# Due Diligence Done Well

A GUIDE FOR GRANTMAKERS

BY LA PIANA CONSULTING

geo GRANTMAKERS FOR EFFECTIVE ORGANIZATIONS

La Piana CONSULTING

GRANTMAKERS FOR EFFECTIVE ORGANIZATIONS

Grantmakers for Effective Organizations is a community of more than 350 grantmakers challenging the status quo in their field to help grantees achieve more. Understanding that grantmakers are successful only to the extent that their grantees achieve meaningful results, GEO promotes strategies and practices that contribute to grantee success. More information on GEO and a host of resources and links for grantmakers are available at www.geofunders.org.

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# Due Diligence Done Well:

## A Guide for Grantmakers

BY LA PIANA CONSULTING

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- Jessica Bearman, Project Streamline
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# Introduction

**Selecting the right grantee** partners is one of the most important jobs grantmakers do. But it is hard to tell from a written proposal whether an applicant represents a good fit and a smart investment for your foundation. You may want to learn more about the potential grantee's strategy and goals, its track record, its reputation and leadership, its programs and their outcomes, its finances, and the capacities and skill sets it brings to its work.

The challenge for you as a grantmaker is to learn as much as you can about potential grantees without asking for more information than you really need and, as a result, placing an added burden on the nonprofit organizations you work with.

Nonprofit leaders regularly complain that they spend too much time responding to grantmakers' requests for information — and that the due diligence process can be confusing, frustrating or worse. Grantmakers for Effective Organizations and La Piana Consulting encourage a more streamlined approach based on a thorough consideration of what grantmakers truly need to know in a given situation. We did not create this document to advocate on behalf of a rigid set of practices but to provide an overview of key issues to guide a grantmaker's approach to due diligence.

This guide is based on one of GEO's most popular publications, *The Due Diligence Tool*. Originally published in 2004 with support from the David and Lucile Packard Foundation, the tool has been used by numerous grantmakers as a primer and a guidebook to the process of gathering information about prospective grantees during pre-grant assessment. The tool also has been integrated into the standard curriculum in a variety of grantmaker education programs.

This new publication, *Due Diligence Done Well: A Guide for Grantmakers*, includes some of the same information as the original tool, but the material has been updated to reflect new learning about effective due diligence. The newer content is based on recent research by GEO and Project Streamline, as well as La Piana Consulting's numerous consultations with grantmakers on the topic.

We applaud the many grantmakers who are finding new ways to make due diligence a more efficient and less burdensome process for nonprofits — and we look forward to learning more.

## ACCESS ONLINE RESOURCES

GEO and La Piana Consulting have created a tool for grantmakers to accompany this guide, with detailed research questions, assessment criteria and more. Please visit www.geofunders.org.

## SHARE YOUR STORY

How is your foundation dealing with the challenges and the opportunities due diligence presents? GEO is spotlighting innovative approaches that effectively balance grantmaker and grantseeker interests. Share your story at www.geofunders.org.

Due Diligence Done Well:
A Guide for Grantmakers

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# What Is Due Diligence — and Why Is It Important?

With origins in the world of business and finance, the term "due diligence" refers to the process through which an investor (or grantmaker) learns more about an organization's financial and organizational health to guide an investment (or grantmaking) decision. For a grantmaker, the decision to invest is based on a balance of strategic fit with the grantmaker's mission and priorities, objective data analysis, insight into the general state of the nonprofit's health and stability, and intuition based on grantmaker experience.

Grantmakers often think about due diligence as a legal process. But U.S. law actually requires little in the way of due diligence when grantmakers are supporting domestic U.S. charities (see sidebar on page 4). As a result, doing due diligence well is largely a matter of learning enough about a grantseeker and its plans so that your foundation can be confident it is making a good grantmaking decision, without posing an undue burden on the grantseeker.

Due diligence is not just about financial and legal compliance issues. The 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 — these factors and more can all come into play as you consider a request for support.

What you will want to know, and the process you will follow, will be based largely on your foundation's needs in a given situation. Your due diligence requirements might vary depending on the size and nature of the grant, your foundation's relationship with the grantseeker and other factors (see page 7). Too many grantmakers err on the side of wanting to know everything. GEO and La Piana Consulting advise that you temper your expectations and adopt a more streamlined due diligence approach, as outlined in the pages that follow.

## Why Due Diligence Is Important

A grantmaker's staff members 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 grantmaker's guidelines and priorities. Next, they must assess the value 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 often must be weighed for its relative merits beside many other worthy proposals.

Due diligence, when done well, can help ensure greater alignment between a grantmaker's mission and grantmaking. It also helps ensure that a grantmaker understands and can manage the risks associated with various grants, and that it is working with nonprofit organizations that have a clear likelihood of successfully achieving their goals.

While the idea contained in a proposal might be a strong one, there may still be many questions grantmakers might want to consider depending on the situation. For instance: Does the organization have a successful track record — or, if it is a startup, does it have the leadership and capacity to achieve its goals? 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 answering these and other pertinent questions about the organization, can lead to funding a project that does not succeed in producing the expected results, or worse. While due diligence will not prevent the failure of an organization or a project, it can ensure that a grantmaker's staff has a solid understanding of the various strengths and challenges a proposal presents.

