DP/OPS/2023/CRP.5

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United Nations Office for Project Services

United Nations Office for Project Services cost recovery model and net assets

I. Executive summary

1. In its decision 2023/4, the Executive Board requested UNOPS to provide an informal briefing before the annual session 2023 on adjustments made to the UNOPS cost recovery model. The present paper complements that briefing, noting the UNOPS commitment to zero net revenue and that its approach to cost recovery has been aligned with applicable United Nations standards, in particular the Harmonized Approach to Cost Recovery endorsed by the Finance and Budget Network of the High-Level Committee on Management of the Chief Executives Board in 2022.

2. The Board further noted that it will decide at its annual session 2023 on the distribution to paying entities of excess reserves accumulated after 31 December 2021.[1] The present paper provides an overview of the key components that comprise and contribute to UNOPS net assets, including to UNOPS reserves and any excess thereof, as well as recent developments related to the overall net assets.[2]

3. UNOPS is guided by the Board and its decisions related to UNOPS reserves, including 2021/21, 2022/5, 2022/13, 2022/21, 2022/24, and 2023/4. UNOPS is committed to distributing to paying entities any excess reserves on a regular basis, including as a matter of priority excess reserves accumulated as of 31 December 2021.

4. Based on the present document, the Board may wish to take two proposals into consideration when deciding at the annual session 2023 on the treatment of excess reserves accumulated after 31 December 2021. The Board may wish to:

(a) Decide that UNOPS will present to the Board, at the end of the **four-year strategic plan period**, the status of UNOPS excess reserve for decision on its refund. Within the strategic plan period, UNOPS would aim to minimize any excess or deficit reserve. The status of excess or deficit reserves would be reported annually to the Board; and

(b) Take note of **funds committed under the S3i[3] reserve**, with a view to abolishing that reserve at the second regular session 2023 pending confirmation by the United Nations Board of Auditors that the total value of S3i-related investments amount to zero following

[1] See also item 15 of the provisional agenda, annotations, list of document and workplan (DP/2023/L.2).
[2] The Executive Board was briefed on UNOPS net assets in advance of the annual session 2020 (DP/OPS/2020/CRP.1).
[3] Sustainable Investments in Infrastructure and Innovation

full provisions and impairment of previously held balances.[4] Upon abolishment of the S3i reserve, previously committed funds would be released into the operational reserve,[5] while noting the need to first meet any mandatory requirements related to UNOPS net assets.

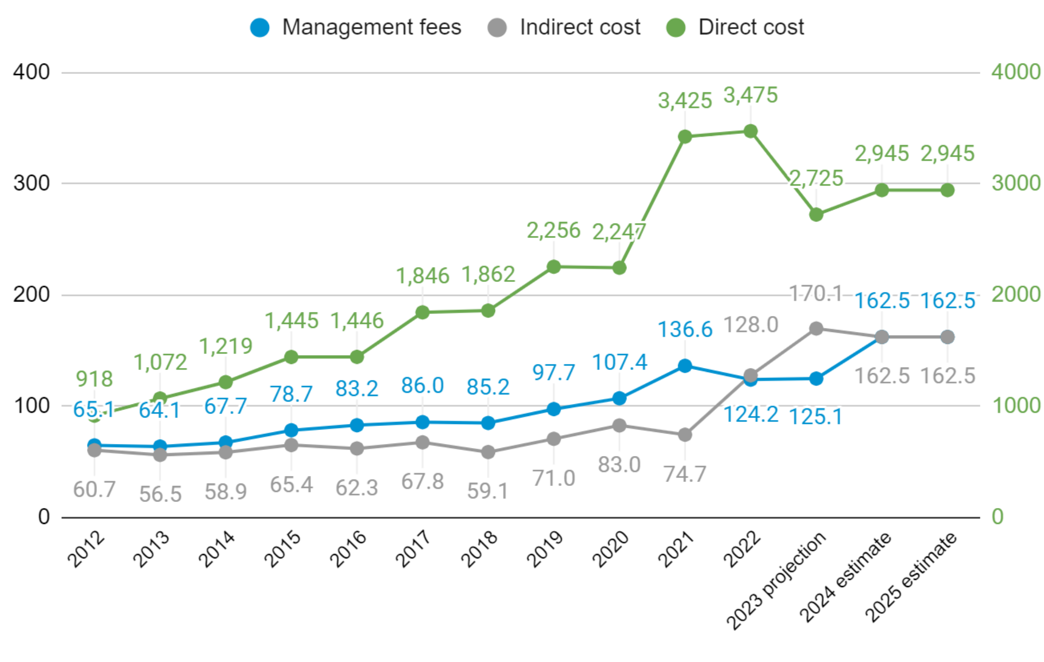
5. The Board should take into account that the submission by UNOPS of the budget estimates, 2024-2025, for consideration at its second regular session 2023, will outline an integrated approach to UNOPS cost recovery and reserve management, including linking management fee-setting to planned indirect costs and the total estimated direct cost for the period, while avoiding the accumulation of excess reserves.

