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In Other Words, the Budgets Are Fake: Why One Funder Eliminated Grantee Budgets to Improve Financial Due Diligence

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REFLECTIVE PRACTICE

In Other Words, the Budgets Are Fake: Why One Funder Eliminated Grantee Budgets to Improve Financial Due Diligence

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Keywords: Financial health indicators, financial management, nonprofit finances, due diligence, preventing fraud, nonprofit budgets, grant review, financial health assessment

Key Points

- In 2013, the Unitarian Universalist Veatch Program at Shelter Rock eliminated budgets from its application requirements. Over the last 18 months, it has worked to overhaul the financial information it requests and the ways in which it is used.
- This article examines the role of financial information in the grant application process, the practice of developing and reviewing funder budgets, and the ways in which they too often fail to provide information relevant to a thorough review of the financial health of a nonprofit organization.
- The Veatch Program provides a case study in how to engage board and staff members in the development of a new standard for reviewing financial information. This article provides an overview of the process, timeline, and tools used to replace funder budgets with a more accurate financial review – a shift that helped reduce the administrative burden on Veatch grantees and provided the program with more relevant insight into grantee financial health based on actual financial data.

Introduction

The Unitarian Universalist Veatch Program at Shelter Rock is the charitable-giving program of a Unitarian Universalist congregation on Long Island. We award approximately $12 million in grants each year and fund almost 200 organizations across the country. Our grantees are largely community-based organizations with annual budgets ranging from $150,000 to more than $10 million. A majority of our grants are general support, with a small number of project support grants. We support organizations that are independently incorporated as well as those who use a fiscal sponsor. The board of governors of the Veatch Program consists of 12 members of the congregation and includes individuals with professional backgrounds in the private and the public sectors.

In 2013, Veatch Program eliminated budgets from our application requirements. Over the last 18 months, we have worked with consultant Carol Cantwell of Fun With Financials to overhaul the financial information we request and the ways in which it is used. Cantwell founded Fun With Financials in 2004 after spending 12 years in various finance roles with nonprofits, including chief financial officer, co-executive director, and board member. She has a degree in economics and has worked with hundreds of nonprofit and philanthropic organizations around the country to help build financial literacy and health.

In this article, we examine the role of financial information in the grant application process, the practice of developing and reviewing funder budgets, and the ways in which they too often fail to provide information relevant to a thorough review of the financial health of a nonprofit organization. The Veatch Program provides a case study in how to engage board and staff members in the development of a new standard for reviewing financial information. We provide an overview of the process, timeline, and tools used to replace funder budgets with a more accurate financial review and illustrate how this shift helps

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to reduce the administrative burden on grantees and provided the Veatch Program with more relevant insight into grantee financial health based on actual financial data. This article concludes with recommendations for the implementation of these practices in grantmaking institutions.

Financial Information and the Grant Application Process

The review of grantee financial information is one of the ways funders ensure they are effective stewards of the resources they are responsible for allocating. The Council on Foundations and the Forum of Regional Associations of Grantmakers developed a core curriculum for new grantmakers that has been adapted into training modules offered through regional associations around the country. The Essential Skills and Strategies (ESS) curriculum defines due diligence as "the process through which an investor or funder researches an organization's legal, financial, and organization status in order to inform and guide an investment or grantmaking decision" (Boccalandro, Donaldson, Hollahan, O'Neill, & Rosenberg, 2010, p. 27). Grantmakers for Effective Organizations (GEO) expands the definition to include "alignment with your mission and goals, the role of the organization's board, the position it holds in its field and community, the staff's qualifications, and the organization's communications and fundraising capacity" (Grantmakers for Effective Organizations, 2010, p. 3).

Both ESS and GEO recommend that financial information be only one part of the overall proposal review. Other types of information a foundation might consider collecting include the project budget; other funding sources and amounts, and the status of each (requested or secured); the organizational budget; interim financial reports to senior management and board of trustees; a final financial statement for the most recent fiscal year, preferably audited; auditor's letters to management; an interim balance sheet and income statement; the current fiscal-year budget with year-to-date and estimated actuals; the most recent IRS Form 990; and plans for sustainability (Boccalandro, et al., 2010). The list is rather exhaustive.

Guidestar (2011) advises that private foundations, donor-advised funds, and donors are required by the IRS only to:

1. "Verify the nonprofit's eligibility to receive a tax-deductible charitable contribution (p. 2)." For most grant circumstances that simply means confirming the 501(c)(3) status of the organization receiving the grant.

2. "Determine if the nonprofit is a supporting organization. If it is, determine what type (p. 3)." A supporting organization is a charity established for the purpose of providing support to another charity. For most funders, this is not a major concern. For funders who regularly make grants to supporting organizations, this has likely been built into the design of the grantmaking procedures.

