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# FINANCE COMMITTEE

## Hundred and Sixty-first Session

Rome, 16 - 20 May 2016

### Report on the Implementation of the FAO Cost Recovery Policy

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### EXECUTIVE SUMMARY

- At its 154<sup>th</sup> session in May 2014 the Finance Committee endorsed the aim, assumptions and guiding principles for the development of a Comprehensive Financial Framework (CFF) cost recovery model, which would provide the basis for preparing a more transparent and equitable cost recovery policy that treated extra-budgetary resources as supporting FAO's programme of work in an integrated budget.
- At its 156<sup>th</sup> session in November 2014 the Finance Committee examined and endorsed a CFF cost recovery model proposed by the Secretariat based on full proportional cost recovery with attributable support costs, and the new categories of Direct Operational Costs (DOC), Direct Support Costs (DSC), and Indirect Support Costs (ISC).
- At its 157<sup>th</sup> session in March 2015 the Finance Committee examined and endorsed the FAO Cost Recovery Policy, based on the CFF model of full proportional cost recovery, and the transition arrangements for its implementation from 1 January 2016.
- As requested by the Finance Committee, this document provides a report on the initial implementation of the policy, including the progress on the complex changes in budgeting and accounting processes, communication with external partners, and the transition arrangements in place for 2016.

### GUIDANCE SOUGHT FROM THE FINANCE COMMITTEE

- The Finance Committee is invited to review progress on the initial implementation of the FAO Cost Recovery Policy, including the progress on the complex changes in budgeting and accounting processes, communication with external partners, and the transition arrangements.

#### Draft Advice

#### **The Finance Committee:**

- **took note of progress on the initial implementation of the FAO Cost Recovery Policy.**

## A. Background

1. At its 154<sup>th</sup> session in May 2014 the Finance Committee examined and welcomed the update on development of a Comprehensive Financial Framework (CFF) for cost recovery,<sup>1</sup> including the identification of FAO-specific financial, administrative and operational issues and recent developments within the United Nations (UN) system. The Committee endorsed the aim, assumptions and guiding principles for the development of a CFF cost recovery model, which would provide the basis for preparing a more transparent and equitable cost recovery policy that treated extra-budgetary resources as supporting FAO's programme of work in an integrated budget.
2. At its 156<sup>th</sup> session in November 2014 the Finance Committee examined and endorsed a CFF cost recovery model proposed by the Secretariat based on full proportional cost recovery with attributable support costs, and the new categories of Direct Operational Costs (DOC), Direct Support Costs (DSC), and Indirect Support Costs (ISC).<sup>2</sup>
3. At its 157<sup>th</sup> session in March 2015 the Finance Committee examined and endorsed the FAO Cost Recovery Policy (in Annex 1) and the ISC rate of 7 percent, which was subsequently endorsed by Council.<sup>3</sup> The Finance Committee:
  - a) noted that initial implementation of the new FAO Cost Recovery Policy, including the related complex changes in budgeting and accounting policies, and the refinement of flexibility criteria, would require careful preparation and monitoring;
  - b) requested the secretariat to communicate with external resource partners during 2015 on transition and implementation measures; and
  - c) requested the Secretariat to report on initial experience with implementation of the policy at its Spring 2016 session.
4. This document provides a report on the initial implementation of the policy, including the progress on the complex changes in budgeting and accounting processes, communication with external partners, and the transition arrangements in place for 2016.

## B. Experience with initial implementation

5. Initial implementation of the policy comprises four main elements with eight milestones during 2015 and 2016 :
  - a) Prepare clear guidelines for project budgeting of direct and indirect costs;
  - b) Design and execute an internal communication plan;
  - c) Inform and communicate with external resource partners on transition and implementation measures; and
  - d) Assess and address implementation issues, including through proposed adjustments to the policy if required.

