برنامج الأغذية العالمي

Programme Alimentaire Mondial

World Food Programme

Programa Mundial de Alimentos

**Executive Board**
**Annual Session**

**Rome, 20–23 May 2002**

# FINANCIAL AND BUDGETARY MATTERS

## Agenda item 6

*For consideration*

# PRELIMINARY REVIEW OF THE INDIRECT SUPPORT COST RATE

Distribution: GENERAL
**WFP/EB.A/2002/6-A/1**
24 April 2002
ORIGINAL: ENGLISH

This document is printed in a limited number of copies. Executive Board documents are available on WFP's WEB site (http://www.wfp.org/eb).

# Note to the Executive Board

**This document is submitted for consideration to the Executive Board.**

The Secretariat invites members of the Board who may have questions of a technical nature with regard to this document to contact the WFP staff focal point indicated below, preferably well in advance of the Board's meeting.

Director, Finance Division (FS): Mr S. Sharma tel.: 066513-2700

Should you have any questions regarding matters of dispatch of documentation for the Executive Board, please contact the Supervisor, Meeting Servicing and Distribution Unit (tel.: 066513-2328).

# Executive Summary

This document is presented in response to the request of the Executive Board at its Third Regular Session in October 2001 for a preliminary review of the analysis of indirect support cost (ISC) rates. The document also responds to the recommendation of the Executive Board, made when approving the Report of the Formal Working Group on the Review of WFP's Resource and Long-term Financing (R&LTF) Policies, at its First Regular Session January 1999. This preliminary review is limited to the methodology of charging and calculating ISC to fund the programme support and administrative (PSA) budget and meet full-cost recovery. The issue of the appropriate level and cost-effectiveness of PSA will be addressed in the second part of the analysis, to be presented to the Executive Board in October 2002.

By way of introduction and background to the ISC analysis, the document provides a brief chronology of the evolution of ISC recovery as a PSA funding mechanism and historical information on ISC rates. A summary of the levels of operational activity and PSA expenditures for the past three biennia and the levels projected for 2002-2003 is presented in the preliminary review of the appropriate level of PSA.

The principles and assumptions that form the basis for the 2000–2001 PSA budget are explained. Detailed comparisons are made between the original and revised budget estimates and the actual results for the biennium in terms of operational volumes, operational costs, ISC income received and PSA income and expenditure. The funding of PSA for 2000–2001 through ISC recovery and other sources, including interest income in the General Fund, is discussed. A number of scenarios on the gap between ISC and PSA are also presented.

The document also focuses on a number of issues related to PSA and ISC recovery, including the fixed and variable nature of PSA cost, the impact of volume and price variances, and the imbalances arising from WFP's accounting policies on income and expenditure recognition. The report briefly discusses the possibility of a second level or marginal rate of ISC for increased operational activity.

On the basis of preliminary observations, the report identifies a number of specific steps to be taken to complete the analysis and prepare the final review of the ISC rate for presentation to the Executive Board in October 2002.

# Draft Decision

The Executive Board:

i) takes note of this preliminary review of the ISC rate, while awaiting the outcome of a more complete and final review to be presented to the Third Regular Session of the Executive Board in October 2002;

ii) agrees to retain the current ISC rate for 2002; and

iii) agrees with the "Next Steps" set out by the Secretariat in paragraph 78.

## INTRODUCTION

1. A single rate for ISC income to fund the PSA under WFP's revised R&LTF policies was introduced in January 2000. The "ISC recovery" is WFP's mechanism to fund its PSA budget. It is subject to review, as per recommendation 2.4 in document WFP/EB.1/99/4-A, adopted by the Executive Board at its First Regular Session in 1999 (WFP/EB.1/99/12), that *"The single rate principle will be subject to review through the normal budget setting process and be able to be discontinued by decision of the Executive Board"*.

2. During the first year of implementation (2000) no meaningful review could be carried out because, at that time, the Secretariat was implementing the new corporate information system, and therefore the financial information necessary for the review was not immediately available.

3. The need for such a review has since been reiterated by the Executive Board during its discussions on:

- the Board's Programme of Work for 2002–2003 (decision 2001/EB.3/35);
- the WFP Biennial Budget for the Period 2002–2003 (decision 2001/EB.3/7); and
- the WFP Information Network and Global System (WINGS) for Cost Analysis and Cost Containment (document WFP/EB.3/2001/5-D/1).

4. From these discussions it became apparent that the review of ISC needed to address two issues: one, the appropriate level and cost-effectiveness of PSA; two, the methodology of charging and calculating ISC to fund the PSA and meet full-cost recovery.

5. Some Board members felt that this review should be undertaken sooner rather than later; hence this submission to the Executive Board of a preliminary review on the methodology, and submission of a full review at the Board's Third Regular Session in October 2002.