3. "Confirm that the recipient does not appear on the OFAC [Office of Foreign Assets Control] list of organizations and persons linked to terrorism (p. 3)." This rule was added with the passage of the USA PATRIOT act and applies to a narrow category of prospective grantees. For making grants where this is a possibility, the OFAC at the U.S. Department of the

> Treasury maintains lists of individuals and organizations whose assets have been frozen because of suspected ties to terrorism; such persons and entities are identified as Specially Designated Nationals (SDNs).

The list of financial materials funders may request do not address these three specific IRS. If all the financial information we are requesting is not required by the IRS, why do we ask for it and what do we hope to learn from it?

A recent report by Project Streamline, a collaboration of associations of grantmakers and fundraisers seeking to reduce the inefficiencies of the grantseeking process, found that dissatisfaction with financial requests and materials being provided was deep on both sides. One nonprofit quoted in the report stated,

> We keep two sets of books (or more). Because foundations often require budgets in a particular format or ask to see expenses broken down in specific ways, many nonprofit organizations keep multiple versions of their budgets. The potential for errors is heightened every time a budget is translated into a new format. (Bearman, 2008, p. 16)

This was a common observation from the funder perspective:

> Often we work with the same grantees over and over again. I am sure they become annoyed that we ask for a new copy of the 501(c)(3) and other financial documentation for each grant. However, we do so to cut down on staff time for copying and retrieving information. (Bearman, 2008, p. 22)

Another funder told the report's researchers,

> [We] used to allow agencies to submit the budget in their own format, but it has been so challenging to figure out how some things were calculated, and [we spent so much time] reconfiguring the budget for presentation to our board, that we now require agencies to use our format. (Bearman, 2008, p. 23)

Here is the uncomfortable truth: The budgets we review are largely created by individuals who have learned exactly what we are looking for and tailor the budgets in their proposals directly to our needs – either those of our specific institution or of the general practices in the philanthropic sector. In other words, the budgets are fake.

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For example, the Foundation Center offers a range of trainings and resources to help grantseekers develop grant proposals with a higher likelihood of being funded. One of the online training modules focuses on the elements of a good budget and warns grantseekers that funders often start with the financial information because "the numbers are stark and straightforward" (Geever, n.d.). It also shared one funder's admission that he would "often look at the budget and then read the proposal backwards" (Geever, n.d.). Some of the most popular fundraising books and websites include some version of the following examples of advice for preparing a budget for a grant request:

> The budget should reflect the cost of the items and activities described in the project narrative portion of the proposal. If an item is not described and justified in the narrative, it should not appear in the budget.

Many funders and boards say that a key reason for financial due diligence is to prevent the misuse of funds by a grantee or confirm there is no fraud or mismanagement. Unfortunately, there is no real protection against this possibility. Fraud and mismanagement happen, and financial statements – including audits – do not protect a funder against the possibility that funds will not be used correctly or a grantee will be the victim of fraudulent activity.

> …The relationship between the budget and the project description should be so tight that the reader can determine what the project is simply by reading the budget (Ward & Hale, 2006, p. 15).
>
> Be certain that the expense estimates are neither too lean nor too high. If you underestimate costs, you may not able to operate within the budget. If this occurs, you will have to go back to funders already supporting the project and ask for additional assistance, seek new donors, or underwrite part of the cost of general operating funds. None of these alternatives is attractive. Likewise, consistently overestimating costs can lead to other problems. … If you have a lot of money left over, it will reflect badly on your budgeting ability, and might affect the funder's receptiveness toward any future budgets you might present (Geever, n.d.).

So what does a well-written, clearly reasoned project or organizational budget tell you about an organization? It tells you how well the writer has been trained to prepare a clearly reasoned project or organizational budget.

Some funders and grant administrators have come to understand this challenge and now request additional information in the form of financial statements, preferably audited, and a board-approved budget. While financial statements are a vast improvement over budgets prepared as part of the application process, they are still limited to the financial picture at a specific time and only report the past results of an organization's operations (Finkler, 2001). What they do not tell us is how an organization develops its financial plans, who is involved, what assumptions went into the process of projecting both revenue and expense, how well an organization will be able to deliver on the proposed project, the comfort level of the senior leadership of an organization with financial management, the long-term stability of the organization or the proposed project, or the trends in an organization's overall financial health.

One important note about reviewing financial materials: Many funders and boards say that a key reason for financial due diligence is to prevent the misuse of funds by a grantee or confirm there is no fraud or mismanagement. Unfortunately, there is no real protection against this possibility. Fraud and mismanagement happen, and financial statements – including audits – do not protect a funder against the possibility that funds will not be used correctly or a grantee will be the victim of fraudulent activity. One study of fraud in nonprofit organizations found that almost half of all cases of fraud were detected by tips from within the organization or after an internal audit; almost one-quarter were detected by accident and only 12 percent were found by an external auditor. The study concluded that clear lines of authority, enforcement of proper procedures for authorization of transactions, board engagement, and an audit committee were the most effective organizational controls against fraudulent behavior in nonprofit organizations (Greenlee, Fischer, Gordon, & Keating, 2007).

