PROGRESS ON THE FINANCIAL FRAMEWORK REVIEW, INCLUDING INDIRECT SUPPORT COSTS

Informal Consultation

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World Food Programme
Rome, Italy

CONTEXT

1. WFP continues to respond to increasing requirements for food assistance for people affected by disaster and conflict in 80 countries, using a range of tools. To do so, WFP must ensure that its financial framework provides for predictable resources, flexible resource management and sound accountability for results. The framework must support tools such as food and nutrition assistance, as well as WFP-managed common services and cluster responsibilities.

2. To meet these challenges WFP enhanced its organizational capacities under Fit for Purpose, and the Resource Management Department (RM) launched a new phase of the Financial Framework Review (FFR) and reviewed the indirect support cost (ISC) rate. These are significant initiatives to ensure transparency and accountability in the management and reporting of financial resources.

3. In 2013 WFP implemented a revised project structure to reflect WFP's evolving toolkit, and in 2014 the Working Capital Financing Facility (WCFF) was restructured to triple WFP's project lending capacity.[1] Thus in 2015, WFP is positioned to address challenges and gaps, and is aligning its regulations, tools and systems to support operations and report results for donors.

4. At the Board's 2014 Second Regular Session, RM presented for approval the document "Method for Determining the Indirect Support Cost Rate for WFP",[2] which concluded that no fundamental changes to ISC policy or methods were required at the present time. The Board approved an ISC rate of 10 percent for private-sector contributions, and looked forward to the finalization of ISC review in 2015.

5. During the ISC review, it became clear that the issues being covered – in particular those related to cost drivers and how PSA fits within WFP's overall cost structures – should not be addressed in isolation. As a result it was decided to address the remaining ISC issues in the context of the financial framework review.

Challenges in WFP's Current Financial Architecture

6. WFP's current financial architecture is fragmented. Piecemeal authority to incur costs is extended to projects as contributions are forecast and received; funding at the country-office level is allocated among projects and extra-budgetary resources such as trust funds; and project funds are programmed into subdivisions such as cost components. This approach limits the flexibility of resource management for country offices because it creates multiple budget envelopes and results in complex and inefficient budget management, particularly where several projects are active in a single country. The resulting inflexibility reduces WFP's ability to manage resources effectively and often results in unspent balances in budget components.

7. Operational planning is also affected by the financial architecture. WFP's project-based approach, whereby it identifies needs and designs interventions that respond to them, is often cited as a particular strength. But although this approach supports rapid responses, implementing several projects in a single country creates fragmented funding streams and

[1] WFP/EB.A/2014/6-D/1.

[2] WFP/EB.2/2014/5-D/1.

programming. Planning is inhibited, implementation may be hampered and performance accountability and results are often sub-standard as a result.

Financial Framework for the Future

8. To address the challenges in the current financial architecture, WFP is re-examining its resource-management framework with a view to supporting operations more effectively and aligning the financial framework with the Strategic Plan. This will enable WFP to respond more effectively to challenges and to support the Zero Hunger Challenge and WFP's vision.

9. Building on the FFR components identified during the Board's 2014 Annual Session,[3] WFP prioritized the requirements and finalized the scope of the review. In 2015–2016, the FFR will aim to:

- increase the predictability of resources, so that country offices can improve operational efficiency and effectiveness;
- increase flexibility with a view to improving responses to operational needs, while maintaining discipline in financial management, reporting and analysis;
- enhance accountability by linking resource management responsibilities and outcomes; and
- simplify the resource-management framework where possible.

10. Following consultations during 2015, WFP will examine:

i) Budget authority: the timing and source of budget authority for operations;
   - currently confirmation of contributions or approval of advance financing.

ii) Budget entities: the units and levels at which a budget is managed and reported;
   - currently projects, trust funds.

iii) Budget structure: the control categories used in each budget entity;
   - currently categories such as food, cash and vouchers, landside transport, storage and handling etc.

11. To develop a financial framework that is "Fit for Purpose", WFP has prioritized the activities described in paragraphs 12–16. The modular approach will ensure that projects are designed and implemented with a view to achieving stand-alone and collective benefits.

