

FINANCIAL MANAGEMENT FOR GEORGIA LOCAL UNITS OF ADMINISTRATION

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NATURE AND PURPOSE

The financing of goods or services provided by one department or agency to other departments or schools within the same Local Unit of Administration (LUA) or to other LUAs on a cost reimbursement basis should be included within the internal service fund classification.

Generally Accepted Accounting Principles (GAAP) does mandate the use of internal service funds. However, in recent years, there has been an increasing use of this fund by LUAs. This use is precipitated by various factors including the following:

- Accounting for the total cost of each activity;
- Greater ease in costing and pricing services (e.g., central warehouse inventories);
- Accumulation of resources for capital asset replacement;
- Transfer of some governmental fund type overhead costs to the internal service fund for redistribution to the benefiting programs; and
- Isolating interfund services so that governmental fund types do not display the revenues and expenditures twice within the same generic fund type (i.e., usually the general fund)--once by the department or school that furnishes the service and once by the department or school that receives the service.

Some LUAs incur interdepartmental charges for the costs of certain goods or services. However, LUAs often use the general fund to account for these activities. One primary consideration in determining the proper fund classification for these transactions should be whether the charge to the user departments or schools is the total cost, including the cost of the Capital assets used in providing the goods or services (i.e., depreciation). If the total cost of the Capital assets is to be passed on to the user, the internal service fund should be used since depreciation expense may be included in the user charge. If, however, the cost for the use of the Capital assets is not going to be recovered through user charges, the internal service fund in most cases should not be used, as this activity can be accounted for better in the general fund, thereby avoiding the creation of an additional fund. If a LUA uses the internal service fund and does not recover depreciation from the fund users, the unrestricted net assets account usually will accumulate a deficit. That is, depreciation must be reported as an expense and there would be no offsetting revenue. Maintaining a deficit is not consistent with the objectives of an internal service fund. Revenues should equal expenses over the life of an internal service fund.

Services to Include

Currently, LUAs include a wide variety of activities within the internal service fund classification. The types of activities that may be classified as internal service funds are almost infinite. Services accounted for in internal service funds usually are tangible, and it should be possible to determine the extent to which they benefit individual departments or schools of the LUA. Some of the more common activities include central garages and motor pools, duplicating and printing services, data processing services, purchasing, central stores (warehouse), communications, and risk management activities.

Number of Funds

Separate internal service funds usually should be used to account for each type of service. Such segregation is essential to: (1) accumulate the costs of providing a service; and (2) assure that the resources generated by one service are not utilized improperly for another.

However, administrative services such as communications, office supplies, purchasing services, and printing and duplicating often are included in a single administrative internal service fund. Still, the accounting system and fund structure must allow for the determination of the total cost of providing each specific service. For example, if the communications function and the data processing function are included in the same internal service fund, the accounting system must have the capability to distinguish the costs of each of these applications in order to appropriately price each specific service. If the LUA's accounting system does not have this capability, then a separate fund should be established for each of these services. Generally, it is suggested that a separate fund be maintained for each identifiable activity.

Alternatively, a LUA would use sub-funds for each specific activity; however, for external financial reporting, a single internal service fund is established by the school board. With this

alternative, external financial reporting is simplified because no combining statements are required and the LUA maintains only one legal internal service fund, yet costing and pricing can occur for each separate activity (e.g., print shop, data processing services) through the use of sub-funds for internal accounting reporting.

BUDGETARY ISSUES

As Chapter 32 indicates, the school board must adopt budgets for all of their internal service funds. However, the budgetary basis used for internal service funds is at the discretion of the LUA. In many instances, the budget is adopted on the modified accrual basis (i.e., a non-GAAP basis for an internal service fund) rather than the accrual basis (i.e., the GAAP basis for internal service funds). This type of budget allows a LUA to better control such costs as equipment purchases and debt service payments. In addition, some feel that budgeting for depreciation, which is required when the budget basis is the accrual basis of accounting, is a non-productive activity.

