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United Nations Office for Project Services

Annual report of the Executive Director on the activities of the United Nations Office for Project Services*

Summary

The present report is submitted pursuant to Executive Board decision 94/32 of 10 October 1994. The report provides an overview of performance in 2004 against financial targets in the UNOPS business plan and reviews UNOPS activities during the year.

* The compilation of data required to present the Executive Board with the most current information has delayed submission of the present document.

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I. Introduction

1. The present report is submitted in compliance with Executive Board decision 94/32 of 10 October 1994, in which the Executive Director of the United Nations Office for Project Services (UNOPS) was requested to report annually on the activities of UNOPS.

2. At the first regular session of the Executive Board in 2005, the Executive Director submitted to the Board a preliminary report on the implementation of the UNOPS budget 2004, together with the projected income and expenditure figures for 2004, including the level of the operational reserve (DP/2004/6). Projections have subsequently been updated as Atlas data have become available. The present report complements the information provided to the Executive Board in document DP/2004/6, assesses performance against projections approved by the Board in January 2004 (decision 2004/3), and provides an update on actual business acquisition for the four months ended April 2005.

II. Implementation of 2004 budget and 2004 financial performance

A. Summary of 2004 performance

(See annex)

3. The year 2004 was a further transition and recovery year for the UNOPS.

4. The UNOPS business model remains highly sensitive to margin management, while the organization experienced a shift in its business portfolio towards increased service delivery in post-conflict and transition situations. In 2004, the average margin on project portfolio services continued to decline: clients, many of whom are also under cost-reduction pressure from their funding sources, pushed UNOPS to deliver services more efficiently and at lower cost; in addition, high-volume, limited-duration infrastructure projects tend to be structured around lower margins. Revenue for the year totalled $45.47 million.

5. In 2004, UNOPS expenditures totalled $57.36 million. UNOPS was able to stabilize its general operating costs, but reimbursements to the United Nations/UNDP and expenditures related to Atlas exceeded projections, at $6.38 million and $3.5 million respectively – the latter exceeding estimates by 40 per cent. At $4.14 million, expenditures for change management were less than had been projected. The organization was required to redirect planned change expenditure and allocate additional funding to address, as a matter of urgency, the recommendations of the report of the United Nations Board of Auditors on the biennium 2002-2003. While UNOPS continued efforts to meet and exceed client requirements, the organization yet again deferred essential investment expenditures on information and technology, operating systems and staff training.

6. In summary, despite variations among individual budget lines, the overall 2004 business and financial results remain within the projections submitted to the Executive Board in January 2004.

B. Management discussion and analysis of UNOPS operations in 2004

Business acquisition

7. For fiscal year 2004, business acquisition is defined as projects, loan and service agreements signed and approved between January 1, 2004 and December 31, 2004. UNOPS is aware that acquiring the 'right' new business in the 'right' way is critical for the organization's long-term viability.

8. The business acquisition process continues to present several challenges, as was already noted in prior years: (a) project, loan and advisory services acquisition and delivery are cyclical[1] and can be random (as in the case of crisis events); (b) the portfolio acquisition cycle can be relatively long, ranging anywhere from six to 24 months; (c) a number of United Nations-system partners prefer to maintain in-house service capacity rather than outsourcing to an entity such as UNOPS; (d) barriers to exit and switching costs, for both UNOPS and its clients, are very high; and (e) agreement or contract periods are relatively long. However, the improved positioning of UNOPS in the post-conflict and transition market ought to contribute to a shortening of contract periods, allowing for more rapid turn-around. At the same time, increased risk exposure requires advanced risk management capacity; while (f) the decision-making trend amongst clients continues to shift from headquarters-based personnel to field-based personnel.

9. New project portfolios acquired in 2004 totalled $728 million. This represents the best annual performance in project portfolio business acquisition since 1998. The analysis of the structure of the acquisition reveals further client diversification and increased demand for project management services in post-conflict and transition situations, such as in Afghanistan.

Analysis of ongoing operations: Delivery and revenues

10. In 2004, UNOPS project delivery exceeded the January 2004 forecast by 2 per cent, or $10 million. This achievement is noteworthy, given the restructuring and related disruption that took place during the year as a result of the rebuilding and transition initiatives of the organization. The attainment reflects positively on the strong commitment and focused efforts of both clients and staff.

