Montgomery County Government

MONTGOMERY COUNTY COUNCIL
OFFICE OF LEGISLATIVE OVERSIGHT

REPORT #84-2 DECEMBER 18, 1984

TITLE

A Description and Evaluation of the Chargeback System in the Montgomery County Government.

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I. SUMMARY AND MAJOR CONCLUDING OBSERVATIONS

1. The County government uses a process in which identified direct and indirect costs associated with providing goods and services by one County government agency to other agencies are budgeted and accounted for under a "chargeback" system. Although the term "chargeback" is not found in any standard text on budgeting or accounting, it has widespread acceptance and use in local governments.

2. Under a chargeback system, the funds required by the service "provider" agencies to pay for costs associated with producing the goods or services are apportioned and appropriated in the operating budgets of the agencies who "use" the goods or services.

3. The County government operates four services under the "chargeback" system: motor pool, computer center, printing and mail, and self-insurance. All are examinded in this report except self-insurance which will be the subject of a separate OLO report.

4. The major concluding observation is that the chargeback system is essentially an accounting system and is useful in identifying the majority of costs associated with providing a service and in apportioning and appropriating the funds for that service. However, the report concludes that the County government's chargeback system is of marginal value and usefulness in satisfying the following additional objectives:

a) To determine total costs of providing a specific chargeback service.

b) To assist managers of service provider agencies to:

- facilitate more efficient planning on the level of service to be offered;
- react to changing demands for their services;
- make them self-supporting through chargebacks; and
- hold them accountable for allocated chargeback funds.

c) To assist managers of service user agencies to:

- facilitate more efficient planning on the level of service to be received;
- use the costs for in-house services as a comparison for selecting similar services from an outside commercial firm;
- force them to operate within their budgeted amount for a specific charged-back service;
- encourage them to be more cost-conscious in the use of the charged-back services; and
- hold them accountable for appropriated chargeback funds.

II. AUTHORITY, SCOPE AND METHODOLOGY

1. Authority. Council Resolution 10-559, subject: CY1984 Work Program of the Office of Legislative Oversight, adopted January 31, 1984.

2. Scope. To review the validity of the original goals and objectives in creating the three County chargebacks systems (internal service funds): motor pool, management information services and printing and mail service. Not included in this review is the self-insurance internal service fund as it will be examined as part of the OLO Risk Management Project.

3. Methodology. This evaluation was conducted during the months of June and July 1984 using a variety of fact finding techniques to include a review of public documents (memoranda, studies and reports); interviews with management and staff of service providers and user agencies; interviews with personnel of other County public agencies (M-NCPPC) and other jurisdictions (Fairfax, Prince George's and Arlington Counties); and interviews with appropriate personnel of national accounting firms experienced in auditing internal service funds.

III. OVERVIEW AND DEFINITIONS

1. Overview. For over a decade the term "chargeback" has been used to describe a budgeting and accounting process in which identified costs associated with providing goods or services by a County government agency are appropriated in the budgets of the agencies receiving the goods or services and reimbursed to the agency providing those goods and services. Although this definition of chargeback is not found in any standard text on budgeting or accounting, it has widespread acceptance in local governments. (Note: the term Reimbursable Expenses is used to describe a similar "chargeback" process in the Federal Government). The County government provides the following four categories of services under the chargeback system, each financed and accounted for by an Internal Service Fund: motor pool, computer center, printing and mail and self-insurance.

County government agencies also receive other goods and services from agencies within and outside the County government for which funds are budgeted to the receiving agency. Included in this category are telephone services, small stores (office supplies), office equipment maintenance, uniforms, etc. These services are sometimes incorrectly labeled as chargebacks. The primary distinction between the four chargebacks and the above category of services is that chargeback services are totally provided by an internal government agency with all direct and most indirect costs associated with providing the service funded in the budgets of the user agencies. In contrast, only partial funding is provided in user agency budgets for the above category of services. To cite an example in the case of telephone services, the Council appropriates funds in the operating budget of the Department of Facilities and Services to pay for the central telephone office personnel and equipment, installation and repair of telephone instruments and other overhead expenses.

Appropriated in the operating budget of each government agency are funds to pay for the telephone instruments installed in that agency, long distance calls, and a prorated share of the cost of leased lines and message units.

As stated earlier, this report will examine the chargeback system as it relates to three services: motor pool, printing and mail and computer center. Self-insurance will be the subject of a future OLO report.

2. Definitions.

a) Agency. A department, office or special fund within the County government or a governmental unit outside County government which receives an annual appropriation from the County Council.

Using Agency. - the agency which receives goods or services from a providing agency.

Providing Agency. - the agency which provides goods or services to a using agency.

b) Direct Costs. Those expenses which can be charged directly as a part of the cost to produce goods or services as distinguished from overhead and other indirect costs. Examples of direct costs include: personnel services (salaries and fringe), operating expenses, raw materials, and depreciation of capital (fixed) assets.

c) Indirect Costs (Overhead). Those expenses necessary in the production of goods or the performance of services which are of such a nature that the amount applicable to the product or service cannot be determined accurately or readily. Examples of indirect costs include: rent, utilities, management, and personnel and legal support.

d) Internal Service Fund. A fund established to finance and account for goods or services provided by one agency to other agencies of the government, or to other governments, on a cost-reimbursement basis. In the County government there are four Internal Service funds: Motor Pool, Management Information Services (computer center), Central Duplicating (printing and mail), and Self-Insurance.

e) Services. For the purpose of this report, services also include goods and products.

IV. DESCRIPTION OF THE CHARGEBACK SYSTEM

1. General. The use of a form of chargeback in County government can be traced back to the mid-1950's when an equipment motor pool fund was established whereby County agencies reimbursed that fund for the use of vehicles and certain heavy equipment. However, it was not until the 1970's that the motor pool chargeback system as presently structured was developed. At approximately the same period, the County Council directed the establishment of a system of chargebacks for printing and mail and the

entire management systems operations. In this section of the report each of these three chargeback systems will be described in detail.

