GEO PUBLICATION SUMMARY

On The Money

A Review of Key Financial Challenges Facing Nonprofits Today — and How Grantmakers Can Help

by Nancy Burd

Despite a wave of interest in recent years in what it takes to build stronger, more effective nonprofits, the sector as a whole still suffers from a chronic case of financial stress that inhibits effectiveness. Philanthropy can be a part of the problem, but also a part of the solution.

INTRODUCTION

As the nonprofit sector struggles to meet escalating service demands while at the same time addressing the underlying causes of social problems from poverty to crime and violence, many foundation and nonprofit leaders continue to argue for grantmaking strategies that are more responsive to the needs of grantees. The goal is not just to enable nonprofits to meet today's priorities but also to provide the kinds of support that will let them build strong organizations for tomorrow.

Advocates of general operating support and other strategies aimed at easing the money crunch facing nonprofits point to a strong, documented connection between how organizations are funded and their ability to deliver results. A core belief underlying this work is that nonprofits with financial reserves and flexible dollars are much better equipped to weather economic and other crises and adapt to a changing environment than those with highly restricted revenues.

This publication marks an attempt by GEO to better understand and communicate the financial challenges nonprofits face, the ways in which grantmakers are both improving the situation for nonprofits and perpetuating the problem, and the areas where knowledge and practice need further development.

ASSESSING THE PROBLEMS

GEO's 2008 survey of philanthropic practice found a pronounced disconnect between the ways in which grantmakers are supporting nonprofits and what nonprofits say could contribute most to their success.[1] For example, while 80 percent of foundations in the study said they devote some portion of their budgets to general operating support for nonprofits, respondents devoted a median of just 20 percent of their grant dollars to such support.

GEO's findings echoed other research that raises serious questions about many of the prevailing practices in philanthropy today. The remainder of this section summarizes some of the key financial problems facing nonprofits today, and how grantmakers may inadvertently contribute to creating (or at least not resolving) some of these problems.

Problem #1: Restrictions on Funding. Like any business, a nonprofit needs a well-managed, fully operational "infrastructure" in order to succeed. Infrastructure includes technology, facilities, human resources, and more. Every successful business, nonprofit or for-profit, depends on it.

Despite the obvious importance of infrastructure to the success of nonprofits, grantmakers overwhelmingly prefer to support direct delivery of services or programs, often leaving out or paying a small percent of the costs to deliver those services or operate the enterprise.

Making matters worse, even when grantmakers support programs, they rarely provide the funding needed to cover the full operating costs of those programs to the nonprofit organization. The same can be said for government funders, which have a long and infamous history of providing insufficient resources for operating and "indirect" costs. The result is a continued and persistent "hollowing out" of organizational infrastructure in the nonprofit sector. Nonprofits lose the structural framework they need to stay strong in good times and bad.

Problem #2: Misperceptions Around Sustainability and Growth. To some grantmakers, sustainability means nonprofits will lessen their reliance on foundation funding and will learn how to pay their own operating costs. To many nonprofits, however, sustainability means implementing a funding strategy with sufficient capital to operate effectively year after year.

Nonprofit Finance Fund's George Overholser has advanced a new framework for understanding philanthropic investments in nonprofits. He calls it "building versus buying."[2] Building an enterprise, he says, requires growth capital and "a patient process of trial and error." In contrast, buying from an enterprise puts a grantmaker in a position of asking that enterprise to "keep doing what it already knows how to do."

For grantmakers, a key takeaway from Overholser's work is the need to be absolutely clear about what type of capital you are providing to nonprofits, and to set your expectations accordingly. For example, if you are

---

[1] Grantmakers for Effective Organizations. *Is Grantmaking Getting Smarter? A National Study of Philanthropic Practice*, 2008. Available at www.geofunders.org.
[2] Overholser, George. "Nonprofit Growth Capital, Defining, Measuring and Managing Growth Capital in Nonprofit Enterprises. Building is Not Buying," Nonprofit Finance Fund. Available at: http://www.nonprofitfinancefund.org/docs/Building%20is%20Not%20Buying.pdf

providing "buy" money, then you cannot expect your grant or grants to deliver any returns to the organization beyond its capacity to continue delivering the services you are funding. Similarly, when providing "build" capital, it's important to understand the level of funding an organization truly needs to achieve real and sustainable growth.