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<sup>1</sup> FC 154/10 and CL 149/4 paragraphs 23-24

<sup>2</sup> FC 156/7 and CL 150/4 paragraphs 17-18

<sup>3</sup> FC 157/10, CL 151/3 paragraphs 22-23, CL 151/REP paragraph 11e)

6. Over the past year, the Secretariat has analyzed cost categorization and prepared draft guidelines for project budgeting, started communications internally and with external resource partners on transitional arrangements and implementation measures, and is applying the policy to individual projects that started formulation in 2016 in close collaboration with the resource partners involved.

7. However, the accounting, financial reporting and IT systems updates necessary to scale-up the implementation of the policy require further work during 2016. Once these issues are resolved, full implementation of the policy for all projects can proceed by the end of 2016.

8. Table 1 shows the status of the implementation plan milestones. Progress and issues being addressed are summarized below.

1) *Implementation team.* A small team with the required skills has been formed, led by the Office of Strategy, Planning and Resources Management and including key functional staff from the Technical Cooperation and Programme Management Department, the Finance Division, the Office of Support to Decentralized Offices, and the Information Technology Division. The team is responsible for the remaining milestones.

2) *Application and analysis of cost categorization.* This milestone has been fully completed with no major issues, providing a solid understanding of budgeting requirements.

3) *Budgeting, accounting and financial reporting implications.* As anticipated, the implications and required changes in budgeting and accounting processes are complex and are still ongoing. Changes are required to the Chart of Accounts, accounting procedures and financial reports, which are under discussion and will be in line with IPSAS.

4) *Budgeting and financial reporting guidelines.* Guidelines for budgeting of direct and indirect costs in project budgets have been drafted, applying the new cost categorization from (2) above. The draft guidelines are being tested on the individual projects to which the policy is being applied during the transition phase and will be further elaborated for wider release by end-May.

5) *Update of corporate IT systems.* The update of corporate IT systems (GRMS, FPMIS, PIRES)<sup>4</sup> will start in May based on the outcome of milestone (3) above. The updates are expected to be released by the end of the third quarter 2016.

6) *Internal training and communication.* Communication with project formulators has started and will continue throughout 2016 to explain the main cost recovery concepts and their application to project budgets. The exercise is gathering feedback on particular aspects that will require attention in clarifying guidance and training. A central Help Desk will support project formulators and provide insight on implementation of the new policy.

7) *Inform main resource partners.* Three of FAO's resource partners (Germany, Japan, Sweden) are being engaged during their regular consultation meetings with FAO, including in applying the new policy to selected projects. The feedback points to the importance of communicating clearly the value added of the new FAO Cost Recovery Policy, developing clear budgeting guidelines for use by partner agencies, and clarifying the transitional arrangements. Based on these consultations, an Information Note for external partners has been prepared (see Annex 2).

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<sup>4</sup> Global Resource Management System (GRMS), Field Programme Management Information System (FPMIS), Programme Planning, Implementation Reporting and Evaluation Support System (PIRES)

Furthermore, there is ongoing close consultation with the EU, the largest single FAO resource partner, to ensure that the EU's approach to certification of UN costs systems under the PAGO<sup>5</sup> provisions will be inclusive of the FAO Cost Recovery Policy to the maximum extent possible. The aim is to simplify costs recognition and the accounting and financial reporting required by the EU, conforming with the FAO Cost Recovery Policy.

8) *Phased implementation with transitional arrangements.* As spelled out in the Information Note (Annex 2), the new policy will be implemented for all those projects that have initiated identification in March 2016, and are still at Short Project Proposal stage. Projects in advance formulation stage or that were signed recently but have been formulated or negotiated under the existing framework will be signed and continue to recover support costs in accordance with the terms of the signed agreements. Where donors of existing contribution agreements express their interest in doing so, the new support cost policy may be applied to those agreements from a mutually agreed date following the implementation of the policy.

