

**THE DECLINING USE OF INTERNAL SERVICE FUNDS:
HOW LOCAL GOVERNMENTS ARE CHANGING THE ALLOCATION OF
INDIRECT COSTS**

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ABSTRACT. Studies involving the allocation of funds among local governments usually are broad in nature with foci based on a variety of factors ranging from service demand to performance outcomes. The conundrum of indirect costs allocation associated with service demand continues to confront local governments. The internal service fund (ISF) has been the primary device used in this endeavor, but over the past two decades, its utilization has decreased. County finance officers in the southeastern United States were surveyed to determine why the ISF is not as prevalently used as in previous years and what has happened to indirect costs as a result of these changes. Findings suggest many reasons for ISF's usage decline including limited usefulness and reallocation of indirect costs to departments. In addition, county governments with a cost allocation plan and larger budget sizes continue to use the ISF as an accounting device.

INTRODUCTION

The continual struggle to provide goods and services with minimum revenue increases has created tremendous capacity issues for local governments. To account for many of the indirect costs which go into providing services, many local governments employ internal service funds (ISFs). These proprietary funds allow for one unit of government to charge for services requested by another unit. Local governments have much discretion concerning the use and

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application of internal service funds creating a litany of cost allocations and applications among units.

This article examines the use of ISFs among county governments in North Carolina, South Carolina, and Tennessee. The declining use of ISFs suggests that county governments are trying to distribute indirect costs in a more discretionary manner. The emergence of service-providing functional departments, lack of resources necessary for implementation, and alternative accounting standards have all contributed to less use of the ISF.

DEFINING INTERNAL SERVICE FUNDS

Internal Service Funds are one of two forms of proprietary funds utilized by local governments. Internal service funds engage in business-type activities that are usually not rendered for public use (Holder, 2004). However, there are cases in which the public can purchase particular services from ISF providing departments directly. Traditionally, ISFs provide services to other departments within the government organization on a cost reimbursement basis (Granof & Wardlow, 2003). This means that the department providing the services charges the receiving department. Often, these departments correspond to related organizational units, such as data processing, vehicle repair centers, janitorial functions, and capital asset leasing. However, they can be established to account for activities in which there is no comparative organizational unit such as self-insurance (Granof & Wardlow, 2003).

ISFs are designed to provide efficiency in the acquisition, distribution, service provision, and the accounting of goods and services. Ives, Razek, and Hosch (2004) suggest that the main reasons for establishing ISFs are (1) to reduce the costs of obtaining goods and services; and, (2) to improve the distribution of goods and services within the governmental unit. Often, the general fund is billed for the service incurred by the ISF, which creates revenue for the ISF. A separate fund is usually used for each unit identified as an object of expenditure since the accumulation of service provision costs must be associated with revenue earned from these same provisions.

ISFs usually engage in the same form of accounting practices as enterprise funds. The full accrual basis of accounting is traditionally used for identifying revenues and expenses that occur between the ISF and the agency receiving services. ISF costs are full costs suggesting the billing rate reflects all operating costs, including depreciation and interests if applicable, and other indirect costs. This creates the opportunity for the government unit to monitor the full cost of providing a good or service with little anticipation for change (Granof & Wardlow, 2003). Financial statements for ISFs are (1) the statement of net assets; (2) statement of revenues, expenses, and change in net assets; and (3) the statement of cash flows.

UTILIZATION AND INTERNAL SERVICE FUND DEVELOPMENT

Proper implementation of the internal service fund provides many advantages for financial officers. First, it provides information regarding common specific services required by departments. From health insurance to motor pools and even to electricity usage, officials can determine the precise usage of assets via departmental service provisions, and in some cases depreciate some of the fixed assets on a regular basis. Second, the use of the internal service fund allows for service cost comparisons (Gianakis, 1995). In most cases, the ISF is comprehensive in nature with full cost application to the services provided. If these costs appear to be creating excessive expenditures, governments can turn to Request for Proposals (RFP) to examine the provision cost as compared to private sector vendors. For state governments, Thurmaier (1990) suggests that many of these costs moved out of the more traditional "overhead cost" areas and into Object Classification Schemes that can be adjusted according to budget or financial needs. Third, ISFs are also very useful in determining the overhead costs to grants (GFOA, 1988). With the broad structure of many grant programs, especially those associated with community development, variable costs increases for implementation are captured through the ISF, therefore acting as a catalyst for managers to sustain the need for increased revenues through grant programs. Hendrick (1998) found that some departments can expect equivalent appropriations annually despite the number of grants received.