6. This paper includes the following:

- a brief chronology of the evolution of the ISC recovery as a PSA funding mechanism;
- an analysis of the 2000–2001 PSA budget, comparing budgeted with actual level of expenditure, as well as PSA expenditure with the actual volume of operations for the past three biennia;[1]
- a review of the difference between income generated from ISC recovery and actual PSA expenditures;
- a presentation of issues related to PSA and ISC recovery, including ways to fund eventual gaps; and
- preliminary observations, proposed next steps to finalize analyses, and recommendations to the Executive Board.

[1] Actual expenditures are based on the unaudited Financial Statements for 2000–2001.

## BRIEF CHRONOLOGY OF ISC-RELATED DEVELOPMENTS

### 1991–1994

7. This period preceded adoption of the R&LTF policies. PSA was funded from the cash contributions (one third) of the regular pledge, which at that time represented mostly the development component of WFP's projects and programmes. Cash generated from these sources was insufficient to fund the PSA fully.

8. In 1991, in order to alleviate the cash shortfall of the PSA, the Committee on Food Aid Policies and Programmes (CFA) approved application of a temporary support cost levy on relief projects and programmes. Nevertheless, WFP continued to face cash shortages. Thus, in May 1994, a paper on WFP's resources and financing was presented to the CFA. This paper confirmed that the cash component of the then current regular pledge was insufficient to meet WFP's costs, and that no specific modality existed to allow WFP to obtain the required PSA funding.

9. In 1994, the CFA established the formal Working Group on R&LTF Policies. One of the group's main tasks was to recommend to the CFA a specific modality to allow WFP to obtain required funding for the PSA budget.

### December 1995 and 1996

10. The CFA adopted the working group's recommendations (CFA – 40/15), one of which was that the PSA budget would be funded from ISC recovery, which would be levied as a component of the costs of each contribution. The working group also called for a cost measurement study and a review of the application of the policies.

11. On the basis of the cost study, sets of ISC rates (as percentages of contributions) for different programme categories were approved by the Executive Board in 1995 and 1996, to be applied to contributions received in 1996 and 1997, respectively. These ISC rates for the programme categories were as follows:

| Programme category | 1996 | 1997 |
|---|---|---|
| | (percent) | |
| Development projects | 14.5 | 13.9 |
| Protracted relief operations (PROs) | 7.2 | 7.1 |
| Emergency operations (EMOPs) | 4.8 | 6.0 |
| Special operations (SOs) | 15.3 | 11.9 |

## 1997–1998

12. Another cost measurement study was undertaken in 1997, and a report was submitted to the Third Regular Session of the Executive Board in October of that year (WFP/EB.3/97/4-E/Add.1), recommending new rates for 1998:

| Programme category | Percent |
|---|---|
| Development projects | 16.9 |
| PROs | 7.0 |
| EMOPs | 5.9 |
| SOs | 5.6 |

13. However, the Executive Board decided to review the policies and retain the rates applicable for 1997 rather than adopt the new ones. The Secretariat presented a review of the implementation of R&LTF policies in May 1998. Subsequently, the Executive Board created another working group to review the application of the R&LTF policies

## January 1999

14. Following the working group's report, the Executive Board adopted a series of recommendations, including:

- that the ISC rate be the same for each programme category;
- that the single rate be determined by applying the approved PSA budget to the projected direct operational costs (DOC) and direct support costs (DSC) of the activities for the biennium;
- that the single rate principle be subject to review through the normal budget-setting process and be able to be discontinued by decision of the Executive Board; and
- that the single ISC rate be fixed for a biennium, but be able to be revised on an annual basis, should the situation so warrant (WFP/EB.1/99/4-A).

15. In its review, the working group attempted to analyse the cost components included in the PSA. It was determined that some of these programme support costs were directly identifiable or linked to project implementation and should therefore be considered DSC and not ISC.

16. The working group considered three options for treatment of DSC and ISC, and recommended lowering the ISC rate to an average of around 7.8 percent by transferring or reclassifying approximately 25 percent of country office PSA costs to DSC. With this option, income generated from ISC recovery was to fund all Headquarters support costs, regional office support costs, and a standard minimum country structure essential for a WFP presence, including management and administration (WFP/EB.1/99/4-A).

17. The Executive Board approved this option, including the use of the single ISC rate of 7.8 percent applied to multilateral and directed multilateral contributions for the four programme categories (development projects, EMOPS, protracted relief and recovery operations [PRROs], and SOs) and retained the use of variable ISC rates ranging from 3 to 7.8 percent for bilateral contributions and trust funds.

### October 1999–2001

18. In line with the above Executive Board decision, both the 2000–2001 and 2002–2003 budgets were prepared on the basis of the single rate of 7.8 percent on multilateral and directed multilateral contributions and variable rates on bilateral contributions and trust funds. The Executive Board approved these budgets.

## APPROPRIATE LEVEL OF PSA

19. As the table below indicates, the actual PSA expenditure over the last three biennia, and estimates for 2002–2003, have remained largely constant, except for the increase in 2000–2001 in order to implement the unusually high volume of operations. The average per-ton PSA cost over the same period declined from US$41 to US$38 per ton.

