UNITED NATIONS DEVELOPMENT PROGRAMME
Office of Audit and Investigations

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AUDIT

OF

UNDP COST RECOVERY PRACTICES

Report No. 1452

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Report on the Audit of UNDP Cost Recovery Practices
Executive Summary

The UNDP Office of Audit and Investigations (OAI) conducted an audit of UNDP Cost Recovery Practices from 27 April to 15 May 2015. The audit aimed to assess the adequacy and effectiveness of the governance, risk management and control processes relating to the following areas and sub-areas:

(a) Adherence of UNDP cost recovery mechanisms to the relevant Executive Board decisions and Quadrennial Comprehensive Policy Review directives, including criteria of full cost recovery and proportional cost recovery from core and non-core funds.

(b) Implementation, monitoring, and oversight of the UNDP cost recovery policies by Country Offices and Headquarters units. This included an assessment of the adequacy of the systems employed for the management of cost recovery as well as a review of the client-oriented dimension of the services provided.

The audit covered the following cost recovery income items: General Management Support, Direct Project Costs, and Agency Services. Not included in the audit were other cost recovery income items related to common shared services (i.e., local premises, security, communication, and dispensary) which are incurred in the field and thus fall outside the scope of this audit. The audit also did not cover the internal cost recovery process among UNDP business units, such as Management Consulting Team services, as well as information technology, and procurement services. These services do not generate an income but are rather a transfer of resources from one UNDP unit to another. The audit covered the period from 1 January to 31 December 2014. This was the first audit of UNDP Cost Recovery Practices.

The audit was conducted in conformance with the *International Standards for the Professional Practice of Internal Auditing*.

Overall audit rating

OAI assessed UNDP Cost Recovery Practices as **partially satisfactory**, which means, "Internal controls, governance and risk management processes were generally established and functioning, but needed improvement. One or several issues were identified that may negatively affect the achievement of the objectives of the audited entity." This rating was mainly due to weaknesses in the implementation of the new Direct Project Costs methodology as well as insufficient justification for the new General Management Support allocation key.

Key recommendations: Total = **5**, high priority = **2**

The five recommendations aim to ensure the following: (a) achievement of the organization's strategic objectives (Recommendation 1); (b) compliance with legislative mandates, regulations and rules, policies and procedures (Recommendations 2, 3 and 5), and (c) effectiveness and efficiency of operations (Recommendation 4).

For high (critical) priority recommendations, prompt action is required to ensure that UNDP is not exposed to high risks. Failure to take action could result in major negative consequences for UNDP. All high (critical) priority recommendations are presented below:

Lack of analytical basis for General Management Support allocation key to cover management costs (Issue 1)	In 2015, UNDP redefined General Management Support as part of its new cost recovery policy and developed a new distribution key. Based on the new definition, General Management Support is supposed to cover costs incurred in providing general management and oversight functions of the organization as a whole. The audit results showed that the internal, unit-level distribution key for General Management Support was not based on a detailed analysis of the management costs by organizational unit. There was no direct link between the income generated through General Management Support and the management costs incurred at the organizational unit level. Further, with the new allocation, the highest share of this income would go to the unit that would implement the project rather than mobilize resources, i.e., mainly Country Offices. Recommendation: The Bureau of Management should (a) revisit the allocation/distribution key for General Management Support and base it on an analysis of current and planned management costs; and (b) consider merging, in one account at the corporate level, management cost collection and distribution.
Weaknesses in the implementation of the new Direct Project Costs methodology (Issue 2)	The implementation of the Direct Project Costs methodology was inconsistent among Country Offices and regions at the time of the audit fieldwork. Further, the necessary implementation tools had not been introduced. Recommendation: The Bureau of Management and Regional Bureaux should review the implementation of the Direct Project Costs methodology with the goal to address the identified inconsistencies among UNDP offices and enhance the implementation of the methodology.

Management comments and action plan

The Deputy Director and Chief Finance Officer of the Bureau of Management accepted all of the recommendations and is in the process of implementing them. Comments and/or additional information provided had been incorporated in the report, where appropriate.

Issues with less significance (not included in this report) have been discussed directly with management and actions have been initiated to address them.

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I. About UNDP Cost Recovery Practices

Cost recovery income is one of the most important sources of funds for UNDP and it is used to finance a significant share of UNDP's management and other expenditures. According to the integrated budget estimates for 2014-2017, cost recovery income for the period would amount to $1.36 billion (approximately $340 million per year), representing 5.6 percent of total UNDP projected resources.

