# New York Nonprofits in the Aftermath of FEGS:

## A CALL TO ACTION


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# HSC OVERVIEW

Founded in 1991, our primary goal is to improve the lives of New Yorkers, from all walks of life and across diverse neighborhoods, cultures, and generations. We do this by strengthening New York's nonprofit human services industry, an economic engine whose more than 200,000 employees deliver services that improve the physical, emotional, economic health and wellbeing of individuals, and help communities fight prejudice and violence, recover from disasters, and create pathways to opportunity.

The Human Services Council works on many levels, helping member organizations address and meet human service needs more effectively by:

- Acting as the intermediary between the nonprofit sector and government agencies, which provide most of the funding for human services, to propose and advocate for policies and legislation that enhance the delivery of services and promote best practices in how nonprofits contract, report, and get reimbursed for this work.
- Serving as the primary advocate for adequate funding of human services, while simultaneously promoting efficiency on the part of service providers.
- Connecting diverse member organizations with each other, government officials, and the education, healthcare, philanthropy and business communities, helping them work together more intelligently and collaboratively, leading to greater impact.
- Training nonprofit groups on advocacy and government relations, as well as how to message their work to the media, to increase visibility, attract volunteers, and raise funds in the social media age.
- Ensuring that social, racial, and economic justice issues are a central component of human services policy and delivery, and helping individuals, families, and communities who depend on human services to have a voice in public policy decisions that affect their lives.
- Strengthening the sector's role in disaster response by ensuring that nonprofits coordinate with each other on preparedness and with government and foundation funders post-disaster.
- Mobilizing support for tackling the social and economic issues that underlie the growing demand for human services.
- Holding government agencies and elected officials accountable for their commitments to meet the human services needs of all New Yorkers.

HSC has a small staff and budget, but exercises significant clout because it represents a strong and broad-based network of leading organizations in the human services sector. We encourage our members to be active participants in advocacy and to build effective relationships with public officials and the communities they represent. By working together with our 170 members and other allies, we have real impact, bringing people together to solve problems and helping some of the least visible and most resilient residents gain the respect, dignity, and services they need and deserve. For a list of HSC Board of Directors and Members, see Appendix D.1 & D.2)

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EXECUTIVE SUMMARY

# NEW YORK NONPROFITS IN THE AFTERMATH OF FEGS: A CALL TO ACTION

Nonprofit human services organizations play a critical and longstanding role in building and supporting the wellbeing of New Yorkers, enabling millions of people to contribute to their communities as students, parents, neighbors, and workers. These providers deliver services to an estimated 2.5 million New Yorkers annually.[1] They train and help keep workers in good jobs, provide early childhood education and after-school programs, run food pantries, respond to emergencies and natural disasters, provide mental health counseling, shelter people experiencing homelessness, and care for the elderly, among many other community services. By administering human services programs, nonprofits are building the wellbeing of New Yorkers, maximizing their potential and ensuring that New York maintains its global competitiveness. The collective services provided by human services nonprofits make the difference between success and failure for countless individuals and families. Yet the sector itself is facing a crisis.

As with any industry, nonprofits in the human services sector close and merge, but recently, there have been many questions about why so many have disappeared. Organizations, including Alianza Dominicana, GroundWork, Day Top Villages, and Palladia, have merged or closed their doors, putting pressure on the rest of the provider community to pick up programs. In March of 2015, the Federation Employment and Guidance Service (FEGS), a $250 million behemoth nonprofit human services provider, announced it would be closing; a clear signal that systemic issues threatened the survival of the sector as a whole.

Until it filed for bankruptcy, FEGS, one of the largest human services providers in New York, delivered an array of mental health, disabilities, housing, homecare, and employment services on an annual budget of about $250 million. The closing of FEGS after 80 years in operation left about 1,900 employees without jobs and unpaid creditors holding more than $47 million in debt. Additionally, the 120,000 households and individuals that relied on FEGS for services had to be transferred. The City and State agencies that contracted with FEGS were blindsided by its poor financial condition and were forced to find replacement providers to administer about 350 of its ongoing program locations.



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FEGS, like hundreds of other human services providers, was funded largely through public contracts with governmental agencies. Over the past 40 years, government has transferred most legally mandated support functions to the more efficient and nimble nonprofit sector at a fraction of what it would cost government to administer directly because of lower expenses at nonprofits and investments made by private funders. ("Private funders" refers to philanthropic giving from institutions, corporate donors, and individuals. It does not include loans or other private non-giving sources of funding.). The combined value of government human services contracts in New York is estimated at more than $5.8 billion for the current fiscal year.

The closing of FEGS raised urgent questions: How could such a large and well-established organization implode? Was FEGS unique or symptomatic of the financial challenges facing the nonprofit human services sector? How many other organizations are in trouble, and how many people would be affected if they close? How can more closures and the associated consequences be averted? What will it cost if this industry collapses? What is required to ensure that this does not happen? In March 2015, the Human Services Council (HSC) set out to answer those questions.

Since 1991, HSC has worked to unite and empower New York's nonprofit human services sector and has advocated for public policies that enable it to better serve New Yorkers. HSC recruited 32 seasoned human services executives, civic and philanthropic leaders, former government officials, and other individuals with critical experience and knowledge concerning nonprofit management and oversight (see Commission Participants, page 41). They were asked to conduct a rigorous assessment of the state of the nonprofit human services sector and to recommend measures to ensure that vitally needed organizations survive and thrive until they are no longer needed. Gordon J. Campbell, a former senior government official and former President and Chief Executive Officer of United Way of New York City, was appointed the Chair of the Commission, charged with examining the state of the nonprofit human services sector in the aftermath of FEGS.

Commission members met frequently over nine months in committees with specific agendas (see committee members and charters, attached as Appendices A.1 through A.5, respectively). The findings of their exhaustive review follow.

EXECUTIVE SUMMARY

## Major findings

Human services nonprofits have a higher rate of insolvency than other types of nonprofits. Organizations with budgets from $10 million to $49 million are more likely to be in financial distress than those with budgets of less than $1 million, and a significant portion—60 percent—are financially distressed, having no more than three months of cash reserves.

Underfunded government payment rates are the primary driver of financial distress. Government contracts dominate provider budgets but pay only about 80 cents or less of each dollar of true program delivery costs, leaving budget holes that private funders cannot, or should not, fill.

Underfunding leads to salaries so low that many nonprofit employees depend on safety net programs, such as food stamps and Medicaid. It also results in inadequate investment to keep facilities safe and in good repair.

Chronic delays in contract payments force providers to undertake costly borrowing to make payroll and rents, often accruing interest not covered by government contracts.

Multiple and redundant audits, along with unfunded mandates and other oversight mechanisms, add up to staggering administrative costs.

The transition to Medicaid Managed Care poses considerable risk for human services providers and there is no assurance that any of the substantial State investment to prepare for this new system will flow to human services organizations.

Government does not fully leverage the expertise of human services providers to design programs, missing a significant opportunity to innovate and develop metrics and requirements that match the government dollars available for a given contract.

Too many government regulations are redundant and unnecessary. The multiplicity of procedures that accompany government contracts detracts from the focus on mission.

Human services providers need to expand their risk assessment and management capacity to ensure that executive staff and boards focus effectively on organizational sustainability and continued delivery of services to the community.

Because of weak internal financial and programmatic reporting, providers may not be alerted to short-term and long-term fiscal dangers early enough to address them. Inadequate funding of indirect expenses has contributed to the lack of resources available for investment in effective risk identification mechanisms.

The philanthropic community is a crucial partner in the capacity building efforts of nonprofit human services providers and should better facilitate investment in these functions.

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Recommendations

To address these issues and ensure the future contributions of the human services sector, the HSC Closures Commission identifies three major problems and makes eight recommendations that are designed to work together to bring the sector back from the brink.

Problem #1: Programs intended to build human potential and social welfare are too often developed without consulting the human services providers who will be responsible for implementing them, resulting in ineffective and unworkable programs.

- Programs that work well require effective partnerships among the public sector, private funders, and human services providers. Human services providers with decades of experience would be instrumental in designing and implementing programs that more effectively serve New Yorkers and should be involved at the outset of program planning.

- Make certain that New York's transition to Medicaid Managed Care is a win for beneficiaries, taxpayers, and human services providers by ensuring that funding is available to nonprofits for investments in information technology, capacity building and training, metrics tracking, and providing a cushion against related risks.

- Oversight regulations and procedures that fail to catch bad actors are a waste of everyone's time and money and should be replaced with meaningful government oversight approaches that ensure that providers are financially and programmatically responsible.

Problem #2: Government contracts and philanthropic grants rarely cover operating costs and payment is often late and unpredictable, resulting in cash flow obstacles and chronic underfunding.

- Contracts and grants must fully cover indirect costs. Indirect (overhead) expenses like information technology, building maintenance, program evaluation, accounting, human resources, and employee training are vitally important to service delivery. Adequate funding by the public sector and philanthropies of indirect expenses is essential for providers to survive.

- Payments must be timely and reliable so that providers are not left "holding the bag." Contracts must allow for payment escalations to cover inflation and unanticipated expenses that exceed reasonable budget estimates. Contract renewals must accommodate cost increases or allow their surrender if they become unsustainable due to unforeseen circumstances, such as costly, new unfunded mandates.

Problem #3: There is a lack of adequate risk assessment in the sector. Providers must accept responsibility for aggressively identifying, assessing, and addressing risks to their fiscal health and put in place the checks and balances needed to protect themselves and the people they serve.