In addition, with grantmakers and nonprofits under increased scrutiny with regard to spending their money in ways that have clear social impact, effective due diligence provides added confidence that grantmakers' investments will deliver results for the communities and the causes they serve. The due diligence process provides an opportunity for grantmakers to demonstrate to themselves and others that they are operating in good faith to achieve their mission.

## Due Diligence Done Well

As grantmakers conduct their due diligence work, they should keep in mind the nature and level of the demands they are placing on grantseekers. Obviously, grantmakers want all the information they can gather that will help them make a good decision. But time and again, nonprofit leaders report that excessive due diligence requirements are frustrating to them. "[M]ore paperwork than anything else" is how one nonprofit executive described grantmakers' application and reporting requirements in an interview with Project Streamline.[1]

Project Streamline identified "due diligence redundancy" as one of 10 ways in which the current system of grant application and reporting places significant burdens on the time, energy and effectiveness of nonprofits.

*Since it is difficult to determine exactly what is needed for due diligence (and since the list regularly changes), grantmakers tend to play it safe at the recommendation of their legal and financial advisors, requiring redundant and often unnecessary documentation from grantseekers.*[2]

## Legal Compliance Issues in Due Diligence

The legal requirements associated with due diligence for grantmakers are not as complicated or as onerous as many people think. Here is what the law says you need to know:

1. **The charitable status of the potential grantee organization.** As part of their due diligence procedures, grantmakers should confirm the legal status of prospective grantees. The most common grantee category includes tax-exempt public charities defined under Section 501(c)(3) of the Internal Revenue Service code. However, there may be times when grantmakers will consider supporting other types of organizations, including nonprofits with other IRS designations such as 501(c)(4), international organizations or other private foundations. In these instances, different requirements may apply, such as demonstrating "expenditure responsibility."[3]

2. **The intended use of the grant funds.** Under federal tax rules, private foundation funds may not be earmarked or designated for activities defined as "lobbying" or attempting to "influence legislation" at the national, state or local level. Grantmaker funds also cannot be used for electioneering purposes — i.e., in support of or opposition to candidates for public office. However, grantmakers should be aware that advocacy-related activities — such as research, analysis and public education — are not included in the definition of lobbying. In addition, grantmaker funds can be used in support of activities related to the electoral process such as voter registration and get-out-the-vote drives.

**For more information:** GEO and La Piana Consulting encourage grantmakers to consult the following resources for additional information about the legal aspects of due diligence:

- Alliance for Justice
  www.allianceforjustice.org
- Council on Foundations
  www.cof.org
- Internal Revenue Service
  www.irs.gov

[1] Project Streamline, *Drowning in Paperwork, Distracted from Purpose: Challenges and Opportunities in Grant Application and Reporting*, 2008. Available at www.projectstreamline.org.

[2] Project Streamline, *Drowning in Paperwork, Distracted from Purpose: Challenges and Opportunities in Grant Application and Reporting*, 2008. Available at www.projectstreamline.org.

[3] The Council on Foundations has published a handbook, *Expenditure Responsibility Step by Step*, which outlines the expenditure responsibility process. Available at www.cof.org. In addition, the Council on Foundations has information at www.cof.org/ppa on specific rules that apply to grants from private foundations and donor advised funds to certain supporting organizations (a specific type of public charity).

To the extent that due diligence imposes onerous requirements on nonprofits (i.e., to complete an excessive amount of paperwork, participate in numerous meetings and phone calls, and/or produce information and documentation that they do not have readily available), the process can become counterproductive, as it distracts the organization and its people from their mission-related work.

Making matters worse, grantmakers often demand the same level of due diligence for relatively small grants as they do for large ones. In GEO's 2008 survey of grantmakers, only 41 percent said their application requirements were often or always proportionate to the size and type of grant. Adding to the problem, many grantmakers have no idea how much work they are asking of prospective grantees. GEO found that only 12 percent of grantmakers said they collect information about how long it takes grantees to meet the administrative requirements tied to their grants.[4]

GEO's findings hint at a problem that many people in the nonprofit sector have noted for years: Organizations often spend so much time and money responding to grantmakers' compliance and due diligence requirements that the true value of a prospective grant can be much less than the actual grant amount. Nonprofit Finance Fund has advanced the concept of the "net grant" as a guidepost for the sector as nonprofits and grantmakers seek to streamline application and reporting processes. "How much did it cost your grantee to acquire and report on the grant from you?" NFF's Clara Miller asks. "Subtract it from the grant, and that's the 'net grant.'"

If the net grant is too small to make a difference to the grantee (or if the requirements associated with the grant are too large as a percentage of the total grant), then the grantmaker is asking for too much.[5]

## A Fresh Approach

Project Streamline advocates a "right-sized" approach to grant application and reporting. A right-sized approach to due diligence would consider the net grant to grantees in relation to the type and level of information a grantmaker needs in order to make a funding decision.

Doing due diligence well requires a high level of skill and sensitivity on the part of grantmakers.

The key is to create a balance between having enough information to understand the proposal and the nonprofit's health but not asking for so much that it becomes a challenge for the organization to comply with your requirements. As described below, weighing how much information you need means considering a variety of factors, from the size and nature of the grant (is it for program support or general operating support?) to whether the organization is a current or new grantee.

For example, if your foundation has an established relationship with an applicant, then you may already have a strong understanding of the grantseeker's history and track record, its vision and financial health. In this case, you may want to focus your due diligence on finding out more about the proposed project and the organization's plans for evaluation.

