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Agenda item 6

For approval

REVIEW OF INDIRECT SUPPORT COSTS RATE

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NOTE TO THE EXECUTIVE BOARD

This document is submitted to the Executive Board for approval.

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 points indicated below, preferably well in advance of the Board's meeting.

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EXECUTIVE SUMMARY

When approving the Management Plan (2006–2007), the Board approved an ISC recovery rate of 7.0 percent for the biennium, but indicated its desire to review this and requested the Secretariat to provide a comparative analysis of actual 2004 and 2005 expenditures and to consider a methodology for setting the ISC rate based on actual audited expenditure.

This paper completes the preliminary analysis presented to the First Regular Session of the Board in 2006. It analyses the 2004–2005 audited financial statements together with other historical PSA expenditure and ISC income, proposes a methodology for setting the ISC rate and recommends an ISC rate for the 2006–2007 biennium.

An overview of Indirect Support Cost income and Programme Support and Administrative expenses for the past ten years highlights the discrepancies that arise between Indirect Support Cost income and Programme Support and Administrative expenditure in individual periods; it also indicates that over the ten years, Indirect Support Cost income has been only marginally less than the associated expenditure. This confirms that the current method of setting the Indirect Support Cost rate has resulted in a relatively accurate, though slightly understated, indirect support cost charge to donors. The paper also explains the role of the Programme Support and Administrative Equalization Account, which was created in 2002 to track these differences in a transparent way.

As requested by the Board, an analysis of 2004–2005 expenditure is presented, showing that indirect expenditure as a percentage of direct expenditure was 7.6 percent for the 2004–2005 biennium. However, further analysis shows that the use of historical data alone would not have resulted in a good approximation of future actual Indirect Support Cost rates. This is because the largest determinant of the difference between Indirect Support Cost income and Programme Support and Administrative expenditure is the volume of funded operations which varies significantly over time. The paper argues that this, together with the associated Indirect Support Cost income, is fundamentally uncertain and that as a consequence matching Programme Support and Administrative expenditure and Indirect Support Cost income in a single period is problematic.

Using the Programme Support and Administrative Equalization Account to equalize the difference between Programme Support and Administrative expenditure and Indirect Support Cost income ensures that Indirect Support Cost charges reflect actual Programme Support and Administrative expenditure over time. The Programme Support and Administrative equalization reserve gives WFP some certainty in planning its Programme Support and Administrative budget, and provides the necessary reserve so that WFP can adjust its Programme Support and Administrative cost structure in a planned manner if Indirect Support Cost income does not materialize at the expected rate. An appropriate target level for the Programme Support and Administrative reserve is suggested as four months of indirect expenditure, or US$66 million for 2006–2007.

In the light of this analysis, a methodology is outlined for setting the Indirect Support Cost rate for a biennium to ensure it is based on audited actual financial results. It is proposed that the Secretariat should outline the following as part of the Management Plan so that the Board can make a decision on the Indirect Support Cost rate:

- a "baseline" starting point for the Indirect Support Cost rate from the latest available audited financial statements;
- adjustments to the baseline rate for:
  - ◊ changes in the indirect cost structure for the plan period;
  - ◊ forecast contribution levels for the plan period;
- the difference between the opening balance and the target balance of the Programme Support and Administrative equalization reserve; and
- a recommendation on the Indirect Support Cost rate, based on the above.

Applying the above methodology to 2006–2007 indicates a rate slightly higher than the 7 percent approved in the Management Plan (2006–2007). However, taking into account historic trends, income and expenditure forecasts, and the difficulties in adjusting the rate in the middle of a biennium, the Secretariat recommends confirmation of 7.0 percent as the Indirect Support Cost rate for the biennium.

DRAFT DECISION*

The Board:

i) takes note of the target level of the PSA equalization account of US$66 million for the current biennium;

ii) requests the Secretariat to apply the methodology outlined in this document for establishing the ISC rate in future Management Plans; and

iii) approves an ISC recovery rate of 7.0 percent for the 2006–2007 biennium as originally proposed in the Management Plan.

* This is a draft decision. For the final decision adopted by the Board, please refer to the Decisions and Recommendations (document WFP/EB.A/2006/16) issued at the end of the session.

SECTION 1: INTRODUCTION AND PURPOSE

1. The purpose of this paper is to review the alternatives for setting the Indirect Support Cost (ISC) rate; propose an appropriate methodology for setting the rate and for managing the relationship between ISC income and Programme Support and Administrative (PSA) expenditure; and to recommend an appropriate ISC rate for the 2006–2007 biennium.

2. The ISC rate is formally approved by the Board each biennium, based on a recommendation of the Secretariat, usually as a decision of the Management Plan. In practice, however, the rate has remained relatively static and is set based on periodic reviews, such as those conducted in 1999 and 2002.

3. During the Second Regular Session of 2005, the Board asked the Secretariat to review the procedure for setting the ISC rate, including an outline of the "potential benefits and consequences of applying a fixed ISC rate or an audited ISC rate based on actual as opposed to estimated costs" (decision 2005/EB.2/9).

