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FINANCE COMMITTEE

Hundred and Seventieth Session

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Update on Commissary Closure and Related Matters

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EXECUTIVE SUMMARY

- The Finance Committee is presented with an update on the FAO Commissary, in particular: (i) the closure process of the operations and of existing outlets on FAO and WFP premises; (ii) the results of the reviews by the Office of the Inspector-General, with the support of an external consulting firm; and (iii) a proposal for a new business model which could be considered for adoption. This document also considers the way forward for the handling of the Staff Welfare Fund and the funds available under the Commissary Reserves.

GUIDANCE SOUGHT FROM THE FINANCE COMMITTEE

- Members of the Finance Committee are invited to take note of the updates and information provided related to the Commissary management, the process of closure of the 'commercial' Commissary entity and the related activities as well as the proposed way forward for a possible new business model, use of Commissary reserves funds and staff welfare support.

Draft Advice

- **The Committee welcomed the report and information provided on the Commissary and related items, and encouraged management to pursue implementation of successor arrangements which would follow the principles highlighted by management of respect for UN values, reduced client base, limited involvement of the Organization in the management of the operation with however conditions to ensure management's oversight and full compliance to the Host Country Agreement. The Committee took note of the proposals for use of former Commissary reserves and support to staff welfare.**

Finance Committee - Commissary Closure and Related Matters

1. This document is submitted to provide updates to the Committee on the review of the business model of the Commissary and on the funding of the Staff Welfare Fund, as requested by the Finance Committee at its 167th and 169th Sessions.

<u>Background</u>

2. The Office of the Inspector-General issued a report at the end of 2016, "Special Review of the FAO Commissary – AUD 2616". Following this report, a senior-level working group was set up, under the direct leadership of the Deputy Director-General (Operations), DDG(O), to address the issues raised and propose solutions and options moving forward.

3. In the context of this review, a number of major decisions was taken such as banning the sale of tobacco products on FAO premises at the end of May 2017, and not renewing the contract with Sanital, an external provider of services in the Commissary, at the end of June 2017. It further became apparent that there was a number of serious concerns to be addressed in the management of the Commissary. Some were related to the appropriateness of a UN Organization directly managing a tax-free shop for the benefit of its staff. Others regarded findings related to the performance in the management and operations of the Commissary that could negatively impact the Organization, as explained in greater detail below. Furthermore, the financial sustainability of the Commissary became an issue as it was severely impacted by the decision to ban tobacco products, which could in turn create a financial liability for the Organization.

4. For the aforementioned reasons, it was decided that the Commissary set-up should be closed. The closure process was overseen by a working group under the close oversight of DDG (O).

Closure process - status update

<u>Closure of commercial operations</u>

5. The Commissary closed the WFP and FAO outlets on 30 August and 30 September 2017, respectively, the latter being the formal end date of all Commissary commercial operations. The closure process itself continued beyond that date and into 2018 to ensure, inter alia, the orderly disposal of the limited stock of unsold items and liquidation of existing assets. As an entity, the Commissary will only remain in existence for accounting purposes and until the accounts and financial statements have been reviewed by the external auditors, as per statutory provisions. As per established practice, the Commissary audited accounts and financial statements will be presented to the Finance Committee.

6. Thanks to close monitoring and tightened management throughout 2017, the financial situation of the Commissary remained positive up to the closure of the commercial operations on 30 September 2017. The total value of the stock at the end of September 2017, following the closure of the salesroom and commercial operations, was just under EUR 8 000, down from EUR 1.6 million at the end of June 2017, when the agreement with the contractor Sanital expired. The stock remaining at closure was donated to the Caritas Foundation, in accordance with a Memorandum of Understanding concluded in November 2016 between FAO and the Foundation.