Additionally, the Association of Certified Fraud Examiners found that the most common forms of fraud in the nonprofit sector are payroll and check-tampering (Greenlee, et al., 2007) – neither of which is likely to be detected in the financial information most commonly requested by funders.

Right-Sizing Financial Requirements

The Veatch Program's work with consultant Carol Cantwell to review the financial information we request from our grantees started with a staff planning retreat, during which we discussed how to work with the board to improve the use of this information in our grant recommendations. We were concerned that there were uneven levels of expertise and comfort with financial concepts and that the current review by the board had focused largely on minor questions about particular budget line items. In contrast, the staff admitted to spending minimal time reviewing the grantee budgets and focusing instead on the list of current and prospective funders and talking with organizations about any significant increase or decrease they were projecting in their overall size and how that would affect the work outlined in the proposal.

We asked Cantwell to prepare training for our board and staff about the basics of financial review, and she asked the staff to share with her the financial information we were requesting and what we believed it was telling us about the grantee organizations. She also shared with us her assessment, formed after years of consulting with foundations and nonprofit organizations, that many foundations rely too heavily on grantee budgets to assess financial health. The problem, as Cantwell sees it, is that budgets are not standard across organizations or even across years within the same organization. In addition, they are merely projections of future activities and do not reveal anything about actual financial health. Even worse, most budgets submitted in grant applications are created for each individual grant application, which takes an inordinate amount of the grantee's time. Cantwell believes funders should instead focus on a financial assessment that relies on standard financial data from either an audit or the IRS Form 990, because they are based on actual numbers and nonprofit organizations are already required to complete them (Cantwell, 2012a).

Budgets are not standard across organizations or even across years within the same organization. In addition, they are merely projections of future activities and do not reveal anything about actual financial health. Even worse, most budgets submitted in grant applications are created for each individual grant application, which takes an inordinate amount of the grantee's time.

It quickly became clear that what was needed was not board training on how to read fake funder budgets, but a transparent discussion between the board and staff on the role of financial information in the grant-review process. At a retreat with board members, Cantwell provided them with an overview of the fundamentals of nonprofit finance and led a conversation about what constituted a healthy nonprofit organization and what type of information would be reliable and consistent for understanding the financial health of grantees. By having the conversation from the bottom up, together with the board, we agreed there would be value to developing and testing a tool that would:

1. standardize the presentation of financial information to the board,

The FHI uses five pieces of information from Form 990 that we believe are most related to long-term financial health: total revenue, total expenses, unrestricted net assets, temporarily restricted net assets, and public support percentage.

2. lower the burden on grantees to prepare and submit financial materials,
3. be simple for the program and administrative staff to administer,
4. use actual financial information, and
5. allow for program officers to exercise judgment in amending the ratings based on the grantee proposal and history.

Grantee Financial Health: What to Measure and Why

Once the board and staff had agreed on the key criteria, Cantwell recommended that our assessment could be based on IRS Form 990. There were two compelling rationales for this: Grantee organizations are required to file Form 990, so it would relieve them of the burden of creating a specialized budget for the grant application; and the form contains standard financial information that creates consistency both across grantees and across time for any particular grantee.

One of the first comprehensive studies of the use of the IRS Form 990 (also known as the 990 Return) concluded that 990 is "a reliable source of information for basic incomes statement and balance sheets entries" and "an adequate source of financial information that is potentially more useful than financial statements for study of nonprofit organizations" (Froelich, Knoepfle, & Pollack, 2000, pp. 252). Moreover, the study found that while

