

TITLE I – FINANCE AND ACCOUNTING

SECTION 475 - OPERATIONAL INTERNAL SERVICE FUND POLICY

A. PURPOSE

To establish criteria for creating County operational Internal Service Funds (operational ISFs) and provide guidance and procedures for operating a County operational ISF. Guidelines are provided for applicable laws and regulations, determining appropriate rates and charges, establishing ongoing consistency in funding levels and reserves, ensuring operational ISF unrestricted net position balances are not excessive, and for loans.

B. POLICY SUMMARY

This policy covers operational ISFs that provide rate-based central services to County departments and agencies.

- Information Services accounts for data processing, duplicating, and telecommunications services provided to County departments.
- Public Works accounts for such County functions as construction and maintenance of the County road system and management of certain special districts and other related activities.
- Service Center accounts for the maintenance of the County fleet of vehicles and for related services to other County departments.

The implementation of the guidelines may minimize General Fund costs and limit on-going funding requirements for additional capital contributions to operational ISFs.

C. LAWS AND REGULATIONS RELATED TO ISFs

This policy is based on governmental accounting standards. Additionally, the State Handbook of Cost Plan Procedures for California Counties, State Accounting Standards and Procedures, and OMB Uniform Grant Guidance provide guidelines covering ISFs.

D. RATES AND CHARGES

Rates for County operational ISFs must be developed in accordance with State and Federal guidelines and generally accepted accounting principles and include direct and indirect costs.

County departments with operating ISFs are required to develop and maintain written procedures for cost accumulation, rate development, and billing for those operational ISFs. A full costing model provides the total cost of a given service, which enables better informed budgeting and planning. The “full cost” of a program is equal to the direct cost of a program plus the indirect costs.

Charges for operational ISFs should attempt to recover sufficient revenues to fund all costs associated with providing the operational ISF’s goods and services, including indirect costs. The objective of operational ISFs is not to make a profit, but to recover the total costs of providing goods and services. Thus, operational ISF rates should be cost-based, and all users of ISFs should be billed equitably.

The ISF operating department should determine the level of detail associated with costing services. A low level of detail might be sufficient for a costing system with limited goals, such as developing rate models or obtaining reimbursement for indirect costs under a grant. A high level of detail would define services at the level of programs or other subunits (e.g., the various subdivisions of Fleet and Information Services) and might be needed for goals like governing the demand for service or promoting discussions about the value of a service.

A higher level of detail will lead to a more accurate costing system since the activities represented by the internal service categories will be more specific. However, more detail also leads to a more complex internal services pricing system and may not be worth the greater complexity.

At a minimum, the determination of operational ISF rates and charges must include:

- A description of the components and methodology used to develop the billing rates charged to the benefiting departments, including items of expense to be included, treatment of surpluses or deficits, and the treatment of the overhead and central support service costs that pertain to the operational ISF.
- The following operational costs (if appropriate):
 - Salary and benefits of operational ISF personnel.
 - Operational expenses such as service and supplies.
 - Allowable indirect overhead costs (department support service costs).
 - Services used from other support services.
 - Allowance for equipment replacement costs.
 - Working capital / operating reserve for volatility (60 days average).
 - A calculation of the required increase to the contingency for gasoline, paper, or other significant costs that are difficult to predict and uncontrollable. For example, this would be the amount of additional cash needed to supplement the fuel volatility reserve in the coming fiscal year.
- A description of the accounting treatment used in clearing the over or under-billings at fiscal year-end.
- A review of the operational ISF's financial statements annually for the most recent fiscal year, including the balance sheet, statement of cash flows, and statement of revenues, expenses, and changes in net position, including making adjustments or corrections when necessary

Once the cost of services is determined, the basis for allocating costs from the operational ISF to customers must be decided. The general principles that should be observed when determining the bases are as follows:

- Cause-and-effect relationship. Costs should be allocated based on usage or causal factors relating to costs incurred by the ISF operating department.
- Benefit received. The basis for allocation should bear a relationship to the benefit the customer receives from the service.
- Fairness. The method of cost allocation that will be used must be seen as fair and legitimate by the users of the costing system.

- Legal constraints. State laws may place constraints on how charges are developed. Also, federal regulations on grants may place limits on internal charges against grant programs.

E. MID YEAR REVIEW

Operational ISFs should review their financial conditions at least midway through each fiscal year. If material surpluses or deficits are projected for the end of the fiscal year, the billing rates for ISFs should be adjusted during the year. Immaterial surplus or deficit should be offset by adjusting the billing rates for the following fiscal year.

F. PRE-PAYMENT

Operational ISFs should not collect pre-payments for services to be provided in a subsequent fiscal year, unless the ISF is also required to pre-pay a vendor (e.g., software licenses) for that service. Certain exceptions may apply for grant funding, depending on the grant's guidelines. Exceptions must be preapproved by the Auditor-Controller's Office and the County Administrative Office.