Of course, doing due diligence well is about more than reducing the burden on nonprofit organizations. It is also about creating a transparent process so that grantseekers understand what is expected of their organizations and when, as well as how, decisions will be made. Communicating in an open and honest way with grantseekers about the parameters of the process — including key assessment criteria you will use — can reduce confusion and uncertainty and ensure that everyone has a clear idea of what to expect.

Due diligence as practiced is more art than science. While many grantmakers have systematic, across-the-board policies and procedures they follow, many others do not. As noted in the introduction to this guide, GEO and La Piana Consulting are not advocating for rigid, fieldwide standards. Rather, grantmakers should think about due diligence strategies that will work for them, and then develop structures and guidelines that will ensure a consistent, effective approach.

[4] Grantmakers for Effective Organizations, *Is Grantmaking Getting Smarter? A National Study of Philanthropic Practice*, 2008. Available at www.geofunders.org.

[5] NFF information and Clara Miller quote are taken from the 2009 GEO publication *On the Money: The Key Financial Challenges Facing Nonprofits Today — and How Grantmakers Can Help*. Available at www.geofunders.org.

## What Due Diligence Delivers: Benefits for Grantmakers

- **Greater confidence.** Grantmakers are like any other investors; they want to be sure they are making good decisions about where to put their money. Due diligence provides grantmakers with greater confidence that they are supporting organizations that are a good fit with their grantmaking mission and strategy, and that grantees offer a likelihood of achieving established goals.

- **More transparency.** When done right, due diligence creates more transparency between grantmakers and grantees. The process can provide a bigger window for grantmakers into a grantseeker's overall capacity, its ability to achieve the goals of a given grant, and (potentially) its need for other forms of support to increase its effectiveness and boost the chances of success. At the same time, an effective due diligence process should leave grantseekers with a better understanding of the grantmaker's interests and needs, as well as how grantmaking decisions are made.

- **Better relationships with grantees.** A thoughtful approach to due diligence can lay the groundwork for a stronger relationship with grantseekers and grantees by enhancing communication and dialogue, building trust, and nurturing a shared understanding of a nonprofit's capacities, strengths and weaknesses.

- **Better insights into the issues facing nonprofits and the communities they serve.** The due diligence process can provide grantmakers with a stronger, more immediate understanding of the day-to-day challenges faced by nonprofits. In the course of due diligence work, including conversations with grantseekers' leaders, staff and others, grantmakers learn more about what is really happening on the issues they care about. Grantmakers can then apply this learning to target their grantmaking more effectively in the future.

# Keeping It Simple: Designing an Effective Process

There is no single "right way" for a grantmaker to do the work of due diligence. Different grantmakers will have different priorities and different objectives as they set out to assess prospective grantees and their proposals. Given different levels of grants and different relationships with specific nonprofits, due diligence procedures are likely to vary even within the same grantmaking organization.

Among the keys to successful due diligence: keeping it simple. To state it again, grantmakers should be mindful that their assessment efforts not place an undue burden on grantseekers and that they result in a reasonable net grant. Scheduling numerous interviews and site visits will reduce the net grant to the organization, especially in a case in which you are making a relatively small investment. The key is to focus on the assessment topics that are most important to your foundation and keep the paperwork, meetings and phone calls to the minimum amount required to obtain the information you need.

Keeping it simple therefore means considering what information you already have about the grantseeking organization, plus what topics you are most concerned about, and then structuring your assessments accordingly.

In a competitive and open proposal review process, the grantmaker should consider every proposal in an equitable fashion so that applicants are ensured an objective review. While it might not make sense to adopt organization wide policies and standards for due diligence, the grantmaker may want to design approaches that are appropriate in specific program or funding areas. This will help ensure that you are not designing a new due diligence process every time a proposal comes in the door. The process can be flexible, based on such factors as your current relationship with the applicant and the size of the grant, but it should be sufficiently straightforward and clear so that all staff members understand your philosophy and priorities when it comes to doing due diligence well.

## Four Things to Think About

GEO and La Piana Consulting have identified four key questions grantmakers should ask themselves as they consider how to design an effective and streamlined due diligence process in a given situation:

### 1 *What do you really want to know?*

Answering this question will depend in large part on the following three factors:

- *Your relationship with the grantseeker.* Is this an organization you have funded or worked with before? Do you know the leaders of the organization and have confidence in their ability to get results? If so, you might focus your due diligence less on learning more about the organization, its leaders and its finances and more on learning more about the project it is proposing. However, if this would be a new grantee for your foundation, you might pay more attention to key organizational-capacity issues.

- *The type of grant.* A request for general operating support might prompt you to want different information and documentation than a request for project support. Before providing general operating funds, for example, you might want to know more about the organization's governance and executive leadership, its track record, and other indicators of overall organizational effectiveness and health. This same information will be useful when making a project grant, but you might focus your due diligence in these cases on the precise scope and goals of the project, who is running it and other project-specific questions.

- *The size of the grant.* Is this a large grant for your foundation? Might it therefore require a higher level of due diligence and analysis? Conversely, if it is a small grant for you, what can you do to streamline the due diligence process? In addition, if the grant in question will have a substantial impact on the grantee's annual budget, how will you make sure you know enough about the nonprofit's capacity to manage a large infusion of funds?

