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FINANCE COMMITTEE

Hundred and Fifty-first Session

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Comprehensive Report on FAO's Support Cost Policy

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EXECUTIVE SUMMARY

- As agreed by the Committee, this paper provides a comprehensive report on FAO's support cost policy covering its evolution, recent implementation, and prospects for harmonization based on changes in the operating environment.
- The handling of voluntary contributions has a cost, and UN organizations have evolved principles, policies and arrangements to ensure allocation and recovery of such support costs in line with their financial regulations. FAO's Support Cost Policy is based on the principle of reasonable alignment of charges to actual costs, and recovers variable indirect costs of administrative and operational support services through a project servicing cost charge rate. Incremental changes have been made in the Policy to realign recoveries to costs incurred, but under-recovery has persisted.
- Changes in the operating environment provide the opportunity to recover costs not captured by the Policy. In 2011, the Council approved the Improved Cost Recovery Uplift (ICRU) mechanism to project staff costs to recover variable indirect costs largely excluded by the Policy. The ICRU mechanism is being gradually rolled out in the 2012-13 and 2014-15 biennium, learning from experience, and has resulted in increased recoveries as reported in this paper.
- Changes to the principles, policies and arrangements for cost recovery by other UN organizations in response to the changing operating environment offer good prospects for a more thorough study of FAO's support cost arrangements, addressing the harmonization of cost recovery and cost categorization.

GUIDANCE SOUGHT FROM THE FINANCE COMMITTEE

- The Committee is invited to review the evolution of the FAO Support Cost Policy and its implementation, including recent progress in the implementation of the Improved Cost Recovery Uplift, and the Organization's initiative to review the policy in light of changes in the internal and external operating environment.

Draft Advice

- **The Committee noted the evolution of the FAO Support Cost Policy and its implementation with the aim to fully recover the variable indirect costs of administrative and operational support to extrabudgetary projects.**
- **The Committee noted that FAO has initiated a study to analyze the impact of changes in the internal and external operating environment on the arrangements for support costs recovery, taking into account the experience of other UN agencies.**

Introduction

1. The Conference at its 37th session in June-July 2011 reaffirmed the policy of full cost recovery of administrative and operational support to extrabudgetary projects that had been approved by the Council in November 2000 in line with Financial Regulation 6.7, and directed the Council to implement measures to improve such recoveries from extrabudgetary-funded activities, building on the experience of other UN Agencies.¹
2. The Council at its 143rd session in November 2011 approved the mechanism proposed to improve the recovery of support costs and noted the need to provide additional information, in particular on the methodology used to assess the deficit of cost recovery and the reimbursement related to the cost of support services.²
3. Following consideration of the additional information provided, the Finance Committee at its 147th session in November 2012 agreed the outline of a comprehensive report on FAO's support cost policy to be presented to the Finance Committee in 2013, which is the purpose of this paper.

Evolution of FAO's support cost policy

United Nations – historic context

4. Organizations of the United Nations system, including FAO, make a clear distinction between the management and use of “assessed contributions” of Members for agreed budgets; and “voluntary contributions”. The handling of voluntary contributions has a cost, and UN organizations have evolved principles, policies and arrangements to ensure allocation and recovery of such support costs.³
5. When support cost mechanisms were established in the 1970's, they were based on the principle of sharing support costs among United Nations system organizations, and between United Nations system organizations and Member States, as an appropriate financial expression of partnership. Support cost recovery rates were based on the original UNDP formula that provided for partial support-cost reimbursement.⁴ The standard rate of 13 percent approved by the UNDP governing body in 1980 was subsequently adopted by almost all legislative organs in the United Nations system. The United Nations Secretariat and most of the specialized agencies continue to apply this rate, with variations.
6. Taking account of the partnership principle and the original standard rate of 13 percent, the United Nations system organizations, including FAO, have developed, and apply support cost policies and arrangements that provide for ‘incremental cost recovery’. This entails the allocation and recovery of the organization's additional costs that occur as a result of an extrabudgetary activity. When examining the support costs associated with supporting extrabudgetary activities, an important distinction has been made between direct and indirect costs.⁵
7. Essentially, *direct* costs have been defined as those that can be attributed to individual activities, while *indirect* costs are those that cannot. These two basic cost categories were then further divided between *fixed* and *variable* costs, i.e. costs that do not increase with the volume of activities and costs that do. Variable costs were considered within scope of the ‘incremental cost recovery’ and partnership principle while fixed costs were considered as costs that do not increase with the volume