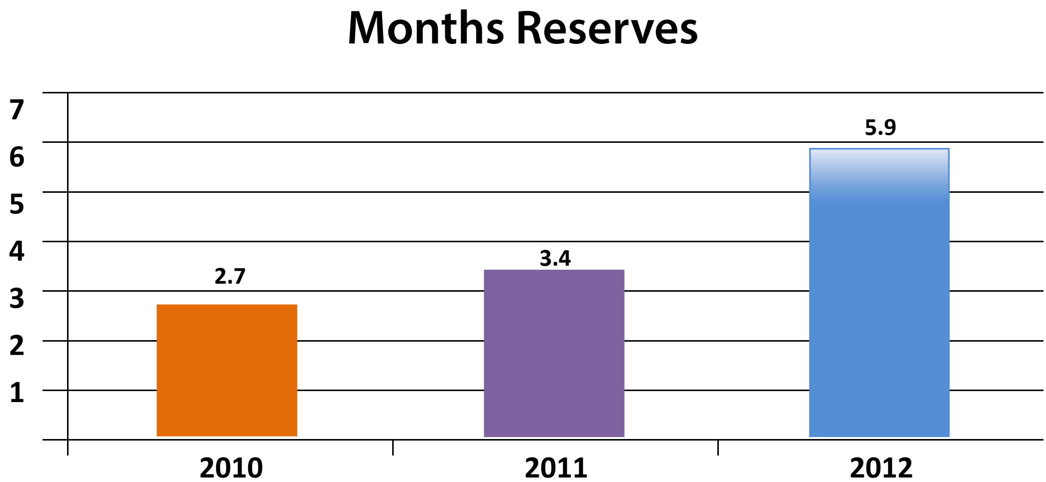
> financial statements might report revenues and expenses in a highly aggregated or uniquely tailored format, the IRS 990 Return specifies a breakdown of the totals into predetermined categories. The specific categories are designed to illuminate financial details that indicate if a nonprofit's activities are consistent with the expectations for charitable organizations. Financial statements might be designed for other purposes including loan applications, strategic decision-making, or public relations (Froelich, et al., 2000, pp. 247).

Cantwell developed a Financial Health Indicators tool (FHI) that averages three years of data from Form 990 and provides the Veatch Program with a more realistic picture of the actual financial performance of grantees than a static budget ever could (Cantwell, 2012a). As the research suggests, Form 990 is especially helpful because all organizations complete the same form and the data is consistent across diverse groups in a way that the individual budgets are not. The FHI uses five pieces of information from Form 990 that we believe are most related to long-term financial health: total revenue, total expenses, unrestricted net assets, temporarily restricted net assets, and public support percentage.

These data points help us understand the following:

- Reserves: Unrestricted net assets are the reserves grantees have available to smooth the inevitable ups and downs in revenue and stabilize expenses, therefore maintaining programs and effectiveness. The amount of unrestricted net assets compared to total expenses provides the initial financial health rating for each grantee. The change in unrestricted net assets over three years shows how the grantee is managing its reserves over time. (See Figure 1.)
- Stability and Growth: Temporarily restricted net assets helps us understand funds secured for future operations as compared to total

FIGURE 1 Median Reserves by Year (Excluding Fiscally Sponsored Projects), n=115



expenses, which indicate an ability to maintain the current expenses into the future. The change in temporarily restricted net assets over three years shows trends mainly in foundation fundraising.

- Sustainability: Public support percentage provides a measure of the diversity of funding sources.

For grantees with a fiscal sponsor, we request Form 990 for the fiscal sponsor, the year-end income and expense report, and year-end fund balance. The FHI then includes a rating for the fiscal sponsor as well as for the project. This insures that the sponsor's financial health will not become a factor that negatively affects the project. By requesting the additional information we are able to ensure that the fiscal sponsor is accounting for the project dollars appropriately.

The FHI incorporates these trends and produces an initial rating that the program officers review together with the financial narrative questions and observations from the overall review of the grantees application materials. (See Figure 2.) The ratings are:

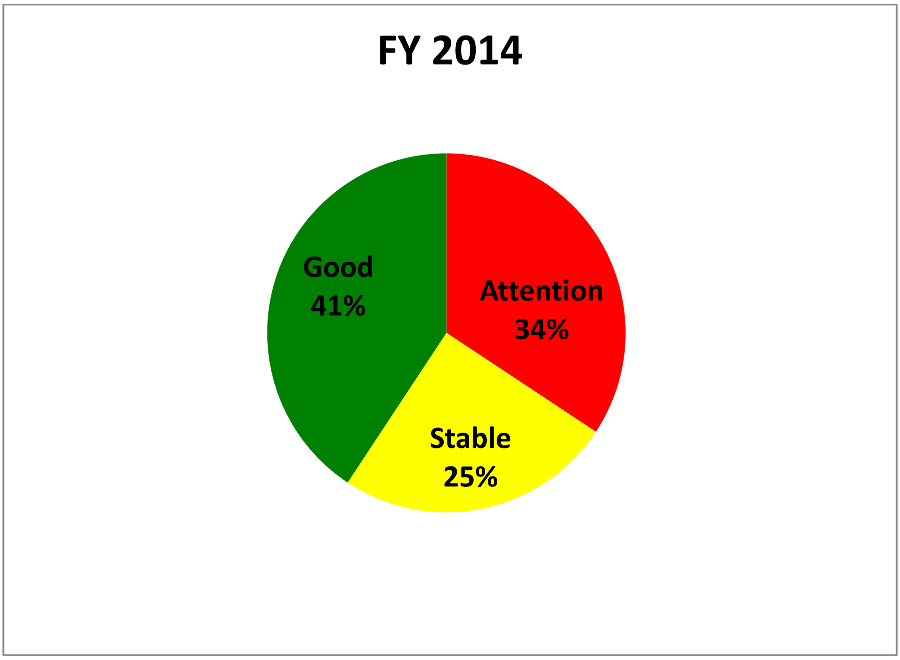
- *Good:* No financial concerns; the outlook for the grantee is positive.
- *Stable:* No immediate financial concerns, but there is room for improvement in the grantee's outlook.
- *Needs Attention:* More attention necessary to improve financial performance; grantees usually have current financial concerns and a negative outlook.