II. Operating model and indirect cost recovery

UNOPS demand-driven operating model and its financial implications

6. As an organization that is fully funded through 'fees for services', UNOPS needs to recover all of its indirect costs through the management fee it collects from project implementation – that is, the percentage fee it charges on direct cost. It has no assessed contributions and receives voluntary contributions only on an exceptional basis. UNOPS funding thus relies in full on the continuing demand for its services and the incurred direct costs.

Figure 1. UNOPS management fees, indirect cost and direct cost ($ millions)[6]



Source: UNOPS financial reports and audited financial statements, 2012-2021; preliminary results, 2022; indirect cost, 2023, includes the comprehensive response plan envelope.

[4] UNOPS notes that decision 2022/13 outlines temporary measures related to UNOPS reserves, hence the need to formalize the abolishment of the S3i reserve at the second regular session.

[5] Pursuant to decision 2022/13

[6] 'Management fees' reflect "total revenue for the period" and 'Indirect cost' reflects "total use of resources" as per Statement V, and 'Direct cost' reflects "Total project expenses" as per financial reports (see UNOPS financial report and audited financial statements).

7. The relation of project expenses as an indicator of the ability of UNOPS to generate management fee is visualized in figure 1, above. It shows that in the past years UNOPS increased its direct cost and thus also the generated management fee, although without commensurate increases in indirect cost. Over time this contributed to the accumulation of reserve. Figure 1 also illustrates the underfunding of the organization in comparison to the increased direct cost of delivering services, as documented by the KPMG consultancy firm in their third-party reviews.

8. UNOPS has implemented measures to ensure that disparity between the collected management fee and the incurred indirect cost will not reoccur. First, many of the measures recommended in the KPMG reviews, as well as by the United Nations Board of Auditors, require UNOPS to invest in key functions. While this increases UNOPS indirect cost overall, it ensures adequate controls and oversight in relation to the level of project expenses.

9. Another measure relates to the approach UNOPS takes to setting management fees for its services. In August 2022, UNOPS released a policy update to stop the charging of any risk increment to new agreements. In addition, UNOPS updated the management fee calculation methodology to reflect the latest financials, namely, the overall project expenses and indirect cost for 2021 and 2022. This significantly reduced the average management fee collected from new agreements. Finally, UNOPS is changing its management fee-setting process to align it with its forward-looking biennial budget, rather than based on past figures. This will be implemented for the first time in the UNOPS budget estimates, 2024-2025, including a proposal to the Board on the appropriate management fee-setting connected to estimated direct and indirect UNOPS costs for the biennium.

10. For 2022 the ratio of indirect cost over project expenses is at 3.7 per cent. That ratio will rise to an average level of 5.5 per cent for 2024-2025, a result of the increase in indirect cost outlined in paragraph 8, above. Further, based on the UNOPS cost recovery approach, one dollar of project expenses (direct cost) will not always require the same indirect cost. UNOPS will continue to set its management fee based on the nature of the project.