- Providers must implement financial and programmatic reporting systems that enable them to identify and quantify the financial impact of changes in the operating environment. Private and government funders must underwrite the development of robust financial and performance monitoring systems necessary for long-term sustainability and program quality.

- Provider boards, in conjunction with staff, must be engaged in risk assessment and implement financial and programmatic reporting systems that enable them to better predict, quantify, understand, and respond appropriately to financial, operational, and administrative risks. Private and government funders should help build their capacity to do so by facilitating access by nonprofit staff and board members to professional development, technical assistance, and coaching.

- The human services sector must establish an RFP rating system and government agency performance survey to illuminate the risks associated with individual government proposals and highlight problematic government agency policies and practices. Providers can start to level the procurement playing field by collaborating to evaluate government performance.

PROGRAM COLLABORATION

## RECOMMENDATIONS FOR CREATING A ROBUST HUMAN SERVICES SYSTEM

**Problem #1: Programs intended to build human potential and social welfare are too often developed without consulting the human services providers who will be responsible for implementing them, resulting in ineffective and unworkable programs.**

Most human services providers in New York have worked for decades to maintain the wellbeing and health of their communities. Some have histories dating back centuries. They are relied on and trusted by the individuals they serve and are expert in needs assessment, program development, and administration. This expertise uniquely qualifies them to diagnose issues affecting their communities and prescribe workable solutions.

Although the State's economy has grown in recent years, persistent issues remain. For example, as of October 2015, at least 60,000 New Yorkers were homeless, at least 650,000 people suffered from diabetes, and about 35 percent of young adults were unemployed or working at low-wage jobs with no way out. Government and philanthropies fund nonprofits to deliver a myriad of programs from Universal Pre-K to job training programs that meet the needs of employers in growing economic sectors. New York City will provide such services by entering into approximately 5,100 contracts totaling \$4.3 billion during fiscal year 2016.[2] In addition, New York State will make about 2,000 awards to local providers with a total value of at least \$1.5 billion. With about \$300 million more in philanthropic funding, human services funding is estimated to total more than \$6 billion.

The absence of a meaningful dialogue with experienced providers before a concept paper is released has too often led to ineffective programs that waste opportunities to do better—like the chance to give a young adult who left school without a diploma a shot at a good career, or move a family out of shelter and into permanent housing. Individuals who know how to design and staff an effective program are excluded from the program development process.[3] The absence of knowledgeable and experienced professionals too often results in poorly designed, inappropriately evaluated, or underfunded programs that are misaligned with the needs of the populations they are meant to help and resources available.


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*People are not widgets*

One-size-fits-all performance metrics fail to acknowledge that higher need individuals need more services than others. For example, a woman who becomes homeless due to a job loss is likely to be more easily rehoused than a man with lifelong schizophrenia. However, contracts do not allot more funding to providers that serve higher need individuals or vary performance metrics based on who is being served.

*Outcomes are more important than outputs*

Programs often incorporate untested performance metrics and measure irrelevant outputs rather than outcomes. For example, many government contracts pay providers primarily on outputs, called "levels of service,"—such as the number of times they counsel a particular individual or the number of individuals they saw in a day—rather than on what they accomplished. Outcomes should encourage responsive services that meaningfully address the conditions that led to the establishment of the program, and they should reward effectiveness, not volume. Some contracts actively discourage providers from making improvements in how they deliver services and cost effectiveness because any "profit" gained from more efficient service delivery is recouped by government. These shortsighted, output-based design structures combine to hinder the effectiveness of programs.

**The City developed a culinary training program for homeless veterans without understanding that older veterans had physical disabilities that make it impossible for them to stand for the 16-hour days required for work.**

*Rigid contracts undermine the achievement of positive client outcomes*

New York City and State contracts often detail every element of program staffing and service delivery. As a result, providers are constrained from altering services to respond to changing client needs by the threat of financial penalties for breach of contract. For example, one provider reported that after use of the synthetic drug K2 became prevalent in its homeless facilities, individuals became violent and experienced unconsciousness, hallucinations, and other medical conditions. The existing staff lacked the skills to address these new issues, but the organization was prohibited from changing staffing patterns to meet its new demands.

Providers are also penalized for failing to place sufficient numbers of homeless, mentally ill individuals in permanent housing, notwithstanding a number of obstacles that are beyond providers' control, including New York City's notoriously expensive housing market. Moreover, providers report that the population of individuals who do not qualify for governmental rental assistance has surged in homeless facilities, making placement particularly challenging. Nevertheless, New York City will not modify contracts to recognize that these individuals cannot be placed in permanent housing within the time allotted.

**The City's new YouthPathways initiative may become another illustration of the challenges presented by programs designed without provider input before the concept paper. YouthPathways, a new initiative that aims to put 18,000 young adults on a career path, is expected to be launched on July 1, 2016.[4] Although the program appears to be based on a proposal by well-regarded youth services intermediary JobsFirstNYC,[5] JobsFirstNYC was not involved in its design.**

**An ambitious range of services were proposed in a concept paper issued by the City's Human Resources Administration, along with a cumbersome process that the provider community believes will discourage participation. The annual budget for this program is only $11 million to serve 18,000 individuals each year—$ 611 per person—about one-fifth of what those that run youth programs believe they need to adequately provide the specified services. Under the current procedures, it was only at the Council hearing on the concept papers after the comment period closed that the agency could clarify the additional funded services to augment the RFP awards and the process for services. The RFP will be issued shortly, and the program is slated to operate for three years.[6]**

**If individuals experienced at working with young adults who left school without diplomas had been drafted to help design the program, YouthPathways might have been better designed to put young adults on career paths. But barriers based on City procurement rules, and a lack of process to engage the community before developing a concept paper, prevents real collaboration.**

**There is hope, however, as feedback provided through the concept paper process may result in important changes to the design. The YouthPathways program is but one example of a program that would have benefited from earlier collaboration between government and nonprofits.**

PROGRAM COLLABORATION

RECOMMENDATION # 1: Create working partnerships among the public sector, private funders, and human services providers to develop effective programs.

To develop effective programs that maximize human potential and ensure wellbeing, government and philanthropies should start by convening a diverse group of stakeholders to assess need, evaluate the efficacy of existing initiatives and best practices nationally, and agree on a set of goals and a model to achieve them. Collaborations between government representatives, nonprofit organizations, researchers, and private funders would create an environment in which pragmatic reform efforts can be proposed, evaluated, and developed.

To help accomplish this, government should engage its contracted and qualified nonprofit partners in two ways before designing and releasing a new RFP.

Before creating a program, government should survey current contract providers in the appropriate area to understand how those contracts fare in the following areas:

- Are the metrics on the current contract appropriately related to achieving the goals of the program?
- Are the metrics of the current contract being met?
- What supplemental services are providers including in contracted programs to help them achieve success?

Both the City and State have procurement systems that identify prequalified vendors—vendors approved to do business in certain service areas—and should invite all of those providers to submit comments and ideas *before* a concept paper is developed. There is often a public comment period after a concept paper is released, but the time to comment is typically short, and the process can seem *fait accompli* to providers. Government has very real limitations on the time it has to design a program, and it has to make choices regarding from whom and how it can solicit feedback. By more strategically utilizing existing systems that identify qualified providers, government can more openly solicit feedback from those with knowledge in the field, and providers will be more involved in design.

Engaging nonprofits on the “front end” in government-nonprofit-philanthropic collaborations will ensure that the programs they ultimately administer are workable and effective for the individuals they are intended to help, and include:

- Evidence-based metrics aligned to the goals to be achieved;
- Contract payments that reasonably cover the services proposed;
- Incentives that encourage efficiency and service quality improvements;
- Innovative new program models; and
- A post-implementation evaluation process that identifies best practices and applies them to successive efforts.

This process should also be applied to the development of new programs, not just to appraise existing ones. While programs are underway, feedback should be regularly elicited from the selected provider(s) concerning what is working and what is not to shape future iterations. Bringing partners together would be the first step in fixing a costly and wasteful system that more often merely ameliorates social issues rather than curing them.

RECOMMENDATION # 2: Ensure that the State's restructuring of Medicaid is a win for beneficiaries, taxpayers, and human services providers.

In April 2015, the New York State Department of Health (DOH) began a fundamental restructuring of Medicaid intended to improve client care and contain costs. The new approach aims to reduce hospitalizations by 25 percent by revamping the delivery system, and transitioning reimbursement to value-based payments. Primary care will be integrated with behavioral services, including mental health and substance abuse services, and the evolution of the current, largely fee-for-service system to a fully managed care model will be accelerated.[7]

The State recognizes that human services providers can be particularly effective in delivering the broad range of preventive interventions that will help New Yorkers become healthier.[8] However, the program's delivery and payment arrangements make their participation an enormously risky proposition. Major financial investments in information technology for appropriate medical recordkeeping and outcomes tracking, staff training, and new accounting and cash flow management systems, among others, are required. These investments will be recouped only if large health care systems designated as "gatekeepers" by the Health Department make referrals to them[9] and if providers are able to establish that their interventions actually improve expected health outcomes.[10] Those are two big ifs.

Providers are also vulnerable because little or no outcome data are currently available for them to plan their programs,[11] and projected revenue can be impacted by a host of other unknowns, including potential reimbursement amounts, measures of health outcomes, claims processing timeframes, and disallowances—not to mention the added complexity in billing multiple insurance companies, each with its own eligibility rules and processes.