### 2 *How will you get the information you need?*

There are numerous ways to develop a stronger understanding of an organization and/or project — from the organization's proposal, from conversations with the nonprofit's leaders and staff and others, and from independent research. Keep the grantseeker's perspective in mind as you set out to acquire the answers and the information you need. And be sure to consider what you can do to reduce the burden on grantseekers — for example, by looking to outside sources such as GuideStar for some of the information you want.[6]

Determining the right people to talk to about a proposal is crucial. Often, grantmakers will want to go straight to the top and be in contact with the executive director or board chair of a prospective grantee organization. But depending on the size and nature of the grant, it may be more appropriate to talk to other staff (for example, the director of development or the director of the program you are being asked to support).

Particularly in cases in which you are not making a large grant, it is probably unnecessary to be in close contact with the organization's senior leaders. To the extent that you ask them to spend time explaining a proposal or project or responding to other requests, you may be distracting them from the important work of leading the organization.

A related consideration is who within the grantmaking organization will be the point of contact for grantseekers. It is sometimes hard to avoid having different staff members interacting with applicants about different issues — e.g., finance staff talking to grantseekers about the money and program staff about strategies and plans. The key is to make sure your due diligence process is not resulting in redundant requests and that your staff is clear about who is asking whom about what.

### 3 *Are there ways to stage the due diligence process?*

Grantmakers should consider what they need to know at different points in the due diligence process — and whether there are ways to "stage" the process so grantseekers do not have to provide all the information and documentation at one time.

Many grantmakers ask for a "letter of inquiry" in which the grantseeker provides a short outline of a proposed project before submitting a more formal proposal. Based on the letter of inquiry, the grantmaker can decide whether the project represents a good strategic fit and is something it might be interested in considering in a more serious and deliberate way. This type of process can help ensure that a grantseeker does not spend time and resources producing a proposal that is unlikely to be funded.

It is important to design the process so that any burdens you place on grantseekers to spend time responding to your requests fall primarily on those that are most likely to receive funding from your organization. Grantmakers should make every effort not to mislead potential grantees and create unrealistic expectations if they are unlikely to receive a positive response to their proposal.

Similarly, a grantmaker might not need to have all the information about a specific project in hand all at once. As a grantseeker goes through the process, and as the grantmaker becomes more convinced that a given proposal might represent a good investment, the grantmaker can ask for additional information about specific areas from staffing to the organization's plans for communications.

The key is to build agreement and consensus within the grantmaking organization about what types of information you want and need at what points in the process, and then to communicate clearly with the grantseeker about your expectations and needs.

### 4 *What can you reasonably expect to learn — and in what amount of time?*

The pace of work at most grantmaking organizations makes it difficult to carve out the necessary time to undertake a thorough due diligence process, even for major grants. Even when grantmakers take steps to "right size" their approach and reduce the burden on grantseekers, due diligence review takes time. Grantmakers therefore should structure their due diligence with an eye to how much time staff members have before they must make a decision.

Among the guiding questions as you consider the timing issue: What can your staff reasonably be expected to do in terms of due diligence in the specified amount of time? And how can you help ensure that staff are using this time wisely (i.e., by drilling down to what is truly essential information that will help your foundation make a good decision)?

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[6] GuideStar offers the ability to review an organization's financial and other information online at www.guidestar.org.

Of course, time is not the only limiting factor when it comes to what you can reasonably expect to learn in the course of your due diligence work. There is also the question of capacity — both your staff's capacity to manage an effective process and the nonprofit's capacity to deliver the information you need.

Many grantmakers hire program officers who are specialists in their fields rather than nonprofit management generalists. Public health physicians, highly respected educators, artists and environmental policy-makers work for many grantmakers, large and small. These professionals may not have had the opportunity to manage a nonprofit organization. It is an all-too-common refrain in philanthropy: "I know the program side, but I really don't know what to ask about the nonprofit organization." Your challenge is to design due diligence processes that provide staff members with a consistent set of guidelines about what they should be looking for and how to do due diligence well.

On the grantseeker's side, the capacity issue is that many organizations, particularly small, short-staffed nonprofits, simply cannot comply with the demands of a rigorous due diligence process. As a result, you should consider whether an applicant organization possesses the resources and capacity to respond to your requests. How much time will it take the grantseeker to deliver the information and documentation you want? And are there other sources you can go to (e.g., GuideStar or the IRS) to find the same information?

## The Basic Steps

Every grantmaker needs to design its own approach to due diligence based on the questions and factors outlined above. The process will vary depending on the grantmaker's unique interests and priorities, as well as the nature of the specific proposal for funding. Nevertheless, there is still a basic framework that will encompass most of the steps in the process. The framework, presented below, includes everything from the initial review of grant proposal materials through conversations with an organization's leadership and staff and presentation of your due diligence findings to your staff and board. Again, your foundation may not follow all these steps in every instance — what is important is making sure you are getting the information you need to make a good decision, without placing undue burdens on grantseekers.

STEP 1: **Review the materials provided by the grantseeker.** Here you are looking at the proposal to assess the fit between the grantseeker or project and your foundation's mission, guidelines and strategy. You will also want a sense that the grantseeker is approaching its work with a sound strategy and focus. Lastly, your review of the organizational and project budgets and supplemental documents should help you gain a better understanding of how the grantseeker plans to finance and manage the work described.