Choosing to implement a cost allocation plan with the utilization of the internal service fund has interdepartmental limitations. First, most departments prefer to be self-sustaining thus recalcitrant to accept many provisional services from other departments. Many agencies and departments relish the opportunity to provide services “in-house” with additional responsibilities and revenues to match. Second, units which have maintained a support role for traditional services can experience capacity issues when particular services are required in an expeditious manner (Davis, 1991). Services stemming from natural disasters and large-scale emergencies require expeditious allocations that local government support departments cannot provide. Third, the full allocation costs surrounding a service can be difficult to determine. User charges are relatively easily accounted for in customer-agencies, but not very transparent upon examination through the ISF department (Gianakis, 1995). Service recipients have many incentives to include all costs, both direct and variable upon estimating comprehensive expenditures for future service provision. The ISF department, which usually is the only department or agency providing particular services, may not fully document all related costs. In many of these cases, managers and decision makers are forced to examine outside contractors for services using equivalent benchmarks for both parties to ensure the most efficient provisions will be available (Ammons, 2002). Government officials, especially those in local government settings, are continually exhausting methods to improve financial practices due to criticisms of continual expense increases (Rubin, 1993). As a result of these practices, the more traditional ISF fund departments are facing challenges from both in-house departments that are interested in obtaining technology to provide the service and private-sector counterparts.

FINDINGS RELATED TO ISF IMPLEMENTATION

Most of the research surrounding the use of ISFs by local governments is rather limited. The studies have mainly included case studies demonstrating anomalies within ISF uses. The most comprehensive study of ISF use by a plethora of local governments was conducted by Coe and O’Sullivan (1993), who examined all U.S. cities with a population of more than 500,000 and 25 percent of cities between 25,000-499,999. Professionally managed govern-

ments (council-manager form) were found to be more likely to implement the ISF compared to governments with the elected chief executive. This was expected since council-manager governments have been found to outperform other forms of local governments on many levels of financial and accounting practices along with providing higher transparency among financial devices (Giroux & McLelland, 2003; Ingram & DeJong, 1987).

The findings of Coe and O'Sullivan also suggested that 72 percent of cities did implement an ISF and further attempted to ascertain overhead costs of providing services, often through some cost accounting mechanism. The primary use of the ISF of responding cities was through the use of motor pools. Costs associated with the operation of a motor fleet are extremely diverse: depreciation, fuel costs, insurance, maintenance, and optimal resale value. Finance officers also responded that insurance was the other common use of the ISF. Health insurance is becoming one of the more scrutinized areas concerning expense reduction; however, this is expected to be an ongoing activity supported by ISFs. Cities that did not utilize ISFs cited reasons ranging from inadequate information to negative cost-benefit ratios. Some of the respondents even suggested the ISF was not needed.

Much diversity exists with the use of ISFs among municipalities, but questions remain as to how cost allocations have changed among local governments. For instance, there is no research concerning the use of cost allocation methods among county governments. As administrative arms of the state with increasing responsibilities surrounding service delivery, these contributions are vital. Also, there is expected to be even more of a disparity among different forms of government than indicated by the Coe and O'Sullivan findings. Professionally administered county governments are expected to be more financially diverse than other forms. From a population standpoint, rural government has been defined in a number of ways by researchers. Much research focuses on governments with at least 100,000 citizens in a locality, but this does not include many rural areas, especially in the case of county governments in which the county is the predominant level of government responsible for services. Finally, there is no research surrounding on why the internal service fund has devolved. Questions remain as to where these costs

are now allocated and if departments have increased in size and manner as a result of in-house provision of services.

