



Report Of The Task Force On Government Nonprofit Contracting

Research Memorandum No. 522



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2015 House Concurrent Resolution 89

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Research Memorandum No. 522

December 2016

Legislative Research Commission

Frankfort, Kentucky
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Foreword

The 2015 General Assembly enacted House Concurrent Resolution 89 to create the Government Nonprofit Contracting Task Force to study the government contract laws and procedures of the Commonwealth relating to nonprofit entities. In the course of its work, the task force discussed many issues, including statistical and general information about nonprofits, problems they face, auditing, contract procedures, the federal Uniform Guidance, and experiences in other states. The task force was to make its final report in 2016. This report represents the final action of the task force.

The task force Co-Chairs wish to thank the members of the task force and all those who assisted in the effort to learn more about this topic.

A handwritten signature in dark ink, appearing to read 'DAB', followed by a long, sweeping horizontal line that curves slightly upwards at the end.

David A. Byerman
Director

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Frankfort, Kentucky
December 2016

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Government Nonprofit Contracting Task Force

Summary

The Kentucky General Assembly established the Government Nonprofit Contracting Task Force in House Concurrent Resolution 89 enacted during the 2015 Regular Session. The task force was created to study

- the effect of current laws, regulations, and policies on nonprofit entities that contract with the commonwealth;
- procedures adopted in other states to facilitate a more cost-effective, streamlined, and accountable process for nonprofits that contract with those state agencies; and
- the feasibility of eliminating any redundant, unreasonable, or unnecessary laws, regulations, or policies that negatively affect nonprofit government contracting.

The 17-member task force began meeting in July 2016 and convened six times during the 2016 Interim. Topics of discussion included statistical and general information about nonprofits; problems faced by nonprofits; Uniform Guidance and how its regulations standardize issues regarding prompt pay, indirect cost reimbursement, auditing issues, and changes in contract midstream; state government contracting procedures; internal contracting procedures of state agencies; experiences in other states; and ways to improve the contracting process for nonprofits in Kentucky.

Statistics And General Information About Nonprofits

The executive director and chief executive officer of the Kentucky Nonprofit Network explained that nonprofits are 501(c)(3) organizations that are exempt from federal and state taxes. They are self-governing entities, run by a volunteer board of directors, and they exist to contribute to the public good. Nonprofits are mission driven and serve as natural partners with federal, state, and local governments. Nonprofits are among the largest industry employers in both the United States and Kentucky. They are the third largest labor sector in the country as of 2010, employing approximately 10.7 million people. In Kentucky, more than 1.8 million people were employed by nonprofits in 2012, with approximately 1 in 9 Kentucky workers employed by a nonprofit. Kentucky nonprofits in 2012 expended more than \$22.6 billion, making it one of the state's largest industries.¹

Most of the revenue received by nonprofits comes from program services and contracts (\$19.6 billion—approximately 84 percent); a smaller portion comes from contributions, gifts, and grants (\$2.7 billion—approximately 12 percent); and the remaining budget comes from dues, net sales, special events income, and investments. Many Kentucky nonprofits doing business with the state are in the health and human services industry. For fiscal year 2016, \$6.2 billion was appropriated from the US Health and Human Services Cabinet to the Kentucky Cabinet for Health and Family Services. Of the \$6.2 billion, \$2.7 billion was awarded to contractors, which included approximately 218 nonprofit organizations.²

Problems Faced By Nonprofits

A policy specialist with the National Council of Nonprofits described some of the concerns of nonprofits when contracting with the state. Budget constraints and an increased demand for programs and services have made it increasingly difficult for nonprofits to continue providing the government services while staying in business. Many nonprofits have experienced late payments beyond contract specifications, government changes to contracts and grants midstream, complex and time-consuming auditing and reporting requirements, and payments that do not cover the full cost of services or indirect costs.

Other concerns include the cost of staffing, possible changes in minimum wage laws, and changes to overtime laws made by the US Department of Labor. Nonprofits may not be able to continue providing services if the grants and contracts received do not adequately cover costs, especially overhead costs. Almost all nonprofit state contracts are cost-reimbursement and there is, on average, a 6-week lag from the time the services are provided to the physical receipt of the funds, making cash flow a serious concern. Additionally, the way that grants and contracts are executed differ among cabinets with no uniformity as to applications, audits, and payment protocols, making nonprofits bear an unnecessary administrative burden.