2. Motor Pool (Vehicles and Equipment) Chargeback

a) Funding for the County's motor vehicle and equipment fleet is provided through the Motor Pool Fund. This Internal Service Fund finances and accounts for fleet parts, fuel, lubricants, technical services and facilities which are furnished by the Department of Transportation's Equipment Division to the various departments of County government, the State's Attorney's Office and Sheriff's Department. With the exception of funding for additional vehicles and equipment for expansion, all costs related to vehicle and equipment operations and maintenance are included in the annual operating budget for the Equipment Division with funding provided by revenue received in the form of chargebacks from the agencies which use the vehicles and equipment.

b) The total costs to operate the Equipment Division and maintain the motor vehicle and equipment fleet are allocated to the various categories of vehicles and equipment as a fixed (flat) charge and as a mileage (operating) charge. The fixed and mileage charges differ between categories of vehicles and equipment and are determined from five major cost components.

(1) Overhead and indirect personnel expenses (salaries and fringe for administrative personnel, stock room personnel and mechanics helpers; utilities, advertising, and outside labor services).

(2) Insurance.

(3) Replacement (depreciation) of all vehicles and equipment except buses.

(4) Parts and labor (spare parts, oil, lubricants, antifreeze, tires, batteries; and salaries and fringes for mechanics, welders and auto body repairmen).

(5) Fuel.

c) The first three components constitute fixed (flat) charges, the latter two, mileage (operating) charges.

d) An agency's budget appropriation for motor pool is determined by the agency's anticipated use of vehicles and equipment and the fixed and operating rates which are computed annually by the Equipment Division and published in the manual which is used in preparing the operating budget.

e) Currently the Equipment Division is self-supporting. After a number of years of operating at a deficit, the Motor Pool Internal Service Fund has operated without a deficit since FY82. At the end of FY83 (June 30, 1983), the Motor Pool Internal Service Fund had retained earnings of $1,651,794 which equates to 14% of that fiscal year's charges for services.

3. <u>Printing and Mail Services Chargeback</u>.

a) Beginning in July 1975 (FY76) The Council included services provided by the Printing and Mail Services Division of the Department of Facilities and Services in the chargeback system. Services under this category include printing (to include all related operations such as typesetting, collating, stapling, binding, etc.), duplicating, postage, mailing and interoffice mail delivery. Not included are outside printing by commercial firms and the use of commercial package express services such as Federal Express and Emory, which are paid directly to the commercial firms with funds appropriated in the operating budget of the agencies using these services.

b) The direct expenses of the Printing and Mail Services Division which are charged back include personnel services (salaries and fringe), all operating expenses (paper, telephones, ink supplies, etc.) and capital outlay in the form of depreciation of the printing and postage handling equipment.

c) The Printing and Mail Services Division and OMB jointly determine each agency's budget allocation for routine printing, postage and photocopying based on the experience of prior years, estimated inflation and any anticipated postal increase. The sum of these agency allocations then becomes the operating budget MARC (maximum agency request ceiling) for the Printing and Mail Services Division. The rate schedule used to set the charges for printing and mail services is developed by the Division and approved by OMB.

d) Accounting for the printing and mail chargeback system is through the Central Duplicating Internal Service Fund. That fund has operated at a loss since FY79, primarily because the rate schedule has not kept up with the annual increases in the operating budget of the Printing and Mail Services Division. (At the end of FY83, the deficit in retained earnings was $226,590, which equates to 12% of that fiscal year's chargeback for services). The rate schedule which was approved in July 1980 was used for two fiscal years (FY81 and FY82). A higher rate schedule was published in July 1982 and was again used for two years. However, in the same four year period, the operating budget of the division increased each year. On July 1, 1984, a new and higher rate schedule was approved for FY85.

4. <u>Management Information Services Chargeback</u>

a. Beginning in July 1976 (FY77), the Council added management information services to the category of services to be charged back to the using agencies. Initially, direct costs for all computer related services (computer center, systems analysis and development, maintenance, etc.) were charged back to the using agencies. However, effective in FY82, a partial chargeback was established for selected elements of County government agencies and special funds. The partial chargeback established on July 1, 1981 was as follows:

(1) For County government agencies only, those direct costs associated with the operation of the Computer Center Division were charged back.

(2) For the seven Special and Enterprise Funds (Landlord Tenant Affairs, Liquor Control, Refuse Collection, Parking Lot Districts, Recreation, Community Use of Schools and Motor Pool) a chargeback was levied for operations performed by the Computer Center Division, and also for certain salary and administrative expenditures related to the Management Systems Division, (systems analysis and development, user information center, and information services).

(3) For non-county government agencies: Montgomery College, M-NCPPC, WSSC, the State of Maryland (including Social Services), municipal governments and all Federal and State grant projects, all computer related costs were charged-back.

b) The most recent change in the chargeback system occurred in FY84. Beginning on July 1, 1983, a chargeback to Special and Enterprise Funds for the work performed by the Management Systems Division was no longer levied. Instead, the cost of this work (systems analysis and development) was considered to be part of the indirect cost allocation charged to Special and Enterprise Funds.

c) The direct expenses of the Computer Center Division which are charged back include all personnel services (salaries and fringe), depreciation and all operating expenses (postage, telephones, supplies, repairs, etc.) necessary to operate the Computer Center.

d) A chargeback allocation to a using agency is determined by OMB on the basis of the agency's Computer Center usage level two years prior. That usage level is projected into the current fiscal year where a per-unit cost for one or more of the following six services is applied, with the sum of all using agency allocations becoming the operating budget MARC for the Computer Center Division:

(1) Data preparation: Key punch charged at a per-hour rate.

(2) Special forms: Procured by the Computer Center and charged back at actual cost.

(3) Equipment rental: Charged at a monthly rate for the use of terminals, printers, disk drives, etc.

