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# FINANCE COMMITTEE

**Hundred and Fifty-fourth Session**

**Rome, 26 - 30 May 2014**

**Comprehensive Financial Framework for Cost Recovery - Update**

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### EXECUTIVE SUMMARY

- At its 151st session, the Finance Committee examined document FC151/8 *Comprehensive report on FAO's support cost policy* and welcomed the initiative to develop a comprehensive financial framework for cost recovery by FAO.
- The present document provides an update on the initiative with respect to: a) the external review of developments related to cost recovery within the UN up to mid-April 2014; b) the internal review of FAO financial, administrative and operating issues related to cost recovery, and c) the draft principles to be employed in the development of a Comprehensive Financial Framework for proportional cost recovery.
- Based on developments within the United Nations system; FAO financial, administrative and operational issues; and the specified assumptions, the Comprehensive Financial Framework is being developed according to the following principles:
  - a) Support and potentially strengthen FAO's ability to deliver on its mandate, especially using resources efficiently and supporting the relationship between FAO project and normative work;
  - b) Align with the decentralization policies that enable decision-making and strengthen activities at the country level;
  - c) Be simple and provide for transparency, equitability and accountability as financially and operationally reasonable; and
  - d) Adopt those existing practices accepted by Member States, donors and governing/oversight bodies within the UN system that would support FAO's efforts in implementing its unique mandate.
- The remaining aspects of the concept phase are ongoing and will be provided to the next regular session of the Finance Committee along with the results of the formulation phase.

### GUIDANCE SOUGHT FROM THE FINANCE COMMITTEE

- The Finance Committee is invited to review and provide any views on the recent developments on cost recovery issues within the UN System, FAO-specific financial, administrative and operational issues that have been identified, and the assumptions and principles for development of a Comprehensive Financial Framework.

#### Draft Advice

- **The Finance Committee:**
  - a) **noted the progress on the Comprehensive Financial Framework initiative, including the provision of the latest information on developments concerning support cost issues in various UN organizations, and the identification of FAO-specific financial, administrative and operational issues;**
  - b) **endorsed the aim, assumptions and principles of the initiative; and**
  - c) **looked forward to reviewing the final concept and implementation considerations at its next regular session.**

### *Introduction*

1. At its 151st session, the Committee examined document FC151/8 *Comprehensive report on FAO's support cost policy*, in which the Secretariat noted evolving operating environments, interest in harmonizing cost categorization and recovery among UN agencies, and UN resolutions regarding full cost recovery.<sup>1</sup> In this context, the Secretariat indicated its intention to conduct a more thorough review of FAO's support cost arrangements, specifically:

The Secretariat intends to take a broad approach to addressing cost recovery and cost categorization issues with a view to proposing a comprehensive strategy that would take the evolving operating environments into consideration and harmonize with other UN agencies to the extent possible.

2. In line with the December 2012 General Assembly resolution on cost recovery made in response to the Quadrennial Comprehensive Policy Review (QCPR), the aim of the FAO review is to develop a cost recovery framework based on the guiding principle of full cost recovery, proportionally from core and non-core resources.<sup>2</sup> A cost recovery methodology providing proportional recovery would also align with the Triennial Comprehensive Policy Review in which the General Assembly requested that organizations "review the issue of cost recovery to ensure that core resources do not subsidize the projects undertaken through non-core/supplementary/Extrabudgetary funding".<sup>3</sup> These resolutions arise from concerns that a portion of costs associated with extrabudgetary-funded activities is borne by Regular Programme resources in the present cost recovery methodology,<sup>4</sup> which "may have a negative effect on the availability of remaining core resources for programme activities".<sup>5</sup>

3. This subsidy issue is linked to the partnership principle, which resulted in United Nations system organizations, including FAO, developing and applying support cost policies and arrangements that provided for partial reimbursement of costs based on a method of 'incremental cost recovery'. This method results in the recovery of only part of the organization's additional administrative costs incurred as a result of an extrabudgetary-funded activity, leaving the balance of these costs funded from Regular Programme resources.

