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FINANCE COMMITTEE

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**Measures to Improve Implementation of the Organization's Support
Cost Policy**

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EXECUTIVE SUMMARY

- The Secretariat has identified several measures that could: (a) reduce the cost recovery gap of variable indirect costs within the current scope of the FAO Support Cost Policy; and (b) improve the cost recovery of categories of costs that have been previously excluded from recovery by FAO, but are normally recovered by other UN Organizations.
- Measures to improve the recovery of the costs as currently defined in the policy are expected to increase recovery by approximately USD 4 million per biennium and include: improving project budgeting guidelines and providing training; simplifying the workflow and paperwork for claiming secondment income; applying a direct charge for services provided by decentralized office Regular Programme staff to projects with PSC rates below the ceiling.
- The Secretariat also proposes to improve cost recovery by identifying categories of costs that have been largely excluded from the FAO Support Cost Policy, including: charging trust fund projects for Information Technology-related costs; and levying direct charges to projects to recover costs for some items which no longer qualify as fixed indirect costs.
- The document also outlines the increased financial risk associated with residual deficit balances on Trust Fund projects. With the increasing volume of trust fund activity it is essential that the risk be recognised and options to deal with the risk be considered.

GUIDANCE SOUGHT FROM THE FINANCE COMMITTEE

- The Committee is asked to take note of the measures identified that could reduce the cost recovery gap of indirect variable costs within the current scope of the FAO Support Cost Policy.
- The Committee is invited to review the measures identified to improve the cost recovery of categories of costs that have been previously excluded from recovery by FAO, but are normally recovered by other UN Organizations, in particular in the area of Information Technology. Further detail will be provided to the Finance Committee at its session in October 2011.
- The Committee is invited to take note of the increased financial risk associated with Trust Fund project deficits and losses due to the higher volume of voluntary contributions, and to note also the intention of the Secretariat to carry out further analysis of the matter (including consideration of practices in place at other organizations) with a view to presenting proposals to mitigate the risk to a future session of the Finance Committee.

Draft Advice

- **The Committee welcomed the measures identified that could reduce the cost recovery gap of indirect variable costs within the current scope of the FAO Support Cost Policy and encouraged the Secretariat to move forward with implementation.**
- **The Committee reviewed the measures identified to improve the cost recovery of categories of costs that have been previously excluded, and looked forward to reviewing further detail at its session in October 2011.**
- **The Committee took note of the increased financial risk associated with Trust Fund project deficits and losses due to the higher volume of voluntary contributions, and looked forward to reviewing the proposals to mitigate the risk at a future session of the Finance Committee.**

Background

1. The voluntary contributions managed by the Organization in Trust Funds have increased significantly in recent years. During the 2008-09 biennium, Trust Fund expenditures amounted to more than USD 1 billion, and for the first time exceeded Regular Programme expenditures. There are a number of emerging issues and risks in the context of increasing Trust Fund activity, in particular concerning cost recovery of services provided in the delivery of the activities funded by voluntary contributions, and residual deficit balances on Trust Fund projects.

2. Financial Regulation 6.7 of the Basic Texts of the Organization sets out the boundaries for the acceptance of any voluntary contribution, in particular stating that there should be no additional financial obligations for Member Nations.

“The acceptance of any such [voluntary] contributions and moneys which directly or indirectly involves additional financial obligations for Member Nations and Associate Members shall require the consent of the Conference.”

3. The FAO policy for setting project servicing cost (PSC) rates, including for voluntary contributions held in Trust Funds, was endorsed by the Council in November 2000.¹ The policy is based on the principle that there should be a reasonable alignment of charges to the actual costs of providing administrative and operational support (AOS) to projects, taking due regard of existing arrangements, and the need for a simple and transparent approach.

