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For action

Establishment of an operational reserve

Summary

The present report has been prepared in response to the recommendation of the Advisory Committee on Administrative and Budgetary Questions to review the advantages and disadvantages of establishing an operational reserve for both regular and other resources (E/ICEF/1999/AB/L.10, para. 9).

This review takes into consideration that UNICEF programme and financial planning are frequently brought before the Executive Board through a series of interrelated documents to facilitate oversight. This close consultation with the Board ensures that expenditure plans are based on reasonable income expectations.

UNICEF has a long history of managing its cash needs and flows through effective planning. Enhancements to UNICEF financial management systems, together with increased Government and National Committee support, will enhance the ability of UNICEF to manage cash resources even more effectively, thereby making the establishment of a funded operational reserve unwarranted at this time.

I. Introduction

1. On the recommendation of the Advisory Committee on Administrative and Budgetary Questions (E/ICEF/1999/AB/L.10, para. 9), UNICEF has conducted a review of its policy of not having an operating reserve for both regular and other resources. A number of other United Nations organizations have such a reserve, but UNICEF, with the approval of the Executive Board, has chosen to manage its spending plan and liquidity requirements without this type of budgetary provision.

* E/ICEF/2001/2.

The Board last considered this issue in 1987 (E/ICEF/1987/AB/L.9) and approved, with a small adjustment, the continuation of the current liquidity policy as adequate to manage UNICEF cash flow requirements (E/ICEF/1987/11, decision 1987/14).

2. A funded operating reserve is an established balance sheet account which holds a designated amount of funds separate and apart from other assets to meet unanticipated short-term shortfalls between cash receipts and disbursement obligations.

3. UNICEF employs a variety of financial management techniques and processes to plan its spending requirements against reasonable income expectations. These financial management tools include the Board-approved medium-term financial plan (MTFP), which is updated annually; the multi-year funding framework (MYFF); the country programme recommendation (CPR); and the biennial support budget. With the critical analysis and discussion at the Board, these key financial planning documents have been indispensable tools for responsible overall financial management and for maximizing resources available to programmes within the constraint of resource availability and predictability.

4. In the absence of an operating reserve and authority to borrow funds to address short-term liquidity requirements, UNICEF ensures adequate cash funding by managing financial planning processes to control programming requirements within reasonable cash flow expectations based upon the financial commitments made by donors.

5. The objective of this review is to make a recommendation regarding how UNICEF should manage its financial liquidity in the future in order to continue to support the maximization and continuity of programme delivery while providing flexibility to address short-term cash flow requirements.

II. Review of existing financial management framework

6. The MTFP is a rolling four-year income and expenditure plan which determines the affordable levels of regular resources for programmes, as outlined in the various CPRs and the biennial support budget. The plan is updated and presented to the Executive Board on an annual basis to ensure that the projections are realistic and in conformity with the expectations of the Board.

7. The MYFF (E/ICEF/2000/5), which was approved at the first regular session of 2000 of the Executive Board (E/ICEF/2000/8/Rev.1, decision 2000/3), was prepared in consultation with Board members to increase the volume and predictability of regular resources. The annual pledging event is one element of the MYFF. At that event, donors are expected to make funding level commitments and provide payment schedules for the next year, and commitments or indications for the ensuing three years. This predictability is extremely important to UNICEF in that it provides for assured programme planning and improved cash flow management.

8. A programme of cooperation is developed for each country in consultation with national authorities. The CPR, presented to and approved by the Executive Board, details the results to be achieved and the financial resources required to attain them. The financial projections in the CPR are estimates based on the best information available at the time because they are forecast for up to five years into the future, with limited assurance at the time of estimation of actual income

availability. The actual regular resources allocation to each country programme is determined through the application of a formula modified and approved by the Executive Board at its 1997 annual session (E/ICEF/1997/P/L.17 and E/ICEF/1997/12/Rev.1, decision 1997/18).

9. The biennial support budget is presented to the Executive Board for approval every two years. This document incorporates the relevant two-year projected regular resources budget for programme, programme support, and management and administration of the organization. The resources upon which the budget is formulated are based on the most recent MTFP already approved by the Executive Board.

10. The Programme Manager System and the Financial and Logistics System have greatly improved the ability of UNICEF to monitor field-level activities on an ongoing basis and to manage cash levels to meet evolving circumstances. Up-to-date information is available to track resource utilization and to spot accumulating underemployed resources.

III. Existing liquidity policy

11. UNICEF submitted proposals to the Executive Board in 1980 and 1981 for the authority to negotiate standby lines of credit to meet the seasonal imbalance in cash flow. In 1981, the Board decided that it was not necessary to have a standby line of credit (E/ICEF/685, para. 205). To address the issue of liquidity, the Board recommended that Governments and National Committees make their remittances to UNICEF as early as possible.