STEP 2: **Conduct additional preliminary research.** A scan of the field in which an organization is working can help the grantmaker develop a more fine-tuned sense of where that organization fits in a movement or community. To what extent is it playing a unique and important role in bringing people and organizations together? Additional research (whether online or through conversations with community stakeholders contacts in the field) can help you develop a better sense of community needs and the degree to which the organization is meeting those needs. Note: You may already have some of this information if the grantseeker is a current or former grantee of your foundation, in which case you can research the foundation's experience with the grantee and the outcomes of previous grants.

STEP 3: **Engage in dialogue with the organization's leadership and key staff.** Conversations and other back and forth with the applicant can be a key step in the due diligence process. This is an opportunity to meet with the organization's leaders and key staff and get a stronger sense of their motivations, strategies and plans. As noted above, however, it is not always necessary to talk to an organization's executive director or board chair, especially in cases when a grant is relatively small (See "How will you get the information you need?" on page 8). In many cases, program and development staff should be able to answer most of the questions you may have.

You also should avoid allowing these conversations to rehash what you already know about the organization and its work. Rather, this is a time when you will want to hone in on key questions raised in your review of the proposal and your preliminary research.

STEP 4: **Conduct additional follow-up research as needed.** If you emerge from your initial due diligence work and conversations with additional questions, you may want to explore answers through further research and discussions with colleagues, experts, and selected staff or members of the board of the grantseeking organization who can provide the information you need.

STEP 5: **Analyze and apply your findings.** This is the step where the rubber meets the road and where you work toward a decision on the proposal. Coming to a decision requires you to weigh those factors that are most important to your foundation, consider any red flags that surfaced in your due diligence research and the extent to which they should weigh on your decision, and begin to consider options for structuring the grant. This is the point in the process where you may consider how to mitigate any of the risks or challenges that surfaced in the course of your due diligence work. (See page 14 for more on reaching a decision.)

STEP 6: **Synthesize the information and present to others.** In the final step of the process, you will present your due diligence findings (and final recommendation on the grant) to your board and others, and then get in touch with the grantseeker to communicate your decision. If multiple staff members have been involved in the due diligence process, you will want to develop a way to manage everyone's involvement. Sometimes, this will mean designating one staff member (e.g., the appropriate program officer) to lead the process by synthesizing the information, communicating the findings and serving as the primary point of contact for prospective grantees.

## Rules of Thumb

Here are a few rules of thumb to guide the due diligence process and help you make sure it delivers good results for all involved:

**Communicate, communicate, communicate.** Be sure to explain the due diligence process and its purpose, ask informed questions and walk applicants through what you expect of them, when you expect it and why. Be clear in your communication with grant applicants — that is, let grantees know the types of constraints your foundation is working with (money available, timing, number of other proposals, etc.). Be sure to let applicants know when you will get back in touch with them — and stick to the schedule so you do not leave people in limbo.

**Think about your long-term relationship with the applicant.** Successful due diligence can contribute to the development of a strong and trusting relationship between grantmaker and grantseeker. This may be the first contact the grantseeker 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. An applicant wants to know that the grantmaker understands the organization's work and recognizes its impact. In the course of your conversations and other contacts, help the applicant see that you have a strong sense of the issues the organization is working on and the challenges it is facing, and that you are focused on respecting (and learning from) the hard-won expertise of the nonprofit organization's leaders and staff.

**Keep the grantseeker's perspective in mind.** The proposal review process can be bewildering and frustrating for even the most seasoned nonprofit leaders. Do not require grantseekers to spend extra time producing information that you do not need or that will not have a significant bearing on your decision. Be available to answer any questions applicants might have about the process. And consider what grantseekers will be most concerned about as they go through the process, from the time frame for your decision to the criteria you will be using to assess their proposals. A little empathy will go a long way in your due diligence work.

# Priorities for Due Diligence

Doing due diligence well means considering a range of factors that could contribute to a grantseeking organization's effectiveness and success. Getting a better idea of the organization's finances is important, but it is not enough. You might also want a better understanding of the organization's leadership, its track record and its evaluation plans for the work at hand.

Due diligence is a process that compels grantmakers to wrestle with the question, what defines nonprofit excellence? Countless books and articles have been written on this topic, and we encourage grantmakers to review the literature for insights and varying perspectives.

Grantmakers do not need to follow the same checklist in assessing every proposal. Different grantmakers will have different priorities and different criteria as they go through the due diligence process. One might be wondering about an organization's capacity to scale up its programs, while another might want to know more about a recent change in leadership. In addition, as noted in the previous section, your relationship with the grantseeker, the type and size of the grant, and other factors will influence the design of your due diligence process and the topics on which you will want to focus (see page 7).

Your challenge is to keep the process as simple and as streamlined as possible, while still developing a solid understanding of the organization and its plans.

For the purposes of this document, GEO and La Piana Consulting have identified eight factors that you may want to consider in your assessment of whether a specific nonprofit organization has the capacity and the potential to achieve excellent results. They are as follows:

[7] For more information about due diligence for startups, see GEO's *Tool for Assessing Startup Organizations: A Due Diligence Supplement for Grantmakers*, available at www.geofunders.org.

### 1. Organizational history and track record

An organization's history and track record can tell you a lot about its ability to successfully carry out the activities outlined in a proposal. You will want to know about the organization's key milestones, including recent achievements that reflect well on the capacity of current board and staff members to deliver on their goals and objectives. You will also want to know how the organization has responded to key challenges such as leadership transitions and difficult economic times. This will help you develop a solid understanding of the sustainability of its programs and operations.