(4) Contracts: Charged back at the actual cost of the contract.

(5) CPU time: Charged at a per-hour rate for the time the computer is working on a particular job.

(6) Teleprocessing: Charged at a designated rate for 1000 Datalanguage (DLI) calls and Message Gets. (Computer transactions are made up of a multitude of DLI calls and message gets).

e) Accounting for the computer services chargeback is through the Management Information Services Internal Service Fund, which has often operated at a loss. (At the end of FY83, the deficit in retained earnings was $1,127,144, which equates to 36% of that fiscal year's chargeback for services). Until FY83, that fund has operated at a loss. The changes to a partial chargeback in FY82 and FY84 were an attempt to reduce some of the unknown factors affecting the recordation of actual costs and to concentrate on the more measurable operations of the Computer Center Division.

V. EVALUATION OF THE CHARGEBACK SYSTEM

1. General. As stated earlier in this report, the County Council established chargebacks because it believed "...that a system of chargebacks which has a using agency pay for the support services received is an efficient management tool." The Council further declared when it established the most recent chargeback in computer services that, "When a using agency is required to budget, justify and pay for such computer services there is created a mechanism for establishing priorities and evaluating the need for a given service."

a) In this section of the report, various rationales for establishing chargebacks will be examined and an evaluation will be made as to the degree that each purpose has been accomplished.

b) The use of chargebacks is a management technique which has application in both the budgeting and accounting process. While the chargeback system identifies anticipated costs to pay for specific services (printing and mail, computer center and motor pool) and provides funds to cover those costs, the chargeback system as practiced in Montgomery County does not control the expenditure of those funds by the agencies using those services.

The operating funds of an agency providing a service (for example, computer services) are apportioned and appropriated in the budgets of the various agencies using the service. Those operating funds are theoretically dedicated to pay for the specific chargeback service provided by the providing agency (in this example, the Computer Center Division). However, the manager of an agency using the specific service is neither required to expend all the funds appropriated in the using agency's budget for that service, nor prevented from expending in excess of what was appropriated for the service if surplus funds can be generated in another category of the agency's operating budget.

2. Purpose of a Chargeback System.

In examining the documentation which established chargebacks and in interviews with managers and staff personnel in agencies which both provide and use those services, the following rationales for a chargeback system were identified:

(a) The County Council and top management are able to identify total costs associated with providing a service.

(b) Once the total costs of providing a service are identified, they can be equitably apportioned and appropriated to the agencies receiving the service.

(c) The responsibility for defending the appropriation for services is shifted from the agencies providing the services to the agencies using the services.

(d) Agency managers' awareness of costs facilitates efficient planning and timely decisions concerning service levels.

(e) Because individual budget allocations for services are under their direct control, agency managers have greater flexibility to address changing priorities and circumstances which may not have been anticipated at the time budgets were adopted.

(f) Agency managers are provided a mechanism to identify costs for a particular in-house service which can be used as a comparison with alternate ways of providing the service, such as outside contract.

(g) The costs for providing services to enterprise funds, other special funds, outside agencies and grant-supported programs can be identified and recovered.

(h) Agency managers are able to identify specific costs for services received, and that awareness will lead to a more cost conscious use of those resources.

(i) Managers of agencies using the services can be held accountable for how efficiently and economically they managed their budget appropriations for those services.

3. Evaluation of the Chargeback System. In evaluating the above rationales, the following questions and comments were examined:

(a) ARE TOTAL COSTS ASSOCIATED WITH PROVIDING A SPECIFIC SERVICE IDENTIFIED AND ARE THOSE COSTS EQUITABLY APPORTIONED AND APPROPRIATED TO THE AGENCIES RECEIVING THAT SERVICE?

Although the majority of the direct and indirect costs are identified and appropriated, total costs are not identified.

For the three chargeback services examined in this report, the majority of the direct and indirect costs associated with providing the services are identified and appropriated to the using agencies according to the amount of the specific chargeback services received. While the majority of the direct and indirect costs are used in arriving at the cost of the service, the "total" costs are not identified. For example, while the cost of utilities is included in the motor pool chargeback computation, utilities are not included in computing either printing and mail or computer center chargebacks. Also not included in the indirect costs is that portion of top management's time which is devoted to managing the agency providing the service. (For example, the OMB Director's time which is devoted to managing the Computer Center). Other indirect costs not currently considered in the "total" costs of providing a service are rent and building use charges.

(b) HAS THE SHIFTING OF RESPONSIBILITY FOR DEFENDING AN APPROPRIATION FOR SERVICES FROM THE AGENCIES PROVIDING THE SERVICES TO THE AGENCIES USING THE SERVICES GIVEN THE USING AGENCY MANAGERS MORE CONTROL OVER SERVICE LEVELS AND COSTS?

Before the chargeback system was introduced, the manager of an agency providing a service was responsible for defending the budget appropriation needed to produce a given level of service to the various using agencies. With the introduction of the chargeback system, the responsibility for defending the budget appropriation for a charged back service was shifted to the managers using the service. However, the using agency managers do not have total managerial control over the two factors which most directly impact on the amount of the chargeback appropriation: the actual level of service to be received and the rate to be charged for that service.

First, the level of service to be received is, in many instances, not totally under the control of the agency manager using the service. While the using agency manager would have discretion as to the level of some services received, in many cases the program priorities assigned to an agency manager will dictate the level of service which must be budgeted. For example, snow and ice removal requires the use of trucks to plow and spread sand and salt. The mission could be accomplished with less trucks if the community would accept a longer period of time to accomplish the mission. However, the community and the government place a high priority on the timely removal of snow and ice which requires the use of many trucks with corresponding motor pool charges. The Director, Department of Transportation could not unilaterally reduce the number of plowing and spreading trucks to reduce the department's motor pool charges.