The internal service fund's revenue budget should be based upon the anticipated user's expenditure budgets. These amounts should equal unless services also are provided to other LUAs. The internal service fund's expense budget should be based upon estimated revenues. However, because most internal service funds are financed on a cost reimbursement basis, the anticipated total cost could be budgeted, and then a cost allocation scheme could be developed to finance the costs from the user departments or schools.

Since a LUA is required legally to adopt an annual budget for its internal service funds, budgetary data for these funds should be reported. Preferably, it should be incorporated within the generic fund type subsection of the financial report.

COSTING

Cost analysis may be defined simply as the process of defining a service and establishing the cost of providing that service. The relationship of costing and pricing is important since the objective of internal service funds is to recover total cost through user charges. Total cost should be defined as all costs incurred to provide the service.

In internal service funds, the costing of services is enhanced because a separate fund (usually for a non-homogeneous service) is established which provides a vehicle to account for direct costs and less cost analysis is required outside of the accounting system. Here, the focus of costing is on the present--determining the cost of providing a service to departments within other funds.

The first step in cost analysis is defining the service. With internal service funds, this task usually is clear because some type of output usually is produced (e.g., printed pages, a repaired bus, consumable inventory). By definition, each internal service fund is established to provide a particular service or services. However, as previously noted, when a LUA includes various types of services within a single fund (i.e., printing and data processing), defining each individual

service to be costed becomes more difficult.

Here again, the selection of a unit of service delivery is important. This task varies widely based upon the type of internal service fund. Some internal service funds may use a single unit of measure (e.g., a unit of clock time for data processing) whereas central stores operation could maintain hundreds of units of measure (e.g., one unit for each different individual inventory item).

In general, it is desirable to have a unit of service focus on outputs. With internal service funds, the output unit of service may be appropriate depending upon the type of services provided. For example, a printing and duplicating fund may use the number of pages printed or duplicated as the unit of measure. However, in a vehicle maintenance fund where repair parts and labor are both used, a single output unit of measure may not be appropriate.

With internal service funds, all costs charged to the fund are considered direct costs of the services provided. If only one service is provided, all direct costs are readily available for analysis and pricing. However, when more than one unit of service is generated in a single fund, some of the costs will be considered direct and some indirect. For example, an individual may be assigned as the director of all internal service fund activities within a single internal service fund (usually only in the very large LUAs). In these instances, all direct costs related to the director (e.g., salary, employee benefits) are considered indirect costs to each individual internal service fund activities and must be allocated through the service unit.

PRICING SERVICES

Normally, costing is considered a factual matter but pricing is a management, policy and political issue. Since the objective of internal service funds is to recover total cost (including any related indirect costs), a common pricing system divides the total cost of operations by the number of units of service resulting in a "per unit" cost.

A primary issue in pricing that needs to be considered is, should depreciation expense be included in the price of the services provided? If the initial capital assets were purchased from another fund and contributed to the internal service fund, depreciation expense need not be charged for cash flow purposes (i.e., to maintain an even cash flow) since depreciation expense does not require cash outflow. Under this pricing system, when the time comes to replace the equipment, cash would not be available for this purpose. The unrestricted net assets would be in a deficit position by the amount of depreciation expense unless subsidies are provided by another fund.

FINANCIAL REPORTING

GASB Statement No. 34, Basic Financial Statements--and Management's Discussion and Analysis--State and Local Governments (GASBS 34), provides new guidance for reporting internal service funds. LUAs report internal service fund data at both the fund financial reporting level and at the government-wide financial reporting level.

Fund Financial Reporting Level - There are three required financial statements at this reporting level that include internal service fund data:

- A statement of net assets
- A statement of revenues, expenses and changes in net assets
- A statement of cash flows

LUAs also include enterprise funds on these statements. The LUA presents the major enterprise funds with all non-major enterprise funds included in a single column. All internal service funds are presented to the right of the enterprise funds, in a single column.