Cost recovery income comes from the following: (a) General Management Support, (b) Direct Project Costs, (c) Agency Services, and (d) other cost recovery items.

(a) General Management Support accounts for 75 percent of the $1.36 billion expected cost recovery income. This encompasses costs incurred in providing general management and oversight functions of UNDP as a whole, basically to support the organization's activities, projects and programmes, and cannot be traced to specific activities, projects or programmes.

UNDP cost recovery policies for General Management Support have been updated in recent years. In 2013, the UNDP Executive Board adopted a new standard cost recovery rate of 8 percent for most third party cost sharing agreements. This rate is harmonized across UNDP, UNFPA, UNICEF and UN Women.

(b) Direct Project Costs are organizational costs incurred in the implementation of a development activity or service that can be directly traced and attributed to that development activity (projects and programmes) or service. Direct Project Costs are charged directly to projects, based on actual costs or on the Universal Price List.

(c) Agency Services are services that UNDP renders for other United Nations agencies and are provided by either a Country Office or Headquarters. On the local level, these can be administrative, financial, human resources, procurement or other services, the charges for which are mostly based on the Universal or on a Local Price List. On a Headquarters level, these services are mostly related to human resources, information technology, financial and travel services. UNFPA, UNOPS, UNDSS and UN Women are the main clients of these services.

(d) Other cost recovery items relate to common shared services, as incurred in a United Nations coordination environment, the Multi-Partner Trust Fund Office, the Management Consulting Team as well as any UNDP internal cost recovery items (e.g., information technology services, procurement services). These were not included in the scope of this audit.

Government contributions to local office costs are not counted as cost recovery income for budgetary purposes, but are recorded as part of regular resources. These contributions are not covered by this audit.

II. Audit results

OAI made two recommendations ranked high (critical) and three recommendations ranked medium (important) priority.

Low priority issues/recommendations were discussed directly and agreed with the Office and are not included in this report.

High priority recommendations, arranged according to significance:

(a) The Bureau of Management should revisit the allocation/distribution key for General Management Support and consider consolidating, at the corporate level, management cost collection and distribution (Recommendation 1).

(b) The Bureau of Management and Regional Bureaux should review the implementation of Direct Project Costs with the goal to address the identified inconsistencies among UNDP offices (Recommendation 2).

Medium priority recommendations, arranged according to significance:

(a) The Executive Office and Bureau of Management should review the time requirements for the issuance of new policies in UNDP (Recommendation 3).

(b) The Bureau of Management should review all existing Memoranda of Understanding and define a timeline for such a review (Recommendation 4).

(c) The Office of Financial Resources Management and Regional Bureaux should review uncleared invoices and recover any outstanding amounts, and the Bureau of Management should assess the feasibility of reviewing the billing business processes and related system functionality (Recommendation 5).

A. Adherence to Executive Board and Quadrennial Comprehensive Policy Review directives

Issue 1 Lack of analytical basis for General Management Support allocation to cover management costs

Funding for Country Offices, Regional Centres, and Headquarters organizational activities is available from the following: (a) integrated budget (regular resources); (b) cost recovery income earned through charging of the General Management Support fee on other resources or extrabudgetary resources; (c) income generated from the provision of support services to United Nations agencies; and (d) Direct Project Costs that directly contribute to the achievement of development results of projects and programmes. The cost recovery income generated from the General Management Support fee is then distributed among the different units providing General Management Support, based on an allocation key. For a fair and transparent process, this allocation key must be based on a clearly defined costing methodology.

In 2015, UNDP redefined General Management Support as part of its new cost recovery policy and developed a new General Management Support distribution key.[1] Based on the new definition, General Management Support is supposed to cover costs incurred in providing general management and oversight functions of the organization as a whole (referred to in this audit report as "management costs").

The audit results showed that the internal, unit-level distribution key for General Management Support was not based on a detailed analysis of the management costs by organizational unit. There was no direct link between the income generated through General Management Support and the management costs incurred at the organizational unit level. Further, with the new allocation, the highest share of General Management Support would go to the unit that would implement the project rather than mobilize resources, i.e., mainly Country Offices.