***Table 1: FAO Cost Recovery Policy – Implementation plan milestones and status as at April 2016***

<b>Timeframe</b>	<b>Milestone</b>	<b>Status at April 2016</b>
April-May 2015	1. Set up implementation team.	1. Completed.
May-July 2015	2. Apply the new cost categorization to all FAO costs and to FAO ongoing projects, and analyse the results to provide insights and identify possible patterns of costs under the new categorization by type.	2. Completed
May-November 2015	3. Identify and address budgeting, accounting and financial reporting implications, and formulate functional requirements.  4. Develop budgeting and financial reporting guidelines for applying the policy.	3. On-going  4. Ongoing, expected end-May for budgeting.
October-May 2016	5. Update corporate systems (GRMS, FPMIS, PIREs) for budgeting, accounting and financial reporting.	5. Will take place May to September
November-January 2016	6. Develop and roll out internal training and communication campaign.  7. Inform main resource partners, including on transitional arrangements.	6. On-going 7. On-going
From January 2016	8. Start phased implementation with transitional arrangements.  - All new projects in early formulation stage fully apply new policy;  - Ongoing projects use current policy until end-date, unless partners agree to modify project budgets.	8. Started and on-going (see Information Note)

<sup>5</sup> Pillar Assessment Grant or Delegation Agreement

### *Annex 1 – FAO Policy on Full Cost Recovery*

*(As endorsed by the Finance Committee and Council in 2015 for implementation from 2016)*

#### *Scope and principles*

1. The scope of the FAO cost recovery policy is full proportional cost recovery from regular programme and extra-budgetary resources, under the FAO Programme of Work under an integrated budget, as encouraged by the UN General Assembly in resolution A/RES/67/226.
2. The policy will
  - a) support and strengthen FAO's ability to deliver on its mandate, using resources efficiently and supporting the relationship between FAO's normative and development 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 that is financially and operationally reasonable; and
  - d) adopt those existing practices accepted by Member States, donors and governing bodies within the UN system that would support FAO's efforts in implementing its unique mandate.

#### *Definition of cost categories for cost recovery*

3. The FAO cost recovery policy makes use of a simplified cost structure with two types of direct costs (Direct Operational Cost and Direct Support Cost), and one type of indirect costs (Indirect Support Cost or ISC). Support costs can be direct (DSC) or indirect (ISC).
4. All the costs of delivering the programme of work under all source of funds are categorized into three cost categories:
  - a) DOC: Direct Operational Costs are any costs relating to specific inputs (other than direct support costs) required to deliver an activity. These are the costs, for example, that comprise project budgets (cost of project personnel, FAO technical support, consultants, travel, contracts, equipment, etc.)
  - b) DSC: Direct Support Costs are the costs of those services that can be attributed to supporting the provision of specific inputs acquired as direct operational costs. These costs include inter alia services for human resource management, finance, information technology, security, monitoring and evaluation. These costs relate to the support the Organization has to provide to deliver the specific inputs.
  - c) ISC: Indirect Support Costs are costs that support the execution of the delivery of activities, but cannot be directly associated to their implementation (e.g. policy, executive direction and management, governance and oversight).

#### *Cost Recovery modalities*

5. The cost recovery policy is based on full Direct Costs recovery, full proportional recovery with attributable Direct Support Costs and the application of an Indirect Support Cost percentage rate to voluntary contributions.

*a) Direct Operational and Support Costs*

6. All direct costs associated with programmes, projects or activities financed by voluntary contributions will be budgeted and recovered in full from projects.
7. All Direct Operational Costs required for the delivery of activities funded by voluntary contributions will be budgeted. FAO Technical Support is an integral part of Direct Operational Costs.
8. Direct Support Costs will be budgeted and recovered following a proportional application between sources of funding, based on relevant Direct Operational Costs budgeted in the project. Direct Support Costs are attributable to Direct Operational Costs.<sup>6</sup>

*b) The Indirect Support Cost Rate (ISC rate)*

9. Indirect Support Costs (ISC) are recovered through the application of a percentage rate.
10. The ISC rate is determined by applying the new cost categorization to the Programme of Work and Budget budgeted level of resources both for regular programme and extrabudgetary delivery, and by calculating the proportion of ISC costs against total direct costs.
11. The ISC rate has been calculated and set at 7%, assuming the current policy frameworks, resource levels financial and operational aspects remain relatively constant.
12. All projects are charged the ISC rate at 7%, with the flexibility as defined in next section.

