

HARVARD | BUSINESS | SCHOOL



2006

Annual Report





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Educating for a lifetime of  
leadership, developing new  
knowledge with power in  
practice, and communicating  
ideas and insights worldwide.





#### From the Dean

As the demand for management education rises, business schools today are facing greater scrutiny than ever before. How can business leaders best be trained to meet the challenges of a rapidly changing world? What role can business play in addressing systemic issues such as healthcare delivery, poverty, and education? These are just a few of the questions being asked as forces including globalization and technology reshape markets and societies.

Harvard Business School is remarkably well positioned to face these challenges. The closeness to practice that is a hallmark of the School fuels a continuous process of innovation that has allowed us to meet, and to anticipate, the needs of business leaders for nearly a century. Recent developments at HBS — many outlined in this report — highlight the range and depth of this process of change.

In the MBA Program, the signature HBS academic formula — case-method instruction and the general management focus — is particularly welcoming to new approaches in the classroom. The required MBA curriculum today includes three courses (Finance II, The Entrepreneurial Manager, and Leadership and Corporate Accountability) introduced in the last five years, as well as a new module on information technology. We have enhanced the elective MBA curriculum as well through a steady stream of new courses and materials — more than 50 new courses in the last five years.

We also launched MBA Learning Teams — small groups of first-year students from diverse backgrounds and drawn from different sections who work together on projects throughout the year designed to improve their teamwork and communication skills. Students thus gain a broad foundation of skills, tools, and frameworks in the first year, and then can choose from a wide array of elective courses, seminars, and field studies in the second year — roughly 90 in 2006 — to tailor the program to their interests and career aspirations.

Attracting and supporting outstanding faculty is crucial to accomplishing the mission of the School and an operational challenge of increasing significance. As fewer young people pursue academic careers, the tightening supply of extraordinary faculty candidates has been a concern for all business schools. And at HBS, we set the bar high: We seek faculty who demonstrate a strong commitment to both teaching and research as well as a deep interest in the practice of business — a rare blend of characteristics. We are working strategically to develop the pool and strengthen the pipeline, and to ensure we are able to recruit the most promising candidates to HBS. Our doctoral programs will play a key role.

We also work hard to help new faculty thrive once they arrive on campus. The C. Roland Christensen Center for Teaching and Learning has been particularly effective on this front. The Center enables new faculty who may not be familiar with case-method instruction to hone their classroom skills, and to learn from other faculty with many years of teaching experience.

Additionally, we have been increasing steadily our investment in resources that support faculty research. This investment has dramatically expanded the research staff and services available to faculty on campus and around the world. Our research centers in California, Latin America, Europe, the Asia-Pacific, and, most recently, India are opening doors to relationships with local companies, governments, and their leaders. Combined with the resources at Soldiers Field, including advanced technology support, skilled research associates and casewriters, and Baker Library's information resources, our faculty are uniquely equipped to pursue ambitious, multiyear, and often cross-disciplinary research projects.

Globalization remains one of Harvard Business School's priorities. With students and faculty becoming more international, and with economies knitting ever more tightly together, we must build on previous initiatives and seek new ways to prepare students to lead and manage in an increasingly globalized world.

HBS classrooms are becoming markedly more international. Members of the MBA Class of 2008 come from nearly 70 countries, bringing with them a rich diversity of perspectives that has a profound influence on learning. The number of cases developed overseas and dealing with issues of globalization continues to rise, as does the number of courses offered in the elective curriculum.

A new area of focus is offering students and faculty more opportunities to work and study globally. January treks, long popular with students as a way to explore career opportunities in key areas around the world, are being developed — following the success of the faculty-led trip to New Orleans to help in the wake of the devastation left behind by Hurricane Katrina — as a way to enable students to immerse themselves in a region, with follow-on coursework so as to enhance the educational component of the experience. A pilot program is planned for China in 2007.

For faculty, we plan to roll out next year a global travel fellowship program that will lower the barriers to prolonged overseas stays. To extend the School's reach and impact, we are expanding the number of regional research symposia, where our faculty take their work back to its origins and test out new ideas with practitioners. In Executive Education, we are steadily increasing the number of programs we offer overseas — again, enabling our faculty to test their ideas where they originated.

