MANAGING COSTS IN SMALL NOT FOR PROFIT ORGANIZATIONS AGAINST A BACKGROUND OF DUBIOUS INFORMATION

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ABSTRACT

Managing costs of any type in small not-for-profit organizations is fraught with challenges. Managing those costs with incomplete or misleading information can lead to a disaster in financial planning. The reliance on information provided by parties to a transaction is no longer enough for a board of directors or for corporate management to make reasonable decisions. The chances are the other party is not telling the whole story. In order to avoid being the victim of a hoax or scam, due diligence has to become more extraordinary that ever before. Boards and managers are now involved in ever more complex transactions and those transactions all have the potential to create seemingly unforeseen consequences. This article tells one tale of such a transaction and asks the reader to use this as a lesson for planning future management decisions.

INTRODUCTION Methods of separating people from their money have been around since the birth of money;[i] before that, I assume, people were scammed out of their mammoth meat or their saber-toothed tiger skins. If truth, as a single static hypothesis could ever be defined, and if people were willing to tell only the truth, then, perhaps, no one would ever be the victim of a scam, a scheme or a con again.[ii] Against this cynical background one must still function in the specialized world we now live in. We are required to enter into business transactions with people we do not really know, since few of us are capable of producing the food, clothing and shelter (not to mention all the other stuff we need) on our own. Money is our medium of exchange and actual authentic information is the primary mechanism that allows us to retain even some of what we earn.

Even before the current economic downturn, community based not-for-profit organizations have customarily struggled to make ends meet. For that reason, and because public support is not readily available, especially for non-glamorous basic service entities[iii], a well intentioned financial management and a dedicated board may be susceptible to entering into financially motivated transactions that are neither the model of present aptness nor, necessarily, in the best long-term interests of the organization. The purpose of this article is to examine a single case in risk management and its related due diligence and, possibly to allow it to serve as a warning for both board members and financial managers.

WORKERS' COMPENSATION COSTS Government mandated Workers' Compensation Insurance (workers' comp) can be, because of its limited materiality, one of the less investigated and more difficult to budget costs in planning the operating budget of the small not-for-profit entity. Budgets for workers' comp are often based on assumptions from one or two years before the fact (historical experience ratings) and on audits of workers' comp liabilities that may not happen for a year or two after the fact.[iv] This insurance is mandated and the laws of the State of

NY offer alternative methods for satisfying the mandate. The simplest way to obtain the insurance is through the NY State Insurance Fund which must provide insurance for any willing employer. Alternative and often lower cost, private insurance is an option for some and self insurance is available for the largest employers.

In the not-for-profit world, funding sources[v] are reluctant to pay for the actual cost of the insurance especially when that actual cost cannot be precisely measured for as long as one or two years after the fact. These funding sources rightfully prefer to allow the budget be based on historical facts and assumptions of future outlays. Further, when an organization's revenues are fee-for-service based (Medicaid, for example) rather than grant-based, no provision for workers' comp is budgeted at all. In these cases, the burden of payroll fringes, even a government mandated one, is determined and accounted for by the internal pricing and cost structure of the organization. The result is that rather than being able to obtain cost recovery, the not-for-profit is forced, for budgeting purposes, to place the cost of workers' comp insurance into a category akin to general overhead.

TRUST MEMBERSHIP In early 2003, our organization's[vi] insurance broker recommended to our management and the board of trustees that they consider joining a mutual benefit trust that would be able to provide very competitively priced workers' comp. This trust advertised that its management had many years of workers' comp and industry experience and because of this it had ability to reduce workers' comp costs by as much as 35%. This appealed to our organization, as it would in theory to anyone looking to save money. The hope was that membership in the trust would make the costs for workers' comp lower and more predictable.

The trust guaranteed the rates year to year. The trust, as detailed in its disclosure documents, would be able to apportion the cost savings to its members because of the sheer quantity of the number of employers and employees. Moreover, because trust members were all from a similar industry group, where workers' comp claims were traditionally low, the larger trust group could negotiate better reinsurance rates[vii] and the trust as an entity would be able to avoid the unpredictability of a single employer plan.

In 2003, our board approved membership in the Health Industry Trust of New York (HITNY). The board, in making its decision, relied upon the recommendations of the organization's long-time insurance broker and on its own review of the financial statements of HITNY. Although the trust was relatively new, the financial statements up to the date of the approval showed that there was revenue growth and even some net worth in the trust before our organization joined.

For the entire period from 2003 through 2008, premiums assessed were paid and the amount of the assessments was reasonable[viii] in keeping with the past experience of our organization. The annual financial statements of the trust were reviewed by the board but perhaps, in hindsight, not as carefully as they should have been. During the entire period in question, it appeared that membership in the trust had done the three things our organization wanted: (1) provide the mandated coverage, (2) keep costs low and (3) allow the budgeting process to become more predictable.

THE END OF THE TRUST AND ITS AFTERMATH In 2008, without any previous notice or warning, our broker informed us that HITNY was going out of business primarily due to investigations by NY State. The NY Workers Comp board had discovered irregularities in the reporting of the trust's financial information. The result was that our organization would have to find a new source for the workers' comp insurance. This news was received at a time when both NY State and NY City were making planned reductions in funding for community based public service not-for-profits. At this point, the NY State Insurance Fund plan, in spite of its higher cost, became our carrier as other alternatives were deemed by our board to be too difficult to evaluate in a short period of time.