**TABLE 1. HISTORY OF OPERATIONAL LEVEL AND PSA**

| | 1996–1997* | 1998–1999* | 2000–2001 | 2002–2003 (projected) |
|---|---|---|---|---|
| Volume (in thousand tons) | 4 885 | 6 272 | 7 736 | 5 471 |
| Gross PSA expenditure (in US$ million) | 226.2 | 230.8 | 238.8 | 209.8 |
| PSA per ton (in US$) | 46 | 37 | 31 | 38 |
| Adjusted PSA expenditure (in US$ million)* | 200.9 | 205.5 | 238.8 | 209.8 |
| Adjusted PSA per ton (in US$) | 41 | 33 | 31 | 38 |

*Adjusted to exclude country office variable costs.

20. To address the issue of whether or not these levels of PSA reflect effective control and spending of PSA, there is need for: a more elaborate measurement study of the organizational structures and work methods, systems and technology available; assessment of required staff competencies and other resources in view of the many changes that have occurred in the organization; and an in-depth review of the directions or priorities in the implementation of programmes and projects. Also, more time will be required to allow the two recent major organizational changes—decentralization and the implementation of a new corporate information system, WINGS—to take effect and become stabilized in order to properly assess their impact on the overall level of the PSA.

21. Therefore, this paper focuses only on the issue of the methodology or process of generating ISC income as the main source of funds for the PSA. The preliminary analysis and the outcome presented here assume that the current level of PSA is appropriate.

## PSA BUDGET AND ACTUAL EXPENDITURES

### Principles and Assumptions

22. The PSA is the portion of the WFP Budget that pertains to providing indirect support to WFP's activities[2] and cannot be directly attributed to any programme category or activity. Activities falling under this category include:[3]

- a minimum country office structure considered essential for a WFP presence;
- regional office (i.e. outposted bureaux and sub-regional offices) support costs; and
- all Headquarters support costs.

23. The 2000–2001 PSA budget was first budget prepared under the revised R&LTF policies.

24. Taking into account the above classification of indirect support activities pertaining to the PSA, and the Executive Board's decision on the ISC rate, the PSA budget for 2000-2001 was prepared on the basis of the following principles and assumptions:

a) Funding for the PSA comes mostly from contributions for ISC, but also from government-counterpart cash contributions (GCCCs) and cancellation of prior periods' unpaid obligations that remain outstanding beyond the 12-month period required as per the Financial Regulations, and other sources. The total of this is defined hereafter as PSA income.

b) The expected ISC income to fund the PSA was determined by applying the ISC rate as a percentage of the estimated direct (operational and support) costs of WFP projects and operations for 2000–2001.

c) The 2000–2001 PSA budget was based on a range of estimates of operations (expressed in tonnage) and resources (expressed in value or costs) that were initially estimated and set out in the Strategic and Financial Plan (2002–2005) (WFP/EB.A/2001/5-B/1).

d) The PSA budget is prepared on a biennial basis.

e) The Executive Director has authority to adjust (increase or decrease) the budget in accordance with variations in the volume of operations, when such variations are more than 10 percent of the planned level (WFP/EB.3/97/13).

### 2000–2001 Budget Estimates and Actuals

25. The 2000–2001 biennium was an unusual period for WFP due to significant additional contributions. Because of these additional contributions, the operational level increased, as did the PSA.

#### *Operational Level*

26. The original budget for 2000–2001 (WFP/EB.3/99/3-A), approved by the Executive Board in October 1999, projected a level of operations of **5,165 thousand tons,** at an operational expenditure of **US$2,464 million** (See Table 2). The actual level of

[2] WFP Financial Regulations I.1.1.

[3] WFP/EB.1/99/4-A.

operations during the biennium was **7,736 thousand tons,** at an operational expenditure of **US$2,899.1 million** (representing a 50-percent increase in volume, and an increase of 18 percent in operational expenditure).

**TABLE 2. OPERATIONAL LEVEL—ESTIMATES AND ACTUALS**

| | Basic operations | Additional | Total |
|---|---|---|---|
| | (thousand tons) | | |
| **A. Volume** | | | |
| Original | 5 165 | 0 | 5 165 |
| Changes | (559) | 2 575 | 2 016 |
| Revised estimates | 4 606 | 2 575 | 7 181 |
| Actual | 5 046 | 2 690 | 7 736 |
| | (US$ million) | | |
| **B. Value** | | | |
| Original | 2 464.0 | 0.0 | 2 464.0 |
| Changes | (459.0) | 1 160.0 | 701.0 |
| Revised estimates | 2 005.0 | 1 160.0 | 3 165.0 |
| Actual | 2 117.3 | 781.8 | 2 899.1 |

## *Indirect Support Cost Income*

27. Originally, the estimated ISC income to be generated to fund the PSA budget was **US$191.9 million.** Subsequently, with the higher level of operations, this figure was revised to generate an estimated net increase of **US$56.1 million,** resulting in a total of **US$248 million** of ISC income (see Table 3).