4. The Organization reports regularly on the level of support costs and recoveries.² The Finance Committee at its 123rd session in October 2008 noted with concern the persistent and growing under-recovery of administrative and operational support costs for extra-budgetary activities, as highlighted by the External Auditor and reported in the Programme Implementation Report 2006-07. The recovery gap has closed somewhat in 2008-09.³

5. At the 128th Session of the Finance Committee in July 2009, the Secretariat informed the Committee of the results of the inter-agency study undertaken by the High Level Committee on Management (HLCM) Finance and Budget Network (FBN) Working Group on Support Costs. The study identified a number of cost categories which are not covered by FAO's support cost policy and rates but would qualify for recovery.⁴

6. Pending the finalization of inter-agency consultations, the Secretariat has undertaken an internal review and identified several measures that could: (a) reduce the cost recovery gap of variable indirect costs within the current scope of the FAO Support Cost Policy; and (b) improve the cost recovery of categories of costs that have been previously excluded from recovery by FAO, but are normally recovered by other UN Organizations, under the in-principle enlarged scope of the Support Cost Policy endorsed by the Finance Committee in July 2009.⁵

¹ CL 119/13 Annex II and subsequent refinements in CL 112/4 paragraphs 21-23; CL 128/4 paragraphs 20-25; CL 131/7 paragraphs 49-52.

² FC 135/5

³ C 2011/8 PIR 2008-09 paragraphs 310-314

⁴ FC 128/13

⁵ CL 137/4 paragraph 61

A. Reducing the cost recovery gap within the current scope of the FAO Support Cost Policy

7. The scope of the current FAO support cost policy is to recover all *variable indirect support costs* associated with projects funded by voluntary contributions. These are mostly defined as administrative and operational services that are a necessary and inherent part of any project the Organization agrees to execute, but which, because of their nature, cannot be readily or directly singled out for charging to the project itself. The current FAO support cost policy and the definition of *variable indirect support costs* are provided in Annexes I and II.

8. Variable indirect costs are recovered through the levy of a percentage rate applied to expenditures, the Project Support Cost (PSC) rate, with a ceiling of 13 percent for non-emergency projects and 10 percent for emergency projects. The 13 percent PSC ceiling rate was determined based on the principle of cost sharing of support costs between the recipient organization and the donor and represented, according to the cost measurement studies performed at the time, approximately half of the total support costs incurred by UNDP in the 1980s and early 1990s. The 13 percent rate was subsequently adopted by almost all legislative organs in the United Nations system⁶, including FAO, as a ceiling rate.

9. FAO staff in decentralized offices (Regional, Subregional and Country Offices) provide direct operational support to trust fund projects including project design, appraisal, monitoring, operational backstopping and administrative support to Evaluations. This is a different set of services than those provided centrally by headquarters or regional office units. Operational support services provided by decentralized office staff are included in the PSC ceiling rate and in such cases these offices receive a share of PSC income. However, these costs are not reimbursed in cases where the PSC rate approved within the policy is lower than the standard 13 percent unless *ad hoc* direct charges for specific support services are levied against project budgets by the concerned units. In the absence of such direct charges, the support services are subsidized by the Regular Programme.

10. The Secretariat is taking measures to improve the recovery of the costs as currently defined in the policy, in particular when a lower than standard PSC rate is applied to projects operated by Country Offices. Such lower rates occur, for example, in the case of Joint Programmes and Multi-donor Trust Funds, where the agreed PSC rate of 7 percent is attributable only to central support services provided by headquarters or regional office units. The measures outlined below will benefit the operating units involved in projects where lower PSC rates apply, which is currently 20 percent of projects, and are expected to increase cost recovery by approximately USD 4 million per biennium.

Simplification of workflow for claiming secondment income

11. The Organization's internal reimbursement procedures have proven to be rather cumbersome, involving the completion of paper forms and waiting for actual recovery, often with follow-up needed. Furthermore, the rules on accounting for secondment income were not always interpreted in a consistent manner. This has often led to a lower than expected level of claims submitted.

12. Measures to facilitate the internal procedure for reimbursement are therefore considered to be of utmost importance. One measure which is being introduced is the submission of electronic requests for reimbursement and electronic acceptance of claims, similar to the approach which is in use for claiming technical support service income on TCP projects. In essence, a no-objection approval is assumed five days after submitting a claim for reimbursement, after which the accounting transaction follows automatically.

⁶ See JIU/REP/2002/3.

