

Financial Management of the City

Managing the City's finances involves both a strategic and operational component.

Strategically, the finances must be managed to accommodate fluctuations in the economy and the resultant changes in revenues and costs.

Operationally, the City must put in place clear financial goals, policies, and tools to implement the strategic direction.

The Mayor ultimately directs all of Boston's financial operations. The Mayor is the chief executive officer of the City and has general supervision of and control over the City's boards, commissions, officers, and departments.

Mayor Menino established a cabinet form of government to recognize the major functional responsibilities of City government and to facilitate improvements in the conduct of the executive and administrative business of the City.

The following six departments, which are included in the Chief Financial Officer's Cabinet, have major roles in the financial management of the City.

- The Treasury Department collects revenues due to the City and pays all amounts due for payrolls and to outside vendors. The Treasury Department also manages the investment of City funds and supervises City borrowings.
- The Auditing Department maintains internal controls, manages grant funds, provides financial reports, keeps the financial records for the City and approves all payments made by the City.
- The Assessing Department supervises the valuation, for tax levy purposes, of all real and personal property located in the City.
- The Office of Budget Management, in addition to overseeing the operating budget, also prepares and monitors the City's capital plan and coordinates the long-range capital

planning activities of City and School Departments.

- The Purchasing Department procures all supplies, materials, and equipment for the City.
- The Retirement Board oversees the City's retirement system.

STRATEGIC FINANCIAL MANAGEMENT

Maintaining a healthy financial base that fully supports City services according to mayoral priorities requires constant vigilance. This work is reflected in restructuring and reshaping City services, new financial management systems, efforts to secure sound recurring revenues, responsible spending adjustments in light of revenue growth limitations and a balanced budget.

A balanced budget is required by Massachusetts General Laws Chapter 59, Section 23. As part of the State Department of Revenue's tax rate certification process municipalities must balance all appropriations, fixed costs and prior year deficits with the approved property tax levy, estimated local revenues, and available prior year surpluses in order to obtain authorization to issue property tax bills.

The overall success in the City's adherence to its financial policies and the City's image in the capital markets have contributed to steady bond rating upgrades. In January 2006, Moody's Investors Service, FitchRatings and Standard & Poor's Rating Services affirmed the City's credit ratings of Aa1, AA and AA, respectively. The City's strong proactive management has clearly been recognized by the credit markets.

Maximizing Return on Investment

The City's administration works to maximize service delivery provided per dollar of revenue by constantly reassessing the management organization and distribution of financial resources toward priority goals that maximize

return. The Office of Budget Management (OBM) informs financial decisions made through service-based budgeting and objective assessments of cost efficiencies and service delivery in certain areas.

Ongoing investment in the city's resources – people, property and systems, is key to guaranteeing solid service delivery for the future. Capital investments weigh changing service needs with the need for adequate building maintenance and upgrades. Human resource training has included specialized management training and a performance appraisal system.

The City's technology needs are continually assessed and updated on an ongoing basis. An upgrade to the City's Human Capital Asset System will change the way employees interact with City government by introducing a self service component. An enterprise-wide on-line permitting system will be launched in FY07, significantly improving customer service delivery by automating workflow and streamlining processes. The City's website will also be revamped this year, using the latest design trends and best practices in eGovernment.

Diversifying the City's Revenue Stream

Eighty percent of total general fund revenue comes from just two sources, the property tax and state aid from the Commonwealth. Both of these revenues are strictly controlled by state law. Therefore, the City remains alert to the possibility of diversifying its revenues base while more closely matching revenues with its economic strengths.

The Mayor continues to steer municipal revenue development through legislation, seeking additional local option revenue sources and a level utility playing field by removing an outdated property tax exemption.

Specifically, the Mayor has filed legislation in recent years to close property tax loopholes that allow private businesses on tax exempt land to avoid taxes and that allow exemptions for certain equipment or corporate structures in the telecommunications industry. These exemptions have the effect of shifting tax burden to other businesses and residents.