**TABLE 3. ISC AND PSA—ESTIMATES AND ACTUALS**

| | Basic operations | Additional | Total |
|---|---|---|---|
| | (US$ million) | | |
| **A. ISC** | | | |
| Original | 191.9 | 0 | **191.9** |
| Changes | (35.3) | 91.4 | **56.1** |
| Revised estimates | 156.6 | 91.4 | **248.0** |
| Actual | 151.5 | 36.0 | **187.5*** |
| **B. PSA** | | | |
| Original | 193.9 | 0.0 | **193.9** |
| Changes/re-costed | (2.2) | 48.0 | **(45.8)** |
| Revised estimates | 191.7 | 48.0 | **239.7** |
| Actual expenditure | 190.7 | 48.1 | **238.8** |

*An additional US$45 million of ISC income for 2000–2001, which should have been received in December 2001, was received only in January 2002.

### *PSA Expenditures*

28. The original PSA budget for 2000–2001 was estimated at **US$193.9 million,** which was later re-costed to **US$191.7 million,** in accordance with the lira-dollar exchange rate fixed by the FAO Conference at its November 1999 session. Following principle e) in paragraph 24, in light of the expected increase in operations, the Executive Director exercised her authority *to adjust the budget in accordance with the variation in the volume of operations.* Accordingly, the PSA budget was increased by 25 percent (**US$27.5 million** in 2000 and **US$20.5 million** in 2001, to a total of **US$239.7 million**). The total increase of **US$48 million** for the biennium was 85 percent of the net estimated increase of **US$56.1 million** in ISC income (see Table 3). The actual expenditure was **US$238.8 million,** including an allocation of **US$6.3 million** to the Financial Management Improvement Programme (FMIP) special account.

29. Most of the additional PSA expenditures (25-percent increase) were incurred to provide support in administering the additional 50-percent volume increase of **2,690 thousand tons**, as indicated in Table 2. The Executive Director, while approving proposals for the additional budget, decided that only expenditures pertaining to activities that were either linked with the increased level of operations or of a non-recurring nature were included in these allocations.

30. In summary, the estimated operational level was **7,181 thousand tons,** at an operational expenditure of **US$3.165 million,** with a corresponding PSA budget of **US$239.7 million.** The actual operational level was **7,736 thousand tons,** at an operational expenditure of **US$2,899.1 million** and PSA expenditure of **US$238.8 million.**

**TABLE 4. PSA EXPENDITURES AND OPERATIONAL LEVEL (2000–2001)**

| | Original | Actual | Change | Percent |
|---|---|---|---|---|
| Volume (thousand tons) | 5 165 | 7 736 | 2 571 | 50 |
| Operational expenditure (in US$ million) | 2 464 | 2 899.1 | 435.1 | 18 |
| PSA expenditure (in US$ million) | 193.9 | 238.8 | 44.9 | 23 |
| PSA expenditure per ton (in US$) | 38 | 31 | (7) | (18) |

31. As Table 4 shows, volume increased by 50 percent, and operational expenditure rose by 18 percent. At the same time, PSA expenditure increased by 23 percent, resulting in a decrease in the PSA cost per ton of 18 percent.

## FUNDING THE PSA BUDGET: ISC INCOME AND OTHER SOURCES

### Indirect Support Cost Income

32. The PSA budget is funded mainly through ISC income. Estimates of ISC income required to fund the PSA budget are made during the preparation of the biennial budget and are generated from donor contributions for direct costs (operational and support) through application of the ISC rate approved by the Executive Board.

33. For the 2000–2001 PSA budget, a rate of 7.8 percent on contributions, excluding bilateral operations and trust funds (which carried rates ranging from 3 to 7.8 percent), was

applied to generate an estimated income of **US$191.9 million** to fund the original budget. As stated earlier, the PSA budget was revised to **US$239.7 million** in line with the increase in the volume of operations during the biennium.

34. For the biennium 2000–2001, the total ISC income collected and recorded as income amounted to **US$187.5 million,** as detailed in Table 5.

**TABLE 5. ISC INCOME FOR 2000–2001 (US$ million)**

| Funding window | Programme category | | | | | |
|---|---|---|---|---|---|---|
| | Development projects | EMOPs | PRROs | SOs | Trust funds | Total |
| Multilateral—7.8% | 23.2 | 4.8 | 12.1 | - | - | **40.1** |
| Directed multilateral—7.8% | 4.2 | 98.2 | 34.5 | 4.0 | - | **140.9** |
| Bilateral operations and trust funds—varying rates | - | - | - | - | 6.6 | **6.6** |
| Prior 1996 | - | - | - | (0.1) | - | **(0.1)** |
| **Total** | **27.4** | **103.0** | **46.6** | **3.9** | **6.6** | **187.5** |

35. For the purpose of analysing ISC income *vis-à-vis* budget expenditures for the biennium, we will use the income of **US$187.5 million**, recognized during the biennium, as shown in Table 5. However, this income may not be comparable with the value of total contributions or expenditures because of timing differences, as explained later in this paper.

