Internal Service Fund Stabilizes Budgeting for Vehicles and Heavy Equipment

By Maureen Rogers and Russell Pankey

The City of Olathe, Kansas, has taken steps to ensure that adequate funds are available to purchase vehicles and equipment, stabilize budgeting for major purchases, and provide a systematic, citywide approach to procurement and disposition of the fleet.

Government agencies need a funding method that allows them to purchase vehicles and heavy equipment without depleting the entire budget, especially when several expensive units have to be replaced in the same year. Budget processes often become tense as departments compete for limited dollars, especially if revenues are down and scheduled replacements are high. The City of Olathe, Kansas, devised a program called the Vehicle and Equipment Replacement Fund (VERF) that has become a valuable process for making vehicle and heavy equipment purchases.

The purpose of the VERF is to ensure that adequate funds are available to purchase vehicles and equipment, to stabilize budgeting for major purchases, and to provide a systematic, citywide approach to procurement and disposition of the fleet. The goal is to provide sufficient cash flow for annual purchases. The VERF is not designed to equal the replacement value of the fleet.

Olathe, a growing city with a population of approximately 125,000, has centralized purchasing and in-house vehicle maintenance. However, the VERF concept can be adapted to any size governmental agency, regardless of structure. The VERF is an internal service fund that owns all the city's vehicles and large equipment. Each departmental cost center pays a monthly lease fee into the VERF, based on the individual assets used by the department. A detailed administrative policy defines staff roles in the process, the lease fee calculation, asset lives, and procedures for acquisition and disposal.

Several key personnel are involved in coordinating the VERF budgetary, purchasing, and accounting process with the city's frontline service departments. The finance director is the "owner" of the VERF and is the decision maker when questions arise. The city manager's office serves an appellate function if needed, and is the final approval point of budgetary decisions. The fleet manager determines when early replacement or extended life of a vehicle is warranted and is responsible for the city's internal vehicle maintenance department. The budget manager coordinates approval of additions and replacements to the fleet; the purchasing division handles procurement; and the accounting department maintains all the capital asset transactions as well as lease fee calculations and payments.

Exhibit 1: Lease Fee Calculation

$$[A + B - D]/\text{life} * C = X$$

A = asset cost
B = fund shortage
C = inflation factor
D = Salvage value
X = normal annual lease fee

Lease fees are based on the formula shown in Exhibit 1. The fees are basically straight-line depreciation of the cost of each asset over its expected useful life, modified by an inflation factor. When an asset is a replacement rather than an addition to the fleet, the formula also reflects the salvage value received for the prior asset, as well as a mechanism to recover overages and shortages that occur when the replacement cost differs significantly from the prior asset. The inflation factor and overage/shortage component of the formula have the flexibility to vary in amount or percentage from year to year, depending on the budgetary capacity of the general fund (or other funds) to pay department lease fees. As part of Olathe's annual budget process, upper management considers the balance between general fund and VERF sustainability in setting the specific formula for the next budget year. For new additions to the fleet, the departmental cost center pays a double lease fee, theoretically to cover both the acquisition cost of the new vehicle and its replacement. The fee for replacement vehicles is a single lease fee, and departments holding vehicles past the end of their useful lives pay a half lease fee for those vehicles.

The city's process for acquiring and maintaining vehicles and equipment includes four cycles: budget, purchasing, receiving, and maintenance. The activities of the budget cycle — shown in Exhibit 2 — are designed to make

