FC 113/10
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April 2006

منظمة الأغذية والزراعة للأمم المتحدة | 联合国粮食及农业组织 | Food and Agriculture Organization of the United Nations | Organisation des Nations Unies pour l'alimentation et l'agriculture | Organización de las Naciones Unidas para la Agricultura y la Alimentación

# FINANCE COMMITTEE

| Hundred and Thirteenth Session |
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| Rome, 8 – 12 May 2006 |
| Treatment of Staff Cost Variance |

## I. Introduction

1. In considering the report on programme and budgetary transfers in the 2004-05 biennium[1], the Finance Committee at its 110th session in September 2005 noted the undesirable effect of the unpredictable nature of the staff cost variance on the implementation of the approved programmes of the Organization. The Committee asked the Secretariat to review possible measures that could be put in place to improve the financial management of the staff cost variance, and to outline some options for the Committee's consideration[2]. This paper responds to the request.

## II. Current practice in FAO

*Standard Rates and Staff Cost Variance*

2. The majority of FAO Regular Programme expenses (66% in 2004-05) relate to staff costs, consisting of salaries, pension fund contributions, dependency allowances, social security and other staff-related entitlements and after-service benefits for the professional and general service staff categories at headquarters and in the field, and National Professional Officers.[3] The methodology for estimating the standard rates for the next biennium entails two types of financial adjustments to the actual staff costs incurred in the current biennium: i) the financial consequences over the next biennium of cost increases that would take effect in the current biennium – biennialization; and ii) the cost

[1] FC 110/2

[2] CL 129/4 paragraph 7

[3] FC 108/11 b) Cost Analysis of Staff Remuneration and Benefits

impact of those adjustments that are expected to take effect during the next biennium – inflation.

3. Based on this approved cost increase calculation methodology, standard rates for staff costs are developed by grade and location at the budget rate of exchange for the biennium. All charges for staff costs during implementation are made at these rates against divisional budgets. The difference between the aggregate charges at standard rate and actual costs incurred by the Organization is the staff cost variance (SCV). Considering the large portion of the staff costs in the total budget, a slight variance between the actual unit staff cost rates and the standard rates has a large impact in cost. For instance, an unforeseen difference of 1% in professional base salary amounts to a US$ 1.8 million forecasting error.

4. Most of the underlying causes of the difference between the actual and standard unit costs of staff, such as exchange rate fluctuations in decentralized offices or decisions of the International Civil Service Commission, are beyond the control of the budget holders or indeed, the Organization. The monitoring of this staff cost variance is, therefore, done centrally by the Office of Programme, Budget and Evaluation. Any surplus or deficit excluding exchange gains or losses arising on euro-based staff costs is charged at the end of the biennium across all programmes in proportion to the staff costs incurred at standard rates.

5. Under present arrangements, the Regular Programme staff cost variance is normally matched by a counterbalancing adjustment to the approved biennial programme of work so that the Organization remains within the appropriations voted by the Conference. This creates fortuitous funding for programmes (in biennia when the SCV is favourable) or unfavourable consequences on the approved programme of work (when actual staff costs exceed the charges at standard rates).

6. In 2002-03, US$ 5.4 million of favourable staff cost variance, net of currency variance, materialized[4]. The 2004-05 biennium closed with US$ 16 million of unfavourable net SCV[5]. The reasons for these variances between projected standard costs and actual costs incurred were unpredictable. Although the difference between the forecasts and actual costs ranges only between 1% and 2.7% of staff costs, they had a significant favourable impact on the resources available for implementation of the 2002-03 programmes and an unfavourable impact in 2004-05.

## III. Comparative review of approaches in other UN system organizations

7. A comparative review of the calculation of the cost increases in five UN system organizations (UNESCO, ILO, UN, UNDP and UNICEF) shows that there are no fundamental differences in the methodologies used in the budgeting process (see Annex). There are some technical differences in approaches, for example, with respect to currency adjustments during implementation, the cost elements included in staff costs and the detail used to build up staff cost increase estimates for the budget. However, the findings do not point to opportunities for improving FAO's forecasting of staff costs, where three factors contribute to the staff cost variance:

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[4] FC 107/2 paragraphs 8-12

[5] FC 113/2 paragraph 5

- the long time lag of up to two and a half years between the budget preparation and full implementation reduces the accuracy of the forecast;
- some expenditure items create unanticipated fluctuations because they do not follow a regular pattern or are unexpectedly decided by bodies such as the ICSC which act independently of FAO; and
- exchange rate fluctuations for those currencies not covered by split assessment (i.e. non-euro or US dollar denominated salaries and benefits) have a significant impact on the local staff costs in the decentralized offices, such as when the US dollar weakened against the budget rate during 2004-05. This is a common problem across the UN system organizations and the matter is under consideration by the Chief Executive Board's Finance and Budget Network[6].

