A not-for-profit (N4P) entity suddenly collapses into bankruptcy after 80 years of successful operation. Who's to blame?

Just to be clear, the N4P entity we're talking about today was a behemoth: running an annual budget of more than $250 million, employing roughly 4,000 people. How does an organization of that size suddenly announce it's closing its doors, literally with no warning whatsoever?

We're talking about Federation Employment and Guidance Services (FEGS), which was one of New York City's largest social services entities, receiving roughly $250 million in state and city grants each year to work with "as many as 12,000 disabled people and other job seekers each day." One report stated that FEGS administered "hundreds of government service programs." But on January 29, 2015, FEGS announced it was closing its doors. A New York Daily News **article** quoted one FEGS staffer as saying, "It's crazy. It's an absolute mess. It's historic mismanagement."

But was it simply mismanagement that killed an 80 year-old institution?

A recent **Law360 article** (written by Rick Archer) shed some more light on the causes that led to FEGS' demise. According to the article—

Chapter 11 papers blamed the bankruptcy on a confluence of factors, including failed expansions and fixed-cost increases that took revenues down to $264 million in the 2014 fiscal year against $285 million in expenses. FEGS … entered bankruptcy with $18.7 million in unpaid advances from city and state agencies on its books.

We look at those two sentences, quoted above, and we see nonsense. There is little substance there, although we couldn't tell you whether that lack of substance comes from the filing papers or the author's haste in summarizing them. Neither "failed expansions" nor "fixed-cost increases" would led to a decrease in revenues. Those are factors that might lead to an increase in expenses, but would have little if anything to do with revenue. FEGS' revenue came from grants. If the grant revenue dried up, that would be a problem. If the grant revenue dried up at the same time management was investing in new service offerings, that would be a

problem. If FEGS' fixed costs (e.g., depreciation) had increased while its top line revenues decreased, that would be a problem. But perhaps all that was just too much to say, and so the author just summarized poorly. Or perhaps the Chapter 11 papers were poorly worded. We don't know.

What we do know is that, one day, FEGS realized that its expenses exceeded its revenues—by $19 million, or about 7 percent of revenue. Apparently the entity had insufficient funds set aside for a working capital reserve, and so when it realized its income would not cover its expenses, it closed its doors. Was that situation because of mismanagement, or because of a "confluence of factors"?

The unsecured FEGS creditors have a different story to tell. They are pointing fingers at the FEGS auditor, who allegedly failed to warn anybody that the N4P entity was in trouble. According to the Law360 article—

… the creditors' petition blamed the bankruptcy specifically on [the] 2014 annual report showing an $18.3 million loss after years of reports showing the agency slightly in the black. … The petition said these losses include[d] the writeoff of doubtful accounts receivables … and bad debts going back as far as 2010. These were not reflected in the agency's annual financial statements, which as a result overstated FEGS' revenues and understated its expenses by a significant amount, given the nonprofit's low margins, the creditors said.

The creditors said Loeb & Troper's annual audit reports to agency management from 2011 through 2013 did not warn of these mounting problems.

'Each of these three management letters stated that Loeb & Troper did not identify any material weaknesses in FEGS's internal controls; nor did the letters disclose any concerns regarding FEGS's continued accrual of … receivables that should have been either classified as doubtful receivables or subject to a reserve for doubtful receivables,' they said.

So according to the creditors, it was not mismanagement that killed FEGS—it was the auditor's fault.

What do we think? Well, this is a bit of a puzzle. Normally we do not expect invoices to state, local, or Federal entities to go unpaid for three or four years. At a certain point—perhaps 90 or 120 days after receipt of the invoice—we expect the contractor to file a claim for unpaid

invoices. We don't know why FEGS let its billed A/R balance extend as long as it did; and certainly we would have expected the auditors to review billed A/R aging with management. But normally you just don't expect bad debts from government entities. You expect to get paid, absent some allegation of wrongdoing. So we really need to understand the billed A/R story here.

It is possible that it was the unpaid invoices that killed FEGS, and nothing more. The invoices were not paid for a very long time, and that revenue would have covered some or all of the current year expenses. The story could be as simple as that.

We would add here that auditors are accountants, but they aren't bookkeepers. They don't do the entity's bookkeeping (or they shouldn't, if they want to remain independent). They are not responsible for determining which debts are bad debts; that's management's job. On the other hand, the auditors are required to express an opinion on management's judgment. It would be interesting to have listened to the conversation between auditor and management regarding the aged billed A/R. Obviously the story told to the auditors worked, right up to the time when it didn't work—and then the write-offs led to a very unfortunate situation.

If you are a government contractor, whether a for-profit or not-for-profit entity, we would expect you to worry about cash flow. We would expect you to review your aged billed (and unbilled) accounts receivable. We would expect you to take action if you had an invoice (or series of invoices) that remained unpaid long after they were due. If you didn't worry about your cash flow, or didn't review your A/R, or didn't take action to collect moneys owed to you, then we would indeed call that mismanagement.

Over on WIFCON the usual suspects have been debating Requests for Equitable Adjustment (REAs) and claims. We've been toying with the notion of devoting an article to the topic here, since many people don't understand the difference between the two contractual actions. It's a general truism that most government contractors don't like to file claims; but, in the case of FEGS, maybe that's exactly what they should have done. Maybe filing a claim to recover invoiced funds that the entity was owed would have led to collecting the billed A/R, and maybe that would have been enough to forestall Chapter 11.

Obviously we don't know the whole story here. But we're pretty sure it wasn't the auditor's job to collect outstanding Accounts Receivable.