HIRTLE CO

The Original Investment Office™

Beyond a Balanced Budget

Why Nonprofits Need an Operating Cushion

The term "nonprofit" is, in many ways, a misnomer. Mission-driven organizations need more than enough revenue to cover expenses; they need a sustainable operating surplus to remain financially viable. A surplus will serve as a cushion in the event of a decline in revenue or unexpected cost increases, such as the recent disruptive increase in inflation. An operating surplus also helps nonprofits maintain a bond rating so they can borrow, allowing them to make strategic investments in programs or facilities that are essential to further the mission.

So why don't more nonprofits build an operating surplus into the budget? In general, organizations tend to budget with a short-term mindset, looking out a year or two, rather than taking a long-term, strategic approach. Annual budget issues often take priority over developing a stronger operating model and building the balance sheet.

This mindset persists at the board level; when an operating surplus exists, many CFOs are admonished, "we could have had a larger salary increase" or "our budget is too conservative."

The past decade, and the challenges introduced by COVID underscored the value of shifting to a long-term mindset. Organizations with consistently positive operating margins weathered revenue uncertainty and periods of inflation from a position of strength. Their greatest advantage was not simply having more financial resources—it was having more time. A healthy operating surplus gives leadership the runway to respond thoughtfully to revenue shortfalls, rising costs and strategic opportunities instead of making decisions under immediate financial pressure.

What Happens Without an Operating Margin?

When a nonprofit experiences a downturn in revenue, it is generally slow to react and adjust its budget. The first year of a revenue shortfall is often mistakenly believed to be a one-year "blip." Then, when the organization faces the second year of missing their revenue budget, it has already started to build the next year's budget having not made the necessary program changes or capital investment to enhance revenue.

AN ORGANIZATION'S REACTION TO A DECLINE IN REVENUE OFTEN TAKES YEARS TO RESOLVE AND GET BACK ON TRACK. AN OPERATING MARGIN GIVES YOU TIME TO RESPOND STRATEGICALLY TO BUDGET SHORTFALLS.

YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Revenue shortfall "just a blip"	Revenue shortfall – time to evaluate the situation	Revenue shortfall – begin to implement changes	Smaller revenue shortfall – continue to implement strategic improvements	Begin to see an improvement in revenue

How Does an Operating Margin Make a Difference?

Rather than getting stuck with an immediate multi-year budget deficit, a nonprofit with an ample operating margin is positioned to weather a revenue shortfall. The below scenario demonstrates the impact an operating cushion can have through a downturn. Let's assume revenue growth slows to 1% annually while expenses continue to grow at 3%. A nonprofit with a cushion — in this case a 5% operating margin — remains in a solid financial position with enough wiggle room to make necessary improvements. Before it ends up running a budget deficit, the Board and administration have time to implement thoughtful changes that strengthen the operating model, whether by increasing revenue, controlling expenses or both.

MINOR REVENUE SHORTFALL SCENARIO

Revenue growth at 1% annually — Expense growth at 3% annually

5% OPERATING SURPLUS					
	Base Year 5% Margin	Year 1	Year 2	Year 3	Year 4
Revenue	$10,000,000	$10,100,000	$10,201,000	$10,303,010	$10,406,040
Expense	-$9,500,000	-$9,785,000	-$10,078,550	-$10,380,907	-$10,692,334
Margin	$500,000	$315,000	$122,450	-$77,897	-$286,294
Operating Margin %	5.0%	3.1%	1.2%	-0.8%	-2.8%

5% OPERATING SURPLUS

In contrast, a nonprofit with no operating margin immediately goes into the red. It is left scrambling without time or resources to react strategically and thus ends up in a deeper hole four years into the crisis.

BREAKEVEN BUDGET					
	Base Year Breakeven Budget	Year 1	Year 2	Year 3	Year 4
Revenue	$10,000,000	$10,100,000	$10,201,000	$10,303,010	$10,406,040
Expense	-$10,000,000	-$10,300,000	-$10,609,000	-$10,927,270	-$11,255,088
Margin	$0	-$200,000	-$408,000	-$624,260	-$849,048
Operating Margin %	0.0%	-2.0%	-4.0%	-6.1%	-8.2%

Breakeven Budget

The example above shows how even modest fluctuations can have a significant impact on the bottom line. It does not take much for a short-term challenge to become a long-term threat to an organization's sustainability. As budget deficits grow, nonprofits are forced to cut expenses, often delaying or abandoning the very strategic investments that would strengthen their financial position. The resulting damage to morale, organizational momentum and stakeholder confidence can undermine long-term plans. Most importantly, the organization's ability to deliver on its mission begins to suffer, making it more difficult to attract and retain the constituents, donors, volunteers or partners on which its success depends. What begins as a temporary revenue shortfall can quickly become a much more difficult long-term sustainability challenge.

Generally, we believe nonprofits should maintain a minimum budgeted operating margin of 3%-5%. However, determining the appropriate level of operating margin is a case-by-case exercise. Organizations should evaluate the following factors to assess the size of their operating cushion:

REVENUE DIVERSIFICATION — The greater diversification of revenue sources —endowment income, gifts, grants, non-core auxiliary services, corporate partnerships — the less vulnerable the budget. To the extent these sources of revenue are uncorrelated, a lower operating margin may be appropriate.