G. REPLACEMENT COSTS

The County may adopt a policy that views any increased costs associated with capital asset replacement as part of the total costs of operating an ISF. Consequently, the ISF charges may be established at a level that includes an amount designed to contribute to replacement on a "pay as you go" basis. Portions for capital asset replacement may be "reserved" to indicate that these funds are not available for general operations. Net Position (See "Net Position/Fund Balance" below) generated by this charge must be reserved. The "reserve" will be supported by a capital asset replacement list to be reviewed annually with the Auditor-Controller's Office and the County Administrative Office.

ISFs operating departments are allowed to set aside depreciation amounts for capital asset replacement. Any amounts in excess of depreciation require special accounting treatment and operating departments should contact the Auditor-Controller's Office.

H. NET POSITION/FUND BALANCE

For ISFs, the difference between assets and liabilities are Net Position. For the County, the appropriate level of Net Position will be comprised of an amount for replacing the original cost of fixed assets (based on an accumulation of depreciation charges) plus 60 days of working capital and any prudent revenue to hedge against fuel volatility or similar uncontrollable costs. At the end of each year, a thorough analysis of the net position held by ISFs must be done.

Formula for Working Capital Calculation:

Operating Expenses	a
Less: Depreciation	<u>b</u>
Adjusted Operating Expenses	[c] = a - b
60 days working capital	[d] = c / 6
Unrestricted Net Assets	e
Over/Under 60 days working capital	<u>[f] = e - d</u>

Net position must be reported in three categories:

- Net investment in capital assets and depreciation includes an ISF's investment in capital assets less accumulated depreciation and principal of debt on these assets;
- Restricted net position has constraints imposed upon them either externally through contractual requirements (such as monies restricted for future debt service costs) or through law by constitutional provisions or enabling legislation; and
- Unrestricted consists of net position that do not meet the definition of "restricted" or "net investment in capital assets."

I. FIXED ASSET/CAPITAL EQUIPMENT

ISFs operating departments may include in their rates depreciation charges to recapture the original cost of their equipment. Depreciation must be charged on a straight-line basis over the reasonable life of the equipment and is done on a Full Cost Recovery Basis. The amount collected as depreciation charges by operational ISFs must be made available for expenditure when the original equipment is replaced or removed from service, and these funds should generally only be used to replace the equipment which generated the depreciation.

Operational ISFs may impose a replacement charge in their rates to compensate for estimated increases in the cost of equipment purchased. Replacement/inflationary charges may not be claimed for reimbursement by Federal, State, or grant funded departments. Amounts charged above the original cost of equipment must be removed from the rates charged to Federal, State, or grant funded departments or specifically identified to these departments so that they are not included in requests for Federal, State, or grant funded reimbursement. These charges must be re-evaluated and adjusted at least annually. Therefore, if operational ISFs set aside amounts in excess of depreciation then they should consult the Auditor-Controller's Office for special accounting treatment.

J. LOANS

Long-term liabilities (such as bonds, notes, capital leases, pensions, judgments and similar commitments) directly related to and expected to be paid from operational ISF funds should be included in the operational ISF fund. These are specific operational ISF liabilities. Also, such liabilities may constitute a mortgage or lien on the specific operational ISF asset or income.

Operating ISFs may loan only to other County funds, subject to the following restrictions:

- The loan must be recorded as receivable in the ISF's County deposited financial records;
- The loan must be repaid with interest and interest computed at the same rate that the ISF could have earned had the loan not taken place;
- The period of the loan must not exceed 36 months;
- The loan must not adversely impact the ISF's current cash requirements; and
- The loan agreement must include a clause that permits the ISF to demand accelerated repayments of all or any part of the loan if its cash requirements so dictate.

If a loan made by an ISF is not fully paid back by the end of the loan period, the loan is regarded as a bad debt and requires a backfill from the County general fund.

Long-term liabilities (such as bonds, notes, capital leases, pensions, judgments or similar commitments) directly related to, and expected to be paid from, operating ISF funds should be included in the operating ISF fund. These are specific operating ISF fund liabilities. Also, such liabilities may constitute a mortgage or lien on the specific operating ISF fund asset or income.

K. DECISION TO CREATE AN ISF

The ISF operating department should take into consideration the advantages and disadvantages listed as part of Frequently Asked Questions in creating an operational ISF. The creation of an operational ISF should be decided upon between the operating department, the Auditor-Controller's Office, and County Administrative Office.

L. PROCEDURES

1. Steps to Establish an ISF

- a. If an ISF operating department desires to establish an operational ISF, it must complete a Fund Type/Fund/Subfund Initiation Request and Input Form (AUD300) and submit, via email, to the General Accounting Division of the Auditor-Controller's Office.
- b. The Auditor-Controller's Office and the County Administrative Office will determine whether the creation of an ISF is valid and will be allowed.