## Other Sources for PSA Funding

36. In addition to ISC income, other sources—such as GCCC and savings from cancellation of prior-period obligations that have remained outstanding beyond the period required in the financial regulations—are included to derive the PSA income, as noted above. Thus, following principle a) of PSA funding as set out in paragraph 24, the total amount generated to fund the actual PSA expenditures of **US$238.8 million** for the biennium 2000–2001 is **US$196.9 million,** as shown in Table 6.

## The Gap in PSA Income and Expenditure

37. A comparison of PSA income with PSA actual expenditures shows a gap for the biennium 2000–2001, as shown in Table 6.

**TABLE 6. GAP IN PSA INCOME AND EXPENDITURES (US$ million)**

| Source | 2000–2001 |
|---|---|
| ISC income | 187.5 |
| GCCC | 3.1 |
| Savings on cancellation of prior-period obligations | 6.3 |
| **Total income from other sources** | **9.4** |
| **Total PSA income** | **196.9** |
| PSA actual expenditures | 238.8 |
| PSA gap | (41.9) |

38. Although Table 6 above shows a gap or a shortfall of **US$41.9 million** of ISC income to meet the PSA, this would have been a surplus of **US$3.1 million** had contributions for ISC of about **US$45 million** been received as expected, in December instead of January 2002. This is noted in Table 3.

## Use of the General Fund

39. In theory, while PSA income should fully fund the PSA, this is not the case due to structural imbalances arising from several factors, as presented in document WFP/EB.3/97/4-C, including:

- PSA expenditures that do not directly vary to the same extent as expenditures for direct operational and support costs, because part of the PSA costs is not variable, regardless of the volume of operations within a certain range. This explains why the level of an approved PSA budget is not adjusted if a change in the volume of operations falls within a range of 10 percent above or below the originally estimated level;
- alterations in the variable cost component of ISC, which could lead to gaps or excesses between resource availability and the funding needs of an approved PSA budget, which is estimated at the beginning of the biennium based on an assumed level of operation in each programme category;
- the accounting policies of the Programme on income recognition and accrual of expenditures, which affect both contributions for direct costs and the ISC income; and
- the volume of operations and costs of commodities, transport and others.

These factors causing the gaps are further explained in the next section.

40. In 1998, the working group recognized the gap and the need to bridge it, and discussed how the General Fund might be used. The group favoured the use of the General Fund **to fund gaps arising from marginal imbalances between total ISC recovery and the PSA budget.** This was covered by the working group's recommendation 4.0, approved by the Board:[4]

> *That the use of the General Fund be the subject of recommendations from the Secretariat to the Executive Board. These recommendations be for specific one-off purposes rather than recurrent items, and may include the funding of gaps arising from marginal imbalances between total ISC recovery and the PSA budget.*

41. WFP experienced PSA funding gaps of **US$43.7 million** in 1996–1997[5] and **US$8.3 million** in 1998–1999.[6] These gaps were reported by the Secretariat in the submission of the relevant audited biennial financial statements, which were approved by the Executive Board.[7]

42. It should be borne in mind that during these biennia, the ISC rates varied for all contributions for the various programme categories, as set out in paragraph 11 of this document.

## SOME ISSUES RELATED TO PSA AND ISC RECOVERY

43. As stated earlier, the determination of the appropriate ISC rate as a basis for funding the PSA is affected by several factors and depends heavily on underlying assumptions.

44. The first element that affects the establishment of the rate is the **nature of the PSA itself.** There is general agreement that the PSA budget as an overhead budget has fixed and variable components.

### Fixed and Variable Nature of PSA Costs

45. At its 40th Session, the CFA discussed and approved (CFA- 40/15) the concept of a flexible PSA, the level of which is determined by two elements: fixed and variable costs, and direct (operational and support) costs.

46. The fixed capacity required to undertake the minimum expected level of activities and the flexibility of being able to expand the capacity to perform additional activities determine the fixed and variable part of the indirect support costs. Generally, support services that do not have a direct link with the level of activities undertaken are considered fixed, while support services that directly change as the level of activities changes are considered variable.

[4] WFP/EB.1/99/4-A.

[5] WFP/EB.3/98/4-A, Audited Biennial Accounts (1996–1997).