13. The policy for crediting income for staff support services rendered to projects will be reviewed in order to streamline the procedure for claiming staff secondments. The aim would be to simplify such transactions in the operating unit and administrative units concerned, resulting in increased reimbursements of AOS as direct cost due to higher rates of compliance.

Other measures

14. At headquarters, some other measures to improve the recovery of costs have already been introduced. For example, the cost of space such as housekeeping and utilities (electrical, garbage, power, etc.) is now charged to extra-budgetary projects for space occupied by their staff and consultants. In the decentralized offices, the recovery of these types of charges is currently done on an ad hoc basis. A review of the incremental costs incurred at the field level will be made to standardize these recoveries, where applicable, using appropriate methodologies in accordance with UN cost recovery principles.

15. Other costs at headquarters that are not yet recovered include those of the in-house building and architectural office. Technical staff and consultants of this office provide direct services and support in the design and construction of facilities funded from extra-budgetary resources without due compensation for time accorded to these projects. Costs related to these services could be charged to the extra-budgetary projects.

16. In addition to operational support and budget holder functions, all decentralized offices provide procurement, transport, cost of servicing space, logistics support and finance services to projects. Currently these services are provided by staff paid from the Regular Programme, except in certain large or complex projects for which donors may agree to pay for project staff to perform some or all of these functions. For projects with PSC rates below the ceiling, the Secretariat will calculate a direct charge based on an automated procedure to be designed. The incremental support cost recovery from these measures would be credited to the decentralized offices concerned. The resources would contribute to address to some extent the chronic lack of capacity, in particular in country offices, to provide support to the delivery of the in-country work of FAO.

17. To ensure that costs are recovered to the greatest extent possible, the Organization is also investing in training and support, including:

- the issuance of improved Project Budgeting Guidelines that will provide steps for better budget formulation practices to ensure full cost recovery; and
- organizing regular training sessions at headquarters and in decentralized offices on support cost policy and its application, and on budgeting and recovery mechanisms of administrative and operational service costs.

B. Improving cost recovery for categories of non-PSC related costs that have been largely excluded from recovery in FAO

18. The section sets out proposals to improve cost recovery by identifying categories of costs that have been largely excluded from the FAO Support Cost Policy, while normally recovered by other UN Organizations: a) type of costs that did not exist at the time the PSC ceiling rate of 13 percent was set, and in subsequent years were not material; or b) were considered fixed costs at a much lower volume of voluntary contributions than today.

*Costs not included in the calculation of the 13 per cent PSC rate:
information technology related costs*

19. Costs under this category are those typically related to the innovation in information technology (IT) that emerged since the time the ceiling rate of 13 per cent was adopted. These services are mostly of a variable indirect nature. They are directly affected by the number of project staff and the size and complexity of projects (e.g. number of computer servers, size of help desks, number of IT technicians required in various locations). The recovery of these costs cannot

realistically be achieved by increasing the 13 percent PSC ceiling rate, but can now be identified and recovered as direct costs to the projects.

20. At the time that cost studies were undertaken in the 1980s and early 1990s as a basis for establishing the PSC ceiling rate, in FAO all costs related to the operation and maintenance of the information technology infrastructure by the Information Technology Division were considered fixed overhead costs. IT services were primarily mainframe based systems accessed only through terminals located in the central finance and personnel departments, and most communication with decentralized offices and projects was by telex. At that time, a decision was also made to limit the telephone service costs included in the PSC rate to directly charged calls (long distance) and assume that telephone equipment and infrastructure was a cost of the Regular Budget.

21. With the rapid expansion and greater dependence of all offices on modern IT services, significant new IT-related costs have arisen at FAO for: e-mail, intranet, and internet access, maintenance and operation; IT help desk support; IT server maintenance and operation; and corporate systems and telephone equipment.

22. It is proposed to charge trust fund projects for the provision of these IT services, as follows: a *headquarters charge* would cover all of the IT and telephone services for all project financed staff and consultants given access to these services; and a *Regional Office charge* and a *Country Office charge* would cover FAO e-mail and internet access, access to corporate systems and IT help desk and maintenance support services provided by headquarters-based staff. The total budgeted cost for each of the services would be divided by the number of staff and consultants given access to the system, and Trust Fund projects would be charged accordingly. It is also proposed to charge directly to project budgets the actual time spent by the systems design and development staff in the support of Trust Fund projects.