¹ C 2011/REP para. 100

² CL 143/REP para. 27

³ FAO Financial Regulation 6.7 sets out the boundaries for the acceptance of any voluntary contribution: “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.”

⁴ Ref. JIU Report 2002/3 on Support Costs related to Extrabudgetary activities in Organizations of the United Nations <http://www.fao.org/unfao/bodies/council/cl124/cl124-e.htm> : in 1975, the UNDP Governing Council approved a rate of support-cost reimbursement of “14 percent of actual project costs” then revised to “13 percent of annual project expenditures”. This level of reimbursement represented, according to cost-measurement studies performed at that time, approximately half of the total support costs incurred.

⁵ CL 145/7 paragraphs 23-26

of activities and hence not within scope of an incremental cost recovery policy. However with time, all costs become variable.

Scope of FAO's support cost policy

8. In delivering its Programme of Work and Budget through projects funded by extrabudgetary contributions, FAO incurs various administrative and operational support costs. The policy of the Organization is to fully recover such costs from projects. The definition, examples and means of recovery of direct and indirect support costs are shown in Annex 1.

9. The FAO support cost policy was endorsed by the Council in November 2000.⁶ 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.

10. The scope of the current FAO support cost policy is to recover *variable indirect costs* associated with providing AOS services to projects funded by voluntary contributions. Such services are a necessary and inherent part of any project that the Organization agrees to execute.

11. Because of their variable indirect nature, the cost of AOS services cannot be readily or directly singled out for direct charging to the project itself. Therefore, the support cost policy establishes project servicing cost (PSC) charge rates to recover the variable indirect cost of providing AOS services. The type of variable indirect costs for administrative and operational services recovered through the PSC are:

- a) administrative services: 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; and security monitoring;
- b) operational services: 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 work plans and budgets; reporting periodically on projects; fellowships placement and formulation of study plans; technical selection of equipment and technical preparation of contracts.

12. There have been several changes made to the Policy over time to realign recoveries to costs incurred:

- a) in September 2002, the Finance Committee at its 100th session endorsed an addition to the Policy, whereby voluntary contributions for the provision of facilities and services for non-FAO sessions should be subject to a 5 percent PSC rate;⁷
- b) in September 2005, the 110th session of the Finance Committee agreed to adjust the definition of emergency activities to include rehabilitation activities and endorsed an increase in the PSC ceiling rate for such projects from 6.5 percent to 10 percent;⁸
- c) in September 2006, the Finance Committee at its 115th session endorsed an increase in the PSC rate for projects in direct support of Regular Programme activities from 6 percent to 13 percent.⁹

Performance in recovering variable indirect costs

13. Despite these changes in the Policy, a significant under-recovery of administrative and operational support costs has persisted. The net percentage of variable indirect costs recovered stood at

⁶ CL 119/REP para. 70

⁷ CL 123/15 paragraphs 31-33

⁸ CL 129/4 paragraphs 20-25

⁹ CL 131/7 paragraphs 49-52

84.4 percent in 2010-11, as reported in the Programme Implementation Report, although it improved from the level of 66 percent in 2002-03, as shown in Table 1.¹⁰

14. An important trend is the falling total cost of administrative and operational support as a percentage of total project delivery, from a high of 14.1 percent in 2004-05 to 9.6 percent in 2010-11. This may be due to economies of scale resulting from increases in project expenditure and delivery levels, and to cost savings from efficiency measures put in place.

