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**RECOVERY OF INDIRECT COSTS FOR CO-FINANCING**

Report of the Executive Director

*Summary*

This report proposes revisions to the current recovery policy for indirect costs incurred by UNFPA. Standardization of UNFPA indirect cost-recovery methodologies has been undertaken in the context of simplification and harmonization initiatives under way in the United Nations system.

The report outlines the current UNFPA cost-recovery policy and proposes to replace the existing structure of multiple rates with a single rate of 7 per cent charged to all non-core expenditures. The report also proposes confirmation of the current rate of 5 per cent for third-party procurement expenditures. Elements for a possible decision by the Executive Board are included in the final section of the present report.

For ease of reference, the annex provides definitions of relevant terms, as well as a table delineating the fixed and variable cost structure for UNFPA.

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## Introduction

1. This report proposes revisions to the current recovery policy for indirect costs incurred by UNFPA. Standardization of UNFPA indirect cost-recovery methodologies has been undertaken in the context of simplification and harmonization initiatives now under way in the United Nations system. UNFPA has closely reviewed the progress made by other United Nations organizations in this regard and has taken into account the recommendations made by the Joint Inspection Unit (JIU) in its report entitled *Support Costs Related to Extrabudgetary Activities in Organizations of the United Nations System* (JIU/REP/2002). In addition, the Advisory Committee on Administrative and Budgetary Questions (ACABQ) in its report on administrative and operational support costs reimbursed to UNFPA (DP/FPA/2000/5) advised to keep the matter of reimbursement of administrative and operational support (AOS) costs under review.
2. In preparing the proposed changes to the current structure for recovery of costs, UNFPA emphasized simplicity, uniformity, transparency in reporting and ease of understanding for potential donor countries. In that context, it is proposed that UNFPA indirect costs, presently segregated into AOS and managerial and support services (MSS) costs, be unified into a single overhead labelled as “indirect costs” (see annex for definitions).
3. The present report seeks to: (a) provide a background on the evolution of the UNFPA policy on recovery of indirect costs; (b) review the current policies for recovery of indirect costs; and (c) propose a revision of the policy on recovery of indirect costs in harmony with the JIU recommendations.

### I. BACKGROUND

4. UNFPA has addressed the issue of recovery of indirect costs with its Executive Board twice in the past, first in 1998 (see document DP/FPA/1998/11 and decision 98/22), and then again in 2000 (see document DP/FPA/2000/2 and decision 2000/6). The Fund’s report entitled *Administrative and Operational Support Costs Reimbursed to UNFPA* (DP/FPA/2000/2) introduced the term “co-financing” to replace the old terminology of “multi-bilateral funding/arrangements” and to include the resource mobilization strategy of cost sharing.
5. In the report entitled *A Review of Multi-bilateral and Trust-fund Arrangements* (DP/FPA/1998/11), it was pointed out that multi-bilateral funding (now termed co-financing) is undertaken within UNFPA as a cross-divisional process wherein the workload is shared by several units, with each unit of the Fund having a specific function to perform in order to ensure that the multi-bilateral (co-financing) arrangement progresses effectively from one stage to the next. UNFPA provides full managerial and substantive support to activities financed from co-financing resources. Co-financing arrangements entail additional managerial and administrative support from UNFPA, regardless of the executing/implementing agency, for such services as developing and maintaining agreements, recording funds, reconciling accounts, providing technical support, monitoring the substantive aspects of the projects, providing oversight and

evaluation, as well as financial and substantive reporting and overall project management. This process is time-consuming and considerable staff time both in UNFPA country offices and at headquarters is devoted to providing the managerial and substantive support needed to effectively monitor multi-bilateral projects.

6. Indirect costs incurred by UNFPA are essentially the same for all elements of co-financing, i.e., both cost sharing and trust funds. Any incremental costs contained in the biennial support budget to provide such services are, in effect, a subsidization of the costs of management and administration of co-financing and should be recovered. In order to recover the relevant costs, there is clearly a need to revise the UNFPA policy for recovery of indirect costs as well as the corresponding recovery rates. In keeping with efforts to harmonize methodologies across United Nations system agencies, UNFPA has followed an indirect cost-recovery methodology.

## II. CURRENT UNFPA POLICIES FOR RECOVERY OF INDIRECT COSTS

7. As approved by the Executive Board in decisions 2000/6 and 98/22, the current cost-recovery rates are as follows: (a) as an interim measure, a standard rate of 7.5 per cent for reimbursement of AOS costs for UNFPA execution of co-financing trust-fund activities; and (b) a rate of 5 per cent for MSS charges to be levied on all multi-bilateral activities.