4. In its 151st session, the Committee welcomed the initiative to develop a comprehensive financial framework for cost recovery by FAO and agreed with the schedule of activities to develop the framework by the end of 2014. The timeline for the review presented three phases with associated activities, as follows:

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<sup>1</sup> FC 151/8 paragraph 31-33.

<sup>2</sup> A/RES/67/226 paragraph 53: "The General Assembly requests the executive boards of the United Nations funds and programmes, and encourages the governing bodies of the specialized agencies to adopt cost recovery frameworks by 2013, with a view to their full implementation in 2014, based on the guiding principle of full cost recovery, proportionally, from core and non-core resources, and a simple, transparent and harmonized methodology, providing incentives, including through differentiated cost recovery rates, and taking into account different volumes and nature of funds to increase core funding and more predictable, flexible and less earmarked non-core contributions that are aligned with the strategic plans adopted by the respective governing bodies."

<sup>3</sup> A/RES/62/208 paragraph 116.

<sup>4</sup> JIU/REP/2002/3 paragraphs 11 and 13.

<sup>5</sup> A/69/63 - E/2014/10 paragraph 59.

**I. Research Phase**

August – December 2013

1. Conduct research on history, recent developments, internal working modalities
2. Review history of FAO cost recovery
3. Consult with Finance Committee in November 2013

**II. Concept Phase**

January – May 2014

1. Review developments on cost recovery initiatives within the UN system; and participate in the Finance and Budget Network Working Group on cost categorization
2. Conduct internal consultations
3. Develop principles for the Comprehensive Financial Framework
4. Develop the Comprehensive Financial Framework concept
5. Identify advantages/disadvantages, implications and feasibility of concept
6. Develop high-level implementation plan
7. Update the Finance Committee in May 2014

**III. Formulation Phase**

June – November 2014

1. Finalize principles and Comprehensive Financial Framework model
2. Identify implementations considerations
3. Develop implementation modality taking into consideration implications for integrated budget preparation and any needed regulation/policy changes
4. Consultation and approval: Finance Committee in November 2014 and Council December 2014

5. The results of the research phase were reported to the Committee's 151st session in November 2013 including the evolution of FAO's support cost policy: 1) United Nations historic context, 2) the scope of FAO's support cost policy, 3) methodological basis for calculation of variable indirect costs and determination of PSC rates, and 4) implementation of improved cost recovery, specifically the application of the Improved Cost recovery Uplift (ICRU).

6. This paper reports on the first three activities of the concept phase:

- a) External review: update on developments related to cost recovery within the UN up to mid-April 2014, with particular emphasis on anticipated events as identified in the November 2013 session;
- b) Internal review: FAO financial, administrative and operating issues related to cost recovery; and
- c) Draft principles, given underlying assumptions, to be employed in the development of a Comprehensive Financial Framework for proportional cost recovery as well as other potential benefits that might be achieved.

7. The remaining aspects of the concept phase are ongoing and will, therefore, be provided to the next regular session of the Finance Committee along with the results of the formulation phase.

8. The Comprehensive Financial Framework concept will adopt existing practices accepted by Member States, donors and governing/oversight bodies within the UN system if those practices could be useful to FAO in implementing its mandate while harmonizing with UN system modalities to the extent possible.

9. Therefore, the intention is to build on three streams of information: 1) developments within the UN regarding cost recovery in order to benefit from experience in addressing cost recovery issues and adopting accepted and relevant practices, 2) analysis of FAO financial, administrative and operational issues regarding cost recovery with a view towards addressing such issues in a comprehensive and integrated manner, and 3) the Committee's guidance on the draft principles for a Comprehensive Financial Framework.

### A. Developments within the UN system

10. Implementing the QCPR principle of full cost recovery proportionally from core and non-core resources is binding for United Nations entities that report to the General Assembly and encouraged for the specialized agencies.<sup>6</sup> In order to benefit from developments within the UN system and to identify modalities that may be useful to FAO, the Secretariat is monitoring several cost recovery initiatives as summarized in the Annex.