4. At the first session of the Board in 2006, the Secretariat presented a preliminary review paper[1], outlining two alternatives for setting the ISC rate:

   - **Alternative 1.** "Fixed" ISC rate: The Board continues to set the ISC rate based on periodic reviews such as that conducted in 2002.
   - **Alternative 2.** The Board establishes a procedure for regular revision of the ISC rate on the basis of actual audited expenditures.

5. The conclusions from the preliminary review paper were that "while the move towards an Indirect Support Cost rate based on actual costs would ensure that the rate is more reflective of actual expenditure, it would also entail the introduction of more volatility to the PSA planning process and possibly increase the risk of underfunding the Programme Support and Administrative budget when there is a decline in the level of operations."

6. This paper aims to determine an appropriate methodology for setting the ISC rate using actual audited expenditures as a baseline. It also examines the role of the PSA equalization account and proposes a target level for this account.

7. The Board's decision in the Management Plan (2006–2007) also stated that "the Board would review and reconsider the ISC rate at its annual session in 2006 based on a report of actual 2004 and 2005 expenditures". The current paper therefore also makes a recommendation on this issue.

SECTION 2: ISC AND PSA OVERVIEW

Full Cost Recovery

8. WFP applies the principle of full cost recovery to contributions. Each donor is expected to meet "the full operational and support costs of its contributions".[2] Therefore, each

[1] See "Review of ISC Rate Modalities" (WFP/EB.1/2006/6-A/1).

[2] General Regulations, Article XIII.2.

commodity contribution must be matched by an appropriate amount of associated costs[3] and all contributions must include a percentage to cover ISC. This percentage is referred to as the ISC rate, and is currently set at 7 percent. Applying the ISC rate to each donation generates ISC income.

ISC and PSA

9. This ISC income is used to fund the PSA budget, which covers the indirect costs of WFP – that is, the expenditure that cannot be linked to any single operation.

10. The PSA budget is submitted to the Board for approval in the last regular session before the start of the new biennium, as part of the Management Plan. Although adjustments are sometimes made to accommodate changing needs, PSA expenditure is relatively fixed and does not fluctuate in direct proportion to the level of operations[4].

11. The ISC rate is also approved at the start of each biennium as a component of the Management Plan and is applied uniformly, with certain exceptions[5], to each donation received during the biennium. However, even with an ISC rate fixed for a biennium, as outlined below, the actual level of operations and associated income is usually substantially different from budgeted levels and therefore actual ISC income usually differs from budgeted ISC income.

PSA Equalization Account Reserve

12. In order to account for these differences and improve the transparency of reporting on ISC income and PSA expenditure, the PSA equalization account reserve was created in 2002. The difference between PSA expenditure and associated income is transferred to this reserve at the end of each financial period.

13. All uses of the PSA equalization account reserve have to be approved by the Board and are generally limited to support costs, including capital and capacity-building costs. In addition the Board has authorized transfers from the PSA equalization account reserve to the Immediate Response Account (IRA) and the Direct Support Cost Advance Facility (DSCAF).

SECTION 3: SETTING THE ISC RATE BASED ON ACTUAL RESULTS

2004–2005 Analysis

14. The Board decision on the Management Plan (2006–2007) indicated that the Board "would review and reconsider the ISC rate at its annual session in 2006 based on a report of actual 2004 and 2005 expenditures".

[3] Associated costs include the costs of delivering food: external transport, landside transport, shipping and handling (LTSH), other direct operational costs (ODOC) and direct support costs (DSC).

[4] The 2002 review of the ISC rate established that approximately three quarters of PSA expenditures were fixed.

[5] The Executive Director can waive the application of the ISC rate to certain types of donations under General Rule XIII.4. Different ISC rates are applied to bilateral contributions and trust funds.

15. Audited ISC income and PSA expenditure for 2004–2005, together with other associated transactions, are outlined in Table 1[6].

TABLE 1: PSA SHORTFALL 2004–2005	
	2004–2005
ISC income	370.0
Total income from other sources	0.8
Total PSA income	**370.8**
PSA actual expenditure	385.1
Capital and capacity expenditure	49.0
Total indirect expenditure	**434.1**
Excess expenditure	**(63.3)**
Other adjustments	(1.2)
PSA shortfall	**(64.5)**

16. Indirect expenditure for 2004–2005 exceeded associated income by US$63.3 million, indicating that a higher ISC rate would have been required to generate sufficient income to fully cover these expenditures. This conforms with the 2004–2005 Management Plan which outlined that the capital and capacity expenditure should be funded from the PSA equalization account balance rather than the ISC income of the period.

17. Further analysis of the 2004–2005 Biennial Financial Statements, as outlined in Table 2, indicates that indirect expenditures (i.e. PSA plus the capital and capacity funds) represented 7.6 percent of actual direct costs for the 2004–2005 biennium.