The State and federal government provided more than $7 billion to major health systems in New York State, which will help buffer the financial costs and risks of Medicaid restructuring, but there is no assurance funds will flow downstream to human services providers.

For human services providers to participate successfully, the State must help pay for necessary investments in information technology, capacity building and training, metrics tracking, and accounting systems, and cushion the impact of delays in claims processing on cash flow and the impact of pay-for-outcome financing.

RECOMMENDATION # 3: Oversight approaches that ensure that providers are financially and programmatically responsible should replace ineffective regulations and procedures.

Once nonprofit human services providers enter into a contract with government, they are subject to a plethora of reporting requirements, independent audited financial statements, IRS Form 990 filings, and oversight by federal agencies and the New York State Charities Bureau.[12] The majority of contracts are audited twice a year–first, to make sure that spending has been consistent with the agreement and second, to confirm that the program is delivering the required outcomes. Even one audit per contract per year can impose a significant burden on the many organizations that hold multiple agreements. Many of the regulations and government oversight mechanisms are redundant and seriously constrain a provider’s ability to deliver services effectively.

Multiple audits waste money and time.

The multiple audits conducted by government are probably the mostly costly—both in time and money—oversight requirement. An organization with multiple contracts may undergo as many as 250 audits a year.13 In addition to the staggering costs of multiple annual audits to taxpayers and providers, problems include:

> *Preparation for multiple audits and managing them while they are underway is extremely labor-intensive.* Full-time employees must be assigned to answer the questions of auditors, who are often unfamiliar with the programs they audit. The amount of paperwork and staff time required for these audits can interrupt services, compromising program outcomes and reducing the number of individuals assisted.
>
> *Audits are needlessly duplicative.* Federal law already requires most providers to undergo annual external audits performed by independent CPAs.[14] There is no reason for City and State government auditors to duplicate this work, or each other's.[15]
>
> *Audits are uncoordinated, inconsistent, and randomly scheduled.* There is no consistency in the documentation requested among agencies. For example, only the New York City Department for Youth and Community Development requires that a check number be produced for every expense, creating much additional and unnecessary work. An organization may even be audited simultaneously by different auditors from the same government agency for work performed during different time periods, or for different programs.
>
> Government audits can be conducted many years after a contract has ended. Few contracts contain a statute of limitations for audits. Records may have to be retrieved from archives for audits of ancient contracts, using staff time that would not have been needed had the audit been performed sooner after the contract ended.

The burden of arbitrary, ineffective, and redundant regulations

Arbitrary, ineffective, and redundant regulations also create unnecessary burdens for providers. Although adopted with good intentions, many such regulations require the resubmission of already-collected materials and are ineffective at achieving their objectives, while adversely affecting the ability of nonprofits to carry out their missions and adding substantial costs to their operations.[16]

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### REQUIRING VOLUMINOUS SUBMISSIONS OF SENSITIVE AND USELESS INFORMATION

**In September 2015, the New York City Council held a hearing on legislation that would have required City-funded nonprofit organizations to file voluminous and intrusive disclosures annually that included personal financial information and business interests of all board members and executives. After testimony by HSC established that the submissions were duplicative of information provided to the State (which the City can access), that the requirements would create extreme delays in contract registration, and that it would be costly to implement, the bill was not voted on.**[17]

Providers that spend public funds should be fully and transparently accountable to the public. But the volume of information being captured is so enormous that meaningful governmental review is impossible, in addition to being of dubious benefit. To effectively police the use of public dollars and guard against corruption, disclosure by nonprofit organizations should be streamlined, starting with duplicate audits:

- Government agencies should standardize and consolidate audit requirements to avoid repeated and unnecessary audits, to minimize interruptions in nonprofit program services, and to reduce the cost to taxpayers of multiple audit teams who review the same books and records.
- Where the federal OMB A-133 Single Audit is available, New York City and State should accept it in lieu of their own audits. If additional program information is needed, the OMB Single Audit could be supplemented with program-specific questions, an approach that has been taken by a number of other states, including Connecticut, Alaska, Hawaii, Florida, Louisiana, and New Jersey.18
- The use of risk profiles should be explored to focus limited auditing resources on organizations that need more attention.

But the biggest issue created by the City and State's regulatory and oversight regimes is that government attention focuses too little on what contract spending is intended to achieve—the ability to manage programs and budgets and deliver good outcomes. This laudable goal is virtually ignored.

**Problem #2: Government contracts and philanthropic grants rarely cover operating costs, and payment is often late and unpredictable, resulting in cash flow obstacles and chronic underfunding.**

New York human services providers are mission-driven. Out of dedication to their communities, they perform an ever-widening array of services with ever more costly and burdensome reporting and oversight requirements. But because of chronic underpayment, these expenses are unreimbursed by government contracts. Consequently, the budgets of half of New York City human services providers are either in the red or are just breaking even, with no cash reserves, as illustrated by Table 2 on page 24. Providers cannot re-balance their budgets by reducing the number of individuals served because contracts have set measures, and many find it difficult to surrender contracts that are no longer tenable.

Furthermore, frequent government contract payment delays put providers at risk of eviction and worsen deficits by forcing organizations to borrow to pay rent and salaries. Crumbling facilities and high staff turnover due to low salaries further compromise the quality of service delivery.

**UNDERFUNDING MEANS LOW PAY FOR STAFF**

**There are approximately 108,600 nonprofit human services workers in New York City, excluding workers providing direct health care services.[19] Human services workers are highly educated, with two-thirds having some college education and nearly half holding a bachelor's degree or higher.[20] Half earn less than $15 per hour.[21] These workers increasingly find themselves in the very same position as their clients—in need of social service assistance to provide for their families. More than one-third of New York City's social service workers are eligible for safety net programs, compared to 24 percent of New Yorkers as a whole.[22] Providers would prefer to pay reasonable salaries, but their government contracts do not provide for the escalations that would make that possible.[23]**

RECOMMENDATION # 4: Contracts and grants must fully cover the costs of their administration.

Contract underpayments affect many budget components, but organizations suffer most from underfunding of indirect (overhead) costs. As the administrative caps imposed by Executive Order #38[24] evidence, spending on administrative costs is falsely equated with inefficiency, waste, and corruption, especially for human services programs.[25]

With few exceptions, government and private funders respond by underwriting little to none of the many necessary “indirect” (overhead) costs of running an organization—like paying rent, maintaining facilities, purchasing equipment, fundraising, maintaining insurance, and managing human resources and accounting functions.[26] In addition to these crucial program components, other indirect costs to an organization such as oversight management, risk assessment, and accountability functions are not covered, meaning nonprofits must cobble together funding for basic costs like repairing a roof, and have an even harder time funding new financial systems or program evaluations systems. Underpayment of indirect costs leads to:

- Inadequate and obsolete facilities, equipment, and technology;
- Under-staffed and under-skilled accounting, human resources, and administrative offices that reduce organizational ability to deliver programs, manage and raise funds, document results, and diminish accountability, oversight, and compliance;
- Low staff salaries and safety net reliance, high turnover, and lower quality of services;
- Lack of continuing education and training for staff, also resulting in lower quality of services;
- Lower productivity and substandard physical conditions;
- Fundraising to fill gaps, rather than applying those dollars toward innovation and service improvements;
- Increased financial vulnerability; and
- Organizational failures.[27]

There is growing recognition nationally that shortchanging of indirect expenses is an enormous mistake. In their 2013 “Letter to the Donors of America,” the presidents of the Better Business Bureau (BBB) Wise Giving Alliance, GuideStar, and Charity Navigator urged nonprofits to spend much more on overhead (see Letter to the Donors of America” (June 17, 2013), attached at Appendix B.1). They stated:

**Thus, while the public and private sector fund nonprofit organizations to make a difference in New Yorkers’ lives and communities, they are starving them of the ability to do so effectively.**

> Overhead costs include important investments charities make to improve their work: investments in training, planning, evaluation, and internal systems—as well as their efforts to raise money so they can operate their programs. These expenses allow a charity to sustain itself (the way a family has to pay the electric bill) or to improve itself (the way a family might invest in college tuition).[28]

Some foundations have also begun to acknowledge the threat posed by inadequate indirect rates,[29] and on December 26, 2013, the White House Office of Management and Budget issued guidance and procedures requiring state and local governments, and other entities that pass through federal funds, to reimburse the reasonable indirect costs of nonprofits (the OMB Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards).[30] The federal government has historically paid significantly higher indirect cost rates on grants to providers than the City or State (see, e.g., Letter from Darryl W. Mayes, US Department of Health & Human Services (redacted) (February 10, 2014), attached as Appendix B.2).

Thus far, however, New York City and State contracts are still characterized by egregiously low indirect payment rates. Half of respondents to a 2015 survey reported indirect cost rates of nine percent or less on City contracts.[31] One provider with an actual overhead ratio of nearly 20 percent reported that only one of its three NYC Department for the Aging contracts provided any overhead reimbursement—at a rate of only seven percent. Another organization reported a seven percent overhead rate from the City Department of Health and Mental Hygiene (DOHMH) and *no* payment of indirect costs from the Department of Homeless Services (DHS) (see DHS Human Service Providers Annual Review Instructions (rev'd 4/14), attached as Appendix B.3). And the City Department of Youth and Community Development stunningly admitted that, although a provider's indirect cost rate was calculated at 18.84 percent, "Department policy is to grant a maximum indirect cost rate of 10 percent" (see September 20, 2013 (redacted) attached as Appendix B.4).