Table 1. Administrative and operational support (AOS) cost recovery

	2002-03	2004-05	2006-07	2008-09	2010-11
	(USD million)				
Total extrabudgetary, TCP and SPFS project delivery	712.3	747.9	898.3	1,226.9	1,706.8
Emergency operating costs	8.1	16.1	21.4	29.1	32.0
All other AOS costs	63.5	89.5	101.5	115	131.2
Total AOS costs	71.6	105.6	122.9	144.1	163.2
Total AOS costs as a percentage of total project delivery	10.0%	14.1%	13.7%	11.8%	9.6%
Reimbursements	47.3	78.4	78.9	106.9	137.8
Under-recovery of support costs	24.3	27.1	44.0	37.2	25.4
Net percentage of cost recovered	66.0%	74.3%	64.2%	74.2%	84.4%

*Methodological basis for calculation of variable indirect costs
and determination of PSC rates*

15. The calculation of variable indirect costs and determination of PSC rates is based on an annual Work Measurement Survey (WMS) and Cost Measurement Study (CMS). The WMS is a Web-based questionnaire completed by FAO Professional and General Service staff worldwide. The CMS is carried out by an independent consultant who analyzes the WMS results using cost accounting principles.

16. The Organization-wide WMS collects information on the work effort of over 1,000 staff worldwide on technical, administrative and operational support to Regular Programme and extrabudgetary activities. The CMS uses this information to determine the variable indirect administrative and operational support costs incurred in servicing various types of projects (e.g. technical assistance, emergency activities, support to Regular Programme). It analyzes the cost structure of the Organization in terms of the administrative and operational support provided to projects to determine the PSC rates. The CMS supported the rate changes noted in paragraph 12 above.

17. The results of the WMS and CMS concerning the cost of technical, administrative and operational support are reported in the biennial Programme Implementation Report. For example, see C 2013/8 paragraphs 259-269 and C 2011/8 paragraphs 300-314.

18. The UN Joint Inspection Unit (JIU) Report on Support Costs Related to Extrabudgetary Activities in Organizations of the United Nations System¹¹ cited FAO's approach as the most likely to

¹⁰ Reviewed from C 2009/8 table 16 and C 2013/8 figure 20.

¹¹ JIU/REP/2002/3 paragraph 32

generate statistically reliable and empirically justifiable results providing useful information as regards the fixed and direct variable costs associated with extrabudgetary activities.

19. The PSC charges are collected on a monthly basis based on project expenditure, and these recoveries are reimbursed to those units providing administrative and operational services. However, as the internal and external operating environment has evolved, there is opportunity to recover variable indirect costs not captured by the PSC charge mechanism.

Implementation of improved cost recovery

20. The Conference at its 37th session in 2011 was concerned about the persistent under-recovery of administrative and operational support costs and urged the Director-General to vigorously pursue improving administrative and operational support cost recovery from extrabudgetary activities, including in areas such as country-level costs, security, and information systems and technology. It requested the Director-General to develop new mechanisms, building on the experience of other UN agencies, notably an uplift on project employee costs to recover those costs most closely associated with the level of staffing of extrabudgetary programmes and projects.¹²

21. Based on the experience of the World Health Organization, the Secretariat developed the Improved Cost Recovery Uplift (ICRU) mechanism to recover variable indirect costs that had been largely excluded from the support cost policy, specifically costs related to information technology, office space occupancy and security. These recoveries would be implemented through the use of an uplift of standard project staff costs and project consultant costs without changing the current PSC ceiling rates and categories.

22. The Finance Committee at its 140th session and Council at its 143rd session in December 2011 approved a plan for implementation of ICRU, as shown in Annex 2.¹³ That plan foresaw implementation in 2012-13 of measures for recovery of security, office space occupancy related charges, and costs of information systems and technology incurred in relation to project personnel at headquarters. It was foreseen then that implementation of these measures in relation to field project personnel will take place in 2014-15.

23. As of April 2012, headquarters ICRU was being implemented through a monthly uplift of project staff and consultant costs for active projects. By its nature, the ICRU is only applied to projects with staff and consultants, and it does not affect or duplicate the current PSC ceiling rates and categories.¹⁴

24. After one year of applying ICRU at headquarters, the recoveries amount to USD 6.6 million, as shown in Table 2. The forecasted ICRU for 2012-13 is USD 10.4 million, of which USD 6.5 million for IT-related costs, USD 1.95 million for security costs and USD 1.95 million for office occupancy costs.

