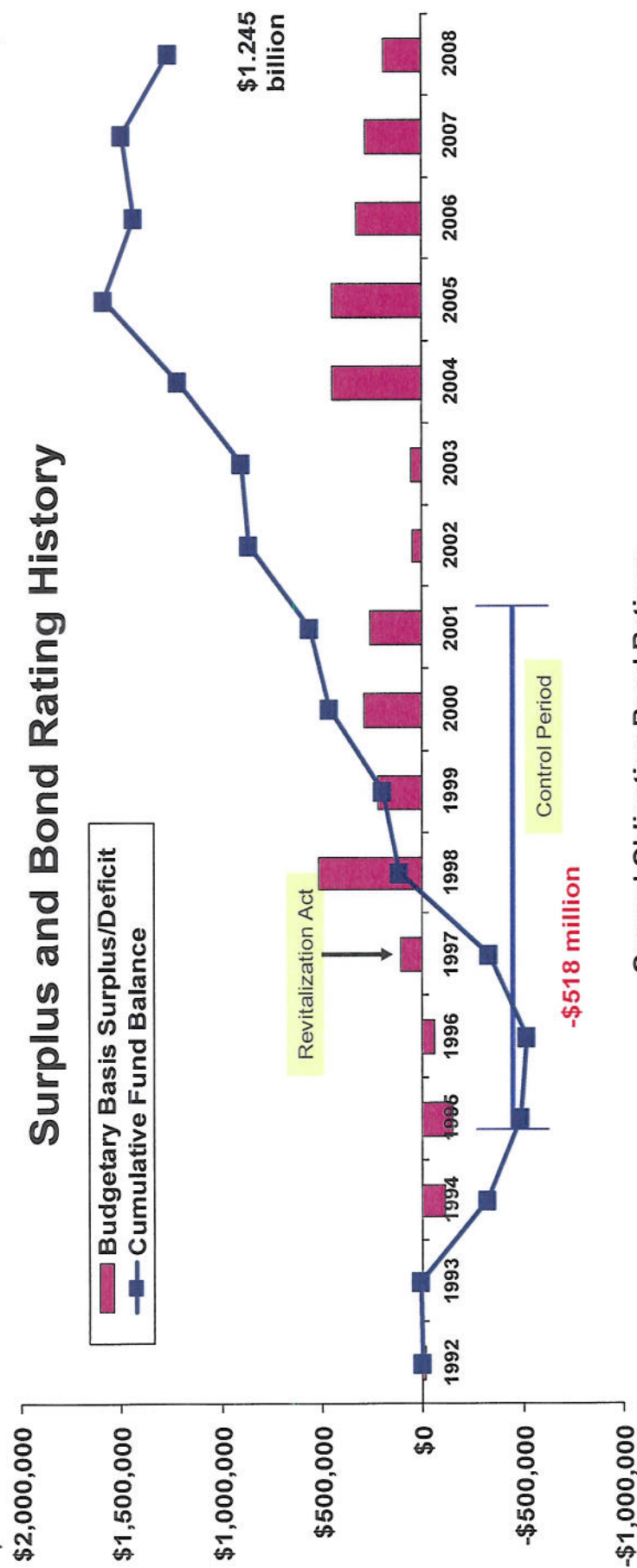
## **Conclusion**

In summary, the District has accomplished much – some might even say miracles - - in the last decade, its fiscal condition is sound, and the elected leadership possesses a steadfast commitment to fiscal responsibility that has become widely

recognized. I assure you that the District will continue to balance its budgets and that the OCFO will strive to follow 'best practices' in all areas of financial management and practice. We will continue to seek ways to do the business of government better, smarter and more efficiently than any jurisdiction in the country. It is what all citizens should expect of their governments, and certainly what we expect of our Nation's Capital.

This concludes my remarks and I will be happy to answer any questions you may have.