**A vicious cycle is leaving nonprofits so hungry for decent infrastructure that they can barely function as organizations — let alone serve their beneficiaries.**

**-2010 US Government Accountability Office report[32]**

Overhead rates in New York State contracts are equally shameful. A New York State Education Department contract reportedly has an indirect rate of merely 2.6 percent, and more than half of survey respondents reported State rates of less than ten percent,[33] although federal rates ranged from 16.9 percent to 23 percent.

*Table 1: Representative indirect cost payment rates in NYC and NYS contracts - 2013*

| Funder | Program | Indirect Rate |
|---|---|---|
| NYC Administration for Children's Services | EarlyLearn NYC | 0% |
| NYC Department of Education | Universal Pre-K | 0% |
| NYC Department of Health and Mental Hygiene | Adolescent Employment and Education Program (AEEP) | 2.3% |
| NYC Department of Homeless Services | Shelters | 8.5% |
| NYC Human Resources Administration | Work Progress Program | 0% |
| NYS Education Department | Community School Grant Initiatives | 2.6% |
| NYS Education Department | Extended Day School | 2.6% |
| NYS Education Department | GED Program | 2.7% |
| NYS Office for People with Developmental Disabilities | Family Support | 9% |

Source: Responses by HSC members to email inquiry (2014)

Low indirect cost rates on public human services contracts are especially crippling because government funding accounts for at least 80 percent of provider revenue.[34] The budget shortfalls created by chronic underfunding are unlikely to be filled by private funders, as only 8.3 percent of the average provider's revenue comes from private foundations or donors, and many of these also set their indirect cost rates as low as 10 percent to 15 percent, if they provide any indirect funding.[35]

## UNDERINVESTMENT IN INFRASTRUCTURE LEADS TO UNSAFE CONDITIONS

**Narrow administrative margins and increasing operating costs mean something has to give, and the first to go is usually infrastructure investment. Building repairs and technological upgrades are postponed so roofs leak and desktop computers date to the last century. Buildings remain inaccessible to individuals with disabilities. Furnishings are threadbare.**

Infrastructure issues are especially serious for organizations that house homeless individuals. In 2015, the New York City Comptroller refused to register dozens of contracts with nonprofit organizations sheltering thousands of homeless people after alleging that housing conditions were unsafe. The executive director of Barrier Free Living reported that:

> Since 1991, we have had an 8.5 percent overhead rate on our contract with the Department of Homeless Services (DHS) that covers less than half the cost of administrative overhead. We were not allowed to have capital reserves in our budget, but DHS has denied almost all of our requests for capital funding for repairs since we own our own building. We now need $4.4 million in capital funding to keep our building viable.

The excessive focus on limiting indirect costs, without considering its harm to organizational performance, suggests that saving money may be more important than achieving meaningful results.

*Unfunded mandates*

During the course of government-funded contracts, compliance with new statutory and regulatory changes is often required of nonprofits. Two recent examples from New York City include a mandate that voter registration applications be made available whenever an application for a City service is filed and that foster care agencies train new staff to provide a culturally competent environment that is welcoming and inclusive of LGBTQ youth and adults.

**THE UNMET COST OF THERAPEUTIC CRISIS INTERVENTION TRAINING**

**Nonprofits operating Children's Community Residences and residential treatment facilities are now required to provide their staff with Therapeutic Crisis Intervention Training. New staff are required to undergo four days of training, and existing staff must take a full-day refresher every six months. One organization quantified the cost for training and staff time for 50 new hires and 261 existing staff at $155,510 per year.**

The aims of these initiatives are commendable but, because they were unanticipated, the cost of compliance, which can be significant, is not covered by contracts. For example, a recent mandate to provide staff training in therapeutic crisis intervention was estimated to add more than $155,000 to the budget of one nonprofit. The financial burden inflicted by unfunded mandates is magnified for organizations that administer multiple contracts with different government agencies.[36]

**WORTHY PURPOSE BUT, NONETHELESS, A BUDGET-BREAKER**

**To protect individuals with special needs from abuse or injury, a new State agency, the New York State Justice Center, now investigates every incident reported in State-operated, certified or licensed facilities and programs. Providers must report every significant incident, even if no harm was found. When an abuse or injury report is made, the organization in charge must document the facts, conduct interviews, respond to allegations, attend hearings, and develop corrective action plans. The accused staff person is put on paid administrative leave until the investigation is completed.**

**From January through November 2015, the Justice Center indicated 33 percent of reports were investigated.[37] Although only 2.7 percent of reports made in 2014 were substantiated, the cost to respond to them was substantial and unreimbursed by State contracts.[38] One organization reported that 14 individuals were on paid leave for periods of up to 27 weeks (108 person-weeks) until they were cleared by investigators, and that investigations had been ongoing with respect to another 12 employees for as long as 33 weeks (151 person weeks). The organization had to hire the equivalent of five full-time substitutes for one year while their permanent employees were on paid leave. Another organization estimated the annual cost of compliance at nearly $100,000.**

## *Cost Escalations*

Human services providers are not immunized against rent increases and spiraling health insurance premiums but automatic contract renewals do not compensate for them, for compliance with unfunded mandates, or for any other increased expense. The nonprofit health care provider, Public Health Solutions, reports, for example, that in the five years since it executed a major government contract, the expense of medical insurance premiums climbed by 16 percent, liability and other business insurance costs rose by 32 percent, and rent increased by 17 percent, but contract renewals reflected no increase in payments.

Contracts with government agencies therefore become more unaffordable every year, but relief is not possible because the contract often cannot be amended or surrendered. For example, when Turning Point Brooklyn, a supportive housing provider, tried to surrender a losing contract, the Department of Health demanded that it identify another provider to assume it, a difficult task given the financial terms of the agreement.[39]

**TRAPPED: NO WAY OUT OF AN UNAFFORDABLE CONTRACT**

**Turning Point Brooklyn has two contracts to provide supportive housing, social services, and money management education to homeless men and women with severe mental illness, with a term running until spring 2016, but low payments make it impossible to perform. One-bedroom or studio apartments in Brooklyn's overheated real estate market rent for a monthly average of $1,400, which exceeds the budgeted amount, and qualified staff are unwilling to work at the salaries permitted by the contract. The organization's consequential understaffing led to a citing by the Health Department for case management and inspection deficiencies, and delays in contract payments led to scores of eviction proceedings.**

**Turning Point's executive director saw no way out of her plight but to give up the two supportive housing contracts, which the City had automatically renewed without increases to cover higher rents and staff costs. She tried to return the contracts in spring 2015, but the Health Department insisted that she find a substitute agency first.**

**Turning Point Brooklyn is not the only organization in this position. At least a half-dozen supportive housing providers like Turning Point Brooklyn have been cited in the past few years for deficiencies, all arising from similar circumstances.**

Across-the-board cuts permitted by government contracts can also wreak havoc with provider budgets. For example, cuts in New York City's budget reduced contract payments by $114 million in City Fiscal Year 2012 and $60 million in 2013, with programs for youth and families taking the hardest hit.[40] After such cuts, rent must still be paid on leased space, even if the sites are closed, and layoffs become unavoidable.

For human services providers to maintain quality services, major changes in philanthropic and public contracting, and payment policies are necessary:

*Contracts and grants must reflect actual indirect expenses.* The respected BBB Wise Giving Alliance has recommended that at least 65 percent of an organizational budget be devoted to program costs, including indirect costs.[41] Funding at this level would reduce staff turnover and enable organizations to make necessary investments in infrastructure, training, and accounting systems.

*Contract renewals must accommodate cost escalations, including costs associated with legislative and policy changes.* If a contract is premised on specific costs that increase during the contract term, then subsequent renewals must either accommodate the increased expense, or permit surrender of the contract. Underfunded nonprofits cannot be expected to make up the difference.

RECOMMENDATION # 5: Timely and reliable payments by government.

Given the outsourcing of so many social services by government, New York human services providers are predominately funded with public dollars. *Nearly every* respondent to the September 2015 HSC survey reported receiving payments from government contracts and grants,[42] and, as noted, this funding represented about 80 percent of provider budgets. By contrast, revenue from foundation and corporate grants constituted a comparatively small seven percent share.

The dominance of government funding puts human services providers at financial risk and operational uncertainty because payments are often made very late. Respondents to a 2015 survey reported that 34 percent of City contract payments and 25 percent of State grant payments were received *more than 90 days late*. The State and City paid only 25 percent and 20 percent of their respective bills on time.[43] Because organizations lack cash reserves, wildly uneven payments on performance-based contracts also make it difficult to budget and pay personnel and operating expenses, which do not shrink in the months when payments dip.

*Registration delays imperil nonprofit organizations*

Late payments often result from delays in contract registration. According to the Office of the State Comptroller, State agencies in 2014 were late more than 77 percent of the time in approving contracts with nonprofit organizations, with 3,568 of 4,630 contracts approved late.[44] The Comptroller reported that 70 percent of nonprofit contracts were approved late on average during the last two decades. New York City also has a record of late contract registrations.

Registration delays can be financially ruinous, as services are expected to begin on the first day of a contract, even if the contract has not yet been registered by the relevant agency. Nonprofits therefore incur substantial costs for service delivery before they have a legal right to be paid and are often forced to borrow to meet payroll.[45] Interest payments on such borrowings are not reimbursable, except in rare cases, and must therefore be paid from reserves already stretched to the breaking point. And that assumes that an organization is able to find a willing lender.