Table 2: ICRU recoveries by personnel category and type of project (USD 000)

April 2012 - March 2013

Category of Personnel		Type of project		Total
		Development	Emergency	
Professional Staff	Professional Staff	2,981	1,114	4,095
	General Service Staff	494	39	533
	Consultants	1,332	683	2,015

¹² C 2011/REP paragraph 100

¹³ FC 140/8 and CL 143/REP para. 27

¹⁴ FC 147/9 paragraphs 7-10

Total	4,807	1,836	6,643
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25. ICRU charges are expected to be rolled out to the decentralized offices in the 2014-15 biennium, meaning field staff and consultants will also be subject to the respective "Field ICRU" charges. Field ICRU charge rates are being defined and could vary depending on the regions' specific cost structures.

26. Through implementing ICRU at headquarters, the Secretariat has learned a few lessons over the past year, which will be taken on board in the future, including timely and clear communication to resource partners on any changes related to support costs including ICRU arrangements.

Prospects for harmonizing support cost regimes

27. FAO's support cost policy was put in place almost 15 years ago based on principles of cost sharing among partners that no longer apply. Over this period other aspects of the environment in which FAO operates have changed substantially, while changes to cost recovery policies and arrangements have taken the form of incremental adjustments.

28. Internally, FAO's administrative, operational and management systems and structures have evolved, most recently with the introduction of the Global Resources Management System and International Public Sector Accounting Standards. The strengthening of the decentralized offices network, and the consequent delegations of authority and accountability, take advantage of these improvements and are changing the way extrabudgetary projects are designed, implemented, monitored and reported. The recent integration of FAO's emergency and development programmes provides the opportunity to harmonize the treatment of support cost recoveries for these two types of projects.

29. Externally, the environment in which FAO operates has changed markedly, affecting delivery mechanisms and underlying cost structures. Such trends include a higher proportion of extrabudgetary funding compared with assessed contributions; improved local capacity for national execution; competition among implementing partners for projects; new resource partner types including emerging economies and the private sector; the changing mix of unilateral, bilateral and multilateral aid flows, including South South Cooperation; and implementation of One UN at country level.

30. One indicator of the changing environment is the significant increase in voluntary contributions managed by the Organization in Trust Funds. During 2008-09, Trust Fund expenditures amounted to more than USD 1 billion, and for the first time exceeded Regular Programme expenditures. In the context of a Programme of Work and Budget increasingly financed by voluntary contributions, FAO's cost structures are changing and the recovery of administrative and operational support services is critical for good financial management.

31. This change in the environment is also reflected in the TCPR and QCPR¹⁵ resolutions calling for full cost recovery.¹⁶ In recent years, UNDP, UNFPA and UNICEF have harmonized cost categorization and have instituted changes to their cost recovery approach, in consultation with their governing bodies, moving away from the original methodology pioneered over 20 years ago by UNDP.

32. UN agencies are also working together through the Finance and Budget Network (FBN) of the Chief Executives Board's High-Level Committee on Management to harmonize cost categorization as a prerequisite for a harmonized approach to cost recovery, building on previous efforts. FAO will continue to participate in this FBN initiative to ensure that operating costs that might be associated with unique mandates of agencies are taken into consideration.

33. The evolving internal and external operating environments and the appetite for harmonization of cost categorization and recovery among UN agencies offers good prospects for a more thorough

¹⁵ Triennial and Quadrennial Comprehensive Policy Review of Operational Activities for Development of the United Nations System (TCPR and QCPR)

¹⁶ UNGA A/RES/62/208 paragraphs 116-117

study of FAO's support cost arrangements. 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. The outcome of this study will be reported to the Finance Committee in 2014.