METHODOLOGY

To examine the changes and uses of the ISF among county governments, a survey was sent to all North Carolina county (finance officers), South Carolina county (auditors/finance officers), and Tennessee (trustees). All of the local governments in North Carolina and a very high proportion of South Carolina county governments are professionally administered with a county manager/administrator while Tennessee had multiple forms of local county governments with the majority having a chief executive. Approximately 241 surveys were sent with a response rate of 40% with the vast majority coming from the professionally administered governments. Of the 97 surveys returned, 61% of North Carolina county governments were represented in the sample as well as 35% of South Carolina county governments. Only 20 surveys were returned from Tennessee county governments. The response rate was expected to be slightly higher since public officials were the source of information, but the segregation of financial responsibilities among county officials created convolution. For instance, in North Carolina, the finance officer is responsible for virtually all aspects of local government finance from budgeting, financial management, and investment practices. In counties with the elected trustee, the responsibility of daily budget transactions including accompanying accounting practices are the responsibility of the finance officer with cash management left to the trustee. In these instances, requests were made to have the responsible party complete the survey.

Other information was obtained through external sources. Information consisting of county budget size was obtained through state entities such as the North Carolina Department of State Treasurer (2008), South Carolina State Budget and Control Board (2007), and the Tennessee Comptroller of the Treasury (2008). County forms of government were obtained through the National Association of Counties.

FINDINGS

Initial findings did support a substantial decline in the use of the internal service fund as compared to the Coe and O'Sullivan study. Only 26% of the sampled county governments responded that they employed internal service funds as a method of determining costs of an activity. Of the counties which responded that they did use the internal service fund, only 23% used it for just one area while the remainder of counties utilized it more frequently. The three most common areas for ISF use were health insurance and workers compensation followed by the county garage or motor pool. For health insurance, all county employees usually contribute to the fund in some manner although use of the insurance by employees is not nearly as equitable. Workers compensation usually just covers employees that work in more hazardous departments such as buildings and grounds and even county garages. The county garage covers a multitude of indirect costs as mentioned earlier, but a key feature of the county garage is that it provides department heads with a mechanism to enhance departmental budgets through automobile acquisitions. Service repairmen in garages can make recommendations for the replacement of automobiles based on criteria such as high mileage, poor performing automobiles, or even an automobile that has been poorly maintained due to continual neglect by department personnel.

The installation of an ISF is usually an alternative used by individuals that are aware of alternative accounting mechanisms used to detect indirect costs. For that reason, there were two general expectations. First, larger county governments were expected to utilize the ISF more than do smaller county governments. The complexity surrounding the variety of methods used to sustain services by larger county governments was expected to incur higher indirect costs and therefore an increased use of ISFs. Second, professionally administered governments, those with the commission-manager or council-manager forms of county government were expected to utilize the ISF more than the other forms. Of the county governments, the professionally administered governments used the ISF overwhelmingly when compared to other government types. Table 1 supports both hypotheses.

TABLE 1
ISF Use by Budget Size and Type of Government

Panel A: ISF Use by Budget Size (in \$ millions)						
ISF Type	<25	25-50	50-75	75-100	>100	Total
County Garage	2	1	2	1	4	10
Workers Comp	2	0	5	2	7	16
Health Insurance	4	1	5	2	9	21
Information System	2	1	1	0	3	7
Legal	2	1	0	0	0	3
Accounting	2	1	0	0	0	3
Leasing Capital	2	0	0	0	0	2
Purchasing	2	1	0	0	1	4
Buildings Grounds	2	1	1	0	2	6
No ISF	31	18	9	4	10	72
Panel B: ISF Use by Type of Government						
ISF Type	Council-Manager	Council	Executive-Council	Charter	Consolidated	Total
County Garage	8	0	1	0	1	10
Workers Comp	13	0	2	1	0	16
Health Insurance	18	0	2	1	0	21
Information System	4	0	1	1	1	7
Legal	2	0	1	0	0	3
Accounting	2	0	1	0	0	3
Leasing Capital	1	0	1	0	0	2
Purchasing	3	0	1	0	0	4
Buildings Grounds	4	0	1	0	1	6
No ISF	54	2	15	0	1	72

