

The Due Diligence Tool

for use in pre-grant assessment



by Liza Culick, Kristen Godard and Natasha Terk
La Piana Associates, Inc.



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for EFFECTIVE
ORGANIZATIONS



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Introduction

The Due Diligence Tool is the product of a collaborative effort and the contributions and thinking of grantmakers from a diverse set of foundations. The original vision for this tool — and a clear articulation for the need — came out of a conversation with a group of program officers at the David and Lucile Packard Foundation who were gathered several years ago to review and provide feedback on another tool that had been developed for program officers, the *Tool for Assessing Startup Organizations*.¹ This group was enthused about the value of a tool to use in assessing new, startup organizations, but they communicated a clear message: It would be helpful to have a guide for use in due diligence efforts with the full range of grantees encountered in their work. Thus, the idea for and commitment to the development of *The Due Diligence Tool* was born.

Those program officers proved to be an accurate reflection of their colleagues around the country. The support for this effort has been tremendous. We are grateful for the participation of a large number of program officers and foundation staff who gamely and enthusiastically agreed to share with us their approaches to due diligence — the challenges and successes they experience in this core aspect of their work — and what they would find most helpful in a new tool or guide.

The Due Diligence Tool represents a blending of best practices from a variety of foundations from around the country. Our process pulled together the practices and materials of a diverse group — private, family, corporate and community foundations, both large and small — and culled from them the best practices to integrate into a basic guide for due diligence.

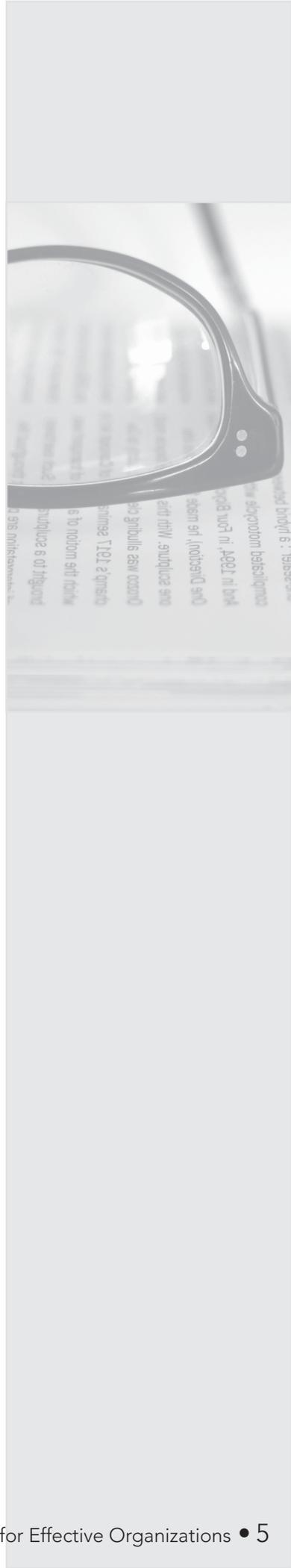
The purpose of this guide is to provide a research-based tool for the foundation program officer, whether specialist or generalist, and a methodology for and orientation to thinking about due diligence. Using *The Due Diligence Tool*, a program officer will be able to ask the most important questions about the organization's health. She will review the most telling documents, ask the most salient questions, and have an understanding of what to look for and what to make of what she learns.

The tool is not designed to be used as a report card, resulting in a passing or failing grade. Nor will it guarantee particular outcomes. The use or adaptation of this tool to your foundation's practice of due diligence will result, we hope, in both the program officer and the applicant learning some important truths about the state of the nonprofit seeking support.

The tool is designed to be an adjunct and an aid to the program officer's insight and experience. Its use offers an opportunity for honest dialogue between grantseeker and grantmaker about the health and prospects of a nonprofit they both want to succeed.

Finally, while this is an initial effort to lay out a general framework for due diligence, the intent is to provide a foundation upon which to build and improve. We hope this will stimulate further conversation about the practices of the sector, and look forward to continued improvements to the product we offer herein.

¹ *Tool for Assessing Startup Organizations*, La Piana Associates, Grantmakers for Effective Organizations (2003). Available for download at www.geofunders.org.



Orientation to Due Diligence and the Tool

Why Due Diligence?

With origins in the private-sector world of business and finance, the term “due diligence” refers to the process through which an investor (or funder) researches an organization’s financial and organizational health to guide an investment (or grantmaking) decision. The decision to fund or not to fund is based upon a balance of objective data analysis, insight into the general state of organizational health and stability, and intuition. A sound and thorough due diligence review is the process through which all the factors that make up that equation are uncovered and understood. It is the process in which a program officer seeks the “truth” about an organization.

Foundation program officers are faced with multiple challenges in assessing whether to recommend a grant to their board or decision-making committee. First, they must ascertain whether and to what extent the proposed activity coincides with the foundation’s guidelines and priorities. Next, they must assess the worth of the proposed activity itself — does it advance the field, provide needed services or generate new learning? If the proposal survives this initial scrutiny, it must then be weighed for its relative merits beside many other worthy proposals. This process requires a great deal of skill and sensitivity.

Due diligence protects a foundation’s investments and reputation and advances its mission and overall strategy. While the idea contained in a proposal might be a strong one, there are still many questions to consider. For instance: Does the organization have a successful track record? Does it operate under an appropriate governance structure? Is it financially and operationally sound? An overreliance on the strength of the ideas presented in a proposal, without ferreting out these organizational strength factors, can lead to funding a project that does not succeed in producing expected results, or worse. A program may not fail because an idea is flawed. Indeed, in many cases we never learn whether the idea was sound or not. Rather, the project fails because of organizational weaknesses — internal strife, disorganization, financial or legal problems — that preclude it from having a chance to succeed on its merits.

Due diligence is an essential step in the proposal review process, and it deserves more than a perfunctory approach. However, there are challenges in achieving excellence in due diligence. First, many foundations seek out and hire program officers who are specialists in their fields rather than nonprofit management generalists. Public health physicians, highly respected educators, artistic presenters and environmental policymakers work for many foundations, large and small. These professionals may not have had the opportunity to manage a nonprofit organization. Thus, we have heard many times, “I know the program side, but I really don’t know what to ask about the organization.”

Further, the pace of work at most foundations makes it difficult to carve out the necessary time to undertake a thorough due diligence process, even for major grants. Due diligence review takes time.

Finally, there are currently no accepted standards for due diligence review in the philanthropic sector. Due diligence is, as practiced, more art than science. Thus, practices within a foundation can be highly idiosyncratic — developed by program officers, one by one, to meet their own understanding of their program’s priorities for proposal review. There are no time-honored, well-regarded tools on the grantmaking bookshelf. Each funder we interviewed developed its own process. If there is training provided for program officers, it tends to be primarily focused in the financial arena only.

One experienced program officer described her first day at work in a new grantmaking position in this way: “They welcomed me, placed a pile of grant folders on my desk, and said ‘here is your portfolio!’ ” She received no particular orientation to her new employer’s approach or philosophy regarding due diligence, and set about applying the skills and practices she’d developed in previous grantmaking positions to her new portfolio challenge. Is this all bad? Not necessarily — each funder need not impose a rigid set of practices upon its program staff. However, the rationale and need underlying due diligence is quite serious and so calls for a serious, thoughtful approach.

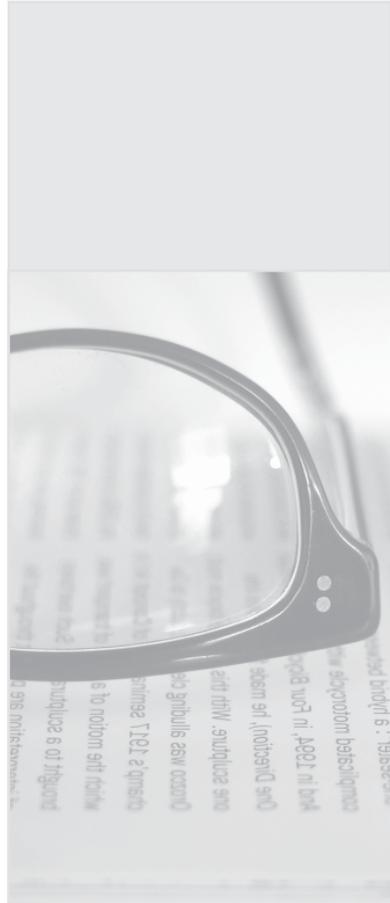
While due diligence is not intended to provide an insurance policy against failure, it can ensure that a program officer has a thorough understanding of the various strengths and challenges an organization presents — and, thus, an understanding of the level of risk a particular grant may carry. While risk is dealt with differently by each funder, *understanding* the risk inherent in a particular grant is essential. It can help a program officer, for example, to decide to augment a program grant with support for strengthening the organization. It can also inform structuring of grant-monitoring and grant-reporting requirements. Further, it can ensure the program officer has a thorough understanding of an organization’s strengths and weaknesses, and thus can effectively support organizational efforts toward success.

Two Approaches to Grantmaking

There are two general approaches to grantmaking that may affect the approach to due diligence:

1. Proposals that arrive unsolicited, in response to published guidelines; and
2. Proposals that are invited or requested by a funder — either directly to a specific organization, or through a request for proposal (RFP) — in order to advance a strategy or initiative established by the foundation.

Funders that have invited proposals may have a level of familiarity or confidence in an organization or project. It is important to avoid the temptation, however, of taking shortcuts in due diligence because you assume you know an organization well. There have been instances of serious issues inadvertently missed or overlooked because a lack of careful due diligence.

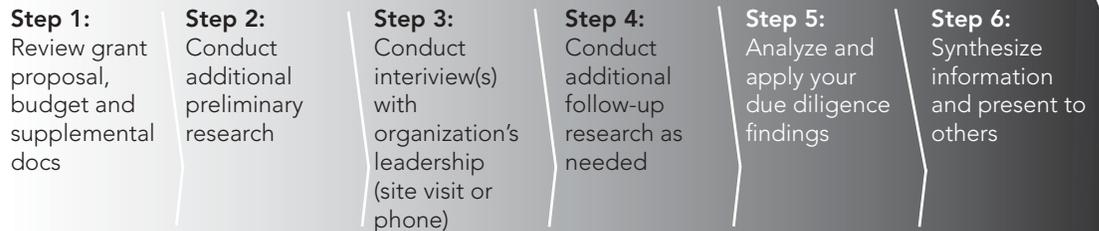


The Process of Due Diligence

When you receive a proposal on your desk, the first step of proposal review is generally a consideration of the alignment of the applicant organization and proposed project with your organization's guidelines and interests. If this initial review is positive, due diligence typically commences with broad research and information gathering to provide a good understanding of the prospective grantee, how it fits into the field and the way in which this project will advance your organization's strategy. You might also contact colleagues for their view of the grantee and its work. Then, you move on to get to know the applicant on a deeper level, including interviews with some combination of the executive director, board chair, other board members and staff members key to the proposed project. Each of these activities is covered in depth in this tool.

The basic steps in a due diligence process are laid out below:

Basic Steps in Due Diligence



Throughout the process: Consider legal compliance issues

- | | | | | | |
|---|---|---|--|---|---|
| <ul style="list-style-type: none"> • Review proposal for fit with foundation's mission, guidelines and strategy • Familiarize yourself with the basics of the proposed project and the organization • Review supplemental materials, such as strategic plans, financial reports, marketing materials, staff bios, etc. • Assess strength of the project focus and design • Consider viability of project budget and overall financial health | <ul style="list-style-type: none"> • Ask your colleagues (funders and other experts in the field) for their input • Review the organization's Web site • Seek out other available data and information relevant to the project | <ul style="list-style-type: none"> • Get to know the executive director, key program staff and board leadership • Explore the organization's health and capacity, including track record, governance and executive leadership, vision and strategy, staffing partnerships, communications and finance • Delve more deeply into the proposed project, focusing on planning, outcomes and evaluation | <ul style="list-style-type: none"> • Probe areas of concern through additional research and discussions with colleagues and staff or board leadership | <ul style="list-style-type: none"> • Consider "red flags" and assess the risk they pose to the success of the project • Weigh the factors important to your organization; determine if there are any "deal breakers" • Consider options for structuring the grant • Make decision about grant | <ul style="list-style-type: none"> • Write up due diligence findings and decision • Craft funding recommendation for staff and board review |
|---|---|---|--|---|---|

Time Is of the Essence

How *do* you balance the various parts of due diligence? One answer is that you need time.

It is important that you allot sufficient time for the due diligence process, particularly when it comes to reviewing what you've learned, weighing the factors in your analysis and shaping your recommendation. Seasoned program officers note that if you have the time and skills to get the job done, the due diligence process is more likely to work well.

However, one of the key characteristics of the program officer's job is time pressures — most of you are carrying heavy loads! So, the challenge is choosing which applicants to devote more time to and with which to limit your due diligence efforts.

The culture of your organization and its relationship with grantees will largely shape the level and timing of direct interaction with applicants. Some organizations prefer *not* to engage with applicants until they are more certain than not that they have a viable proposal for their portfolio. Other organizations, notably some community foundations or smaller foundations that work closely with their communities, begin the due diligence process with a phone call and then proceed to in-person meetings or site visits if all indicators are promising after an initial level of document review and background research. Finally, there are organizations that make grants based solely upon the written proposal submitted and don't seek additional contact.

Regardless of when in the process you engage with the potential grantee (if at all), it is important to acknowledge that once you have had personal interaction, it feels more difficult to say no. Indeed, it is critical to choose your interactions wisely so as not to raise inappropriate expectations. This is discussed further in “Getting to Know the Applicant” (see page 12).

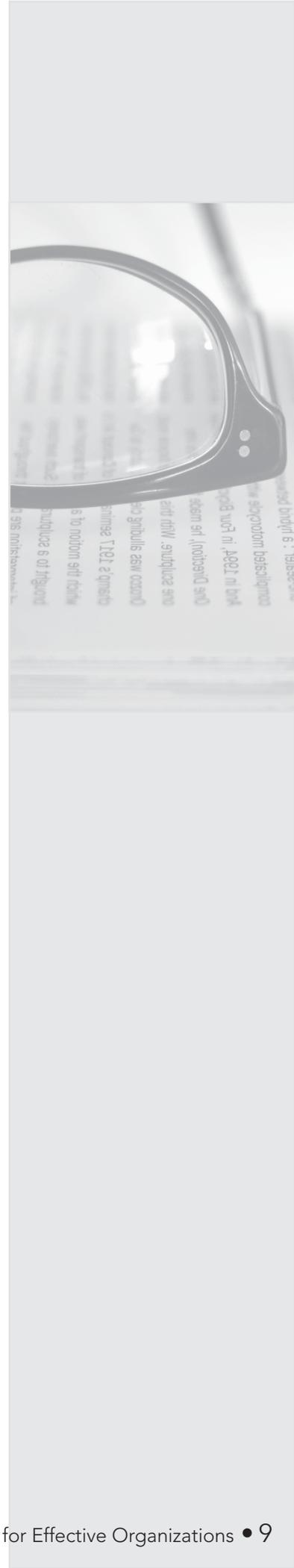
Understanding the Context of Your Work

Part of a successful due diligence process is an understanding of the context within which you, as a program officer, are working. This context includes both the foundation for which you work and the particular program area(s) for which you are accountable.