If a group receives the "needs attention" rating two years in a row, the program officers request the audited financial statements, review them with the organization, and directly address the rating in the FHI's financial-analysis section. The FHI is summarized into a standard, one-page format with the amount recommended, financial health rating, reserves, grant funds for the future, organizational revenue, organizational expenses, and the financial-analysis narrative prepared by the program officer. (See Figure 3). In order to assist the program officers in providing reasonably standardized assessment narratives, the consultant prepared sample sentence starters for describing the results of the FHI. There is also a reference guide included with each docket to remind board members of the key definitions and to describe the ratings and what they measure.

Board Implementation

After approving the FHI, Veatch board members outlined the core assumptions under which they were operating when the indicators were adopted.

FIGURE 2 FHI Rating Distribution by Year (Including Fiscally Sponsored Projects), n=140



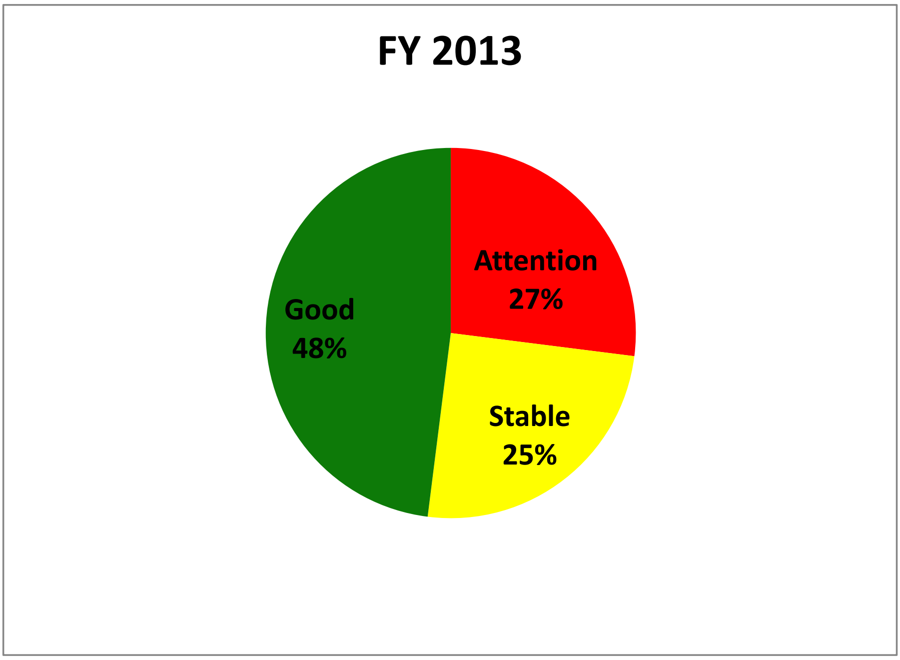


FIGURE 3 Sample Financial Health Indicator Summary for the Veatch Program Board

Grantee:	GRANTEE

Amount Recommended	FY13	FY14
	$40,000	$40,000

Financial Health Rating	JAN.-DEC. 2012	JAN.-DEC. 2011
	ATTENTION	ATTENTION

Financial Year Analyzed	JAN.-DEC. 2012	JAN.-DEC. 2011	NOTES...
Reserves [in Mths]	0.7	1.3	Reserves provide stability to absorb the ups and downs of funding without having to cut programs.
Temp Restricted Grant Funds for the Future [in Mths]	6.6	3.7	Grant funds for the future affects stability of future budgets. Groups with high individual support may be lower here and it's ok.
Organizational Revenue	$1,460,013	$1,076,472	
Organizational Expenses	$1,166,998	$822,502	

Financial Analysis	Grantee has recently used a significant portion of their reserves and has low overall reserves. Grantee has a healthy amount of grant funds for the future and has an upward trend in raising money for future work, which means they are in a strong position to maintain or grow their current budget. The years reviewed are the three during which the grantee was undergoing a merger of two organizations. They used their reserves to cover the added expenses of this endeavor and have come out of the process a stronger and well managed organization.