UNOPS approach to cost recovery

11. In its approach to cost recovery UNOPS relies on activity-based costing principles. Considered industry best practice, those principles ensure fair attribution of UNOPS indirect cost to its partners. UNOPS fulfils the requirements expressed in the quadrennial comprehensive policy review and aligns with the Harmonized Approach to Cost Recovery endorsed by the Finance and Budget Network of the High Level Committee on Management of the Chief Executives Board in 2022.[7] In January 2023, UNOPS engaged with key United Nations controllers on its approach to cost recovery, receiving positive feedback on its methodology.

12. The basic principles driving UNOPS management fee-setting are the size, complexity and risk associated with a given project. Based on the project specifications to be delivered on behalf of a partner, UNOPS considers those three factors in an algorithm that calculates the management fee to be charged. The starting point in establishing the calculation methodology is the average cost recovery rate – that is, the overall management fee needed to cover the indirect cost of the period. Based on that need, UNOPS applies a sliding scale to ensure that larger projects incur a lower fee. That is a core UNOPS principle, as it avoids cross-subsidization from partners funding large projects to partners signing on for smaller activities. At the same time, UNOPS ensures that more complex projects will in turn have a higher management fee. As indicated in paragraph 9, above, risk is currently not an active element in management fee-setting.

[7] Session report of the Finance and Budget Network Meeting, May 2022, item VIII

III. UNOPS net assets

Composition of UNOPS net assets

13. UNOPS net assets represent the balance between its assets and liabilities, reflecting its ‘residual financial position’ at the end of the financial period. Positive net assets indicate that, at the time of reporting, UNOPS had sufficient assets to cover its liabilities. The net assets comprise two parts: (a) UNOPS reserves; and (b) changes reported in accordance with the International Public Sector Accounting Standards.

14. Pursuant to decision 2022/13, in 2022 UNOPS transferred into the operational reserve any balance not committed to projects from the growth and innovation reserve, accumulated surpluses, and the S3i reserve. Further to that consolidation, the UNOPS reserve contains the following elements:

(a) *Operational reserve.* In its decision 2021/21, the Board established a new minimum operational reserve to guarantee the financial viability and integrity of UNOPS as a going concern. The level of the reserve is determined by a formula that reflects UNOPS financial exposure, based mainly on the size of its various service lines.

(b) *Committed S3i funds*. In its decision 2022/5, the Board approved the establishment of an S3i reserve at the level of $105 million. In line with decision 2022/13, UNOPS presently maintains that reserve at $63 million, which corresponds to the amount of funds committed through S3i investments.[8]

(c) *Operational reserve above minimum.* Any amounts over and above those two elements are considered excess reserves. The proposal is to refund them at the end of the strategic plan period.

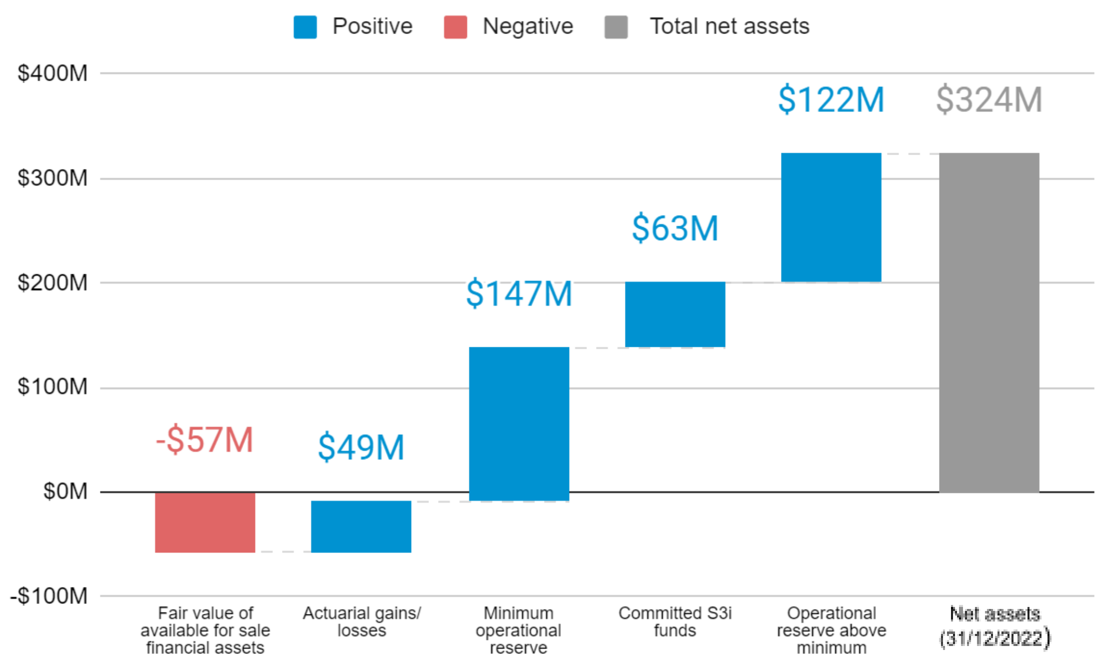
15. The other part of UNOPS net assets consists of requirements connected with the International Public Sector Accounting Standards: *actuarial gains/losses* related to post-employment benefits, and *fair value of available-for-sale financial assets* related to financial investments.