11. In tables 1 and 2 below, UNOPS 2004 revenues are shown by client funding source and by divisional geographic/service line provider, respectively. UNDP core-funded portfolios yielded 25 per cent of revenues. UNDP management services arrangements (MSAs, which serve as a channel for third-party client contracts), other United Nations entities, and the World Bank, collectively represent a growing client base and source of revenues for UNOPS. After a small increase in 2003, service income from the International Fund for Agricultural Development (IFAD) remained stable in 2004, while service contracts for the Global Fund to Fight AIDS, Tuberculosis and Malaria (GFATM) provided a new source of revenue. By division, global and interregional projects (including mine action projects) performed

[1] Project funding for most UNOPS clients is based on regular one- to four-year financing cycles. UNOPS must therefore manage its key clients' funding cycle proactively during the business acquisition process and revise its pricing structure from a flat percentage fee maintained over the project's duration to pro-active up- and downward revision as service delivery evolves over the duration of the project.

consistently, while Afghanistan posted strong returns as a leader in the emerging post-conflict transition market. In the new Europe/North Africa/Central Asia Division, Iraq began to emerge as a high-return but high-risk portfolio base. Business acquisition in Latin America started to grow. Asia/Pacific and West/Central Africa Divisions both experienced significant readjustments during the organizational change/restructuring process and present challenging environments in which to enhance portfolio acquisition and delivery. A small but steady source of income was derived from sub-letting of space in the Chrysler Building headquarters.

Table 1. 2004 revenues by client source of funds
(in millions of dollars)

Client/funding source	***Revenue***	***Percentage***
UNDP CORE FUNDS	11.3	25%
UNDP - Other trust funds	3.5	8%
UNDP – Global Environment Facility	2.2	5%
UNDP – Montreal Protocol	0.5	1%
UNCDF	0.1	0%
UNODC	0.8	2%
UNDP MSA	5.3	12%
UNFPA	0.2	0%
United Nations organizations	5.4	12%
DPKO	2.7	6%
OHCHR	1.0	2%
World Bank	2.4	5%
Subtotal – project income	***35.4***	
RSA	1.4	3%
IFAD (gross)	7.0	15%
PAPP income	0.2	0%
Subtotal – services income	***8.6***	
Miscellaneous income	0.1	0%
Rental income	1.2	3%
Interest income	0.2	0%
TOTAL	**45.5**	100%

Table 2. 2004 revenues by geographic/service division
(in millions of dollars)

Division	Project Income	IFAD	RSA	PAPP	Other	Total
Afghanistan (APIF/OSU)	9.6					9.6
Asia/Pacific (APRO)	1.6	1.9	0.5			4.0
Eur/N.Africa/C.Asia (CANANE)	6.0	1.3	0.3			7.6
East/Southern Africa (ESARO)	2.1	2.1				4.2
Global/interregional (GLO)	10.3		0.4			10.7
Lat. Amer./Caribbean (LAC)	4.0	0.7				4.7
West/Central Africa (WCARO)	1.6	1.0	0.1			2.7
Procurement	0.2					0.2
Finance			0.4	0.2		0.6
Other					1.5	1.5
Unclaimed			(0.3)			(0.3)
Total	**35.4**	**7.0**	**1.4**	**0.2**	**1.5**	**45.5**

12. Given the quantum of official development assistance (ODA) funding directed to post-conflict and transition situations, UNOPS believes that significant expansion opportunities exist in the provision of services to partners and clients working in these volatile situations. As part of its action plan initiative, discussed in conference room paper CRP/2005/10, UNOPS undertook a review of market potential and options to position the organization in a balanced risk management model in post-conflict and transition situations (track 1) and in development and poverty alleviation segments (track 2) of the market.

13. In 2004, UNOPS generated $45.5 million in total revenues. 2004 revenues exceeded 2004-approved revenue estimates (DP/2004/06), of $44 million, by $1.5 million.

14. The annex, on page 9, is a consolidated statement of revenue, expenditures and changes in fund balances for the year ended 31 December 2004. Project services continued to provide the largest percentage of total UNOPS revenue ($35.4 million of $45.5 million, or 78 per cent of total revenues). The percentage of total support costs and fees contributed by various client sources of funds varies considerably, as does the cost of service delivery. A 2004 review of the business portfolio revealed several instances where the actual cost of service delivery did not match the fees received for service delivery. Thus, in 2005, UNOPS is giving priority to instituting correct pricing of services as a basis for full cost recovery.