11. The summary review of these recent developments reveals three major themes emerging as part of implementation, as summarized below.

12. In general, organizations are moving towards *full cost recovery proportional from core and non-core resources*. In some cases, however, organizations continue to fund a portion of their activities from Assessed Contributions or Regular Programme resources without proportional recovery of costs. For instance, WHO intends to budget costs of stewardship (strategic management, general management, governing bodies, and legal, oversight and compliance) separately from technical areas and fund these costs from assessed contributions. Likewise, UNDP/UNICEF/UNFPA/UN-Women established a separate cost category for cross-cutting functions to be funded solely from Regular Resources. A recent report of the Secretary-General, however, notes that the General Assembly resolution did not make a provision for such an exclusion.<sup>7</sup>

13. As part of the move towards proportional funding, organizations are *recovering the full costs of activities rather than incremental costs*, including as direct costs. For instance, in the UNDP/UNICEF/UNICEF/UN-Women model, it was noted that "there are elements of costs previously funded centrally, that will in the future be embedded in programmes and projects", with the expectation that "the direct attribution of centrally managed costs will enable budget owners and donors to be better informed regarding the costs of projects".<sup>8</sup>

14. Organizations may have *different recovery rates*, which may be related to contribution type or purpose. For instance, UNDP/UNICEF/UNFPA/UN-Women established differential recovery rates: 8 percent for resources with proportional recovery (non-core); 7 percent for thematic contributions (with UN-Women maintaining the rate of 8 percent as a temporary arrangement) and preferential rates for government cost-sharing, South-South contributions and private-sector contributions.<sup>9</sup>

15. The Secretariat will monitor up-coming proposals and decisions. It will take particular note of the differences in business models that could include the impact of economies of scale between humanitarian and knowledge-based organizations, scalability of some types of costs, operating modalities and any other differences that might affect cost recovery modalities in order to identify potential innovations and practices that could be relevant to the FAO context.

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<sup>6</sup> Includes 11 Funds and Programmes, 6 research and training institutions (UNICRI, UNIDIR, UNITAR, UNRISD, UNSSC, UNU) and three other entities (UNAIDS, UNISDR, UNOPS)

<sup>7</sup> A/69/63 – E/2014/10, paragraph 68

<sup>8</sup> DP-FPA/2013/1 – E/ICEF/2013/8 Table 3 (note) and paragraph 33

<sup>9</sup> UNW/2013/11 paragraphs 4, 5.a and 5.b

## **B. FAO Financial, administrative, operating issues**

16. Internal discussions with concerned FAO offices at headquarters and in the field identified fourteen issues in three main areas that warrant consideration in developing a Comprehensive Financial Framework.

### *Financial issues*

- a) Current extrabudgetary budgets do not reflect full costs because of support from the Regular Programme and technical departments may not be identifying all work performed for projects.
- b) Some directly attributable costs are recovered through the cost recovery rate rather than being included in direct costs.
- c) Multiple support cost rates may affect resourcing as donors may direct funds to activities with lower recovery rates.
- d) Financial reporting on extrabudgetary and Regular Programme activities is not comparable at the activity level.
- e) Reporting on extrabudgetary resources varies by donor resulting in time-consuming processes.
- f) Costs eligible for recovery, accepted recovery modalities and accepted recovery approaches can vary by donor.
- g) The current cost recovery modality does not provide incentives for contributions to core resources or encourage non-traditional donors (private sector, South-South).

### *Administrative issues*

- a) Separate administrative processes, support structures and operating modalities exist to delineate extrabudgetary costs from Regular Programme activities for budgeting and cost recovery.
- b) The method for calculating recovery rates is complex, time consuming and difficult to communicate internally and externally.
- c) The modality of cost recovery, either through an applied rate or through staff occupancy charges (ICRU), is complex in application, in redistribution of recovered amounts aligned with work requirements, and difficult to communicate.
- d) Assessment of requests within the approved policy for rate adjustments pertaining to special circumstances are time consuming and may give the appearance of inequitable treatment among donors.