**GOING BROKE FROM BROKEN PROMISES**

**In summer 2014, the State awarded Solutions to End Homelessness Program (STEHP) grants, with services to start October 1, 2014, but the agency did not execute the contract of at least one grantee until late February 2015, nearly five months into the one-year contract term.**

**City agencies can be equally irresponsible in their conduct. For example, in March 2015, providers of DYCD Middle School Expansion services were notified of grant awards for summer services. Because it was nearly summer, they immediately began assembling staff and space. But awards were abruptly retracted in May. Parents had registered their children by this time and providers and parents were unsure what programs would operate, if at all. Awards were reinstated in June, giving providers mere weeks to launch services to tens of thousands of children. But contract modifications were not registered until mid-August, thereby forcing 100 providers to front all the money during the entire summer for their programs.**

Given their often precarious financial conditions, compelling most nonprofits to borrow to pay for space, furnishings, technology, reporting systems, and other expenses necessary for new government-sponsored programs is unconscionable. New York City and State should instead provide contract advances that cover reasonable start-up costs, as many federal contracts do.

Once contracts are underway, providers must be able to count on equal monthly contract payments to meet payroll and operating costs, as the State of New Jersey provides. This would allow them to reliably budget and be confident in their ability to pay workers and meet operating costs. At the end of the contract term, an audit can determine whether excessive payments were made and ensure that overpayments are recaptured.

**Problem #3: There is a lack of adequate risk assessment in the sector. Providers must accept responsibility for aggressively identifying, assessing, and addressing risks to their fiscal health and put in place the checks and balances needed to protect themselves and the people they serve.**

A significant number of New York human services providers are in financial distress. These organizations are running deficits or are barely breaking even with little to no cash reserves. The loss of a major contract or a bad bet on Medicaid Managed Care could easily send them over the precipice and deprive hundreds of individuals, if not thousands, of services on which they depend.

But because of weak internal financial and programmatic reporting, providers may not be alerted to short-term and long-term fiscal dangers early enough to effectively address them. Moreover, inadequate funding of indirect expenses has left most organizations without the resources needed to upgrade financial and programmatic reporting systems and to train staff in effective oversight practices.

*Human Services Providers Are in Serious Financial Trouble*

A significant number of New York City's human services providers are financially distressed. Nearly one out of five was insolvent[46] in 2013, and 30 percent had only two months or less of operating reserves. The budgets of half showed losses between 2010 and 2013, even after they implemented a wide range of measures to reduce outlays. For example, a 2012 Urban Institute survey of New York State nonprofits with government contracts or grants found that in the prior year:

- 49 percent froze or reduced employee salaries;
- 43 percent drew on reserves;
- 27 percent reduced their employee headcount;
- 14 percent reduced the number of programs or services offered;
- 13 percent reduced the number of people they served;
- 11 percent borrowed funds or increased lines of credit; and
- 7 to 10 percent reduced health, retirement, or other staff benefits.[47]

These organizations have no margin in the event of funding cutbacks or emergencies, and recent data suggest that their financial woes are worsening—27 percent of respondents to the 2015 Nonprofit Finance Fund (NFF) survey reported operating deficits of five to 25 percent for fiscal year 2014.[48]



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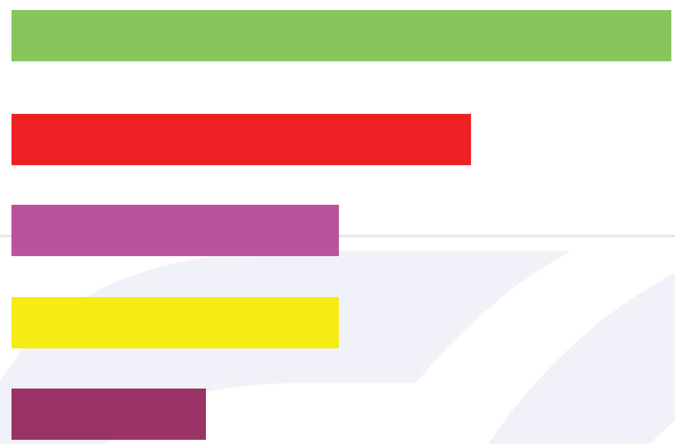
Sixty percent of respondents to the 2015 HSC provider survey reported that their organizations had less than three months of unrestricted operating reserves, and one-quarter reported less than one month of reserves. As indicated below, nearly 75 percent also reported that either they had no line of credit, or their credit line equaled one month of expenses or less; only one provider out of ten reported a line of credit that covered three months of expenses or more.[49]

**27 percent of New York City human services providers had an operating deficit in fiscal year 2014**

**How many expenses can you cover with your line of credit?**

| Response: | Count: | |
|---|---|---|
| **We do not have a line of credit** | 20 | 33.3% |
| **Less than 1 month** | 14 | 23.3% |
| **1 month** | 10 | 16.7% |
| **2 months** | 10 | 16.7% |
| **3 months or more** | 6 | 10.0% |
| | Total: 60 | |



Source: 2015 HSC Provider Survey

Many large organizations, with budgets in the tens of millions serving hundreds or even thousands of individuals, are technically insolvent, and an even larger share are on a financial knife-edge—either in the red or barely breaking even, with no cash reserves. And that doesn't even account for much smaller organizations, whose disappearance would be equally catastrophic to the people they serve, although less likely to generate headlines (see Table 2, below).[50]

**Table 2: Insolvent health and human services nonprofits by budget size - 2013**

| | |
|---|---|
| All HHS | 18% |
| Less than $1 million | 14% |
| $1 million up to $5 million | 24% |
| $5 million up to $10 million | 16% |
| $10 million up to $50 million | 19% |

Source: Analysis by SeaChange Capital Partners and Oliver Wyman based on data provided by GuideStar.

RECOMMENDATION # 6: Provide funding and technical assistance to enable human services providers to implement comprehensive internal financial and programmatic reporting systems.

With so many human services providers struggling to survive, comprehensive and coherent financial and programmatic reporting is essential for them to:

- Fully understand program costs and available financial resources;
- Recognize short-term and long-term financial dangers;
- Track program outcomes and ensure that they adhere to contract metrics;
- Strategically deploy resources;
- Anticipate and respond quickly to funding delays or cutbacks; and
- Plan investments in management and support functions and critical infrastructure.

The financial and programmatic reporting of many human services providers falls short of meeting these demands. A substantial number of service providers report financial information less frequently than is optimal and fail to provide their board members and program staff with critical financial information, such as balance sheets.[51] Unfortunately, inadequate funding of indirect costs has prevented many providers from investing in updated financial systems and constrained them from developing effective financial, reporting, and oversight systems.

Private and government funders must underwrite the development of the robust financial and performance monitoring systems necessary for long-term sustainability and program quality. This support would enable providers to track key performance indicators tailored to their organizational structure, review “dashboards” showing financial and programmatic performance and purchase the software needed to generate financial reports and monitor performance (see Standards of Excellence in Nonprofit Financial Management, Fiscal Management Associates (FMA) (December 2015), attached as Appendix C.2).

Key performance indicators (KPIs) and dashboards should be distributed to organizational decision makers on the staff and the board, and issued frequently enough to timely alert them to significant changes in the operating environment. A robust set of KPIs were developed by the Commission’s Financial Conditions Committee.

(See, Standards for Nonprofit Financial Reporting (December 2015), attached as Appendix C.3. Budgets should have sufficient specificity to facilitate financial monitoring and should employ a cost allocation methodology that aligns service needs and funder requirements.)

RECOMMENDATION # 7: Provider boards, in conjunction with staff, must be engaged in risk assessment and implement financial and programmatic reporting systems that enable them to better predict, quantify, understand, and respond appropriately to financial, operational, and administrative risks. Private and government funders should help build their capacity to do so by facilitating access by nonprofit staff and board members to professional development, technical assistance, and coaching.

Managing a human services organization in 2016 is among the most challenging jobs in New York. Perpetually trying to make do with less is obviously daunting, but even more demanding is the constant struggle to anticipate and overcome looming and unpredictable risks that could fatally damage the organization. These risks are wide-ranging and include:

- Elimination of government programs, or major budget cuts;
- Leased space that is no longer needed or becomes unaffordable due to government budget cuts;
- Performance-based contracts with unrealistic metrics, third party payments, and reimbursements made at less than the vouchered amount, despite conditions outside the provider’s control; and
- Facility maintenance and repair emergencies.

Organizations can also be imperiled by new programs if their contract costs are not fully covered, performance metrics are unrealistic and unachievable, staffing and infrastructure are insufficient for programmatic demands, or if the program could harm its reputation. Changes in their operating environment—such as a recession, legislative requirements, or a gentrifying neighborhood —can also undermine organizations if they have not anticipated and assessed the potential impacts and developed plans that address them.

Providers rarely engage in that kind of scenario or strategic planning. More than 60 percent of respondents to the September 2015 HSC survey reported that they budgeted for no longer than one year, and only 43 percent engaged in scenario planning. Without a mechanism to forecast and plan, human services providers can be blindsided by new needs and changing circumstances.

Risk management and long-term planning, while managing complex organizations with multiple sources of restricted revenue, particularly while operating in an emergency management mode, require specialized skills that are difficult to master with only on-the-job training. It also depends on inclusive management and accountability that imposes broader responsibility for identification of risk factors and oversight among the staff and board. Unfortunately, technical assistance and training to build the capacity of executives and their staffs to meet these challenges is largely unavailable.