Office Of Management And Budget Uniform Guidance

The Federal Office of Management and Budget (OMB) has issued Uniform Guidance to facilitate contracting between nonprofits and government. This Uniform Guidance is the consolidation of eight OMB circulars related to federal grants and contracts, codified in the Code of Federal Regulations, effective December 26, 2014. The goal of Uniform Guidance is to improve performance and outcomes while ensuring the financial integrity of taxpayer dollars. To achieve its goals, the requirements in Uniform Guidance were designed to ease administrative burden; to increase efficiency and effectiveness; to strengthen oversight; and to reduce risks of fraud, waste, and abuse.

A specialist with the National Council of Nonprofits explained that Uniform Guidance is divided into three sections: Administrative Reforms, Cost Principle Reforms, and Audit Reforms. Under Administrative Reforms, pre-award requirements for states include providing information specific to the contract or grant, making funds available for awards at least 30 days in advance, and following selection process criteria for competitive grants. There are approximately 1,000 OMB forms, but the federal government is looking at ways to reduce and standardize forms to ease the application and contracting processes. Cost Principle Reforms address the most important piece for nonprofits: paying allowable and indirect costs. The rules under Cost Principle Reforms are outlined and provide guidance as to which direct and indirect costs are accepted.

Procurement requirements, under Uniform Guidance, require nonprofits to follow federal acquisition regulations when making purchases using federal dollars. States may continue to use their own policies and procedures, but nonprofits must follow the new regulations.

Understanding Uniform Guidance definitions is important to ensure that monitoring procedure requirements are followed. Monitoring procedures differ depending on whether the procurement is considered a grant or a contract. Grants are used to carry out a public purpose, but contracts are used to acquire property or services for the direct benefit or use of the federal awarding agency or pass-through entity. A subaward is an award provided by a pass-through grant entity to a subrecipient for the subrecipient to carry out part of a federal grant award. It does not include payment to a contractor. A subaward may be provided through any form of legal agreement, including an agreement that the pass-through entity considers a contract.

Uniform Guidance differentiates between a contractor and a subrecipient. Although the differences do not affect indirect cost reimbursement, they affect how the recipient of the grant or contract should be monitored and audited. The Audit Reform section of the Uniform Guidance establishes that contractors typically are awarded contracts, while subrecipients are typically awarded grants. Determining whether the money will be used for a contract or grant and whether the recipient is a contractor or subrecipient establishes whether the money is counted toward a single audit and the reporting and auditing requirements. Almost all federal funding passed through the state and awarded to nonprofits would be considered grants, even though the state would consider the transaction a contract. The transaction may continue through the state's procurement system so long as the monitoring and risk assessment align with Uniform Guidance regulations.

Uniform Guidance also requires any pass-through entity, like the commonwealth, to notify a subrecipient in writing regarding the amount of funds awarded and the source of the funds. Notification is important because it will help the nonprofit determine whether the funds are federal or state or a combination of both, and whether Uniform Guidance will apply. Before an award using federal funds is finalized, the pass-through entity must complete a risk assessment of the subrecipient it has selected to receive the award. The risk assessment focuses on whether the nonprofit is able to properly manage government funds. The risk assessment will also determine what monitoring requirements apply.

Prompt Payment

The Uniform Guidance requires agency reimbursements to nonprofits to be made within 30 days of billing unless the agency detects something improper about the request for reimbursement.

Kentucky also requires government agencies to pay vendors within 30 days of receipt of an invoice in accordance with KRS 45.453. If an agency receives a valid invoice that has been properly submitted and the agency is unable to issue payment within 30 days, a late payment will be added. However, the state is excused from prompt payment if the invoice is not correctly submitted. Invoices may be incorrect because of incorrect contract numbers, lack of supporting documentation, amounts that do not reflect the contract amount, and supporting documentation that does not match the invoice.