### *Operating issues*

- a) Resources are not initially linked to specific activities and may come from various separate funding streams — extrabudgetary, Regular Programme, recoveries — and therefore may affect operational effectiveness (by creating uncertainty in timing and sufficiency of necessary funding).
- b) Activities with smaller budgets may not include resources necessary for effective implementation since some required inputs may not be readily scalable on a project-by-project basis.
- c) Operational effectiveness may be hampered and financial efficiency may be reduced due to resource use restrictions.

### **C. Draft principles as basis for comprehensive financial framework development**

17. The scope of the Comprehensive Financial Framework review is broad to encompass cost recovery and cost categorization issues, in the context of external and internal factors as well as working modalities, with a view towards harmonizing with other UN agencies to the extent possible. In addition to external factors (developments within the UN system, emerging operation modalities, donor trends) and internal factors (analysis of financial, administrative and operational issues regarding cost recovery), the review will take into consideration FAO's changed business model including decentralization, introduction of the strategic objective results framework, integration of emergency and development activities, and improved working modalities.

18. The expected output is a Comprehensive Financial Framework for cost recovery which supports FAO's mandate and knowledge-based approach.

19. The underlying assumption for the review is that policy frameworks, resource levels and financial aspects of the Organization remain relatively constant, that is, no substantive changes are anticipated that would affect eventual potential framework modalities. In other words, the assumption is that the current policy frameworks relating to strategic objectives, programme implementation, strategic focus, etc. are expected to remain in place; the current resource levels will remain relatively constant even if there are some fluctuations in level, type and distribution; and the financial practices, administrative processes and operational modalities associated with Regular Programme and extrabudgetary funding are deemed appropriate to the current operating context.

20. Based on developments within the United Nations system; FAO financial, administrative and operational issues; and the specified assumptions, the Comprehensive Financial Framework is being developed according to the following principles:

- a) Support and potentially strengthen FAO's ability to deliver on its mandate, especially using resources efficiently and supporting the relationship between FAO project and normative work;
- b) Align with the decentralization policies that enable decision-making and strengthen activities at the country level;
- c) Be simple and provide for transparency, equitability and accountability as financially and operationally reasonable; and
- d) Adopt those existing practices accepted by Member States, donors and governing/oversight bodies within the UN system that would support FAO's efforts in implementing its unique mandate.

21. In addition to proportional cost recovery, the Comprehensive Financial Framework concept will achieve, to the extent possible, other potential benefits, such as:

- a) More transparent and consistent costing proposals that will enable contributors to understand those costs that are directly charged to programmes and projects as well as the cost-recovery rate that is applied;
- b) Clearer, more complete and potentially more predictable budgeting for full cost recovery at the activity level;
- c) Increased efficiency and transparency in the use of cost-recovery resources;
- d) Streamlined processes for budgeting and recovering costs from diverse funding sources;
- e) Better overview of resource deployment at the activity level for measuring efficiencies, identifying impact and financial reporting on a comparable basis;
- f) Strengthened link between planning, resources and results; and
- g) Increased donor awareness and confidence due to the clarity of budgets and applied cost recovery methodology.

### **D. Next steps**

22. The concept and formulation phases of the Comprehensive Financial Framework initiative will be completed as follows:

- a) Monitor and analyze any relevant developments within organizations conducting cost recovery reviews and continue to contribute to the activities of the Finance and Budget Network (FBN) working group;
- b) Develop an approach for cost recovery in the context of the FAO mandate, taking into consideration the identified assumptions, principles and any feedback and guidance provided by the Finance Committee;
- c) Identify the advantages/disadvantages, implications (such as resource mobilization, impact on delivery, etc.) and implementation considerations of the proposed cost recovery approach;
- d) Develop a high-level implementation plan taking into consideration implications for budget preparation and any needed financial regulation and policy changes; and
- e) Present the finalized concept and implementation considerations to the Finance Committee.