8. As a result, the existing practice at UNFPA is as follows: (a) trust-fund contributions, regardless of implementing partner, are subject to a 5 per cent recovery for MSS; (b) cost-sharing contributions implemented by UNFPA are subject to a 5 per cent recovery of AOS; (c) trust-fund contributions implemented by UNFPA are subject to an AOS of 7.5 per cent; (d) government execution is subject to an AOS of 5 per cent payable to UNFPA for support; (e) when non-governmental organization (NGO) partners implement programme activities, they can cover their own indirect costs up to 12 per cent; and (f) when United Nations agencies implement programme activities, they can cover their own indirect costs up to 7.5 per cent. Clearly, this regime is complicated and UNFPA proposes to simplify the calculation for indirect costs incurred by the Fund.

9. The main objective of the approach proposed in the present report is to ensure that the methodology used is clear and transparent while meeting the key requirement of generating sufficient cost-recovery funds to ensure that no “subsidization” of co-financing contributions is taking place. What is proposed is that the existing AOS and MSS structures (outlined in the above paragraph) be replaced by one rate, determined by the analysis of the budgetary implications of the management of co-financing, which will be calculated as a percentage of all co-financed activities during a fiscal period.

10. In reviewing the recovery rates, UNFPA also reviewed the fee charged for third-party procurement activities<sup>1</sup>, currently calculated at 5 per cent of the value of goods procured. This analysis confirmed the appropriateness of the current rate, and therefore UNFPA does not propose to change this at the present time.

11. UNFPA also reviewed the rates of AOS costs applicable to NGOs and United Nations agencies, as authorized by the Executive Board in decision 2000/6. These rates determine the level of reimbursement to an implementing agency as a result of its administration of programme activities financed from UNFPA funds. These rates have been found to be appropriate and the corresponding expenditures will be included as direct costs in the related programme activities.

### III. UNITED NATIONS SYSTEM-WIDE DISCUSSIONS ON RECOVERY OF INDIRECT COSTS

12. In its report on *Support Costs Related to Extrabudgetary Activities in Organizations of the United Nations System* (JIU/REP/2002), the JIU favours the harmonization of policy principles throughout the United Nations system, although the JIU does not intend to prescribe a unified support cost rate across all United Nations system organizations. However, the approach in the determination of said rates must be consistent across these organizations. The harmonization of the approach of determining support cost rates will improve the understanding and acceptance of these rates by Member States.

13. According to the JIU report, the fundamental principles for ensuring a consistent approach to the determination of support cost rates are the following: (a) resources must be efficiently deployed; (b) policies must be straightforward, transparent and easy to implement; and (c) exceptions and special arrangements must be equitable. To achieve these, the JIU recommends that support cost rates be based on the direct benefits of the extrabudgetary activity and on how well the said rate reflects the cost of support based on the type of activity, conditionality and volume of resources.

14. Several agencies have reviewed their own indirect cost rates, utilizing either detailed cost surveys or an analysis of historical financial data. UNFPA has adopted an approach that quantifies the portion of fixed and variable indirect costs attributable to the support of co-financing activities.

### IV. FORMULATION OF THE POLICY ON RECOVERY OF INDIRECT COSTS

15. Using an indirect cost-recovery model, UNFPA has estimated the actual indirect cost to the Fund as a percentage of co-financed expenditures. As a first step, UNFPA determined the level of fixed costs in each of its divisions. Fixed costs do not increase with the volume of co-

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<sup>1</sup> The term “third-party procurement” provides greater clarity than the previously used term “reimbursable procurement”.

financing and can be generally defined as expenditures for the division director's office and for staff exclusively involved in the management and administration of regular resources. For the Division for Oversight Services (DOS) and the Office of the Executive Director (OED), all expenditures would be considered fixed since the size of those units is independent of the volume of extrabudgetary resources (see annex for details on determination of fixed costs). Variable costs are the remainder after fixed costs are deducted from total costs. They would be zero for DOS and OED. Variable costs are substantial in the Division for Management Services (DMS), the Resource Mobilization Branch and in the UNFPA country offices. Variable costs may further be broken down into costs attributable to co-financing funds, to regular resources and to procurement services, based on respective contributions. The resulting variable costs attributable to co-financing resources represent the contributions of each division to overall overhead.

16. Based on the model noted above, UNFPA has calculated the actual recovery rates required for the 2000-2001 and 2002-2003 biennia. For 2000-2001, the amount required to recover indirect costs was equal to 8.1 per cent of all co-financed expenditures while for 2002-2003 the equivalent percentage was 6.5 per cent. These percentages will vary marginally based on the actual levels of both recoverable costs and allowable expenditures for a biennial period. However, the analysis is sufficiently robust to allow for a proposal of one rate, calculated at 7.0 per cent, which, when calculated on all co-financed expenditures and based on the Fund's projections for the future, will ensure no cross-subsidization of indirect costs by core resources.

