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Fiscal Policy ■ Financial Planning ■ Analysis ■ Training ■ Organizational Review

Internal Service Funds

The following is based on my reply when I was the Director of Finance & Information Technology for the City of San Luis Obispo to a "CSMFO ListServ" survey regarding the use of internal service funds.

The policy in the City of San Luis Obispo is to avoid using internal service (IS) funds. (And we follow this policy: right now, the City doesn't have any IS funds).

For example, rather than setting-up an IS fund for information technology services like some cities do, we allocate these costs through our cost allocation plan. The end result is the same (a reasonable allocation of shared, organization-wide support costs, which is especially important for enterprise operations) but with a lot less organizational effort.

We take this approach in allocating costs for a number of internal support service costs. We don't view allocating copier costs (or vehicle maintenance costs) as being conceptually any different than allocating costs for the City Manager's Office (or City Attorney or Finance). I'm not aware of anyone who accounts for these kind of organizational support services as IS funds (although many distribute these kinds of costs through indirect cost allocation plans), yet the concept of charging for these services based on use by the operating departments is no different than for any other internal support costs (including those most-often accounted for in IS funds).

Some specific reasons for limiting the use of IS funds to where they are truly the best management (not accounting) solution:

- Operating departments generally don't like them; they result in charges to their budget that they don't control. A lot of organizational energy can get consumed in dealing with their concerns.
- It's a lot of work to correctly capture use data and set fees. (And if you're not going to devote the effort needed to do this correctly, why bother to do it at all?) If your ability to get financial management resources is limited (ours are, at any rate), then don't you want to ensure that you are using them for the highest priority, "value-added" services? If you're doing detailed accounting for printing or postage costs, then you don't have the resources to do something else that might have a more meaningful community or organizational impact.
- It can often result in a misleading picture of overall city costs. In budget documents, IS funds are either ignored (in which case a large part of the organization might be overlooked); or more commonly, they are included in city-wide totals, resulting in an overstatement of city costs (since the same costs are conceptually included in both the operating department

budgets as well as the IS fund). This is why generally accepted accounting principles (GASB Statement No. 34) eliminate IS funds at the government-wide level.

- One argument for IS funds is that they improve organizational accountability (and thus, hopefully, productivity) and resource allocation by better linking services with fees. Maybe, but I'm from Missouri on this one.

In fact, it may obscure problems. If the vehicle maintenance staff is doing a poor job of meeting my department's needs, I'm not sure how this gets improved by directly charging my budget for it. (In fact, it seems to just add insult to injury.)

The underlying issue isn't how my budget is being charged, but whether I have reliable transportation to meet my service needs – and whether this is being provided efficiently and cost-effectively. This should just be straightforwardly addressed as the management (not accounting) problem that it really is. And since the IS fund needs to recover its costs, if there are efficiency and effective problems, it seems to me that the end-result (without addressing the real problem) will simply be to increase internal "per unit" charges than to address fundamental customer service and productivity concerns.

In short, IS funds are often the result of looking for an accounting solution to fix something that isn't really an accounting problem at all (something we've accused GASB of doing with its infrastructure reporting requirements and attempts at setting "service efforts and accomplishments" standards).

In the final analysis, IS funds are just a cost allocation tool. They don't result in additional City resources (although they may result in a better allocation of resources, but that's a leap of faith that I'm not likely to easily make, either). If there are equally reasonable ways of allocating costs that get you the same basic result, why use a harder one?

In summary, there may very well be cases where an IS fund is really the best accounting approach in helping solve a management problem. But I think these are far fewer than actual practice. In deciding to set-up an IS fund, the primary policy considerations should be:

- Will this result in much better management of the operation?
- Will the end service delivery will be significantly better or cheaper simply because of the way we account for it?

If the answers are "yes," then by all means set-up the IS fund. But if the answers are "probably not" (or no), then save your "car fare" and allocate your limited financial management resources to something else where you can answer "yes."