8. Over the years, there have been improvements in FAO's capacity to estimate staff costs through new information systems which permit more detailed analysis of the expenditure data used to build up the estimates. The most recent improvements reported to the Finance Committee in September 2005[7] concerned the periodic updating of the actuarial valuation for after-service staff liability schemes for the purposes of the budget preparation exercise and matching the budgeted costs with actual charges.

9. The comparative review of approaches in financially managing the staff cost variance reveals an important difference in the funding mechanisms available to organizations to handle staff cost variances during implementation. In the UN, the programme budget is recosted three times in the biennial cycle as an established practice to take into account the latest actual inflation trends, the outcome of salary surveys, the evolution of the operational rates of exchange, etc. For example, the first performance report for 2004[8] identified an increase of US$ 162.5 million or 5.9% of the net appropriation due to the variations in the inflation and exchange rates assessed to Member Nations. For the 2008-09 biennium, the UN is considering the establishment of a reserve fund within the appropriation to cover the variations in costs due to cost increase factors.[9]

10. In FAO, the Special Reserve Account (SRA) was established by Conference in 1977. It is only exceptionally used for financing unbudgeted extra costs due to unforeseen inflationary trends, subject to prior review by the Finance Committee and approval by the Council. Moreover, split assessment does not provide protection for approximately 20% of the Organization's expenditures incurred in currencies other than euro or US dollars.

## IV. Conclusions

11. The comparison of different methodologies among the five organizations confirms the common practice of basing staff cost increase projections on past expenditure patterns coupled with estimates from external sources. However, even with sophisticated projection methodologies, actual staff costs remain difficult to predict up to two and a half years in advance. Variances between estimated unit staff cost rates and actual costs are therefore inevitable. This puts at risk full implementation of the programme of work if the estimates are understated. Recent improvements in the timing of actuarial valuations

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[6] CEB/2006/HLCM/3 Standard Staff Costs used in the UN Organizations – Executive Summary

[7] FC 110/2 paragraph 5

[8] A/59/578 First performance report on the programme budget for the biennium 2004-05

[9] A/60/6 Proposed programme budget for the biennium 2006-07 Foreword and introduction

for after-service staff liabilities and the use of this data for budgeting and accounting purposes have helped reduce the risk.

12. However, FAO does not have a mechanism for protecting the programme of work against currency fluctuations for staff costs incurred in currencies other than the euro or US dollar. The Special Reserve Account is only exceptionally used to finance unbudgeted extra staff costs due to inflationary trends. Conversely, there is no mechanism in place to establish a reserve when budgeted staff costs exceed actual staff costs.

13. The arrangements at the UN for recosting the budget and adjusting the appropriation would not be realistic in FAO. However, proposals at the UN to establish a reserve fund within the appropriation to cover variations in costs due to cost increase factors may merit further review at a future session of the Finance Committee.

**Annex: Comparative Analysis of Staff Cost Increase Elements**

| Cost Increase Elements | UNESCO [10] | ILO [11] | UN [12] | UNDP & UNICEF [13] Harmonized Approach | FAO |
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| Base to which cost increases are applied | ▪ Approved budget of the current biennium adjusted to the new programme structure and activities of the proposed biennium. | ▪ Actual expenditures of the 1st year of the current biennium | ▪ Revised appropriation as at the end of the 1st year of the current biennium | ▪ Approved appropriations<br>▪ Estimates for the 1st and 2nd year of the proposed biennium calculated separately using appropriations of each year of the current biennium. | ▪ Actual expenditures of the current biennium and forecasts |
| Cost increase calculation unit<br><br>- Unit of standard costs | ▪ By matrix of grade (DG, DDG, ADG, D1-2, P1-5, G1-6, L1-8, NOA-E)<br>▪ By location | ▪ By category (PR & GS)<br>▪ Not location specific for professional staff.<br>▪ By object of expenditures | ▪ By category, level, and duty station<br>▪ Common staff costs (CSC) budgeted as % of net salaries.<br>▪ Salaries and PA based on the update of Post Adjustment (PA) indexes (see below) | ▪ Location specific | ▪ By grade and location<br>▪ By expenditure category |

[10] 2006-2007 Draft Programme and Budget (33C/5), 2004-2005 Approved Programme and Budget (32C/5), Basic Texts 2004 edition

[11] Programme and Budget for the Biennium 2006-07, Programme and Budget for the Biennium 2004-05.

[12] 2006-07 Proposed Programme Budget (A/60/6 Introduction), 2004-05 Proposed Programme Budget (A/58/6 Introduction), Revised estimates: effect of changes in rates of exchanges and inflation (A/58/528, A/58/7/Add.11, A/60/599), First Performance Report on the Programme Budget for the Biennium 2004-2005 (A/59/578)

[13] UNDP: UNDP Budget Estimates for the Biennium 2006-2007 (DP/2005/31), UNDP Budget Estimates for the Biennium 2004-2005 (DP/2003/28)

UNICEF: Biennial Support Budget for 2006-2007 (E/ICEF/2006/AB/L.1), Biennial Support Budget for 2004-2005 (E/ICEF/2003/AB/L.14)