## District of Columbia Surplus and Bond Rating History



## General Obligation Bond Ratings

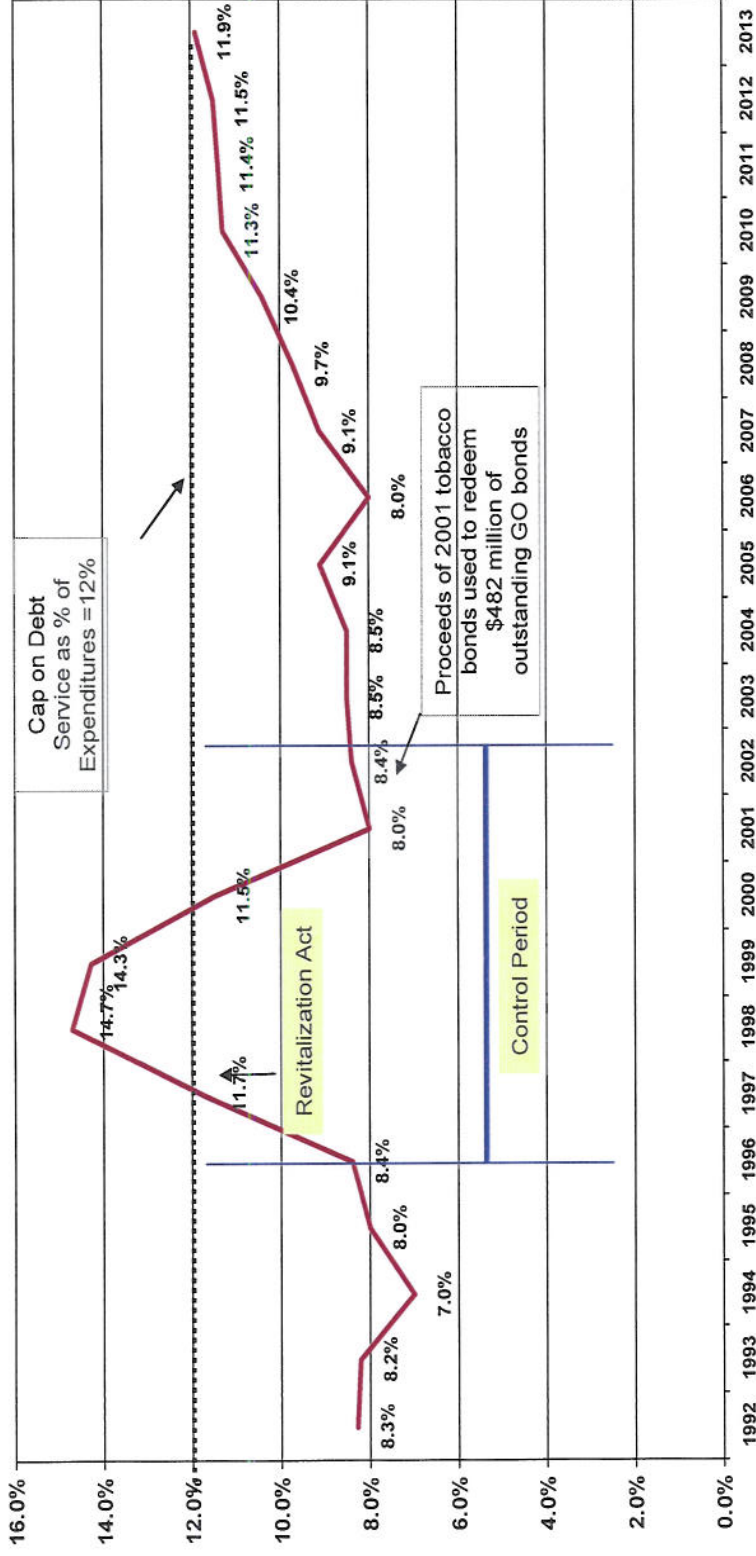
	S&P:	A-	A-	BBB-	B	Ba2	BB	BBB	BBB+	BBB+	A-	A2	A+	A+
Moody's:	Baa	Baa	Baa	Ba	Ba	Ba2	Ba1	Ba1	Baa3	Baa3	Baa1	A2	A2	A1
Fitch:	A-	BBB+	BB	BB	BB	BB	BB+	BB+	BBB	BBB+	A-	A-	A	A+

2009 Income Tax Secured Revenue Bonds:	S&P: AAA	Moody's: Aa	Fitch: AA
--	----------	-------------	-----------



# Debt Burden

Debt Service as % of Expenditures  
(as of September 30 of each fiscal year)



## YELLOW BOOK FINDINGS FY 2001 - FY 2008

	<b>Material Weaknesses</b>	<b>Reportable Conditions/Significant Deficiencies*</b>
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	<b>NONE</b>	Unemployment Comp Claimant File Mgmt Management of Disability Comp Program
FY 2005	<b>NONE</b>	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
FY 2008	Treasury Functions Management of the Medicaid Program	Compensation Office of Tax and Revenue District of Columbia Public Schools Management of the Postretirement Health and Life Insurance Trust