In 2009, the New York State Workers' Compensation Board notified us that, as a member with unlimited liability[ix], our organization was subject to an assessment for accumulated deficits of HITNY. The $220,921,073[x], deficit amassed by HITNY in its few short years of existence amounted to a sum almost equal to the total of all premiums paid into the trust from 2000 to 2008[xi]. The trust had been under-billing its members for years and, one can only assume, that this was done so that new members could be recruited into the trust. This schema of under-billing appears, in retrospect, to have been a type of pyramid game, where more and more members were being recruited[xii] to pay the shortfalls of the previous years.[xiii]

The impact of the state assessment was to double, retroactively, our workers' compensation cost for the entire period of our membership[xiv]. Our organization was now burdened with a significant retroactive cost. This was a cost that could not be brought into current budgets. It was also a cost that could not have been reasonably anticipated, as neither the audited financial statements of the trust nor the review of the liability by our own auditors disclosed any potential obligation on our part until NY State sent us that bill and demanded payment.[xv]

ALLOCATION OF BLAME Although assigning blame is a favorite American pastime, it is often unproductive and serves no master other than vanity. In the case of HITNY the blame for the accumulated losses had many contributors. The managing agent was clearly to blame as they were the instigators of what now seems like a fraudulent scheme. The State of NY had licensed the managing agent of the Trust through its insurance department thus giving the managing seeming creditability. The insurance broker had recommended the Trust not, perhaps, fully understanding its workings and its managing agents' background. The board had been too willing to allow the insurance agent to influence its decision even though there is an inherent conflict of interest (commissions) in any brokered insurance contract. But parsing the blame does not solve the problem; it only makes the victim feel a little better.

WHAT HAS BEEN LEARNED? The lesson learned is, perhaps, that in examining methods of controlling costs, a board must be careful not only to do the necessary investigation of the planned alternatives but also to examine the potential for future liability and the impact of future obligations on the budget model of the organization. Outside the box thinking is now almost always needed. In this case, it appeared that the insurance broker and hundreds of other member organizations were either fooled by the plan organizers or perhaps failed to do the due diligence that needed to have been done.

HITNY, on its face, appeared to be legitimate but, as it turns out, may have been another in a growing list of "Madoff"[xvi] type cash flow kiting schemes. Fees for managing the trust were always paid. Fees for legal counsel to fight claims were always paid. The claims themselves, it seems, were not. When HITNY wound up its operations in 2008, it had accumulated the above mentioned deficit of $220 million but had managed to pay out management fees of $43.1 million and other costs of $43.6 million which included underwriting and general administrative expenses[xvii]. The payments were made to public companies whose officers have since been suspended by the SEC and some of whom are either under investigation or have already been indicted. Further, reinsurance fees of many millions of dollars were paid to companies related to the managing agent.

CONCLUSION Not-for-profit organizations must invest in cost savings much as a for-profit organization does but because of the inability of the not-for-profit to rely on accumulated earnings, the amount of risk that they can absorb is necessarily less. Involvement in alternative and non mainstream ventures may be beneficial to the organization but each step taken on this road less travelled must be taken with much care. Although it is not likely that one can foresee criminal or quasi-criminal activity on the part of parties with whom one conducts business, extra care must be exercised when using new sources or entering into new relationships. Although workers' comp is only a minor cost in the entire picture of an organization, watching every penny and every transaction is the rule by which every organization must function if they are to survive.

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[i] Money as a medium of exchange rather than something of intrinsic value has existed for at least the entire period of recorded time. The western bible traces it back over 2,000 years and eastern philosophy thousands of years more.
[ii] Charles Ponzi did not invent the confidence game named after him but he certainly made it more known to the public. Any denizen of a major US city could tell you of the "three-card Monte" game she/he "almost" beat.
[iii] Organizations like the American Red Cross can attract major donors whereas small community based organizations have very little ability to bring in a significant number of major contributors.
[iv] This timing difference may impact the smaller not-for-profit more than the larger ones because of the volatility of premiums resulting from new classifications of employees that may or may not have been contemplated when original budgets were created.
[v] Funding sources include City and State agencies as well as private corporate grants.
[vi] The organization is a small not-for-profit community based counseling and education corporation.
[vii] The reinsurance costs referred to here are the policies purchased by the trust to protect it against extraordinary risks. Unfortunately, in this case, the reinsurer was a related party to the management company and the actual insurance coverage for this risk may have never existed.
[viii] The premium billings were lower than could have been purchased via the State Insurance Fund.
[ix] The issue of unlimited liability had never presented itself before in this matter. The papers given to us made no mention of this and the audited financial statements of the trust never stated that members would be responsible for funding any short-fall in net revenues. In documents discovered in 2010, it appears that the signature of our director had been placed on trust documents by someone other than our director and in those documents the member liability is stated.
[x] "Deficit Reconstruction and Assessment of Healthcare Industry Trust of New York for the New York State Workers' Compensation Board" by Bollam, Sheedy, Torani & Co., LLP, CPAs, November 29, 2009, page 1.
[xi] Ibid. Schedule 1.
[xii] Ibid. Schedule 6. (A total of 326 separate organizations eventually joined the trust.)
[xiii] Eventually, as with any pyramid, the number of members needed to keep the scheme going exceeds the number of available members. The problem for us was that NY State had decided that the burden of the pyramid was not to go away but rather that they would chase each and every member for the liability that the state had computed.
[xiv] Not only were we charged with paying accumulated short-falls but also we were being charged with the defaulted amounts for member organizations that had gone out of business.
[xv] As of the writing of this article, we have not admitted to any liability beyond the payments already made by us to HITNY.
[xvi] This trust may be dissimilar only in that its total magnitude is much less than in the Madoff case as it is not clear that any actual workers' comp claims were ever settled other than via payments received in the following periods from members.
[xvii] "Deficit Reconstruction and Assessment of Healthcare Industry Trust of New York for the New York State Workers' Compensation Board" by Bollam, Sheedy, Torani & Co., LLP, CPAs, November 29, 2009, Schedule 1.