Other costs that were identified by FAO as fixed indirect costs

23. At the time that detailed cost studies were undertaken in the 1980s and early 1990s as a basis for establishing the PSC ceiling rate, voluntary contributions were a minor part of total FAO resources (39 percent in 1996-97). They were provided primarily by the United Nations Development Programme (UNDP) and were administered centrally.

24. Given the above, certain costs were excluded from the calculation of the PSC ceiling rate due to immateriality or measurement difficulties. Furthermore, fixed costs were already correctly budgeted under the Regular Programme and donors were not prepared to cover FAO's fixed costs⁷, nor was it seen to be desirable to fund substantial fixed costs from limited variable income.

25. Fixed indirect costs excluded from the scope of the original FAO variable indirect cost recovery policy⁸ were defined as costs of general management (ODG, ADG offices), general financial accounting, auditing, IT infrastructure (treated above), costs of administering personnel, security and maintenance of information technology infrastructure (e.g. telex), and central records.

26. The significant increase of voluntary contributions, the limited growth of the Regular Programme, and the new modalities of project operations necessitate bringing under the cost recovery policy those costs which were at the time classified as fixed indirect. The volume of activities financed by voluntary contributions contribute significantly to the work load of the support units, and therefore some of them no longer qualify as *fixed* indirect costs. The Secretariat therefore proposes to include under the FAO support cost policy, beginning in 2012, the levying of direct charges to projects to recover costs for some of these other items until now classified as

⁷ FC 94/4(d)

⁸ FC 93/4

fixed indirect. Further detail will be provided to the Finance Committee at its session in October 2011.

C. Residual Balances on Projects

27. This section reviews in more detail an area of increased financial risk in the context of an increase in Trust Fund activity, specifically the risk associated with residual deficit balances on Trust Fund projects. Whilst over the years the Organization has minimised the occurrence of such instances, given the increasing volume of Trust Fund activity it is essential that the risk be recognised and options to deal with the risk be considered.

28. It is recalled that Financial Regulation 6.7 of the Basic Texts of the Organization sets out the boundaries for the acceptance of any such voluntary contribution, in particular stating that there should be no additional financial obligations for Member Nations with regard to the receipt of voluntary contributions⁹. This is reflected in FAO policies and practices in several ways in addition to the support cost policy, including in that project budget holders are not allowed to incur expenditures, or enter into commitments, beyond the budget agreed by donors; and that project budget holders are not allowed to incur expenditures beyond the cash balance actually received from donors.

29. Procedures are in place to support the above policies and to guide budget holders in the management of project funds in accordance with FAO's financial rules and regulations and, indeed, results to date have shown that FAO has been very successful in dealing with the unplanned events on projects. However, whilst these policies and practices are applied as part of the process of due care exercised by FAO management, there are cases when losses on extra-budgetary funded projects can and do in fact arise. This is most often due to:

- exchange rate effects, where the contribution is in non-USD currency and this currency depreciates against the USD during the lifetime of the project;
- exchange rate effects where project inputs procured in non-USD appreciate against the USD between the time of commitment and actual payment;
- price effects, where the price of planned inputs increases;
- expenditures within budget which are subsequently deemed ineligible by donors;
- non-payment of the full contribution by the donor; and
- losses of project funds or assets due to the difficult operating conditions in which some Trust Fund projects are implemented.

30. While good project management, careful budget monitoring and timely liaison with donors can mitigate many of the risks above, it is not always possible to avoid deficits or losses from occurring. It is therefore necessary that the Organization recognise that the occurrence of project deficits or losses is an inherent part of its business and this is becoming ever more important as FAO undertakes an increasingly large and complex extra budgetary programme.

31. Under current practice, gains and losses on the Organization's extra-budgetary operations may be held in the balance sheet for years awaiting extra-ordinary resolution and losses are only written-off after full investigation in accordance with the strict requirements set out in the Financial Regulations and Financial Policies of the Organization. In this regard, it is noted that the provision of USD 2.9 million which was made in the Organization's official accounts for 2008-09 in respect of Trust Fund project deficits considered as being not recoverable accumulated over a period of more than 15 years.

