Executive Board
Third Regular Session

Rome, 21–25 October 2002

FINANCIAL AND BUDGETARY MATTERS

Agenda item 5

COMMENTS OF THE (OUTGOING) EXTERNAL AUDITOR

For information*

The Executive Director is pleased to submit herewith the comments of the (outgoing) External Auditor on the following WFP reports:

- Final Report on the Analysis of the Indirect Support Cost (ISC) Rate (WFP/EB.3/2002/5-C/1);
- WFP's Cash Balances: Composition and Appropriate Levels of Cash (WFP/EB.3/2002/5-D/1); and
- Final Report on Balances of Projects Closed Prior to 2001 and Migrated to WINGS (WFP/EB.3/2002/5-E/1).

[*] In accordance with the Executive Board's decisions on governance, approved at the Annual and Third Regular Sessions of 2000, items for information should not be discussed unless a Board member specifically requests it, well in advance of the meeting, and the Chair accepts the request on the grounds that it is a proper use of the Board's time.

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INTRODUCTION

1. Following the requests of the Executive Board, I have considered the following World Food Programme (WFP) reports:

- Final Report on the Analysis of Indirect Support Cost (ISC) Rate (WFP/EB.3/2002/5-C/1);
- WFP's Cash Balances: Composition and Appropriate Levels of Cash (WFP/EB.3/2002/5-D/1);
- Final Report on Balances of Projects Closed Prior to 2001 and Migrated to WINGS (WFP/EB.3/2002/5-E/1).

My comments on these documents are detailed in the paragraphs that follow.

FINAL REPORT ON THE ANALYSIS OF INDIRECT SUPPORT COST (ISC) RATE

Background

2. At its 2002 annual session, the Executive Board considered the document entitled "Preliminary Review of the Indirect Support Cost (ISC) Rate" (WFP/EB.A/2002/6-A/1 and Corrigendum 1). The Board took note of this preliminary review, while awaiting the outcome of a more complete and final review to be presented to the third regular session in October 2002. The Board also decided to keep the current ISC rate for 2002 (7.8 percent), pending its review and decision at this session, and agreed on a series of "next steps", which would enable the Secretariat to complete the final report.

3. As part of these "next steps", the Secretariat was to embark on a series of analyses together with a comparative study with other United Nations organisations, and "*present the outcome of these analysis and the study to the External Auditor for review, with the Auditor's recommendations to be presented in October 2002*".[1] My initial intention was to include my comments and recommendations in my report on the 2000–01 accounts, which already addressed Programme Support and Administration (PSA) income and expenditures [paras. 54 to 71]. However, the analyses and study were not complete when I finalised my report (only the annotated outline of the final review was available).

4. Subsequently, my staff were provided, in mid-August 2002, with a draft of the final report on the analysis of ISC and made some preliminary comments and suggestions, which were duly incorporated in the revised draft. My staff were provided, on 18 September 2002, with the final report, which calls, in my opinion, for the following comments and recommendations concerning respectively:

- the structural imbalances between PSA income and expenditures;
- the nature of PSA expenditures;
- the ISC rate for the 2002–03 biennium;
- the management of PSA gaps;

[1] Cf. "Decisions and recommendations of the Annual Session of the Executive Board, 2002" (WFP/EB.A/2002/10).

- other funding options for PSA;
- the appropriate level of PSA; and
- the comparative study with other organisations.

Structural Imbalances between PSA Income and Expenditures

5. As detailed in Sections 2 and 3 of the final report, the structural imbalances between PSA income and PSA expenditures are a result of the present accounting convention for income (cash basis) and expenditures (accrual basis), price and volume fluctuations and other unforeseen PSA expenditures and income. As already indicated in my report [paras. 58 to 64] the gap caused by the accounting convention practice can be addressed by simply changing the accounting policy for income. Such was the basis for my recommendation that WFP record both its income and expenditure on an accrual basis. I, therefore, welcome the Executive Director's decision "*to change the accounting policy on income recognition to an accrual basis, effective from 1 January 2002*" as announced in paragraph 30 of the final report.

Nature of PSA Expenditures

6. Section 4 of the final report examines the nature of PSA expenditures and concludes notably that a substantial portion of them (approximately three quarters for the 2002–03 budget) is fixed in relation to changes in operational volume. Regarding the PSA expenditures, which vary with the level of operations and can be directly linked to the support of an operation, the final report concludes that "*there is a strong case for these costs to be reclassified to DSC* [Direct Support Costs] *to make the PSA more fixed in nature*". Therefore, the approval of the Board is sought for the reclassification of those expenditures.