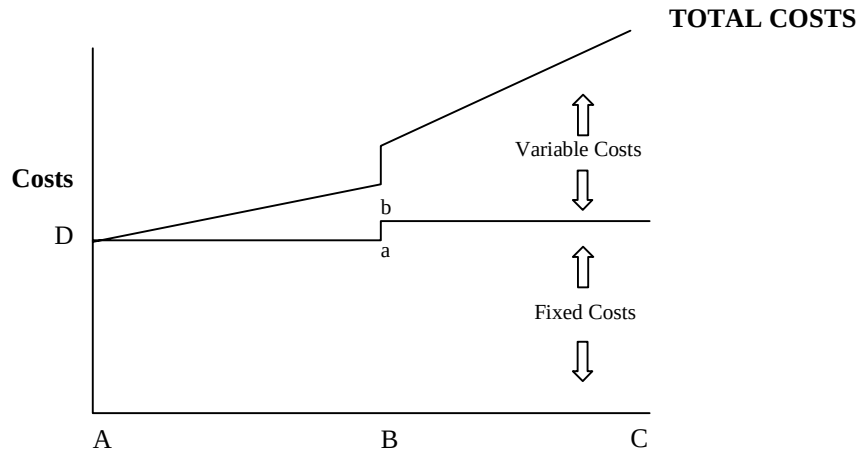
[6] WFP/EB.3/2000/4-B/1, Audited Biennial Accounts (1998–1999).

[7] EB.3/1998/13 (item 2) and EB.3/2000/13 (item 6).

47. An analysis performed during the preparation of the budget for 1996–1997 indicated that about half of the PSA costs were fixed in nature.[8] However, for the 2000–2001 PSA budget, the fixed-cost component was expected to be higher because of the transfer of some items of expenditure to the DSC cost category, as explained above in paragraphs 15 and 16. Most of these costs were country office costs linked to projects, and were initially considered variable in nature.

48. Fixed costs remain constant (points *A* to *D* in the figure below) within a certain range of operations (points *A* to *B*). When the operational level rises beyond this range (at point *B*), additional capacity needs to be added, requiring the first level of fixed costs to increase in "step-like" fashion (from points *a* to *b*). This is the rationale for the authority granted to the Executive Director to adjust the budget when the volume of operations increases or decreases by more than 10 percent of the originally estimated level.

**EFFECT OF CHANGE IN VOLUME ON FIXED COSTS**




49. When the volume of operations was estimated to increase from **5,165 thousand tons** to **7,181 thousand tons** (an increase of 39 percent) in 2000–2001, the PSA budget was increased from **US$193.9 million (re-costed at US$191.7 million)** to **US$239.7 million** (an increase of 24 percent).

## Second-Level Rate for ISC or Marginal Rate

50. Therefore, taking into account the interplay among the elements described above, and their impact on the PSA (i.e. that PSA activities and expenditures do not vary in equal relationship with changes in the volume of operations, or in prices of commodities and other direct costs), there is a case for introducing the concept of a marginal ISC rate based on a second level or extra volume of operations. This will be explored in the next phase of this review.

[8] CFA40/4/REV.1, WFP/EB.3/97/4-A, WFP/EB.3/99/3-A: WFP Biennial Budget for 1996–1997, 1998-1999, 2000–2001.

## Direct (Operational and Support) Costs

51. The second element that affects the determination of the ISC rate is the base, made up of direct (operational and support) costs. These costs are directly affected by both volume and price:

- **The volume of WFP operations determined in terms of tonnage.** Within a certain range of quantity of food delivered per year or biennium, the fixed portion of the indirect support costs will be unaffected by change in the volume within that range. However, the variable costs portion will correspondingly change even within that range. But if the volume exceeds that range, then both fixed and variable costs change in a step-like fashion, as discussed above.
- **Prices for commodities, external and internal transport, and other direct costs.** These prices and costs determine the aggregate costs for direct operational and support costs, which are then used as the basis for applying the ISC rate. Any increase or decrease in these prices resulting in higher costs or savings would not have an impact on the level of PSA activities, or therefore on the level of actual PSA expenditures. However, these price and costs changes would reduce or increase the base of total direct costs and consequently the ISC income generated from these formulations. Such changes may also cause a gap in PSA funding.

## Imbalance in ISC Income Due to Accounting Policies

52. The Programme's accounting policy on income is to recognize and record all kinds of income earned (except interest) only when it is actually received or collected. This is referred to as the **cash method** of accounting for income. In most cases, ISC income is received at the same time as the contributions for other cost components are collected. But some donors contribute the ISC component from other sources, and may contribute it at different times. Hence the recording of their contributions for the other cost components and for ISC occurs on different dates, which at times fall across different financial periods.

53. This was the case for the biennium 2000–2001, when ISC income of **US$45 million** for 2001 contributions expected in December was received only in January 2002. Had this amount been received and recorded in 2001, then the ISC income would have been higher by this amount. Accordingly, **US$12.5 million** of the shortfall of **US$41.9 million,** as shown in Table 6 is due to the timing difference as follows:

| | **US$ million** |
|---|---|
| 2000–2001 ISC income received in 2002 | 45 |
| Prior-period ISC received during the biennium | 32.5 |
| **Shortfall due to timing difference** | **12.5** |

## Imbalance in Contributions for Direct Costs and Expenditures Due to Accounting Policies

54. There is also an imbalance arising from accounting procedures for contributions for direct (operational and support) costs and expenditures. On the one hand, WFP uses the **cash method** of accounting for income, in which income is recorded only at the time of the actual receipt of the contribution. Therefore, even if donors confirm their contributions, these are not recorded as income until they are actually collected. At the end of each

financial period, there are situations in which a contribution is confirmed in one biennium and the collection received and recorded as income in the following biennium.