The “major funds” concept does not apply to internal service funds. Combining statements for each type may be presented in the internal service fund subsection of the financial statements.

Government-wide Financial Reporting Level - The reporting of internal service funds at this financial reporting level is somewhat complex. When a LUA presents the statement of net assets, it must include the internal service fund data in either the governmental activities column or the business type activities column. The factor that determines where internal service fund data is presented is the identification of the primary customer of each internal service fund. The primary customer is determined by the amount of revenue the internal service fund earns from each of the customers (i.e., each fund type). Generally, the primary customer of internal service funds is governmental funds. In this instance, the LUA should present the internal service fund data in the governmental activities column.

If the enterprise funds (e.g., the school food service fund) were the primary customers, the LUA would include the internal service fund data in the business activities column. GASBS 34 requires that internal service fund operating data be eliminated and not reported on the statement of activities. If the internal service fund reports no gain or loss in the reporting year (i.e., revenues equal expenses), this data is simply eliminated and not reported in the statement of activities since the user funds already are reporting their costs for the internal service fund services.

However, in practice, most LUAs report either a profit or a loss in each reporting year. Therefore, before the LUA eliminates the internal service fund operating data, it must adjust the profit or loss to zero (i.e. to a break-even basis). The Governmental Accounting Standards Board (GASB) calls this adjustment the “look back.”

If the internal service fund reports a profit, this means that this fund charged the user funds more than the actual costs. Therefore, the LUA must reduce the various expenses of the user funds, which results in a decrease in the internal service fund revenues. Normally, the functional expenses would be reduced in proportion to the amount of the internal service fund reported as revenues. As a result, the internal service fund will report “breakeven” and the LUA can

eliminate this fund's data.

If the internal service fund reports a loss, this means that the internal service fund did not charge its users enough to cover its costs. Therefore, the LUA must increase the various expenses of the user funds, which results in an increase in the internal service fund revenue. After this adjustment, the internal service fund will "breakeven" and the LUA can eliminate this fund's data from this statement.

ACCOUNTING ISSUES

Like all other proprietary fund types, internal service funds are accounted for on an economic resources measurement focus using the accrual basis of accounting at both the fund level and the government-wide level of financial reporting. Chapter 7 explains these concepts.

Revenues

The majority of sources of internal service fund revenues are charges for goods and/or services to other individual funds within the LUA or other LUAs. LUAs should recognize these revenues in the period in which they earn them. That is, as soon as a service is performed or a product is provided, a receivable and revenue should be reported. In practice, the reporting of this transaction usually is delayed until the actual billing is completed (i.e., when the receivable is measurable), usually monthly.

Normally, deferred revenue would not be reflected in an internal service fund since the receivables would not be reported until the service is provided (i.e., the revenue recognition criterion is met). However, if any user fund has been paying a fixed monthly charge to the internal service fund with an adjustment made at year-end to reflect the actual charges, it is possible that the user fund could be overpaid and the reporting of deferred revenue would be appropriate in the internal service fund.

Expenses

LUAs recognize internal service fund expenses in the period in which they incur them. For services rendered to the internal service fund, the expense is reported when the service has been performed and the amount of the liability can be estimated. Practically, LUAs usually report this type of transaction upon receipt of a vendor invoice. Inventories of consumable materials and supplies are recognized as expenses when they are consumed in providing the service. For example, repair parts are reported as an expense in a vehicle maintenance internal service fund when the parts actually are used in repairing the vehicle. Usually, the cost of supplies and materials used is reported as an expense when the inventory is withdrawn from the inventory stock (i.e., the central stores).

ILLUSTRATIVE JOURNAL ENTRIES

The following journal entries and discussion, where applicable, illustrate the financial transactions required for the establishment and the operation of an internal service fund at the fund reporting level during a year.