**REAL ESTATE RISKS:**

**As commercial rents increase, human services providers are at risk of losing leases. Two-thirds of the office space occupied by the human services providers surveyed by HSC is leased, but fewer than half the organizations surveyed by HSC had staff knowledgeable about real estate leasing.[52]**

Human services provider boards of directors are charged with ensuring that policies and procedures are adequate to protect organizational assets, financial reporting is reliable, laws and regulations are complied with, and effective and efficient operations are achieved.53 The Charities Bureau of the New York State Department of Law has stepped up scrutiny of nonprofit board oversight. Boards that neglect, fail to perform, or otherwise do not meet their responsibilities for the management and disposition of corporate assets could be held liable.54 But board members rarely receive the nuanced training needed to discharge these oversight responsibilities appropriately with ever more complex government contracts and program design.

The lack of resources for staff and board capacity building stymies the implementation of systems needed to assess potential operational and institutional risk. To make sure that vitally needed providers are around for the "long haul," government and the philanthropic community must help them to build sound financial management and oversight capacity and adopt robust risk management systems.

*Capacity building*

Private and government funders should help build provider capacity by facilitating access by staff and board embers to professional development, technical assistance and coaching by nonprofit support organizations and other sources. Areas that need particular attention include:

- Management of assets and liabilities and help with non-operational budget issues;
- Training on usage of financial reports, as well as monitoring and communication of financial performance;
- Data management and reporting systems;
- Risk assessment;
- Legal compliance;
- Strategic planning; and
- Real estate planning.

Providers also need more support in developing sectoral and cross-sectoral peer-to-peer networks to facilitate the safe sharing of information and encourage joint advocacy efforts by nonprofit leaders.

*Make risk assessment a dedicated staff function.* Human services providers should systematize risk assessment to identify and quantify the impact of operating environment changes, including the financial and administrative consequences of scenarios requiring scaling back or closing programs, and ensure that new contracts are sufficiently funded, programs are consistent with the provider's mission or otherwise advantageous to undertake, performance metrics are realistic and achievable, and existing staff and infrastructure are sufficient to fulfill contract demands.

*Make risk assessment a function of the board.* Human services providers should systematize risk assessment not only at the staff level, but also at the board level.

RECOMMENDATION #8: Human services providers must affirmatively identify risks to their survival and collectively act to address them.

Many of the issues outlined in this report arise from a procurement system in which nonprofits have little or no leverage to shape the terms of their contracts. The amounts they are paid, the timing of payments, and conditions that may affect them are generally dictated to providers by contracting governmental agencies and are rarely negotiable.

Human services providers transact business with agencies individually and do not systematically share procurement-related information among themselves. Their bargaining power is further weakened by their commitment to serve as many people as possible, even when it means entering into money-losing contracts for deeply flawed programs. Providers are further disadvantaged by their lack of awareness of both the cost to administer new programs and the government agency-specific policies that may create obstacles to payment.

The establishment of an objective RFP (Request for Proposal) Rating System and Government Agency Performance Survey would help even the playing field by enabling providers to make informed decisions and incentivizing government agencies to be more responsive to them.

The RFP Rating System would evaluate the potential financial risks and programmatic issues of new government initiatives and circulate ratings and findings concerning their feasibility. This information would enable providers and boards to make informed determinations as to whether a program is in the best interests of the organization and its clients, or represent a potential liability.

The Government Agency Performance Survey would empower providers by alerting them to issues commonly encountered when organizations contract with specific government agencies. To prepare the performance survey, nonprofits would be asked to rate the practices of government agencies with which they contract and to compare performance across agencies concerning:

- Contract procurement timeframes;
- Contract registration and payments;
- Client data reporting systems;
- Adequacy of indirect cost rates;
- Relevancy of performance metrics; and
- Overall staff helpfulness and knowledge.

Provider responses would be aggregated in an annual report card similar to the annual State of the Subways ratings issued by NYPIRG's Straphangers Campaign.[55] Just as the State of the Subways report card lifted a curtain on the relatively dismal performance of certain transit lines and prompted their improvement, the Commission hopes to spur reform of agency contracting practices by spotlighting disparities in contract registration timeframes, inequitable overhead payments, unhelpful staff, and other issues.

An RFP rating system and government agency performance survey would also empower the sector as a whole. Strong information that identifies problematic agencies and proposals will arm groups like HSC with information they can use to educate and mobilize their members and networks, and buttress advocacy for fairer procurement practices and systemic change.

**WHAT HAPPENS WHEN A PROVIDER STUMBLES AND FALLS?**

**After operating for more than 80 years, Federated Employment and Guidance Service (FEGS), filed for bankruptcy in March 2015. With annual revenue in excess of $250 million, FEGS was one of the largest human services providers in the New York metropolitan area. In addition to hundreds of creditors left unpaid, approximately 1,900 people lost their jobs and 120,000 individuals in 350 behavioral health, disabilities, housing, homecare, and other program locations were in danger of losing services. Many affected individuals were highly vulnerable. For example, FEGS provided residential care and support for about 4,000 individuals with developmental disabilities and complex physical and psychological needs, and psychiatric rehabilitation and outpatient mental health services to another 23,000 individuals with serious mental illness.**

**The closing of FEGS was also disruptive to the two State and three City agencies that rushed to transfer its programs to other providers after it became clear that the organization was failing. In addition, FEGS left more than $15 million in outstanding balances on mortgages financed by public authorities for the construction, rehabilitation, and furnishing of facilities and carried more than $21 million in State and City advances on its books.**

**Even its banks did not emerge unscathed. At the time of its closing, the organization owed more than $6 million to JPMorgan Chase and Bank of America on loans to upgrade telephone and information technology systems.**

**While the magnitude of FEGS' collapse is unique, the circumstances contributing to its closing are all too common among undercapitalized human services organizations. For example, revenues fell at FEGS while the cost of salaries and benefits increased. Several large contracts were discontinued. An outdated financial management system led to delays and losses in billing and cash collection. And FEGS entered into unprofitable agreements with losses worsened by a failure to create adequate reserves and plan for higher administrative overhead costs.**

# CONCLUSION

It is hard to exaggerate the importance of New York's human services sector. It touches the lives of nearly three million children and adults each year, be it through a pre-school or after-school program, Meals-on-Wheels, job training for a construction career, emergency services after a fire or flood, or any of a thousand other ways. Human services providers make the difference between poverty and sustainable income, joblessness and employment, and illness and wellness for countless individuals and families.

HSC created the Commission and this report to bring desperately needed attention to the looming crisis our sector is facing. We must act not because nonprofits themselves should survive, but because the programs we deliver are a critical component to prosperity, working in conjunction with health and education systems to ensure overall wellbeing. While the sector was able to work diligently to absorb and continue the nearly $230 million in programs that would have shuttered when FEGS closed its doors, there are a finite number of organizations and resources to absorb another closure, and more organizations will go out of business if we do not change course.

We have offered these recommendations as a way forward, but need the engagement of others if they are to advance. We call on leaders in the business, education, and health care sectors to endorse these ideas, and ask our philanthropic partners to lead by example by adopting many of the recommendations we have outlined. Government, of course, is the most significant driver and will need to make a re-envisioned approach to the nonprofit human services partnership a priority in order to turn the tide of this weakening system.

But nonprofit human services organizations and their boards must also come to the table, acknowledging their shortcomings. We cannot continue to take on endless government contracts that do not pay the real costs of service, nor should we. We as a sector are responsible to communities first and must look more critically at the contractual or other arrangements we agree to with an eye toward how they impact our ability to achieve meaningful outcomes. If contracts and grants do not pay adequate rates or involve significant hurdles such as unfunded mandates or unjustified metrics, the programs cannot be as effective as they could be, and for too long

# CONCLUSION

nonprofits have filled the gap. Now, the gap is too large. Providers have to say no, not only to shed light on funding issues, but because these chronic issues eat away at the fabric of the human services delivery system.

A bright future for human services is possible, but we need the collective will to make the necessary changes. We have provided a roadmap and invite input. This is a first step toward a new approach to human services. We urge all stakeholders to join us in making these changes reality.

# ENDNOTES

[1] Number determined by taking the budget of FEGS and the number of people served, then applying the per unit cost ($2,000 per person) to the $5 billion human services budget.

[2] Analysis of the NYC FY 2016 adopted budget by James Parrott, Fiscal Policy Institute 2015.

[3] By design, the competitive procurement process excludes knowledgeable and experienced providers because they are considered potential "competitors." They are therefore not included in governmental planning and problem solving processes. Instead, their input is generally solely sought on the "back end" with an invitation to comment on a concept paper describing a program already scheduled for imminent release. There is often a public comment period after a concept paper is released, but the comment period is typically short and the process can seem like a fait accompli to providers. Government has very real limitations on the amount of time it has to design a program, and has to make choices regarding from whom and how it can solicit feedback.

[4] See YouthPathways concept paper, available at http://www1.nyc.gov/assets/hra/downloads/pdf/contracts/concept_papers/2015/july/HRA_YouthPathways_Concept_Paper.pdf

[5] Unleashing the Economic Power of the 35 Percent, Margaret P. Stix, JobsFirstNYC (July 2014).