32. The Committee is invited to take note of the increased financial risk associated with Trust Fund project deficits and losses in a context of higher volumes of voluntary contributions and to note also the intention of the Secretariat to carry out further analysis of the matter (including

⁹ See background section for quote of FR 6.7.

consideration of practices in place at other organizations) with a view to presenting proposals to mitigate the risk to a future session of the Finance Committee.

ANNEX I

CURRENT FAO SUPPORT COSTS POLICY

1. The scope of the current FAO support cost policy is to recover all variable indirect support costs associated with projects funded by voluntary contributions. These are mostly defined as administrative and operational services which are a necessary and inherent part of any project which the Organization agrees to execute, but which, because of their nature, cannot be readily or directly singled out for charging to the project itself.

2. More specifically, FAO has defined variable indirect support costs in MS 250 as follows:

Administrative services may include such items as:

- *recruitment, briefing and servicing of project personnel;*
- *servicing of fellowships;*
- *procuring supplies and equipment, formalizing contracts;*
- *preparation of budgets and control of project expenditures;*
- *receipt, custody and disbursement of funds, maintenance of project accounts, financial reporting, external and internal audits, etc.;*
- *security monitoring.*

Operational services may include such items as:

- *assembling and submitting proposals to donors;*
- *negotiating agreements and plans of operation with project-sponsoring bodies and recipient governments;*
- *location and recommendation of qualified personnel;*
- *guidance and supervision of the implementation of projects;*
- *preparing, monitoring and revising workplans and budgets;*
- *reporting periodically on projects;*
- *fellowships placement and formulation of study plans;*
- *technical selection of equipment and technical preparation of contracts.*

3. It is noted that all of these costs fall under the definition of **indirect project support costs**.

SUMMARY

Table 1: Matrix of Activities by Funding Source and Type

| Funding Source | Technical Assistance (TA) | | Emergency Assistance | Normative Programmes and Other RP Activities | |
|-------------------|---|---|----------------------|--|---------------------------|
| | National Funding | Donor Contributions | Donor Contributions | FAO RP Normative Activities inc. Commissions | Jointly Funded Activities |
| Extra-budgetary | 13% ceiling (see text below for exceptions) | 13% ceiling (see text below for exceptions) | 10% ceiling | 13% (see text below for exceptions) | As per MoU |
| Regular Programme | TCP and SPFS: ceiling of 7% | | TCP 7% ceiling | FAO Regular Programme | FAO Regular Programme |

4. The following notes apply these principles to the each of the categories of programme defined in Table 1 above.

EXTRA-BUDGETARY PROGRAMMES

Technical Assistance - Government Cost Sharing

5. These are defined as technical assistance projects in the field which are funded by the Government of the recipient country, including those which are funded through loans from international financing institutions.

6. In principle, such projects should reimburse the variable indirect support costs associated with the project. Standard rates are not to exceed a ceiling rate (currently 13 percent) but can be adjusted where appropriate for special circumstances:

- high proportions of contracts, supplies and equipment requiring minimal AOS costs (current Manual Section 250 provisions to continue to apply);
- national execution in whole or in part;
- inclusion of project support costs in the project budget as direct project costs;
- other cost sharing or complementary support arrangements; and
- exceptionally large projects when economies of scale apply.

Technical Assistance – Donor Contributions

7. These are defined as technical assistance projects in the field which are funded by a third party other than FAO or the recipient Government.

8. In principle, such projects should reimburse the variable indirect support costs associated with the project. Standard rates are not to exceed a ceiling rate (currently 13 percent) but may be adjusted where appropriate for special circumstances:

- rates established by inter-governmental bodies of the UN system organizations (including the international financial institutions);
- high proportions of contracts, supplies and equipment requiring minimal AOS costs (current Manual Section 250 provisions to continue to apply);
- Associate Professional Officers (APOs) which are charged a fixed rate of 12 percent;
- inclusion of project support costs in the project budget as direct project costs; and
- exceptionally large projects when economies of scale apply.