Transaction - a new fleet management internal service fund is being established to account for the cost of operating a maintenance facility and providing vehicles used by other LUA departments for activities that formerly were included in the general fund. The general fund provides \$85,000 of working capital to this internal service fund. Of this amount, \$40,000 must be repaid in equal annual installments over a five-year period (i.e., \$8,000 per year) and the remaining \$45,000 is considered a contribution, which never will be repaid. The amount to be repaid is reported as an advance payable with the balance reported as capital contributions (i.e., as revenue) since this will not be repaid.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Cash in bank	0101	\$85,000	
Advance from other funds - general fund	0403		\$40,000
Capital contributions	XXX		45,000

Explanation - \$40,000 is credited to the long-term interfund payable account "Advance from other funds" and the \$45,000 balance is credited to capital contributions since it will not be repaid. An offsetting entry also would be made in the general fund.

Transaction - capital assets (e.g., vehicles, tools and a maintenance garage) previously used for this activity in the general fund are transferred to this internal service fund. The Capital assets transferred have an original cost of \$4,253,000 (i.e., building \$87,000 and vehicles and tools \$4,166,000); however, the book value at time of transfer is \$2,160,000 (i.e., building \$83,000 and vehicles \$2,077,000).

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Buildings	0231	\$87,000	
Machinery and equipment	0241	4,166,000	
Accumulated depreciation - buildings	0232		\$4,000
Accumulated depreciation -			

machinery and equipment	0242	2,089,000
Capital contributions	XXX	2,160,000

Explanation - the capital assets should be capitalized and recorded at the original cost less the accumulated depreciation.

The book value of the equipment is recorded as capital contributions from the general fund since this equipment was purchased originally from general fund resources. However, no entry should be made in the general fund for this equipment transfer.

Transaction - billings for services totaling \$1,036,000 are sent to the general fund.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Interfund accounts receivable	0132	\$1,036,000	
Other local revenues	1995		\$1,036,000

Explanation - this transaction is simply a revenue charge on account.

Transaction - billings for services totaling \$13,000 are sent to various other LUAs receiving services.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Intergovernmental accounts receivable	0141	\$13,000	
Services provided other LUAs or governmental units	1950		\$13,000

Explanation - this transaction is similar to the above transaction. However, an “intergovernmental receivable” account is affected.

Transaction - cash is received on account from the general fund in the amount of \$1,036,000 and \$9,000 from other LUAs.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Cash in bank	0101	\$1,045,000	
Interfund accounts receivable	0132		\$1,036,000
Intergovernmental accounts receivable	0141		9,000

Explanation - this transaction simply records cash collected on account.

Transaction - treasury bills costing \$31,000 are sold for \$35,000.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Cash in bank	0101	\$35,000	
Investments	0111		\$31,000
Earnings on investments or deposits	1500		4,000

Explanation - In most internal service funds, interest revenue is classified as nonoperating revenue on the statement of revenues, expenses and changes in net assets.

Transaction - interest earned on investments, but not yet received at year-end, totaled \$8,000.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Interest receivable	0114	\$8,000	
Earnings on investments or deposits	1500		\$8,000

Explanation - The interest is recorded as revenue since the LUA has earned it. The subsequent collection of this interest would reduce the interest receivable account.

Transaction - an LUA purchases school busses on account at a cost of \$572,000 (\$663,000 less \$91,000 trade in allowance). The traded-in vehicles originally cost \$452,000 and had a book value of \$48,000.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Machinery and equipment	0241	\$620,000	
Accumulated depreciation - machinery and equipment	0242	404,000	
Accounts payable	0421		\$572,000
Machinery and equipment	0241		452,000

Explanation - Determining the proper amount at which the new vehicles should be capitalized is addressed in Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions (APB Opinion No. 29). The basic underlying principle of this pronouncement is that nonmonetary transactions should be valued on the same basis as monetary transactions. When the transaction also results in the exchanges of monetary consideration, APB Opinion No. 29 provides additional guidance. Since a gain from this type of transaction occurred (e.g., trade-in value of \$91,000 [i.e., assumed to be the fair value] and a book value of \$48,000 or a gain of \$43,000), the new assets are valued at book value of the traded-in asset plus the cash paid and the LUA does not recognize the gain.