Most government contracts require performance of services before payment. This arrangement requires many nonprofits to take out loans to provide services and meet payroll requirements for the first month of service. Nonprofits are concerned that payments are not being remitted timely

because of a lack of communication between the agency and the nonprofit. The delay in prompt payment forces some nonprofits to establish lines of credit, which in turn, adds interest costs, forcing the nonprofit to operate at a loss, and undermining its ability to provide services. A nonprofit representative testified that he has waited on average 75 days before receiving payment, and that he has been waiting 3 months for a contract to be finalized.

Interest costs become a larger concern for nonprofits that handle large or multiple contracts. One nonprofit has taken out an \$800,000 line of credit with interest totaling \$93,000. Taking the line of credit is necessary to account for the \$600,000 to \$700,000 in services that the nonprofit is contracted to provide statewide.

The director of Kentucky Emergency Management (KYEM) and the assistant director of emergency management with the Department of Military Affairs explained how their divisions approach prompt pay. KYEM has implemented a sophisticated reimbursement system, including a transparency tracker that covers approximately \$70 million in grants per year. Objectives of KYEM are to maximize available federal funding, provide general guidance to the recipients of federal grants, and ensure that reimbursements are documented properly. In 2014, KYEM began a process to retool the grants management process. The solutions being sought were in the areas of customer service, transparency, efficiency of reimbursement, and accountability.

Over the past 8 years, KYEM has responded to 17 presidential declarations of emergency and has passed through \$830 million to subrecipients. Currently, KYEM has 3,000 projects with subrecipients. KYEM grant recipients include county and city governments, quasi-governmental entities, state agencies, and nonprofit entities. The assistant director stated that many problems encountered by KYEM subrecipients result from subrecipients not always understanding many of the federal procurement requirements, so KYEM has made an intensive effort to become compliant with federal requirements and to educate applicants in order to obtain the maximum amount of available funding.

Beginning in 2014, KYEM intensified monitoring of federal grants, developed and implemented online applications to simplify processes and increase transparency, and developed and delivered numerous grant management courses and workshops. These courses and workshops focused on federal program requirements, accounting, contracting, documentation, alternative funding opportunities, and Uniform Guidance. Grant-specific training was conducted statewide, attended by approximately 3,500 people. KYEM will start conducting webinars in the coming months to make it easier and more affordable to train and educate their contracting partners.

KYEM developed three trackers, which have online and mobile access for all entities. The trackers illustrate different payment stages, granting entities the ability to see when they will receive payment after they make a reimbursement request. All submissions are electronic, and if there is an issue, the tracker shows a red signal and the reason why payment is stopped. If mediation is required, the process begins with an email and is followed up with a phone call. Payments can be made a day after a request is made. The tracker shows all the forms that are necessary for payment reimbursement and shows purchase orders and receipts. All boxes must be green to get a reimbursement. The program is WEB EOC, which is the disaster management

software that the entire nation uses. KYEM has not yet been able to integrate its system with eMars.

Indirect Cost Reimbursements

Indirect costs are overhead costs or the cost of doing business such as rent, utilities, audit fees, legal fees, and insurance. According to Uniform Guidance, indirect costs are organizational costs that are shared across programs. Many nonprofits do not receive adequate payment to provide services and to cover their indirect costs. Indirect cost reimbursement applies to both contracts and grants under Uniform Guidance. There are exceptions if there is a cap in indirect costs in federal statute, or for any block grants created under the 1981 Omnibus Budget Reconciliation Act. Community services block grants, however, are subject to indirect cost reimbursement under Uniform Guidance. The indirect cost requirement is a significant step toward the goal of more reasonable reimbursement for nonprofits. Ensuring proper implementation of the indirect cost requirements across all cabinets and their subdivisions will help resolve some issues with paying full costs. However, no additional federal funds or budgetary authority has been made available from any source to increase the total payout to the nonprofit agencies for indirect costs authorized under Uniform Guidance.