This document will be included in the orientation materials of future board members and program staff (Hafid, 2012). The assumptions include the following:

- The board respects and values the professional staff and developed this tool in partnership with them and not in response to any concerns about the quality of the review being conducted by Veatch Program staff.
- The board recognizes that if it is receiving a grant recommendation, the staff believes it merits support and recommends it for funding regardless of the specific financial-health rating.
- The goal of FHI is to provide a consistent metric for measuring the financial health of Veatch Program grantees, provide the staff with a vehicle for ongoing discussions with grantees about the long-term financial management, and identify opportunities for possible capacity-building support.
- Despite the use of numbers and financial state-

TABLE 1

Time	Task
July	Staff trained
September	Board trained
October	Board approves concept and authorizes FHI development
	Board approves program officer discussion guide
December	Pilot 1: 25% of grant recommendations presented with FHI only and no fake funder budget
	Board feedback
January	Staff and consultants adjust FHI
February	Pilot 2: 25% of grant recommendations with FHI, list of current and prospective funders, no fake funder budget
	Board feedback
March	Staff and consultants adjust FHI
April	Pilot 3: 100% of grant recommendations with FHI, list of current and prospective funders, no fake funder budget
	Board feedback
May	Staff and consultants adjust FHI
June	Pilot 4: 100% of grant recommendations with FHI, list of current and prospective funders, no fake funder budget
	Final FHI approved for full implementation in Fiscal Year 2014
July	Grant application revised
	Communication to grantees about new financial requirements and review process
Ongoing	Application revisions and administrative improvements

ments, FHI is essentially a qualitative assessment tool and only one measure of an organization's health, and should never be used by the board as a deciding factor in approving or rejecting a grant.

- We expect that the Veatch Program portfolio will always include a healthy mix of groups across all three rating levels.
- It is expected that an organizations will move up and down on the scale depending on the overall financial climate, how ambitious their programmatic work is within a given fiscal year, changes in their organizational structure or leadership, and other factors that will be noted clearly in the comments section of the rating and the text of the précis.
- Some groups will always be at the top of the scale. Some will always be at the bottom. The goal is not for groups to reach the top of the scale.

The decision to pilot FHI and eliminate fake funder budgets was made following the first docket of the fiscal year. It took a full year to develop, test, revise and fully implement the tool. (See Table 1.) Revising our application materials for clarity and ease of use and fine tuning the assessment tool and administrative processes are ongoing; they are managed by the program associate and one of our senior program officers.

Board members shared some observations after the first FHI pilot (Hafid, 2014):

> The new finance sheet looks awfully short – and makes us think we're not really doing our job of due

> diligence. How do we reassure ourselves as board members that we're not just rubber-stamping staff decisions?
>
> It would be helpful to have some more orientation/explanation materials for some of the functional aspects of the assessment, such as: What does it mean when there are blank boxes on the form? When do groups fill out the 990? Is it still helpful when there has been a long delay between the 990 information and the day the board is reviewing the grant? Are there guidelines for understanding what constitutes a reasonable delay in the financial?
>
> It will be helpful to include the listing of other donors and income sources on the finance summary sheet (or another attachment).

The goal of FHI is to provide a consistent metric for measuring the financial health of Veatch Program grantees, provide the staff with a vehicle for ongoing discussions with grantees about the long-term financial management, and identify opportunities for possible capacity-building support.

The board feedback resulted in two significant changes to the second and third pilot dockets. The first change addressed the concern that that the form appeared too short and that the board was not fulfilling its fiduciary responsibility – a concern made more acute by what became known as the "missing year" problem. Form 990 is prepared after an organization has completed its fiscal year, which can be any 12-month period but is usually January to December or July to June. There can be a four- to six-month delay from the close of a grantee's fiscal year to the time Form 990 is submitted. The variation in grantees' fiscal years, combined with the filing lag time and the different times of year when a group can be reviewed for a grant, often results in a 12-to18-month lag time in the financial information available on Form 990 and the review of FHI by the Veatch staff and board.

As the purpose of FHI is to examine overall trends in financial health, the board and staff agreed that the "missing year" was insufficient to prevent the use of FHI. During the remainder of the pilot year, we identified supplemental information (preliminary audits and/or an unaudited balance sheet) that we requested directly from grantees as part of the application process. The board agreed that for organizations that were in the "good" and "stable" categories, the additional information was less important in light of the overall positive trend. We agreed that any organization receiving the "needs attention" for two years in a row would trigger a review of the additional information and be separated out for discussion at the board meeting. This encouraged program officers to have an even more in-depth conversation with the grantees and allowed board members to feel they were ensuring appropriate due diligence.

The second change addressed the observation that the trends might not clearly indicate whether the organization was positioned to continue to raise the funds required to deliver on the plans described in the grant proposal. In response, we started to include the list of current and prospective funders for the board to review. This helped to assure the board that the organizations had enough prospects in the pipeline to reasonably project a stable, increased, or decreased budget in the upcoming year.