In addition, the Mayor filed legislation to enact a 1% local option tax on prepared food and beverages sold in municipalities on top of the 5%

state tax already in place. A meals tax is a good fit for what has become a strong tourist and travel economy in Boston. It would provide revenue growth at a nominal rate without placing a heavy burden on residents, tourists or travelers as the total rate of taxation would continue to remain the lowest of any major city. Revenue from this tax would also increase along with the related costs the City incurs when large public events held in the City.

At the same time, the Mayor has filed legislation to enact a local option tax on parking in commercial parking lots. The City, like other regional employment centers, expends considerable resources on traffic control and street maintenance in support of this employment. But unlike other cities, Boston does not have any taxing authority to recover those costs.

INTERNAL MANAGEMENT CONTROLS

The City has established a system of internal management controls to effectively manage its financial operations. These controls are designed to maximize revenue collections, manage operating and capital spending, evaluate infrastructure needs, and formalize the City's internal procedures. Major components of the City's system of financial management controls are discussed in the following paragraphs.

Capital Planning

The Office of Budget Management's Capital Budgeting Program (CBP) is responsible for managing the capital budget of the City. It oversees infrastructure investment, resulting in the protection and preservation of the City's capital assets. CBP's mission is to evaluate the condition of the City's capital stock, forecast the timing and financial requirements of new construction and rehabilitation, and recommend allocation of current and future resources to meet the City's infrastructure and capital requirements. Resource availability and capital needs are assessed frequently and appropriate planning responses are taken. CBP evaluates and refines the relationship between the City's capital needs and resources as the City moves through each fiscal year. This process is documented by an annually updated five-year capital plan.

In addition to its planning functions, CBP also plays an ongoing project oversight and supervisory role during the implementation phase of its capital projects. CBP reviews and approves all capital contracts and monitors project costs and schedules to ensure the adequacy of available funding sources.

Program-Based Budgeting and Assessments

The City of Boston uses a program-based budgeting system to track expenditures and service levels by major functions or programs. This budgeting system complies with the standards of the Government Finance Officers Association, which has consistently recognized the City's efforts with its Distinguished Budget Presentation Award.

The City has built on this base of budget and performance information to design a system of departmental accountability for service outcomes, making sure services are delivered at the level expected, with a focus on customer satisfaction and service efficiency. The Office of Budget Management (OBM) plays a central role in the collection and analysis of performance data, ensures proper documentation of results, and assists departments in pursuing opportunities for improvements. All financial commitments by departments are first reviewed by OBM for conformance with service priorities and funding availability. The City plans to improve its management tracking system, "Boston About Results" in FY07, further integrating budget and performance metrics into a unified system to effectively measure performance.

Debt Management

The Treasury Department manages all City borrowings. The City's cash flow is carefully managed and anchored by quarterly billing of the property tax and quarterly receipt of state aid distributions, eliminating the need for short-term borrowings. Guidelines established by the Treasury set forth the City's management policies toward rapidity of debt repayment, debt affordability, the limitation on the level of variable rate debt the City will issue, and the target savings amount on debt to be refinanced.

Two mainstays of the City's positive debt service position have been the relative stability of the annual debt cost to remain below 7% of total

general fund expenditures and adherence to rapid debt retirement ensuring that at least 40 percent of outstanding principal be retired in five years, and 70 percent in ten years.

Other factors have contributed to this favorable debt position in the recent past. The City has taken maximum advantage of the low interest rate environment and has refunded close to \$452 million since FY01 for a net present value savings of \$26.2 million. The City also utilizes lease-purchase financing of equipment with a two to seven year useful life. Annual lease-purchase financing has totaled \$7 to \$10 million for vehicles, computers, and lighter equipment.