Reimbursement for indirect costs has been troublesome for nonprofits and state agencies. State agencies and nonprofits are not in agreement as to the proper reimbursement rate. The problem compounds itself when there are both state and federal funding sources. State agencies indicated that they try to work with and negotiate with nonprofits if the contract and funding allow, but they generally stick to a 10 percent rate if the contract is funded by both state and federal funds, even if federal reimbursement rates were higher. There is also disagreement as to whether the 10 percent reimbursement rate for contracts funded by state funds is mandatory or discretionary. One agency sets a standard 10 percent reimbursement rate for contracts funded with state money, but another tries to keep reimbursement rates for indirect costs as low as 8 percent. One nonprofit representative testified that his organization has had indirect cost reimbursement rates as low as 3 and 4 percent, but the rate has now increased for the nonprofit to 10 percent.

Nonprofits also have difficulty understanding which costs are reimbursable. There have been times when nonprofits thought expenses were approved when they negotiated the contract, but they later found out that the costs would not be reimbursed. One example is legal costs: Legal costs may be approved in the contract, but a nonprofit might not be reimbursed for them. Similarly, other quasi-governmental agencies have received inconsistent responses on indirect cost reimbursement. State agencies have informed an area development district at different times that it would not be reimbursed for indirect costs, it must have a negotiated rate, or it could use a 10 percent de minimis rate, even though the 10 percent de minimis rate does not apply to area development districts. The differing interpretations have caused area development districts at times to be out of compliance with Uniform Guidance.

However, if a nonprofit has a federally approved indirect cost rate, all pass-through entities are required to pay that rate under the Uniform Guidance. If a nonprofit does not have a federally approved rate and has never had a federally approved rate, it can use the 10 percent de minimis rate, use 10 percent of modified total direct cost, or negotiate an indirect cost reimbursement rate

based on federal cost principles. Federal cost principles are set to try to standardize allowable costs, but because of budget constraints, cost reimbursement may be offset by a reduction in services. Federal regulations usually cap administrative costs but rarely cap indirect costs. In some agencies, however, administrative costs for program administration may be a direct or an indirect cost. The formula is not always user friendly.

Auditing Issues

Any nonprofit expending more than \$750,000 in federal funds in a fiscal year will undergo a single audit under Uniform Guidance. This figure was raised from \$500,000, resulting in reduced administrative costs for many nonprofits, as well as governments. The single audit would be provided to each pass-through state agency. However, each state agency must review the audit and request a corrective action plan for any significant audit findings. Therefore, if a subrecipient receives federal funds from multiple state agencies, each state agency must receive a copy of the audit, examine the audit, and request applicable corrective action plans. Though this approach reduces the administrative costs for nonprofits, many agencies do not have the expertise to analyze audit findings and determine appropriate corrective actions. A possible solution proposed by a representative of a nonprofit is for one agency in state government to receive the single audits from all subrecipients, review the findings, request corrective actions plans, and determine the sufficiency of corrective actions.

As noted above, risk assessments must be performed for each subrecipient prior to disbursement of federal funds so as to determine whether the subrecipient is capable of properly using federal awards. An issue that arises from this arrangement is that if a subrecipient receives federal funds from multiple state agencies, those agencies will perform multiple risk assessments. A solution similar to that proposed for a single audit would be to have one agency in state government perform risk assessments for all agencies, resulting in subrecipients submitting only one risk assessment.

Discussion led to the possibility of a “document vault,” which would be a place where state agencies and nonprofits could store and retrieve certain documents such as audits and risk assessments. Such a document vault could potentially be cost effective and efficient.

Changes In Contracts During The Term Of The Contract

A nonprofit administrator stated that changes in a contract during its term cause serious issues for nonprofits. She referred to reduction in a grant that was slated to be used for hepatitis C testing along with HIV testing. There was a decrease in the amount of the contracted funds due to a 3 percent reduction in funding from the Centers for Disease Control and Prevention, as well as a reduction in state funding. The nonprofit continued its deliverables for HIV testing and discontinued hepatitis C testing after all the test kits were used. After hepatitis C testing was discontinued, those clients were referred to local health departments for that test, but most local health departments do not administer it. Those clients most likely will go without hepatitis C tests, and 54 percent of the tests administered prior to the cuts were positive.