One key to success is your knowledge of the field and region with which you are concerned. The deeper your knowledge and the broader your view, the more keen your questioning and your subsequent assessment of what you find. Using your network of colleagues is an important part of this strategy, as is keeping abreast of the current research and best practices in the field.

It is also important to understand your organization's strategy — what are you responsible for accomplishing? It is equally important that you understand the foundation's general philosophy and what it wants to get out of due diligence, because it is not a one-size-fits-all effort. That is, the process will not be applied the same way to every proposal and applicant organization. Thus, it is important to ground yourself in your organization's values related to a variety of issues covered in the “Assessment Questions” section of the tool (see page 20).

Finally, you need to know the “deal breakers,” if any, for your organization. For example, a budget deficit might be a guaranteed deterrent for some funders. For others, funding would be



denied if the prospective grantee didn't have a staff and board that truly reflect the diversity of the communities it serves. Or a funder may reject a grant request if the applicant can't articulate a sound theory of change.

Due Diligence: Art or Science?

As is often said, the work of grantmaking is more of an art than a science, and assessing grantees is heavily reliant upon your ability to intuit future success. Experienced grantmaking program officers rely on conversations with a grantee's staff and board leaders, as well as confidential talks with colleagues in other foundations. Due diligence is an inherently interactive and iterative process.

The truth about making decisions on funding requests is that it relies a lot on intuition. Program officers with years of experience in the field state again and again that they will make a grant based in part upon their "feel" about the leadership. Do you trust the executive director? Does he, in your best estimation, provide appropriate leadership for the organization? Interviews are one effective way for you to get a sense of these issues. They are, in fact, a key part of the due diligence process. Without a doubt, a review of the proposal and supporting documents is the place to start, but unless you augment that review with phone or personal interaction, you are going to miss a key part of the puzzle.

Additionally, it is important to acquire a basic familiarity with the keys to healthy nonprofit management. Due diligence is not just about financial and legal compliance issues. Governance, the role of the board, the relationship between the board and the executive director, the position an organization holds in its field and community — these factors and more all come into play in a sound decision regarding a grant request. A sound assessment of the merits and design of the proposed program is augmented by your understanding of the strength of the organization in which that program resides, and upon which the success of the program depends. (See "The Elements of a Healthy Nonprofit" on page 11 for a review of the characteristics of healthy nonprofits.)



The Elements of a Healthy Nonprofit

While an entire book could be written on the factors contributing to a healthy, well-functioning nonprofit (in fact many have*), this is a brief overview of the key elements that are associated with effective organizations. Nonprofits are a diverse, complex mix of people, ideas and resources. Nonetheless, in order to succeed in advancing their missions, they *must* have these elements in place:

- 1. A Healthy Governance Function** — The organization has a board of directors that works collaboratively with the executive director, defines the mission, and then develops strategies and policies that advance it. It also provides an independent check on management's actions, and a connection to the community served.
- 2. A Competent Executive Director** — The staff leader of a nonprofit must be a jack-of-all-trades. She must work collaboratively with the board and staff; provide a bridge to the community, funders and clients; chart a future course; raise funds; and model a high ethical standard. The executive director sets the tone for internal communications and staff's working relationships with one another.
- 3. A Sound Financial Management System** — Nonprofits need a system that controls expenditures and offers accurate, timely reporting to management on income and expenses. Management also needs data for accountability and decision making, including an annual budget. There should be regular external review, both by the finance committee and, periodically, by independent auditors.
- 4. A Workable, Legal, Human Resource Policy** — Nonprofits typically spend upwards of 80 percent of their income on people: salaries and benefits, as well as training and supervision. They must manage this function wisely, complying with complex government laws and regulations, compensating people adequately within limited resources, and motivating them to perform their best. Internal communications must be structured to provide staff with appropriate input into decision making and current knowledge of the activities of other units within the organization.
- 5. A Successful Fund Development Strategy** — One way or another, a nonprofit must obtain funds: from grants, contracts, fees or individual gifts. It is a matter of life or death, and a nonprofit that cannot attract resources is in desperate trouble indeed. Whether or not there is a development director, the board and executive director must work together to raise the necessary funds.
- 6. A Clear, Consistent Message** — A nonprofit must communicate what it is about to anyone who can either help it or be helped by it. Going well beyond a newsletter, its marketing and communications efforts should make use of all available media and take advantage of opportunities that arise to tell its story.
- 7. A Good Program That Advances the Mission** — This is the heart of the nonprofit.

* Some examples include *Managing the Nonprofit Organization*, by Peter Drucker; *Making Nonprofits Work*, by Paul Light; and *Strategic Management for Nonprofit Organizations*, by Sharon Oster.

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"The Elements of a Healthy Nonprofit" was originally included in *Tool for Assessing Startup Organizations* by La Piana Associates, published by Grantmakers for Effective Organizations in January 2003.



Getting to Know the Applicant

The challenge of getting to know the applicant rests on a variety of levels. Successful due diligence relies heavily upon your ability to listen beyond the applicant's written or spoken words. The process is an opportunity to seek the "truth" about an organization — that is, to go behind that which is presented on paper.

Establishing a Relationship Through Due Diligence

The interaction between the funder and potential grantee in the due diligence process sets the tone for the future relationship. This may be the first contact the organization has had with your foundation, and it is your opportunity to lay the groundwork for a positive, open relationship that will benefit your future work together. If it is not the first interaction, and the relationship has been less satisfying than you would like, now is the time to begin moving it onto the right track.

An effective and satisfying due diligence process is one that educates and benefits both parties. The funder can help make the process meaningful and valuable for the applicant by providing an overview of the process and its purpose, asking informed questions, treating the applicant with respect and keeping an open mind. As you seek to understand an organization and its proposed project, the applicant can benefit from an examination of its organizational health, especially if the program officer adds value to the process by offering useful feedback and suggestions.

Building Trust and Setting Expectations

It cannot be stated too frequently that trust is essential to a successful due diligence process.

How do you build trust? A first and important rule is to be honest in your communications with grant applicants — that is, do what you say you are going to do and don't make promises you can't or know you won't keep.

It is also very important to be clear about the application process up front — what you look for, what the applicant can expect — and be consistent in your actions. Grantseekers, like grantmakers, talk to each other and compare notes. So be aware that your actions may be observed by a network of community members with whom you have a stake in building a good relationship. Honesty and consistency are cornerstones to that relationship.

Another way you will build a trusting relationship is by clarifying roles, responsibilities and expectations at the outset of the proposal review process. "This is what we hear from you, why we are interested in your proposal, and here's what we need from you."

Continue to clarify expectations moving forward — let the applicant know exactly what they can expect from you, what you will be asking from it and why. It is helpful for an applicant to understand the process in the same way that you do. Avoid making assumptions about what makes sense. It is easy to be so entrenched in our work and our processes that we lose touch with how an "outsider" might experience that which we take for granted.

Finally, treat all applicants with respect. The grantseeking process can be bewildering and frustrating for even the most seasoned nonprofit leaders. You may encounter grant applicants who are not meeting your needs or expectations in their attempts to gain support from your organization. Always endeavor to give and foster respect, even in trying circumstances.

By observing these trust-building practices, even if you eventually make a decision to deny a grant request, you will establish a foundation of trust and goodwill with the applicant that will serve you both in the future.

Site Visits

Site visits are often an important part of due diligence. Some foundations use pre-grant site visits in select situations; others may conduct site visits after the grant is made as part of ongoing relationship development and project monitoring. Still other foundations rarely make site visits, and then only for major grants.

Regardless of when or why site visits are conducted, they are not to be taken lightly. Site visits are an important part of your research and also serve to raise expectations on the part of the organization. Therefore, it is important that when you decide to conduct a site visit, you communicate clearly the “meaning” of this added investment of your time and theirs.

Remember that site visits take time and preparation, so be sure to use the applicant’s time wisely. *Grantmaking Basics* has a very useful chapter on conducting site visits that addresses all the key areas of good practice (see the resources section on page 59).

Maximizing the Conversation: An Opportunity to Educate

The conversation about organizational issues offers an important opportunity to engage in open, inquisitive dialogue about the challenges of guiding a nonprofit.

This conversation can be helpful — and educational — for both parties. You don’t need to be a management expert to ask insightful questions about issues that matter to a grantee’s organizational health. Asking open-ended questions about pertinent competency areas, such as the ones in this tool, serves to highlight issues that should be on the table for a nonprofit leader.

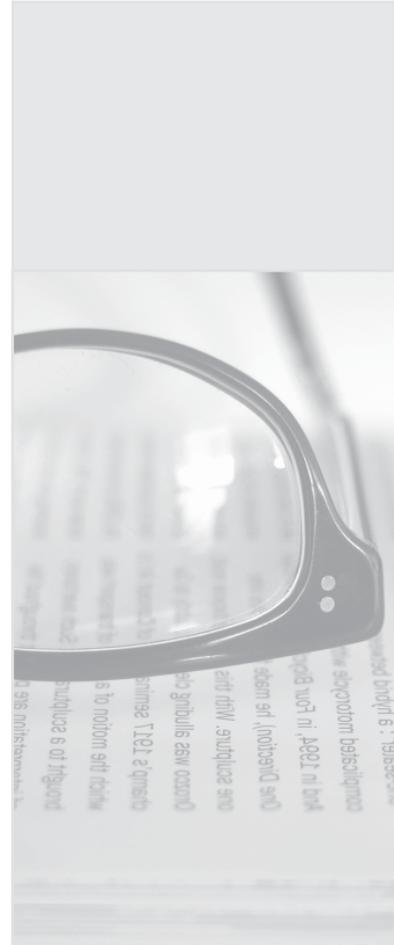
Once the issues are raised, you may find that the applicant has interest in further exploration. The inclusion of resources in each section of the tool is intended in part to help you direct the learning impulses of interested nonprofit leaders.

What’s the Right Answer?

It isn’t enough to ask great questions — you need to know how to interpret and react to the answers! Many suggested interview questions will not elicit precise answers, and there is, in fact, no single right answer for the majority of the questions.

A key to successfully using the tool will be your comfort with asking questions that don’t necessarily result in clear answers. The best approach is to ask direct, open-ended nonjudgmental questions, listen carefully to understand the answer, ask for clarity where needed, and don’t try to fit every nonprofit into the same mold.

Remember, too, that you want to listen to the “music” as well as the words — what is your gut reaction to the interview? Do you feel confidence in the organization’s leaders? Trepidation? Your confidence will come, in part, from the interaction. Pay attention to the comfort level you feel with the applicant.



Using the Tool

The Due Diligence Tool offers a basic framework for review of proposals your organization is considering for funding. It provides guidance for review of the proposal, budget and other written materials, and then leads you through an in-depth examination of the applicant organization and proposed project.

Scope of *The Due Diligence Tool*

The process in this tool comprises minimum due diligence; essentially, it is an approach that allows you to make a good grant. It is not a tool for ensuring highly strategic philanthropy. Nor is it a tool that guarantees outcomes. Ultimately, the tool is successful if it helps you gain a fuller appreciation for the organization, including its strengths, its weaknesses and the challenges it faces.

As you engage in due diligence, it is important to note that grantees vary in the sophistication of their management systems and governance structures. A lack of sophistication is not in itself a sufficient reason to decline a proposal. In using the tool, what the program officer seeks, above all else, is the answers to three questions:

- What are the chances this proposed project will succeed? That is, is the application a good plan? Will the applicant's leadership be able to do what it says it will do?
- Does the applicant have a sufficient understanding of the tasks before it and the tools at its disposal to manage this project well enough for it to succeed?
- What could the foundation do beyond granting the requested funds to help this organization to succeed?

Components of *The Due Diligence Tool*

Specifically, the components of the tool are as follows:

A. Proposal and Document Review

This section includes guidelines for performing an initial review of the written proposal and budget (as well as supplemental documents).

B. Conversation With the Applicant

This section provides assessment questions to be used in an in-person or phone meeting with the applicant, covering “big-picture” organizational issues (e.g., governance and executive leadership, vision and strategy development, and financial health), as well as issues that are specific to the project being proposed for funding (e.g., planning, staffing outcomes and evaluation).

We have included the questions to ask, what to look for, and how to understand what you are seeing and hearing. We have also listed issues, called “red flags,” that are critical enough to warrant further attention and review, or that can suggest that making a grant may not be a wise decision.

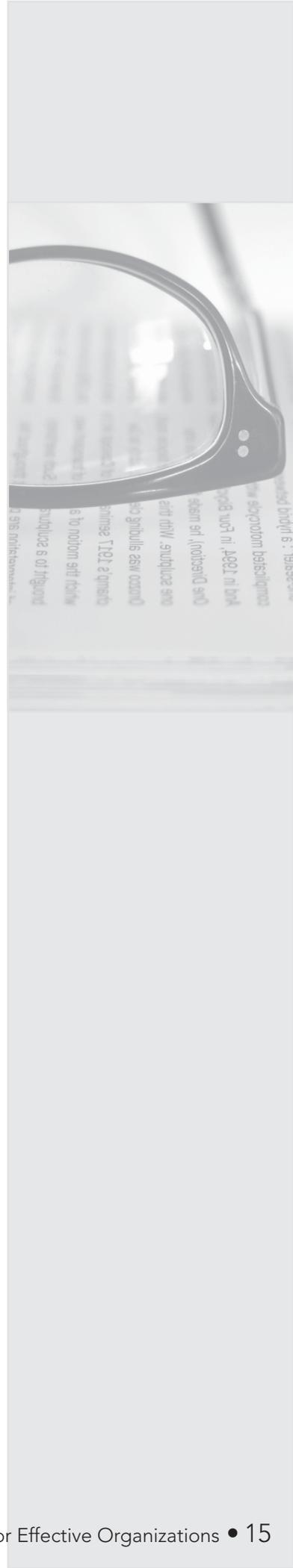
C. Applying Your Due Diligence Findings

This section presents factors to consider and options for moving ahead in making decisions based on what you learned through the proposal review and applicant

discussions. You may find that the tool prompts you to ask questions that may not have clear answers. Or, that a given answer may mean different things in different organizational contexts. The tool is intended to provoke thought, not to yield a precise numerical score or prescriptive solution. As such, it includes a variety of approaches you might consider in making your final funding recommendation.

