An Overview of Equipment Rental and Revolving Fund

A reference document prepared by
Washington State Auditor's Office
Local Government Support Team
with assistance from State and Local Agencies.

Acknowledgements:
The Washington State Auditor's Office would like to acknowledge the following entities and individuals for help during the development of this document.

City of Tacoma - Catherine Mitchell and Steve Hennessy
County Road Advisory Board – Walt Olsen and Chris Mudgett
Spokane County – David M. Stark

Introduction:

This guide is designed to provide information on the formation and basic operations of Equipment and Rental & Revolving (ER&R) funds. The guide contains answers to common questions and discusses issues that have been encountered during audits of ER&R funds. Areas covered are:

- Overview
- Who's required to have an ER&R fund and how are they formed?
- Operation of the fund:
  - Rate setting
  - Revenue assets
  - Investments
- Accounting requirements – financial reporting
- Common questions
- Common audit issues

Overview:

Equipment Rental and Revolving funds, also known as ER&R funds, are established to provide equipment rental services within a local government. They increase government efficiency by giving the entity a way to allow expensive equipment and supplies to, in essence, be rented to the entity's other departments. These departments are internal service funds and should operate at zero profit. Their rental equipment ranges from computers to police and fire vehicles to heavy road equipment to specialized high voltage trucks.

Who's required to have an ER&R fund and how are they formed?

All counties and cities with populations over 8,000 are legally required to have an ER&R fund for operating county road and street departments. ER&R funds may be expanded to provide services to other departments including public works, utilities, fire and police. Legal references: RCW 35.21.088, cities and RCW 36.33A.010, counties.

ER&R funds are created by city councils or county commissions. Counties pass a resolution and cities an ordinance defining the origin of the resources, purpose, and specific duties of the fund. Start-up resources usually come from an interfund transfer of cash and/or equipment. The transfer may be as a loan or a permanent transfer. Further discussion of interfund transactions and ER&R funds can be found in the Budgeting, Accounting and Reporting System Manual volume 1, part 3, Chapter 4, sections A&B.

Operation of the fund

The management of the ER&R fund is responsible for assuring that the fund's operation complies with what is set out in the ordinance or resolution. These goals include rates that cover the costs of operation and equipment replacement; charges to departments are equitably allocated; tracking of equipment; and investment of excess funds. Management has the further responsibility to ensure that all revenues and expenses are properly coded, summarized and reported in the formats prescribed both internally and externally.

- *Rate setting*

ER&R rate structures need to cover all costs associated with the operation of the fund. In counties, the rate structures are determined by the county engineer and reviewed by the legislative body, RCW 36.33A.040. Rental rates are typically composed of four components:

1. Expenses due to maintenance and operation (employee wages, building rental, equipment repair, supplies, etc.)

2. Depreciation of equipment.

3. A surcharge for equipment replacement.

4. Corrections for prior year charges.

It is extremely important to have a system in place that separates charges for replacing equipment from the other components. Most federal grants allow only actual costs to be submitted for reimbursement. Surcharges for equipment replacement are an estimate and not allowable under A-87 cost principals. Inclusion of surcharges of equipment replacement in federal reimbursement requests could lead to questioned costs.

Deficiencies in revenues should be made up from transfers from the general fund or funds of other departments using the services. Excess revenue should be allocated back to departments that are over charged. Under the prescription of RCW 43.09.210 “it is not legal for one fund to benefit from another”.

Rates can be developed for individual assets or similar groups of assets. They can also be billed as a single rate or separately. Composite rates (single rates that apply to dissimilar assets), should be avoided. They tend to lead to overcharges or undercharges.

- *Revenue Assets (rental equipment)*

Records must be maintained that identify revenues, costs, and depreciation associated with rental equipment (revenue assets). Rental equipment needs to be monitored by a tracking system and physically inventoried. Tracking is essential to ensure the items are not lost or misappropriated and are properly depreciated. Equipment should be valued at purchase price or the fair market value when it is transferred to the fund. In addition to internal policies, criteria for asset accounting and monitoring are prescribed by external sources. They are:

- Category 1 Counties and Cities: RCW 36.32.210 (counties only); 2002 BARS Manual, volume 1, part 3, chapter 7.
- Category 2 Counties and Cities: RCW 36.32.210 (counties only); 2002 BARS Manual, volume 1, part 3, chapter 1, section B.
- Entities purchasing assets with Federal grants: Common Rule, Section 32(d)(2).

