

Information Note 2

What is the feasibility of OP127 [question tabled by the representative of the United States]?

OP127

Request the CEB, including HLCM and UNDG, to develop a common definition of operating costs, including direct and indirect costs, and a common and standardized system of cost control and report to the Executive Boards of the funds and programmes by the end of 2014. In this regard, the General Assembly may wish to request the funds and programmes and encourage the specialized agencies and other entities of the United Nations system to establish such a harmonized cost classification system by 2016.

Context

With the introduction of the “delivering-as-one” (DaO) approach, UN entities engaged in a number of initiatives aiming to increase UN coherence and reduce transaction costs at the country level. In connection with the establishment of common services, a number of UN country teams in DaO and self-starter countries have engaged in attempts to calculate transaction costs to determine cost savings as a result of the reform initiative. Supported by the findings of the recent independent evaluation of DaO, countries have not been able to present considerable evidence of concrete cost savings as a result of increased coordination and the implementation of common services. Apart from existing capacity and organizational constraints, the absence of established systems that effectively control operating costs of UN entities at the country level made it extremely challenging to provide concrete information on the cost of any operational activities in programme and operations. For instance, the requirement of UN country teams to provide quantified evidence for efficiency gains through the implementation of the ‘One Office’ concept has led to the recognition that the UN system does not calculate and monitor operating and other expenses to the extent that they could serve as a baseline for monitoring progress in the reduction of transaction costs. This is supported by a UNDG analysis on transaction costs, which indicates that the lack of baselines is one of the major hindrances for calculating transaction costs.

The overall experiences from the DaO process as documented by the country-led evaluations and the independent evaluation have shown that a *system-wide development and implementation of effective cost-controlling mechanisms are important to enable the calculation and reduction of transaction costs*. The challenges involved to calculate real savings has made it difficult for the DaO countries to follow the mandate of the 2007 TCPR resolution, which states that, to the extent possible, savings resulting from reductions in transaction and overhead costs should accrue to development programmes in programme countries. The 2004 and 2007 TCPR resolutions extensively refer to the terminology of transaction costs in the framework of the UN reform process and costs incurred to UN organizations and their national partners as the result of operational activities of the UN system. While the resolutions request activities through the harmonization and simplification of business practices, alignment and coordination resulting in the reduction of transaction costs, there has been no common understanding established on what constitutes costs and how they would be defined in the context of the UN system.

With relatively little information about the direct and indirect costs and different cost controlling systems applied throughout the UN system, it has been difficult for UN country teams to provide concrete information about the potential savings and efficiency gains through the harmonization of business practices across agencies. This finding is supported by the ECOSOC resolution E/2010/52, which confirms that a significant number of countries reported achieving cost savings through shared services, but have not indicated the volumes of respective savings. In addition, current budgeting, cost

accounting and reporting systems do not foresee the preparation of consolidated reports on expenditures and transaction costs because of differences in the cost terminology, definitions and classifications. Following this, *a clear definition of the terminologies seems imperative to ensure that UN entities and UN country teams use similar methodologies to calculate and assess costs at the headquarters, regional and country level.*

The challenges of DaO and self-starter countries have revealed that there has been no common system in cost controlling, which provides concrete information about operating costs and establishing baselines that could serve as an orientation for potential savings and other efficiency gains. In the past, the business models of most UN entities did not require cost controlling in terms of distinguishing direct from fixed and variable indirect costs and obtaining updated and concrete information on the generated overhead costs in provision of services. Different from private sector entities, where the calculation of profit margins requires permanent and diligent monitoring and controlling of operating costs, most UN entities are basing their operational activities on budgets that do not require a clear distinction and separation of operating costs from other expenses.

Definitions

To gain a common understanding on the terminology used in the above recommendation, operating costs are usually defined as expenses associated with administering a business on a day-to-day basis. **Operating costs** include both fixed costs and variable costs. While fixed costs, such as overhead, remain the same regardless of the number of services provided or products produced; variable costs, such as input in materials or labour, can vary according to how much output an organization produces.

Overhead costs for a business are the costs of resources used by an organization just to maintain its existence; they include payment of rent on the office space an organization occupies and related personnel costs.

With reference to the above mentioned experiences of the DaO initiative, **cost control** describes the practice of managing and reducing business expenses, starting with identifying what the costs are and evaluating, whether the costs are reasonable and affordable. Cost control typically includes investigative procedures to detect the variance of actual costs from budgeted costs and diagnostic procedures to ascertain the causes of variances. As a result, cost control can help an organization to determine if it is spending more than it should and finding ways to reduce costs.