7. In my opinion, it would be premature to seek the approval of the Board for such a reclassification, for the following reasons:

   - Although the fact is not explicitly mentioned in the final report, my staff were informed that the Programme did not intend to proceed with the reclassification for the current biennium (2002–03), but only from 2004 onwards.
   - The exact nature of the expenditures to be reclassified is not indicated in the final report. Likewise, the "*system to attribute these costs to projects and allocating the funds for various uses*" remains to be set up.
   - In fact, and as pointed out in my report on the 2000–01 accounts, in spite of the improvements made, the Programme has still to define in a more precise and realistic manner the expenditures that are PSA in nature. I, therefore, recommended that "*a comprehensive document on PSA expenditures be presented to the Executive Board for its review as soon as possible or, at least, well in advance of the 2004–05 biennium budget preparation*" [para. 68].

8. In view of the above and taking into account the fact that, for the 2004–05 PSA budget, the Secretariat committed itself to undertaking a complete review of the assumptions and basis for setting PSA expenditures, I recommend that the approval of the Board be sought at a ater stage should the review show the necessity of any reclassification of PSA to DSC.

ISC Rate for the 2002–03 Biennium

9. Section 5 of the final report examines the current mechanism of ISC funding and, on the basis of three different scenarios, the implication of the PSA gap on the single ISC rate.

One of the conclusions is that, even after adjusting for accounting convention differences, there has been significant PSA shortfalls for the period 1996 to 2001, which were funded from interest income. Furthermore, assuming that all other factors remained as budgeted and that average direct costs per metric ton were to stabilise at 2000–01 levels, a PSA shortfall would also be experienced for the 2002–03 biennium at the current ISC rate.

10. On that basis, a course of action has been proposed in paragraphs 74 and 75 of the final report. The Executive Director has decided "*to revise the remaining PSA budget downwards by 10 percent from 1 January 2003*" and recommends to the Board that it confirm the ISC rate of 7.8 percent for 2002 but approve the reduction of the ISC rate to 7.0 percent for 2003. These decisions would still result in a PSA shortfall of US$28.5 million if direct input prices stabilised at their 2000–01 levels.

11. In my opinion, the decision taken and the recommended course of action call for the following comments:

- When approving the WFP biennial budget for the period 2002–03 at its third regular session in 2001, the Board authorised the Executive Director to adjust the PSA component of the budget. However, it was only "*in accordance with any variation in volume of operations when such variations were more than 10 percent from the planned level*".[2] Since the planned revision of the budget is not related to a variation in volume of operations, it should not be decided by the Executive Director but by the Board itself. I acknowledge, however, that if the Executive Director does not have the authority to make a formal revision of the budget, he is not forced to spend all the approved appropriations. On the contrary, in line with General Regulation VII.7,[3] he is encouraged to achieve cost reductions whenever possible.
- Since the current ISC rate of 7.8 percent would already lead to a PSA shortfall for the 2002–03 biennium, a reduction of this rate might not be the most appropriate measure.
- In paragraph 71 of my report on the 2000–01 accounts, I had indicated that *"in order to be able to review the current ISC rate, the Executive Board should be provided with the following in addition to the information on the nature and extent of expenditures that will be charged as PSA mentioned above:*
  - ◊ *detailed information on the level and types of future contributions, for which the standard rate of 7.8% would either be reduced or waived completely; and*
  - ◊ *a good indication of the other sources of PSA funding, namely GCCC* [Government Cash Contributions for local Costs] *and savings on prior-period obligations".*

Although I acknowledge the limited impact of the above on PSA income, I still consider that these issues should be fully examined.

- Last but not least, I would not encourage the Programme, as a general rule, to change the ISC rate in the middle of a given biennium. Preferably, the ISC rate should, at least, be fixed for the whole budgetary and financial period (currently two years).

[2] Cf. Decisions and recommendations of the Third Regular Session of the Executive Board, 2001" (WFP/EB.3/2001/14).

[3] General Regulation VII.7 states the following: "*The Executive Director shall keep the cost of management and administration of WFP to a minimum consistent with the maintenance of efficiency and accountability and shall use the most efficient and cost-effective services, including in the field*".

Management of PSA Gaps

12. Section 6 of the final report deals with the management of PSA gaps since it is estimated that, regardless of what ISC rate is set by the Board under the current system, there will almost certainly always be a PSA gap. In order to address the problem, the establishment by the Executive Director of a PSA equalisation account for the 2002–2003 biennium to record actual gaps has been announced. In addition, the following recommendations are made for consideration by the Board:

- In case of PSA surpluses, the ISC rate would be reduced to zero out the PSA equalisation account.
- As done for past biennia, interest income would be used to fund PSA shortfalls, if any.
- Other mechanisms would be established to address future situations where interest income were not sufficient to cover these shortfalls.