Also, some managers of user agencies have no control over the level of charged back services. For example, the Finance Department has responsibility for the FAMIS system. A major part of that system is the monthly publication of numerous computer-generated reports to all County government agencies. The funds necessary to pay the computer center charges to generate those reports are appropriated in the Finance Department's operating budget. The Director of Finance cannot unilaterally reduce his budget for computer services by arbitrarily reducing the number and frequency of FAMIS reports he distributes to the other County government agencies.

As for the rate that using agencies are charged for a given level of service, the using agency managers have no control. The rate or unit cost for charged back services is determined by the agency providing the service, usually in conjunction with OMB; and is set to cover the agency's estimated operating costs to provide the anticipated service. The using agencies have no input in the process of setting rates. In fact, with the exception of motor pool charges, most using agencies are not aware of the current chargeback rates.

In summary, the chargeback system places responsibility for defending an appropriation for motor pool, printing and mailing and computer center services on the agency managers using those services. However, because of limited control over missions, priorities and program requirements which directly impact on the level of service, and no control over the rate charged to produce that level of service, managers of agencies receiving charged back services have little managerial discretion over the amount of the charged back appropriations.

(c) ARE SERVICE PROVIDER AND SERVICE USER MANAGERS ABLE TO EXERCISE GREATER FLEXIBILITY IN ADDRESSING CHANGING PRIORITIES AND CIRCUMSTANCES FOR CHARGED-BACK SERVICES WHICH MAY NOT HAVE BEEN ANTICIPATED AT THE TIME THE BUDGETS WERE ADOPTED?

Managers of agencies using chargeback services have more flexibility in reacting to changing priorities and circumstances than do managers of agencies providing the services.

Managers of agencies using printing and mail and computer center services are informed by OMB early in the budget formulation stage of the amount that each agency must budget for those services or justify to OMB any variance from that amount. That allocation is based on the experience of a prior year, inflation, and any other anticipated increase (such as a known postal increase). In the case of motor pool charges, the monthly fixed and operating rates for each category of vehicle and equipment to be used by that agency are published in OMB's Manual for Preparing the Operating Budget.

Should operational or program changes during the fiscal year result in a reduction in the required level of service after the appropriation is adopted by the Council, the using agency manager can reduce the demand for that service and thereby reduce the agency's expenditure for service in that category. For example, a winter season of less than average snowfall would reduce the motor pool operating charges for the large fleet of plowing and sanding trucks. Also, fixed motor pool charges can be reduced by simply turning in a vehicle or piece of equipment for which there is no longer an operational need. Likewise, should changing priorities or program demands require additional services, a manager can increase the service level received and pay the additional costs with other appropriated funds through reallocation, transfer, or with additional funding provided in a supplemental appropriation.

In sharp contrast, the manager of an agency providing the charged-back service has less flexibility to react to changing priorities and circumstances, especially a change which results in a reduction in service demand. When service demand is reduced, there is a corresponding reduction in the level of payments from the using agencies to the providing agencies. Recalling that the operating budgets of the service provider agencies are based on programmed payments received for an anticipated and budgeted level of service, any reduction in that level of service will result in a shortfall in funding for the service provider. A decision by the service user manager not to "buy" at the budgeted level of service results in a shortfall for the agency providing that service.

Unlike commercial operations where fluctuations in the market demand can be met with changes in the personnel complement, agencies which provide charged-back services are staffed with merit employees and their annual personnel complements are rigid, especially for the current fiscal year. The fact that two of the three internal service funds, Central Duplicating (printing and mail) and Management Information Services (computer center) have often operated with a deficit is partially due to the fact that services actually provided were at a level less than that which was anticipated and for which funds were appropriated in the budgets of the agencies using those services. The other major reason for these deficits can be traced to rate schedules which were set too low.

In the event there is an increase in service demands, service provider managers have considerably more flexibility. In the case of motor pool and printing, the service provider can go to overtime operations or use a commercial firm to absorb the overflow. In the event overtime operations are required to satisfy an increased demand for services, the agency receiving the services is charged directly for the overtime hours worked by the service provider employees.

(d) ARE MANAGERS OF USING AGENCIES ABLE TO USE IDENTIFIED COSTS FOR CHARGED-BACK SERVICES AS A COMPARISON FOR SELECTING SIMILAR SERVICES FROM AN OUTSIDE COMMERCIAL PROVIDER?

With the exception of outside printing, using agency managers do not have the option of choosing an outside commercial vendor for charged-back services (motor pool or computer center services).

Rarely and only under unusual circumstances can agency managers contract for services similar to those provided by the charge back agencies, especially motor pool and computer center services. In the case of printing services, funds to contract with a commercial printing firm can be budgeted under an object code distinct from the chargeback printing object code to which in-house printing funds are appropriated. Commercial printing is limited to jobs beyond the capability of the in-house equipment or special multicolor printing requirements.

Under certain limited situations, agencies which obtained prior authorization from the Printing and Mail Services Division or the Equipment Management Division may use funds appropriated for in-house printing or vehicle and equipment services to purchase similar services from an outside commercial firm. However, there are no procedures whereby agencies can use funds appropriated for services from the in-house computer center to purchase similar services from a commercial firm.

(e) <u>ARE COSTS FOR PROVIDING A SERVICE TO ENTERPRISE AND OTHER SPECIAL FUNDS, OUTSIDE AGENCIES, AND GRANT SUPPORTED PROGRAMS MORE READILY IDENTIFIED AND RECOVERED WITH A CHARGEBACK SYSTEM?</u>

The chargeback system has facilitated the identification of these services and the recovery of costs from special and enterprise funds and programs not appropriated in the general fund. However, costs for the other operating expense services not under the chargeback system are also identified and recovered from these non-general fund activities. (For example, telephone service). In addition, the County imposes a 15% charge for general overhead services on most of the special and enterprise funds (exceptions are the Fire Departments, Landlord-Tenant Fund and Community Use of Educational Facilities Fund). This charge is made to recover the indirect costs of providing general oversight (executive management) budgeting, financial, personnel and legal support to the special funds.