A number of DaO countries have engaged in **activity-based costing**, a method of allocating costs to goods and services provided. While activity-based costing allows to attribute costs to activities and products more accurately than traditional accounting methods, the identification of activities and or processes to be allocated properly is cumbersome and takes a lot of effort. This has been recognized by some of the DaO countries, which have experienced considerably increased coordination costs while engaging in process mapping throughout different UN entities at the country level. However, activity-based costing has been successful for a number of country teams, where inaccurate costing information prevented to calculate the feasibility of implementing common services. For instance, activity-based costing has successfully made the case for the establishment of common long-term agreements with local providers of goods and services. The process analysis enabled UN entities to receive concrete information about their costs of individual and case-by-case procurement in comparison to common procurement, based on the establishment of long-term agreements.

Most cost estimates are broken down into **direct and indirect costs**. Cost control of most UN entities distinguishes between these costs in connection to determining their cost recovery rates. In 2003, the High-Level Committee on Management (HLCM) adopted common definitions of cost categories and principles. According to the HLCM's definition, all organizational costs are classified into direct, fixed indirect and variable indirect costs.

Direct costs are defined as all costs incurred for, and that can be traced in full to an organization's activities, projects and programmes in fulfillment of its mandate. This include the costs of project personnel, equipment, project premises, travel and any other input necessary to achieve the results and objectives set out in programmes and projects.

Fixed indirect costs are defined as costs incurred by the organization regardless of the scope and levels of its activities, projects and programmes. These costs typically include the top management of an organization, its corporate costs and statutory bodies not related to service provision.

Variable indirect costs are defined as costs incurred by the organization as a function of and in support of its activities, projects and programmes and cannot be traced unequivocally to specific activities, projects and programmes. These costs typically include services and administrative units as well as their related system and operating costs.

UN entities' cost recovery policies

According to a recent joint review of UNDP, UNFPA and UNICEF on the impact of cost definitions and classifications of activities on harmonized cost-recovery rates, the policy of the agencies has been to fund **fixed indirect costs** solely from core resources and to fund **variable indirect costs** proportionally from core and non-core resources, based upon the relative programme volume. Beginning 2012, UNDP, UNFPA and UNICEF presented a roadmap to an integrated budget, including the development of a harmonized conceptual framework for defining and attributing organizational costs and cost recovery calculation methodology. The implementation of a **common system of cost control** is, therefore, closely related to the calculation of cost recovery rates, as common definitions determine the applicability of cost recovery for certain cost classifications. For example, the recent review proposes to replace the current cost recovery methodology, which is based in part on indirect fixed costs funded only from core resources, to an approach that would eliminate the distinction between indirect fixed costs and indirect variable costs. Therefore, this would widen the basis applicable for cost recovery through a fixed percentage rate.

Through benchmarking cost control systems of other selected international organizations, the review arrived to the conclusion *that it is possible to classify costs using a consistent methodology or framework that promotes simplicity and transparency*. It further concluded that there is no difference between indirect fixed and indirect variable costs and administrative costs can be charged as direct costs if clear criteria are met. For the establishment of appropriate cost recovery rates, the distinction and application of commonly defined direct and indirect costs remains extremely important as all indirect costs are in principle subject to the application of cost recovery. *The joint work being undertaken by UNDP, UNFPA and UNICEF on cost recovery harmonization underlines the importance of the above recommendation as the establishment of a harmonized cost control system and the application of common definitions influences the calculation of applicable cost recovery rates.*

Cost recovery charges to cover for indirect costs amounting to seven per cent and one per cent for the

Administrative Agent service function do not necessarily reflect the actual overhead costs of programme delivery at the country level. These would most likely differ from country to country due to differences in prices for locally procured goods and services, international and national staff costs, or necessary security measures, depending on the individual country situation. The seven per cent lump sum represents a surcharge, which supports administrative costs at the country, regional and headquarters level of respective agencies. However, it does not reflect the actual operating costs incurred through programme delivery at the country level.

It is safe to assume that overhead costs are not covered through the uniform seven percent cost recovery charge on contributions. While this would indicate that the UN system at the headquarter, regional and country level has concrete information about its direct and indirect costs and the ability to calculate and monitor its transaction costs, a recent UNDESA study estimated actual indirect costs in the order of fifteen percent. The analysis was based on data on management and programme support costs provided by 23 entities accounting for 87 percent of total UN development-related expenditures in 2010. A uniform seven percent charge on administrative costs would not reflect the actual costs of operational support services and other overhead for the UN system; therefore it does not constitute the actual amount available for administrative and indirect costs. For instance, operational support services are covered from both administrative and programme related budgets.