13. In my opinion, the decision taken and the recommended course of action call for the following comments:

- Regarding the establishment of the PSA equalisation account, the issue of the nature of this account has to be raised. Although the final report does not give any indication in this regard, I would assimilate the PSA equalisation account into a reserve account since this might lead to the creation of surpluses. In that case, such an account should be established by the Board itself in line with Financial Regulations 10.1[4] and 10.7.[5]
- The use of the PSA surpluses, if any, should also be set by the Board at the time of the establishment of the PSA equalisation account. Should the Board decide to use surpluses to reduce the ISC rate as proposed, I would recommend that such be done either at a given frequency (at the end of every two biennia, for instance) or when the surpluses have reached a given amount. For the sake of consistency for the Programme and stability for the donors, it would be better to avoid any major fluctuations in the ISC rate from one financial period to another.
- As far as the use of interest income to fund any PSA shortfalls is concerned, the decision to do so belongs to the Board as rightly indicated in the final report. I can only concur with the necessity to establish other funding mechanisms to address future situations where interest income would not be sufficient to cover these shortfalls. As pointed out in paragraph 35 of my report on the 2000–01 accounts, the reprogramming and refund of unused fund balances will have repercussions for the level of cash balances and, therefore, for the level of interest income.

Other Funding Options for PSA

14. Section 7 examines other funding options for PSA. The options initially examined by the Working Group in 1998 are revisited and updated. In addition and, as announced in paragraphs 27 and 71 of my report on the 2000–01 accounts, preliminary information on GCCC is given. I concur with the proposal to include in the review of the Resources and Long Term Financing (R&LTF) policies the issues of collecting, accounting and recording GCCC as part of PSA income. However, I am of the opinion that the poor results achieved

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[4] Financial Regulation 10.1 states the following: "*The WFP Fund shall be subdivided into a General Fund, programme category funds, trust funds and such other funds as the Board may establish from time to time. The Executive Director shall establish such accounts within the WFP funds as are necessary to implement these Regulations.*"

[5] Financial Regulation 10.7 states the following: "*The Board may establish other reserves as required*".

so far in setting up GCCC agreements with host governments (in line with Financial Regulation 4.7) are partly the result of the delays encountered within the Programme as described in paragraphs 23 to 27 of my report on the 2000–01 accounts. Although GCCC are not a significant source of PSA income, the Programme should refrain from renouncing this source of funding, which would be in contradiction with the general trend as observed in the other United Nations organisations. I, therefore, stress again the necessity of adhering to the February 2003 deadline for presenting to the Executive Board, a “management paper” on this issue.

Appropriate Level of PSA

15. Section 8 examines how the appropriate level of PSA could be determined. I concur with the commitment taken to prepare the 2004–05 budget on the basis of a zero-based approach with a view to setting an appropriate level of PSA. I also concur with the recommendation to consider a results-measurement framework for PSA-funded activities.

Comparative Study with Other Organisations

16. The comparative study conducted with other United Nations organisations provides very useful information. However, as rightly pointed out in the executive summary of the final report, the results have to be considered with caution since a “*straightforward comparison is difficult to achieve because of differences in mandates, strategies, modalities for implementation of programmes, outputs and costs classifications*”.

WFP’S CASH BALANCES

Background

17. At its 2002 first regular session, the Executive Board approved the report entitled “Cash and Investment Management: Level of Financial Investment and Investment Policy” (WFP/EB.1/2002/4-A/1) and “*requested that a detailed analysis be provided of the reasons for the current level of cash balances and that an appropriate level of cash balances be indicated, together with the steps to be taken to reduce cash balances to that level, to be presented to the Board for consideration at its October 2002 session”*[6]. At the same time “the Board wished “*the External Auditor to review cash balances*”.[7] Likewise, the Advisory Committee on Administrative and Budgetary Questions (ACABQ) also requested “*that the External Auditor for WFP review the implementation of the investment procedures described in the report, as well as the efficiency of the investment process. This should include an examination of the transparency of the provision governing the use of investment income, as outlined in paragraph 41 of the report*”.[8]

18. The extensive review of the Treasury management my staff conducted during the 2000-01 biennium is reported in paragraphs 72 to 165 of my report on the 2000–01 accounts. In addition, paragraphs 36 to 37 comment on the evolution of cash flow for the

[6] Cf. “Decisions and Recommendations of the First Regular Session of the Executive Board, 2002” (WFP/EB.1/2002/12).

[7] Cf. para. 23 – “Summary of the work of the First Regular Session of the Executive Board, 2002” (WFP/EB.1/2002/13).

[8] Cf. para. 5 – “Report of the Advisory Committee on Administrative and Budgetary Questions (ACABQ)” (WFP/EB.1/2002/4(A, B)/2).

period 1994 to 2001. My initial intention was also to include some comments on the detailed analysis requested by the Board. However, that analysis was not complete when I finalised my report. In fact, the document was finalised on 18 September 2002 only. It calls, in my opinion, for the following comments and recommendations concerning respectively:

- the composition of WFP's aggregate cash balances;
- the cash flow forecasts; and
- the cash levels in excess.