While it is fair to conclude that the enterprise and other special funds pay their equitable share for the chargeback services they receive, they currently do not share in the funding of any end-of-fiscal-year supplemental appropriation which may be needed to cover deficiencies in any of the three internal service funds. Because supplemental appropriations are usually drawn from the unappropriated general fund surplus, the enterprise and special funds do not contribute their proportionate share.

(f) <u>DOES THE AGENCY MANAGERS' ABILITY TO IDENTIFY SPECIFIC COSTS FOR RECEIVING A CHARGED-BACK SERVICE LEAD TO A MORE COST-CONSCIOUS USE OF THOSE RESOURCES?</u>

The following case is usually made in response to this question: "Because managers of agencies using charged back services have the funds to cover the costs of those services appropriated in their budgets, and are responsible for the expenditure of those funds, they are more cost-conscious. This increased cost-consciousness results in more economical decisions being made concerning the expenditure of those funds and the level of service received."

While it is obvious that the budget appropriation is, in itself, a limit on expenditures for motor pool, printing and mail or computer center services, there is no evidence that the chargeback system is in itself a motivating influence to use those resources in a more conservative manner. Agency managers are confronted with funding limitations in a broad range of expenditure categories, in addition to those included in the chargeback system. These other expenditure categories, like charged-back services, are identified and appropriated in the individual agency operating budgets. Examples include salaries, fringe, communications (telephone service), local travel, dues and subscriptions, office supplies, etc. The majority of agency managers who were interviewed did not believe that they were more cost conscious in the use of those County resources which were subject to the formal chargeback system than in the expenditure of funds for services in the other operating expense categories which are appropriated in the agencies' budgets, but not included in the formal chargeback system.

One of the reasons that it is difficult to determine whether chargebacks contribute to an increased cost-consciousness is the lack of data and analysis to support that claim. Interviews with user agency managers reveal that when a situation occurs which requires services in excess to that which had been budgeted, the manager must make a number of program decisions of which the cost of the charged-back services is only one of the considerations. In almost every case, responding to a new mission requirement is of greater importance to a manager than is the possibility of increased expenditures for charged-back services. An example of such a situation would be the added motor pool charges incurred in removing snow and ice during a season of unanticipated severe weather.

(g) <u>ARE AGENCY MANAGERS HELD ACCOUNTABLE FOR HOW EFFICIENTLY AND ECONOMICALLY THEY MANAGED THEIR BUDGET APPROPRIATIONS FOR CHARGED-BACK SERVICES?</u>

A major reason why it is difficult to determine whether the chargeback system contributes to a more cost-conscious use of resources is that there is presently no formal system of reconciliation whereby managers are required individually to demonstrate to the Council how efficiently and economically they managed their charged-back services.

In the case of using agency managers, the charged-back services, the actual end-of-fiscal-year expenditures are rarely the same as the amount originally appropriated by the County Council. The differences are usually due to changing priorities and circumstances which necessitate the shifting of fund allocations between operating expense categories by the agency manager, the transferring of appropriation authority by the Executive or County Council, or the adding of funds through a Council-approved supplemental appropriation.

If the combined end-of-fiscal-year expenditures (and encumbrances) for all categories of operating expenses of an agency's operating budget (the three charged-back services plus the other non-charged-back services) do not exceed the amount originally appropriated for operating expenses, there is no over-expenditure. However, if all the combined expenditures (and encumbrances) of all categories of operating expenses do exceed the original Council appropriation, then the operating expense category is over-expended.

When an over-expenditure occurs, a Council and/or Executive transfer or a supplemental appropriation is required. However, at the time the transfer or supplemental is submitted to the Council, seldom is there presented a detailed explanation of how and why the over-expenditure occurred. Thus, the Council is not systematically informed of whether the over-expenditure was the result of added program requirements or changing circumstances beyond the control of the manager (for example, inflation, severe weather impact on snow removal and public safety operations, increase in citizen demand for a particular service, etc.), or simply a case of a manager not efficiently managing budget resources.

Likewise, in the case of providing agency managers, their operating expenses at the end of the fiscal year may exceed the operating revenues which were appropriated in the various user agency budgets as chargebacks.

There are two primary reasons a providing agency may over-expend its budget: rate schedules which were not set high enough to cover actual operating costs of the agency; and actual user demand was less than anticipated and budgted. Other reasons for an over-expenditure may be due to an increase in the cost of supplies and materials or performance deficiencies by the providing agency's staff. Unfortunately, there is no accounting to the Council which would serve as a detailed review of the reasons why the original appropriations were insufficient to fund these provider agencies.

It must be noted that the Annual Financial Report includes combined statements on the Internal Service Funds which account for the charged back services. These statements are examined by the Council's independent auditor. However the Annual Financial Report is published several months after the close of the fiscal year and after action has been taken on transfers or supplementals. Thus, a review of Internal Service Fund statements do not serve as a timely review of how efficiently and economically the charged-back services were managed.

VI. THE USE OF CHARGEBACKS IN OTHER COUNTY PUBLIC AGENCIES AND LOCAL JURISDICTIONS

1. Information was obtained from other County public agencies and three local jurisdictions so as to compare the County government's chargeback system and Internal Service Funds with similar systems and funds with those other agencies and jurisdictions. All public agencies and jurisdictions use some type of chargeback for services provided to another external public agency or jurisdiction. However, not all public agencies use chargebacks for services provided another agency internal to the organization or jurisdiction. A summary of the policies and procedures relating to chargebacks to agencies internal to the organization is outlined below.

2. Board of Education. The school system does not have any formal chargebacks or internal service funds; however, they do have a revolving warehouse fund for supplies and materials. In addition, a procedure has been established to reimburse selective charges for services to projects in the capital budget. Finally, the Division of Transportation has a procedure for securing reimbursement for field trips. In 1981, a Management Operations Review and Evaluation (MORE) study recommended that planning and development of a cost accounting system be initiated, and after a cost accounting system is in place, a re-examination of the desirability of implementing a chargeback system should be made.