[6] Source: WFP/EB.A/2006/6-A/1, Section II.

TABLE 2: ANNUAL BREAKDOWN OF 2004–2005 (US$ million)			
	Unaudited	**Unaudited**	**Audited financial statements**
	2004	**2005**	**2004–2005**
Commodities	1 565	1 227	2 792
Ocean transport and related costs	335	287	622
Landside transport, storage and handling	530	748	1 278
Other direct operational costs	140	287	427
Direct support costs	305	319	623
Total direct expenditures	**2 875**	**2 868**	**5 743**
PSA (including foreign exchange impact)	173	212	385
Capital and capacity funds	25	24	49
Total indirect	**198**	**236**	**434**
Total expenditure	**3 073**	**3 104**	**6 177**
Indirect expenditures as a percentage of direct expenditures	**6.9**	**8.2**	**7.6**

Annual Financial Statements

18. With effect from 2006 WFP plans to introduce annual audited financial statements[7]. As indicated in the last session of the Board, this means that at the time of preparing the Management Plan, the organization will have a comparatively recent set of audited financial statements[8] that could be used as the basis for setting an ISC rate based on actual audited expenditures.

19. For example, as indicated in Table 2, actual indirect expenditure for 2004 represented 6.9 percent of direct costs. Had these figures been audited, they could have been used as a basis to set the ISC rate for 2006. However, had audited financial statements for 2005 become available, they would have indicated an equivalent rate of 8.2 percent.

Annual Analysis 1996–2005

20. Using the annual breakdown of expenditure for the past ten years, it is possible to review how accurate the use of actual historical rates would have been as a basis for setting the ISC rate.

21. Annex III shows what ISC rates would have been set for the past ten years had actual results *alone* been used to set the ISC rate for the coming period. It also shows what ISC rate was actually used. These two rates are then compared to the underlying expenditure pattern for the period covered, for the following two scenarios:

[7] See "International Accounting Standards" (WFP/EB.2/2005/5-C/1).

[8] In the biennial cycle, audited financial statements are 22–23 months old at the time of setting the PSA budget; in an annual cycle they would be 10–11 months old.

- The alternative ISC rate, based on historical expenditure rates only, for a given *biennium* is set at the actual PSA expenditure as a percentage of direct costs from the last available complete year: for example the 1996 actual expenditure rate is used as the ISC rate for the 1998–1999 biennium; the 1998 actual expenditure rate is used as the ISC rate for the 2000–2001 biennium.
- The alternative ISC rate, based on historical expenditure rates only, for a given *year* is set at the actual PSA expenditure as a percentage of direct costs from the last available complete year: for example the 1996 actual expenditure rate is used as the ISC rate for 1998; the 1997 actual expenditure rate is used as the ISC rate for 1999.

22. The result shows that, for both scenarios, the rates set using periodic reviews — that is the methodology actually applied during the last ten years — *in all cases* yielded a closer approximation of the underlying expenditure pattern than rates set based on historical expenditures.

SECTION 4: IMPACT OF OPERATIONAL AND RESOURCE LEVELS

23. As outlined in the previous section, historical results do not appear to act as an ideal indicator for setting the ISC rate for a future period. This indicates that there are more significant variables at work other than historical expenditures. This section reviews what have been the main factors causing differences between ISC income and PSA expenditure over the past ten years.

24. Annex II analyses the differences between PSA expenditures and associated income for the five biennia since the introduction of the ISC concept. Table 3 outlines the relative size of the factors that created a difference between ISC income and PSA expenditure during this period.

TABLE 3: MAIN DETERMINANTS OF PSA SHORTFALLS AND SURPLUSES FROM 1996 TO 2005

	%
A. Accounting convention differences	-54.3
B. Price differences	-2.3
C. Volume differences	237.7
D. Other income differences	29.8
E. Differences due to increased PSA expenditure	-128.3
F. Differences due to ISC rate changes	-55.4
G. Additional income resulting from once-off accounting policy change	72.3
Rounding difference	0.5
Total	**100.0**

25. It can be seen from this analysis that differences between the budgeted level of activity and the actual level of activity — that is difference C, "volume differences" — were by far the biggest variable in the attempt to match ISC income and PSA expenditure. If higher than anticipated levels of operational activity had not been compensated for by increased PSA expenditure (difference E) and reductions to the ISC rate (difference F), the PSA surplus for the period would have been over twice its current size.

26. This is because the level of operations and associated funding is, by its nature, difficult to predict. At the time of the budget-setting exercise, the operational needs are forecast for over two years in advance. Given the nature of WFP's work and the increasing emergency portfolio, the volume of operations — and with it the value of direct costs and associated revenue — will almost certainly change during the biennium. This significantly impacts the ISC income level.

27. The conclusions that can be drawn for this are the following:

i) The level of (funded) operations have been the biggest single determinant in the differences between PSA expenditure and associated income.

ii) In order to match PSA expenditure to ISC income, the projected level of funded operations should therefore be taken into account in order to set the ISC rate.