A representative from the state Cabinet for Health and Family Services explained that there are several reasons the amount of money contracted may be reduced. Some contracts have funding-out provisions that permit termination of an agreement with 30 days' written notice if funds are not appropriated or not otherwise available. Budget shortfalls also trigger reduction of discretionary expenditures within contracts, narrowing the scope of services within a contract, and reduction of ancillary contracts before direct services. She stated that when there is a state budget shortfall, federal contracts that require state matching funds may be affected. Similarly, reduction in federal funds for a particular grant would result in contract reductions for agreements funded by that grant.

The president and chief executive officer of a consulting firm gave an overview of how midstream funding changes affect a nonprofit's overhead and its ability to provide efficient and high-quality services. He stated that when funds are reduced, there is a limit on how much money a nonprofit agency can raise privately, and that levels of private fund-raising vary by the services that the nonprofit provides.

Uniform Guidance invites nonprofits and government to work in collaboration to promote consistent interpretations and applications to make the contracting process as fair as possible. Adjusting to funding changes may proceed more smoothly when government and nonprofits engage in collaboration and communication. The hope is that as they evolve, contracting processes will be streamlined, saving taxpayer dollars for more services.

Experiences And Perspectives From State Agencies

The director of budget and financial management with the Department of Education stated that the combination of all the OMB circulars into the Uniform Guidance has gone well and that it has been a painless transition for his department.

The managing director of corporate planning and accountability with the Kentucky Housing Corporation (KHC) stated that KHC is the recipient of federal awards as well as federal pass-through funds to subrecipients in the state. KHC is a pass-through agency for state funds as well. KHC has experienced some difficulty with different rule sets for state and federal awards. The biggest challenges so far are with subrecipient agencies and dealing with indirect cost rates. KHC does not have indirect cost rates approved, and there is a lack of education with the subrecipients on the allowable indirect cost rate. Subrecipient monitoring is going to create more work for KHC, but overall, the Uniform Guidance has been easy to implement.

The procurement director with the Cabinet for Health and Family Services (CHFS) said the CHFS cabinet level staff work closely with their departments to ensure that all federally mandated requirements are addressed and enforced. The boilerplate language in all of its contracts addresses the Uniform Guidance requirements so the cabinet will be in compliance with federal regulations.

A certified public accountant with CHFS stated that, if the definitional differences between Kentucky law and the Uniform Guidance could be reconciled, it would be very helpful.

Government Contracting Procedure In Kentucky

Most contracts between agencies and nonprofits are in a memorandum of agreement (MOA). MOAs are agreements between governmental entities and nonprofits for the purpose of carrying out a governmental function. MOAs must be signed by the nonprofit, the government agency, and a government attorney. Generally, work may not begin until the MOA has been finalized and filed by the agency with the Government Contract Review Committee. State agencies are prohibited from entering into a noncompetitive agreement with a nonprofit that does not have 501(c)(3) status or is not carrying out a governmental purpose (KRS 45A.095 and 45A.700).

When contracting with nonprofits, agencies determine their need for resources related to a particular governmental function, contact one or more nonprofits that provide the needed function, negotiate the scope of work, draft an MOA, and have the appropriate persons sign the MOA. Once the agency has its approved signatures, it submits the MOA with the signatures to the Finance Office of Procurement Services. After the MOA is approved by the Office of Procurement Services, it is reviewed by the Finance Office of General Counsel and the Finance Secretary. After all of the parties give their approval, the MOA is submitted to the Government Contract Review Committee for approval. The submitted MOA should contain the final document, signature page, IRS 501(c)(3) documentation, affidavit for bidders and contractors, and the nonprofit's secretary of state's identification number in accordance with KRS 45A.695.

Agencies' Internal Contracting Procedure

While each cabinet, agency, or department may have different or additional steps in its internal contracting processes, the general processes are similar. As was explained by the procurement office of the Department of Corrections, the department or agency first identifies the need for service. The department or agency's program staff will notify its procurement office that the nonprofit can provide the service. Then program staff corresponds with procurement staff to review and create a scope of work. The scope of work includes what the nonprofit is responsible for providing.