Composition of WFP's Aggregate Cash Balances

19. The first section of the document examines the composition of WFP's aggregate cash balances, which amounted to US$905 million as at 31 December 2001 (broken down into US$819.6 million of cash and short-term investment assets and US$85.4 million of long-term investment assets as disclosed in Statement II of the audited accounts). For the sake of the analysis, the overall amount has been classified in two categories: "cash relating to projects" on the one hand and "cash not relating to projects" on the other hand. The distinction makes sense. However, the way the following cash components have been classified can be disputed:

- The long-term loan of US$106 million has been classified into the "cash not relating to projects" category. However, it does indeed relate to a large emergency operation as detailed in paragraphs 152 to 154 of my report on the 2000–01 accounts. Furthermore, since the present value of the loan proceeds far exceeds the expected repayments for interest and principal, the excess could be used for project implementation should the Board agree.
- Likewise, the monetisation funds in country offices of US$57.3 million have also been classified as "cash not relating to projects", while these funds have been entrusted to the Programme for the funding of specific projects agreed with the governments concerned.

20. In view of the above, I recommend that, for future reports, a different classification be used in order to reflect better the true nature of the different cash balances. The same classification used for the presentation of the Statement of Cash Flow (Statement III of the audited accounts) could, for instance, be used with a distinction between cash from operating activities, financing activities and other sources.

Cash Flow Forecasts

21. The third and fourth sections of the documents disclose the results of the cash flow forecasts for the period 2002 to 2005 using respectively previous years' rates and higher disbursement rates. While these forecasts provide some useful information, I regret that the methodology used for forecasting was only based on trend analysis of past years and that the assumption of higher disbursement rates by 10 percent was not substantiated. In paragraphs 120 to 123 of my report on the 2000–01 accounts, I had already indicated that, while trend analysis could provide valuable information, forecasts should be prepared instead on the basis of current criteria, since the full implementation of WINGS in January 2002 would undoubtedly result in changing patterns for receipts and disbursements. These criteria could be: average time span for settlement of suppliers and other accounts payable, collection of contributions, recovery of accounts receivable, time lag between obligations and disbursements and between the closing of projects and the reprogramming or refunds of unspent contributions.

22. In view of the above, I recommend that these criteria be set and formally documented to serve as the basis for the preparation of future cash forecasts. As also pointed out in my report [paras. 103 to 105], this was an area where improvement was needed, since no automated system was used at the time of my staff's review. The existing functionalities of WINGS should, however, facilitate forecasting once put into use as envisaged.

Cash Levels in Excess

23. The last two sections of the document address the issue of the excess cash levels and provide an action plan. I concur with the actions envisaged and would only recommend that the plan also address the issue of cash flow forecasts.

FINAL REPORT ON BALANCES OF PROJECTS CLOSED PRIOR TO 2001 AND MIGRATED TO WINGS

Background

24. At the 2002 first regular session, the Executive Board examined the document entitled "Balances of Projects Closed Prior to 2001 and Migrated to WINGS" (WFP/EB.1/2002/4-B/1). It took note of this preliminary report on the status of the financial balances of closed projects migrated to WINGS and of the actions being taken to complete the work and issue a final report. I was not officially requested to comment on this final report. However, since the issue at stake has an impact on the level of cash, my staff was provided, in early August 2002, with a draft of the final report and made some preliminary comments and suggestions, which were duly incorporated in the revised draft. My staff were provided, on 18 September 2002, with the final report, which calls, in my opinion, for the following comments concerning the impact on cash balances.

Impact on Cash Balances

25. As indicated in paragraphs 28 to 31, the impact on cash balances is quite significant: US$46.69 million for closed projects migrated to WINGS and US$30.90 million for completed projects targeted for financial closure in WINGS. In paragraph 35 of my report on the 2000–01 accounts, I had already commented on the fact that, for the reprogramming and refund carried out during the 2000–01 biennium, the decrease of the cash balance had been a slow process. I welcome, therefore, the strategies envisaged to improve project closure processes and reporting.

26. The issue of the origin of the phenomenon of unspent balances, which is not analysed in this paper, is partially addressed in paragraph 42 of the report on the WFP's Cash Balances. As rightly pointed out, the phenomenon could be due to actual savings or over-budgeting. Since no definite answer could be given at that stage, the Secretariat took the commitment of investigating the issue further by conducting notably more timely reviews of budgets against actual expenditures and revisions of budgets if necessary. I strongly support this plan of action and recommend that the results of these reviews be presented to the Board.

Michèle Coudurier
Directrice
pour le Premier Président de la Cour des Comptes
de la République Française
Commissaire aux Comptes

1 October 2002