15. In general, UNOPS has continued to experience downward price pressure from its clients. The average fee rate that UNOPS earned from project services has declined from 7.65 per cent in 2001 to 7.04 per cent in 2003 and 6.85 percent in

2004. As previously stated, this reflects a general demand trend for lower-cost services. It also reflects the growth of UNOPS services in post-conflict transition environments, characterized by the acquisition and delivery of high-volume, low-margin, short-duration projects.

Analysis of ongoing operations: Expenditures

16. In 2004, expenditures totalled $57.36 million. As is typical for a service organization, 50 per cent of total operating expenditure relates to staff salaries and benefits.

17. The $25.79 million expended on staff costs in 2004, however, is well below the $27.9 million expended on staff costs in 2003.

18. Contractual services, equipment, communications, travel and general operating expenses in 2004 equalled $15.18 million. UNOPS paid $6.38 million in reimbursements to UNDP and the United Nations for a range of central and operational support services.

19. The introduction of the consolidated resource planning system, known internally as Atlas, for five United Nations organizations, significantly increased the UNOPS cost base. UNOPS spent $3.5 million, or 7 per cent of its total expenditure base, on 'wave 1' roll-out, technical interfaces with legacy systems, data scrubbing, and training activities. The amount expended exceeded the budgeted provision of $2.5 million by 40 per cent

20. In 2004, UNOPS paid $4.14 million related to its ongoing change management programme, including the recruitment and installation of a new senior management team and the alignment of its client service divisions.

21. In mid-2004, UNOPS was apprised of the findings of the United Nations Board of Auditors for the 2002-2003 biennium. UNOPS senior management immediately proceeded to develop a comprehensive management plan (DP/2005/12) in response to the recommendations of the United Nations Board of Auditors to: (a) ensure that UNOPS financial statements fairly present, in all material respects, the financial position of the organization, the results of its operations, and its cash flows, in conformity with accounting principles generally accepted in the United Nations system; (b) repair material weaknesses in internal controls; (c) build necessary business infrastructures and architecture; (d) ultimately, ensure the continued financial viability of UNOPS. The transparent, accountable and efficient provision of services is the raison d'être of UNOPS. Thus, high priority is accorded to the implementation of the audit observation initiatives, which required redirection of planned change expenditures and funding in the amount of $1.51 million. This plan continues in 2005.

Analysis of ongoing operations: Gross margins on project services

22. Gross margin is typically defined as net revenue less cost of acquisition. The cost of acquisition is the direct cost incurred to deliver the project or service to the client. Direct costs include the salaries and benefits of client delivery and direct marketing personnel and direct information technology (IT), office equipment, telecommunications, occupancy, travel, and other costs. The declining margins are caused by three primary factors: (a) the spread of UNOPS service locations; (b) the pricing methodology used for project services and less-than-optimal screening at project acceptance; and (c) inefficient, non-technologically enabled work processes.

23. The project services pricing model currently used by UNOPS is highly simplistic. Revenue is equal to a flat, negotiated percentage fee multiplied by the dollar value of project-related expenditures. This flat percentage fee remains in effect during the lifetime of the contract and over the life cycle of the project – from start-up through management to project closure. The issues associated with the UNOPS pricing model were discussed in DP/ 2004/23.

24. In line with decision 2005/6, UNOPS is developing an action plan presenting options for building long-term financial viability. The action plan work includes a provision for a new pricing approach. UNOPS also agreed with reiterated recommendation of the United Nations Board of Auditors to: (a) evaluate the basis and calculation of the cost of services, with a view to ensuring that all costs are identified and recovered; (b) implement a system that addresses all shortcomings identified in the existing workload system; and (c) consider the feasibility of using a fixed minimum margin to better control fluctuations in cost recovery rates, while ensuring that UNOPS remains cost effective.

25. New project acceptance procedures were promulgated in April 2005, requiring that projects be accepted only on the basis of full cost recovery for project-related costs. This measure will be supplemented once a new pricing methodology and fee scale takes effect. To position UNOPS for long-term viability, management will submit an action plan at the second regular session of the Executive Board in September 2005.