16. In its financial statements, UNOPS has reported the accumulated changes in those two elements since the introduction of the Standards in 2012. Any increases or decreases in the requirements will, *ceteris paribus*, impact the overall value of UNOPS net assets. In practical terms, this means that net negative changes to the International Public Sector Accounting Standards will reduce the operational reserve.

17. The above elements comprise UNOPS net assets, as illustrated in figure 2, based on the preliminary financial statements for 2022.

[8] See paragraph 4(b) on the need to formally abolish the S3i reserve

Figure 2: UNOPS net assets as at 31 December 2022 (preliminary)



Note: Recognizing decision 2022/13 on the operational reserve, the 'minimum level of operational reserve' and 'operational reserve above minimum' are shown separately, for illustrative purposes.

S3i reserve

18. In 2019 UNOPS established a growth and innovation reserve. The reserve provided funding for, *inter alia*, activities under the S3i initiative. The value of the reserve was set at 50 per cent of the excess operational reserves. At the end of 2021, UNOPS had allocated $63 million to S3i projects.

19. In its decision 2022/5, the Board established the S3i reserve at the level of $105 million. Further to its decision 2022/13, any uncommitted funds from that reserve were transferred into the operational reserve. As a result, UNOPS presently maintains a balance of $63 million in the S3i reserve, reflecting the value of the funds already committed as part of S3i projects.[9]

20. **Proposal:** The Executive Board may wish to take note of funds committed under the S3i reserve, with a view to abolishing the reserve at its second regular session 2023, pending confirmation by the United Nations Board of Auditors that the total value of S3i related investments held in UNOPS books amount to zero following full provision and impairment of previously held balances. Previously committed funds should be released into the operational reserve, noting the need to first meet any mandatory requirements related to UNOPS net assets.