Improving efficiency and quality in the business of healthcare is of critical importance to HBS. Our alumni hold positions of leadership in every healthcare sector and student interest in the field is high. Faculty involved in the School's Healthcare Initiative, launched last year, are working to produce leading research, a world-class MBA healthcare curriculum, and executive programs that enhance the skills of healthcare leaders. HBS stands at the center of the world's most significant community of researchers and practitioners in the field, and we are unusually well-equipped to contribute knowledge to this important field.

We see a number of opportunities as the University moves forward with its Allston development and begins construction of a 500,000-square-foot science complex that will bring life sciences and other groups in close proximity to our students and faculty. Over the next decade, the plans for Allston call for the construction of a 1-million-square-foot science zone and a professional schools corridor that will include HBS, the relocated Schools of Education and Public Health, and the John F. Kennedy School of Government.

The development of Allston puts HBS both literally and figuratively at the heart of the University and allows us to collaborate more closely with the world's foremost experts in a wide range of fields, with profound impact on business, government, and society. In addition to the new MD/MBA dual-degree program with Harvard Medical School, our faculty is exploring a true joint degree program with the Kennedy School of Government.


While it will be many years — indeed decades — before Harvard's full vision for Allston is realized, we are preparing for this potential in the way we think about the School's academic programs and the shape of our campus in the future. In 2007 we will be developing a comprehensive master plan for the HBS campus. We hope to identify new opportunities for interaction with colleagues throughout the University, from informal partnerships on research, to teaching undergraduates, to longer-term projects and programs. As this process unfolds, we will continue to invest in the facilities renewal and growth necessary to achieve greater excellence and impact in our teaching and research, while maintaining the integrity and unique residential quality of our campus.

Moving forward, it is clear that innovation will remain crucial. We must continue to experiment and to launch new initiatives that strengthen the core activities of the School: outstanding educational programs, pathbreaking research, and the dissemination of new ideas to a broad range of business practitioners.

We begin the new fiscal year with momentum and strength. I look forward to keeping you informed about our progress.