SECTION 5: EQUALIZATION OF PSA EXPENDITURE AND ISC INCOME

Equalization Within a Single Period

28. From the above it is clear that the fluctuating operational level makes it difficult to exactly match PSA expenditure with ISC income for any single period where the ISC rate is set in advance. Even if an actual historic rate of PSA expenditure is used to set the ISC rate, it will, in all likelihood, not reflect the actual expenditure patterns for the period to which it is applied.

29. The only available method to equate ISC income with PSA expenditure for a given period would therefore be to adjust ISC after the financial closure of the period. For example, an ISC rate based on 2004 expenditure rates of 6.9 percent could have been set for 2006. At the end of 2006 the audited financial statements could be used to compare the ISC income generated with the actual PSA expenditures incurred during that period. This could then be followed by:

- where ISC income exceeded PSA expenditures (i.e. a PSA surplus), a refund to all donors based on the amount of ISC contributed by each donor during the year; or
- where PSA expenditures exceeded ISC income (i.e. a PSA shortfall), an extra payment by each donor to fund the deficit based on the ISC contributed during the year.

30. This methodology would have the following advantages:

i) The organization could, in theory at least, be certain that sufficient ISC income would always be generated to fund the actual PSA expenditures incurred.

ii) Donors would be charged only their share of the actual audited PSA expenditures incurred during the period covered.

31. However it also has the following drawbacks:

i) As a voluntary funded organization it would be difficult to ensure that all donors pay a share of any shortfall after the closure of a given year.

ii) Theoretically, any surplus or shortfall would have to be apportioned between every single donor to WFP. Shortfall amounts would have to be collected from all donors. This would be difficult for administrative reasons and costly to implement.

iii) Following periods of PSA surpluses all donors would receive a refund and, following periods with a PSA shortfall, they would be required to pay an additional amount for the past period. Some donors may have difficulty dealing with either case.

Equalization Over Time

32. An alternative to equalizing PSA and ISC within a single period is to equalize over a longer timeframe.

33. Table 4 outlines ISC income, PSA expenditure and the PSA surplus from the introduction of the ISC concept in 1996 to 2005. The supporting biennial breakdown, extracted from the audited financial statements, is outlined in Annex I.

TABLE 4: PSA SURPLUS 1996 THROUGH 2005

	1996–2005 cumulative
ISC income	1 305.6
Total income from other sources	22.0
Total income for PSA	**1 327.6**
PSA expenditure	1 310.2
Capital and capacity expenditure	49.0
Total indirect expenditure	**1 359.2**
Excess of expenditure	**31.6**
Adjustment from once-off change to accounting policy	88.4
Other adjustments	17.2
PSA surplus	**74.0**

34. This indicates that:

- Taken as a whole, the PSA surplus for the ten-year period arose because of the accounting policy change implemented in 2002–2003.
- Indirect expenditure over the ten-year period marginally exceeded ISC income (by US$31.6 million, or 2 percent of total expenditure).
- To give an exact match between ISC income and indirect expenditure the ISC rate should have been, on average, 0.16 percent higher; for example instead of being 7.8 percent for a given period, the rate should have been 7.96 percent.
- All of the above ISC income was fully utilized for actual PSA expenditures.
- Although significant differences between ISC income and PSA expenditure have arisen in individual periods, overall the present method of setting the ISC rate has resulted in a relatively accurate, though slightly understated, ISC charge to donors.

- The overall surplus for the ten years was US$74 million. The balance on the PSA equalization account reserve was US$122 million. This is because the equalization mechanism was established in 2002 and therefore does not reflect the shortfalls incurred between 1996 and 2001[9].

SECTION 6: MINIMIZING ORGANIZATIONAL RISK

35. The exercise of setting an ISC rate which, when applied to uncertain future income, would produce exactly the correct amount of income to fund PSA expenditure is particularly challenging.

36. PSA expenditures are relatively fixed in nature, and do not vary proportionately, at least in the short term, with the level of operations. However, the level of operations, and the associated ISC income, is highly variable. In addition the PSA expenditure level must be set in advance of the biennium, while ISC income is generated throughout the two-year period.

37. Another dimension to this is the coping mechanisms the organization has available to deal with any differences between ISC income and PSA expenditures. At present WFP has no significant other source of income to cover a shortfall should ISC income not be sufficient to cover PSA expenditure.

Mitigating Risks

38. One way to mitigate the risks associated with this is to have improved forecasting of resource availability. WFP has already taken steps to better forecast future donations in order to determine the level of funding that any individual operation is likely to have. However, over the long time period that the biennial ISC cycle encompasses, it can be difficult to accurately forecast the level of operations and all of their individual resourcing outlooks. A more realistic approach is therefore to look at the long-term aggregate level of potential funding and consider trends in income and expenditure at a macro level.