26. UNOPS management is aware of the service pricing issue, and has flagged it as a priority for the last four years. UNOPS has examined the project acceptance process and implemented a more rigorous procedure. In line with the service pricing work, a new financial screening process will be instituted, including analysis of: (a) the ‘net present value’ of the business versus the ‘net present value’ of the cost to deliver the business: delivery costs will include business development and acquisition costs as well as direct and indirect delivery costs; (b) the lifetime value of the client (its entire business relationship history); and (c) the diversity of the overall book of business from a client or source of funds; geographic considerations; service type; and the execution risk perspective. Additionally, UNOPS management will investigate the possibility of pre-billing its clients. This ‘front-loading’ would more equitably distribute the working capital ‘float’ that UNOPS must currently finance.

27. Additional factors negatively affecting UNOPS project service margins include: (a) ineffective and non-technologically enabled business and work processes often used by the organization, and (b) a failure to examine policies and processes over which the organization has control to determine whether they are value-adding, value-neutral or value-destroying, from both a client perspective and an organizational bottom-line perspective. Currently, the UNOPS information technology systems are neither enabling nor state-of-the-art. To streamline and, in some cases, eliminate specific non-value adding, non-risk mitigating work steps, UNOPS management plans to revise its current financial rules and regulations and re-engineer its processes to better leverage the Atlas system.

C. Fund balance: operational reserve and working capital

28. As at 31 December 2003, UNOPS had a fund balance of $23.2 million. This amount was composed of $6 million in operational reserve and $17.2 million in working capital. As at 31 December 2004, UNOPS had a fund balance of $14.46 million. As previously noted, the proposed draw-down on the end-2003 fund balance was presented to the Executive Board in January 2004, addressing 2004 investments in change management and the Atlas roll-out.

III. Analysis of UNOPS year-to-date business acquisition for the four months ended 30 April 2005

29. UNOPS acquired $590 million in new business during the first four months of 2005, compared to $147 million in new business acquired during the first four months of 2004. However, high business acquisition levels mask significant changing market characteristics, such as the growth in large-scale procurement contracts (Latin America) or large infrastructure engineering projects (post-conflict transition countries), both of which are characterized by low margins. Thus, in its assessment of future financial viability, UNOPS must take into account the need to lower its fixed cost base to adapt to the changing market.

Table 3. 2005 business acquisition as of 28 April 2005, by client service unit

UNIT	Budget (2005 acquisitions)		Estimated revenue
	Total	2005 delivery	2005
GLO	67,633,016	63,254,811	**2,970,570**
APIF/OSU	243,010,812	181,930,929	**11,444,695**
APRO	10,283,413	10,103,413	**706,837**
CANANE	13,641,264	12,668,071	**695,515**
ESARO	6,047,916	6,047,916	**573,447**
LAC	246,526,692	189,235,314	**3,000,840**
WCARO	2,996,032	996,430	**56,757**
Total	**$590,139,145**	**$464,236,883**	**$19,448,662**

Annex. Consolidated financial statement for 2004

	2004 Actual (in $ millions)
Section 1: Delivery	
Delivery amount	$495.27
Section 2: Revenues and expenditures	
Revenue from implementation of project portfolio	
UNDP core and trust funds	$17.57
UNDP MSA	$5.26
Other United Nations organizations	$12.55
Total project revenue	$35.38
Revenue from 'service only'	
International Fund for Agricultural Development (IFAD)	$7.03
Programme of Assistance to the Palestine People (PAPP)	$0.18
Reimbursable service agreements (RSA)	$1.42
Total 'service only' revenue	$8.63
Other revenue (interest, rent)	$1.46
Total revenue	**$45.47**
Administrative expenditures	
Salaries and benefits	$25.79
General and administrative	$15.18
Subtotal	$40.97
Reimbursement expenditures	
Atlas-related payment to UNDP	$3.50
Reimbursements made to United Nations organizations	$6.38
Subtotal	$9.88
Change Management programmes	$4.14
Audit observations-related initiatives	$1.51
Allowance for doubtful accounts	$0.80

Host government contributions and expenditures	$0.06
Total administrative expenditures	**$57.36**
Income/(loss) from ongoing operations	**($11.90)**

Section 3: Fund balance roll-forward

Beginning fund balance (including $6 million operating reserve)	$23.20
Income/(loss) from ongoing operations	($11.90)
Savings on prior biennium purchase orders	$3.16
Ending fund balance (including $6 million operating reserve)	**$14.46**