55. On the other hand, WFP uses the **accrual method** of accounting for expenditures. Through this method, expenditures are recognized and recorded upon receipt of goods and services ordered during the biennium and for purchase orders or contracts that are executed or released to the relevant suppliers or vendors as at the end of the biennium.

56. Furthermore, under the Financial Regulations, the Secretariat is allowed to incur expenditures without having to wait for actual collection of these contributions. These are initially funded either from the Operational Reserve (based on a confirmed contribution), DSC Advance Facility (based on levels approved by the Executive Board and not necessarily based on confirmed contributions), or sometimes the Immediate Response Account (IRA).

57. This type of imbalance exists only when projects are viewed within a certain period only, such as a specific biennium. Total project expenditures may be higher than total actual income collected, which is usually the case at the early stages of project implementation, and then over time, towards the closure of a project, the reverse situation (income higher than expenditures) occurs. This imbalance was recognized by the working group of 1999; hence, they recommended the use of interest income to fund this imbalance in the PSA recovery mechanism, as stated in paragraph 40.

58. But if income and expenditures are viewed within the entire life of a project, there is no imbalance, because after completion of the project, the financial report on that project reflects an equal amount of actual income and actual expenditures. This is because any excess of actual income collected (except for the relevant ISC income on the excess) over actual expenditures incurred is declared as fund surplus of completed projects, reported to the donors concerned, and either reprogrammed for other projects or refunded to the donors, as the case may be.

59. For the ISC income levied on the funds surplus, the current practice is to credit this to the General Fund, where ISC income is recorded and included in PSA funding for the biennium during which such income is actually collected. However, in cases where reprogramming of these surplus funds is authorized by donors, these surplus funds are taken up like new contributions for projects, but no further ISC recovery is levied on them.

## The Gap between the PSA and ISC, and Scenarios of Comparison

60. Imbalances between ISC income and PSA funding are caused by various factors: the fixed and variable nature of PSA expenditures, direct costs (as influenced by volume and prices), and accounting policies (resulting in timing differences and structural imbalances).

61. In this preliminary analysis, we are presenting the current and alternative procedures of comparing ISC revenue and PSA expenditures.

### ➪ *Current Procedure: Based on ISC Income Actually Received During the Biennium*

62. This is the currently applied procedure, which is to record the ISC income that is actually received during the relevant biennium. Conceptually, this amount should equal the 7.8 percent rate applied on the contributions made for direct operational and support costs of the various programmes and projects. But this is usually not the case. The revenue generated through this method, and the gap, are shown below.

**TABLE 7. CURRENT PROCEDURE**

| | (US$ million) |
|---|---|
| ISC income (see Table 5) | 187.5 |
| Other sources | 9.4 |
| **Total PSA income (see Table 6)** | **196.9** |
| Actual PSA expenditures | 238.8 |
| Funding surplus/deficit | (41.9) |

63. Using this procedure, the gap is a deficit of **US$41.9 million.** Under existing policies, this deficit can be funded from interest in the General Fund, subject to Executive Board approval. It should be noted, however, that since the main reason for the gap is the delayed receipt of **US$45 million** (received in January 2002), other things being equal, this should result in an equivalent surplus in the current (2002–2003) biennium.

### *Scenario I: Based on ISC Income Generated from Contributions Received*

64. The first scenario is based on ISC income that is generated from contributions for direct (operational and support) costs made during the biennium. If this scenario had been followed, and assuming a rate of 7.8 percent had also been applied to bilateral operations, the situation of ISC income and PSA expenditures for 2000–2001 would have been as shown in Table 8.

**TABLE 8. RECOVERING ISC INCOME ON RECEIPT OF CONTRIBUTIONS**

| | (US$ million) |
|---|---|
| **Total contributions for direct costs** | **2 994.9** |
| ISC recovery at 7.8% | 233.6 |
| Other sources | 9.4 |
| **Total PSA income** | **243.0** |
| PSA expenditures | 238.8 |
| Funding gap—surplus | 4.2 |

65. Therefore, if the procedure had been to recognize ISC income in proportion to total contributions, there would have been a surplus of **US$4.2 million** for the biennium 2000–2001 and it would have been credited to the General Fund. The difference between this method and the first is due to the timing lag in the recording of ISC contributions.

### *Scenario II: Based on ISC Rate of 7.8 Percent on Actual Direct (Operational and Support) Costs*

66. The second scenario involves applying the ISC rate of 7.8 percent against actual total direct (operational and support) costs incurred during the biennium, as shown in Table 9.