7. This satisfactory outcome was the result of a series of measures put in place to ensure close oversight of Commissary activities and steps leading to the closure of the commercial operations, in particular:

- decision not to renew the agreement with Sanital, the company contracted to carry out a number of operations for the Commissary (e.g. salesroom, logistics and cashier functions) and to let the contract expire at its term of end June 2017;

- deployment of FAO Commissary staff within the unit to ensure the adequate coverage of all required key functions and the continued operations of the salesrooms throughout the period July to end September 2017;
- stringent monitoring of the stock and sales levels, performed on a weekly and subsequently daily basis, and definition/implementation of corrective measures for any significant issue identified (e.g. drop in sales level) between July and end September 2017;
- adoption of a marketing strategy with longer opening hours, attractive discounts to prompt sales, and regular communication to all clients over the July-September period;
- early closure of the WFP outlet, based on the relatively low level of sales, at end August 2017;
- implementation of a progressive reduction in staff costs starting early September, through a gradual reassignment within headquarters of FAO Commissary staff in concomitance with the decrease in the level of activities and sales.

8. The aforementioned set of measures ensured the rapid reduction of the stock to a minimum level, as well as protection of the financial situation of the Commissary, and ultimately of the Organization.

9. In accordance with contractual provisions and good practice, detailed inventories were undertaken. These took place at the end of 2016 and, at the end of June 2017, date of expiry of the agreement with the contractor Sanital. At those dates when contractual responsibility for losses of goods and the corresponding financial responsibility were determined and respective amounts attributed to either the Commissary or the contractor. A final inventory took place end September 2017, upon closure of the Commissary commercial operations.

Final closure process

10. Following the cessation of operations and final closure of inventories, responsibility for the management of the remaining financial operations (e.g. pending invoices, preparation of financial statements) was handed over to the Finance Division as of February 2018, along with responsibility for the liquidation of the Commissary assets and for the management of the Commissary funds.

11. Full inventory and cataloguing of all Commissary assets was entrusted to the Corporate Services Department, with the liquidation of the assets, handled through bulk sales, scheduled to be completed in April 2018.

12. The level of the reserves of the Commissary as at the end of 2017 was circa EUR 2 673 000. Some payments and adjustments which were outstanding at closure such as pending invoices for Sanital, staff costs (to assist in residual functions e.g. preparation of the 2017 Commissary financial statements for external auditors review) will be processed as part of the closure of the 2017 accounts. These payments imply some charges that will reflect on the reserve funds final figure but do not create any financial risk given the current level of the Commissary reserves.

13. Closure activities were undertaken in close consultation with the Office of the Inspector-General that guaranteed the validity of the inventory findings and confirmed the soundness of the liquidation measures put in place.

Oversight – External and Internal Reviews

14. In October 2017, a private consulting firm was contracted to carry out an external review of the Commissary operations and examine the adequacy of the Commissary management and business practices over the period 2014-17.

15. The findings corroborated main weaknesses in the Commissary operations documented by OIG over the past years, in particular in the “Special review of the Commissary” (AUD 2616).

16. The shortcomings in the management of the Commissary operations identified by these oversight reports gave important indications as to which type of management model the Organization should give preference when considering a possible business model and successor arrangement for the Commissary.

Significant management weaknesses

17. Both the report of the external firm and the OIG special review point to significant weaknesses in the operations and the management of the Commissary in recent years:

- **deviation from the original purpose:** the Commissary management oriented operations primarily to the achievement of financial self-sustainability, which led to an increase in luxury/high-value items on offer as well as the continued sale of tobacco, in contradiction with UN values. This was a deviation from the original Commissary purpose (i.e. to make available to expatriate staff products not easily available on the local market) and created a reputational risk for FAO with regard to the ethics of such sales on its premises;
- **direct management and lack of adequate operational procedures:** some core operational practices were not in line with sound business practices and in most cases not supported by adequate procedures;
- **procurement/purchasing procedures** showed repeated shortcomings relating to the absence of prior profitability analysis and market research, formalization of contracts, vendor selection, vendor evaluation, vendor rotation and concentration;
- **financial management:** a number of shortcomings in the financial management were identified including in book keeping, data recording and cash management procedures;
- **inventory management procedures:** there was a lack of effective action to mitigate operational and year-end losses (lack of internal procedures and IT-based tools to manage information on inventory losses/expiry of goods) and such losses showed a significant increase during the period under review while the volume of sales was decreasing;
- **outsourcing:** the normal procurement process for awarding a contract, in this case for providing the logistical and inventory services to the Commissary, was not followed. Instead, the contract was awarded to the FAO-contracted cleaning company (Sanital) with no experience in that area, through an amendment to the existing contract for cleaning services. Successive amendments to the initial contract not only extended the duration of the contract, but also increased the duties and activities of the contractor, despite the original contract for cleaning services not having been renewed.
- **Inadequate staffing and management costs:** the staff involved in the Commissary operations, including from the contractor's side, had no prior experience in such an operation nor was specific training provided. The FAO staffing to support the operation, i.e. sixteen FAO employees, including up to four professionals, in addition to the staff provided by the contractor (on average approximately twenty individuals) and staff provided by some suppliers of cosmetic products for promotional purposes (two to three) was way beyond industry standards for such an operation (approximately threefold).

18. As a result of all the above management shortcomings, overhead costs to run the Commissary amounted to approximately 22 percent of the volume of sales and therefore, the management model was not economically viable.

19. **Management of the IVA exemption privilege:** serious shortcomings were identified with regard to potential access to duty free exemption via the sale of goods, ordered by the Commissary management, through the FAO Brand Centre, the management of which was also outsourced to the company Sanital.

20. **Management of Security controls:** problems were identified in the management and coverage of security cameras.

21. **Client base:** the client base of the Commissary comprised FAO and WFP staff (members and consultants), as well as employees from other UN organizations in Rome and personnel from diplomatic missions. The number of recognized officials who had access to the Commissary at the time of closure was 5 740. Considering that, in accordance with applicable rules, recognized family members could also access the Commissary, this led to a high number (over 11 000) of potential clients but also the continuous flow of supplier trucks in the FAO compound which posed evident security issues.

Ethical issues and reputational risks

22. Both the internal and external reviews raised some fundamental issues of reputational risks, for a UN organization with the mandate of FAO, attached to the running of a commercial activity such as that of the Commissary:

- **UN values:** concerns were raised as to the appropriateness of the Organization, a UN entity with humanitarian and development goals, running a commercial activity selling a range of tax-free products, with cosmetics, alcohol, tobacco and luxury items representing 84 percent of annual sales. In line with these concerns, and in accordance with standards promoted by the World Health Organization, a decision to ban the sale of tobacco in the Commissary was taken by FAO in May 2017 (WFP had imposed the ban in its Commissary outlet in 2015). This entailed that the Commissary lost a large part of its income. Tobacco represented 41 percent of the gross margin and subsidized the sales of other items that generated little to no margin or were sold at a loss. As a result of the ban, the Commissary model was no longer sustainable from a commercial and economic standpoint.
- **Reputational risks:** both reports highlighted shortcomings with the management of the activity that exposed the Organization to legal, financial and reputational risks. It can also be noted that the Commissary no longer met one of its founding purposes, i.e. to make available products to expatriate staff that were not easily found on the local market (as per the Headquarters Agreement of 1951). Over the years, the range of items on offer had evolved and many products did not fall under this category. The expansion of products available on the local market and via internet (online) also meant that staff could easily purchase many of the products from their country of origin through other means.

Successor Arrangements

New Business Model for the Commissary activity

Key principles

23. Taking into account the aforementioned considerations, options for a revised business model should meet the following four principles:

a) UN FAO values: refocusing the category of goods on offer to better align with UN values and the objective of making available international goods. The range of products on offer would be reduced, with clear guidelines regarding appropriate products (excluding tobacco), and focus on international goods that are not readily available on the local market. This would respect one of the initial purposes of the Commissary, which is to enable expatriate staff members to find products from their home countries.

b) Reviewing the client base: under the Commissary set-up, all FAO and WFP staff members (General Service, Professional and above and eligible family members) and consultants, as well as members of permanent representations, and staff of authorized UN organizations and IGOs, had access to the Commissary. Under the revised model, it is suggested that only FAO and WFP staff members and staff of authorized UN organizations and IGOs benefit from the facility.