12. Steps to increase the predictability of resources will include proposals to extend budget authority to country offices earlier and in a more aggregated way. WFP will use mechanisms such as the WCFF to pilot Upfront Budgetary Authority for prioritized operations and develop risk-mitigation methods to preserve current internal lending capacities. A new resource-based planning approach is being developed that will ensure that aggregated spending authority is provided against a realistic expectation of resource levels. This will build on the experience of the provisional prioritized plan of work first presented in the WFP Management Plan (2015–2017).

13. WFP also intends to review the possibility of a single budget entity that can support all country-level food assistance interventions. Such an approach could reduce the fragmentation of funding at the country-office level. Case studies from current and recent operations will be used, with attention to humanitarian and development trends and best

[3] WFP/EB.A/2014/6-D/1. The document was approved and the Board welcomed further discussion as outlined in Annex I.

practices. This work will be carried out in close consultation with Board members and donors.

14. Internal discussions led to the inclusion of "simplicity" as an objective of the next phase of the review. In response to proposals by senior managers and in consultation with the regional bureaux and the FFR project board, a limited number of simplification initiatives will be implemented during 2015 and 2016.

15. The FFR will also make proposals for harmonizing resource-management tools and improving the quality of data to support country operations and provide greater visibility in terms of value for money.

16. In line with the Quadrennial Comprehensive Policy Review, and to develop a financial framework that is aligned with other United Nations agencies, WFP will review the financial architecture of the United Nations Children's Fund and the Office of the United Nations High Commissioner for Refugees to determine where harmonization is feasible.

Status of the ISC review

17. The 2014–2016 Management Plan proposed a review of the ISC rate to ensure alignment with the Strategic Objectives and the Management Results Framework.

18. The first phase, presented to the Board's 2014 First Regular Session,[4] outlined the context and drivers of the review. These included: i) the Quadrennial Comprehensive Policy Review; ii) current and future resourcing environments; iii) value for money; and iv) cost and support structures. The paper highlighted four questions:

i) Given that WFP is a voluntarily funded organization with no core budget, should it consider core funding or other funding approaches to fixed and variable costs?

ii) Should WFP continue with a single ISC rate, or should the rate vary according to the type of intervention?

iii) Could WFP use variable ISC rates to encourage resource mobilization, for example through South-South cooperation or host-government contributions?

iv) Recognizing that some support and administration costs are covered from other sources, should WFP consider multiple sources for funding costs such as security and non-recurring investments?

19. A second paper presented at the 2014 Second Regular Session addressed three of these questions and reached the following conclusions:

i) The current voluntary funding model is preferable to a core funding model.

ii) The current single-rate ISC model is simple and transparent and should be maintained.

iii) Variable ISC rates linked to programme categories or activity types would not be an improvement.

iv) Variable ISC rates would probably not incentivize additional contributions through South-South cooperation or host-government contributions.

v) A single ISC rate of 10 percent should be applied to private-sector donations.

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[4] WFP/EB.1/2014/4-B/1.

20. The fourth question of the ISC review, proposed at the Board's 2014 Second Regular Session,[5] was: "As some costs related to support and administration are covered from sources other than the ISC recovery rate, WFP should undertake a detailed analysis of its indirect costs and review the PSA Equalization Account, which serves as a safety net for unplanned fluctuations in ISC recovery. Should WFP continue to consider multiple sources of funding for costs such as security and non-recurring investment?."