39. However, no matter how successful WFP is in improving revenue and expenditure forecasts, there will always be a risk associated with unforeseen events. Therefore, to mitigate the risk of having unfunded overhead expenditure WFP needs a funding source to draw on should a PSA shortfall occur.

40. The PSA equalization account currently plays this role. Maintaining a reserve in the PSA equalization account is the only tool that WFP has to manage the variations between the PSA expenditure and ISC income. As outlined in the preliminary review paper, the PSA equalization account reserve:

- reduces the risk of WFP having insufficient resources to cover its fixed overheads; without such a reserve, WFP would have no certain means of dealing with cases where ISC income is lower than PSA expenditure, and would in such cases have to seek additional funding from donors to fund fixed overhead expenditures that had already been incurred;
- gives WFP some certainty in planning PSA; and

[9] Annex I provides details of this.

- gives WFP time to adjust its PSA cost structure if ISC income fails to materialize at the expected rate.

41. The conclusions that can be drawn from this are:

i) As a voluntarily-funded organization, a reserve (currently the PSA equalization account reserve) is the only mechanism the organization has to manage the variations between the PSA expenditure and ISC income.

ii) Maintaining a PSA equalization account reserve:

- reduces the risk of WFP having insufficient resources to cover its fixed overheads;
- gives WFP some certainty in planning PSA; and
- gives WFP time to adjust its PSA cost structure if ISC income fails to materialize at the expected rate.

SECTION 7: AN APPROPRIATE TARGET LEVEL FOR THE PSA EQUALIZATION RESERVE

42. Determining an appropriate level of PSA equalization account reserve is important because:

i) Adjusting PSA expenditure levels too quickly as a reaction to an ISC income change would result in an unstable management and support structure.

ii) Adjusting PSA expenditure levels too slowly as a reaction to an ISC income change could result in unfunded fixed overhead costs.

43. To illustrate the first point the first three months of 2006 can be used as an example. The approved PSA level and the capital and capacity funds (in total US$393 million) would need an average ISC income of US$16.4 million per month for every month of the 2006-2007 biennium.

44. The combined ISC income for January and February 2006 was US$12 million[10], i.e. less than 40 percent of what would be required to cover the PSA expenditures for the same period.

45. If there had been no PSA equalization reserve, WFP may have had to initiate a substantial PSA budget cut, undermining the entire organizational structure. The existence of the PSA equalization reserve allowed the organization to wait out this temporary distortion. The ISC income for March was US$41 million, bringing ISC income for the first quarter of 2006 up to the required level.

46. In terms of time frame, any PSA reserve should be sufficient to cover:

- the time needed to recognize that ISC income is permanently substantially lower than expected; and
- the time needed to plan and implement a significant reduction in PSA expenditure.

47. As indicated above a minimum time frame for the first is two months, although this may not always be the case.

[10] Based on the unaudited internal monthly financial statements for February 2006.

48. The time needed to make a significant reduction in PSA expenditures is also difficult to establish, as it depends on many variables, including, for example, the length of staff contracts. However, based on past experience, a minimum time of two months would be needed to plan and implement a significant PSA reduction.

49. The following conclusions can be drawn from this:

i) It is estimated that it would be prudent to keep at least four months indirect expenditures in reserve to cover the time frame needed to recognize a permanent reduction in ISC income and to implement the associated PSA cost reductions.

ii) For 2006–2007 this would be equal to US$66 million.

SECTION 8: PROPOSED METHODOLOGY FOR SETTING THE ISC RATE

50. As mentioned in Section 1, the introduction of annual audited financial statements makes it possible to use relatively recent audited PSA expenditure as a basis for setting the ISC rate. The Secretariat recognizes that ensuring full transparency in the process of setting the ISC rate is important to donors and to the Board. Therefore, because basing the rate on a more recent audited PSA expenditure has become technically possible, WFP should take this opportunity to improve transparency and accountability in the methodology of setting the ISC rate.

51. Taking into consideration the most recent audited financial statements would help ensure that the ISC rate reflects actual audited PSA expenditures. However, as the analysis above shows, setting the rate based on this alone could increase the difference between ISC income and PSA expenditure for a given biennium and would result in a more volatile ISC rate.

52. In the light of the above analysis, the Secretariat proposes that the ISC rate continue to be set on a biennial basis as part of the Management Plan, using the following methodology:

- Step 1: The latest available audited financial statements should be analysed to determine actual PSA expenditures incurred as a percentage of the direct expenditures and this should be used as the “baseline” starting-point for setting the ISC rate.
- Step 2: The baseline rate should then be adjusted for any changes to planned indirect expenditures: while indirect expenditure remains relatively fixed over the biennium, changes in the overhead structure of the organization are usually incorporated into the Management Plan. The baseline rate should therefore be adjusted to consider the difference between the indirect cost structure in the baseline period, and the plan period.
- Step 3: The baseline rate should also be adjusted to reflect forecasted contribution levels: the level of funded operations will be a big determinant of ISC income for the plan period. Therefore the baseline rate should be adjusted to consider the difference between the actual contribution income in the baseline period and the forecasted income level of the plan period.
- Step 4: The baseline rate should be adjusted to reflect the expected opening balance in the PSA equalization reserve and the target level of the PSA equalization reserve.
- Step 5: Based on the above analysis, as part of its decisions on the Management Plan, the Board should set the ISC rate for the biennium.