**TABLE 9. RECOVERING ISC ON ACTUAL EXPENDITURES**

| | (US$ million) |
|---|---|
| Actual direct costs for all programme categories, including bilateral operations and trust funds | 2 899.1 |
| ISC income by applying 7.8% to the above | 226.1 |
| Add other sources | 9.4 |
| **Total PSA income** | **235.5** |
| Actual PSA expenditures | 238.8 |
| Funding gap—deficit | (3.3) |

67. In this scenario, the rate applied is the same for all categories, including bilateral operations and trust funds. If the existing variable rates for bilateral operations and trust funds had been applied on the actual direct costs of these operations, then there would have been a slightly higher deficit.

### *Scenario III: Generate a New ISC Rate Based on Actual Costs*

68. The third scenario involves generating a new ISC rate by applying the total actual PSA expenditures on total direct (operational and support) costs expenditures. In this scenario, instead of using the predetermined rate of 7.8 percent, the actual PSA expenditure is applied to the total actual direct costs (operational and support) for the biennium. This rate is then used to generate ISC income.

**TABLE 10. ACTUAL PSA ON DIRECT COST EXPENDITURES (US$ million)**

| | | |
|---|---|---|
| (a) | Actual PSA expenditure/a | 238.8 |
| (b) | Actual direct costs (DOC & DSC) | 2 899.1 |
| Rate: (a)/(b) | | 8.2 percent |

69. In this scenario, donors would be expected to contribute an additional 0.4 percent of the total expenditures of the biennium towards ISC, in addition to the 7.8 percent.

70. Due to time constraints, this preliminary review has been limited to an analysis of our current procedure and three scenarios. However, other options will be explored in the next phase of the review.

## PRELIMINARY OBSERVATIONS

71. Following this preliminary analysis, and using the unaudited financial statements as the source of actual expenditures, the following observations are made:

### On the Appropriate Level of PSA

72. The appropriate level of the PSA and cost-effectiveness of the relevant activities have not been definitively examined. The PSA level needs to be vetted to determine whether

WFP has the most responsive organizational infrastructure to administer its operations. This is difficult to answer at this point, even more so because WFP is still at an early stage in its decentralization, and the new corporate information system is still in the process of stabilizing and being rolled out to the country offices.

73. One of the business practices to examine the appropriate level of PSA is benchmarking, i.e. comparing an organization's performance against industry standards. In the case of WFP, this involves comparing the Programme's PSA level of activities with those of other United Nations organizations or agencies with a more or less similar nature, scope of operations and levels of resources.

### On the Methodology

74. The causes for these gaps must be further analysed to establish the extent to which they result from timing differences in recognizing income and/or from the fixed and variable nature of the PSA.

75. The PSA must be scrutinized further to identify those items of expenditures that are deemed to be fixed costs within the first range of operations established at the beginning of a biennial budget and those that are deemed to be variable costs. There must be a clearer determination of costs that belong to fixed and variable groups of expenditures and of how these costs vary with changes in the level of operations.

76. In this analysis, there is a need to look at the broader impact of operations, not only on PSA funding but also on DSC funding.

77. It is possible that the conclusion reached on the analysis of fixed and variable costs may lead to the emergence of two ISC rates: one for the original contributions and a marginal rate for additional contributions when a certain level of operation has been reached. If a marginal rate emerges, there will be a need to see how it would work (applied across the board or donor based) and how it would be triggered.

## NEXT STEPS

78. In finalizing this review of preliminary observations, the following steps will be taken in the review to be reported on and presented in October 2002.

a) Complete the analysis of the structural imbalances and the review of the existing accounting conventions for recording income and expenditures.

b) Analyse of the PSA cost structure, including fixed and variable costs, the structure of country offices and the effect of changes in volume and value of operations. This will also be basis for determining the "step-like" increase in fixed costs and the possibility of setting a second rate for ISC, and procedures to implement this.

c) In analysing the rates and the fixed and variable costs in the PSA, revisit the other funding options initially presented by the working group of 1998.

d) Conduct a comparative study of the funding and costs for the administrative and support budgets of comparable United Nations organizations, and determine appropriate levels.

e) Present the outcome of these analyses and study to the External Auditor for review, with recommendations to be provided in October 2002.

f) Develop recommendations on methods of calculations for charging and collecting or levying this ISC income in order to fund the PSA at the appropriate level and at the appropriate time.

g) Recommend or formulate other policies that may emerge from this study.

## RECOMMENDATIONS

79. The Secretariat is committed to working with the Executive Board in reaching a cost-effective level of PSA, reaching agreement on how the ISC rate should be calculated and identifying mechanisms for bridging any structural imbalances. Therefore, the Executive Director recommends that the Executive Board:

i) take note of this preliminary review of the ISC rate while awaiting the outcome of a more complete and final review to be presented to the Third Regular Session of the Executive Board in October 2002;

ii) keep the current ISC rate for 2002; and

iii) agree with the “Next Steps” set out by the Secretariat in paragraph 78.