3. Montgomery College. Montgomery College does not have any internal chargeback system; however, a method of reallocating selective costs relating to computer operations is in effect. The reallocations are based on past usage and anticipated projects and include a prorated share of the cost of leasing the hardware, maintenance of the system and paper

supplies. Personnel costs are not reallocated to the using agencies.

4. Washington Suburban Sanitary Commission. The WSSC does not utilize any chargebacks.

5. Maryland-National Capital Park and Planning Commission. Three services are charged back in the M-NCPPC: information systems, risk management and certain categories of capital equipment. All computer related services provided the Montgomery County portion of the Commission are charged-back to the users except systems development and programming for the Planning Division, which has its own staff programmers.

6. Arlington County, Virginia. Arlington County utilizes chargebacks in four areas: central stores, automotive equipment, data processing and printing and duplicating. For each of these services, an internal service fund is used to finance and account for the goods and services. Data processing costs include all direct expenses (personnel, equipment, supplies) relating to computer center operations. Data analysis and systems development services are provided by a separate County government department and are not charged-back; however, present plans call for expanding the chargebacks to include these two services.

7. Fairfax County, Virginia. This county has five chargeback services, each with its own internal service fund to finance and account for goods and services: central stores, motor pool, self-insurance, communications (print shop, radios and graphics), and computer operations (computer center, systems analysis and development).

8. Prince George's County, Maryland. Prince George's County has internal service funds for three chargeback services: self insurance, vehicle maintenance and printing and reproduction. Unlike other jurisdictions, Prince George's does not have a chargeback for computer operations because the county contracts out all computer operations. The county owns the hardware, but contracts with a private commercial vendor to operate the computer center, and perform systems development, key punch, systems maintenance, and other computer-related operations. Funds to pay for these contracted services are included in the County's general fund appropriations.

VII. OTHER MATTERS

1. In the course of this evaluation, several matters relating to the charged back system were noted and are presented in this section of the report.

2. Absence of sanctions for spending in excess of an appropriation.

Section 311 of the County Charter explicitly states that, "No expenditure of County funds shall be made or authorized in excess of the available unencumbered appropriations therefor." Section 309 of the County Charter carries an implicit prohibition on expenditures in excess of the original appropriation by providing limits to Council transfer authority between departments, boards or commissions, or to new accounts; and Executive transfer authority within a division or between divisions of the same department.

Nowhere in the Charter or in legislation is there any reference to sanctions against any fund manager who over-expends an appropriation. Federal law, Section 1349 and 1350 of Title 31, Money and Banking, provides for administrative and criminal sanctions, respectively, for those who make or authorize an expenditure or obligation exceeding the amount available in the appropriation.

In addition, Federal law (Section 1351 of Title 31) provides that those responsible for expenditures in excess to an appropriation must report such over-expenditures to the President and the Congress with all relevant facts. Neither County law nor administrative regulations require that custodians of County appropriated funds report to the Council the reasons at the time an over-expenditure occurs.

3. Enforce procedures to request budgetary changes.

Prior to the creation of the Office of Management and Budget, the Office of Budget and Research established by a memorandum dated March 16, 1979, a procedure for the use of the BR-10 form. This form was to be submitted when requesting any of the following budgetary changes:

Supplemental appropriations
County Council Transfer
County Executive Transfer
Reallocation of Appropriation
Substitution of Capital Outlay

Two observations can be made regarding the memorandum. First, the requirement to submit the BR-10 Form and obtain OMB approval before the agency head is permitted to reallocate expenditures between the several operating expense categories of the agency's operating budget should either be enforced or rescinded. Second, the subject matter of the memorandum is of such importance that it should be updated and published as either an administrative procedure or as part of OMB's Manual for Preparing the Operating Budget.

There is no prohibition either in the Charter or the Code against an agency head shifting allocations between categories of operating expenses. A recent review of the OMB files of submitted BR-10 Forms indicated that few agency heads submit a request before reallocating an operating expense appropriation, even if the reallocation affects one of the three charged-back services.

4. Operation of The Chargeback System Requires Resources.

The operation of the chargeback system requires the expenditure of resources. Although providing agencies do not maintain records of specific costs associated with operating the chargeback system, the principal expenses can be identified. Each of the three agencies providing services which are charged-back employ at least one full-time employee to maintain the various agency records necessary to operate the system: posting journals, billing customers, processing accounting documents, etc. Also, provider agencies have developed special forms for processing service requests and billing customers. In addition, computer and Wang operating time is required to process the billing and accounting documents and produce printouts. Finally, in the case of the computer center, a special software program is used to account for the time the computer is used for each customer.

VIII. CONCLUDING OBSERVATIONS AND COMMENTS

1. The chargeback system is essentially a cost allocation and accounting system. The system is useful in identifying the majority of costs associated with providing a specific service and in apportioning and appropriating the funds for those services in the operating budgets of the agencies using the specific service. However the current chargeback system is of marginal value and usefulness in satisfying the following additional objectives:

a) To determine total costs of providing a specific chargeback service. Although the majority of costs associated with providing a service are identified and appropriated, other indirect costs are not identified, specifically; top management, utilities (except for motor pool), rent and other building use charges.

b) To facilitate more efficient planning by service providers on the level of service to be offered and by service users on the level of service to be received. The imposition by OMB of a MARC (maximum agency request ceiling) on both the service provider agencies and the service user agencies which is based on two years previous service delivery experience, permits the agency managers little flexibility in planning service levels.

c) To permit managers of service provider agencies to react to changing demands for their services. Should the demand for service increase beyond anticipated funded levels, service providers can contract with commercial firms to absorb the additional demand. However, should the demands for service be less than anticipated funded levels, the service provider agency affected does not have flexibility to react quickly and reduce operating expenses, especially the current fiscal year's salaries and fringes, so as to avoid an operating loss (over-expenditure).