Another sustainability challenge facing nonprofits is the preference of many grantmakers for one-year grants. Philanthropy's aversion toward multiyear commitments to grantees ignores a basic fact about nonprofit finance: It is almost impossible for an organization to develop a long-term business plan or build financial stability without knowing where funds will be received on a year-after-year basis.

Problem #3: "Too Many Masters" Revenue diversification is the rule of thumb in resource development for nonprofits. But, a greater variety of resources comes with a corresponding increase in resource dependencies, management challenges and mission creep. Although the benefits of diversification may mitigate the risk of losing one or more funders, the consequences of "too many masters" may create problems for the typical nonprofit.

Hilda Polanco, managing director of Fiscal Management Associates, a New York agency that works with nonprofits on finance issues, observes that nonprofits under-invest in business planning during times of organizational growth. They raise money from one funder at a time, developing a strategy that is customized for each funder's program and grantmaking strategy. Considering the small size of most foundation grants, this piecemeal approach to raising money can lead to haphazard growth and can divert the organization from its core focus and mission as it tries to meet the varying demands and interests of an array of funders.

For grantmakers, the message is clear: revenue diversification is not always the best measure of a healthy nonprofit. Equally important is the level of funding that the organization receives from various sources (including your foundation), and the strings that are attached to that funding.

Problem #4: Onerous Grantmaking Practices. Nonprofits — and many grantmakers themselves — often take philanthropy to task for the varying and sometimes onerous requirements that organizations must follow in applying for and reporting on grants. From duplicative grant applications that can take days to complete to demands for arbitrary impact indicators, many grantmakers place enormous burdens on their grantees — even those that receive relatively small amounts of money or that may receive funding from the same foundations every year.

The 2008 Project Streamline study, *Drowning in Paperwork, Distracted from Purpose*, concluded that many common grantmaking practices — such as "one-size-fits-all" application requirements — can inhibit grantee success and actually interfere with the ultimate effectiveness of grants. Among the other findings in the study: nonprofits continually reinvent their programs — at least on paper — in response to foundation preferences; and grantmakers' due diligence procedures tend to require redundant and unnecessary documentation from grantseekers to "play it safe."[3]

[3] Bearman, Jessica. "Drowning in Paperwork, Distracted from Purpose: Challenges and Opportunities in Grant Application and Reporting," Project Streamline, 2008.

In GEO's national study of philanthropic practice, only 41 percent of respondents said their application requirements were proportionate to the size and type of grant (for example, fewer requirements for small grants or event sponsorships). GEO's national study also found that only 12 percent of respondents collected information about how long it takes grantees to meet their organizations' administrative requirements.

Problem #5: Knowledge gaps. Perhaps the biggest money problem facing nonprofits and their funders — and a problem that underlies all the others — is a misunderstanding on both sides of the nature of money in the nonprofit sector.

According to Miles Wilson, director of The Grantmaking School, a program of the Dorothy A. Johnson Center for Philanthropy and Nonprofit Leadership at Grand Valley State University, foundation staff generally are hired for their expertise in specific program areas rather than their knowledge of nonprofit finance. This creates a problem for both grantmakers and grantees because the effectiveness of programs is so closely tied to their underlying finances.

"Understanding the cash flow of the organizations you are granting to will tell you a lot about the degree of capacity they have to deliver on the results they are promising," Wilson said.

Adding to the knowledge gap that keeps grantmakers from providing nonprofits with the right kind of support at the right levels is a lack of understanding of what it actually costs nonprofits to deliver services or to achieve their goals for growth. Further complicating the problem is the common (and flawed) perception that nonprofit overhead costs should be low no matter what. This contributes to a lack of transparency among nonprofits about the true costs of running their programs and sustaining their organizations.