A blank version of the tool, for use or adaptation in your organization, is included as three worksheets in the appendices on page 45.

Following the tool itself, there is a section called “Legal Compliance Issues” on page 39. It is important to check the legal status of any applicant and make sure that the proposed project meets the legal standards for use of a grantmaker’s funds. This section provides tips for identifying and handling critical legal compliance issues.



The Tool

Proposal and Document Review

The first steps in the due diligence process are to read the proposal, budget and other supplemental materials provided by the applicant; visit the applicant's Web site; and consult with foundation colleagues or other experts to find out more about the organization, its programs and its position in the field. This section of the tool includes guidelines for this initial stage of the process.

Project Focus and Design

The assessment of the programmatic focus and project design is at the heart of pre-grant due diligence.

This includes an examination of the project plan and intended outcomes to determine if the organization's rationale is sound and if the proposed strategy is likely to have the intended impact it seeks.

The rigor with which you assess the prospective grantee's articulated project design and outcomes will depend upon the culture and values of your organization. Some funders ask for a well-developed logic model or theory of change from each grant recipient. (A logic model is a blueprint for designing and evaluating programs. See sidebar on page 26 for more information.) Others simply look for a clear statement of desired outcomes, with well-developed activities that are likely to achieve the outcomes the grantee is seeking.

Before you get to the specifics of the project design itself, you will want to understand the general context of the proposed project and how well it fits with your organization's strategy. As noted above, part of the ongoing work of a program officer is to remain current with the field in which you make grants, paying attention to trends, including research and keeping abreast of the organizations that are well respected, innovative and successful — whether or not they are your grantees.

The initial questions in your proposal review should include:

- Does the project fit within the field? How will the project benefit the field or the community? Is there a need for the services and outcomes?
- Is the approach solid? Are there better approaches for achieving the outcomes?
- Does the project fit with your organization's theory of change? Does it build on other grants?

The second level of consideration revolves around the fit between the proposed project and the organization in which the project is housed. You are seeking a solid and clear alignment between the applicant organization and its work, and its ability to meet its goals. Questions to ask yourself include:

- Does the project fit with the applicant's mission and theory of change? Does it shift the applicant away from its mission?
- Does the project design make sense? Do the proposed activities fit with the overall project goals?

- Do the costs make sense?
- Is the program likely to succeed in achieving its desired results? What are the major challenges to success? How will these challenges be addressed?
- Is this the right organization to do the job? Are there others doing anything like this; and if so, might they do it better?
- Does the applicant have a successful history of running a similar project? If the proposed scope of work is new for the applicant, does it have the capacity to meet the goals?

The answers to these questions may not be found within the proposal, however, so additional document review or research may be necessary. You can gain significant insight into an organization by reviewing its strategic plan, staff bios or financial statements, for example. (A complete checklist of documents that you should consider requesting from the grant applicant can be found in the appendices on page 47 as Worksheet #1: Materials for Review.) A visit to the applicant's Web site can also be valuable.

You will also want to consider the applicant's reputation among your foundation colleagues and experts in the field:

- How are the organization and its key staff leadership perceived in their peer group and by other funders?
- Does the applicant have a positive history of working and networking with others in the community?

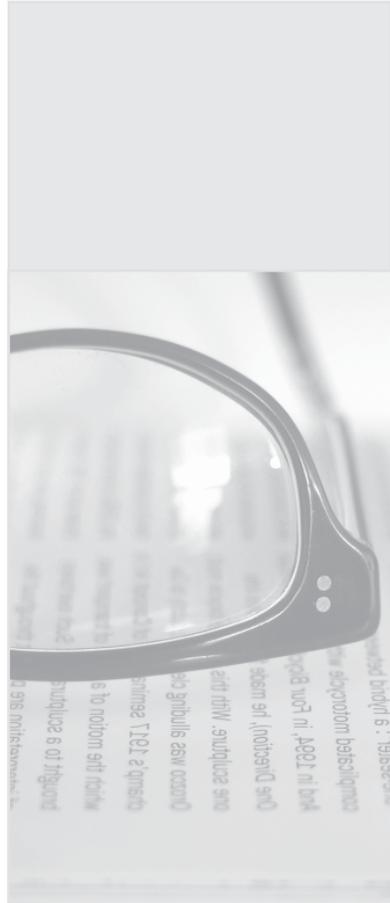
Project Budget and Overall Financial Health

Although financial health is only one criterion of organizational health, it is an important one. The ability to manage finances is central to an organization's survival and growth. An organization must make sure it brings in at least as much money as it spends and that it plans for future expenditures.

The first step in assessing financial issues occurs when you review the proposed project budget. You should:

- Become familiar with the project budget.
- Review the description of the project's staffing: Does the proposed staff design seem adequate?
- Consider how the project supports or doesn't support the work of the organization: Do the two fit together?

Once you've familiarized yourself with the project and its expenses and income, you should then turn your attention to assessing the organization's overall financial health. A good place to start is the balance sheet, which will give you a snapshot of its finances at a *specific time*. In general, the organization's total current assets (such as cash, receivables and securities) should be greater than its total current liabilities (such as payables, deferred revenue and current-year loan and note payments), or the organization may face solvency problems in the near term.



On the other hand, if an organization's cash and equivalents greatly exceed its current liabilities — i.e., it is running a current ratio of 3:1 or more — it may not be putting its money to the best use.

In reviewing the applicant's balance sheet and income statement, look for the following indicators of financial health:

- The organization has working capital that is equal to the current liabilities plus three months of operating budget.²
- The organization has positive net assets (also called a *fund balance*).³
- The organization does not have an operating deficit in the current year (revenue exceeds expenses).

It is also advisable to verify that the organization has filed a Form 990 to the IRS,⁴ and that the information in its audit corroborates that on the 990. You can also use the most current 990 to determine if the salaries of top-paid staff seem reasonable and appropriate.

A complete checklist of financial documents that you should consider requesting from the grant applicant can be found in the appendices on page 47 as Worksheet #1: Materials for Review.

It should be noted that financial management is not a great strength or passion of all program officers. If you are somewhat intimidated by this area of investigation, you are not alone. Training in reading nonprofit financial statements, as well as books, manuals and other resources, does exist. We encourage you to visit the resources section of this tool on page 59 for printed resources and training opportunities available to the sector.⁵

Getting the Most from Document Reviews and Conversations in Due Diligence

Keep in mind that the process of reviewing documents and conducting interviews is both interactive and iterative. Each area of inquiry supports and informs the other. The documents are where you start collecting general background information; then you follow up in your conversations with the applicant.

² Working capital is equal to current assets minus current liabilities.

³ *Net assets* or *fund balance* is also called *net worth* or *profitability* in the business world. This is equal to revenues minus expenses.

⁴ Organizations with expenses less than \$25,000 in a given year are not required to file a Form 990.

⁵ There is also a terrific chapter in *Grantmaking Basics* (see citation in resources section on page 59) on understanding nonprofit financial health.

Conversation With the Applicant

If, after proposal and additional materials review, there is a favorable fit with your foundation's guidelines and priorities, and the project is of interest, you can move on to finding out more about the applicant and its proposed project through an in-person meeting or phone conversation.

Whether it's on the phone or in person, think of this meeting as the beginning of a relationship. The most important aspect of this encounter is to encourage the applicant to engage in an ongoing discussion. Through this discussion, you will have the opportunity to ask questions to assess the various aspects of the organization's health.

Each of the areas of organizational assessment is complex and essentially an independent field of study unto itself. Nonetheless, you should build your basic understanding of the key areas of nonprofit management and be prepared and comfortable discussing them within the context of the tool.



Basic Tips for Effective Interviews

It is helpful to use the proposal documents you have reviewed as a starting point for your discussion. They contain information the applicant is familiar with, and that establishes a comfort level that can help you start a productive conversation.

- 1. Always ask open-ended questions.** That is, avoid questions to which the only answers are "yes" or "no." You will not learn much nor will you generate worthwhile conversation! Open-ended questions typically start with:

Tell me about...

How do you...

What are...

The tool itself provides many examples of questions that will elicit information that is useful without leading the interviewee to the "right" answer.

- 2. Keep questions simple.** Don't combine multiple areas of inquiry to form a long, complex, difficult-to-track question. One question at a time focused on one issue of interest is the best method to guide a conversation.
- 3. Avoid questions that communicate judgment.** For example, "You didn't think about the implications of..., did you?" This is a sure conversation stopper, and will it inhibit your ability to foster an open and honest relationship.
- 4. Always conclude your conversation with one of the following questions:**

Is there anything I didn't ask about that you wish I had asked?

Is there anything we have left out and not talked about?

The Assessment Questions

The assessment questions are divided into seven topic areas, although all are interrelated. These areas are:

- Organizational History and Track Record
- Governance and Executive Leadership
- Organizational Vision and Strategy
- Proposed Project: Planning, Outcomes and Evaluation
- Human Resources
- External Communications and Relationships
- Financial Health

Within each area of assessment, the tool includes the following information:

- **Overview of assessment area:**

A brief discussion of why that area is important to a healthy nonprofit and, thus, to due diligence.

- **Whom to interview:**

A list of the appropriate person(s), by role, to interview for each area of assessment.

- **Questions to ask and what to look for:**

Each of the assessment areas includes suggested questions to consider, with a corresponding list of indicators of effectiveness to look for in the area. We've also included potential "red flags" you might uncover. Red flags are findings that may cause concern that the nonprofit is deficient in an important area of organizational capacity, and thus may not be capable of implementing the funder's grant. Please see "Applying Your Due Diligence Findings," on page 34, for a full discussion of red flags.

Organizational History and Track Record

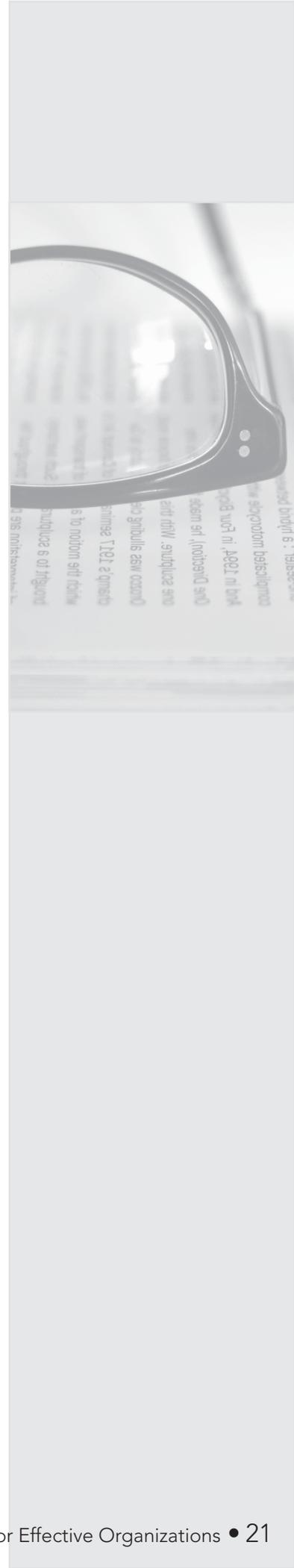
The history and track record of an organization is an important context for you to understand. It will convey the big picture of what the organization has accomplished, the significant challenges it has faced and how it fits into its community and field.

This is an area of due diligence that is highly reliant upon conversations with your funder colleagues and organizations in the field that may know about the potential grantee, as well as upon review of the materials provided to you by the organization itself on its history, work and accomplishments.

In addition to this research, you can glean important information from direct questioning of the applicant, as outlined below.

Interviewees: Executive director, key program staff

Category of Issues	Questions to Consider	Indicators of Effectiveness	Red Flags
History	<p>Tell me about the history of your organization. What have been the key milestones in its development?</p> <p>What have been the most significant accomplishments of the past three to five years?</p> <p>What have been the most significant challenges?</p>	<p>The organization has a proven ability to succeed.</p> <p>The organization has a track record of results that demonstrates an impact on its constituency or target population.</p>	<p>The organization's leadership cannot (or will not) openly articulate both successes and challenges.</p>
Recent Accomplishments	<p>What have been the most important accomplishments this past year?</p>	<p>The organization has a <i>recent</i> record of an active and vital program.</p>	<p>The organization cannot demonstrate recent program accomplishments.</p>



Governance and Executive Leadership

Strong governance and staff leadership are both essential to the health and stability of an effective nonprofit. As a result, an organization's board and executive director — and their relationship — are typically two of the most important determinants of an organization's strength and capacity.

The board is the oversight body for any nonprofit organization, providing governance and strategic direction. Understanding how the board functions can give you insight into institutional stability and health. The executive director is the key staff leader, so it is critical that you believe in his ability to lead the organization and accomplish the work described in the proposal.

It is also necessary to assess to what extent the board and executive director are likely to work well together, sharing strengths and covering each other's weak spots. Few weaknesses within an organization are in themselves fatal, but the ability and willingness of the board and chief executive to work together, to get help when needed and to make adjustments are key success factors for any grantee — especially during any period of crisis or vulnerability.

Interviewees: Executive director, board chair and/or other board member(s)

Category of Issues	Questions to Consider	Indicators of Effectiveness	Red Flags
Role of the Board	<p>Describe your board and the role it plays in the organization.</p> <p>How do the board and E.D. work together? How are decisions made?</p> <p>What is the board's role in strategic planning? In fundraising? In financial oversight?</p>	<p>An active board, engaged in fiscal oversight, structured in a way that makes sense for the governance needs of the organization.</p> <p>A board and E.D. that understand, and agree upon, their respective roles.</p> <p>Board members who are willing to contribute money, with a goal of 100% board giving (amount given is less important).</p>	<p>The board is not active or is disengaged, especially with regard to fiscal oversight.</p> <p>An E.D. who doesn't value a strong board of directors, or who has a very negative perception of or relation to the board.</p> <p>A mismatch between E.D. and board perceptions of their respective roles.</p>
Structure of the Board	<p>How does the board make decisions? Do appropriate committees exist? How often does the board meet?</p> <p>If applicable, what is the role of any advisory board(s)? Who serves on it?</p>	<p>An E.D. who understands the importance of developing an effective board, and looks to the board to fill in skill gaps.</p> <p>Enough board members to get the work done.</p> <p>Adherence to board member term limits.</p> <p>The advisory board has a clear role and reflects the organization's key stakeholders.</p>	<p>The organization cannot demonstrate recent program accomplishments.</p>

Governance and Executive Leadership (cont.)