Pension Management

As required by law, the State-Boston Retirement System (SBRS), of which the City is the largest member, performs a full valuation at least once every three years. The valuation is used to determine the total system liability and the annual funding requirement. The SBRS hires an investment manager who oversees the various fund managers of the SBRS pension assets. The long-term investment performance of the SBRS has exceeded the long-term investment assumption of 8% upon which the funding schedule is partly based, recording an average annualized return from January 1, 1985 through December 31, 2004 of 10.30%. Its intermediate five-year (ending in 2004) average annualized return was 3.09% and short-term (2004 only) return was 12.01%. In 2004 the composite rate of return for all Massachusetts' public pension funds was 13.53%. Over the years, the City has worked with the SBRS to maintain a conservative and responsible pension-funding schedule. This has included maintaining a conservative investment rate of return assumption and a funding schedule that fully funds the system several years earlier than the statute requires.

Other Post Employment Benefits (OPEB)

In June 2004, GASB issued Statement No. 45., *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This Statement establishes standards for measurement, recognition, and display of Other Postemployment Benefits (OPEB). OPEB includes postemployment healthcare, as well as other forms of postemployment benefits such as life insurance. The City will be required to

implement the provisions of Statement No. 45 for the fiscal year ending June 30, 2008. The City currently provides postemployment healthcare and life insurance benefits to eligible employees in accordance with state law and pays its share of the cost of such benefits on a pay-as-you go basis. The City has begun the process of determining its unfunded actuarial accrued liability with respect to future post-employment benefit obligations.

Risk Management

The City of Boston's Risk Management Program focuses on a planned strategy of self-insurance supported by strong prevention and cost reduction efforts, financial reserves and catastrophic insurance. The Office of Budget Management works to maximize the effectiveness of this intradepartmental effort by reviewing citywide risk costs, assisting risk management efforts, and implementing a citywide risk financing strategy.

Following is further discussion of certain types of losses and how they are managed:

- The Office of Human Resources (OHR) manages healthcare costs through competitive bidding and annual negotiations of benefits with HMO healthcare plans, and a self-insured indemnity plan. As discussed further in the Summary Budget section, the average annual per-employee cost increase for health insurance has exceeded over 10% for the past five years, for a total projected city cost exceeding \$235 million in FY07.
- The Office of Human Resources and the Police and Fire Departments manage citywide employee injury costs, which total over \$50 million per year. Specific efforts continue in the Fire department to contain injury costs which represent approximately 40% of the citywide total.
- The City's low liability claims costs average between \$3 million and \$7 million annually. Managed by the City's Law Department, legal claims are limited by MGL Chapter 258, which caps the City's liability for most claims.
- Unexpected losses to physical city property have been minimal, and are managed by individual operating departments.

Because the City's risk financing program stresses departmental accountability, typical risk costs for injuries, legal claims and property losses are

funded by individual departments. Citywide funds protect department budgets against unusually high claims. The City budget in turn, is protected through a risk retention reserve, that will reach an \$11.1 million balance in 2006, and catastrophic property insurance coverage that covers property losses which exceed a \$10 million retention.

Property Tax Collections

The City's aggressive enforcement program continues to reduce the number of tax accounts that are delinquent and to discourage new delinquencies. The City achieved a property tax collection rate of 98.8% of the FY05 gross levy as of June 30, 2005. The City's program includes a variety of collection remedies authorized by state statute such as including past due amounts on tax bills.

The Taxpayer Referral and Assistance Center provides "one-stop" service to Boston taxpayers on tax-related matters. An on-line bill payment option is offered for taxpayer convenience. Parcel-specific information as well as payment history is also available on-line.

Expenditure Controls

In addition to the management systems described above, the City operates under several statutory financial control systems. Certain controls established in the 1982 Funding Loan Act and its 1986 amendments set limits on flexibility in financial administration. Under the 1982 Funding Loan Act, for example, until April 15 of each year, the Mayor is authorized to reallocate no more than \$3 million.