Note: If the organization is a startup nonprofit, your focus might be less on its history and more on its staff and board leadership and their credentials, as well as their plans for fundraising, project execution, communications and more.[7]

### 2. Governance and executive leadership

The board is the oversight body for a nonprofit organization, providing governance and strategic direction. Understanding how the board functions and how it collaborates with the executive director can give you important insights into the organization's overall stability and health. You will also want a sense that the organization has strong and capable leaders who work well together and whose individual strengths and weaknesses are balanced effectively. Strong governance is essential for an effective nonprofit.

### 3. Organizational vision and strategy

Effective organizations are guided by a clear vision and strategy. The board, executive director and staff all should have a shared understanding of what their work is about, where it is leading them and their constituents, and what core strategies they are following as they strive to reach their goals.

But remember: Vision isn't everything. Execution is key. In your due diligence review, you will want to know that the organization's work is founded on realistic goals and proven tactics — and that the vision and strategy are feasible, given the resources and the capabilities the organization brings to its work. You will also want to know that the leaders of the organization have a strong understanding of current trends in the field and of how those trends will affect the organization's work in the months ahead.

### 4. Proposed project: planning, outcomes and evaluation

Your initial proposal review should give you a good sense of what the applicant intends to do with your support. As you weigh the organization's plans, you will want to know that the project methodology is sound. You will also want to know that the work is aligned with the organization's mission, strategy and theory of change, and that the project plan allocates sufficient resources (staff, expertise and money) and an adequate time frame to accomplish the project goals.

Another important consideration is whether the organization has a plan for evaluating its progress and applying what it learns. A nonprofit's leadership needs to know what it is trying to accomplish and to have a system for measuring its progress toward meeting those goals.

### 5. Human resources

It is important to know which staff members will be primarily responsible for working on a proposed project and what kinds of experience they bring to the work. Unless you already know key staff members from the organization, you may want to do more than read their staff biographies in the proposal. More broadly, grantmakers will have confidence in an organization to the extent that they feel it has an overall management structure that makes sense and that is based on clear job descriptions and logical lines of reporting for staff.

Another important consideration: Does the organization invest in staff training and development? Are there articulated, shared values within the organization and a culture that supports them? Does the organization have appropriate human resources policies and procedures in place?

### 6. External communications

A nonprofit's capacity to communicate about its work can have a huge impact on its overall effectiveness. As part of your due diligence work, you may want to explore whether the organization has a clear sense of its audience, a clear message to communicate about its work and its role in the community, and a communications plan for doing so. And, with online platforms and social media driving much of today's communication in all sectors, you may also want a sense of how the organization is using the latest communications tools to build understanding of and support for its work in the community it serves.

### 7. Relationships and networks

In this time of increased need and diminished resources, the willingness and the ability of a nonprofit to collaborate or partner with others are increasingly important to the organization's success. Board members and staff leaders should understand the position of their organization in the field, with whom they are competing for resources and where there are opportunities for strategic cooperation with others. Partnerships — ranging from one-off connections to long-term relationships — are an indicator that an organization is looking for ways to increase its impact and efficiency.

### 8. Financial health

A nonprofit needs appropriate financial systems for developing budgets based on realistic plans, plus the capacity to monitor those plans through accurate, timely reports that compare budgets to actual financial performance. You will want to confirm that the organization has prepared a realistic budget with reliable sources of revenue and reasonable expenses, as well as understand how it would respond to any unexpected revenue shortfalls or cost overruns. Additionally, you will want to know whether the nonprofit has a track record of operating in surplus, whether there are any cash flow challenges and whether the organization has sufficient financial reserve.

The due diligence process is also an opportunity to review a nonprofit's broader financial strategy and plans. Do the organization's leaders have well-thought-out plans for attracting sustainable sources of funding? Does the organization have what it needs to support operational requirements in areas from staff salaries to technology and other infrastructure? Has the organization considered an optimal structure for its balance sheet to help it realize its future plans?

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**The tool portion of this publication,** *Due Diligence Done Well: A Tool for Grantmakers,* available online, provides a detailed overview of questions to consider and indicators of effectiveness across these topics. Please visit www.geofunders.org.

# Reaching a Decision

The due diligence process rarely leads to a consistent set of findings — either all good or all bad. 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 concern. Making a decision means weighing a variety of factors. It means thinking through both the strengths *and* weaknesses of a proposal and the organization putting it forward. Coming out of the due diligence process, you should have a stronger understanding of whether or not a grant is a good fit with your mission and strategy and represents a sound investment for your foundation.

In addition, it is important to remember that the decisions you reach coming out of a due diligence process are not made in a vacuum. Grantmakers often weigh the merits of one proposal for funding against those of others. Limited resources, issues of timing, changing grantmaker priorities and the level of support for an organization from other grantmakers all can influence the ultimate decision about whether or not to support a specific organization or project.

Making the right decisions therefore depends a great deal on each grantmaker's understanding of the context in which those decisions will be made.

Reaching a decision, however, should not be a long, drawn-out process. Nothing is more frustrating for a nonprofit organization's staff and board than having to wait in limbo for weeks or months after complying with a grantmaker's due diligence requests — and then getting a response of "no." Grantmakers should work to design due diligence processes that are as efficient and as fast as possible, while still allowing for a thorough exploration of key issues that they believe are important.