Program Staff Implementation

The program staff – executive director, three program officers, and the program associate – participated in the development and testing of FHI. The process was led by Senior Program Officer Molly Schultz Hafid, working directly with Cantwell. The consultant also worked closely

The most important part of the financial assessment is the Program Officer Discussion Guide (Cantwell, 2012b), which helps us to have focused conversations with our grantees about their overall financial health. Not every question is asked of each grantee; the questions are selected based on their relevance to a particular grantee's situation.

with the program associate to train her on Form 990, develop easy answers to grantee questions about the financial requirements, and complete the FHI templates consistently. The program associate has sole responsibility for collecting the required information and preparing FHI for the program officers; they are forwarded to the program officers before the application review meetings with the grantees.

The FHI alone is not sufficient to ensure quality review of the financial health of an organization; it simply standardizes the criteria for review and provides benchmarks for understanding the trends in the financial health of grantees. The most important part of the financial assessment is the Program Officer Discussion Guide (Cantwell, 2012b), which helps us to have focused conversations with our grantees about their overall financial health. Not every question is asked of each grantee; the questions are selected based on their relevance to a particular grantee's situation. This information is then factored into the overall ranking for the organization and addressed in the narrative portion of the FHI.

In the grant-review discussions, the program officer explains the FHI tool and the rating the organization has received. We then use a combination of the following questions to begin a conversation with the grantee about their overall financial health:

1) Based on the trends in the Financial Health Indicators Matrix: I've noticed a…
   a) trend (up or down) in unrestricted net assets:
      i) Do you expect that to continue? Why or why not?
   b) trend (up or down) in temporarily restricted net assets:
      i) Do you expect that to continue? Why or why not?
   c) low level of public support:
      i) How will you diversify your funding sources?
   d) low level of reserves:
      i) Do you plan to build reserves? What's the plan?
   e) low level of temporarily restricted funds:
      i) What are your fundraising prospects? Any new funders in the pipeline?
2) Any projected changes in revenue?
   a) New funders.
   b) New donor or earned income strategies.
   c) Loss of funders.
3) Any projected changes in expenses?
   a) New programs.
   b) Cutbacks.
   c) One-time capacity-building or consulting efforts.
4) Are you projecting a surplus or deficit for this year? Why?
5) Are there any staffing changes?
   a) New positions.
   b) Staff leaving. (Is their position being filled or restructured?)
   c) Cutbacks or hiring freezes.
6) Are there any changes on the board?
7) For groups with a c3 / c4 structure:
   a) Do you have a cost-sharing agreement in place? Is the c3 or the c4 the "lead" agency?
   b) How often do reimbursements happen? Monthly? Quarterly?
   c) Do you track c3 and c4 time on timesheets?

Are they up to date?
8) For fiscally sponsored projects:
a) How often do you get reports from your fiscal sponsor? How timely are the reports?
b) Do you plan to stay with your current fiscal sponsor?
c) If looking for a new sponsor, how are you assessing potential sponsors?
d) Any plans to get your own c3 status?

In every case, the goal is to have a frank and candid conversation with grantee leaders about their organization's financial health over the past three years. We eventually realized that the questions we had included in the Program Officer Discussion Guide would be helpful to ask organizations to answer as part of the financial requirements. For full implementation of FHI, we added the following financial narrative questions to the application:

1. Describe the current status of your foundation fundraising efforts. We are interested in learning about any new funders you have secured in the last year, any funders you will have/will be cycling off from, and any other unexpected changes (good or bad) in your overall foundation fundraising.

2. Are you diversifying or trying any new approaches to fundraising (e.g., matching grants, grassroots fundraising, events, new appeals, major donor development, government grants)? If so, what were the results?.

3. What were your actual revenue and actual expenses for the most recently completed fiscal year?

4. Based on your most recent fiscal year-end and your projections for your current fiscal year: What do you expect to be changing in your current fiscal year? For example: major new expenses, major savings, staff expansions or contractions, new programs or campaign expenses, and major capital costs (moving or expanding your office space, major computer upgrades, new databases, buying a building or building maintenance, etc.).

The goal is to have a frank and candid conversation with grantee leaders about their organization's financial health over the past three years.

Finally, to support the organizations in developing improved practices, the Veatch Program established a discretionary fund to allow grantees to work with a consultant to improve their financial practices. Organizations have utilized this fund to improve their cash-flow management and projections, review and tighten internal procedures, develop new budget-planning processes, and train board and staff.

Grants-Management Implementation

The essential element to transition from a concept to full implementation was early ownership of the FHI tool by the Veatch Program grants-management team. The program associate, grants manager, and a computer systems/finance coordinator participated in the early staff training with the consultant, and the grants administrator and program associate worked closely to develop the workflow that moves from the submission of the application materials to the final mailing of the board docket. We allocated additional time in the consultant contract to train the program associate and to be available to answer questions and review draft FHIs throughout the year.