*Flexibility in the application of the ISC rate*

13. Flexibility in applying the ISC rate where appropriate, for special circumstances, can be implemented as part of the FAO full cost recovery policy in the following cases:
- a) Rates established by inter-governmental bodies of the UN system organizations (including international financing institutions and funding mechanisms, e.g. GEF);
  - b) Existing long terms trust fund accounts where specific support cost arrangements have been included in the statutes and funding agreements (e.g. Commissions, committees, conventions established under Article XIV or VI of the FAO Constitution);
  - c) Extra-budgetary contributions with particular partnerships with cost-sharing or complementary support arrangements, e.g. South South Cooperation;
  - d) New Operational Modalities (NOM) for national execution in whole or in part, and funds transfer as Administrative or Managing Agent (AA or MA);
  - e) Complex arrangements or major changes in conditions of resource partnership relationship<sup>7</sup> for which the implications would have to be carefully monitored and analysed.
- Are exempt from the application of the ISC rate those contributions for:
- f) Travel costs of participants from developing countries to conferences and consultations on matters within FAO's mandate;
  - g) Refurbishment and improvement of FAO premises (both at Headquarters and in Regional and Sub Regional offices);
  - h) Sponsorship funds in support of awareness raising and/or promotional events
  - i) Telefood Projects.

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<sup>6</sup> Attributable means that costs relate to, but are not univocally traceable to, the specific Direct Operational Costs of the activities funded by voluntary contributions.

<sup>7</sup> Currently the EU is revising the terms and conditions for multilateral funding.

14. In case of significant changes in context and assumptions, in particular relative to adjustments to variable levels of operations, considering the unpredictability of voluntary contributions funding, the ISC rate would be adjusted.

*Monitoring and reporting requirements of the policy.*

15. The FAO cost recovery policy implementation will be monitored and reported annually to the Finance Committee.

16. The ISC rate will be reviewed every two years, to assess changes in context and assumptions. The review of the cases requiring some flexibility and the overall context of the application of the ISC rate will be monitored by the Secretariat and arising adjustments reported to the attention of the Finance Committee.

17. The ISC rate and the DSC proportional recovery through attribution will replace the current three standard PSC rates and 15 special PSC rates under the current policy<sup>8</sup> and the ICRU, from 1 January 2016, taking into account transitional arrangements for existing projects.

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<sup>8</sup> See FC 156/7 Annex 3

## *Annex 2- Information Note*

### *FAO Cost Recovery Policy in a nutshell*

#### *Why does FAO recover costs from projects?*

FAO delivers its Programme of Work using assessed and voluntary contributions in an integrated budget. In line with the Basic Texts, FAO's governing bodies require that the cost of delivering projects funded by voluntary contributions is fully covered by the projects.

#### *What is the scope of the policy?*

The FAO cost recovery policy, which is in line with UN-wide policy and practice, enables the Organization to:

- Efficiently delivery its Programme of Work under all sources of funds;
- Delegate decision-making and implementation to the country level;
- Provide for improved transparency, equitability and accountability to Members and partners in presenting project costs.

#### *What type of costs are covered by project budgets?*

Under the policy, project budgets in the entirety cover three types of cost, two of which are directly attributable to the project and one of which is indirectly associated:

- Direct Operating Costs (DOC) are all **specific project inputs** (e.g. human resources, travel, equipment, contracts, operating expenses, project office space) provided by a project to achieve its objectives.
- Direct Support Costs (DSC) are the **cost of FAO services needed to deliver specific project inputs**. For example, the FAO services to recruit the project personnel, deploy the necessary technical assistance, procure equipment, prepare certified financial reports, perform evaluation, and ensure project personnel are safe and can use FAO systems are DSC type costs.
- Indirect Support Costs (ISC) are **FAO costs incurred that support the execution of the delivery of project activities but cannot be attributed to their implementation** (e.g. policy, executive direction and management, governance and oversight). The ISC is applied to all projects as a flat 7% percentage rate, with some exceptions for lower rates (e.g. refurbishment and improvement of premises, Telefood projects, long-term budgets of Commissions and Article XIV bodies in existence).