## Identifying Risks, Red Flags and Deal Breakers

Different grantmakers will enter the due diligence process with different ideas about what might disqualify an organization from receiving a grant or what might be cause for concern. The key is to enter the process with a common understanding among your staff of any risk factors, deal breakers and red flags that might influence your decision.

**Risk assessment.** Deciding whether to provide a grant comes down to an assessment of risk versus opportunity. Adopting a big-picture view of the risks involved in making a particular grant will add to your confidence that you have taken key considerations into account in your decision. To the extent that you believe the strengths of a proposal or an organization outweigh the weaknesses, then you will likely decide that it is worth the risk to fund the organization and its plans.

### Assessing Risk: Questions to Consider

- Overall, what is the level and nature of the risk involved in making this grant? Does the potential benefit outweigh the risk?
- To what extent is the grantseeker's proposal founded on tested strategies and a solid track record of accomplishment?
- Is your foundation generally risk-averse, or is there an interest among your staff and board leaders in "pushing the limits" and exploring new (and sometimes untested) solutions to problems?
- Is the grantseeker working in a field or a community where your foundation has history and institutional knowledge, or is much of this new to you and your staff?

Some proposals will entail greater risks than others, and in some instances you may decide that the risks are simply too great for the program to merit your support.

But how do grantmakers assess and quantify the risk associated with specific proposals so they can justify the decisions they make, and then communicate those decisions in a cogent way? In a process that often relies in part on intuition regarding people and organizations and the projects they administer, how can grantmakers ensure (and demonstrate to others) that they are making appropriate decisions about risk based on the information they have in hand?

One answer is to develop criteria that provide staff with some guidance in assessing risk and making grantmaking decisions. For example, you might want to look at some of the categories identified in the previous section of this document (organizational history and track record, governance and executive leadership, etc.) and specify what level of risk (low, moderate or high) might be associated for your foundation with specific due diligence findings in each.

Some grantmakers might not be overly concerned if a grantseeking organization were proposing to work in a new program area, or to adopt a new strategy for achieving its mission, while others would consider such a grant a higher risk. Similarly, a change in leadership might be a major concern for some grantmakers but not others. The key is to find the level of risk your organization is comfortable with as a grantmaker and to make certain that all your staff and board members are on the same page.

Yet another factor to take into account in assessing risk is the strategic alignment between your foundation and the prospective grantee. If this grantseeker is the only one in a specific community or field that is doing the kind of work you consider critical to your mission, then you might decide to make the grant despite identifying risks that in other instances could lead to a negative decision.

An alternative approach to risk assessment might come into play if your foundation is making an experimental type of grant. You may have all the confidence in the world in a grantseeker's leadership and finances, but perhaps the project itself entails some risk — for example, when the organization is trying something entirely new. As a grantmaker, you may believe the work is important and will generate valuable learning, but you may be uncertain at the outset about what kind of impact the work will have. In these instances, you will want to be clear about the level of risk involved in the grant. You might also want to pay special attention to the organization's plans for evaluation so that any new learning can be captured and applied to the work as the project moves forward.

**Red flags and deal breakers.** In the course of your due diligence, you may identify red flags in one or more assessment areas. Red flags are findings that indicate that the grantee may be deficient in an important area of organizational capacity and thus may not be fully capable of implementing the grant. For example, you may have concerns about a recent change in staffing or leadership at the organization, or about a program that has not lived up to the community's expectations.

A red flag does not necessarily mean you should deny the grant. Rather, it suggests a need to assess what the

### Identifying Red Flags and Deal Breakers: Questions to Consider

- What red flags do you see and what do they tell you? How extensive are any deficiencies they suggest?
- To what extent could any deficiencies imperil the organization's ability to carry out the proposed program?
- Are the red flags representative of "fixable" problems or are they signs of broader dysfunction within the organization?
- If you still want to support the organization, what actions can you and the grantseeker take to address deficiencies related to the red flags you have identified?
- What are some of the key deal breakers that would cause your foundation to reject a request for funding?
- Conversely, what do you absolutely need to see in an organization in order to support it (a strong and active board, a current strategic plan and vision, a well-reasoned theory of change, a balanced budget, etc.)?
- What can you do to communicate to grantseekers about your deal breakers and the factors you consider key to an organization's overall health and success?

red flag tells you about the organization and its plans. This analysis should take into account the fact that all red flags cannot be weighted equally. Some deficiencies may be relatively simple to address through technical assistance to the organization (e.g., upgrading its accounting software or working with the applicant to bring financially skilled leaders to the board). In other cases, it may take more time to see real change (e.g., the organizational culture does not promote appropriate involvement of the board of directors). Sometimes, it may be highly unlikely that the organization will ever meet the grantmaker's minimum standard in an important area.

Red flag analysis can provide a better understanding of what a grantseeker might need in order to advance its mission and succeed in implementing a funded program. If you decide that the organization and the proposed project are worth funding, and the red flag issue you have identified can be addressed, then you may want to consider providing capacity-building support — such as additional grant money or consulting help to assist the organization in addressing the issue.

Deal breakers, by contrast, are issues or organizational problems that you believe will be a clear and obvious barrier to the success of the organization or project. Common deal breakers for many grantmakers include serious legal or financial problems or a poor track record of delivering on organizational goals.

Your foundation may have its own deal breakers, and it is important to communicate these to current and prospective grantees so they understand what will cause you to reject a proposal.