[1] New General Management Support distribution key: Country Offices (72.5%); Regional Bureaux (8.1%); Central (18.5%); Bureau for Policy and Programme Support (0.9%)

The lack of detailed analysis of management costs may lead to an inaccurate allocation key for the General Management Support income. This in turn may result in lower financial incentives regarding mobilizing non-core resources, and/or disincentives regarding implementing the new Direct Project Costs methodology, since some units (particularly Country Offices) continue benefiting from a higher percentage of General Management Support income (refer to Issue 2).

Priority	High (Critical)

Recommendation 1:

The Bureau of Management should

(a) revisit the allocation/distribution key for General Management Support and base it on an analysis of current and planned management costs; and
(b) consider merging, in one account at the corporate level, management cost collection and distribution.

Management action plan:

The Bureau of Management will revisit the current distribution key for General Management Support to seek to align it with management costs and the accountability framework.

Estimated completion date: July 2016

B. Implementation, monitoring, and oversight of cost recovery policies

Issue 2 Weaknesses in the implementation of the new Direct Project Costs methodology

The roll-out of any new policy or methodology requires management support in order to ensure that the objectives of the roll-out are achieved.

UNDP had first issued draft policies on Direct Project Costs and other cost recovery items in 2014. Although guidelines were issued to Country Offices and webinars were conducted, the migration of the policies into the 'Programme and Operations Policies and Procedures' took over a year and was only completed in May 2015.

The new policies constitute a significant change for the organization. As an example, the policies are expected to result in more Country Office and programme support functions (e.g., the Bureau for Policy and Programme Support with its central and regional functions) having to be financed from Direct Project Costs instead of General Management Support at the latest by the end of 2017.

Overall, the audit indicated that implementation of Direct Project Costs was not consistent among Country Offices and Regional Bureaux at the time of the audit fieldwork, based on a sample of 12 Offices reviewed by OAI, as follows:

- Some Country Offices with sufficiently high General Management Support (refer to Issue 1) did not consider the Direct Project Costs implementation as mandatory, but as a backup option in case of reduced future General Management Support. Out of the 12 Country Offices interviewed or surveyed by

OAI, 4 had not implemented the new policies on Direct Project Costs at all, while the implementation efforts of 5 more Country Offices were partial to nil.

- In some Regional Bureaux (such as the Regional Bureau for Europe and the Commonwealth of Independent States, and the Regional Bureau for Africa), the implementation of Direct Project Costs had just started and thus was not optimal. Regional Bureaux therefore did not hold Country Offices accountable regarding the Direct Project Costs implementation. Furthermore, the Bureau for Policy and Programme Support had not concluded on the way to implement the Direct Project Costs methodology.

In addition to the weaknesses in the implementation of the Direct Project Costs methodology, the audit indicated that no oversight systems and monitoring tools for Direct Project Costs had been developed so far. As a result, Regional Bureaux and Headquarters units had no user-friendly way of monitoring the Direct Project Costs implementation or the amount of funds recovered by way of Direct Project Costs.

The lack of traction of the Direct Project Costs methodology implementation may lead to issues of financial sustainability for UNDP as a whole.

Priority	High (Critical)
Recommendation 2: The Bureau of Management and Regional Bureaux should review the implementation of the Direct Project Costs methodology with the goal to address the identified inconsistencies among UNDP offices and enhance the implementation of the methodology	
Management action plan: The Office of Financial Resources Management highlights progress made in the Direct Project Costs implementation to the Regional Bureaux during its quarterly financial reviews and will continue doing so. In addition, Regional Bureaux will hold Country Offices accountable regarding Direct Project Costs implementation through effective oversight. **Estimated completion date:** July 2016	

Priority	Medium (Important)
Recommendation 3: The Executive Office and Bureau of Management should review the time requirements for the issuance of new policies in UNDP with the goal to achieve more reasonable lead time for a policy to be mainstreamed into the 'Programme and Operations Policies and Procedures'.	
Management action plan: Management agrees to review the process of the 'Programme and Operations Policies and Procedures' revisions and updates with a view to having a reasonable timeframe for policies to be mainstreamed.	

Estimated completion date: July 2016

Issue 3 Multiple agreements with United Nations agencies

According to the 'UNDP Programme and Operations Policies and Procedures', the services provided by UNDP to other United Nations agencies are required to be based on Memoranda of Understanding (MOUs). The Bureau of Management's survey in May 2014 noted a high level of duplication of MOUs at Headquarters and Country Office levels. In response to the survey, the Bureau of Management developed a new framework whereby all MOUs are to be signed at the corporate level only, and if needed, the auxiliary Service Level Agreements to be signed at the Country Office level.