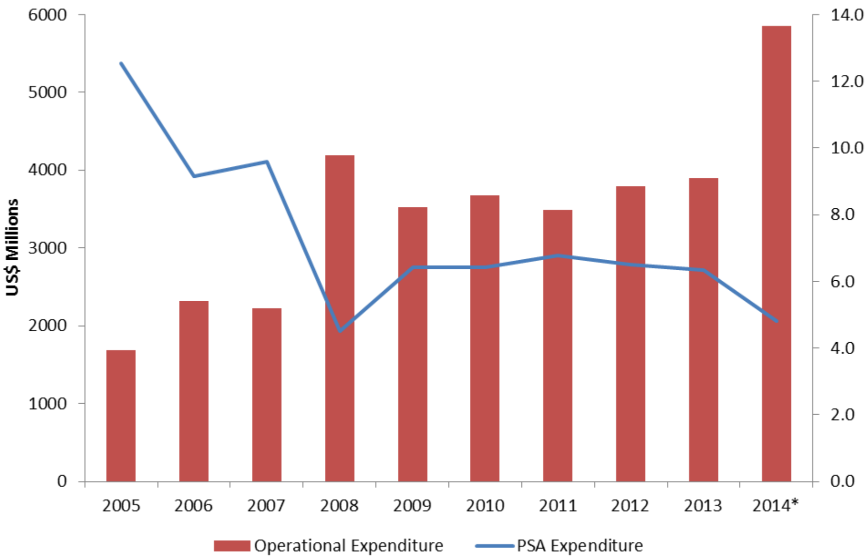
⇒ *Review of PSA and Cost Drivers*

21. The PSA budget is defined as "the portion of the WFP Budget that pertains to providing indirect support to WFP's activities".[6] It covers most of Headquarters and regional bureau costs as well as a core presence in each country. It is subdivided into three appropriation lines:

- programme support: regional bureaux and country offices;
- programme support: Headquarters; and
- management and administration.

22. The primary driver of the regular PSA budget is the level of operational implementation. WFP is not a static business, and the changes in scope and size of its operational response is the core driver of PSA expenditure. Figure 1 shows a 10-year trend of operational and PSA expenditures.

Figure 1: PSA Expenditure as a % of Operational Expenditure, 2005–2014



*2014 based on Management Plan planning figures

23. With the approval of the Strategic Plan (2008–2013), WFP began a transition from food aid to food assistance that introduced an added degree of complexity into WFP's work. The on-going transition includes a scale-up of transfer tools such as cash and vouchers, maximizing the nutritional impact of each intervention and building lasting resilience in populations. This has made WFP's work more effective but also more challenging. The

[5] WFP/EB.2/2014/5-D/1.

[6] WFP Financial Regulations, I: Definitions.

expansion of WFP's toolbox, and the growing complexity of its work, is also a driver of the PSA budget.

24. Various other PSA-like costs such as those related to the United Nations Department for Safety and Security (UNDSS), the United Nations system and WFP information technology are indirect in nature have not always been treated as part of the regular PSA budget.

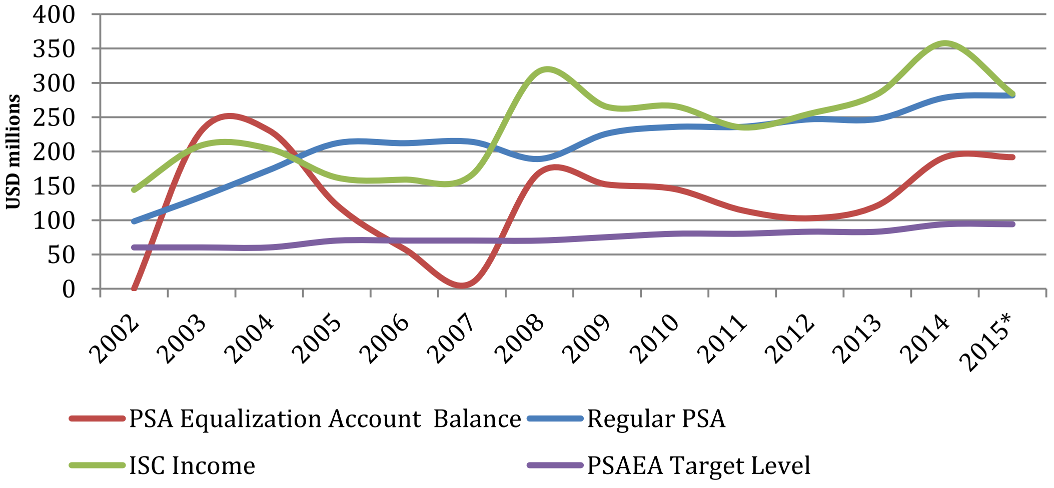
25. Until 2014 WFP has utilized the net interest income accrued to the un-earmarked portion of the General Fund that could not be charged directly to projects to fund UNDSS obligations. But falling interest rates have diminished this funding source and caused the organization significant difficulty in funding these costs. Interest income should only therefore be used for recurring expenditures as a last resort.