## ANNEX: Overview of recent developments regarding cost recovery in the UN system

1. **UNDP/UNICEF/UNFPA/UN-Women** have recently:
  - a) Harmonized cost categories taking into consideration their respective business models including: mandate, size, location, engagement in development coordination/special purpose activities, and funding sources;
  - b) Established a separate cost category for cross-cutting functions (to be excluded from the calculation of the cost recovery rate) to be funded solely from Regular Resources, with a cost recovery rate of 7 percent;
  - c) Harmonized cost recovery rates at 8 percent for non-core contributions;
  - d) Removed the distinction between indirect fixed costs and indirect variable costs;
  - e) Indicated that some costs funded from Regular Resources in the past will now be included in projects.
2. A recent report of the Secretary-General notes that the General Assembly resolution did not make a provision for any exclusion<sup>10</sup> such as the one relating to funding a portion of costs identified as cross-cutting functions solely from Regular Resources rather than proportionally from core and non-core resources. Nevertheless, these agencies have made substantial progress towards the implementation of the guiding principle of full cost recovery, proportionally, from core and non-core resources, supported by the removal of the distinction between indirect fixed and variable costs. In fact, elements of costs previously funded centrally, will in the future be embedded in programmes and projects.
3. Overall budgets for these organizations were submitted to their respective boards in 2013 and reflect the new conceptual framework for defining and attributing organizational costs and the new methodology and rate for cost recovery. In reviewing these submissions, their Executive Boards recognized that:

...full cost recovery, proportionally from core and non-core resources, will lead to fewer resources being drawn from core resources to finance the management costs of non-core contributions, and a larger share of core resources being allocated to programme activities, thereby providing incentives for core contributions.<sup>11</sup>
4. **Finance and Budget Network (FBN)**. At its June 2013 session, the FBN established a working group on cost categorization with the aim of potential harmonization among UN system organizations. As a starting point, the working group will consider potential harmonization around the UNDP/UNICEF/UNFPA/UN-Women common cost classification, which consists of: 1) Development activities, 2) UN Development Coordination, 3) Management, and 4) Special Purpose.
5. During the June 2013 session of the FBN, agencies noted that: 1) there would be the need for further refinement and clarification of the proposed categories for example to enable differentiation between administrative costs that could be directly attributable to programme delivery, and those which were indirectly attributable, 2) work would be needed in respect of capital costs, and 3) a category of costs targeted for humanitarian assistance would need to be introduced.<sup>12</sup>
6. These issues warrant consideration, since the harmonized UNDP/UNICEF/UNFPA/UN-Women cost categories may not fully reflect the operating modalities of FAO and other specialized agencies. For instance, FAO has a substantial emergency programme, and many of FAO's activities have worldwide application (benchmarking studies, development of standards, international treaties and commissions). FAO emergency, normative and standard-setting activities would all fall into the "special purpose" category under the UNDP/UNICEF/UNFPA/UN-Women cost categories, which would not be appropriate in the FAO context since these activities are not special purpose to FAO but part of its mandate.

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<sup>10</sup> A/69/63 - E/2014/10.

<sup>11</sup> DP/2014/2 paragraph 2013/9-2 and UNW/2013/11 paragraph 2.

<sup>12</sup> CEB/2013/HLCM/FB/15 paragraph 10

7. As such, FAO has recommended that the FBN develop inclusive cost categories to represent appropriately the varied activities of organizations with diverse mandates, funding structures and operating modalities.

8. **World Food Programme (WFP).** In the WFP model, implemented since 1996, all activity costs — categorized as direct operational, direct support and indirect support — are linked for budgeting and resourcing purposes. Initially implementing differential recovery rates for different types of activities, WFP shifted to the current modality of a single recovery rate in 1998.