The audit indicated that, at the date of the audit fieldwork, only 3 out of 67 United Nations agencies that receive services from UNDP had signed MOUs under the new framework (UN Women, UN Staff College and UNITAR). Moreover, there was no timeline for negotiating or signing MOUs under the new framework with the remaining 64 agencies.

Further, UNDP arrangements for Agency Services were not consolidated, with the following issues noted:

- multiple agreements with the same agencies at different levels of the organization;
- inconsistencies in the MOU provisions, e.g., regarding exit clauses, review/amendment intervals and cost recovery arrangements;
- differing charges for agencies receiving the same services, e.g., UNFPA receiving special financial arrangements for human resource services; and
- lack of harmonization of costing mechanisms. As an example, the Office of Human Resources used the "fully loaded" cost approach which involved receiving in advance an allocation for the support to be provided (this budget would include direct staff costs and other oversight/support costs), while services at the Country Office level were mainly based on the Universal Price List.

Duplication and inconsistencies in MOUs may lead to increased transaction costs, give rise to disputes, and may result in the failure to recover costs for the provision of Agency Services.

Priority Medium (Important)

Recommendation 4:

The Bureau of Management should review all existing Memoranda of Understanding and define a timeline for such a review, in order to harmonize and consolidate all under the new framework, where applicable.

Management action plan:

The Bureau of Management will prepare a work plan in consultation with Regional Bureaux for coordinating a review and update of these MOUs with the Country Offices.

Estimated completion date: July 2016

Issue 4 Atlas billing module not user-friendly

According to the UNDP 'Programme and Operations Policies and Procedures', the Atlas billing module should be used for the cost recovery of Agency Services.

OAI's survey and interviews with Country Offices and Headquarters indicated that the Atlas billing module was cumbersome and difficult to use. Many Country Offices were using General Ledger Journal Entries for cost recovery purposes, which cannot be tracked in the UNDP Atlas system and therefore, there was no effective way to ensure that costs were recovered.

For the period from 2010 to 2014, there were approximately 1,800 uncleared invoices amounting to $7.3 million in the Atlas billing module. It could not be determined if these invoices were still valid and thus needed to be finalized and if the amounts needed to be recovered.

Transactions not properly tracked may dilute accountabilities while uncleared invoices constitute a financial risk for UNDP.

Priority Medium (Important)

Recommendation 5:

(a) The Office of Financial Resources Management and Regional Bureaux should review uncleared invoices and recover any outstanding amounts, and thereafter, conduct regular reviews of the Atlas billing module.

(b) The Bureau of Management should assess the feasibility of reviewing the billing business processes and related system functionality, or of developing an alternative and more user-friendly IT solution.

Management action plan:

(a) The Office of Financial Resources Management/Bureau of Management shall support the Regional Bureaux in their review of uncleared invoices, taking into account the cost-benefit of such review activities.

(b) The Office of Financial Resources Management/Bureau of Management and the Office of Information Systems and Technology/Bureau of Management will review the feasibility of an alternative solution for agency billing.

Estimated completion date: July 2016

Definitions of audit terms - ratings and priorities

A. AUDIT RATINGS

- **Satisfactory** — Internal controls, governance and risk management processes were adequately established and functioning well. No issues were identified that would significantly affect the achievement of the objectives of the audited entity.
- **Partially Satisfactory** — Internal controls, governance and risk management processes were generally established and functioning, but needed improvement. One or several issues were identified that may negatively affect the achievement of the objectives of the audited entity.
- **Unsatisfactory** — Internal controls, governance and risk management processes were either not established or not functioning well. The issues were such that the achievement of the overall objectives of the audited entity could be seriously compromised.

B. PRIORITIES OF AUDIT RECOMMENDATIONS

- **High (Critical)** — Prompt action is required to ensure that UNDP is not exposed to high risks. Failure to take action could result in major negative consequences for UNDP.
- **Medium (Important)** — Action is required to ensure that UNDP is not exposed to risks that are considered moderate. Failure to take action could contribute to negative consequences for UNDP.
- **Low** — Action is desirable and should result in enhanced control or better value for money. Low priority recommendations, if any, are dealt with by the audit team directly with the Office management, either during the exit meeting or through a separate memo subsequent to the fieldwork. Therefore, low priority recommendations are <u>not included in this report</u>.