## Stepping Outside the "Yes or No" Box

Grantmakers often will approach the due diligence process assuming they have two options based on what they learn: They can either make the grant or deny it. But there are other options as well, depending on the deficiencies uncovered during due diligence and the grantmaker's overall sense of the level of risk presented by the grant. Other options for grantmakers include the following:

- **Give an experimental grant.** In some instances, you may want to provide a grantseeker with an experimental grant so the organization can test certain ideas and approaches presented in a proposal — for example, if the grantseeker is proposing to use new and untested strategies, and you believe this work is important and could generate useful learning. An experimental grant will allow the organization to try something new or different. The grantmaker can then monitor the program supported by the grant and consider additional funding later if the work is proving a success.
- **Fund the proposed project, along with capacity-building support.** Another option is to consider offering capacity-building support as part of the grant package if the applicant appears to have capacity issues that could hinder the success of the funded work. Grantmakers can offer a variety of resources to organizations to assist them in building their capacity — from consulting and technical assistance on financial issues to leadership development support for the board and staff.
- **Propose a new scope.** On occasion, a grantmaker might have confidence in an organization and its program model but still have concerns that the goals or strategies associated with the proposal need fine-tuning. In these instances, a grantmaker might consider working with the grantseeker to rework or refine its plans — for example, by reframing the goals of the project.
- **Find partners.** Solving complex problems usually requires the involvement of multiple parties working on solutions from a variety of angles. To the extent that a due diligence process surfaces concerns that a problem or issue demands a more multifaceted response, a grantmaker might want to suggest that the grantseeker work with partners to help it achieve the goals of a project or initiative. This could mean structuring a grant in such a way that you fund just one aspect of the work (on the assumption that partners will take on other aspects), asking the grantseeker to come back to you at a later date with a proposal that reflects a more collaborative approach to the issue, or providing matching funds to help the grantseeker attract support from other sources.

## Communicating Your Due Diligence Findings to the Applicant

Once you have completed your due diligence and reached a decision, it is time to relay that decision to the grantseeker. In your communication, you should try to ensure that your due diligence serves as a learning opportunity for the grantee. Whether your ultimate funding decision is yes or no, you have most likely learned things about the organization that may be helpful to its leaders and staff as they move forward.

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.

- **If you are denying funding:** Of course, there will always be situations in which a grantmaker simply does not feel comfortable moving forward with a recommendation to fund a particular organization. Rejecting a grant request can be a difficult thing to do. Be clear about the reason or reasons why you are choosing not to fund the organization. Is its work duplicating other efforts you are funding? Do you have specific concerns about the organization's finances, strategy or other issues? Try to explain what it was about the organizations you *are* funding that caused them to stand out. Be honest but not critical or judgmental. Make observations about what you learned in your due diligence research. And be sure to take time to point out the strengths of the organization.
- **If you are providing funding:** Be specific about what you see as the strengths of the organization and the proposed project and its fit with your mission and interests. Discuss any potential problems in the proposal or supporting documents, or things that you learned in the course of your conversations with the organization's leaders and staff and others that raised red flags or concerns. Whether addressing these issues is a condition of your funding or not, consider identifying things that the grantee can do to try to resolve any problems. Communicate your sense of excitement about your foundation's future (or continuing) work with the grantee, and use this opportunity to build the foundation for a relationship built on honesty, openness and a shared commitment to impact.

It is not the role of the grantmaker to play judge and jury. Whether your answer to a proposal is yes or no, offer your perspective, communicate with respect and help make sure that the due diligence process benefits both your foundation and the grantseeker.

# Conclusion

**Nonprofit leaders regularly** assert that grantmakers' due diligence procedures are arbitrary, drawn out and confusing. Imagine for a moment what they might say about due diligence done well:

- "It didn't take too much of our time."
- "I felt that they weren't running us through a standard checklist. They only asked for information and documentation they really needed."
- "It was easy to find the information and documents they asked for. We didn't have to create a lot of new material just for them."
- "It was clear from the start what they wanted from us and what criteria they would be using to make their decision."
- "I knew how long it would take and understood the likelihood that we would get the grant."
- "I didn't have to deal with a lot of different people at the foundation requesting lots of different information."

Grantmakers are rightly concerned about spending their limited grant funds as wisely as possible. Due diligence provides a means for helping to make sure this happens. By developing solid systems for gathering information about the capabilities and key characteristics of grantseeking organizations, grantmakers can approach their work with more confidence that they are making good decisions — and that they are getting the best results possible.

As outlined in this guide, however, doing due diligence well means striking a balance between acquiring the information you need and not placing an unnecessary and counterproductive burden on the nonprofits that are looking to your foundation for funding. GEO and La Piana encourage all grantmakers to look at the process from the grantseeker's point of view. Help nonprofit leaders understand what kind of information and documentation you need and why you need it. Try to minimize the impact of the due diligence process on their daily work. And communicate clearly and openly about the process.

Approach due diligence with these priorities in mind, and you might just get a response like this: "I see why they're doing it…and it wasn't really that bad at all."

## ACCESS ONLINE RESOURCES

GEO and La Piana Consulting have created a tool for grantmakers to accompany this guide, with detailed research questions, assessment criteria and more. Please visit www.geofunders.org.

## SHARE YOUR STORY

How is your foundation dealing with the challenges and the opportunities due diligence presents? GEO is spotlighting innovative approaches that effectively balance grantmaker and grantseeker interests. Share your story at www.geofunders.org.

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