12. In 1986, the UNICEF Executive Board, noting that the financial crisis facing the United Nations might possibly have implications for UNICEF and its liquidity policies, requested a review of those policies to be presented at its 1987 session (E/ICEF/1986/12, paras. 175-176). At its 1987 session, the Board reviewed and approved:

(a) The continuation of the existing liquidity policy;

(b) The increase in the convertible year-end liquidity requirement for regular resources cash balances from 8 to 10 per cent of the following years' regular resources income.

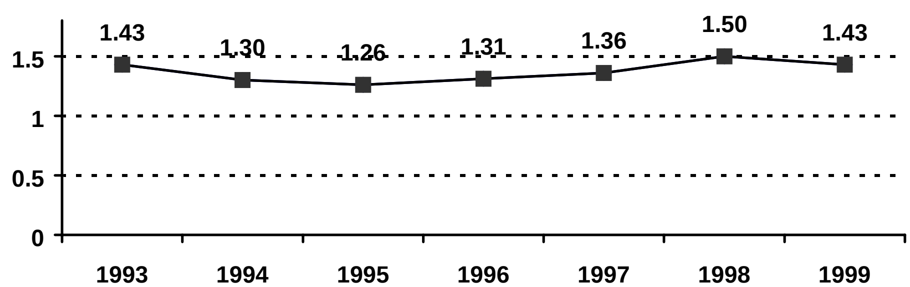
13. The liquidity policy is limited to regular resources because other resources must be self-funding, with the norm that the funds must be received in advance of any obligations or spending being undertaken by UNICEF. Within the liquidity policy is the understanding that UNICEF pools its financial resources and can make temporary use of up to one half of other resources on hand within a financial period to offset short-term imbalances between regular resources expenditures and income.

14. Within the existing operating parameters, the norm for the other resources liquidity ratio is 1 to 1, i.e., short-term assets can be expected to equal short-term liabilities; hence, the liquidity ratio for other resources can never be expected to be in excess of 1 to 1. For regular resources, the liquidity ratio should be at least 1 to 1, but prudent financial management principles would dictate a ratio of 1.5 to 1 to provide for variations in the timing of cash receipts. With the existing almost equal split of regular resources to other resources, this translates into a desirable combined

liquidity ratio of about 1.25 to 1. The ratio becomes a trade-off between holding too much unutilized cash versus not having enough cash to meet current obligations. It is a balance which has to be viewed in terms of its implication for programme implementation. In these terms, it means that every dollar held back to support liquidity is one dollar that cannot be employed in the programme effort of the organization.

15. The UNICEF combined liquidity ratio for the period 1993-1999 ranged from a low of 1.26 to 1 to a high of 1.50 to 1. In 1999, it was 1.43 to 1. The historical liquidity ratios fall above the desirable level as indicated below.

Liquidity Ratio



16. Liquidity requirements and/or an operating reserve can only be used to address temporary mismatches between resource inflows and outflows. Anything other than temporary mismatches must be addressed through increased income or decreased programming. Liquidity requirements and reserves can only provide management with some time to react and to put in place longer-term adjustments.

IV. Key elements to consider

17. Predictability is key to establishing the balance between income and expenditure planning. This predictability requirement has to be addressed both internally and externally. Within UNICEF, the new information systems are enhancing access to timely information in order to manage cash more efficiently. Externally, UNICEF is endeavouring to enhance income predictability within the principles embodied in the new MYFF.

18. Short-term imbalances between income and expenditures can be managed through the use of working capital (the pool of financial resources that an organization holds which can be used to meet its short-term obligations). This is the primary technique that UNICEF has employed for 53 years.

19. A pre-arranged resource transfer schedule from donors would greatly assist the organization to manage cash requirements and to reduce the level of working capital needed to meet disbursement requirements. An improved scheduling of cash transfer is being introduced with the National Committees, in the context of the new Recognition Agreements, that calls for quarterly, rather than annual, transfers to UNICEF. Government donors have started providing commitments to resource transfer schedules as part of the MYFF process. In 2000, 10 countries committed to

advance schedules, and these 10 accounted for about 72 per cent of the total of $337 million pledged by government donors.

20. The other resources component of income has been increasing in an erratic pattern as a percentage of total resources. In 1993, other resources equalled 41 per cent of total resources; in 1999, it increased to 47 per cent. While other resources increased by 48 per cent between 1993 and 1999, regular resources increased by only 16 per cent. This changing pattern tends to increase the pool of cash available because other resources are normally provided in advance of the obligating stage of the spending cycle.

Change in income proportion

(In millions of United States dollars)

Year	*Regular resources*	*Other resources*	*Total income*	*Percentage of other resources to total income*
1993	509	357	866	41
1994	535	471	1 006	47
1995	537	474	1 011	47
1996	551	393	944	42
1997	547	355	902	39
1998	571	395	966	41
1999	589	529	1 118	47

21. There has been a dramatic shift in the sources of regular resources income over the same seven-year period. The private sector has gone from representing 19 per cent of regular resources income in 1993 to 34 per cent in 1999. The move to quarterly receipts from this growing source of income will provide for a smoother and more predictable cash flow stream.