ISFs are predominantly used to determine the indirect costs of a particular service. However, when counties which used the ISF were asked if they depreciated assets, only seven responded. Depreciation took place only within two areas: county garages and information systems. For county garages that do not depreciate, vehicles are rotated based on different criteria such as an approximate age of the vehicle or other equipment and if the service provider has determined replacement to be more beneficial. Information systems replacement is usually done on an in-house basis as needed.

In an effort to determine why so many county governments are not using the ISF, respondents were asked to submit reasons why the ISF was not utilized. Most of the respondents (27%) maintained that they were unable to implement ISFs due to limited resources (Table 2). Nearly 25% claimed the costs associated with ISF implementation

exceeded the benefits while another 24% claimed a vast array of reasons including lack of necessity, year-end accounting of indirect costs, and GASB 34 substitution. In addition, another 20% were unfamiliar with the ISF. Findings such as this generally lead to the general presumption of non-clarity in local government financial auditing (Wallace, 1981).

TABLE 2
Reasons for Non-Implementation of ISF by Budget Size and Government Type

Panel A: Reasons by Budget Size (in millions)						
Reasons	<25	25-50	50-75	75-100	>100	Total
Unfamiliar	9	2	1	0	0	12
Limited Resources	9	4	2	0	1	16
Limited Benefits	3	6	3	0	2	14
Other Reasons	4	2	2	5	1	14
Multiple Reasons	0	1	0	0	1	2
Panel B: Reasons by Type of Government						
Reasons	Council-Manager	Council	Executive-Council	Charter	Consolidated	Total
Unfamiliar	6	0	5	0	1	12
Limited Resources	11	1	4	0	0	16
Limited Benefits	12	1	1	0	0	14
Other Reasons	13	0	2	0	0	15
Multiple Reasons	2	0	0	0	0	2

The other portion of the research question focused on identifying key areas that have supplanted the use of ISFs. There were only 12 responses to the question with the majority indicating that many of these costs are attributed to a specific department which has evolved from just simply functioning as a support area. Other answers suggested that the activity covered by the fund had been contracted out, such as the case with health insurance, or the county used general fund monies to cover the costs. More than 67% of the respondents have been in their current position for more than five

years thus providing the conclusion that these costs have been allocated in this manner for an extended period of time.

The lack of use of the ISF provided the supposition that local governments are actively using cost allocation plans to detect indirect costs encountered during the fiscal year. Surprisingly enough, nearly half of the respondents (47%) stated that they did *not* use a cost allocation plan to determine indirect costs. The majority of county governments that utilized cost allocation plans (36%) charged other administrative departments on a regular basis. One respondent did account for indirect costs during the course of the fiscal year, but did not change the general ledger to reflect those costs while another respondent used a cost allocation plan only for federal and state grants.

To determine what factors contribute to the use of ISFs, Table 3 presents a model with construction of the ISF, a dummy variable in this case, as the dependent variable. With the exception of state use of the ISF, which were dummy variables representing each state in the study, the other explanatory variables were coded on a 1-5 scale. Cost allocation plan responses were allocated based on responses ranging from using the ISF to account for indirect costs to using miscellaneous methods to account for indirect costs. Finance officer experience, finance officer education level, and county budget size were all coded relative to their responses as well as available information. There were also five different forms of county government: council/commission-manager, council, county executive, charter, and consolidated. While there were just minimal responses from charter and consolidated county governments, these anomalies provided an additional facet to the study.