## V. RECOMMENDATION

17. **In light of the above analysis and conclusions, the Executive Board may wish to:**

- (a) Take note of the present report (DP/FPA/2005/5);**
- (b) Endorse the methodology to avoid cross-subsidization of co-financing activities;**
- (c) Decide that only one rate should be used to recover indirect costs for co-financing activities;**
- (d) Set the recovery rate to be levied on co-financing expenditures at 7 per cent;**
- (e) Confirm the current rate of 5 per cent for third-party procurement expenditures;**
- (f) Confirm the limits of indirect cost recovery by NGOs and United Nations agencies, as authorized by the Executive Board in decision 2000/6;**
- (g) Authorize the Executive Director to periodically review the indirect cost-recovery rate and to make amendments as necessary to avoid cross-subsidization.**

## ANNEX

I. Definitions of selected terms

***Administrative and operational support (AOS) costs:*** *The expenses reimbursed to an executing agency as a result of its administration of programme activities financed from UNFPA funds; AOS is now subsumed under indirect costs.*

***Co-financing:*** *A resource mobilization modality through which contributions may be received in support of specified purposes consistent with the mandate of UNFPA. These contributions may be in the form of cost sharing or trust funds and shall be considered over and above the regular resources available for programmes.*

***Cost sharing:*** *An arrangement by which the costs of projects that are normally charged to UNFPA regular resources, including the reimbursement of indirect costs paid to implementing partners/agencies, are covered in full or in part by a contribution or contributions from the recipient Government, or from one or more Governments other than the recipient Government, or from an organization or organizations of the United Nations system, or from intergovernmental institutions or agencies not part of the United Nations system, or from private sector entities and individuals.*

***Direct costs:*** *All costs traced in full to activities, projects, and programmes in fulfillment of the UNFPA mandate (e.g., cost of project personnel, equipment, project premises, travel).*

***Fixed indirect costs:*** *All costs that are incurred regardless of the scope and level of the Fund's activities, and which cannot be traced unequivocally to specific projects (e.g., top management, corporate costs, statutory bodies).*

***Managerial and support services (MSS) costs:*** *The full range of management and administrative support provided directly to develop, oversee and monitor projects financed by co-*

*financing contributions in accordance with the provisions of the funding agreement. MSS is now subsumed under indirect costs.*

**Multi-bilateral funding/arrangements:** *A term previously used for trust funds and now subsumed under co-financing.*

**Overhead:** *Another term for indirect costs or support costs.*

**Support costs:** *A term used by the Joint Inspection Unit (JIU) and UNICEF for indirect costs.*

**Third-party procurement:** *Procurement of commodities and equipment carried out by UNFPA for and on behalf of Governments, NGOs and other third parties with whom a memorandum of understanding has been concluded. Funding for such procurement may be provided by that third party or any other donor. Third-party procurement costs shall include the costs of the goods plus inspection, testing and quality assurance activities that are a direct requirement, together with costs associated with freight, insurance and customs clearance at the point of entry in the country of final destination.*

**Trust fund:** *Funds accepted by UNFPA under the terms of the UNFPA Financial Regulations to finance activities specified by the contributor, which activities must be consistent with the policies and mandate of UNFPA.*

**Variable indirect costs:** *All costs that are incurred as a function of the administration and management of projects, and which cannot be traced unequivocally to specific projects (e.g., service and administrative units, project management).*

## II. Fixed and variable cost structure for UNFPA

	<b>Fixed costs (not included for recovery of indirect costs)</b>	<b>Variable costs (used to determine recovery of indirect costs) Total support costs less fixed costs</b>
<b>Country level</b>	Aggregate staff costs for field offices related to operational costs.	Remainder distributed based on ratio of cost sharing/trust funds to regular resources.
<b>Headquarters level</b>	<i>See below by unit</i>	<i>See below by unit</i>
Office of the Executive Director (OED) and Division for Oversight Services (DOS)	All costs for these divisions are fixed.	None.
Geographical Divisions	Staff costs for posts dealing with policy, planning and overall management.	Remainder distributed based on ratio of cost sharing/trust funds to regular resources.
Information, Executive Board and Resource Mobilization Division (IERD)	(1) Staff costs for posts dealing with external relations, Executive Board, media campaigns, planning and overall management; (2) Costs of the Resource Mobilization Branch related to management of regular resources.	Remainder distributed based on ratio of cost sharing/trust funds to regular resources.
Strategic Planning Office (SPO)	Staff costs for posts dealing with policy, planning and overall management of the unit.	Remainder distributed based on ratio of cost sharing/trust funds to regular resources.
Division for Management Services (DMS)	Management Information Systems Branch, and Procurement and Facilities Management Branch almost exclusively deal with the management of regular resources. The Finance Branch staff dealing with regular resources.	Remainder distributed based on ratio of cost sharing/trust funds to regular resources.
Division for Human Resources (DHR)	Staff costs for posts dealing with policy issues.	Remainder distributed based on ratio of cost sharing/trust funds to regular resources.
Technical Support Division (TSD)	Staff costs for posts dealing with policy, planning, overall management, and inter-country projects for regular resources.	Remainder distributed based on ratio of cost sharing/trust funds to regular resources.

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