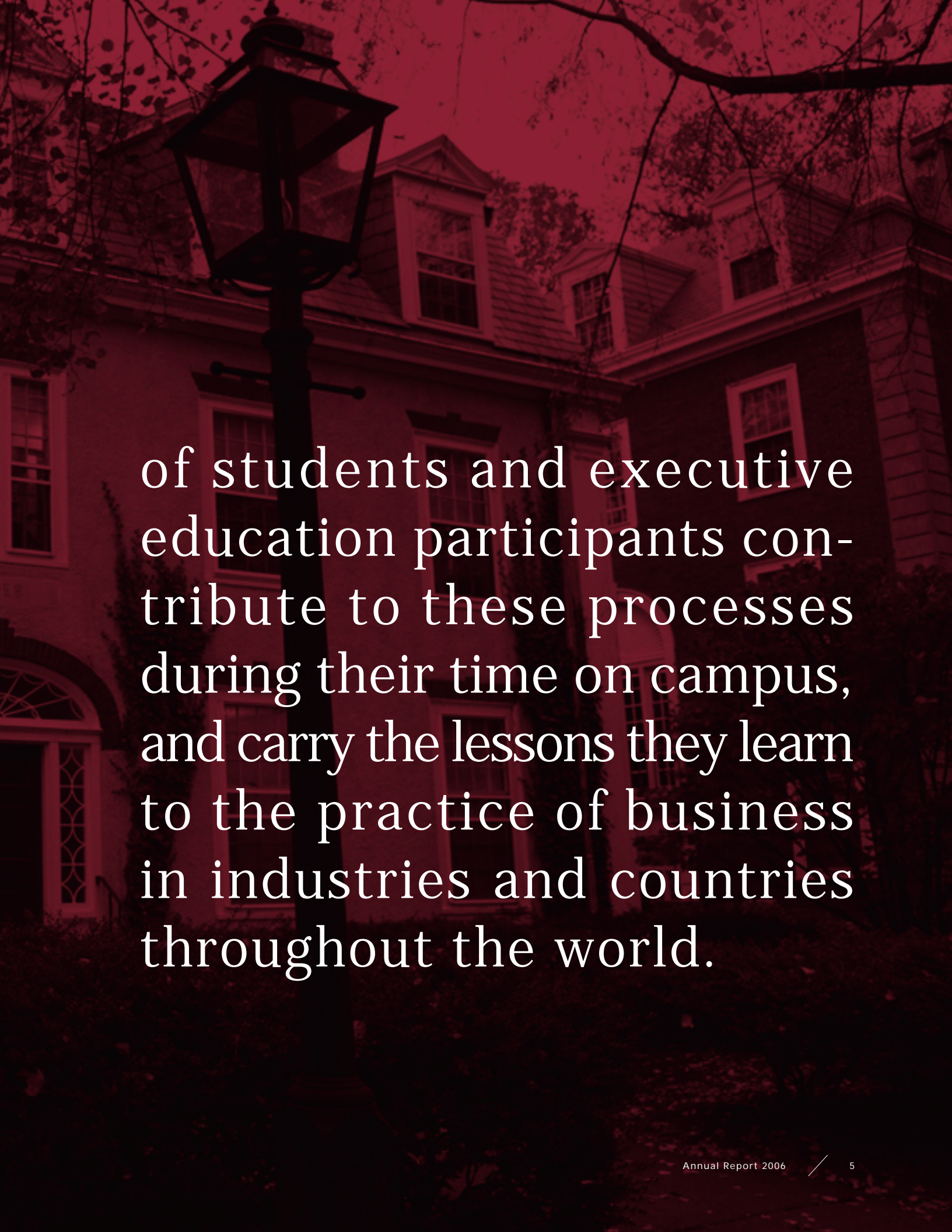


Jay O. Light, Dean of the Faculty  
George F. Baker Professor of Administration



Innovation is the essence of Harvard Business School. Each year, faculty launch groundbreaking research projects, publish novel insights, devise new courses, and test more effective ways to teach. And each year, new generations





of students and executive education participants contribute to these processes during their time on campus, and carry the lessons they learn to the practice of business in industries and countries throughout the world.

“When I leave HBS next year, I will have learned remarkable lessons, sharing experiences inside and outside the classroom with an Irish professional tennis player, a Navy SEAL, a South African engineer, a Serbian banker, an Indian police officer, an American brain surgeon, a Swiss management consultant, a British

economist, a White House speechwriter, a Senegalese entrepreneur, a French venture capitalist, and an Israeli Army colonel. This is the kind of opportunity that childhood dreams are made of.”

Arijit Roy,  
MBA Class of '07

The School remains committed to a general management curriculum, with a rigorous array of required courses in the first year and an entirely elective second year (offering students 96 courses in 10 subject areas from which to choose). Within this context, faculty continue to develop new ways to enrich the learning process. For example, the School has introduced MBA Learning Teams — six-member groups of students from different sections assigned to work together throughout the first year on graded projects. Learning Teams complement the classroom experience by bringing together students with different backgrounds and perspectives to collaborate on specific assignments, allowing them to refine teamwork skills, learn from one another, and broaden their relationships at HBS.

## A transformative experience — inside and outside the MBA classroom.

Over the past five years, HBS has nearly doubled annual MBA fellowship awards, making it possible to attract an increasing number of students who would otherwise be unable to attend the School. The case method of teaching that is a hallmark of HBS builds explicitly on the diversity of perspectives in each classroom. For the MBA class beginning in fall 2005, international students represent 33 percent of the 914 students enrolled, hailing from nearly 70 countries. HBS also enrolls more women than any other leading business school, and minority students comprise 22 percent of the School's MBA classes.