Transaction - consumable supplies costing \$1,530 are purchased on account and delivered.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Inventory for consumption	0171	\$1,530	
Accounts payable	0421		\$1,530

Explanation - since internal service funds use the consumption inventory method, they capitalize this purchase.

Transaction - a two-year insurance policy for \$8,760 is purchased with cash.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Prepaid expenditures/expenses	0181	\$8,760	
Cash in bank	0101		\$8,760

Explanation - Since this policy covers two years, it is reported as a prepaid expense (an asset) and in future reporting periods, the asset is reduced as the term of the policy expires and the

LUA will recognize the expense (see transaction below).

Transaction - a billing for \$8,000 is received from the general fund for various administration services provided.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Expenses	(Various accounts)	\$8,000	
Interfund accounts payable	0402		\$8,000

Explanation - This transaction is simply recorded as an expense with an offsetting interfund payable.

Transactions - various services are provided by outside vendors and invoices are received totaling \$8,100.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Expenses	(Various accounts)	\$8,100	
Accounts payable	0421		\$8,100

Explanation - This transaction is simply recorded as an expense with an offsetting payable.

Transaction - 20 percent of the advance due to the general fund is classified as current.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Advance from other funds - general fund	0403	\$8,000	
Interfund loans payable - general fund	0401		\$8,000

Explanation - since this amount (\$40,000 @ 20% = \$8,000 see above entry) is now a current liability, it should be reclassified from an advance payable to an interfund payable. A similar entry would be made in the general fund.

Transaction - excess cash is invested in short-term investments for \$48,000.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Investments	0111	\$48,000	
Cash in bank	0101		\$48,000

Explanation - the purchase of investments affects only the statement of net assets accounts.

Transaction - a payment for \$2,000 is made pursuant to an operating lease for a copy machine. This amount has not been recorded in accounts payable.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Rental of equipment and vehicles	(function) 442.xx	\$2,000	
Cash in bank	0101		\$2,000

Explanation - Operating leases are reported similar to other operating expenses.

Transaction - an adjustment is made against the general fund pooled cash for \$3,000 for an expenditure paid from the fleet management internal service fund rather than the general fund, in error.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Cash in bank	0101	\$3,000	
Expenses	xxx.xx		\$3,000

Explanation - This transaction is reported as a reimbursement. The original expense account charged is credited to correct the error.

Transaction - operating supplies valued at \$1,200 are withdrawn from the materials and supply inventory and used.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Supplies	(function) 610.xx	\$1,200	

Inventory for consumption 0171 \$1,200

Explanation - the expense account is affected when the LUA withdraws the inventory.

Transaction - pension cost payments for \$4,700 are sent to the Georgia Teachers Retirement System.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Employee benefits	(function) 200.xx	\$4,700	
Cash in bank	0101		\$4,700

Explanation - The employer's share (i.e., the LUA's share) is recorded as an expense.

Transaction - depreciation expense for the year totaled \$419,000 (i.e., building \$4,000, vehicles and tools \$415,000).

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Depreciation	(function) 740.xx	\$419,000	
Accumulated depreciation - buildings	0232		\$4,000
Accumulated depreciation - machinery and equipment	0242		415,000

Explanation - the depreciation expense is charged with an offsetting entry to the applicable accumulated depreciation accounts.

Transaction - one-half of the insurance premium expires and is charged to current operations.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Insurance	(function) 520.xx	\$4,380	
Prepaid expenditures/expenses	0181		\$4,380

Explanation - the expense account is charged and the asset account is relieved of the expired portion of the insurance premium.

Transaction - the compensated absences payable (i.e., \$5,000) is adjusted to current salary rates at year end.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Personal services	(function)100.xx	\$5,000	
Compensated absences payable	0423		\$5,000

Explanation - Annually the LUA should adjust this liability to the total outstanding compensated absences payable amounts using the appropriate days owed employees calculated at current salary rates.