\* "Significant Deficiency" used starting FY 2007

**Material Weakness****Reportable Condition/Significant Deficiency**

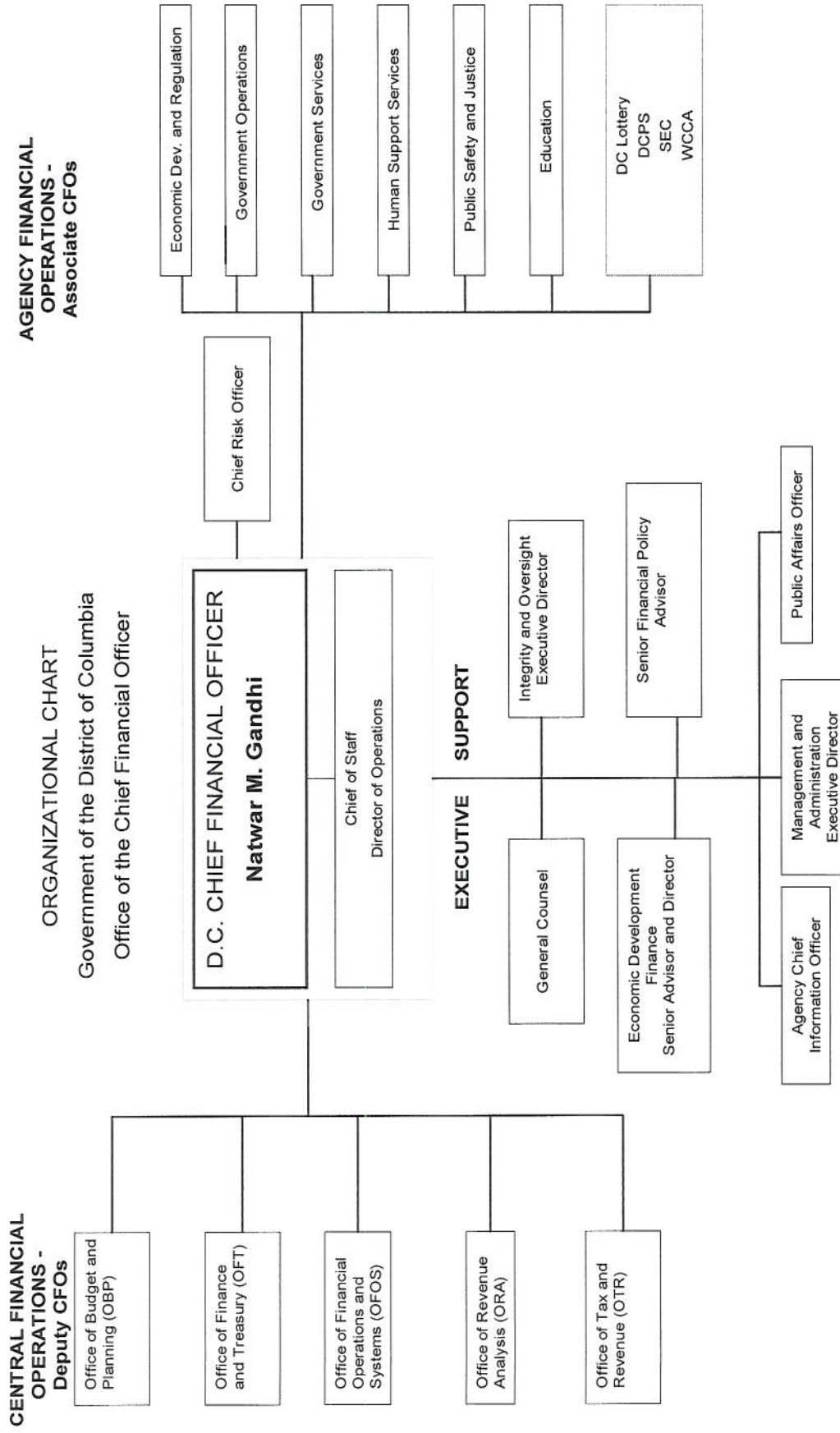
Medicaid FY 2001, FY 2002, FY 2003, FY 2007, FY 2008

DCPS FY 2001, FY 2006, FY 2007

FY 2008

Compensation

FY 2001, FY 2002, FY 2003, FY 2007, FY 2008





# Revenue Estimates for FY 2009 – 2013

Revenue Estimates: Original and Revised

Local Source, General Fund Revenue Estimate (\$ millions)	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
<b>1 Revenue estimate included in June budget (Original)</b>	<b>5,562.9</b>	<b>5,831.7</b>	<b>6,099.2</b>	<b>6,402.5</b>	
2 Change in the estimate (September 2008)	(130.7)	(151.9)	(148.5)	(162.3)	
<b>3 Revenue estimate of September 2008</b>	<b>5,432.2</b>	<b>5,679.7</b>	<b>5,950.7</b>	<b>6,240.2</b>	
4 Change in the estimate December 2008)	(127.1)	(303.8)	(330.4)	(327.5)	
<b>5 Revenue estimate of December 2008</b>	<b>5,305.1</b>	<b>5,375.9</b>	<b>5,620.3</b>	<b>5,912.7</b>	<b>6,216.9</b>
6 Change in the estimate (February 2009)	(135.7)	(346.3)	(488.3)	(613.8)	(676.9)
<b>7 Revenue estimate of February 2009</b>	<b>5,169.4</b>	<b>5,029.5</b>	<b>5,132.0</b>	<b>5,298.8</b>	<b>5,540.0</b>
8 Dollar Change in General Fund revenues compared to prior year		-139.9	102.4	166.9	241.2
9 Percent Change in General Fund revenue compared to prior year		-2.7%	2.0%	3.3%	4.6%
10 Change in the estimate since June budget	(393.5)	(802.1)	(967.3)	(1,103.7)	n/a
11 Loss sustained compared to June budget	-7.1%	-13.8%	-15.9%	-17.2%	n/a