Exhibit 2: Budget Cycle

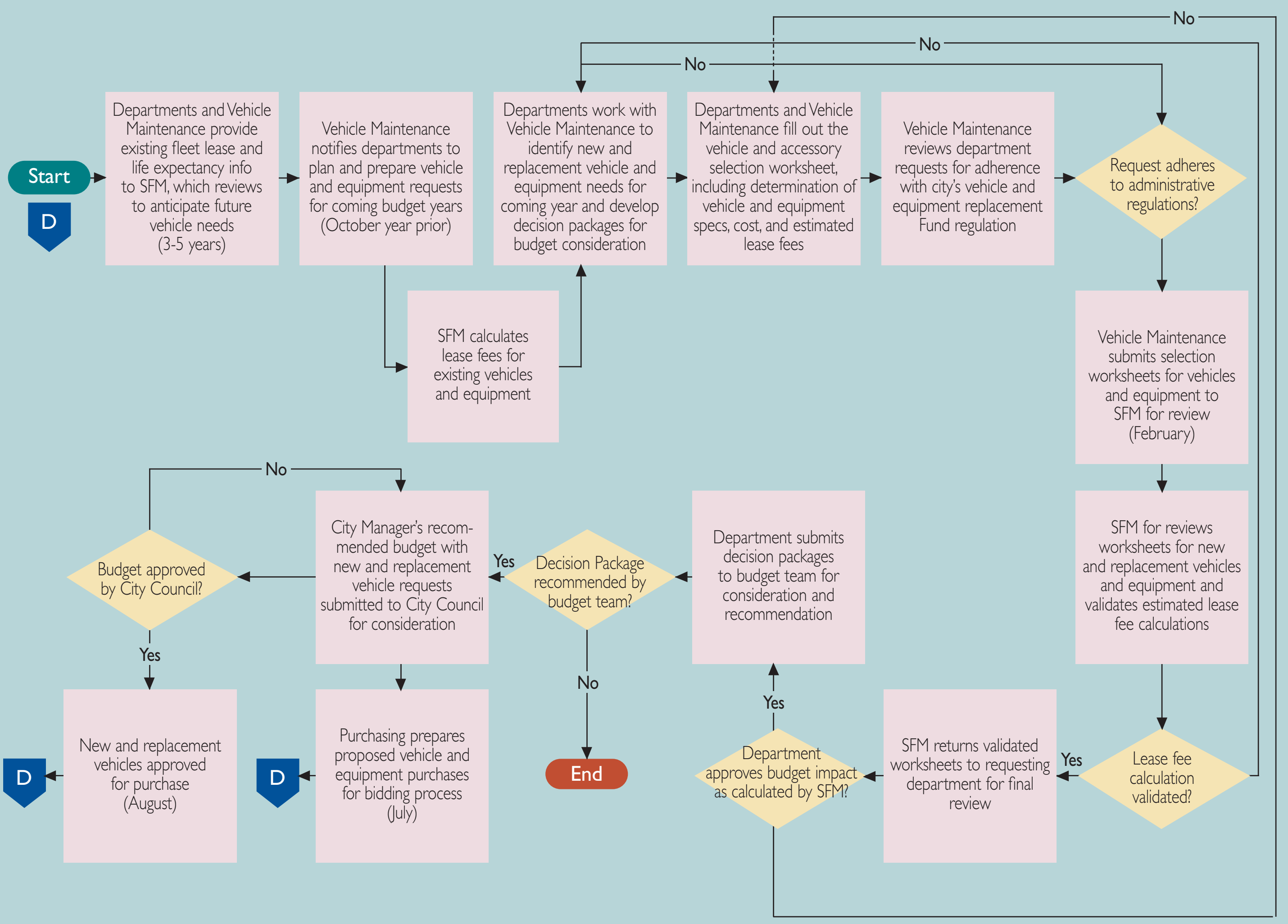

Exhibit 3: VERF History

	December 31, 1999	December 31, 2001	December 31, 2003	December 31, 2005	December 31, 2007
Fleet Value	$16,511,693.09	$22,116,711.12	$23,786,619.54	$29,653,541.47	$35,271,226.98
Depreciation	$9,358,503.14	$11,203,845.10	$13,406,619.98	$17,170,734.29	$19,633,931.41
Net Book Value	$7,153,189.95	$10,912,866.02	$10,379,999.56	$12,482,807.18	$15,637,295.57
FUND BALANCE	**$3,376,942.00**	**$2,356,117.00**	**$4,055,763.00**	**$2,444,892.00**	**$3,620,515.00**
Fleet Value	20.45%	10.65%	17.05%	8.24%	10.26%
Depreciation	36.08%	21.03%	30.25%	14.24%	18.44%
Net Book Value	47.21%	21.59%	39.07%	19.59%	23.15%

sure that requests for vehicles itemize not only the base cost of the vehicle but also the cost of all accessories, so the cost of the vehicle as actually purchased is very close to the cost of the vehicle as approved.

It has proven helpful to map out each process with the personnel involved and then to periodically revisit the maps to make sure they remain relevant. It has also been valuable to conduct a citywide quality improvement process (QIP) every few years to review the policy governing the VERF and explore ways to ensure that the fund remains sustainable. Exhibit 3 shows a trend in the VERF fund balance that concerned the QIP team and prompted it to focus on the future direction of the fund.