Several other financial controls were enacted by state law and implemented during the 1980s. An expenditure allotment system prevents departmental overspending of personnel appropriations. Additional state law provisions are directed at the control of School Department spending. These controls, teamed with conservative and cautious estimates of annual revenue, have aided the City in avoiding operating budget deficits every year since FY85, and have aided the School Department in avoiding operating budget deficits every year since FY90.

Reserve Fund

As required by law since 1986, the City has been maintaining a reserve fund equal to 2 1/2% of the preceding year's appropriations for all City departments except the School Department. The fund may be applied to extraordinary and unforeseen expenditures after June 1 in any fiscal year with the approval of the Mayor and the City Council. To date, this budgetary reserve has not been utilized. As of June 30, 2005, the reserve fund had a balance of \$22.6 million. The City fulfilled the FY06 Tregor Reserve requirement by adding \$1.1 million to the reserve before the close of FY05. The City expects to fulfill any FY07 requirement prior to the close of FY06.

Accounting System

Financial management is supported through the City's PeopleSoft System. This integrated financial and human resources management system is designed to track and control daily activities and report the financial position of the City. This system supports the rigorous monitoring and reporting requirements enforced by the City.

Management Letters

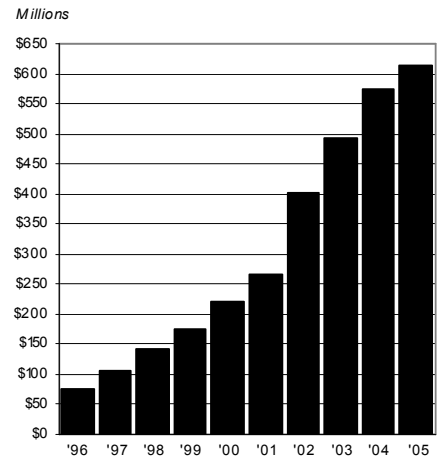
Following the completion of the financial statements, the City's independent auditors deliver a management letter containing comments and recommendations on internal financial controls. The current management letter indicated no material weaknesses in the City's management. Specific management improvements have been recommended in the management letters, and many of the controls that the City has implemented originated from the auditors' recommendations.

Contracting Procedures

The Uniform Procurement Act, Massachusetts General Laws Chapter 30B, enacted by the Commonwealth in 1990 (the UPA), creates uniform procedures for the contracting of services and supplies by all municipalities in the Commonwealth. The City has implemented internal processes to conform its contracting procedures to the requirements of the UPA.

General Fund Equity

The City's management of its finances has resulted in a continuing upward trend in general fund equity. This trend was interrupted by merger of the City's two public hospitals with a private



General Fund Equity (GAAP Basis)
FY96-FY05

Figure 1

hospital to form a new private entity in 1996. This improved the City's future financial outlook by shielding the City from the likely growth in hospital subsidies that would have been required without the merger. (Figure 1)

General Fund equities for FY02 through FY04 appear artificially high as compared to prior years due to the required implementation of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*. GASB No. 34 fundamentally changed the treatment of liabilities and receivables in the General Fund.

It is expected that the actual results at the close of FY06 will not add significantly to the upward trend in general fund equity that the City has experienced since FY96. The City hopes to preserve its policy of maintaining a GAAP Undesignated Fund Balance in the General Fund that is 10% or higher than the current fiscal year's GAAP General Fund Operating Expenditures, while maintaining a Budgetary Undesignated Fund Balance between 5% and 10% of Budgetary Operating Expenses.

Auditing and Budgeting Practices

The City prepares its comprehensive financial reports in accordance with generally accepted accounting principles (GAAP). However, accounting practices established by the Commonwealth's Department of Revenue, the so-

called budgetary basis method of accounting, are used in the annual general fund budget and property tax certification process. Budgetary basis departs from GAAP in the following ways:

- (a) Real and personal property taxes are recorded as revenue when levied (budgetary), as opposed to when susceptible to accrual (GAAP).
- (b) Encumbrances and continuing appropriations are recorded as the equivalent of expenditures (budgetary), as opposed to a reservation of fund balance (GAAP).
- (c) Certain activities and transactions are presented as components of the general fund (budgetary), rather than as separate funds (GAAP).
- (d) Prior years' deficits and utilized available funds from prior years' surpluses are recorded as expenditure and revenue items (budgetary), but have no effect on GAAP expenditures and revenues.

