

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, maintains 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. During the State Department of Revenue's tax rate certification process municipalities must raise any deficits from the prior year and balance all appropriations with estimated revenues for the current year 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 bond rating upgrades. In February 2005, Moody's Investors Service upgraded Boston's credit rating to Aa1, the highest rating ever achieved in the City's history. At the same time, Fitch Ratings upgraded the City to AA and Standard & Poor's affirmed their AA rating. 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 finances toward priority goals that maximize return. The Office of

Budget Management (OBM) also informs management of financial decisions 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 are made as part of the annual city budget, weighing changing service needs with the need for adequate building maintenance and upgrading. 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 as demonstrated by implementation of an enterprise-wide management information system.

Diversifying the City's Revenue Stream

Over 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.

For example, in order to support the funding for the convention center, the City did not draw upon the current revenue base. New City revenue sources were established and earmarked for convention center funding. Among the city and state funding sources is an increase in the hotel excise tax in Boston and Cambridge, the full hotel excise tax for new hotels, the earmarking of certain state taxes in a convention center district, a car and truck rental fee, and the sale of additional taxi medallions. These revenue sources are targeted at those who will use the convention center or businesses that will profit from convention center activity, rather than burdening city residents. In spite of the increase, the hotel tax rate remains competitive with other major U.S. cities.

With the level-funding of state aid after substantial cuts in FY03 and additional cuts in FY04, the Mayor continues to support several legislative changes to shore up the property tax and to allow municipalities to generate more own source revenue.

Specifically, the Mayor has filed legislation 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.

In addition, the Mayor filed legislation to enact a 1% local option tax on prepared food and beverages sold in municipalities in addition to the 5% state tax already in place. If the Legislature were to adopt this local option revenue stream, the City could recover an estimated \$17 million annually. 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.

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. This local option tax could generate \$19 million annually.

All of these measures were defeated in the Legislature for FY04, but the City remains active in support of their eventual passage and will continually stress the importance of a diversified and equitable revenue system for municipalities. In fact the Mayor recently called upon the Boston Municipal Research Bureau to conduct a study into the City's revenue structure.

Protecting the City from Sudden, Unexpected Catastrophic Losses

Risk management efforts work to protect the City from sudden adverse asset losses, whether caused by a natural disaster, workplace injuries, a drop in revenues or sudden cost increases. Risk prevention efforts take place in all departments, for example: MIS maintains back-up tapes for computerized data; the Municipal Police implement a citywide security system; Risk Management provides departmental incident information; operating departments diversify vendors and implement long term contracts.

Although any asset loss has a financial impact, specific efforts to protect city finances include diversifying the City's revenue sources, maintaining a conservative debt ratio and a risk reserve, and prudent purchase of insurance. Risk prevention and financing efforts are further described later in this chapter.

Strategic Economic Development

At the core of City government finances is a healthy Boston economy for all citizens. A critical area for economic development in Boston has been the building of a new convention center. With the leadership of the Mayor, Governor, and legislative leaders, the Boston Convention and Exhibition Center was completed and opened its doors for business in June 2004. Using \$157.8 million in a 1998 loan authorization by the City Council, the City completed site acquisition and groundbreaking occurred in spring of 2000. The loan is supported by hotel excise revenue from new hotels and from other new revenue sources. The Commonwealth fully covered the cost of construction.

Additionally, as interest in development in Boston continues, the Mayor has clearly stated that all decisions on when, where and what to build will be made with the interest of the City as a whole in mind.

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 has overseen the significant increase in the level of infrastructure investment, resulting in the protection and preservation of the City's capital assets and the creation of jobs in the construction sector. 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. For example, there has been a greater need for construction and renovation of schools due to changes in enrollment, educational initiatives and accreditation needs, and this has been done with a focus on maximizing the reimbursement from the state's school building reimbursement program.

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.

Debt Management

The Treasury Department manages all City borrowings. The Treasury Department focuses on the timing of borrowings to take advantage of favorable market conditions. 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.

The City uses a comprehensive, interactive debt capacity model in evaluating the potential impact of debt issues on cash flow, credit and statutory debt capacity. 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.

Risk Management

Across the City, risk management efforts are made to prevent, minimize, and finance unexpected losses to the City's human, financial and physical assets. The Office of Budget Management's Risk Management Program 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. The average per -employee annual cost increase for the past ten years has been contained at 8.9% per year.
- 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 total 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, with the exception of the 1998 flood at the McKim Library, 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. The City budget in turn, is protected from a large loss through a risk retention reserve, that will reach a \$7.68 million balance in 2005, and catastrophic property insurance coverage that limits 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 98.6% of the FY04 gross levy as of June 30, 2004. The City's program includes a variety of collection remedies authorized by state statute such as including past due amounts on tax bills.

In addition, the Taxpayer Referral and Assistance Center – known as TRAC provides “one-stop” service to Boston taxpayers on tax-related matters. Parcel-specific information, including payment history is also available on-line for taxpayer convenience.

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, 2004, the reserve fund had a balance of \$21.6 million. The City fulfilled the FY04 Tregor Reserve requirement by adding \$151,146 to the reserve before the close of FY03 and the FY05 requirement by adding \$416,566 before the close of FY04. The City expects to fulfill any FY06 requirement prior to the close of FY05.

Accounting System

Financial management is supported through the City's PeopleSoft System. This financial management and human resources system is designed to track standard accounting functions such as revenues, expenditures, accounts payable, accounts receivable and general ledger in addition to performing the specialized functions of encumbrance control, fund accounting and grant management.