d) To make managers of service provider agencies self-supporting through chargeback. With the exception of motor pool operations, appropriated chargeback funds have not been sufficient to permit the provider agencies to be self-supporting.

e) To enable managers of service user agencies to use the costs for in-house services as a comparison for selecting similiar services from an outside commercial firm. Service users do not have the option of "shopping around" and selecting an outside commercial service provider who may be capable of providing a similiar service at a lesser cost. Except for outside printing, which is a separately budgeted category of operating expense distinct from the chargeback printing and mail services appropriation, outside services are permissible only with the approval of the in-house service provider manager. In practice, the chargeback service providers have a monopoly over the services they provide.

f) To force managers of service user agencies to operate within their budgeted amount for a specific chargeback service. User agency managers are able to expend funds originally appropriated for specific chargeback services for other categories of operating expenses.

g) To encourage managers of service user agencies to be more cost conscious in the use of those services. There is no convincing evidence either to refute or to support the assumption that the chargeback system increases the cost-consciousness in service users, and, correspondingly, more economical decisions on the expenditure of funds. However, it is certain that to operate the chargebacks system does involve the expenditure of resources.

h) To hold managers of service provider and service user agencies accountable for appropriated chargeback funds. Over-expenditures by service users and operating deficits by service providers have traditionally been covered by end-of-fiscal-year transfers of appropriation authority. Currently, these transfers are usually made without the depth of examination and discussion which would provide top management and the County Council with an accounting of the reasons for the over-expenditures and/or operating deficits.

IX. RECOMMENDATIONS

This report has described the County government's system of chargebacks and evaluated the system against a number of reasons for using this budgeting and accounting process. In view of the report's concluding observations and comments, it is recommended that:

1. The Office of Management and Budget review the system of chargebacks and the use of internal service funds to budget and account for motor pool, computer center, and printing and mail services and present recommendations to the County Council on revisions to the current system to correct the shortcomings identified in this report.

2. A specific area of review should include a process to identify an over-expenditure in an appropriation at the time of its occurrence and to establish a procedure for promptly reporting the circumstances behind the over-expenditure to the County Council .

X. DEPARTMENT COMMENTS AND OLO RESPONSE

Before submitting this report to the County Council, a draft copy was sent to the Chief Administrative Officer and the heads of all affected departments. Responses were received from the Directors, Departments of Transportation, Facilities and Services and Finance. Those responses are included in this section of the report as received.

1. Comments of the Director, Department of Transportation.

M E M O R A N D U M

November 9, 1984

TO: Mr. Robert K. Kendal, Assistant Chief Administrative Officer

FROM: Robert S. McGarry, Director, Department of Transportation RSMcGarry wmk

SUBJECT: OLO Report #84-2, Chargeback System Evaluation

This is in response to your memorandum of October 24, 1984, concerning the Office of Legislative Oversight report on Chargeback System Evaluation.

As you are aware, the Department of Transportation is both a user agency and a provider of service agency. From both perspectives, we have been quite satisfied with the chargeback system. We believe that the system works well and is the appropriate method, particularly for motor pool charges.

The current system does provide cost accountability as opposed to putting one large amount of funding in the Division of Equipment Management. Also, the current chargeback system allows the user agency (which knows its needs better than anyone else) to have adequate control over its equipment.

Our Highway Maintenance Section is a very large user of the motor pool. During years of limited budget resources, they have determined, as part of the budget formulation process the need to reduce the quantity of equipment. In line with their needs, they were also able to decide which type of equipment to get rid of. Hence, there is a large degree of cost consciousness during budget preparation and the user maintains significant control with the existing chargeback system.

Similarly, from the point of view of the service provider (Division of Equipment Management), the current system works well. For the past few years, they have operated on a sound financial basis. Also, they have taken a variety of actions including computer systems and improved facilities to strive for improvements in the efficiency of their operations.

2. Comments of the Director, Depart. of Facilities and Services.

MEMORANDUM

November 7, 1984

TO: Robert K. Kendal, Assistant Chief Administrative Officer

FROM: Thomas S. Abraham, Director
Department of Facilities and Services

RE: OLO Report #84-2 - Chargeback System Evaluation

Comments here relate to the Printing and Mail Services chargeback system portions of the OLO Report #84-2, for which you requested departmental comments by November 12.

Section I — SUMMARY AND MAJOR CONCLUDING OBSERVATIONS

1. Chargeback systems are also used in private industry print shops.

4b. Chargeback systems do facilitate efficient planning in that service providers have accurate history and trends from previous years to determine levels of service required for proper budgeting. Service users are influenced by chargeback rates when determining quantities, types of stock, and printing methods.

Section IV — DESCRIPTION OF THE CHARGEBACK SYSTEM

3d. Printing and Mail Services rate structure is now revised annually. This year a rate schedule based on our FY 86 budget request is included with our FY 86 budget request.

The Printing and Mail Services FY 84 retained earnings was a plus $61,515. Chargeback rates are based on actual budgeted costs and workload estimates based on prior history. With chargeback rates revised annually, variations in workload is the primary variable which would cause significant pluses and loses in retained earnings.

Section V — EVALUATION OF THE CHARGEBACK SYSTEM

3b. 4th paragraph. Copies of Printing and Mail Services chargeback rates have been sent to all Departments and Agencies since the beginning of our chargeback system. FY 85 rates were sent out with July 1984 chargebacks. Additionally, publication rates are included in the Budget Preparation manual.

3. Comments of the Director, Department of Finance.

MEMORANDUM

November 20, 1984

TO: Robert K. Kendal, Assistant Chief Administrative Officer

FROM: Max R. Bohnstedt, Director, Department of Finance MRB

SUBJECT: OLO Report #84-2

With the exception of some editing changes, I do not find the report to have any serious factual errors. I am not, however, able to define the focus of the report from the conclusions or recommendations well enough to respond with specifics.