53. Using this methodology the Secretariat believes that the process of setting the ISC rate will become more transparent. The Board would be able to consider the latest actual audited PSA expenditure rate and compare this to the new proposed ISC rate. At the same time, the methodology allows other key factors (changes to the PSA cost structure; forecasted income; and the PSA equalization account balance) to be considered by the Board in setting the ISC rate.

SECTION 9: AN APPROPRIATE ISC RATE FOR 2006–2007

54. Table 5 outlines the forecasts for the PSA equalization reserve as presented in the Management Plan and the latest forecasts from the Update to the Management Plan.

TABLE 5: PSA EQUALIZATION FORECAST, 2006–2007 (US$ million)

	PSA equalization forecast from the 2006–2007 Management Plan	PSA equalization forecast from Update to Management Plan
1 January 2006 opening balance	**78**	**122**
2006–2007 ISC income (based on 7 percent assumed ISC rate)	327	353
2006–2007 PSA expenditure (including carry-over)	(368)	(373)
Capital and capacity funds 2006–2007	(25)	(25)
31 December 2007	**12**	**77**

55. In the Management Plan (2006–2007), the Secretariat recommended an ISC Rate of 7 percent. Based on a funding assumption of US$5 billion (or 81 percent of approved programmes and their logical extensions) it was anticipated that this would generate ISC income of US$327 million. This would result in a shortfall between projected ISC income and planned indirect expenditure (US$393 million) of US$66 million, which would be met from one of the following three sources:

- the PSA equalization account (as outlined in Table 5 above);
- a higher-than-expected funding level for approved programmes and their extensions; or
- funding for unforeseen new emergencies.

56. In its decisions on the Management Plan 2006–2007, the Executive Board approved the 7 percent ISC rate for the biennium, but indicated that it would review and reconsider this issue at the 2006 annual session.

57. The following section proposes the establishment of an ISC rate based on the methodology outlined above.

Step 1: Establish a Baseline Rate From the Latest Available Audited Financial Statements.

58. In this case the audited financial statements for the 2004–2005 biennium can be used, as they are now available. The breakdown of expenditures is outlined in Table 2 above and indicates total indirect expenditures of US$434 million and total direct expenditures of US$5,743 million. This gives a baseline rate of 7.56 percent based on actual audited expenditures.

Step 2: Adjustment for any Changes to Planned Indirect Expenditures

59. The actual indirect expenditures incurred for 2004–2005 were US$434 million. Indirect expenditures for 2006–2007 are planned at US$393, or US$41 million lower than the last biennium. The baseline ISC rate should be adjusted downwards by 0.63 percent to reflect this.

Step 3: Adjustment for Funding Projections

60. As outlined in the Update to the Management Plan, the latest funding forecast indicates a potential resource level of US$5.4 billion, of which US$353 million would be ISC and US$5,047 million would be for direct costs. This would represent a decline in funding available for direct costs of US$696 million compared to 2004–2005. It would require an increase (of 0.94 percent) in the ISC rate to compensate.

Step 4: Adjust for Target Level of PSA Equalization Reserve

61. The actual opening balance of the PSA equalization on 1 January 2005 was US$122 million. The Secretariat has recommended that US$23.7 million of the PSA equalization account be used for various purposes outlined in the Update to the Management Plan document. This would leave a balance of US$93 million, whereas the target level, as outlined above, is US$66 million. In order to reduce the reserve to this target level, the ISC rate should be reduced by 0.53 percent.

Step 5: Recommend an ISC Rate

62. Table 6 summarizes the above steps.

TABLE 6: POTENTIAL ISC RATE FOR 2006–2007			
		US$ million	**%**
1	Indirect expenditure 2004–2005	434	
	Direct expenditure 2004–2005 (base)	5 743	
	Baseline ISC percentage		**7.56**
2	Adjustments for indirect expenditure level		
	Indirect expenditure proposal (2006–2007)	398	
	Reduction in indirect expenditure	-36	
	ISC rate reduction for lower indirect expenditures		**-0.63**
3	Adjustment for forecast level of funded operations		
	Forecasted funded direct costs	5 047	
	Direct expenditure 2004–2005 (base)	5 743	
	Potential change in base	-696	
	Expressed as percentage	-13.8%	
	Increase in ISC rate required to compensate		**0.94**
4	PSA equalization reserve		
	Opening level	122	
	minus: proposed uses	-24	
		98	
	Target level	66	
	Target reduction in PSA equalization reserve	-31	
	Reduction in ISC rate to reduce PSA equalization account		**-0.63**
5	**Resulting rate**		**7.25**