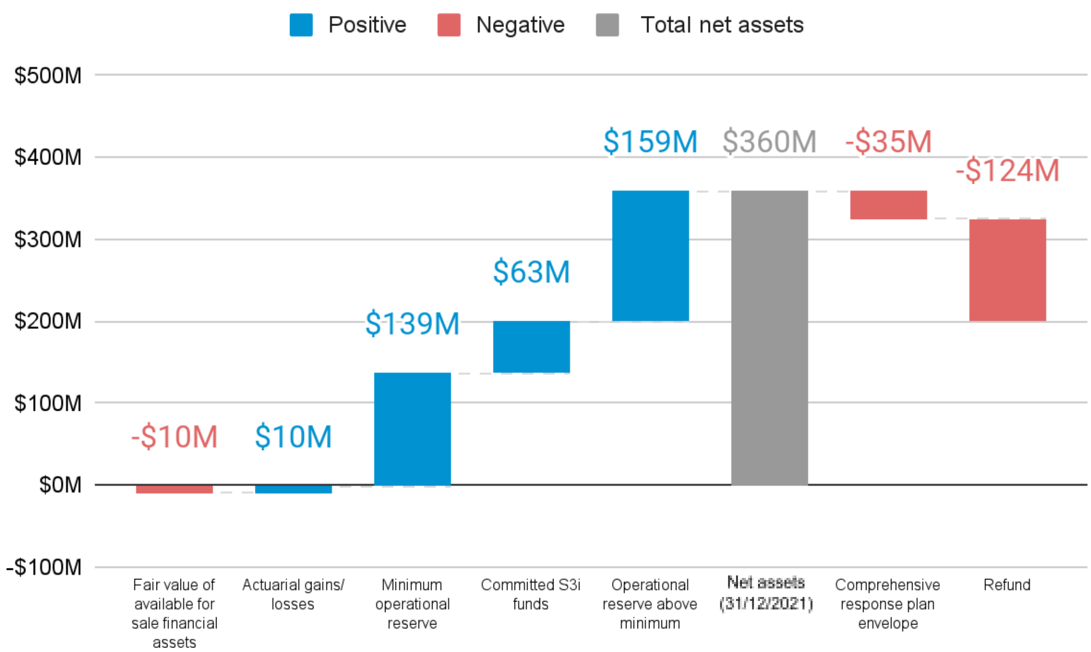
[9] Decisions 2022/5 and 2022/13

Explanation of refund to paying entities

21. In its decision 2023/4, the Board defined that excess reserves are the "total accumulated reserves minus the minimum operational reserve", as established in decision 2021/21. The Board requested UNOPS to distribute excess reserves accumulated as of 31 December 2021 – minus $35.4 million – to each paying entity.

22. In accordance with those instructions, and reflecting decisions 2022/5 and 2022/13, UNOPS calculated that based on the financial statements as at 31 December 2021 its excess reserve amounted to $123.8 million (see figure 3, below).

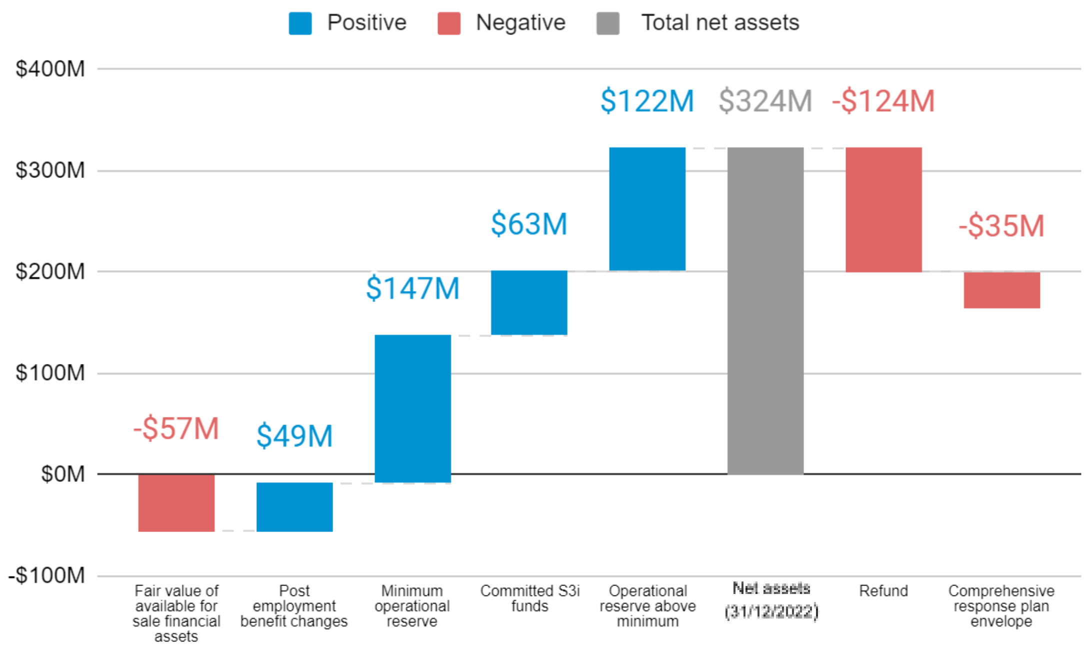
Figure 3. Calculation of excess reserves to be refunded to paying entities



Note: Recognizing decision 2022/13 on the operational reserve, the 'minimum level of operational reserve' and 'operational reserve above minimum' are shown separately, for illustrative purposes.