Category of Issues	Questions to Consider	Indicators of Effectiveness	Red Flags
Composition of the Board	<p>Who is on your board? What do they bring to the organization?</p> <p>How do you recruit and select your board members? Who is involved in this process?</p> <p>Describe your commitment to diversity of staff and board members.</p>	<p>A board that is representative of the community or stakeholders it serves.</p> <p>A diversity of membership on the board, with skills and knowledge important to the organization, especially financial management and organizational knowledge.</p> <p>A strategic, ongoing board nominations process.</p>	<p>Staff members (other than the E.D.), staff spouses or relatives on the board.</p>
Relationship Between E.D. and Chair	<p>Describe the partnership between the E.D. and the board chair.</p> <p>How do you/they work together?</p>	<p>A working relationship that shows positive, mutual regard and respect.</p>	<p>Obvious conflict between the E.D. and the board chair.</p> <p>A clear difference in their respective views of their roles and how they work with each other.</p>
Executive Leadership	<p>For E.D.: What are your background and qualifications? How long have you been with the organization?</p> <p>How do you work with staff? How do you work with the board of directors?</p> <p>For board members: Describe the leadership your E.D. brings to the organization.</p>	<p>An E.D. who is a passionate leader, knowledgeable about managing the organization — if she doesn't have all the skills, she is aware of what is needed and has resources to get the needed skills.</p> <p>An E.D. with the qualifications to run the organization, and a good reputation in the community and the field of which the organization is a part.</p>	<p>An E.D. who fails to inspire your (or her board's) confidence.</p> <p>The E.D. does not have the necessary experience or training to run the organization. Or the opposite exists: The E.D. is well trained and experienced, but does everything herself, and the whole organization would collapse in her absence.</p>



Organizational Vision and Strategy

Setting the vision and overall direction of the organization is a key role for the board to undertake. Working in partnership with the executive director and other staff leadership, the board must engage in developing strategy and plans for the organization. This involves having a strong understanding of the environment in which the organization is working. Visioning and strategy formation require an important blend of governance and leadership that warrants special attention in due diligence, as it is so critical to a successful organization.

Interviewees: Executive director, board chair and/or other board member(s)

Category of Issues	Questions to Consider	Indicators of Effectiveness	Red Flags
Vision	<p>What is your organization's mission?</p> <p>What is your vision for the organization?</p>	Agreement between E.D. and board as to the mission and long-term vision for the organization.	Leadership is unable to articulate mission and/or vision.
Strategy Formation	<p>How do you set overall direction for the organization?</p> <p>Do you have a current strategic plan? If not, how do you develop strategy?</p> <p>Who is involved in strategic planning and thinking?</p> <p>How do you incorporate current strategies into your work?</p>	<p>A current strategy for achieving the organization's mission with realistic goals.</p> <p>Involvement of the board in strategy development.</p>	Leadership cannot describe any internal process by which opportunities are evaluated and/or goals are set.
External Environment	<p>How does the organization keep abreast of the latest thinking in your field?</p> <p>What are the top three challenges facing the organization over the next five years?</p>	Leadership can describe programmatic trends or movements in the field and how they will affect the organization's work.	Inability to articulate major challenges beyond needing funds.

Proposed Project: Planning, Outcomes and Evaluation

Your initial proposal review should have given you a good sense of the project that the applicant seeks to implement. The written word, however, has its limits. Having a conversation with the applicant is a key step in going deeper in your understanding of what the leaders seek to accomplish.

In your conversation, ask the applicant about the approach and plan for the project, as well as the resources needed to implement it. You should also focus on the programmatic goals and outcomes the applicant has established, ensuring they are well defined, meaningful, and measurable.

Evaluation has several purposes. Engaging in ongoing evaluation provides organizations with information about moving toward success in achieving outcomes and provides guidance regarding what's working and what needs to be changed and improved. Evaluation also provides knowledge for the benefit of others in the field, both practitioners and funders. Finally, sound evaluation practices help to ensure accountability.

Most grantmakers require some form of program evaluation from at least some of their (larger) grantees, though the depth and focus can vary widely. Although formal evaluation is generally prohibitively expensive for grantees, effective organizations should be able to articulate intended outcomes and describe a plan for tracking and measuring the success of their work. They should have methods of measuring their impact and incorporating what they learn into their program practices.

For some grantmakers, a grantee's lack of capacity to track and measure its work is a "deal breaker." For others, because that capacity is very important, there is a commitment of resources to work with grantees to build it. Because evaluation is expensive, grantmakers that require outside evaluation generally provide the funds to support the work. Other funders seek only basic monitoring and assessment, which can be handled in-house by the grantee. So, the key issue is whether you are getting the evaluation information necessary to match your particular institution's values and standards.

Interviewees: Executive director, key program staff, board member that is a project "champion" or supporter

Category of Issues	Questions to Consider	Indicators of Effectiveness	Red Flags
Project Planning	<p>Describe the basis for your approach to this project. What research do you rely upon for your proposed approach?</p> <p>Describe the resources needed to accomplish your goals, and how you plan to obtain them.</p> <p>If relevant, discuss the following:</p> <ul style="list-style-type: none"> • Scalability of model • Replicability of model • Potential for broad impact • An innovative approach 	<p>The methodology makes sense, given what is considered accepted or best practice in the field.</p> <p>The project design supports the applicant's theory of change (whether consciously articulated or implicit).</p> <p>The project plan allocates appropriate resources (staff, expertise, money, an appropriate time frame) to accomplish what is anticipated.</p>	<p>The logic model⁶ or rationale for the program does not make sense.</p> <p>The approach is outmoded, showing a lack of awareness of developments in the field in recent years.</p>

⁶See the definition of a logic model in "Logic Models," page 26.

Proposed Project: Planning, Outcomes and Evaluation (cont.)

Category of Issues	Questions to Consider	Indicators of Effectiveness	Red Flags
Project Outcomes	<p>What are the goals and outcomes identified for this project?</p> <p>What was the process for developing the outcomes? How do you use lessons learned from previous projects?</p> <p>Describe your organization's greatest strengths in terms of your capacity to achieve your intended outcomes.</p> <p>What significant challenges inhibit your ability to achieve your intended outcomes?</p>	<p>Desired outcomes are plausible and aligned with the nonprofit's mission and strategy.</p> <p>Goals are realistic and achievable within the grant period.</p> <p>The resources available are appropriate, and the cost of the program will result in a reasonable impact.</p> <p>Outcomes are SMART: specific, measurable, achievable, realistic and time sensitive.</p>	<p>Project plans are overreaching — goals are too ambitious or resources available are clearly insufficient to reach the goals.</p> <p>The outcomes are not in alignment with the theory of change for the project.</p> <p>The cost-benefit analysis is unacceptable (i.e., it is not worth the expense for the anticipated impact).</p>
Evaluation	<p>How do you evaluate your programs? What tools do you have in place?</p> <p>How do you incorporate what you learn into your ongoing and future work?</p> <p>What is the plan for evaluation for this project? What resources are allocated for evaluation in the project budget?</p>	<p>Organization knows what it accomplishes and can articulate how it will apply what it learns.</p> <p>If outcomes are not achieved, leaders can explain why and have strategies to improve ability to meet outcomes.</p>	<p>Organization has no understanding of the value of tracking its outcomes.</p>

Logic Models — What Are They and Why Are They So Popular?

A logic model — also known as a *theory of change* — is a blueprint for designing and evaluating programs. A logic model typically outlines the interim objectives, key strategies and key activities necessary to achieve a specific long-term goal. It is essentially a picture of a planned project or of an organization — and illustrates the connections between planned outcomes and the work that will get done.

Funders who are requesting logic models of their grantees find that the process of developing them produces improved thinking, planning and communication about desired program outcomes and actual accomplishments.

For more information on logic models and how to develop them, see the W.K. Kellogg Foundation's "Logic Model Development Guide." The publication can be found at www.wkkf.org.

Human Resources

The people who provide a grantee’s services, run its programs and raise, and manage its funds are the core of the organization. Most grantees spend the majority of their budgets on staff, including salaries, benefits and taxes, so human resources management is worthy of strategic thought and planning. This includes developing sound practices in hiring and management, building an organizational structure that meets the needs of programs, and providing staff with opportunities for ongoing learning and professional development.

There are two primary human resources management functions: the technical side (maintaining employee files, collecting salary and benefits information and conducting periodic reviews); and the strategic side (recruiting, developing and retaining a motivated, excellent staff). Organizational leaders must manage these human resources functions wisely, complying with complex government laws and regulations, compensating people adequately within limited resources and motivating them to perform their best. In reality, however, few grantees have well-developed human resources management, so this area can be challenging to assess. It is important to keep in mind the reality of resource constraints of any grantee you are assessing, balanced with the need to effectively meet the organization’s human resources responsibilities.

As you assess the human resources of an organization, ask about the number of people on staff, their qualifications and experience, the professional development opportunities offered on a regular basis, and the organization’s ability to efficiently and effectively grow or reduce its staff as needed. You will want more detailed information on the key staff who will work on the project you are being asked to fund in order to assess their capacity and skills for delivering the services proposed.

Interviewees: Executive director, key program staff

Category of Issues	Questions to Consider	Indicators of Effectiveness	Red Flags
General Staff and HR Concerns	<p>Describe your organizational structure and staff roles/reporting relationships.</p> <p>How are staff recruited and hired?</p> <p>How are staff oriented and trained for their jobs?</p> <p>How do you handle staff performance reviews?</p> <p>How do you invest in professional development for staff?</p>	<p>Organizational structure is clear and there are logical lines of reporting for staff.</p> <p>Organization values and invests in staff training and development.</p> <p>Contractors and/or consultants are used and managed appropriately.⁷</p>	<p>Staff turnover seems unusually high.</p> <p>There is no evidence of a human resources function within the organization — no job descriptions, no organizational chart, etc.</p>
Project Staff	<p>Who are the staff members responsible for the proposed project? What are their backgrounds and qualifications?</p>	<p>There is sufficient staff with the skills and experience to do what the organization says it will do.</p>	<p>The key project staff do not have the necessary experience and/or training to do the job.</p>

⁷ A word on contractors/consultants: Hiring contractors to do specialized work can be cost-effective and is a good way for an organization to be nimble, but they must be managed effectively. A contractor should be managed by an employee, and any contractors should have a clearly defined scope of work, a work plan and timeline, and a written contract. Beware of contractors doing staff-like work, which is sometimes an attempt to get around tax withholding. It is a quite common practice in all sectors, and it is illegal.



External Communications and Relationships

Understanding how an organization interacts with and positions itself in the external environment is an important part of due diligence. A grantee's capacity to communicate who it is and what it does, and its ability to develop and skillfully manage external relationships, can impact the organization's overall effectiveness. You should spend time exploring the work of the applicant in both of these areas.

The way an organization communicates with its external audiences can greatly affect its potential to remain viable. When a grantee knows how to communicate effectively, its relationship with its stakeholders is strengthened. Through marketing and communications activities, a grantee makes its stakeholders aware of what it does and the value of its work. When an organization's constituents are fully aware of its achievements and value, they are more likely to support it — financially, politically and programmatically.

Look for organizations that can communicate their message clearly and effectively and can communicate and form relationships with important stakeholders. A grantee that has a communications or marketing plan — and is working to implement it — is likely to be more effective in cultivating and maintaining a loyal constituent base and to have better relationships with funders and donors.

Further, the willingness and ability of a nonprofit to collaborate or partner with other organizations is a vital capacity in today's nonprofit sector. It is important that an organization's leaders understand their position in the field, who they are competing with for resources and where there are opportunities for strategic collaboration. Partnerships — ranging from one-off situations to long-term relationships — are often an indicator that an organization is looking for ways to increase its effectiveness and efficiency.

Interviewees: Executive director, key program staff, board chair or other board member(s)

External Communications and Relationships (cont.)

Category of Issues	Questions to Consider	Indicators of Effectiveness	Red Flags
Communications	<p>Who do you consider your key audience(s)?</p> <p>How do you communicate with those audiences?</p> <p>How do you disseminate information about your work or share what you learn with others in the field?</p>	<p>The organization has a clear message to communicate about its work and role in the community.</p> <p>The organization has a communications plan that describes audiences and outlines strategies and tactics to reach them.</p> <p>There is an awareness of the importance of sharing knowledge.</p>	<p>Lack of awareness of the need to communicate.</p>
External Relationships	<p>What partnerships or collaborations are you involved in? What role do you play?</p> <p>How do you approach and develop partnerships or collaborative relationships with others?</p> <p>Who is your “competition”? How do you work with them?</p>	<p>The organization has a strong awareness of others in its field – both competitors and partners.</p> <p>The organization looks for ways to collaborate, and engages in creative partnerships.</p> <p>E.D. and staff participate in network or coalition activities, such as collaborative trainings or roundtable policy discussions.</p>	<p>The organization tells you it has no competition because there is no other organization that provides the same service.</p> <p>Lack of involvement in or awareness of key networks or coalitions.</p> <p>Lack of awareness of key competitors, believing it has no competitors.</p>



Financial Health

During your initial proposal review, which will include a very close read of the project and organizational budgets (discussed in detail in “Proposal and Document Review” on page 16), you will have developed clarifying questions to ask in your meeting with the potential grantee.

There is an important interaction between the document review and interviews in understanding the financial health and overall competency level of an organization. By using the financial documents as a starting point for your conversation about financial health, you will be able to explore broader issues of financial management more deeply.

Additionally, your conversation will offer you the chance to assess the overall competency level of the organization’s leaders with respect to financial management. It is critical that a grantee has internal finance management skills and someone on staff that understands the organization’s financial issues. In small organizations, this should be the executive director, at a minimum; in larger organizations, there may be a CFO or dedicated finance staff.

You should also be looking for grantees that have solid financial systems in place to track income and expenses, have performed well in the past, and are realistic about their future. In the case where an grantee’s financial picture is weak, find out if it has learned from past or current challenges and has realigned its systems and projections to avoid overspending, revenue shortfalls or cash shortages, whichever the problem has been (it could be two, or all three).

This area of due diligence is one in which funders often provide training, resources and support for their program officers. This section describes the primary issues related to financial health but is not intended to serve as a training guide. You are encouraged to seek training and assistance from your foundation or through other resources for program officers. (See the resources section of this tool on page 59 for printed resources and training opportunities available to the sector.⁸)

Interviewees: Executive director, finance/operations staff, development director, board chair, treasurer and/or other board member(s) involved in financial oversight

⁸ There is also a chapter in *Grantmaking Basics* (see citation in resources section on page 59) on understanding nonprofit financial health.