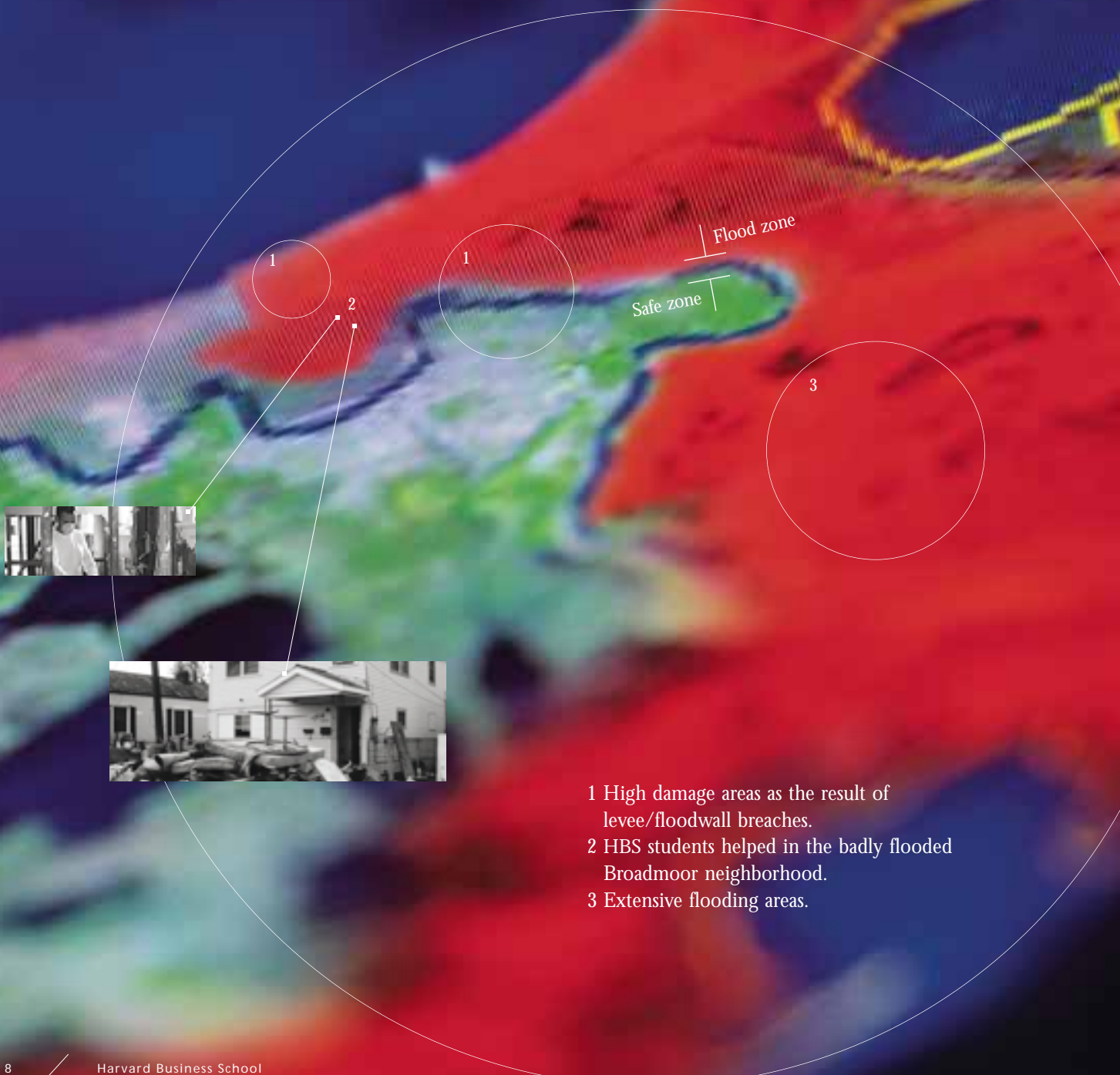


# 45

minute simulations

In the first-year Technology and Operations Management (TOM) course, student teams learn firsthand the complexities of developing a production system for a light-flashing circuit board module. They then demonstrate their process design as part of an intense, two-day exercise.

Hurricane Katrina made landfall in Louisiana on August 29, 2005, at the upper end of Category 3 intensity, with sustained winds of 125 mph. It was the third-strongest landfalling U.S. hurricane on record and caused widespread devastation.



- 1 High damage areas as the result of levee/floodwall breaches.
- 2 HBS students helped in the badly flooded Broadmoor neighborhood.
- 3 Extensive flooding areas.





In January 2006, a group of 57 HBS students, faculty, and staff traveled to New Orleans to contribute to the recovery efforts following Hurricane Katrina. Some students worked with government agencies to plan economic redevelopment strategies. Others helped clean and rebuild homes, secure personal and business bridge loans, and assess public education reform needs. Several students returned during spring break, helping to create an economic redevelopment plan for the badly flooded Broadmoor neighborhood. Students and faculty will return in January 2007 to provide strategic consulting to church and community groups and to help build homes with Habitat for Humanity.