63. The above methodology suggests an ISC rate of 7.25 percent for the 2006–2007 biennium. However, the following factors should also be considered:

- The latest funding assumptions, outlined in the Update to the Management Plan, indicate an expected ISC level of US$353 million for the current biennium. While this is a slight increase over the assumptions outlined in the Management Plan, it still falls short of the expected indirect expenditure level of US$393 million. The Secretariat expects therefore that if a 7 percent ISC rate were to be maintained, all of the ISC income for the current biennium would be fully utilized for actual PSA expenditure.
- As indicated above, the ISC income generated for the first quarter of 2006 was US$53 million, while the planned PSA expenditures for the period were US$51 million. This indicates that the current 7 percent ISC rate is generating income in line with the associated expenditures.
- The methodology used to set the ISC rate over the past ten years has resulted in ISC income that is fractionally lower than PSA expenditure for the same period.

64. All of the above indicate that the current ISC rate of 7 percent is a reasonable one. It should also be noted that changing the ISC rate mid-biennium would be difficult for administrative reasons.

65. The Board is therefore requested to endorse the 7.0 percent ISC rate initially approved in the Management Plan

ANNEX I

BIENNIAL PSA SURPLUS / (SHORTFALL) ANALYSIS						
	1996–1997	**1998–1999**	**2000–2001**	**2002–2003**	**2004–2005**	**Cumulative**
ISC income	178.0	215.7	188.5	353.4	370.0	1 305.6
Total income from other sources	4.5	6.8	7.3	2.6	0.8	22.0
Total PSA income	**182.5**	**222.5**	**195.8**	**356.0**	**370.8**	**1 327.6**
PSA expenditure	226.2	230.8	235.9	232.2	385.1	1 310.2
Capital and capacity expenditure	-	-	-	-	49.0	49.0
Indirect expenditure	**226.2**	**230.8**	**235.9**	**232.2**	**434.1**	**1 359.2**
Difference between income and expenditure	**- 43.7**	**- 8.3**	**- 40.1**	**123.8**	**- 63.3**	**-31.6**
Adjustment from once-off change to accounting policy				88.4		88.4
Other adjustments				18.4	-1.2	17.2
PSA gap : surplus / (shortfall)	(43.7)	(8.3)	(40.1)	230.6	(64.5)	74.0

Reconciliation to PSA equalization account reserve

The PSA equalization account was established with effect from 1 January 2002. Prior to that date all PSA shortfalls were absorbed within the General Fund. Therefore the balance on the PSA equalization account at 31 December 2005 is composed of the following:

Surplus created in 2002–2003 (above)	230.6
Shortfall in 2004–2005 (above)	(64.5)
Transferred to Immediate Response Account in 2004	(20.0)
Transferred to Direct Support Cost Advance Facility (DSCAF) in 2004	(24.0)
Balance 31 December 2005 (audited financial statements)	122.1

Two conclusions can be drawn from this:

i) The establishment of the PSA equalization in 2002 has resulted in a higher balance on this account than if it had been established when the ISC concept was introduced in 1996.
ii) The overall PSA surplus originated in 2002–2003.

ANNEX II

Main Determinants of PSA Surplus / Shortfall

Comparing the assumptions of the original PSA budget to the actual income and expenditures for the above five biennia, we can determine the factors that led to a difference between ISC income and PSA expenditure during the period.

Using the methodology established in 2002 and outlined in the Review of ISC Rate Modalities, the relative weighting of each is as follows:

MAIN DETERMINANTS OF PSA SURPLUS / SHORTFALL (%)						
	1996–1997	**1998–1999**	**2000–2001**	**2002–2003**	**2004–2005**	**Cumulative**
A. Accounting convention difference	-3.4	91.6	-100.0	-0.6	-208.6	-54.3
B. Price difference	-73.5	-397.6	-60.3	-1.9	507.4	-2.3
C. Volume difference	-55.4	896.4	151.4	-71.7	88.9	237.7
D. PSA other income difference	10.3	81.9	13.2	-8.2	4.9	29.8
E. Difference due to increased PSA expenditure	8.7	-202.4	-104.5	9.6	-492.6	-128.3
F. Difference due to ISC rate change	13.3	-572.3	0.0	11.3	0.0	-55.4
G. Additional income resulting from accounting policy change				-38.3		72.3
Rounding difference	0.0	2.4	0.2	-0.1	0.0	0.5
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

ANNEX III

Use of Annual Historical Data

This Annex uses data from the ten individual years since the introduction of the ISC concept (1996–2005) to compare the following:

- "fixed" ISC rate: the actual rate used over the ten years from 1996 to 2005; with
- an alternative ISC rate based *solely* on actual audited expenditures.