c) Limited involvement of FAO in the operations of the new business model/successor arrangements: the Organization would have limited involvement in the running of the operations that would be outsourced to a contractor. This would ensure that the Organization is no longer subject to any financial or legal risks linked to the running of a commercial activity for which it has no adequate competence. It is suggested that the new mechanism be inspired by the current arrangement for the provision of tax-free petrol to eligible officials, which is outsourced at no cost for the Organization.
d) Ensure the Organization’s obligations vis-à-vis the Italian authorities in line with the Headquarters Agreement. As the Commissary was set up, at least in part, as a means to exercise collectively the individual rights of FAO officials to duty-free and tax-free products, FAO will retain an oversight role over the running of the Commissary successor arrangement and, in particular, retain overall responsibility for managing the quotas and ensuring that only eligible individuals be granted access.

Proposed way forward

24. It is proposed to move towards an online catalogue mechanism, fully managed by an external supplier of tax-free goods. Under this option, eligible clients would pass orders online for selected types of goods. Such a proposal would address many of the concerns over the Commissary identified by management and in the audit reports, whilst allowing control over the entitlements granted by the Host Government. It would simplify greatly the work of the Organization and shift financial responsibility for the management and running of the chosen facility to the contractor. The clear advantage of such a model would be the minimizing of financial and reputational risks.

Staff Welfare Fund (SWF)

25. The Staff Welfare Fund (SWF) was established by the Conference in 1953 to finance activities designed to improve the welfare of staff. As provided for in the Administrative Manual[1], the SWF may inter alia fund contributions to the Staff Benevolent Fund, general social services and cultural and recreational group activities of a voluntary nature as approved by the Director-General in consultation with recognized Staff Representative Bodies.

26. Successive Conference resolutions were adopted on the use of the Commissary income to finance the SWF.[2] The SWF was entirely funded by the Commissary, through a mechanism initially providing that one percent of the amount of sales would automatically be transferred to the SWF and the possibility of transferring income to the SWF, upon approval of the Director-General. The automatic transfer of one percent of the amount of sales was abolished by resolution 19/2017 in July 2017 while the possibility of transferring income generated by the Commissary remains.

27. The contemplated change in business model of the Commissary impacts on the SWF and its financing modality. Under a new business model that would outsource the management of the Commissary type activity, no internally generated income would be available and this source of funding would, a priori, no longer be available.

28. Alternative funding sources could be considered such as applying a mark-up/percentage on the sale of tax-free petrol and/or on tax-free items to be purchased under a Commissary new business model. Yet, preliminary projections tend to indicate that both the percentage and the volume of sales would need to be rather significant to generate a meaningful level of resources and reasonable level of SWF funding. Feasible options will need to be further investigated.

29. In keeping with the spirit of the Conference resolutions that (i) created the SWF to fund activities for the welfare of staff and (ii) decided on the use of the Commissary income to finance the

[1] Manual Section 350 Appendix B
[2] 27th Conference (Nov 1993) Resolution 18/93 and 40th Conference (July 2017) Resolution 19/2017

Fund, it is proposed that the Commissary reserve funds (i.e. Retained Earnings and Working Capital Fund as per the Financial Statements of the Commissary) continue to be earmarked for staff welfare initiatives including to cover possible unforeseen liabilities due to activities associated with staff welfare but also for any future investment and expenses related to the establishment of a Commissary successor arrangement.

30. This would also offer an opportunity to refine and update the objectives of the welfare initiatives and the use of the funds as currently stated, and to introduce, in particular, a specific reference to initiatives in support of the welfare of staff based in Decentralized Offices.

31. As noted above, the level of the Commissary reserves at the end of 2017 was circa EUR 2 673 000. The cash balance would be managed by the Treasury Unit of the Finance Division in line with the guidelines used for FAO’s own short-term investments and with clearly separate accounting records relating to the Commissary Reserve Funds.