MEETING THE CHALLENGE: IDEAS FOR GRANTMAKERS

Obviously, grantmakers cannot solve all of the financial challenges facing nonprofits today. But, grantmakers *can* take a number of steps to ensure that the support they provide to grantees, and the policies and procedures connected to that support, allow nonprofits to fulfill their missions as effectively and as efficiently as possible.

The following is a summary of some of the important ways in which grantmakers can work to ease the financial burdens on nonprofits and ensure that philanthropy becomes a boon, not a barrier, to nonprofit success. Also included are questions that grantmakers can ask of themselves and others as they consider how to implement these ideas in their organizations.

Listen to grantees. Grantmakers should engage grantees in conversations and dialogue about the fiscal challenges nonprofits face, and about grantmaking practices that may or may not be supporting nonprofit success.

Questions for Grantmakers

- To what extent do your grantmaking strategies and the types of support you provide reflect the perspectives of grantees?
- How does your organization engage with grantees outside the application and reporting process to better understand their financial and operational challenges and needs?
- What more can you do to make sure you are getting honest feedback from grantees about the kinds of financial support that will help them most?

Provide the types of support nonprofits need most. Grantmakers should cover the full costs of the services they are funding nonprofits to deliver, while considering increased levels of general operating support and multiyear support for grantees.

Questions for Grantmakers

- What portion of your organization's grantmaking is in the form of unrestricted general operating support? How about multiyear support? And what is stopping you from providing more of these types of funds?
- What is the size of your average grant for either general operating support or program support? Is this enough to make a real difference vis-à-vis grantee capacity to achieve their goals and mission?
- Do your organization's program grants cover the full costs of the program to the organization? If you are partially funding a program, do you know what the full costs are?
- Do grantees provide "full-cost" information to help guide your grantmaking decisions?

Reduce the burden on grantees. Grantmakers should take steps to streamline application and reporting processes they impose on grantees.

Questions for Grantmakers

- Are your organization's application and reporting requirements proportionate to the size of your grants — i.e., fewer hoops for smaller grants?
- Have you tried to calculate the costs to grantees of working with you as a grantmaker (i.e., "net grant")?
- To what extent can you streamline grantmaking procedures while still getting the information you need from grantees?

Work with other funders to reduce red tape, pool resources. Grantmakers should consider working together to simplify the grantseeking process for nonprofits while delivering larger, higher-impact grants. Among the options: strategic co-funding arrangements where two or more grantmakers support one nonprofit or a group of nonprofits; and syndication models where one foundation aggregates the capital for a nonprofit and provides the grants management services on behalf of partner investors.

Questions for Grantmakers

- Is there potential to work with other grantmakers to institute common grant application and reporting processes among your grantees?
- Are you funding in issue areas or geographic communities where it would make sense to pool resources in strategic co-funding or syndication arrangements?

Consider alternative financial tools. Increasingly, grantees are appealing to grantmakers for different types of investments that will meet their capital needs. These include cash-flow loans and program-related investments (PRIs), which can include loans and lines of credit offered to nonprofits, as well as equity investments and other tools.

Questions for Grantmakers

- To what extent would your grantees benefit from non-grant forms of support such as cash-flow loans and program-related investments?
- How would the addition of PRIs and similar investments to your organization's portfolio affect its overall risk profile and return?
- Is your organization equipped with the staff and the capacity to manage loan programs, or would it be smarter to work through intermediaries to provide these funds to nonprofits?

CONCLUSION

With this report, GEO has attempted to identify many of the systemic fiscal problems facing the sector, as well as an initial set of activities that grantmakers can undertake to ensure that nonprofits have the resources they need to succeed. Looking ahead, GEO hopes to initiate a wider and deeper conversation among grantmakers and nonprofit leaders about changes that are needed to make the world of nonprofit finance a saner, more reasonable place.

Many grantmakers are doing remarkable and commendable work to support nonprofits as they struggle to meet current service demands while planning and building for the future. GEO intends to continue sharing their stories, and to draw lessons from them that can benefit the field as a whole. The more knowledge that we can share on these issues, the more powerful our sector will be in addressing the crucial sustainability challenges facing nonprofits today.