Regular resources income

(In millions of United States dollars)

Year	*Voluntary contributions*	*Private sector*	*Other income*	*Total regular resources income*	*Private sector share of regular resources income (%)*
1993	384	95	30	509	19
1994	377	113	45	535	21
1995	367	132	38	537	25
1996	365	150	36	551	27
1997	360	160	27	547	29
1998	346	180	45	571	32
1999	348	203	38	589	34

V. How some other voluntarily-funded United Nations agencies manage liquidity

22. The United Nations Development Programme has established a funded reserve to support continued short-term programme activity at planned levels in the event of income/disbursement imbalances. At the end of 1999, the reserve amounted to $180 million. The calculation of their reserve for regular resources is the sum of the following components:

(a) Income component. The equivalent of 10 per cent of the average of the annual voluntary contributions received over the most recent three years, rounded to the nearest $1 million;

(b) Expenditure component. The equivalent of 2 per cent of the average total annual expenditure incurred over the most recent three years;

(c) Liability and structural risk component. The equivalent of 10 per cent of the sum of the income and expenditure components, rounded to the nearest $1 million;

(d) Cash flow component. The equivalent of the cash needs for one month, calculated as one twelfth of the total expenditure of the most recent year, rounded to the nearest $1 million.

23. The World Food Programme has a funded operational reserve with a balance of $57 million. This is used to cover shortfalls in cash against confirmed, but uncollected, contributions. Once the cash is collected against the confirmed contribution, it is returned to the reserve. Currently, there is no provision for replenishing the reserve should the contribution become uncollectable.

24. The World Health Organization has a Working Capital Fund that was funded up to $31 million at the end of 1999. The fund finances regular budget implementation pending receipt of assessed contributions. There is no reserve for voluntary contributions.

25. The Office of the United Nations High Commissioner for Refugees has a Working Capital and Guarantee Fund and an operational reserve. The former has an Executive Committee-established level of $50 million, and the latter is required to be 10 per cent of the proposed programmed activities in the annual programme budget being submitted for approval. The operational reserve must be a minimum of $10 million. In 2000, the actual level was established as $82.1 million.

VI. Alternatives

26. UNICEF does require a strategy for dealing with periodic mismatches between receipt and disbursement requirements. Anything longer than a short- term mismatch must be addressed by more permanent changes in income or programming levels. While access to information and donor multi-year commitments and schedules will reduce the frequency and size of the short-term mismatches, they will never be entirely eliminated. The alternatives available to manage the potential short-term gaps are to maintain the current system or create a funded operating reserve.

Alternative 1 — Retain current system

27. UNICEF can continue to manage its short-term liquidity requirements on a cash flow basis. The current 10 per cent liquidity requirement,[1] along with the norm that other resources contributions are provided before UNICEF enters into commitments, should provide adequate funding to meet short-term shortfalls.

28. UNICEF will be assisted further in managing its cash flow requirements with the greater income predictability and payment schedules afforded by the MYFF and the anticipated quarterly funding flows from the National Committees. In addition, the new financial management systems will provide more timely and accurate financial information on the total activities of the organization to promote more effective cash management.

29. The retention of the current system would not change the amount of planned programme expenditures for the period 2001-2003.

Alternative 2 — Establish a funded operating reserve

30. The establishment of a funded operating reserve would be coupled with all of the elements mentioned in Alternative 1 above except that the year-end 10 per cent liquidity requirement established in 1987 would be eliminated as being redundant. However, UNICEF would have to maintain a working capital at a sufficient level to meet daily cash requirements.

31. Determining the appropriate level of reserve is subject to a variety of assumptions. As an example, it could be one month of regular resources expenditures to cover delays in receipts and unexpected decrease in income for a total of about $47 million at current year 2000 expenditure levels. Such an allocation of receipts could not be transferred to a reserve in one year, thus its creation would have to be phased over a number of years in order to mitigate the impact on programming. Unless there is an extraordinary increase in regular resources income, it would be reasonable to expect to build up the reserve over a period of four years at an average annual rate of about $12 million.

32. Under this scenario, the approval and creation of a funded operating reserve, if all other things remained equal, would require a reduction in planned expenditures for 2001-2003 of $36 million.

VII. Recommendation

33. The Executive Director *recommends* that the Executive Board adopt the following draft recommendation:

The Executive Board

Decides that UNICEF should not establish a funded operating reserve. The funding of such a reserve would divert resources from programmes and have a negative impact with no added value. In addition, present and future enhancements in the predictability of cash receipts from income and data availability from the new financial management systems make the establishment of such a reserve unwarranted at this time.

Notes

[1] The UNICEF liquidity policy recommends a minimum year-end regular resources convertible cash balance equal to 10 per cent of projected regular resources income.