In addition, there are certain differences in classifications between revenues, expenditures and transfers. The following reconciliation summarizes the differences between budgetary and GAAP basis accounting principles for the year

ended June 30, 2005.

Financial statements for the fiscal year ended June 30, 2006 are expected to be available in late fall.

Budgetary Support

Fund Balance can be appropriated for use during the fiscal year. Fund balance, or budgetary fund balance, is more commonly referred to as "free cash" when used this way. This item is most simply described as the portion of available reserves, generated to a considerable degree by annual operating surpluses, which the City can responsibly appropriate for spending. The law governing the calculation and availability of budgetary fund balance for cities and towns is Chapter 59, section 23 of Massachusetts General Law and is administered by the Massachusetts Department of Revenue. The FY04 Budget made use of \$20.0 million in appropriations from the fund balance of the general fund. The FY06 Budget assumes use of an additional \$20.0 million and the FY07 Budget \$8.0 million.

Adjustments Between Budgetary Basis and GAAP Basis of Accounting for FY05

(in thousands)

	Revenue	Expenditures	Other Financing Sources (Uses), Net	Excess (Deficiency) of Revenue and Other Financing Sources
As reported on a budgetary basis	1,980,425	1,972,092	-	8,333
<u>Adjustments:</u>				
Revenues to modified accrual basis	31,321	-	-	31,321
Expenditures, encumbrances and accruals, net	-	(150)	-	150
Free Cash Used	-	-	-	-
<u>Reclassifications:</u>				
State-funded teachers' retirement costs	(76,521)	(76,521)	-	-
Convention Center Fund Revenue	(18,000)	-	18,000	-
Transfers	(4,504)	-	4,504	-
As reported on a GAAP basis	<u>1,912,721</u>	<u>1,895,421</u>	<u>22,504</u>	<u>39,804</u>

**Statement of Revenues, Expenditures, and Changes in Fund Balances -
General Fund
Years ended June 30 2005 and 2004
(in Thousands)**

	\$	<u>2005</u>	\$	<u>2004</u>
Revenues:				
Real and personal property taxes		1,138,254		1,082,574
Excises		93,906		85,354
Payments in lieu of taxes		42,218		42,373
Fines		65,280		66,342
Investment income		17,970		8,253
Licenses and permits		33,491		33,900
Departmental and other		60,704		45,556
Intergovernmental		460,898		459,836
Total revenues		<u>1,912,721</u>		<u>1,824,188</u>
Expenditures:				
Current:				
General government		57,471		30,061
Human services		23,821		22,642
Public safety		457,541		390,854
Public works		106,749		87,045
Property and development		29,836		31,088
Parks and recreation		15,708		11,260
Library		27,594		24,089
Schools		673,009		656,291
Public health programs		60,586		58,762
County		-		-
Judgements and claims		6,620		(3,544)
Retirement costs		59,419		87,934
Other employee benefits		142,721		129,937
State and district assessments		115,894		111,061
Capital outlays		2,683		393
Debt Service		115,769		120,938
Total expenditures		<u>1,895,421</u>		<u>1,758,811</u>
Excess(deficiency) of revenues over expenditures		17,300		65,377
Other financing sources (uses):				
Operating transfers in		23,529		17,000
Payments to escrow agent to refund debt		(1,025)		(511)
Transfers from component units		-		-
Transfers to component units		-		-
Total other financing sources		<u>22,504</u>		<u>16,489</u>
Net change in fund balance		39,804		81,866
Fund balance - beginning		573,220		491,354
Fund balance - ending	\$	<u>613,024</u>	\$	<u>573,220</u>

Fund Structure and Use

The accounts of the City are organized on a fund basis. Each fund is considered to be a separate accounting entity and complies with finance-related legal requirements. All of the funds of the City can be divided into three categories: Governmental Funds, Proprietary Funds and Fiduciary Funds.