[6] See YouthPathways concept paper, available at http://www1.nyc.gov/assets/hra/downloads/pdf/contracts/concept_papers/2015/july/HRA_YouthPathways_Concept_Paper.pdf

[7] Referred to as the Delivery System Reform Incentive Payment (DSRIP) Program, DSRIP is intended to integrate primary care and behavioral health services (including mental health and substance abuse services) which is believed to result in reduced health care costs. At the end of the five years, 80 to 90 percent of Medicaid payments are expected to flow through a value-based arrangement tying spending to outcomes. DSRIP Update, Peggy Chan, Office of Health Insurance Programs, NYS Department of Health (DSRIP Update).

[8] "Community-based groups have uncertain role in Medicaid reform," Dan Goldberg, Politico.com (September 28, 2015), available at http://www.capitalnewyork.com/article/albany/2015/09/8577329/community-based-groups-have-uncertain-role-medicaid-reform

[9] Eleven New York City health care systems have been designated as Performing Provider Systems (PPSs) by DOH and are charged with implementing the new managed care system. PPSs can select partners from among hundreds of organizations, or can deliver services through their own subsidiaries. Human services providers could make large infrastructure investments "on spec" and not be selected.

[10] Interventions identified as effective by DOH include measures relating to economic stability; education; health and healthcare; social, family, and community; and neighborhood and the environment. Research has consistently demonstrated that only about 20 percent of population healthcare outcomes are attributable to direct service delivery while the remaining 80 percent are governed by social circumstances such as these. DOH is allocating up to $6.42 billion for Value Based Payments (VBPs) based upon achieving predefined results in system transformation, clinical management, and population. See DSRIP Frequently Asked Questions (FAQs): New York's MRT Waiver Amendment Delivery System Reform Incentive Payment (DSRIP) Program available at https://www.health.ny.gov/health_care/medicaid/redesign/docs/dsrip_faq.pdf

[11] Analysis at the micro level is ushering in an understanding of the impact of nutrition, health care literacy, exercise, and community support on population health, but it is far from categorical as yet.

# ENDNOTES

[12] The prequalification process in HHS Accelerator has drastically reduced paperwork and redundancy. However, additional New York City reporting requirements include VENDEX and questionnaires. (http://www1.nyc.gov/site/mocs/resources/forms.page)

[13] The City of New York is centralizing audit management and performance to reduce audits. Nonprofit organizations may soon also be able to substitute federal audits to satisfy local requirements.

[14] An entity expending $750,000 or more of federal funding assistance is required to undergo a rigorous, annual organization-wide audit of its operations by a public audit firm/certified public accountant which includes financial statement presentation, compliance issues, and managerial controls, known as the OMB A-133 audit, or Single Audit. Single Audit Act of 1984, P.L. 98-502, and the Single Audit Act Amendments of 1996, P.L. 104-156. The OMB Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards updated these requirements in 2014. This guidance is available at https://www.federalregister.gov/articles/2013/12/26/2013-30465/uniform-administrative-requirements-cost-principles-and-audit-requirements-for-federal-awards

[15] For example, City financial auditors check invoices against expense reports to confirm spending, as do desk (program) auditors.

[16] Nonprofit organizations that operate in New York City are subject to numerous reporting and approval requirements, including VENDEX questionnaires; the prequalification process in HHS Accelerator; program and fiscal audit on every City contract; independent audited financial statements or OMB Circular A-133; the IRS Form 990; program and budget approval by the City; and oversight by federal agencies and the State Charities Bureau.

[17] Intro 288-A was introduced in the City Council following highly-publicized reports that the former Chief Executive Officer and Chief Operating Officer of the Queens Borough Public Library (QBPL) used their QBPL credit cards for more than $310,000 in prohibited expenses and that the CEO had also failed to report outside business income.

[18] See, e.g., Compliance Supplement to State Single Audit Act for Fiscal Years Beginning On or About July 1, 2014, State of Connecticut, Office of Policy Management (May 2015), available at http://www.ct.gov/opm/lib/opm/2015_Official_Compliance_Supplement_5-21-15_-_Copy.pdf

[19] Analysis by James Parrott, Fiscal Policy Institute (FPI), 2015. The number of workers and their earnings is based on FPI's analysis of the 2010-2014 American Community Survey, expressed in 2014 dollars.

[20] Id.

[21] Id.

[22] Id.

[23] During the writing of this report, New York City Mayor Bill de Blasio announced plans to support a minimum wage increase to $15 per hour for nonprofit human services contracted workers. Discussions at the State level are ongoing regarding the funding of an increase for State funded human services contracts, but no commitment has been made.

[24] Executive Order #38 established that annual administrative expenses could not exceed 20 percent of the organization's budget during SFY 2015; or 15 percent of budgets going forward for nonprofits receiving State funds and State-authorized payments are required to establish that (Executive Order #38). Compliance requires extensive documentation, adding to already excessive administrative and financial reporting. And it unfairly subjects nonprofits to absurdly low limits on overhead that for-profit entities are exempt from, although they too use public dollars. See Executive Order #38 Provider Guidance, available at http://executiveorder38.ny.gov/content/guidance.

# ENDNOTES

[25] A survey by the BBB Wise Giving Alliance found that 62 percent of Americans believed that nonprofit organizations spent too much on indirect costs and that over half felt that nonprofit organizations should have overhead rates of 20 percent or less. See http://overheadmythcom.b.presscdn.com/wp-content/uploads/2013/06/GS_OverheadMyth_Ltr_ONLINE.pdf . However, indirect rates of nonprofits that serve other populations are usually unquestioned. For example, Harvard University is said to have an indirect cost rate of 68 percent. http://blueavocado.org/content/board-members-guide-nonprofit-overhead.

[26] Indirect expenses can include accounting and legal expenses, administrative salaries, office furnishings, rent, repairs and maintenance, information technology and telephone systems, insurance and utilities (also referred to as "overhead"). Indirect costs are defined as costs that “have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective.” See Cost Principles for Non-Profit Organizations (OMB Circular A-122), at 2 CFR Part 230.

[27] Jan Masaoka, Nonprofit Overhead Project, “How inordinately low overhead hurts nonprofits, foundations, and communities,” available at http://calnonprofits.org/overhead/about-the-nonprofit-overhead-project/how-inordinately-low.

[28] The BBB Wise Giving Alliance evaluates and reports on charities and promotes high standards of conduct among organizations that solicit contributions from the public. GuideStar gathers and disseminates information about every IRS-registered nonprofit organization. Charity Navigator is largest nonprofit evaluator with professional analysts that examine tens of thousands of non-profit financial documents annually to produce a rating system for donors.

[29] For example, Ford Foundation’s influential president, Darren Walker, vowed that Ford will double the indirect rates paid to grantees and committed the foundation to a dialogue with grantees about the real costs of running programs “What’s next for the Ford Foundation?” Darren Walker, President (June 11, 2015), available at http://www.fordfoundation.org/equals-change/post/ whats-next-for-the-ford-foundation. See also http://www.insidephilanthropy.com/home/2014/11/20/control-why-so-many-funders-fear-general-support-and-cant-st.html.

[30] See Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (OMB Uniform Guidance) (December 26, 2013), available at https://www.federalregister.gov/articles/2013/12/26/2013-30465/uniform-administrative-requirements-cost-principles-and-audit-requirements-for-federal-awards. The OMB Uniform Guidance explicitly requires applying the nonprofit’s federally negotiated indirect cost rate, if one already exists. If a negotiated rate does not yet exist, then nonprofits are empowered either to request negotiating a rate or to elect the default rate of 10 percent of their modified total direct costs.

[31] State of the Nonprofit Sector 2015, Nonprofit Finance Fund (NFF), available at http://survey.nonprofitfinancefund.org/?filter=state:NY%7Corg_type:Human%20Services (2015 NFF Survey). For the purposes of this report, NFF’s survey data was filtered to retrieve data only for the 76 New York State-based human services provider respondents.

[32] US Government Accountability Office, Treatment and Reimbursement of Indirect Costs Vary Among Grants and Depend Significantly on Federal, State, and Local Government Practices, GAO-10-477, May 2010.

[33] See 2015 NFF Survey at http://survey.nonprofitfinancefund.org/?filter=state:NY%7Corg_type:Human%20Services.

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[34] Between August and September 2015, HSC conducted a detailed survey of budgeting, financial practices, board engagement, and various challenges faced by New York City human services providers (2015 HSC Provider Survey). Commission and Committee members participated in development of the survey and survey responses informed the recommendations herein for a sustainable delivery system. Representatives of 60 providers responded, with budgets that ranged from under $1 million to over $25 million. Some providers were contacted for follow-up interviews by members. The 2015 HSC Provider survey is available at http://www.humanservicescouncil.org/Commission/HSC%20Report %20Questions%20Final.pdf.

[35] The Nonprofit Starvation Cycle, Ann Goggins, Gregory & Don Howard, Stanford Social Innovation Review (Fall 2009), available at www.ssireview.org/articles/entry/the_nonprofit_starvation_cycle.

[36] Recent unfunded mandates include: the licensing of operators of after-school programs, implementing the new NYS Justice Center requirements, registering clients to vote, LGBTQ staff training, and therapeutic crisis intervention staff training.

Agencies that operate after school programming for children under 12 years of age must now be licensed by the NYS Office of Children and Families through the NYC Department of Health and Mental Hygiene. One provider reported,

It's an incredibly laborious process to obtain a license. Moreover, the license is actually in the name of the program director so every time you change directors (which sadly happens not infrequently in this under-paid profession), you need to get a new license. Similarly, every time you change the capacity of your program or seek to operate in a different classroom in the school, you need a change to the license. All licenses also need to be renewed two years after initial award and every four years thereafter. The NYC Department of Health's Bureau of Childcare conducts extensive regulatory visits and frequently cites agencies for things beyond our control, such as inadequately maintained school buildings.