#### **What has changed compared with the previous project support cost policy?**

The new Cost Recovery Policy recovers the same costs, but in a more refined, systematic, equitable and transparent manner. The new Policy is better harmonized with other UN Agencies.

FAO's Direct Support Costs, which were part of the previous 13% PSC flat rate, will only be recovered if and when they occur, as they depend of the specific project inputs that need to be delivered.

The Indirect Support Cost rate has been reduced from 13% to 7%, and the ICRU is discontinued.

#### *How are Direct Support Costs associated with delivering the inputs identified?*

Inputs related to recruitment, deployment and management of all types of personnel and technical assistance to projects incur HR servicing and Security costs. Procurement of all goods and services incur procurement service costs. These are dependent on the project design. On the other hand, all inputs and projects monitoring and reporting for all projects require the utilization and support of FAO

ERP and corporate IT systems and networks, financial reporting and other financial related services. Projects inputs are delivered from centralized and decentralized service units, depending on the inputs and location of the project implementation.

Therefore, the following costs elements will be included in the projects budgets as relevant:

- Direct Support Costs related to personnel and technical assistance to the project include HR Services for recruitment; performance management; contract servicing; management and processing of payroll, social security, travel, other entitlements/benefits and leave; provision of services related to staff learning and Security Services for a secure working environment;
- Direct Support Costs related to the delivery of procurement and of all goods and services and running costs to the project: tendering (e.g. Procurement Committee); supplier database management; contracting and contract management; partnership agreements and letters of agreement. This cost component includes general running costs of office premises of the FAO unit which is directly operating the project;
- Direct Support Costs related to financial services provided to the project include maintaining trust funds and accounts in the general ledger; managing invoicing, receivables and payments; banking operations and treasury; assets management; financial reporting (apply to all projects); and
- Direct Support Costs related to IT services provided to projects include the costs of provision of all FAO electronic communication systems and corporate information systems, software licenses, LAN network, hardware maintenance, helpdesks (apply to all projects).

The first two costs elements only apply if the related inputs are included as direct operational costs in the project budgets. The last two (apply to all projects.)

#### ***How is a project budget prepared under the new Cost Recovery Policy in a nutshell?***

Project formulators and partners are being sensitized to the application of the Cost Recovery Policy in preparing budgets for projects which would have initiated formulation in April-May 2016, where:

1. The project budget provides for the cost of all the needed inputs (the Direct Operating Costs - DOC) to deliver the identified results and activities of the project. Each project budget will have to ensure adequate inclusion of all resources necessary for the full and timely delivery of project objectives, including project specific operational, programmatic and results monitoring and reporting. This will require more stringent budgeting and review before the projects reach final consultation stage.
2. Any FAO costs associated with delivering the inputs (the Direct Support Costs – DSC -) are identified and budgeted to ensure the inputs are delivered by FAO to the project effectively.
3. The ISC rate of 7% (with some exceptions for lower rates as foreseen in the policy) is applied to the sum of all direct costs (DOC and DSC), and the calculated amount is added to the project budget.

An FAO Helpdesk has been set up and can be contacted at [OSP-Support-Costs@fao.org](mailto:OSP-Support-Costs@fao.org) to support the budget formulation in each specific case.

#### ***What are the transitional arrangements to start the policy implementation?***

The new policy will be implemented for all those projects that have initiated identification in March 2016, and are still at Short Project Proposal stage.

Projects in advance formulation stage or that were signed recently but have been formulated or negotiated under the existing framework will be signed and continue to recover support costs in accordance with the terms of the signed agreements.

Where donors of existing contribution agreements express their interest in doing so, the new support cost policy may be applied to those agreements from a mutually agreed date following the implementation of the policy.

An FAO Helpdesk has been set up and can be contacted at [OSP-Support-Costs@fao.org](mailto:OSP-Support-Costs@fao.org) for clarifications.