⇒ *PSA Equalization Account*

26. The PSA Equalization Account was established in 2002 to manage surpluses or deficits between ISC revenue and the PSA expenditures; it mitigates risk if ISC income does not materialize at the expected rate. The Board adopted a target level of four months of expenditure for the PSA Equalization Account, and has approved all uses of the account.

27. Figure 2 plots actual ISC income and PSA expenditures since 2002. Between 2005 and 2007, the regular PSA budget ran a deficit when ISC income did not materialize; WFP drew down the PSA Equalization Account to provide certainty for PSA planning and realign the management and support structure with actual income. Since 2007, WFP has built the PSA Equalization Account balance to reach and exceed the target level and, with the approval of the Board, has conservatively utilized the positive balance.

Figure 2: Regular PSA, ISC Income and PSA Equalization Account Trends 2002-2015



28. During 2007, because of the declining balance on the PSA Equalization Account, the organization prepared and presented a PSA budget for 2008–09, which involved a 21 percent reduction in real terms. The budget proposal involved i) a streamlining of the organizational structure, including the merger of two departments; ii) an overall reduction of 290 PSA funded posts and iii) a reduction in the number of regional bureaux from 7 to 6.

29. However, in 2008 WFP faced unprecedented challenges from dramatically rising food and fuel costs to turmoil in international financial systems. "Progress towards the Millennium Development Goals (MDGs) was suddenly reversed. To meet these challenges, donors

provided WFP with more resources than in any other year and WFP was able to assist a record number of beneficiaries"[7].

30. The experience of 2007 and 2008 would indicate that large-scale reductions in PSA are challenging, can have quite dramatic consequences for the organization and should be, if possible, undertaken gradually.

31. The primary purpose of the PSA Equalization Account reserve is to "give time to adjust [the] PSA cost structure if ISC income fails to materialize at the expected rate."[8] Furthermore, a stated purpose of the ISC review is to establish financial resilience. As an entirely voluntary funded organization with a core mandate to respond to emergencies, income fluctuations can quickly undermine WFP's ability to cover all indirect costs. This calls for periodic validation of the robustness of WFP's financial safety nets.

32. It would therefore be appropriate to undertake further review to optimize the current target level of the PSA Equalization account. This may result in consideration being given to changing the target level, currently four months of PSA expenditure.

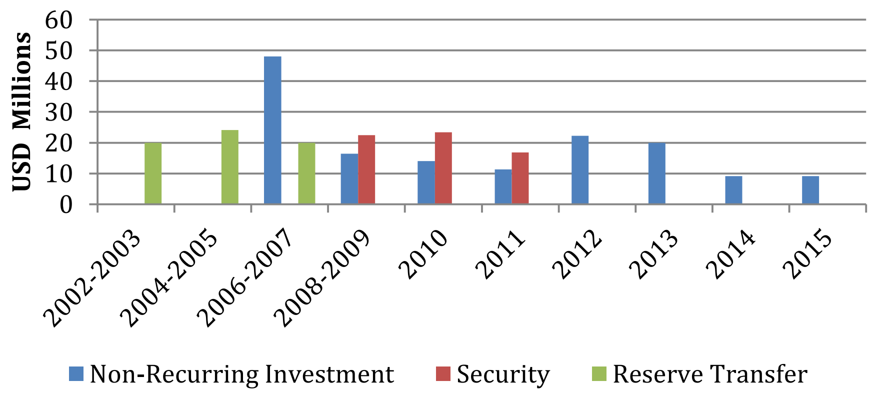
33. The PSA Equalization Account also enables WFP to implement priorities that would otherwise not be affordable in the regular PSA budget. Since 2002, the Board has approved the allocation of USD 275 million from the PSA Equalization Account for items outside of the regular PSA budget. The actual utilization of approved allocations is reported in the annual financial statements. Figure 3 breaks down the allocation into:

i) non-recurring investments – USD 150 million allocated for corporate initiatives for capital and capacity building;

ii) security – USD 60 million allocated over three years for field security upgrades and WFP's share of the UNDSS security management system; and

iii) reserve transfers – USD 60 million authorized for transfer to increase the balances of the Immediate Response Account and the direct support costs advance facility which was later merged into the Operational Reserve.