The Auditing Department has developed a fiscal year closing process that limits and controls departmental appropriation reserves through encumbrances and closely monitors the amount of prior year reserves carried forward, which maximizes the City's undesignated fund balance. In addition, the process allows for the year-end closing and accompanying financial statements to be completed in an efficient and timely manner.

Management Letters

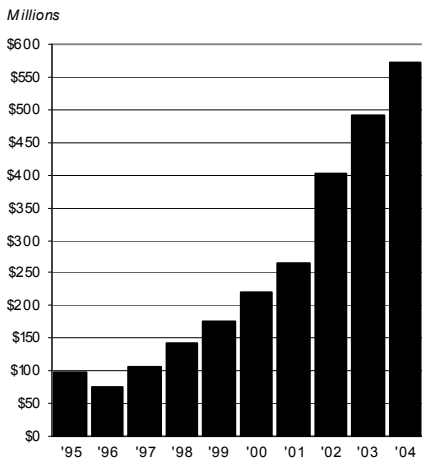
Following the completion of the financial statements, the City's independent auditors deliver a management letter containing comments and recommendations on internal financial controls. The current management letter indicated no material weaknesses in the City's management. Specific management improvements have been recommended in the management letters, and many of the controls that the City has implemented originated from the auditors' recommendations. Through its own efforts and, when required, through appropriate legislation, the City continues to modify and improve its internal financial controls with the advice of its auditors.

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 Auditing Department, working with the City's Law Department, has developed and implemented internal processes to conform City contracting procedures to the requirements of the UPA and other statutes specifying required contract procedures.

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 two events: the dramatic state aid reductions in FY91 and FY92 and the merger of the City's two public hospitals with a private hospital to form a new private entity in 1996. The latter event 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 Equity (GAAP Basis)
FY95 - FY04

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 FY05 will not add significantly to the upward trend in general fund equity that the City has experienced since FY97. 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).

fund balance of the general fund. The FY05 Budget assumes use of an additional \$15.0 million and the FY06 Budget \$20.0 million.

(d) Amounts raised for prior years' deficits and available funds from prior years' surpluses are recorded as revenue items (budgetary), but have no effect on GAAP 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, 2004.

Financial statements for the fiscal year ended June 30, 2005 are expected to be available in November, 2005.

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

**Adjustments Between Budgetary Basis and
GAAP Basis of Accounting for FY04**

(in thousands)

	Revenue	Expenditures	Other Financing Sources (Uses), Net	Excess (Deficiency) of Revenue and Other Financing Sources
As reported on a budgetary basis	1,892,787	1,888,402	-	4,385
<u>Adjustments:</u>				
Revenues to modified accrual basis	25,017	-	-	25,017
Expenditures, encumbrances and accruals, net	-	(72,464)	-	72,464
Free Cash Used	(20,000)	-	-	(20,000)
<u>Reclassifications:</u>				
State-funded teachers' retirement costs	(53,684)	(53,684)	-	-
Convention Center Fund Revenue	(17,000)	-	17,000	-
Transfers	(2,932)	(3,443)	(511)	-
As reported on a GAAP basis	<u>1,824,188</u>	<u>1,758,811</u>	<u>16,489</u>	<u>81,866</u>

**Statement of Revenues, Expenditures, and Changes in Fund Balances -
General Fund
Years ended June 30 2004 and 2003
(in Thousands)**

	\$	<u>2004</u>	\$	<u>2003</u>
Revenues:				
Real and personal property taxes		1,082,574		1,053,945
Excises		85,354		94,133
Payments in lieu of taxes		42,373		40,910
Fines		66,342		59,187
Investment income		8,253		8,951
Licenses and permits		33,900		30,217
Departmental and other		45,556		62,373
Intergovernmental		459,836		444,751
Total revenues		1,824,188		1,794,467
Expenditures:				
Current:				
General government		30,061		53,343
Human services		22,642		24,738
Public safety		390,854		394,692
Public works		87,045		86,819
Property and development		31,088		29,260
Parks and recreation		11,260		14,622
Library		24,089		27,715
Schools		656,291		654,958
Public health programs		58,762		63,897
County		-		4,539
Judgements and claims		(3,544)		2,880
Retirement costs		87,934		74,720
Other employee benefits		129,937		114,512
State and district assessments		111,061		69,009
Capital outlays		393		2,971
Debt Service		120,938		121,184
Total expenditures		1,758,811		1,739,859
Excess(deficiency) of revenues over expenditures		65,377		54,608
Other financing sources (uses):				
Operating transfers in		17,000		34,637
Payments to escrow agent to refund debt		(511)		-
Transfers from component units		-		-
Transfers to component units		-		-
Total other financing sources		16,489		34,637
Net change in fund balance		81,866		89,245
Fund balance - beginning		491,354		402,109
Fund balance - ending	\$	573,220	\$	491,354

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
FY99	13.133	(1.500)	7.736	19.369
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	(10.000)	9.000	35.991
*FY06	35.991	(10.000)	9.000	34.991

Notes: (\$millions), *projected

Cemetery Trust Fund				
Fiscal Year	Beginning Year Balance	Funds Out	Funds In**	Ending Year Balance
FY99	11.744	(1.589)	2.008	12.163
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)	1.500	10.742
*FY06	10.742	(2.110)	1.500	10.132

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

Surplus Property Disposition Fund				
Fiscal Year	Beginning Year Balance	Funds Out	Funds In	Ending Year Balance
FY99	33.909	0.000	0.000	33.909
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	(1.876)	0.000	48.498
*FY06	48.498	(9.226)	0.000	39.272

Notes: (\$millions), *projected

Figure 2