It is important to note that the pilot dockets and the full implementation of FHI were disruptive to the grants-management team. The first two pilot dockets were unintentionally a separate, additional docket to be prepared for the board. The final two dockets, with 100 percent of the grant recommendations utilizing FHI, were more integrated, but time required by the program associate to prepare all the FHI delayed the grant evaluations by program officers and forced a reconfiguration of the process for assembling the docket.

The best time to have an honest conversation about the role of financial information in the grant-review process is when everything is functioning smoothly. It is easier to learn together when an institution is running well.

The grants-management disruption and the investment in staff training have short- and long-term impacts on the costs to the Veatch Program. We took these steps to directly reduce the number of hours our grantees devote to preparing the application, thereby effectively increasing our net grant amount for each group. The Nonprofit Finance Fund (NFF) coined the term "net grant" to describe "the total grant amount minus the costs organizations incur to manage the grant itself (e.g., reporting requirements, proposal writing, and funder updates)" (Nonprofit Finance Fund, n.d.). The NFF believes that funders should use this concept to simplify their requirements and increase the amount of a grant that is dedicated to the work they have committed to fund. It is therefore appropriate that the Veatch Program more directly assume the cost of our due diligence and financial-reporting requirements to increase the net grant and improve the efficiency and effectiveness of our grantees.

Recommendations

By simplifying our financial due diligence and concentrating on quality assessment using actual financial data, we have been able to more accurately assess the financial health of the organizations we fund. We offer a few recommendations to other funders considering this approach:

- Prevention is the best protection. The best time to have an honest conversation about the role of financial information in the grant-review process is when everything is functioning smoothly. It is easier to learn together when an institution is running well.
- Dig beneath the numbers. The FHI uses actual financial information to standardize the assessment of overall financial health, but it is important to use it as part of your overall grant-review process. Invite the group to share with you their aspirations and concerns either through targeted financial narrative questions or in the form a discussion guide, which will help you more accurately assess their ability to deliver on their mission.
- Phone a friend. We found that having a skilled and respected expert from outside the organization helped facilitate the learning and reduce anxiety. The project required work with the board as well as our program and administrative staff. The consultant understood both the conceptual and the practical challenges and was able to work with the organization to create investment at all levels. She was critical in enabling us to learn, create systems, and address concerns as they arose.
- Eliminate small print. By explaining directly to grantees what we are looking for and how we are measuring financial health, we are able to engage them in a more dynamic discussion. These insights help us better understand the challenges faced by different areas of the nonprofit sector as well as underscore the need for increased capacity-building in the area of financial management.
- Stay alert for unexpected benefits. The quality of our conversations with grantees is enhanced, the dialogue with the board about the financial health of grantees is improved, staff are satisfied that we have developed a fair and consistent review process, and the improvements in our financial review creates tangible savings for our grantees by reducing the time they spend on our application and renewal.

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Financial Health Indicators: Key Definitions

- Unrestricted net assets: Funds that are not restricted by time or purpose and are available for the group to use as needed.
- Reserves: Technically, the amount of unrestricted net assets compared to total expenses. Reserves provide stability to absorb the ups and downs of funding without having to cut programs.
- Temporarily restricted net assets. Funds that are restricted by time or purpose and that can be released for the organization to use only at the time the restriction is met. For example, when a group receives a multiyear grant, the first year's funding is available for use immediately; funds for the other two years are accounted for as temporarily restricted net assets. When the second year of the grant begins, the group can use that money for work in the year it is intended.
- Public support. A term from IRS Form 990 that refers to a five-year average of donations above a certain level. The public support calculation is included in FHI as a proxy for measuring the diversity of the organization's sources of support.

Recommended Resources

- **Project Streamline,** www.projectstreamline.org, was launched in 2007 to identify the flaws in the current application, monitoring, and reporting practices of grantmakers; develop recommended principles, resources, and tools to help grantmakers address those flaws; and support grantmaker efforts to change.
- **Nonprofit Finance Fund,** www.nonprofitfinancefund.org, seeks to unlock the potential of mission-driven organizations through tailored investments, strategic advice, and accessible insights. Founded in 1980, NFF helps organizations connect money to mission effectively and supports innovations such as growth capital campaigns, cross-sector economic recovery initiatives, and impact investing.
- **Due Diligence Done Well: A Guide for Grantmakers,** www.geofunders.org, Learn about effective due diligence and how to create a grantee-friendly approach to information gathering that enhances communication, trust and confidence.
- **Essential Skills & Strategies (ESS) for New Grantmakers,** http://www.cof.org/ess, is a comprehensive educational program to help familiarize new and up-and-coming grantmakers with the foundation world and the field of philanthropy. Designed by experts in the philanthropic sector, ESS is the field's standard orientation for grantmakers. The sessions are designed to provide new grantmakers with the knowledge, insight, skills, and tools they need to be effective in their work. The program has been endorsed by philanthropic groups and foundations staff around the country.

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