9. WFP is conducting a review of its indirect support cost (ISC) rate in two phases: i) identification of a method for calculating a new rate; and ii) application of this method to generate an indicative ISC rate. In the first phase of the review in early 2014 the FAO Finance Committee and the WFP Executive Board considered four key questions:

- a) Should core funding or different funding approaches to fixed and variable costs be considered?
- b) Should WFP continue with a single indirect support cost recovery rate, or should the rate vary according to the type of intervention?
- c) Could WFP use differentiated indirect support cost rates to encourage resource mobilization?
- d) Should WFP continue to consider multiple sources for funding costs such a security and non-recurring investments?<sup>13</sup>

10. In its initial feedback, the FAO Finance Committee indicated that “continuation of a single ISC rate for all programmes and activities would be beneficial for WFP and that a core budget model for WFP would not be supported”.<sup>14</sup>

11. The Finance Committee also underscored the importance of considering the different business models of UN organizations and the 100 percent voluntary funding of WFP. Likewise, the ACABQ commented on the impact of different business models, noting that:

...the methodology for the determination of the recovery rates for programme support costs is not uniform among United Nations system organizations, and that the requirement for overall programme support costs varies according to the mandates and the nature and scope of operational activities undertaken. For example, organizations engaging primarily in logistical and administrative support activities will have support needs that will differ significantly from those that are more substantive in nature.<sup>15</sup>

12. **UN Office for Project Services (UNOPS).** To ensure the stability of its self-financing model, UNOPS plans to take a two-pronged approach: 1) it will attribute direct costs using activity-based costing to enable, over time, a reduction of amounts needing to be recovered as indirect costs; and 2) its pricing model for recovery of indirect costs will be refined to include other relevant cost-drivers associated with the value added by UNOPS, thereby distributing costs more fairly.<sup>16</sup> This concept is interesting as it links costs associated with activities to provide a clearer picture of full costs. Such a policy is akin to the change in the WFP resourcing and financing policy implemented in 1996 whereby commodity contributions were accompanied by linked cash contributions required to implement the commodity effectively. Prior to this change in policy, organizations were encouraged to contribute commodity and cash, aiming at one-third cash in the aggregate. The lack of a link of resources required to implement an activity resulted in operational inefficiencies; the subsequent linking of resources for activities under the 1996 resourcing and financing policy greatly facilitated operational effectiveness.

<sup>13</sup> WFP/EB.1/2014/4-B/1 Executive Summary.

<sup>14</sup> CL 149/3 paragraphs 7-12

<sup>15</sup> WFP/EB.1/2014/4(A,B)/2 paragraph 27

<sup>16</sup> UNOPS Strategic Plan, 2014-2017, paragraph 81; A/69/63 – E/2014/10 paragraph 72

13. **UN Office on Drugs and Crime (UNODC).** In line with prevailing Secretariat-wide policies and the need to align the uses of funds with their intended purposes, UNODC is implementing direct costing and full cost recovery policies that will move direct costs of technical assistance from general-purpose and programme support cost funds into project and programme budgets.<sup>17</sup> Like the UNOPS and WFP modalities, the technical assistance cost structure links costs associated with an activity, identified as substantive costs, direct support costs and overhead costs,<sup>18</sup> nearly a mirror of the WFP direct operational, direct support, and indirect support cost structure.

14. **World Health Organization.** WHO, a specialized agency like FAO, presented a document to its Executive Board in January 2014 on the financing of administration and management costs. In the new WHO model:

- a) stewardship and governance costs (approximately USD 460 million, comprised of strategic management; general management; governing bodies; and legal, oversight and compliance) are to be budgeted separately from its five technical areas and funded from assessed contributions, and
- b) infrastructure (comprised of upkeep of premises, running costs, maintenance and a provision for capital investment) and administration support (services at country, regional and headquarters level in support of programme implementation, including financial, information technology, human resources, security, procurement and transportation) costs which total approximately USD580 million are to be budgeted under each of its five technical areas and funded from both direct charges to programmes (regardless of funding source) and indirect charges.<sup>19</sup>

15. The WHO model retains a link to the original concept of ‘incremental cost recovery’ hence funding a portion of costs (stewardship and governance) through assessed contributions rather than proportionally from core and non-core resources.

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<sup>17</sup> E/CN.7/2013/15 – E/CN.15/2013/28 paragraph 23

<sup>18</sup> UNODC Fundraising Strategy 2012-2015 page 28

<sup>19</sup> WHO EB134/11 paragraphs 9, 13, 24