Figure 3: PSA Equalization Account Allocations, 2002-2015



[7] 2008 APR.

[8] Review of Indirect Support Cost Rate 2006.

34. Prior-year non-recurring investments include WINGS II, support for International Public Sector Accounting Standards (IPSAS) implementation, enhancement of financial management such as the Statement on Internal Control, IT modernization and Fit for Purpose. These go beyond the support and administrative activities funded in the regular PSA budget. These investments have played a critical role in WFP adapting and developing over time to better meet the needs of its beneficiaries and stakeholders. Such change would not have been possible without recourse to the PSA equalization account.

35. However, over the period, WFP used a variety of terms to describe these investments. In order to maximize transparency, and for consistency, it is proposed that the term "critical corporate initiatives" used in future.

Multiple ISC Rates

36. As outlined at the second session 2014, "variable ISC rates linked to programme categories or activity types would … not be desirable". However, the organization currently operates four different ISC regimes:

- 7 percent ISC applied to all contributions to WFP programme category activities;
- 4 percent ISC applied to certain trust funds activities;
- 10 percent ISC for private sector donations, and
- exemptions from ISC allowed under WFP General Rule XIII.4.

37. In order to bring greater clarity and consistency to the application of these rates the Secretariat will, as part of the FFR, strengthen internal guidance on their application.

⇒ *Preliminary Conclusions*

38. Based on the above, the Secretariat puts forward the following preliminary conclusions on ISC for discussion with the Membership at the March 17th consultation:

39. **Preliminary conclusion 1:** Interest income, which accrues to the un-earmarked portion of the General Fund, should be used: firstly, to strengthen the organizations reserves and management of financial risk and, secondly, to fund critical corporate initiatives where there are insufficient funds available in the PSA equalization account. It should only be used to fund recurring costs as a last resort.

40. **Preliminary conclusion 2:** Including security costs that cannot be charged to an individual project in the PSA budget, when no other funding source is available, is in line with the indirect nature of the costs.

41. **Preliminary conclusion 3:** consideration should be given to optimizing the target level of the PSA Equalization Account, on the basis of further analysis, in order to better equip the organization to deal with any sharp decline in funding.

42. **Preliminary conclusion 4 :** The PSA Equalization Account is a suitable source of funding for discrete non-recurring investments that are indirect in nature and provide the highest strategic value for WFP (critical corporate initiatives).

43. **Preliminary conclusion 5:** WFP should in future use the term "critical corporate initiatives" for such discrete non-recurring investments from the PSA Equalization Account.

Follow-on from ISC Review

44. It is recognised that PSA expenditure is a central part of WFP's cost structure and – together with all other cost components and funding streams – should be part of any review of WFP's costs. The FFR will work to introduce structures, systems and processes that will provide more regular, simplified, holistic cost information.

Consultation Approach and Governance Structure

45. WFP must determine whether it can adopt the target financial architecture to improve resource management. By reducing the fragmentation of funding and addressing challenges relating to the budget structure, WFP can position itself to continue its assistance in emergencies and develop a structure that allows for results-oriented planning over a number of years with a view to responding to food insecurity and developing sustainable food and nutrition security interventions.

46. The Board will be consulted on the development of these concepts and will receive updates on: i) the review of the changes in accountability, processes and risk management required to implement the concepts; ii) the selection of pilots for implementation; and iii) the benchmark study to quantify the efficiency gains in the pilots.

47. Proposals will be made to the Board on revised procedures for managing the associated risks of the review. At the Board's 2015 Annual Session, the Secretariat will present its response to question 4 of the ISC review and the issues examined in the FFR, and a mechanism for approval that consolidates funding of PSA and PSA-like expenditures to enhance accountability and transparency with regard to the use of corporate funds.

48. An additional update on the FFR is planned for the Board's 2015 Second Regular Session.

ACRONYMS USED IN THE DOCUMENT

FFR	Financial Framework Review
ISC	indirect support costs
IT	information technology
RM	Resource Management Department
UNDSS	United Nations Department for Safety and Security
WCFF	Working Capital Financing Facility