We estimate that it costs us nearly $125,000 annually to obtain, modify and renew our licenses. This includes time for a dedicated Contract Manager, someone in Human Resources, and administrative staff in our four regional divisions that operate our 27 after school programs for elementary and middle school students.

Mayoral directives and Local Law now require that voter registration applications be made available whenever someone applies for or renews a City service. In the spring 2015, the Department of Youth and Community Development, alone, delivered over 250,000 voter registration applications in various languages across its portfolio of programs. Providers are required to report to their funding agencies on compliance with the voter registration initiative. Reports must include: a) the number of forms distributed and collected; b) the number of program participants/families served; and c) the number of staff trained on how to offer the opportunity to register to vote. In addition, providers must request the number of forms needed for each language, arrange for their pick up, and distribute to their sites. A large multi-service organization serving 80,000 persons reported that the logistics of pick-up, distribution, and compliance tracking was "no small feat. We estimate it will cost us nearly $30,000 for this new, very worthwhile initiative. So while we fully support the idea, we are once again scrambling for ways to figure out how to pay for it."

To ensure a culturally competent environment that is welcoming and inclusive of LGBTQ youth and adults, foster care agencies are now required to provide seven hours of appropriate training to staff. One organization reported that this unfunded mandate affected 300 direct care employees paid an average of $13 per hour ($27,000). In addition, NYC-approved training consultants are required at a cost of $1,000 per day for 10 days of training ($12,000), for a total unfunded cost of $39,000.

[37] Protecting New Yorkers with Special Needs, Monthly Data Report, Justice Center for the Protection of People with Special Needs (November 2015) available at http://www.justicecenter.ny.gov/sites/default/files/documents/Monthly_Data_Report_ Nov_2015_issued_11%2010%202015.pdf.

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[38] Protecting New Yorkers with Special Needs, Monthly Data Report, Justice Center for the Protection of People with Special Needs (October 2015). According to the Data Report, 2,363 allegations of abuse and neglect were substantiated out of 87,979 reported in 2014. The Justice Center investigates and prosecutes allegations of abuse and neglect at facilities or programs operated, licensed, or certified by the Office for People With Developmental Disabilities (OPWDD), the Office of Mental Health (OMH), the Office of Children and Family Services (OCFS), and the Office of Alcoholism and Substance (OASAS). Also covered are certain adult care facilities and summer camps overseen by the Department of Health (DOH) and residential schools and programs overseen by the State Education Department (SED).

[39] City Won't Let Homeless Group With Poor Record Out of Contract, James Fanelli, DNAinfo, (November 24, 2015), available at https://www.dnainfo.com/new-york/20151124/sunset-park/city-wont-let-homeless-group-with-poor-record-out-of-contract.

[40] New York City Releases More Budget Cuts to Already Struggling Human Service Programs, HSC News (December 7, 2011) available at https://humanservicescouncil.wordpress.com/2011/12/07/new-york-city-releases-more-budget-cuts-to-already-struggling-human-service-programs/. With earlier reductions, the number of children able to take advantage of the major after-school program was reduced by 60 percent. In the SFY 2014 Executive Budget, Governor Cuomo flat-funded State agencies, which effectively cut nonprofit contractor funding taking into account cost increases.

[41] Standards for Charity Accountability, BBB Metropolitan New York Alliance, available at https://www.bbb.org/new-york-city/charities-donors/standards-for-charity-accountability/.

[42] See 2015 HSC Provider Survey at http://www.humanservicescouncil.org/Commission/HSC%20Report%20Questions%20Final.pdf.

[43] See 2015 NFF Survey at http://survey.nonprofitfinancefund.org/?filter=state:NY%7Corg_type:Human%20Services.

[44] DiNapoli: State Needs to Ensure Timely Execution of Contracts with Not-for-Profits. Press release, Office of the New York State Comptroller (May 29, 2015). The State's Prompt Contracting Law (Article 11-B of the State Finance Law), enacted in 1991, establishes time frames for processing contracts with NFPs to prevent payment delays that could impair services to vulnerable New Yorkers, but annual reports show that agencies are largely noncompliant.

[45] See 2015 NFF Survey at http://survey.nonprofitfinancefund.org/?filter=state:NY%7Corg_type:Human%20Services.

[46] "Insolvent" is defined as having liabilities exceeding assets.

[47] Urban Institute, National Survey of Nonprofit-Government Contracts and Grants (2013). Data are based on a survey of 501(c) (3) public charities with expenses of $100,000 or more. Hospitals and higher education nonprofits unlikely to have government contracts and grants were excluded from the sample and analysis was limited to nonprofits reporting government contracts or grants. Although the study looked at six types of nonprofits, at 44 percent of the total surveyed, human services organizations constituted the single largest share and so the findings are considered to be applicable to the sector. (Arts, culture, and humanities—the next highest – represented only 20 percent of the organizations surveyed.)

[48] Only 16 percent reported a surplus of more than five percent at the close of the year. 2015 NFF Survey.

[49] See 2015 HSC Provider Survey at http://www.humanservicescouncil.org/Commission/HSC%20Report%20Questions%20Final.pdf.

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[50] Information for this analysis was gathered using IRS 990 data. This information is submitted to the IRS by nonprofits, and is the only standardized information collected regarding nonprofit financials. The 990 data is not comprehensive and greatly limited in showing the individualized finances of a nonprofit. Changes in real estate, program expansion, endowments, and other information in a given year can skew how a nonprofit's 990 reads without additional context.

[51] According to the 2015 HSC provider survey, only 60 percent of surveyed organizations prepared monthly balance sheets, while 40 percent prepared balance sheets quarterly or annually. Seventy-three percent of surveyed organizations get monthly comparisons of actual-to-budget data by program. Many organizations prepare these figures quarterly, annually, or as needed.

[52] See 2015 HSC Provider Survey at http://www.humanservicescouncil.org/Commission/HSC%20Report%20Questions%20Final.pdf.

[53] Source: http://www.charitiesnys.com/pdfs/Charities_Internal_Controls.pdf

[54] NY Not-for-Profit Corp. Law § 720 (McKinney 1997).

[55] See the 2015 State of the Subways report card at http://www.straphangers.org/statesub15/

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# ACKNOWLEDGEMENTS

This report was researched and authored by Margaret Stix of Lookout Hill Public Policy Associates. Margaret engaged in the Commission process from the outset and captured the experiences of participants to create a practice-based perspective of the sector.

Risa Heller and Jennifer Burner of Risa Heller Communications were the public relations consultants for this project, offering invaluable insights on communicating our message effectively. The report was designed by Milad Sarkis and the cover art was designed by Maxx Berkowitz.

Gordon J. Campbell volunteered a significant amount of his time and expertise to chair the Commission, and his involvement was invaluable in bringing people to the table and reaching consensus.

The Commission members realized the importance of this moment to evaluate the state of the sector, and we thank them for giving so much of their time and energy to this process.

The Committee Chairs gave an incredible amount of time and knowledge, and we greatly appreciate the amount of information collected and shared by them over the course of the process.

Many individuals also participated in the Committees, developed and executed surveys, delved into their own organizational issues and past experiences, and created tools that can be used by providers across the country. We thank all the Committee members for their active participation in this process, and their experience in the field can be found throughout the report.

In addition to Commission members, many people contributed their time and expertise as the report was developed. They include: Paul Feuerstein of Barrier Free Living; Ilsa Flanagan of the National Human Services Assembly and the FrameWorks Institute; Philip Gartenberg of Fulcrum Associates;  Patrick Germain of Project Renewal; Linda Manley of Lawyers Alliance for New York; Christy Parque of Homeless Services United; and James Parrott of the Fiscal Policy Institute.

Joel Copperman, HSC Board Chair, provided the necessary leadership to ensure the engagement of stakeholders throughout the process, a critical component to consensus building.

# ACKNOWLEDGEMENTS

Allison Sesso, Executive Director of HSC, acted quickly when it was announced that FEGS was closing to bring stakeholders together, forming this Commission. Her foresight in not only creating the Commission, but in working with government from the outset, has positioned the sector to use this failing as an opportunity for positive change.

Michelle Jackson, HSC's Associate Director and General Counsel, managed the Commission process. She organized the work of the Committees, oversaw staff and consultant tasks, and ensured that deadlines were met. She also brought her incredible ability to synthesize a variety of perspectives and simplify complex issues into actionable objectives. Her leadership ensured a successful process.

The HSC staff went above and beyond to make this report possible. David Ng, Government and External Relations Manager, and Tracie Robinson, Policy Analyst, staffed committees. Marisa Semensohn, Policy Associate, coordinated the Commission schedule, and Luis Saavedra, Executive Assistant scheduled countless meetings. Jason Wu, Membership Services Manager, facilitated technological connectivity, including website updates and survey implementation. HSC interns, Clifford Augustin and Annie McGrath, were instrumental in assisting with background research and providing administrative support.

Jennifer Geiling volunteered to work with the Commission, staffing a Committee, and assisting in the work of the Commission as a whole. Her time and experience with the sector were great contributions to the process and the final product.

HSC also thanks the following funders for their generous support: Altman Foundation, The Clark Foundation, The New York Community Trust, and the United Way of New York City. Support by these funders does not constitute implicit or express endorsement of the contents of this report.

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For the appendices, please see
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