Once the scope of work is determined, the program staff and the nonprofit discuss pricing. At this stage, the nonprofit is aware of which department wants it to provide what services, and it can provide an accurate contract price. Examples of items contained in pricing include personnel costs, program supplies, and travel. Some programs, such as Medicaid and community health services, are based on a flat fee and are non-negotiable. Generally, departments and agencies try to negotiate pricing with nonprofits when applicable.

After department staff negotiate pricing with the nonprofit, that staff and the department's legal team review the MOA and send the MOA to the nonprofit through the procurement office for review and signature. If both parties agree to the terms and there are no changes, the nonprofit returns the original signed MOA to the department. Then the department will submit the MOA to the Finance Cabinet for review and submission into the eMars system.

Once the MOA is entered into the eMars database and the database shows all levels of approval, the department knows the MOA is approved and final. The procurement office scans and sends the fully executed MOA to the nonprofit for its records. This notifies the nonprofit that the MOA has been approved.

Experiences In Other States

The executive director and chief executive officer of the Kentucky Nonprofit Network stated that successful task forces in other states have embraced collaboration and are working to establish document vaults, to eliminate redundant applications and reporting requirements. However, the only state that has completely transformed its contracting process is Illinois.

Illinois' Government Nonprofit Contracting Task Force

Rep. Patti Bellock, a member of the Illinois General Assembly, gave an overview via teleconference about her experience and perspective of working with the Nonprofit Contracting Task Force in Illinois. The task force was authorized when the state recognized that billions of federal grant dollars were not being dutifully tracked. The nonprofit community and government staff were included in the task force, and after 3 years of ongoing collaboration and work, the task force recommended that the entire contracting process in Illinois be restructured. The result of that recommendation was the creation of the Illinois Single Audit Commission.

The commission recognized that the grant process had no common application, no common grant agreement, no uniform administrative rules, no lists noting noncompliance, and a lack of transparency. To address these issues, the commission focused on how the federal government administered and managed grant money. After review, it was decided that if the grantees were held to a higher standard when they applied for a federal grant, then the state should also be held to a similar standard with regard to state grant money. The findings of the Single Audit Commission led to the Grant Accountability and Transparency Act, which the Illinois Legislature enacted in 2013 in House Bill 2.

HB 2 was the vehicle leading to Illinois' status as a national model for nonprofit contracting with a state. The White House recognized Illinois as the first state with legislation requiring the implementation of a comprehensive set of standards that mandate transparency and accountability throughout the entire grant life cycle.

House Bill 2 also created the Centralized Grant Management Union housed within the Governor's Office of the Management of the Budget. Rep. Bellock stated that HB 2 was major reform and that it has saved Illinois billions of dollars.

Rep. Bellock stated that it was critical to involve nonprofits in the process from the beginning. The Illinois nonprofits were initially worried that the changes were going to be duplicative and paperwork oriented, and the state government agencies also thought it would be more work for them. However, the efforts of the task force, the Single Audit Commission, and the legislature have resulted in the use of criteria that are the same for federal- and state-level grants, leading to

accountability and transparency. Providing accurate data has proven to be key in enforcement and helps drive decision making.

Recommendations

After its Interim work, the task force was left with more questions than answers, but with a better understanding and a healthy appreciation for the complexity of the subject matter it had undertaken. With the experience of Illinois in mind as to the cost and time needed to develop more comprehensive government nonprofit contracting solutions, the task force recommends:

That the Finance and Administration Cabinet will coordinate an ongoing collaboration between state agencies and nonprofits who contract with the Commonwealth to explore the following:

1. The state mirroring all or part of OMB Uniform Guidance regulations and standardizing definitions;
2. Address gaps between state and federal indirect cost reimbursement rates;
3. Streamline the commonwealth's contracting and auditing processes; and
4. Establish and implement training of the state contracting processes and the OMB Uniform Guidance for both Kentucky nonprofits and state agencies.

Endnotes

¹ Clore, Danielle, and Beth Bowsky. Presentation. Meeting of the Government Nonprofit Contracting Task Force. Frankfort. July 7, 2016.

² Ibid.