Table 3 presents a logit model of likely ISF use by local governments based on five different independent variables. In the model, the use of a cost allocation plan is significant and positive indicating that local governments that do not use a cost allocation plan are less likely to employ the use of the ISF compared to those that use a cost allocation plan. Also significant were budget size of the local government and local government type. Local governments with larger budgets were 61% more likely to use the ISF compared to smaller local governments. Council-manager and commission-

TABLE 3
The Determinants of Internal Service Fund Usage by County Governments

Variable	Parameter Estimate	Odds Ratio
Cost Allocation Plan	-0.7173	(0.4880)**
Finance Officer Experience	0.0096	(1.0097)
Finance Officer Education Level	0.4348	(1.5446)
Government Type	1.4200	(4.1367)**
Budget Size	0.4788	(1.6142)
State Use of ISF	-1.3850	(0.2503)*
Threshold 1	2.8850	
N	86	
Log Lik.	-38.4032	
LR Chi-Squared (6)	26.87**	
McFadden's Pseudo-R ²	0.2592	
** $p \leq .05$; * $p \leq .10$ (two-tailed test)		

manager governments that were professionally administered utilized the ISF much more frequently compared to council, charter, and consolidated governments. This finding corresponds with state use of the ISF. All 100 North Carolina counties as well as 41 of 46 South Carolina counties have professionally administered governments. Only 5 respondents outside of North Carolina stated they used the ISF. Education and experience were expected to be significant factors in determining the use of ISFs among county governments, but the null hypothesis was supported in both cases. Those with higher education levels and experience levels used the ISF less frequently.

DISCUSSION

The research has illustrated a vast array of practices that county governments engage in when encountering indirect costs. The declining use of the internal service fund has been the result of many factors including more progressive accounting measures, departmental growth, and even managers covering costs in the most expedient manner possible. However, there definitely appears to be

no decisive way to handle indirect costs - although in many cases, they may be increasing among local governments.

Caution has to be exercised when trying to generalize these findings across other local governments. First, a high percentage of the responses came from professionally administered governments under the council-manager form. There is not really sufficient information to determine the indirect costs processes of other forms of county governments. Second, much information which may be needed to determine indirect costs was not accessible such as comprehensive annual reports, journal and/or ledger entries, or even specific third party contracts. Third, there were believed to be more respondents that did not know the definition of an internal service fund than what was indicated suggesting that there are many finance officers conducting daily financial transactions without full knowledge of accounting alternatives.

There are also many implications associated with the findings. First, with the absence of indirect cost allocation and the internal service fund, the environment for continued departmental budget increases is realized. The ability for managers and elected officials alike to question departmental funding is severely limited. Second, elected officials actually see themselves very involved in the budget process in general, although the amount of time they actually spend on intimate accounting details is very limited (Modlin, 2008). These findings support those conclusions; elected officials will now be even more disadvantaged when attempting to rationalize departmental expenses. Finally, the findings demonstrate that it is very important to prepare students with the best training possible prior to public sector financial endeavors. Many texts do not cover many of the accounting facets necessary to develop strong cost finding skills (Finkler, 2005; Lee, Johnson & Joyce, 2004; Mikesell, 2007; Smith & Lynch, 2004).

CONCLUSION

This study has attempted to answer two basic questions. First, to determine whether or not local governments, especially county governments are using the ISF less now as compared to previous years; and second, if there is less usage, to determine where these costs are allocated. There is definitely less usage of the ISF

compared to what was found in previous studies. Only 27% of respondents were using the ISF as a method of allocating costs. In addition to this finding, many finance officers responded there was no need to use the ISF because costs were distributed by other means through interdepartmental mechanisms or just accounted for at the end of the fiscal year. The use of the cost allocation plan and the size of the county budget were significant factors in determining use of the ISF.

Indirect costing is an important facet within the daily financial activities of local governments. For many reasons, the practice has become quite limited with few participants. Local governments should attempt to utilize as many approaches as necessary in order to increase financial transparency. The ISF can still be a very useful tool and a tremendous accounting asset for finance officers as well as a method to determine areas that have problems associated with cost effectiveness.

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