LEVEL OF OPERATING RESERVES — Having significant reserves may reduce how much operating margin is needed. However, reserves are a one-time funding source and should not be viewed as a solution to a persistent revenue shortfall or expense increase.

CAPITAL NEEDS — Future capital needs should influence an organization's operating margin target. A higher operating margin enables nonprofits to accumulate capital reserves or unrestricted endowment over time, strengthening the balance sheet and providing greater flexibility to invest in facilities and other strategic priorities.

PLANNED STRATEGIC INVESTMENT — Institutions that have a strategic plan requiring investment should consider whether they have enough resources set aside to make the necessary investment over the life of the plan to achieve their goals. This is especially important where investment will lead to future revenue growth and revenue diversification.

How Can an Organization Protect and Grow Its Operating Margin?

Moving from a breakeven situation to a 3% to 5% operating margin will take time. Building a higher margin should be viewed as an incremental, long-term strategy. If a nonprofit can grow its margin by 0.5% a year, then it can build up to a 5% operating margin over the subsequent 10 years. As a perpetual entity, nonprofits are in a unique position to take full advantage of a longer time horizon. While a decade may seem like a long time, it is a more realistic goal and can be transformational over the long term. The key is to start working toward that goal today rather than waiting until the next crisis to focus on building operating margin.

It is helpful to have an opportunistic mindset. A few opportunistic strategies include:

1. With the recent strong market returns resulting in growth in endowment spending, consider allocating some of the additional revenue from the endowment into an operating margin.

2. Look to build extra margin into an expense reduction plan. To the extent your organization is going through a multi-year budget reduction process, we recommend budgeting in enough cuts each year to start building an operating margin. However, it is not wise to cut funding for maintenance of buildings or IT infrastructure, as doing so will likely create a larger, institutional problem.

3. In years when there is a budget surplus, build an operating margin instead of increasing your expense base. There will always be ways to spend extra funds today, but a nonprofit is better off saving them for a future time when they are most needed.

4. Develop a multi-year financial plan and work with senior staff, board, etc. to educate the community about the strategic importance of building an operating margin. It is easier to achieve buy-in from key stakeholders by helping them understand the relationship between operating margin and long-term financial sustainability.

Conclusion

Whether an organization is thriving or facing financial headwinds, building an operating margin should remain a strategic priority. Yet budgeting for an operating surplus is often politically difficult because organizations face competing demands from every direction. There is pressure to keep tuition or fees low and expand programs, pressure from staff to increase compensation and resources and pressure from donors to direct every available dollar toward immediate impact. While understandable, these competing priorities often reinforce a short-term mindset that leaves organizations revisiting the same budget challenges year after year.

Instead, organizations should adopt a long-term mindset and commit to gradually building a modest operating margin. Doing so creates the flexibility to absorb periods of volatility, make thoughtful decisions under pressure and continue investing in the mission when others are forced to retreat. Boards readily accept that endowments need reserves to withstand market downturns. Operating budgets deserve the same discipline. An operating margin is not excess—it is the foundation for financial resilience that allows an organization to pursue its mission through good times and bad.



John Griffith | JGriffith@hirtle.com

John is a Director and Endowment Specialist with Hirtle & Co. He has over 35 years of higher education experience. From 2003 until 2014, he was the Chief Financial Officer and Treasurer of Bryn Mawr College. As the Treasurer at Bryn Mawr, he oversaw an $850 million endowment, managed cash, issued debt and was responsible for budgeting and strategy planning. At Bryn Mawr, he assisted in modernizing and diversifying the endowment. During the latest recession, Bryn Mawr was one of only a few colleges whose debt rating was upgraded. Prior to Bryn Mawr, John spent 15 years in various financial roles at the University of New Hampshire. John started his career at Coopers & Lybrand. He earned a Masters in Finance from Bentley University and a B.A. in Business Administration from the University of New Hampshire.

Founded in 1988 as The Original Investment Office™, Hirtle & Co. has been serving as a dedicated, independent investment office for nonprofit organizations and families for nearly 40 years. Our business is centered around making it personal. With each client in mind, we create customized investment programs that are diversified across global opportunities, including public and private markets. We hold ourselves accountable as if we are employees in our clients' own internal investment office, knowing that their investment results will help create opportunities, solve difficult societal problems, educate generations of students and make our world a better place. Learn more at www.hirtle.com.

DISCLOSURE STATEMENT AND IMPORTANT INFORMATION

Hirtle & Co. is a Delaware Limited Liability Company and is registered as an investment adviser with the U.S. Securities and Exchange Commission. Registration as an investment adviser does not imply any level of skill or training.

Certain information in this document may constitute "forward looking statements", which can be identified by the use of forward looking terminology such as "may', "will", "should", "expect", "anticipate", "project", "estimate" or "believe" or the negatives thereof or other variations thereon or other comparable terminology. Due to various risks and uncertainties, actual events or results or actual performance may differ materially from those reflected or contemplated in such forward looking statements.

Past performance is not an indicator of future results.

No part of this document may, without Hirtle & Co.'s prior written consent, be copied, reused or distributed in any form for commercial purposes.

The information presented in this document is general in nature and is not designed to address your investment objectives, financial situation or particular needs.

© 2026, Hirtle & Co.