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| Accounts included as staff costs | ▪ Salary and PA<br>▪ Organization's contribution to the UN Pension Fund<br>▪ Organization's contribution to the Medical Benefit Funds<br>▪ Separation payments<br>▪ Other staff allowances including hardship/mobility allowances<br>▪ Statutory travel (home leave) | ▪ All staff costs related accounts<br>▪ Staff Health Insurance Fund for both serving and retired staff members included on a pay as you go basis. | ▪ Net base salaries for established and temporary posts.<br>▪ PA for PR staff.<br>▪ Accounts for all CSCs including staff allowances, social security payments, education grants & travel, home leave, appointment, separation, transfer, other payments such as special claims, reimbursement of income taxes.<br>▪ Staff assessment<br>▪ Representation allowance | ▪ Cost elements corresponding to 4 inflationary factors<br>i. Movement of PA<br>ii. International travel and CSCs<br>iii. Salaries and CSCs of local staff (including national professionals)<br>iv. All other costs as operating expenses.<br>▪ A separate appropriation line for centrally-shared security costs.<br>▪ A separate inflation factor for medical insurance for retirees (UNDP). | ▪ All staff related costs<br>▪ The following staff-related liabilities for PR and GS staff included:<br>o Compensation Fund<br>o ASMC<br>o Termination Payment Fund<br>o Separation Payment Fund |
| Biennialization<br><br>- Financial impact of events that have already taken place before the implementation of the proposed budget | ▪ Yes<br>▪ *"Recosting"* exercise to include statutory increases in staff costs that have already occurred during the current biennium or should occur in the remaining period prior to an approval. | ▪ Yes although not explicitly recognized in the document. | ▪ See the inflation and currency adjustment sections below. | ▪ Yes, overall, similar to FAO.<br>▪ *"Volume adjustments"*: real changes in requirements calculated and applied to the approved appropriations.<br>▪ *"Cost adjustments"*: only known changes that have occurred in the 2 years since the preparation of the | ▪ Yes<br>▪ Full biennial effect of increases that have materialised or are expected to materialize in the current biennium included. |

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| | | | | current biennial budget applied to the approved appropriations with volume changes. This includes:<br>o Change in average step of posts by grade level<br>o Within-grade salary increments<br>o Financial impact of reclassifications<br>o ICSC decisions on staff entitlements<br>▪ *"Inflation adjustment"*: approved appropriations of the current biennium (with volume, cost, and currency adjustments) adjusted for the actual and estimated inflation for the factors described above. | |
| Inflation<br><br>- Cost impact of those adjustments that are expected to take effect at | ▪ *"Anticipated cost increases"* estimated based on the best forecasted inflations available at the time of budget preparation applied to the recosted base.<br>▪ Budgeted in a separate | ▪ Commonly agreed assumptions for inflation in Geneva applied.<br>▪ Cost trends of field offices considered individually, including salaries and allowances of locally | ▪ *"Recosting"* exercise to provide for projected inflation.<br>▪ Forecasts from ICSC and The Economist used for anticipated inflationary increases.<br>▪ Salaries and PA updated based on i) | ▪ *"Inflation adjustment"*: inflation projections for the proposed biennium applied to the factors described above. | ▪ *"Inflation"*: as the cost impact of adjustments that are expected to take effect at various points in the proposed biennium<br>▪ Forecasts from ICSC and The Economist used for anticipated |

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| various points in the proposed biennium | fund.<br>▪ The use of this fund subject to prior approval of the Executive Board. | recruited staff separately considered.<br>▪ Programme activities where special consideration is appropriate explicitly adjusted. | forecast of PA indexes provided by ICSC in Oct-Nov of the year prior to an approval of the budget and ii) uplift factor for CSCs.<br>▪ Additional adjustment requirements due to the variation calculated through recosting exercises and reported in 2 performance reports:<br>i. First report at end of 1st year of a biennium and<br>ii. Second report at end of 2nd year.<br>▪ Variance in vacancy rate adjusted. | | inflationary increases |
| Currency adjustment | ▪ Split assessment methodology in place for the euro component of expenses to protect the programme of work from exchange rate fluctuations (Financial Regulations 5.6) | ▪ Assessments provided all in Swiss Francs while functional currency is the US dollar.<br>▪ The effect of adjustments in the exchange rate between local currency and the US dollar and the Swiss franc taken into consideration. | ▪ *"Recosting"* to adjust for exchange rate fluctuations.<br>▪ Programme budget recosted 3 times: i) prior to its adoption, ii) after one year, and iii) towards the end of the biennium. The last recosting used as the basis for the next biennium. | ▪ *"Currency adjust-ment"* calculated as part of the overall cost increase estimates, by year, on the total appropriations including all costs adjustments from above.<br>▪ This step taken prior to the application of *inflation adjustments* for the current and proposed biennia. | ▪ Since 2004-05, split assessment for euro and euro linked currencies in place as a mechanism to protect from currency fluctuation.<br>▪ No protection mechanism for the US dollar linked currencies. |