I have attached a copy of a memo from the Accounting Division expressing their reaction to the report. I have marked what I think are the more significant points in that memo.

Was the report intended to evaluate the accounting and reporting mechanisms appropriateness for Montgomery County? Our use of the mechanism? Assess how well we meet the stated reasons for using the mechanism (what were the stated reasons used to justify it in the first instance)? While the report treats these items, it does not bring the decisions to closure by taking a position as to their applicability or a recommendation as to their usefulness.

If we are to make better use of the mechanisms, we will have to better accept some of the implications and decide how we want to use this particular form of accounting and reporting. To the degree that the OLO report projects this need through a reporting of the funds' histories, I agree. The use of this mechanism or form is, however, only incidental to these decisions which are in fact a commitment to act in a certain way.

Attachment:

(Attachment to Comments of the Finance Director)

MEMORANDUM

November 8, 1984

TO: G. Peter Mech, Chief, Division of Accounting

FROM: Richard J. Duthoy, Assistant Chief, Division of Accounting

SUBJECT: Department comments on OLO #84-2: Chargeback System Evaluation

The following represents my observations on the noted OLO report. The draft report is factual and deserves the attention of all involved. Most points listed below support Mr. Mansinne's observations and conclusions and are presented as reinforcements to the draft report.

If you have any questions or require additional information, do not hesitate to ask.

1) FY84 Financial Information is available for incorporation into the final report, if desired.

2) V-1 - Computer services are basically assigned and therefore little or no discretion exists at the user agency. Many of the charges are dictated by tradition--"the way we have always done them"--or because some third party beneficiary wants it that way, i.e., FAMIS and CULPRIT reports. (Page 10, 1st paragraph)

   User agencies do not participate in management decisions of the Internal Service operations--equipment purchases, hiring practices, tiers of management, etc. Therefore, they cannot control the unit price of the chargeback given constant usage. Also, there is no control over level of service (if a job needs to be rerun, it is charged twice).

   An alternative to charging a user agency for errors on the part of the provider agency (i.e., MS reruns or Central Duplication reprints) may be to have the provider agency absorb the incurred expenses and be reimbursed through a general fund nondepartmental transfer. While the result to the provider agency is the same, the user agency would not suffer undue hardship because of circumstances beyond its control. On the other hand, a difficulty would surely arise in casting blame in many instances.

3) Internal Service Funds do not generally accumulate the necessary resources to replace capital equipment. Internal Service Funds should be able to finance from its own operations replacements, modernization and expansion of plant and equipment used in operations.

4) Page 11, 3rd paragraph: "The agency receiving the services is charged directly by the Payroll Section for the overtime hours worked..." This charge is a product of the payroll system and originates with the provider agency. The Payroll Section processes timesheets but does not make charges.

5) All the inflexibilities and lack of control over expenditures for all the valid reasons noted in the Draft report would not diminish if the internal service funds were to be abolished. The internal service funds are mechanisms for accumulating, classifying, and reporting costs of services. The cost controls, no matter how desirable, are not inherent in the fund accounting structure, but in the management of the services provided and received. It must be remembered that the management of the services provided and received is quite separate and distinguishable from the accounting structure (the accumulating, classifying and reporting of costs and revenues). The management of the services must be existant no matter what the format of the reporting process. The shortcomings of the reporting process should be separated from the shortcomings of the management of services process.

6) Page 11, paragraph (d): The option exists on a limited basis to use private autos and then seek reimbursement. This may in many instances be less expensive to the user agency than the use of the Motor Pool vehicle since the flat rate charge is avoided.

7) Page 14, last paragraph: Deficit retained earnings, accumulated over time, reported after the effect of transfers and supplementals, should provide a clue on how effectively, efficiently and economically the charged-back services were managed. Granted, it may be difficult to pinpoint blame, however, it should be readily apparent that some problems do exist.

8) Page 15, paragraph 5: MNCPPC has an internal service fund for Capital Equipment in addition to those noted.

9) During FY84, OMB proposed that charges be made based on the appropriation rather than actual usage. Subsequent years' appropriations were to be adjusted to include factors for prior years' usage adjusted for the current year's rates. After discussion with Department of Finance personnel, this decision was reversed.

10) The formal financial reporting structure reflected in the CAFR for internal service funds does not reflect performance relative to budgets as budgetary data is not presented. Only financial information on a GAAP basis (reflecting results of operations from a profit and loss standpoint is presented. The budgetary data relative to internal service funds is incorporated into the budgetary statements of the governmental funds and the J-14 schedule for the enterprise funds. Even so, operations of the internal service funds (on a budgetary basis) cannot be specifically identified in either instance; that is, the budgetary statements of the governmental funds or the J-14 schedule for the enterprise funds.

11) Internal Service Funds service levels have changed over time.

12) Page 12, paragraph 3: In FY79, page 63 of Annual Financial Report clearly identifies the following:

	Motor Pool	MIS	Central Duplicating
Operating Transfer In	$336,979	$229,891	$33,148

The funding was as follows:

	Motor Pool	MIS	Central Duplicating
General	$226,128	$189,742	$27,221
Special Revenue	65,710	1,057	4,681
Enterprise	44,627	32,207	733
Internal Service	514	6,885	513
Total	$336,979	$229,891	$33,148

FY79 was the last time in recent history that losses were adjusted in this manner. Subsequent years operations adjusted losses through increased rates or were absorbed by the internal service fund.

13) Page 17, paragraph 3: The reason the BR-10 is not submitted by the agency to OMB for reallocation is because OMB does not consider reallocations important enough to devote resources to.

14) Nowhere in the Draft report is there reference to a basis of accounting for "chargeback" (i.e., measurements of usage vs. appropriation vs. some other arbitrary basis).

15) Prices should be less than using funds would have to pay outside vendors for equivalent products and services if the existence and continued operation is to be justified.

cc: Max R. Bohnstedt

RJD/jw/47K