23. Combining the preliminary view of UNOPS net assets at 31 December 2022 with the calculation of excess reserves based on the financial statements, 2021, the likely effect of the refund on UNOPS net assets – particularly the operational reserve – is demonstrated. The $124 million refund slightly exceeds the level of the operational reserve above the minimum level. This level is further exceeded when including the envelope for the comprehensive response plan (see figure 4).

Figure 4: Modeling implementation of decision 2023/4, based on UNOPS net assets as at 31 December 2022 (preliminary)



24. UNOPS commenced the first refund of excess reserves to a paying entity in April 2023. Lessons learned from the exercise could inform decisions on future refund processes:

(a) While the partners that UNOPS engaged so far have been very supportive, for most this is an exceptional process, taking additional time and resources for partners to administer.

(b) A number of partners have engaged in a detailed reconciliation process with UNOPS to verify and compare records.

(c) The administrative burden brings challenges to the relationship with partners.

(d) Commingled funds are a challenge for both UNOPS and partners.

(e) Refunds to government partners cannot always be channelled back into the development system as budgets on the partner-end expired and have to be returned to different authorities.

IV. Operational reserve excess management process

Considerations for excess reserves accumulated after 31 December 2021

25. Given the volatility of the UNOPS demand-driven operational model, meeting zero net revenue on an annual basis is a challenge. Combined with fluctuations in net finance income/(expense) that may increase or reduce net assets in a given year, an annual approach to distributing any excess reserves would lead to UNOPS updating its cost recovery model on a suboptimal basis. Fees might be increased one year, only to be reduced the following year (and vice versa) due to changes in partner demand, leading to reduced predictability for partners and increased transaction costs for UNOPS.

26. UNOPS has reviewed the approach taken by other United Nations entities with respect to their funding cycles. Other funds and programmes reporting to the Executive Board have aligned their funding cycles with their strategic planning period and now present integrated budget proposals with the same duration. While UNOPS, given the uncertainties of its financial flows, would recommend maintaining the biennial budgeting cycle, it would be beneficial to align the excess reserve refund process with its strategic planning period.

27. In the following proposal, UNOPS would carry forward any excess reserve balances between years within a strategic planning period. Excess reserves should be avoided or reduced through two measures:

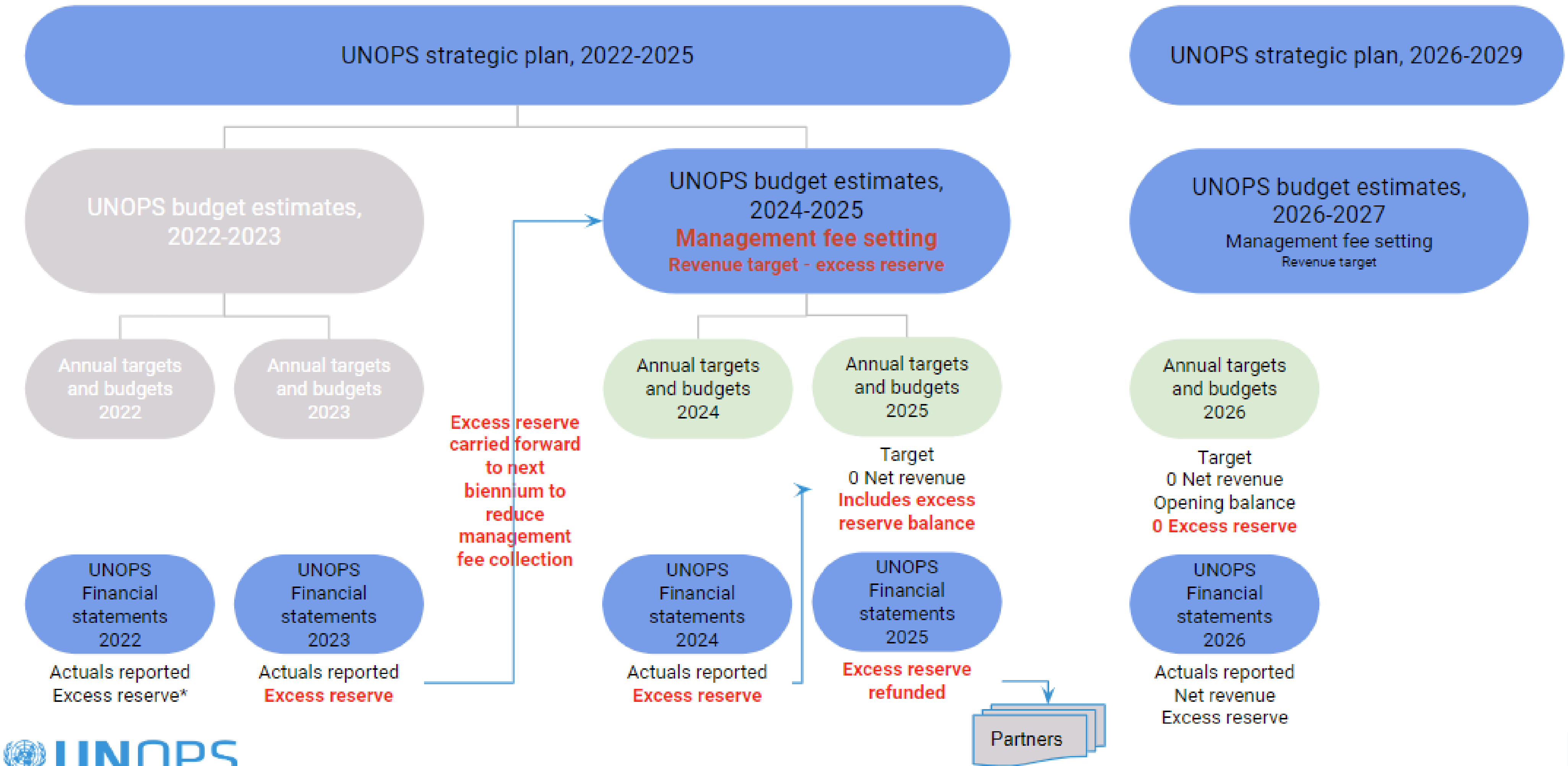
(a) *Reduction of management fee*, as any excess reserve balance at the end of the first biennium within the strategic plan period would be used to reduce the revenue need for the next biennium. This would lower the fee for new engagements and ensure that additional funds are available for project implementation.

(b) *Resourcing organizational capacity*, whereby balances would be carried forward between annual budget-cycles to ensure that UNOPS can evolve its institutional 'backbone' in line with the need to develop and manage its global portfolio of projects based on partner requirements and available technology.

28. **Proposal** (illustrated in annex I): To adhere to the principle of not accumulating excess reserve, allowing implemented changes to its cost recovery approach to take effect, and accommodating fluctuations in net finance income/expenses, UNOPS proposes that distribution of excess reserves should be viewed in the context of the strategic plan period, and that any decision on refunding should be taken by the Executive Board following the conclusion of the relevant strategic plan period.

29. In the present document, UNOPS has outlined key points for consideration by the Executive Board when deciding at its annual session 2023 on the treatment of excess reserves accumulated after 31 December 2021. With UNOPS committed to distributing to paying entities any excess reserves on a regular basis, these include viewing the excess reserve in the context of the strategic plan period, and taking note of funds committed under the S3i reserve, with a view to abolishing that reserve at the second regular session 2023.

Annex I. Proposed excess management process



*In 2022 this will be presented as "other operational reserves" as part of UNOPS net assets