Emergency Assistance

9. FAO emergency assistance is defined as a situation where an urgent and exceptional external response is needed in the agriculture sector to address the impact of a particular disaster, natural or man-made. If a project is characterized as an emergency, the request follows the "fast track" and is operationally treated as such. Generally, "prevention" and "preparedness" are not within the meaning of "emergency" for project operational purposes.

10. The ceiling rate for emergency assistance projects is 10 percent. Rates for emergency assistance are to be determined on a case-by-case basis to recover the full variable indirect support cost of the project. When Emergency Operations and Rehabilitation Division (TCE) operates technical assistance projects because of special situations, the reimbursement rates for technical assistance shall apply.

Regular Programme Normative Activities

11. These are defined as voluntary contributions which directly support the implementation of Regular Programme activities. Such activities will generally be normative in nature and be implemented at Headquarters or at a Regional Office rather than directly in the field.

12. A standard PSC rate of 13 percent will apply.

13. Such rates can be adjusted to reflect the impact of certain special circumstances:
- contributions to cover the travel cost of participants from developing countries to conferences and consultations on matters within FAO's mandate will be exempted from indirect support cost charges;
 - sponsorship funds in support of awareness raising and/or promotional events will be used to cover the identifiable direct costs of these activities and as such, are not subject to project servicing costs;
 - contributions to FAO for the refurbishment and improvement of FAO premises (both at Headquarters and in Regional and Subregional Offices) are exempt from PSC charges;
 - Associate Professional Officers (APOs) which are charged a fixed rate of 12 percent; and
 - long-term trust fund accounts (e.g. Commissions established under the auspices of FAO) will be subject to a case by case estimate of the actual level of variable indirect support costs and charged accordingly.

Jointly Funded Activities

14. These arrangements cover activities which are part of the Regular Programme and are usually normative in nature. They are defined as partnership arrangements between FAO and other inter-governmental organizations including, in particular, UN system organizations.

15. The special nature of these partnership arrangements will be recognized and translated into an agreement to share direct costs in a manner appropriate to the joint activity's contribution to the Strategic Objectives of the Organization. Variable indirect costs are generally to be funded by the host organization although recognition of this fact should generally be given in the Memorandum of Understanding and related cost sharing formulae.

16. It is noted that the FAO-GEF Agreement foresees a flat reimbursement fee of 10 percent for full size projects for support and supervisory costs. This arrangement is still being evaluated by FAO. GEF-funded PDF Block B projects that have become operational have been granted Project Support Servicing of 6 percent, which seems sufficient to fully recover variable indirect support costs.

REGULAR PROGRAMME

TCP and SPFS

17. Regular Programme funded technical assistance (including emergencies) should, in principle, reimburse the variable indirect support costs incurred by "operating units" or their equivalent associated with the project (i.e. for operational services). This should be based on an average rate (currently 7 percent).

ANNEX II

General Categories of Cost¹⁰

DEFINITION

The following table defines the terms used in the current FAO support Cost policy. This terminology is in line with the harmonized concepts approved by the HLCM, while the application varies widely among UN System organizations.

Table 1 Definition of Cost Accounting Terms

| Cost Accounting Term | General Definitions | Term used in this paper | Original application |
|--|--|--------------------------------|---|
| Direct Costs | Items of cost that are directly traceable to the product or output. | Direct project costs | Project inputs that are directly traceable to the project and charged to it |
| Indirect Costs (also referred to as "overhead"): a) Variable Indirect Costs | Items of cost that are associated with the production of several outputs but which are not traceable to individual outputs. They will tend to vary indirectly with the volume produced | Indirect project support costs | Administrative and operational support costs and some technical services to projects involving staff time which cannot be discretely identified |
| b) Fixed Indirect Costs | Items of cost that are not easily traceable to the production of a single output and which do <u>not</u> vary with the volume of output | Fixed overhead costs | Costs of general management (e.g. ADGs and D2s; ODG), general financial accounting; central HR function, auditing, messenger service, central records and procurement for Regular Programme, etc. |

¹⁰ See FC 93/4 table 1 and paragraph 29.