Financial Health (cont.)

Category of Issues	Questions to Consider	Indicators of Effectiveness	Red Flags
Organizational Budget	<p>How do you develop your organizational budget? What is the role of the board in the process?</p> <p>Has your organizational budget increased or decreased from last year? Please explain why.</p> <p>What is your anticipated organizational income breakdown in the committed, identified and unknown categories?</p>	<p>The executive director understands the financial aspects of the organization.</p> <p>The expenses and income outlined in the budget are reasonable.</p> <p>The organization appears to have appropriate income streams and a realistic budget that adequately covers core operating costs.</p> <p>A comparison of the budget to actuals year-to-date shows that the organization is close to meeting its budget.</p> <p>There is someone in the organization who knows its financial performance and can explain any patterns.</p>	<p>The executive director cannot explain the financial aspects of the organization. For example, the E.D. cannot answer, off the top of his head, in round numbers, the question “What is your current annual budget size.”</p> <p>The board is not involved in the budget development process.</p> <p>In reviewing anticipated income (committed, identified, unknown), the unknown is too big.</p> <p>Budgeted income exactly equals budgeted expense — this is a “plugged” budget; nature is never this precise.</p>
Project Budget	<p>Describe the budget for the proposed project and how it supports the plan outlined in the proposal narrative.</p> <p>How much of the project funding is committed? What will happen if you don't receive the anticipated funding from other sources (known and unknown)?</p> <p>How did you arrive at your budget estimates? (Ask them to further explain any line items that are questionable or unclear.)⁹</p>	<p>The project budget is aligned with the organizational budget.</p> <p>The overall project budget seems appropriate for what is described in the proposal narrative.</p> <p>There appear to be appropriate income streams and a realistic budget that adequately covers program costs.</p>	<p>The project budget is unrealistic and/or not consistent with the proposal narrative.</p> <p>In reviewing anticipated income (committed, identified, unknown), the unknown is too big.¹⁰</p>

⁹ Be aware of project budgets seem to be “padded” with excess expenses beyond the proposal narrative. Similarly, a project budget may be too lean. In this case, it may be necessary to increase your funding or suggest the organization reduce its activity if no additional funds are available.

¹⁰ Though it is fine if all funding is not secured, if the unknown category is unrealistic, this is a red flag.



Financial Health (cont.)

Category of Issues	Questions to Consider	Indicators of Effectiveness	Red Flags
Financial Systems and Reporting	<p>What financial statements do you generate? How frequently? Who prepares them? Who reviews them?</p> <p>Describe the financial expertise on your board.</p> <p>What role does the board play in financial oversight?</p> <p>What is the process for providing the board with regular financial information?</p>	<p>The organization has regular audits if its annual budget is greater than \$250,000.</p> <p>The board has member(s) with financial expertise, and the board performs regular financial reviews.</p> <p>The board receives financial reports at least quarterly.</p> <p>Management and program staff understand how to read the financial statements.</p> <p>Financial reports are used to inform programmatic and other decisions.</p>	<p>There are no financial reports or statements generated.</p> <p>The organization has financial statements, but they are not reviewed by the board, or they are out of date (more than two months old).</p> <p>The organization “borrows” from other programs or restricted funds.</p> <p>The organization’s mid-year financial statements indicate it is way off budget.</p> <p>Auditor’s letters to management indicate weakness in internal controls.</p>
Financial Position and Trends	<p>Describe your organization’s current financial state.</p> <p>Has the organization borrowed money? If so, what are the terms of the loan? Was borrowing for capital expenditures such as a building or to cover an operating loss?</p> <p>(If debts exceed available cash) what is your plan for debt reduction?</p> <p>(If there was an operating loss) what are you going to do to avoid another loss this year?</p> <p>What is your vision for (continued) financial health? Where do you see the organization, financially, in five years?</p>	<p>The organization has a history of breaking even or operating in surplus.</p> <p>The financial manager and executive director can describe the organization’s current financial state.</p> <p>The organization has a long-term vision of where it wants to be financially.</p>	<p>The organization does not have enough cash on hand to meet demands.¹¹</p> <p>The organization has a growing accumulated deficit because it ended the past fiscal year with a deficit and is projecting another deficit this year.</p> <p>The balance sheet shows negative net assets.</p> <p>The organization has debt other than long-term debt for asset acquisition, such as for buying a building, and has no debt reduction plan.</p> <p>There are unusual items in the organization’s financials (loans from board members, unpaid salaries) that are not clearly accounted for.</p> <p>The auditor has issued a “qualified opinion.”</p>

¹¹ The current ratio (current assets to current liabilities) will tell you whether the organization can meet short-term cash requirements. It must be at least 1:1.

Financial Health (cont.)

Category of Issues	Questions to Consider	Indicators of Effectiveness	Red Flags
<p>Fund Development Planning and Oversight</p>	<p>Describe your fund development plan (i.e., fundraising goals and plan for reaching them).</p> <p>How is the board involved in fundraising?</p> <p>What role do board members play in developing strategies to maintain or grow the organizations' contributed income?</p> <p>How do you monitor progress against your fundraising goals? What role does the board play in this process?</p>	<p>There is a plan for raising money, developed with the involvement of board members.</p> <p>The board of directors is aware of or involved in the organization's fundraising goals and activities.</p>	<p>The organization cannot articulate a plan for fundraising.</p> <p>The board is not involved in fundraising.</p> <p>The board members responsible for fundraising and development oversight don't have the skills or interest.</p> <p>The budget projects a perfect breakeven, and the fundraising budget number is exactly the amount needed. Ask for last year's actuals and see if the current-year fundraising goal is reasonable, or is just "plugged."</p>
<p>Funding Mix</p>	<p>How would you describe the health and balance of your funding mix — i.e., is it diversified enough?¹² What areas, if any, do you seek to change or improve? How?</p> <p>What are your concerns, if any, about your funding picture?</p>	<p>The organization has diversified contributed income, as well as earned income (if appropriate).</p> <p>The fundraising goals (for the organization or the project) and overall budget are realistic based on the economy and past experience.</p>	<p>The E.D. and board member(s) cannot articulate their funding mix.</p> <p>The organization is overly dependent on one source of funding.</p> <p>The organization has had a difficult time meeting the public support test¹³ and maintaining its public charity status.</p>

¹² Determine an organization's dependence on any single source by looking at the revenue line item as a percentage of the organization's total expenses. Is any one source predominant?

¹³ The public support test is designed to ensure that a charity has a broad base of support and is, therefore, responsive to the general public rather than a few individuals. Grantees must develop and maintain support from a diversity of donors; this is determined through a formula established by the IRS and provided to the grantee. It is the grantee's responsibility to understand this issue and track its support to ensure that it is not in danger of losing its 501(c)(3) status.

Applying Your Due Diligence Findings

In the introduction to this tool, we stated that due diligence is both art and science. Once you have immersed yourself in the process of rigorously examining an organization and its leadership through the course of due diligence, you will have a clearer understanding of the truth of this statement.

It would be terrific if your investigations led to a consistent set of findings — either all great or all bad. However, this is generally not going to be the case. In reviewing your due diligence findings, you may uncover some issues that lead you to a favorable impression of the organization and others that cause you concern. You may also have identified red flags.

The analysis of due diligence findings is generally a weighing of a variety of factors in order to determine whether you should feel caution about making the grant recommendation.

During the course of due diligence, you will develop an understanding of the organization's financial health, its capacity to deliver on the proposed project, its reputation in the community and its approach to working with others. You will also develop a perspective on the leadership of the organization — both paid and volunteer. Now is the moment to consider all the factors that have come into play and to explore how to balance what you have learned in order to reach a decision about whether the organization warrants a grant from your foundation.

What Are Your Organization's Values? How Do They Relate to Grant Decisions?

Every organization has values that are reflected in decisions about grants. These will shape your due diligence process and the way you evaluate what you learn. It is your responsibility to understand what matters to your organization and how you weigh those issues in your process. Examples of specific values might include:

Board and staff diversity — Does it matter to your organization that the staff and board are representative of the constituencies the applicant serves? How strongly will you take a position?

Social enterprise issues — If you are funding social enterprises that must demonstrate financial sustainability by the end of your commitment to the prospective grantee, you may have this bottom line as a clear value that guides your assessment.

Cutting-edge work and innovation — If you seek to fund innovative or cutting-edge work, a perfectly respectable proposal from a reliable but not innovative nonprofit may not pass muster.

Financial capacity and practices — Some organizations place a particular value upon understanding and promoting financial competency. Extra attention may be paid to this area, and effort invested in assisting grantees in building their capacity in financial management.

Red Flag Identification and Understanding the Risk

In your analysis of the data collected through document review and interviews, you may have identified red flags in one or more of the assessment areas. Red flags are findings that indicate the grantee is seriously deficient in an important area of organizational capacity and thus may not be fully capable of implementing the grant.

It is important to note: Not all assessment areas will reveal red flags, and not all red flags mean that you shouldn't award a grant.

Further, you may have issues that matter to your particular organization and would be a deal breaker — so, your organization may have additional red flags beyond those we have included.

If you have identified any red flags, they can be recorded on Worksheet #3: Assessment Questions (See page 51 in the appendices section). You then need to assess the risk that the red flags, taken as a whole, represent to the foundation's objectives. This involves looking at the big picture formed by the due diligence process:

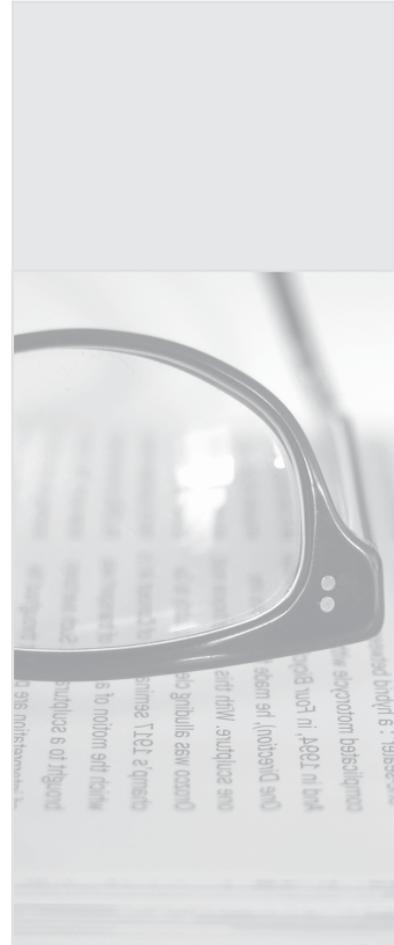
- What do the red flags tell you?
- Overall, what is the level and nature of the risk in making this grant? Does the potential benefit outweigh the risk?
- Are there actions that might effectively manage or ameliorate the risk?

This evaluation must take into account the fact that the red flags can't be weighted equally. Some issues are relatively simple to address through the use of an outside consultant with specific expertise (e.g., setting up an adequate financial management system). In other cases, it may take more time to affect real change (e.g., an organizational culture that does not promote appropriate involvement of the board of directors). In some cases, it may be highly unlikely that the organization will ever meet the funder's minimum standard in an important area.

It will be your challenge to determine how to move forward with funding decisions in light of any identified red flags. Your assessment and understanding of the red flags can be guided by the following set of questions:

1. How extensive are challenges or organizational deficiencies? Are there many red flags across different areas, or are they clustered?
2. Taken as a whole, are the challenges *significant* (critical) enough to affect the organization's ability to carry out your grant? Why?
3. Could the issues be addressed? How?
4. Is the organization willing to take the necessary steps to remedy the weakness or deficiency? Are you willing to provide resources to support it?

Providing organizational support — such as additional grant money or consulting assistance — to an organization that could benefit from it is an option if your organization generally supports such activities for grantees. What this red flag analysis can provide is a better understanding of what an organization might need in order to advance its mission and succeed in implementing your funded program.



Factors to Balance

In determining how to address problems surfaced by the due diligence process, here are some key factors to consider:

1. **Size of grant** — Is it large for your organization? If so, you will want to be sure about your decision to fund. A different level of analysis is needed for different sizes of grants. You know what is “large” for your organization, and when you are considering a high level of investment, or a long-term investment, your due diligence process will likely be more exacting and intense.
2. **Size of grant relative to the applicant’s budget** — Will this make a large impact on the grantee’s annual operating budget? If so, it will be critical to pay attention to the health of the organization and its capacity to manage a large infusion of money.
3. **Recent leadership changes at the applicant organization** — If there has been a recent leadership change, you may choose to spend additional time exploring the reasons for the change and trying to understand how the organization is managing the transition. Times of leadership change can be challenging and may warrant additional support or a decision to postpone new projects.

Communicating Your Due Diligence Findings to the Applicant

Once you have completed due diligence and analyzed what you have learned, what do you communicate to the applicant? In order for due diligence to be a useful process for both the grantor and grantee, thought should be given to what and how you communicate back to the applicant. Whether your ultimate funding decision is yes or no, you have learned things about the organization that may be helpful to it.

This communication takes time. However, it is this extra step and investment in the relationship that makes due diligence a valuable process for both parties. Whatever the mode of communication — in writing, by phone or in person — think carefully about what you will say and how you will say it.

Be honest, but not critical or judgmental. Make observations about the organization’s health and challenges, but don’t criticize.

Be clear about the reason(s) you are choosing not to fund it. It is difficult to turn down a grant applicant — and even more difficult to communicate that information directly. It is helpful to the applicant, however, if it understands the reasons for your decision. If you are denying funding, be clear on your reservations about the organization’s health and stability.

Be specific. Discuss issues in the proposal or supporting documents, or things that you learned in the course of your interviews, that raised red flags.

Acknowledge strengths and challenges. Don’t just communicate your concerns about challenges. Take time to point out the strengths of the organization that you have observed.

It is not your role to play judge and jury. However, if you have invested time in due diligence, you have learned things about the organization — strengths and challenges — that the leadership might appreciate hearing about.

Offer your perspective, communicate with positive regard, and you can ensure that due diligence has benefited both the grantor and the grantee.

What Are Your Options Moving Forward?

As we have suggested, one of the biggest challenges for the program officer conducting due diligence is that you will be weighing a variety of issues and trying to assess a whole organization that is a sum of disparate parts. A challenge can arise, for example, when you have reviewed finances, staffing, track record and so forth, and feel that you have everything “in the can” but that the applicant’s leadership is a problem. What do you do? When there are benefits to the grant that outweigh the risks, yet there are very real risks involved in a grant, a simple yes or no to the grant request may feel inadequate or even irresponsible.