ADVANTAGES AND DISADVANTAGES

An important advantage of the VERF is that it prevents wide fluctuations in departmental operating budgets. For example, if the Fire Department did not need to replace any units in a given year, the department would continue paying lease fees into the VERF during that year. The positive result is that funding would then be available the next year, when the Fire Department might have three units to replace, and its operating budget would not be depleted by making the purchase.

The VERF also provides a citywide framework for budgeting, procurement, and fleet management. Its policy includes a timeline, providing a guide for all city departments to use. This allows the VERF process to operate consistently.

Historically, there has not been as much budget oversight of the VERF as there has been of operating budgets, which has been a disadvantage. Care must be taken to ensure that only items directly associated with a particular vehicle — and with a similar life expectancy — are charged to the VERF, rather than consumable items only loosely related to the function of the vehicle. Recent revisions to the VERF policy have corrected this loophole.

The original VERF plan did not provide for significant increases in equipment cost, but this problem has been corrected by modifying the lease fee equation. Departments were paying lease fees based on the original cost of the equipment, which changed significantly, especially for equipment with a lifespan of 10 or 15 years.

Along the same lines, "scope creep" has also been a challenge for the VERF. There have been instances where a vehicle's specifications and accessory list have grown during the replacement process, or even from the time of budget approval to actual purchase. Exhibit 4 illustrates what happens to the VERF financially when an asset is allowed to become a higher-end vehicle when it is replaced. More stringent justification requirements and advance planning can ensure the vehicle is equipped with only what is necessary to perform its function, and that the city has ample funding to make the purchase.

HOW TO SET UP A VERF

The first step in setting up a VERF is creating a policy document. It is critical to gather input from all departments in the organization that have use of vehicles and equipment, as well finance, purchasing, top management, and fleet maintenance. Roles should be established for the purchasing department and the vehicle maintenance department, and an approach has to be

Exhibit 4: Scope Creep in the VERF

	Year of Purchase	VERF Balance	Vehicle Cost	VERF Balance Immediately After Purchase	Vehicle Life	Lease Fees During Vehicle Life	Balance Remaining for Replacement
Pumper Truck — Original Purchase	1990	—	$150,000	-$150,000	10 years	$300,000	$150,000
Replaced with a Quint	2000	$150,000	$600,000	-$450,000	10 years	$600,000	$150,000
Replaced with an Aerial Ladder	2010	$150,000	$1,000,000	-$850,000	10 years	$1,000,000	$150,000

agreed on for when there is no internal vehicle maintenance function. The organization should also decide who the final decision maker will be. Also, a VERF team, comprising representatives of the stakeholders mentioned above, should draft a policy that includes every aspect of the VERF process (e.g., budget, purchasing, receiving, maintenance, and disposition).

The accounting entries for establishing a VERF are straightforward. First, make journal entries to transfer the asset balances from all funds where they currently reside into the VERF. Then, begin charging departmental cost centers for the appropriate lease fee for each vehicle and transferring the fees to the VERF. Since lease fees are beginning in various stages of the lives of the individual assets, determine the method and timing for transferring the accumulated depreciation on the current assets into the VERF. Olathe opted to do a phased transfer over three years.

FUTURE DIRECTIONS

The VERF in itself does not solve the problem of a wrong-sized fleet or vehicles that are not appropriate for the services the city provides. However, a VERF can help establish a data framework for addressing those issues. Olathe is currently using the information provided in the VERF to design a five-year plan for vehicles and equipment, similar to a capital improvement five-year plan. With increasing budget pressure brought about by declining growth in assessed valuation and sales tax revenues, the city is also considering establishing a vehicle control team. If implemented, all departments would be required to present a business case for each vehicle replacement, as well as for requests for new vehicles. The team's role would be to evaluate the business cases and determine if the proposed vehicles are actually needed, or if less expensive alternative vehicles would provide adequate service.

CONCLUSIONS

The VERF provides a good solution to the problems that arise when vehicles are purchased directly from department budgets, or even from a fund that is funded by annual transfers from the general fund. The concept is simple and easily understood by non-financial city staff and management. It can also help an organization address problems such as wrong-sized fleets or inappropriate vehicles for the services provided.

Experience, along with the information learned from the QIP, has helped the City of Olathe learn to regularly review and refine the VERF as often as needed as the city's needs change. Additionally, the lease fee equation and fund balances should be reviewed regularly to ensure that adequate funds are available and that the budget is stabilized for major purchases, with a goal of providing sufficient cash flow for annual purchases.

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