This comparison is done using two scenarios:

- **Scenario 1:** The alternative ISC rate for a given *biennium* is set at the actual PSA expenditure as a percentage of direct costs from the last available complete year (e.g. the 1996 actual expenditure rate is used as the ISC rate for the 1998–1999 biennium; the 1998 actual expenditure rate is used as the ISC rate for the 2000–2001 biennium, etc.).
- **Scenario 2:** The alternative ISC rate for a given *year* is set at the actual PSA expenditure as a percentage of direct costs from the last available complete year (e.g. the 1996 actual expenditure rate is used as the ISC rate for 1998; the 1997 actual expenditure rate is used as the ISC rate for 1999, etc.).

Scenario 1: The alternative ISC rate is set for each biennium

On the assumption that the alternative ISC rate would have been set for each biennium, the first section of Table A outlines what rate would have been used had the most recent available year's PSA expenditure as a percentage of direct costs been used as the ISC rate for each coming biennium[1]. The table then compares the rate that would have been set to the actual result for the biennium (percentage difference column). The table also compares the actual ISC rate used with the underlying actual PSA percent for each biennium (in the *fixed ISC rate* section).

Table A		Alternative ISC rate – based on historical actual rates				Fixed ISC rate – actual ISC rates used		
Used for the biennium	Actual PSA % of the biennium	Rate based on: (input year)	Actual PSA % from input year	Absolute difference	Percentage difference	ISC rate used	Absolute difference	Percentage difference
1998–1999	8.67	1996	9.94	-1.26	14.6	8.46	0.21	2.4
2000–2001	8.05	1998	7.76	0.29	3.6	7.8	0.23	2.8
2002–2003	4.79	2000	8.53	-3.75	78.3	7.40	-2.61	54.5
2004–2005	7.42	2002	6.16	1.26	17.0	7.00	0.42	5.7

[1] For example, as indicated in the first line of the table, actual PSA expenditure for 1996 would be used as the ISC rate for the biennium 1998–1999. The second line indicates that 1998 actual results would be used to calculate the rate for 2000–2001, and so on.

Analysis of the data from Table 1 shows that the actual rate from the previous year seems to have no statistical relationship with the results for the period covered. In other words, the actual PSA expenditure as a percentage of direct costs from previous years has no value, in statistical terms, in predicting the future actual biennial rate.

Furthermore in each instance the actual ISC rate used (i.e. the fixed ISC rate) is closer to the underlying expenditure rate for the period covered. In other words, the methodology used over the past ten years has always yielded a more accurate result.

Scenario 2: The alternative ISC rate is set for each year

Table 2 performs a similar analysis, but assumes that the alternative ISC rate had been set on an annual basis.

Table B		Alternative ISC rate – based on historical actual rates				Fixed ISC rate – actual ISC rates used		
Used for the year	Actual PSA % for the year	Rate based on: (input year)	Actual result from input year	Absolute difference	% difference	ISC rate used	Absolute difference	% difference
1998	7.76	1996	9.94	2.17	28.0	8.46	-0.70	9.0
1999	9.46	1997	11.25	1.79	18.9	8.46	1.00	10.6
2000	8.53	1998	7.76	0.77	9.0	7.80	0.73	8.6
2001	7.73	1999	9.46	1.73	22.3	7.80	-0.07	0.9
2002	6.16	2000	8.53	2.38	38.6	7.80	-1.64	26.6
2003	4.12	2001	7.73	3.62	87.8	7.40	-3.28	79.6
2004	6.83	2002	6.16	0.67	9.8	7.00	-0.17	2.5

A statistical analysis of the alternative rate using this set of data confirms that the majority of the changes in the future PSA expenditure rate cannot be predicted using the historical data[2]. In addition, as was the case with Scenario 1, the actual methodology used to set the ISC rate (i.e. fixed ISC rate methodology) resulted in a more accurate rate in all cases.

Conclusions

Statistical analysis[3] of both of the above data sets therefore indicates that the historical expenditure rate is not a good predictor for the future ISC rate.

It is also clear from the above that the methodology used to set the ISC rate during the last ten years has always resulted in a more accurate rate (i.e. a rate that more accurately reflects the actual expenditure of the period covered) than would a rate set using historic percentages alone.

It is clearly shown that the fixed ISC rate methodology gives rise to a much more stable ISC rate, which helps planning both from an organizational and a donor perspective.

[2] A slightly better predictive formula obtained by comparing the year-to-year figures in Table B than that of Table A is probably due to comparably conservative PSA expenditure in the first year of each biennium which adversely impacts the accuracy of the rate in Table A.

[3] Regression analysis was performed using the "actual result from the input year" column as the explanatory variable and the "actual result of the year (biennium)" as the dependent variable.

ACRONYMS USED IN THE DOCUMENT

CFO	Division of the Chief Financial officer
CFOB	Office of Budget and Financial Planning
DSC	direct support costs
DSCAF	Direct Support Cost Advance Facility
IRA	Immediate Response Account
ISC	indirect supports costs
LTSH	landside transport, storage and handling
ODOC	other direct operational costs
PSA	Programme Support and Administrative (budget)