If you have decided that you definitely want to make a grant to the organization, there are a range of options for the structure of the grant that you might consider, depending upon the level of risk represented by the deficiencies uncovered during due diligence. These include:

1. **Fully fund the proposed project, with no stipulations.**
2. **Fully fund the proposed project, with stipulations** — Make a program grant as requested. Require the grantee to remedy the deficiencies and report back within a prescribed time frame. Tie future grant payments to these stipulations.
3. **Give an experimental grant** — Make a program grant for one year only, negotiating specific, reasonable objectives, and monitor the grant closely. Consider additional funding later when agreed-upon benchmarks are achieved.
4. **Give an exploratory program grant, coupled with organizational assistance** — Consider offering consulting or training assistance as part of the grant package if the applicant appears to have substantial or complex capacity issues. Make a program grant only for one year; negotiate specific, reasonable objectives; tie grant payments to achievement of benchmarks; and monitor the grant closely.

There may still be situations where you would not feel comfortable moving forward with a recommendation to fund a particular organization given its weaknesses. Explain to the organization your reservations, given the instability of its structure or deficiencies in its systems. It is helpful to the applicant to review specific issues of concern.

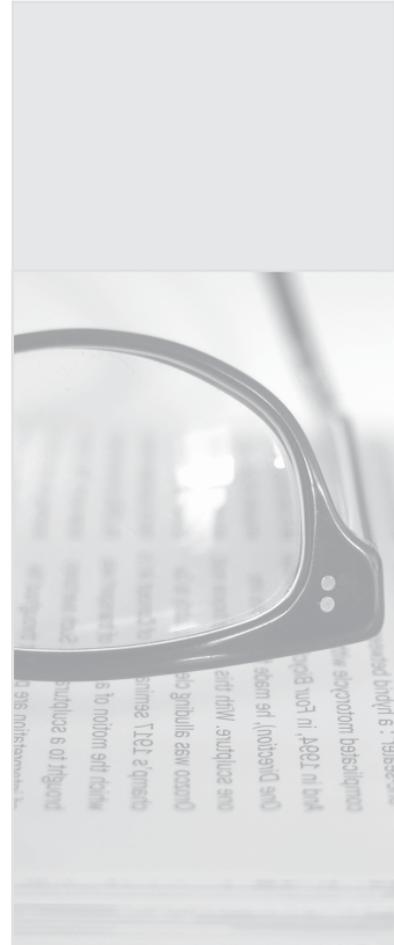
If you have sincere interest in the organization or project, you can invite the organization to resubmit its proposal at a later time coupled with concrete evidence of organizational development or change related to the concerns you have raised.

Assistance to Organizations to Strengthen Capacity

There are specific steps your foundation can take to help an organization in which you have a keen interest in enhancing its effectiveness. If the organization isn’t sound in certain areas, but you want to make a grant, there are steps you can take and resources you can offer that can assist the organization in building its capacity so that it is better able to deliver on what it aspires to accomplish.

Things you can do to assist an organization:

- Provide additional funding to support strengthening the organization’s management (most commonly called a grant for *organizational effectiveness* or *capacity building*).
- If you don’t provide organizational effectiveness or capacity-building funding, familiarize



yourself with other funders in your region that do provide grants for capacity building. You can search for funders by visiting www.geofunders.org and reviewing GEO's membership list.

- Know your local nonprofit management resources — nonprofit resource or support centers that provide consulting or information about consultants, trainings/workshops for skill building in nonprofit management, and other resources and information for nonprofit staff and boards.
- Compile a list of great Web sites with helpful nonprofit resources (suggestions included in resources section of this tool on page 59).
- Build a bibliography or library of useful, practical books that address nonprofit management issues (see resources section on page 59).

Finally, we encourage you to incorporate ongoing learning about nonprofit management and governance issues into your own work. The more familiar you are with the organizational side of nonprofit work, the better equipped you will be not only to conduct sound and thorough due diligence, but also to offer resources and ideas (that don't cost anything) to the organizations you work with.



Legal Compliance Issues

The legal standard that private foundations must meet in their grantmaking is fairly simple and straightforward: The grant must be made for a charitable purpose. In general, it is also the case that the grant recipient must be a charitable organization, although there are several ways for grantmakers to provide funding to other types of entities.

Thus, the legal issues that a program officer is concerned with in grantmaking fall into two general categories:

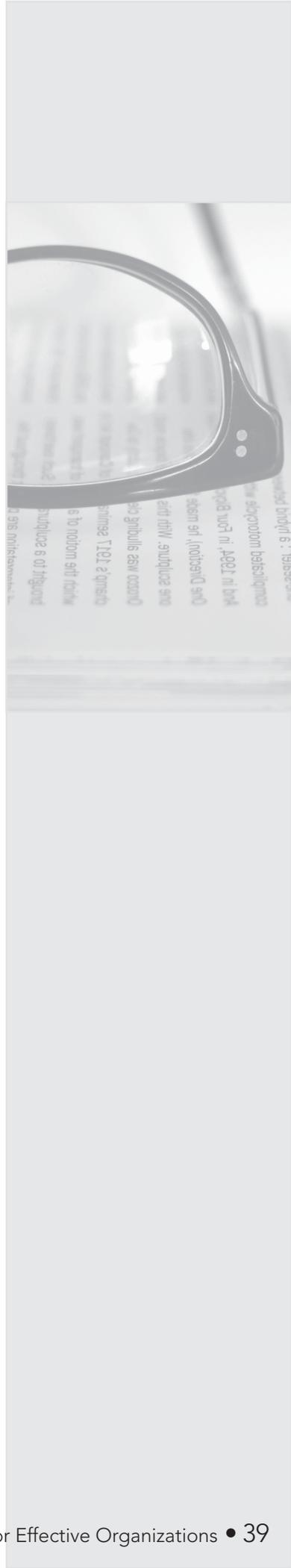
1. The intended use of the grant funds; and
2. The charitable status of the potential grantee organization.

Of course, this is deceptively simple. There are a variety of legal issues that can arise in the process of grantmaking, some of which are subtle and complex. Larger organizations often have in-house legal expertise, or grants administration staff, to provide support to program officers in the grantmaking process. At many organizations, however, program staff is responsible for ensuring that the key compliance issues are identified and appropriately addressed.

A thorough treatment of the legal compliance issues that may arise in due diligence, and the analysis of each, is beyond the scope of this tool. We have instead endeavored to lay out the basic issues of which a program officer should be aware, and identified the resources for assistance that are available to the philanthropic sector.

This summary of issues is intended to present the basic legal issues that arise in due diligence. This section is not intended to provide legal guidance, solve complex legal issues or replace legal counsel. If you are unsure about a specific grantmaking situation, always seek professional help from an attorney competent in these areas.

A good place to start for general legal resources and advice is the Council on Foundations (www.cof.org).



Intended Use of Grant Funds

The first step in your review is to confirm that the proposed activities to be funded are for charitable purposes as defined by the IRS. In sum, this means that the activities are intended for public benefit — not to benefit any private individuals (such as the organization’s members, officers or directors), financially or otherwise.

There are some specific restrictions that may arise related to use of funds, including for lobbying, electioneering and activities that have the potential to support terrorism.

Lobbying

Under federal tax rules, foundation funds may not be used for activities defined as “lobbying” or attempting to “influence legislation” at the national, state or local level. All public charities (defined in the section on charitable status, page 41) are permitted to do *some* lobbying, but foundations may not make grants directed to supporting this work. Related activities — such as research, analysis and public education, as well as some advocacy and policy work — are not included in the definition of lobbying, however, and you may provide funding for these activities.

As a grantmaker, you need to be familiar with the IRS’s definition of lobbying. In proposal review and due diligence, it is crucial that you understand exactly what the grantee proposes to undertake, so that you can ensure that your funds are used appropriately — that is, for advocacy, policy or public education activities, but not for lobbying.

There are several good sources for information and guidance on understanding the complexities of this area. The Alliance for Justice provides technical advice to foundations. Contact the Alliance at www.allianceforjustice.org. You can also seek guidance from the Council on Foundations at www.cof.org.

Electioneering

Participation or intervention in any political campaign for or against any candidate for public office (national, state or local) is absolutely prohibited for public charities. Foundation funds may never be used to support such activities. However, foundations may support work related to the electoral process such as voter registration and get-out-the-vote efforts in compliance with the relevant IRS regulations.

Terrorism

The U.S. government took a series of steps after September 11, 2001, to stop the flow of funds to terrorists and terrorist organizations (including passage of Executive Order 13224 and the Patriot Act). Some of these actions directly affect grantmaking for charitable activities. In sum, the measures dictate that it is the grantmaker’s responsibility to avoid supporting any terrorist activities, and they allow for sanctions even if support is made unknowingly.

This is an ongoing and evolving area of concern. Best practices relative to these federal counter-terrorism measures have not been determined, although it is important to note that both domestic and international grantmaking are affected. If this is an area of concern to your foundation, consult the Council on Foundations’ *Handbook on Counter-Terrorism Measures*.

Be Aware of Tipping

When you make large grants to organizations that may be without a broad (that is, diverse) base of support — for example, a new or small organization that has not received many grants in the past — you should alert the grantee that it needs to be aware of an issue called “tipping.”

Grantees must develop and maintain support from a diversity of donors; this is determined through a formula established by the IRS and provided to the grantee. Tipping occurs when support from a single source of funding “tips” a public charity out of compliance with the public support test, converting it into private foundation status. It is the grantee’s responsibility to understand this issue and track its support to ensure that it is not in danger of losing its public charity status.

That said, if you know that you are providing a large grant to an organization that does not have a variety of other donors, you can be helpful to it by raising the concern, so that it can take the appropriate steps to build a diverse funding base and a broad set of supporters.

Charitable Status

Once you have established that the proposed activities to be funded are for charitable purposes, you must determine the legal status of the prospective grantee. The most common grantee category is tax-exempt public charities 501(c)(3) organizations. However, grants for charitable purposes may also be made to other types of organizations.¹⁴

Depending on which category the potential grantee falls into, there are issues to understand.

Grants to Tax-Exempt Public Charities

Most grants are made to a tax-exempt public charity, defined under Section 501(c)(3) of the IRS code as a corporation that is organized and operated exclusively for a charitable, scientific or educational purpose. A public charity either has an inherently charitable function (a college) or receives its financial support from a broad segment of the general public.

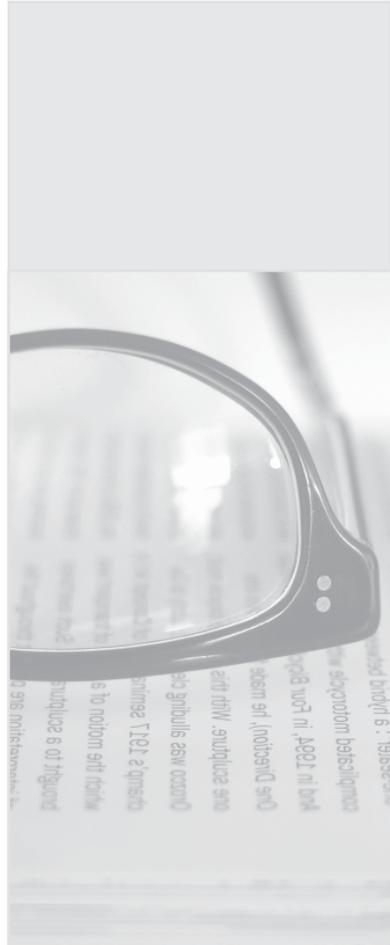
The key first step is to determine the applicant’s 501(c)(3) status by requesting the organization’s IRS determination letter.

Organizations that have applied for tax-exempt status from the IRS will receive a letter advising them of the IRS’s ruling on their application. This letter is a common requirement for grant applications and will contain the information you need to confirm that the organization has a current IRS determination.

In the IRS determination letter, you want to look for:

- Tax-exempt status under 501(c)(3)
- Classification as a public charity or private foundation [under Section 509(a)]
- Correct name and address of grantee
- Advance ruling period that has not expired or “permanent” ruling. (If the advance ruling

¹⁴ Some organizations make grants to individuals. There are complex IRS rules that govern these grants. Consult the Council on Foundations (www.cof.org) for guidance on compliance.



period has expired, the organization should have submitted a Form 8734 to the IRS. You should request a copy of the permanent determination letter when it is received by the organization.)

Another way to determine the status of a nonprofit is to check the cumulative IRS listings, found on the Internet at www.guidestar.org.

Grants to Other Types of Organizations

There may be times when you want to make a grant to an organization that is not a public charity. These would include:

- Organizations whose application for 501(c)(3) tax exempt status and public charity classification is in process
- Another private foundation
- A project without its own exemption that has a 501(c)(3) fiscal agent¹⁵
- Nonprofits with an IRS designation other than 501(c)(3) [e.g., 501(c)(4), (c)(5), or (c)(6)]
- International organizations
- For-profit entities

In any of these situations, your two most likely avenues are to make an expenditure responsibility (ER) grant or to make a grant to a fiscal sponsor.¹⁶ Both of these approaches involve a set of procedures to ensure that grant money is being spent for charitable purposes, even though the end recipient is not classified as a public charity by the IRS.

Expenditure Responsibility

With an ER grant, the grantmaker puts special restrictions and more rigorous reporting requirements into place, providing assurance that the funds will be used for the intended charitable purposes. There are specific IRS rules for the administration of ER grants, which must be followed carefully. The Council on Foundations has published a useful handbook, called *Expenditure Responsibility Step by Step*, which outlines the ER process and includes sample forms and documents.

In brief, you should keep in mind the following important procedures:

1. **Conduct a pre-grant inquiry:** Your organization should have in place written procedures for complying with the pre-grant inquiry required by the IRS. The pre-grant inquiry documents in writing items such as those listed below. (Note: This is not a complete list.)
 - Identity of proposed grantee and whether there is an IRS determination letter

¹⁵ Please see the sidebar on page 44, “Fiscal Sponsor or Fiscal Agent?” for a definition of fiscal agent.

¹⁶ It is also possible for an international organization to establish “equivalency” in accordance with IRS rules, enabling the foundation to make the grant directly to the applicant, as if it were a 501(c)(3).