Information that should be maintained for assets includes:

1. Historical cost, type of asset and a cross-reference to the capital asset record (finance record), identification of the primary user or whether it is a pool asset.

2. A periodic summary (at least annually) of all operating expenses, including any special operator costs.

3. A periodic summary of depreciation expense and indirect expenses

4. A periodic summary of rental income, service charges, or user fees.

5. Periodic calculation of net income or loss.

6. Annual summary of 2-5 above.

7. Cumulative net income or loss.

While separate records are recommended, group asset records are acceptable.

- *Investments*

Revenue collected for replacement equipment is the property of the ER&R fund and is not to be transferred to other funds. They should be invested only in allowable investments. These funds should also be reviewed during budgetary review. Investment levels in the ER&R fund should reflect the projected amount needed to replace equipment. Rental rates and or fees should be adjusted if investment levels are above or below the targeted amount.

Accounting Requirements – Financial Reporting

Accounting and financial reporting are prescribed by the Washington State Auditor's Office. Reporting requirements are based upon the size of the municipal corporation. Category 1 and those category 2 choosing to prepare GAAP financial statements should refer to the Category 1 Budgeting Accounting and Reporting System (BARS) manual, volume 1, part 3, chapter 7, section G. In pre GASB 34 reporting the ER&R fund is reported as a proprietary fund using full accrual accounting. The required basic financial statements are a balance sheet, operating statement and statement of cash flows.

Category 2 entities should review the Category 2 Budgetary Accounting and Reporting System (BARS) manual, volume 1, part 4, chapter 4. Category 2 entities are required to complete 04 and 05 schedules for internal service funds.

Common Questions

- *How big should the fund balance of the ER&R fund be?*

One of the primary goals of an internal service fund is to break even. Therefore, the fund balance should reflect a level that is anticipated to assure continued operation of the fund. It should not contain an excess or deficit to that projected amount. When the fund balance is not in line with the project amount, rates need to be adjusted to bring the fund balance to that level.

- *What should be included in the cost of equipment purchases/leases?*

All actual costs associated with the operation of the ER&R fund should be included when determining the rate structure for equipment. Allocation of the costs should be made on an equitable basis such as asset life. Costs should be allocated for salaries and benefits, general cost of operations, attorney fees, insurance, etc. The four components of rate-setting are further discussed in the rate setting section above.

- *How is replacement cost defined?*

Replacement cost is that amount that is anticipated to replace the existing asset above the cost being recovered through depreciation. This portion of a rental charge should be tracked separately. Replacement costs are estimates and are not allowable for federal reimbursement.

- *How do we handle assets that are depleting, such as quarry sites or pit areas?*

These assets should be handled as other assets. Their use charge should be based on operation costs, historical cost depreciation/depletion rate, and replacement inflation factor. The goal is continued break-even operation of the ER&R fund, which includes future replacement of the depletable asset.

- *How do we decide on an appropriate inflation factor for equipment that has a 10-year lifetime?*

Rates for assets should be re-evaluated on a yearly basis. This would include review of the inflation factor as well as operational costs. If the amount invested for purchase of a replacement vehicle is not on target, an adjustment should be made. Care must be made when signing contracts with other departments so that rates are not locked in for an entire 10-year period.

Common Audit Issues

1. Failure to maintain a current list of assets and lack of the performance of physical inventories. (This was the most common condition observed.)

2. Failure to retain adequate records for support of expenditures.

3. Failure of the ER&R fund to bill departments for use of equipment and supplies.

4. Submitting replacement cost estimates for reimbursement with grant money.

REFERENCES

RCW 35.21.088 Equipment Rental Fund

RCW 36.32.210 Inventory of county capitalized assets -- County commission inventory statement -- Contents

RCW 36.33A.010 Equipment Rental and Revolving Fund – Establishment – Purpose

RCW 36.33A.020 Use of fund by other offices, departments or agencies.

RCW 36.33A.030 Administration of fund

RCW 36.33A.040 Rates for equipment rental

RCW 36.33A.050 Deposits in fund

RCW 36.33A.060 Accumulated moneys

RCW 43.09.210 Local government accounting -- Separate accounts for each fund or activity