Annex 1: Definition of costs used in FAO support cost policy

Cost Accounting Term	Definitions	Examples of services provided	Means of recovery in FAO	
Direct Costs	Costs that can be directly traced to a product or output.	Project personnel, equipment, premises, travel and any other input necessary to achieve the results and objectives set out in specific activities or projects.	Fully recoverable from extrabudgetary resources. To be directly included in project budget.	
Indirect Costs	Variable Indirect Costs	Costs that are associated with the production of several outputs, but which are not traceable to individual outputs, and which tend to vary indirectly with the volume produced.	Services provided by administrative and operational staff supporting specific activities or projects, which cannot be discretely identified.	Levy PSC as percentage charge against actual expenditures.
	Fixed Indirect Costs	Costs that are not easily traceable to the production of a single output and which do not vary with the volume of output.	Costs of general management: senior management; general financial accounting; central HR function; auditing; messenger service; central records, etc.	Not to be financed from extrabudgetary resources.

Annex 2: Improved cost recovery measures, as approved by the Finance Committee and Council - Implementation Arrangements

Service	Calculation of Charge	Charging methodology	Status of implementation
Headquarters IT Services - services provided to project staff and consultants - e-mail connection, intranet and internet connection, mobile and desk phone services, corporate desktop software, website design and development, server hosting management, data centre equipment life cycle management, system security, network connectivity	Global budgeted CIO costs of providing services divided by global budgeted compensation of users (staff and consultants) from all funding sources = percent	Percent uplift on project personnel costs (staff compensation plus consultant fees), charged to all projects	Started in 2012-13
IT Services in Field Offices - same as headquarters, excluding services related to mobile and desk phone services and IT support not provided to field locations	<p>a) Costs of CIO services provided to GF personnel in decentralized offices (DOs) divided by costs of GF personnel in DOs</p> <p>b) Percentage derived from a) adjusted by the weight of IT services procured locally</p>	Percent uplift on project personnel costs (staff compensation plus consultant fees) located in FAO regional offices, FAOR offices and project offices; charged to all projects	Planned to start in 2014-15
Headquarters Security - costs of badge issuance and management, maintenance of security equipment, headquarters security guard services, UN security service charges attributable to staff and consultants at headquarters	Budgeted headquarters cost of security services divided by cost (total budgeted compensation) of headquarters based staff and consultants from all funding sources = percent	Percent uplift on cost of project personnel located at FAO headquarters (staff compensation plus consultant fees); charged to all projects	Started in 2012-13
Field Security - costs of ensuring safe and secure operating environment for FAO projects in field locations (other than those covered by UNDSS budget for Jointly-Financed Activities)	Actual costs of providing safe and secure operating environment for GF personnel in DOs divided by costs of GF personnel in DOs = percent	Percent uplift for the relevant region on project personnel costs (staff compensation plus consultant fees) located in FAO regional offices, FAOR offices and project offices; charged to all projects	Planned to start in 2014-15
Regional/subregional offices - space occupancy charges (for project personnel located in regional offices)	Annual budgeted RO/SRO cost of space, telephone, IT support and internet access divided by total compensation of staff and consultants located at each office	Percent uplift on cost of project personnel located at each regional office (staff compensation plus consultant fees); charged to all projects	Carry out review to ensure consistent approach across offices and then extend to all offices in second half of 2014

Service	Calculation of Charge	Charging methodology	Status of implementation
Country offices and other decentralized offices – space occupancy	The variety in cost structure patterns requires a well thought approach to recovery	Application of an ICRU <i>average</i> rate relating to office occupancy at the country office level implementation modalities	Deferred until a more in depth evaluation is made on the conditions needed for charging such a rate
Headquarters space - costs of building maintenance and repairs, cleaning, utilities and related costs for space occupied at headquarters by staff and consultants.	Annual budgeted headquarters cost of building services divided by costs (total compensation) divided by costs of headquarters based staff and consultants from all funding sources = percent	Percent uplift on cost of project personnel located at FAO headquarters (staff compensation plus consultant fees); charged to all projects, replacing current cumbersome methodology which is based on average square metres of space occupied	Started in 2012-13 (replaced the cumbersome process of manual data collection and processing)