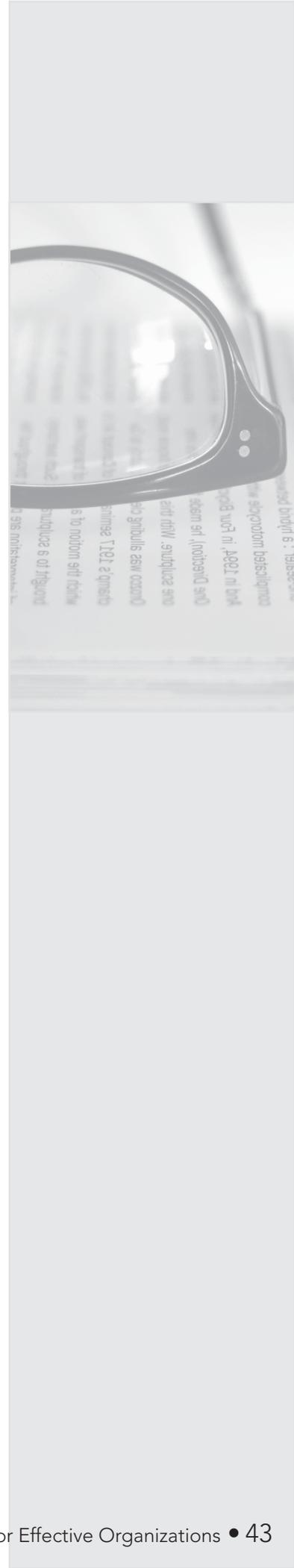
- Why ER is required
 - Written proposal detailing the project and project budget
 - Complete financials
 - History and experience of proposed grantee and its managers, including prior grants made by your foundation and others
 - Names/titles of chief personnel and board of directors
 - Grantee's stability, solvency and overall reputation
- 2. Establish proper terms for the grant and lay them out in a written ER agreement:** ER grants require a detailed, written agreement. In this agreement, you should lay out the terms of the grant and the commitments that will be adhered to under the grant.
 - 3. Ensure that the ER grantee has created a separate account for your grant dollars:** Because the grant recipient may be conducting other activities that are noncharitable, the IRS requires the organization to segregate and carefully track funds that are earmarked for charitable purposes.
 - 4. Obtain narrative and financial reports from the grantee:** You must obtain full and complete reports from grantees on how grant funds are spent. If you don't receive narrative and financial reports on time, or if the reports are inadequate and don't fully address the terms of the written ER agreement, you should suspend further payments until the matter is resolved. If you are concerned that there has been a potential diversion of funds — that is, money spent in any ways that are not consistent with the ER agreement — you must fully investigate and address the issue immediately. Although it is rare that there is a diversion of funds, you should get legal advice, as you may be required to take certain steps per the Internal Revenue Code.
 - 5. Foundation reports on ER grants to the IRS:** ER grants must be reported to the IRS on a separate list of ER grants attached to the Form 990-PF (the foundation's tax report). The IRS requires reporting for the year the ER grant is made and until all grant funds are used and the final report is received from the grantee. You must keep all grant records so that they are available for the IRS on request. IRS regulations lay out specific instructions in more detail.

In practice, this is not as onerous as it may sound. Creating standardized procedures in advance of an ER grant greatly facilitates the process. For a complete list of when ER grants are required, and for more information about how to manage and report on ER grants, consult the Council on Foundations.

Fiscal Sponsors

Another option is to make the grant to a separate organization that is a 501(c)(3) charity, called a *fiscal sponsor*. The fiscal sponsor assumes legal responsibility for the grant, although the funds will be used by another group to carry out the proposed project. (See the sidebar on page 44, “Fiscal Sponsor or Fiscal Agent?” for further information.)

There are two issues to note here. First, a grant made to a fiscally sponsored group must be



seen as a grant to the fiscal sponsor. The mission and activities of the sponsored project must be consistent with those of the fiscal sponsor. You must treat the fiscal sponsor as the grantee and verify its nonprofit status. The fiscal sponsor's governing board has general supervision and control over the project, and the fiscal sponsor is legally responsible for everything the funded project does, including progress and financial reporting to the foundation and IRS.

Therefore, in addition to assessing the organizational capacity of the project you are considering funding, you should closely assess the stability of the fiscal sponsor organization.

Second, it is important to also understand the relationship between the project and the sponsoring organization. It is not uncommon to find that these relationships are set up informally, without clear agreements. There should be a written agreement between the two that clearly delineates the relationship.

Fiscal Sponsor or Fiscal Agent?

The first grantee designated to receive grant funds and to pass all or a portion of the grant funds to a secondary grantee or consortium may be referred to as a "fiscal sponsor," "fiscal agent," or "intermediary." These terms are often used interchangeably. However, they do have specific meanings.

- **Intermediary** is a general term and can be used to apply to any situation where you are making a grant to one grantee (an intermediary) for payment to another grantee.
- **Fiscal sponsors** assume legal responsibility for a grant to a secondary grantee or for a project. Typically, fiscal sponsors are 501(c)(3) organizations that receive funds on behalf of other organizations that are not 501(c)(3)s, but this is not always the case. The tax exempt status and public charity classification of the fiscal sponsor (first grantee) determines whether or not ER is required.
- **Fiscal agents** act on behalf of a secondary grantee (as principal). The secondary grantee may be another organization, a joint project, or a consortium. A fiscal agent (first grantee) may pass through grant funds to a secondary grantee, or administer the financial aspects of the grant and pay funds as needed. Unlike a fiscal sponsor, the tax exempt status of the fiscal agent (first grantee) is ignored or looked through, and the tax exempt status and classification of the secondary (ultimate) grantee determines whether or not ER is required. Sometimes it is simpler to make the grant directly to the secondary grantee.

The key difference between the fiscal sponsor and fiscal agent is the relationship between the primary and secondary grantees. A fiscal sponsor actually exercises control over a project/program. For example, the first grantee accepts legal responsibility for and controls finances for the project, and the board of the first grantee has general supervision over the grant. If these types of factors are not present, and the first grantee is acting as an administrator of the funds and is essentially providing accounting functions to the secondary grantee, then it is likely a fiscal agent relationship.

Appendices

Due Diligence Tool Worksheets

Three worksheets are provided for *The Due Diligence Tool*:

1. Materials for Review

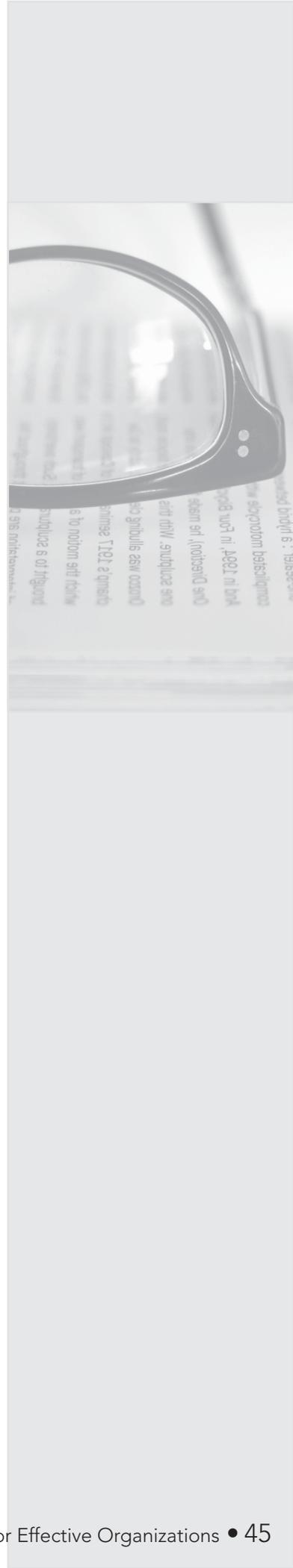
This is a list of documents to request in an assessment of a prospective grantee. These documents are supplemental to the programmatic information you receive with a proposal.

2. Initial Proposal and Document Review Questions

This includes questions for you to consider as you go through the steps involved in the initial review of the applicant's proposal, budget and supplemental materials (particularly financial documents).

3. Assessment Questions

This worksheet contains a chart of the questions for organizational leaders with space to track brief comments and to mark red flags that arise.



Due Diligence Tool Worksheet #1

Materials for Review

Proposed Project

- Narrative proposal
- Grant proposals to other foundations (for reference purposes)
- Current strategic plan or business plan (showing how resources will be used toward achieving organizational and program goals)
- Evaluation plan(s) or tools to track progress, if available

Financial Health

Proposal-specific documents

- Proposal budget
- A list of all anticipated project funding (committed, secured, pending)

Organizational documents

- Organization-wide budget
- Interim financial reports to senior management and to the board of directors
- Annual financial statements from the end of the most recent fiscal year (audited, if available)
- Auditor's letters to management
- Interim balance sheet and income statement
- Budget for current fiscal year (with year-to-date numbers, if available)
- Most current IRS Form 990 if available (for organizations with budgets under \$25,000)

Organizational History and Track Record

- General organizational documentation, including annual reports, grant reports, newspaper clippings, etc.
- Organization's URL address

Governance and Executive Leadership

- Board member list, with name, position on board, location, community/professional affiliation, etc.
- Executive director's resume
- List of other management staff with brief biographical information

Due Diligence Tool Worksheet #1 Materials for Review (cont.)

Vision and Strategy

- Most current strategic plan or business plan
- Other materials related to strategy or strategy development efforts

Human Resources

- Organizational chart
- Job descriptions for each staff position
- Resumes of key staff on proposed project

External Communications and Relationships

- Marketing/PR packet, including materials such as brochures, newsletters, etc.
- Communications plan, if available

Due Diligence Tool Worksheet #2

Initial Proposal and Document Review Questions

Steps in Process	Questions to Consider
First-Level Proposal Review	<ul style="list-style-type: none"> • Does the project fit within the field? How will the project benefit the field and/or the community? Is there a need for the services/outcomes? • Is the approach solid? Are there better approaches for achieving the outcomes? • Does the project fit with your organization's theory of change? Does it build on other grants?
Second-Level Proposal Review	<ul style="list-style-type: none"> • Does the project fit with the organization's mission and theory of change? Does it shift the organization away from its mission? • Does the project design make sense? Do the proposed activities fit with the overall project goals? • Do the costs make sense? • Is the program likely to succeed in achieving its desired results? What are the major challenges to success? How will these challenges be addressed? • Is this the right organization to do the job? Are there others doing anything like this; and if so, might they do it better? • Does the organization have a successful history of running a similar project? If the proposed scope of work is new for the organization, does it have the capacity to meet the goals?
Discussion with Colleagues	<ul style="list-style-type: none"> • How are the organization and its key staff leadership perceived in their peer group and by other funders? • Does the organization have a positive history of working and networking with others in community?
First Level of Financial Consideration	<ul style="list-style-type: none"> • Become familiar with the project budget. • Review the description of the project's staffing: Does the proposed project staff design seem adequate? • Consider how the project supports or doesn't support the work of the organization: Do the two fit together?
Financial Document Review	<ul style="list-style-type: none"> • Does the organization have working capital that is equal to the current liabilities plus three months of operating budget?¹⁷ • Does the organization have positive net assets (also called a <i>fund balance</i>)?¹⁸ • Does the organization have an operating deficit (expenses exceeds revenues)? • Has the organization filed a Form 990 to the IRS,¹⁹ and does the information in its audit corroborate the info on the 990?

¹⁷ Working capital is equal to current assets minus current liabilities.

¹⁸ *Net assets* or *fund balance* is also called *net worth* or *profitability* in the business world. This is equal to revenues minus expenses.

¹⁹ Organizations with expenses less than \$25,000 in a given year are not required to file a Form 990.

Due Diligence Tool Worksheet #3

Assessment Questions

Area of Review	Question	Notes
Organizational History and Track Record		
History	Tell me about the history of your organization. What have been the key milestones in its development?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	What have been the most significant accomplishments of the past three to five years?	
	What have been the most significant challenges?	
Recent Accomplishments	What have been the most important accomplishments this past year?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
Governance and Executive Leadership		
Role of the Board	Describe your board and the role it plays in the organization.	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	How do the board and E.D. work together? How are decisions made?	
	What is the board's role in strategic planning? In fundraising? In financial oversight?	
Structure of the Board	How does the board make decisions? Do appropriate committees exist? How often does the board meet?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	If applicable, what is the role of any advisory board(s)? Who serves on it?	

Due Diligence Tool Worksheet #3
Assessment Questions (cont.)

Governance and Executive Leadership (cont.)		
Composition of the Board	Who is on your board? What do they bring to the organization?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	How do you recruit and select your board members? Who is involved in this process?	
	Describe your commitment to diversity of staff and board members.	
Relationship Between E.D. and Chair	Describe the partnership between the E.D. and the board chair.	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	How do you/they work together?	
Executive Leadership	For E.D.: What are your background and qualifications? How long have you been with the organization?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	For E.D.: How do you work with staff? How do you work with the board of directors?	
	For board members: Describe the leadership your E.D. brings to the organization.	

Due Diligence Tool Worksheet #3
Assessment Questions (cont.)

Area of Review	Question	Notes
Organizational Vision and Strategy		
Vision	What is your organization's mission?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	What is your vision for the organization?	
Strategy Formation	How do you set overall direction for the organization?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	Do you have a current strategic plan? If not, how do you develop strategy?	
	Who is involved in the strategic planning and thinking?	
	How do you incorporate current strategies into your work?	
External Environment	How does the organization keep abreast of the latest thinking in your field?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	What are the top three challenges facing the organization over the next five years?	

Due Diligence Tool Worksheet #3
Assessment Questions (cont.)

Area of Review	Question	Notes
Proposed Project: Planning, Outcomes and Evaluation		
Project Planning	Describe the basis for your approach to this project. What research do you rely upon for your proposed approach?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	Describe the resources needed to accomplish your goals, and how you plan to obtain them.	
	If relevant, discuss the following: <ul style="list-style-type: none"> • Scalability of model • Replicability of model • Potential for broad impact • An innovative approach 	
Outcomes	What are the goals and outcomes identified for the project?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	What was the process for developing the outcomes? How do you use lessons learned from previous years/projects?	
	Describe your organization's greatest strengths in terms of your capacity to achieve its intended outcomes.	
	What significant challenges exist in your capacity to achieve your intended outcomes?	
Evaluation	How do you evaluate your programs? What tools do you have in place?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	How do you incorporate what you learn into your ongoing and future work?	
	What is the plan for evaluation for this project? What resources are allocated for evaluation in the project budget?	

Due Diligence Tool Worksheet #3
Assessment Questions (cont.)