The City has four governmental funds. The General Fund, the Special Revenue Fund, the Capital Projects Fund and all non-major governmental funds in an “Other” category.

The General Fund is the only fund for which a budget is legally adopted and is used to account for all revenues, expenditures and other financial resources except those required to be accounted for in other funds.

The Special Revenue Fund is used to account for the proceeds of specific revenue sources that are legally restricted for specific purposes. This fund accounts for a number of federal and state grants that provide additional support to department programs. It also accounts for money that has been set aside by state statute and can also be used to support the City’s general fund operations. The Capital Projects Fund accounts for financial resources, primarily from the issuance of bonds, used for the acquisition or construction of major capital facilities.

Proprietary Funds are used to show activities that operate more like those of commercial enterprises (Enterprise Funds). Both the Convention Center Fund and the Hospital Bond Fund were established for activities related to bonds for which revenue streams have been pledged as security repayment.

Fiduciary Funds are used to account for resources held for the benefit of parties outside City government and are not available to support the City’s own programs. The City’s fiduciary funds are the Employee Retirement Funds and Private Purpose Trust Funds.

The City’s operating budget is also supported by available governmental funds transferred and appropriated from three available funds. The City appropriates yearly parking meter revenues (Special Revenue Fund) to support the Transportation Department, cemetery trust

monies (Other Governmental Funds) to support the City’s maintenance of its public cemeteries, and surplus property disposition proceeds (Capital Projects Fund) to fund a risk retention reserve and the City’s “Leading the Way” affordable housing initiative. Figure 2 provides a history, as well as projected changes in fund balances for the available funds used to support the City’s operating budget.

Additional discussion of these revenue sources used to support the operating budget can be found in the Summary Budget section.

Parking Meter Fund				
Fiscal Year	Beginning Year Balance	Funds Out	Funds In	Ending Year Balance
FY00	19.369	(5.031)	8.243	22.582
FY01	22.582	(6.677)	7.923	23.828
FY02	23.828	(2.790)	8.821	29.859
FY03	29.859	(10.000)	5.905	25.764
FY04	25.764	(1.000)	12.227	36.991
FY05	36.991	(3.500)	9.314	42.805
*FY06	42.805	(10.000)	9.500	42.305
*FY07	42.305	(10.000)	9.500	41.805

Notes: (\$millions), *projected

Cemetery Trust Fund				
Fiscal Year	Beginning Year Balance	Funds Out	Funds In**	Ending Year Balance
FY00	12.163	(1.724)	3.179	13.618
FY01	13.618	(1.678)	1.301	13.240
FY02	13.240	(1.778)	-0.678	10.784
FY03	10.784	(1.849)	1.541	10.476
FY04	10.476	(1.932)	2.728	11.271
FY05	11.271	(2.029)	1.539	10.781
*FY06	10.781	(2.110)	1.600	10.271
*FY07	10.271	(2.225)	1.700	9.746

Notes: (\$millions), *projected, **Includes appreciation

Surplus Property Disposition Fund				
Fiscal Year	Beginning Year Balance	Funds Out	Funds In	Ending Year Balance
FY00	33.909	0.000	0.191	34.100
FY01	34.100	0.000	8.474	42.574
FY02	42.574	0.000	13.300	55.874
FY03	55.874	(13.000)	0.000	42.874
FY04	42.874	0.000	7.500	50.374
FY05	50.374	(6.650)	0.000	43.724
*FY06	43.724	(9.226)	0.000	34.498
*FY07	34.498	(13.331)	0.000	21.167

Notes: (\$millions), *projected