2. Annual Reporting of ISF Rates and Charges

- a. ISF operating departments must submit a draft schedule of rates and charges for the upcoming year to County Administrative Office consistent with the Budget Timeline. The ISF operating department must include a detailed explanation of how the proposed rates and charges were calculated. Projected beginning (July 1) net position, estimated revenues, projected costs, and projected yearend (June 30) net position should be included.
- b. An updated schedule of rates and charges for the upcoming year must be submitted by the ISF operating department to the County Administrative Office consistent with the Budget Timeline.
- c. A final schedule of rates and charges for the upcoming fiscal year will be submitted by the ISF operating department to the County Administrative Office consistent with the Budget Timeline.
- d. The County Administrative Office will review the above schedules of rates and fees and come to an agreement on the final rates and charges for the upcoming fiscal year. This review should include reviewing the reasonableness of costs to be charged, output estimates, net position balances, and methodology of allocating costs.

- e. The County Administrative Office will incorporate the initial schedule of rates and charges for the upcoming year in the ISF operating department's budget as presented by the Concluding Report during budget hearings.
- f. The Adopted Budget will present budgets for operational ISFs which were adopted by the Board of Supervisors. These budgets will incorporate the final ISF rates and charges.
- g. Based on December 31 data of the current fiscal year and no later than the end of February, the ISF operating department must perform a mid-year review of the rates and charges. This review must be submitted to the County Administrative Office upon completion. The review must include:
 - A determination of whether adjustments are needed because of significant surpluses or deficits.
 - A comparison of actual costs of goods and services to the total costs recovered through existing billing rates. This comparison shall be at a level of detail sufficient to ensure equitable billing for services. However, ISFs should avoid a level of complexity requiring administrative efforts which outweigh the benefit of that precision.
 - A calculation and justification of Net Position.
- h. The ISF operating department must submit a report of reserve balances as of the end of the prior fiscal year with explanations demonstrating compliance with this policy to the County Administrative Office consistent with the Budget Timeline.
- i. If the reserve exceeds or does not meet the guidelines in this policy, then the ISF operating department must provide plans to adjust reserves and fund balance to acceptable levels.

3. ISF Loan Proposals

- a. ISF operating departments must submit a loan proposal to the Auditor-Controller's Office and the County Administrative Office.
- b. The Auditor-Controller's Office and the County Administrative Office will review proposals from ISF operating departments for ISF loans and approve or reject the requests.
- c. All ISF loan proposals must include a draft written agreement that will be submitted to the Board of Supervisors and the debt committee, if applicable.
- d. The Auditor-Controller's Office will monitor the ISF to ensure payments are being made according to the payment plan.
- e. If payments are not appropriately made, the Auditor-Controller's Office will recommend corrective action.

M. DEFINITIONS

1. "ISF operating department" means a department that provides goods and services to other County funds, operating departments or agencies, or to other governments, on a cost reimbursement basis, for example fleet, information services, or printing services.

N. FREQUENTLY ASKED QUESTIONS

1. When is a County operational ISF to be used?

The use of operational ISFs is encouraged by the Auditor-Controller's Office in order to report County activities that provide goods and services to other County funds, operating departments, or agencies of the County, or to other governments, on a cost reimbursement basis. Operational ISFs should be used, rather than enterprise funds, only if the County is the predominant participant in the activity.

2. What are the advantages and disadvantages of creating a County operational ISF?

Advantages

- More efficient use of equipment and staff.
- Ability for users to compare the benefit of services or products to expenditures incurred.
- Long-term perspective in budgeting and planning a break-even analysis.
- Ability to more easily control consistency in goods and services delivered to users, thereby improving accountability and accuracy.
- Better planning for capital acquisitions.
- Provides a mechanism to present and capture an audited historical recorded of revenues, expenditures, and capital amounts on a detail basis.
- Transparency of the cost and rate of providing services and products is readily available and the responsiveness to changes in demand is enhanced.

Disadvantages

- ISF financial reports are more complicated to understand.
- Disparate treatment in rates may occur.
- Lack of clear incentive for users to control cost.
- Competitive pressure for operating ISFs agencies/departments to lower cost and improve customer service.
- Viewed as an overhead burden.
- Added complexity in accounting.
- Lack of flexibility in adjusting rates.
- Potential for accumulating excess reserves.
- Possibility of overcharging customers and government grants.

O. RELATED INFORMATION/GUIDANCE

- Handbook of Cost Plan Procedures for California Counties

https://sco.ca.gov/ard_county_cost_allocation.html

(Sections: 2160, 2230, 2240, 2235, 2245, 4310, 2245, 2500, 4310)

- Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards
- State Accounting Standards and Procedures

http://www.sco.ca.gov/Files-ARD-Local/ASP_Manual.pdf

Chapter 13.06 Accounting Objectives

P. HISTORY

Date	Change Made
6/16/2020	Policy Adopted
6/13/2023	Policy Amended