Area of Review	Question	Notes
Human Resources		
General Staff and HR Concerns	Describe your organizational structure and staff roles/reporting relationships.	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	How are staff recruited and hired by the organization?	
	How are staff oriented and trained for their jobs?	
	How does the organization handle staff performance reviews?	
	How does the organization invest in professional development for staff?	
Project Staff	Who are the staff members responsible for the proposed project? What are their backgrounds and qualifications?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No

Due Diligence Tool Worksheet #3
Assessment Questions (cont.)

Area of Review	Question	Notes
External Communications and Relationships		
Communications	Who do you consider your key audience(s)? How do you communicate with those audiences?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	How do you disseminate information about your work and/or share what you learn with others in the field?	
External Relationships	What partnerships or collaborations are you involved in? What role do you play?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	How do you approach and develop partnerships or collaborative relationships with others?	
	Who is your “competition?” How do you work with them?	

Due Diligence Tool Worksheet #3
Assessment Questions (cont.)

Area of Review	Question	Notes
Financial Health		
Organizational Budget	How do you develop your organizational budget? What is the role of the board in the process?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	Has your organizational budget increased or decreased from last year? Please explain why.	
	What is your anticipated organizational income breakdown in the committed, identified and unknown categories?	
Project Budget	Describe the project budget and how it supports the plan outlined in the proposal narrative.	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	How much of the project funding is committed? What will happen if you don't receive the anticipated funding from other sources (known and unknown)?	
	How did you arrive at your budget estimates (Ask them to further explain any line items that are questionable or unclear)?	
Financial Position and Trends	Describe your organization's current financial state.	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	Has the organization borrowed money? If so, what are the terms of the loan? Was borrowing for capital expenditures such as a building or to cover an operating loss?	
	(If debts exceed available cash) What is your plan for debt reduction?	
	(If there was an operating loss) What are you going to do to avoid another loss this year?	
	What is your vision for (continued) financial health? Where do you see the organization, financially, in five years?	

Due Diligence Tool Worksheet #3
Assessment Questions (cont.)

Financial Health (cont.)		
Financial Systems and Reporting	What financial statements do you generate? How frequently? Who prepares them? Who reviews them?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	Describe the financial expertise on your board. What role does the board play in financial oversight?	
	What is the process for providing the board with regular financial information?	
Fund Development Planning and Oversight	Describe your fund development plan (i.e., fundraising goals and plan for reaching them).	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	How is the board involved in fundraising?	
	What role do board members play in developing strategies to maintain or grow the organization's contributed income?	
	How do you monitor progress against your fundraising goals? What role does the board play in this process?	
Funding Mix	How would you describe the health and balance of your funding mix — i.e., is it diversified enough? What areas, if any, do you seek to change or improve? How?	Red Flags? (List below) <input type="checkbox"/> Yes <input type="checkbox"/> No
	What are your concerns, if any, about your funding picture?	

Resources

There are many excellent print and Web-based resources available to grantmaker staff and grantee staff and boards that address the issues we have discussed in the tool. We have selected some basic resources that are relevant to the work of a program officer and may also be helpful as references for grantees. We have also included information about training resources for program officers.

Publications and Web Resources

The Art and Craft of Grantmaking

Barbara Kibbe, Fred Setterberg and Cole Wilbur. *Grantmaking Basics: A Field Guide for Funders*. Council on Foundations: Washington, D.C., 1999. A guide and a workbook for grantmakers. *Jointly published by the Council of Foundations and the David and Lucile Packard Foundation, and available at www.cof.org.*

Joel Orosz. *The Insider's Guide to Grantmaking*. Jossey-Bass: San Francisco, 2000. Written for program officers, this volume is a practical guide to making foundation grants and developing essential skills for effective and ethical grantmaking.

Ellen Furnari, Carol Mollner, Teresa Odendahl and Aileen Shaw. *Exemplary Grantmaking Practices*. Published by National Network of Grantmakers. www.nng.org.

Grant Craft is an online source of tools and publications for effective grantmaking. www.grantcraft.org.

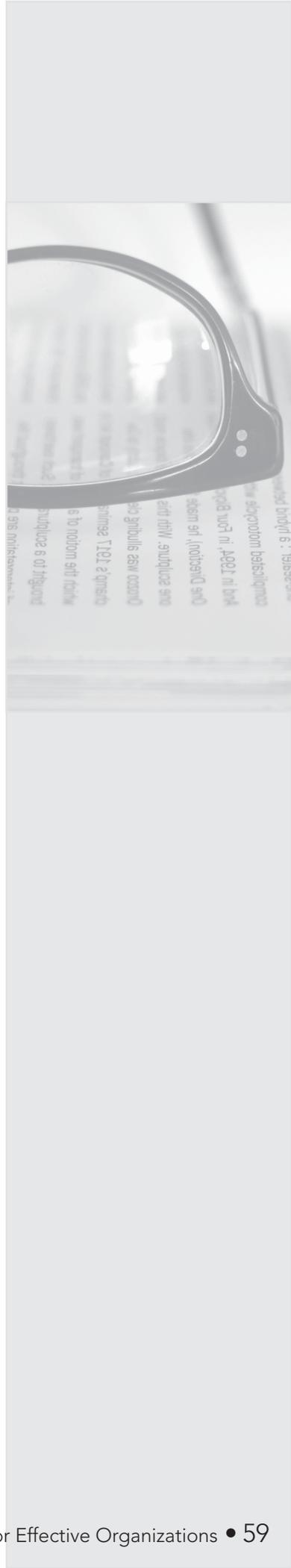
Grantmakers for Effective Organizations provides a range of support and resources to funders interested in organizational effectiveness. GEO's Web site houses a database of research, articles and other useful resources. www.geofunders.org.

Council on Foundations is a membership organization of foundations and giving programs. The Council provides a variety of services to members and the general public, including leadership expertise, legal services, and networking and training opportunities. www.cof.org.

Evaluation

Paul W. Mattessich, Ph.D. *The Manager's Guide to Program Evaluation: Planning, Contracting and Managing for Useful Results*. Amherst H. Wilder Foundation: Saint Paul, Minn., 2003.

“Key Steps in Outcome Management.” This is a guide offered by the Urban Institute and available in a PDF file on its Web site. www.urbaninstitute.org.



“W.K. Kellogg Foundation Logic Model Development Guide.” This is a comprehensive guide to logic models — what they are and how to develop them. It is available at the Kellogg Foundation Web site at www.wkcf.org.

Innovation Network, a nonprofit organization that is dedicated to developing and sharing evaluation tools and know-how with nonprofits and funders. At Innonet.org you will find helpful tools and training resources for evaluation.

Lobbying

Alliance for Justice. This organization’s Web site has many resources for foundations and nonprofits on guidelines for lobbying and advocacy. The Alliance also provides technical support for foundations that have questions about the rules governing foundation support of nonprofit advocacy. www.allianceforjustice.org or 866-NPLOBBY (866-675-6229).

The **Amherst H. Wilder Foundation Publishing Center** has published a series of books on lobbying:

The Lobbying and Advocacy Handbook for Nonprofit Organizations, by Marcia Avner, is aimed at nonprofit executives, managers and lobbyists. This guide covers the manager’s role in shaping public policy, how to assess the benefits of lobbying to fulfill mission, and how to develop and carry out an advocacy plan.

The Nonprofit Board Member’s Guide to Lobbying and Advocacy, by Marcia Avner, is second in the series. This book is designed for all nonprofits, large and small, and shows nonprofit board members how to use their power and privilege to move their organization’s work forward.

Legal — Charitable Status

Guidestar is a useful resource available to verify a charity’s legitimacy. This organization has official verification of tax-exempt status using IRS Publication 78, as well as a tutorial on understanding how to read 990s. Information comes from the Internal Revenue Service’s Business Master File (BMF), the organizations’ Forms 990 or 990-EZ, and the nonprofits themselves.

Governance

BoardSource is a national organization that works to strengthen nonprofit boards of directors. A great resource, BoardSource offers a large array of titles to help board members learn and perform their duties. Most consist of brief, easy-to-read guides written specifically from and for the board member’s perspective. www.boardsource.org.

Kim Klein and Stephanie Roth. *The Board of Directors*. Chardon Press: Oakland, 1997. A collection of reprints from the *Grassroots Fundraising Journal*. This is a collection of short articles that each focus on an aspect of governance, including such topics as board development, board roles and responsibilities, getting the board to raise funds, the board’s role in strategic planning, and so forth. Each piece is highly practical and especially relevant to smaller organizations.

Nonprofit Finance

Murray Dropkin and Bill La Touch. *The Budget Building Book for Nonprofits: A Step-by-Step Guide for Managers and Boards*. Jossey-Bass: San Francisco, 1998. This workbook is a nuts-and-bolts guide to developing a budget for a nonprofit. It includes worksheets and tools that guide the reader through each step of the process.

Regina E. Herzlinger and Denise Nitterhouse. *Financial Accounting and Managerial Control for Nonprofit Organizations*. South-Western Publishing: Cincinnati, 1994. This is a user-friendly textbook that covers the tools of financial analysis and managerial control. It is a bit academic and does not include some of the latest accounting changes, but it is a useful financial management guide for senior nonprofit managers.

Russy D. Sumariwalla. *Unified Financial Reporting System for Not-for-Profit Organizations*. Jossey-Bass: San Francisco, 2000. Sumariwalla provides a conceptual framework and design for nonprofit financial reporting systems covering year-end financial reporting, tax reporting, budgeting, internal financial reports and reports to funders. This is an up-to-date useful guide for financial managers, accountants and bookkeepers.

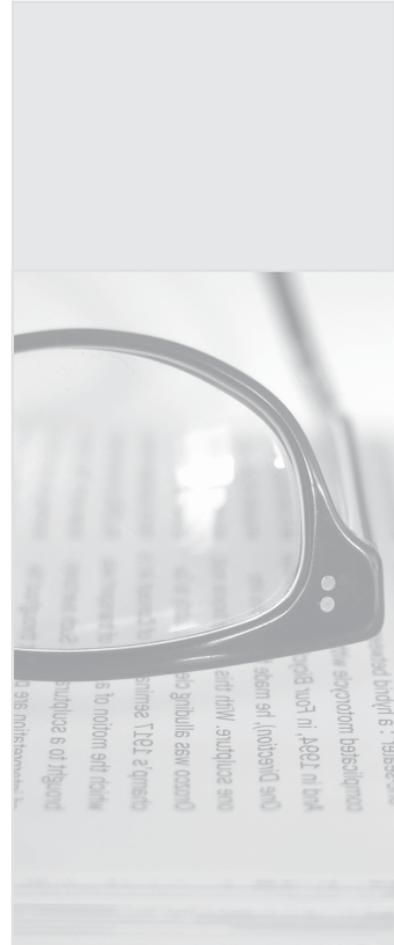
Fund Development and Marketing/Communications

Kim Klein. *Fundraising for Social Change*. Chardon Press: Oakland, 2001 (4th ed.). An excellent primer on fundraising for nonprofits. Easy to read, it presents a framework for planning and implementing a fund development plan that is practical and readily adaptable to the needs of organizations at an early stage of development. There is great information about the role of the board, and even a section on dealing with anxiety.

Henry Rosso. *Rosso on Fund Raising*. Jossey-Bass: San Francisco, 1996. An overview of fundraising from the acknowledged “father of fundraising.” This book, written near the end of Rosso’s long career, distills his wisdom into digestible elements while addressing the most important issues new fundraisers face.

Gary J. Stern. *Marketing Workbook for Nonprofit Organizations, Vol. 1, Develop the Plan*. Amherst H. Wilder Foundation: Saint Paul, Minn., 2001 (2nd. Ed.). This is a practical workbook for the development of a marketing plan. Topics include how to set marketing goals, position the organization, conduct a market survey and evaluate the plan.

The W.K. Kellogg Foundation Web site has created a communications tool kit that can be found at www.wkkf.org/Toolkits/Communication. It includes sections on planning, media relations, getting ready, advertising, evaluation and resources. The planning section has a PDF file for free download on “Elements of a Strategic Communications Plan.” This is essentially a simple workbook (just 22 pages) that has worksheets for developing a plan.



The SPIN Project (Strategic Press Information Network) (www.spinproject.org) Web site has a series of helpful tutorials on effective media strategies and tactics: The SPIN Tool Kit. Topics include strategic media plans, news hooks, cultivating relationships with reporters, making news with your report, Internet PR, photo ops and media events, media lists and working with PR consultants.

Sources of Information About Training Opportunities

“Workshops & Courses on the Craft of Grantmaking,” Felicia Khan, program associate, Ford Foundation. A recent scan of the philanthropic field on who is doing what and where. This is a collection of over 25 training resources for grantmakers, including regional associations of grantmakers, networks and membership organizations, and universities and colleges. www.grantcraft.org.

The Grantmaking School. Developed with the guidance of national experts and leaders in philanthropy, The Grantmaking School presents the first university-based, practitioner-led curriculum for program officers aimed at advancing grantmaking as a field. The curriculum of The Grantmaking School is designed to help experienced grantmaking practitioners increase the social impact of their grants, improve the effectiveness of the grantmaking field, and achieve greater success in their own careers. www.grantmakingschool.org.



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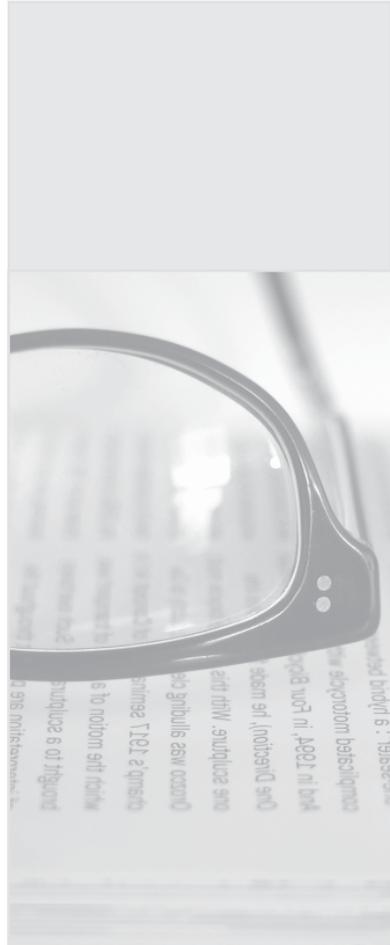
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Grantmakers for Effective Organizations is a community of grantmakers dedicated to building strong and effective organizations. GEO's mission is to maximize philanthropy's impact by advancing the effectiveness of grantmakers and their grantees. Through research, conferences, its Web site, publications and other activities, GEO highlights knowledge and practices in the field that advance the organizational effectiveness movement. More information about GEO and a host of resources and links for funders are available at www.geofunders.org.

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