## Students are faced with real-world problems in a real-world environment.

"The first thought I had when I heard about the destruction left by Katrina was, 'Let's do something about it — let's match the expertise of the students and faculty here with the needs of the New Orleans community.' If we are going to make a real difference, we need to build both relevance and sustainability into the work we do."

Anthony D'Avella,

"The MBA curriculum prepares

our students to take on complicated, ill-defined problems. There is plenty of opportunity for that in New Orleans today."

Professor Dutch Leonard,  
Co-Chair, HBS Social Enterprise  
Initiative

*The Chattanooga Ice Cream Division* introduces students to the case method by putting them in the shoes of a general manager challenged with turning around a business in decline. Students are challenged with the dilemmas of managing cross-functional teams operating under pressure to deliver results.



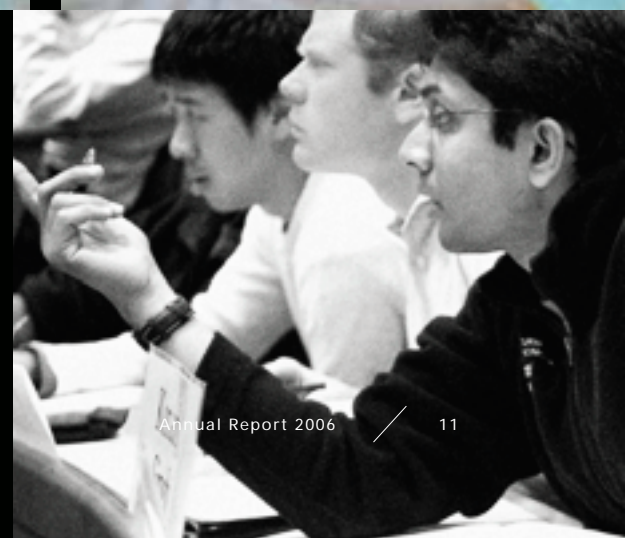
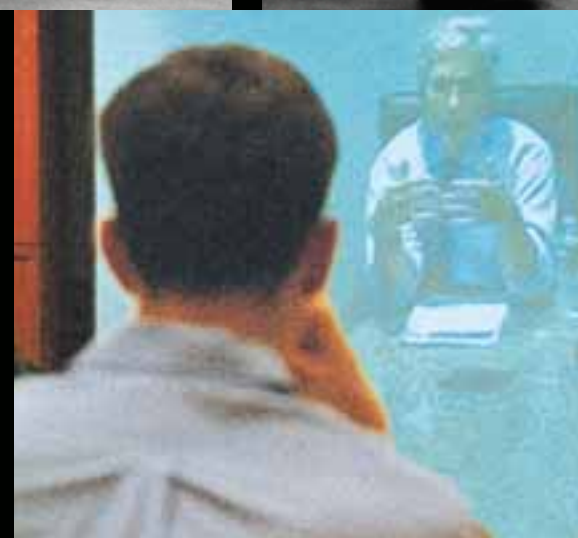
The HBS classroom remains a vibrant, engaging arena for learning. In the required first-year curriculum, roughly a third of the cases are new each year, focused on timely and relevant issues, industries, and geographies. Moreover, nearly every class incorporates online resources and tools such as interactive exhibits, live polling, simulations, and videoconferenced discussions with case protagonists. In the second year, students can select from among half courses, full courses, field studies, and individual student research projects. When combined with club activities, treks, the annual Business Plan Contest, and other activities, the breadth and depth of options available to HBS students is unparalleled among leading business schools.

## The protagonist will see you now.

"I walk into class each day with a certain view of the case and what strategy I believe the protagonist should take. But in each class I am astonished by the views and opinions of my colleagues. Our debates are invigorating, and they create a learning environment unlike any I have ever known."  
Michael Arlotto,  
MBA Class of '06

"The effectiveness of the case method is based on its connection to the real world of practice. Advances in technology have allowed us to bring more of that world directly into the classroom."  
Professor Joe Badaracco,  
Senior Associate Dean and Chair,  
MBA Program







"As a faculty member, you see yourself in action. You see how close you get to your students. You see how much time you spend at the blackboard with your back turned to the class. You see whether you smile when students are speaking. The first step in enhancing case-method teaching is recognition. You can't change or improve what you can't see."

**Professor David Garvin,**  
*Chair, Faculty Advisory Group,  
C. Roland Christensen Center  
for Teaching and Learning*

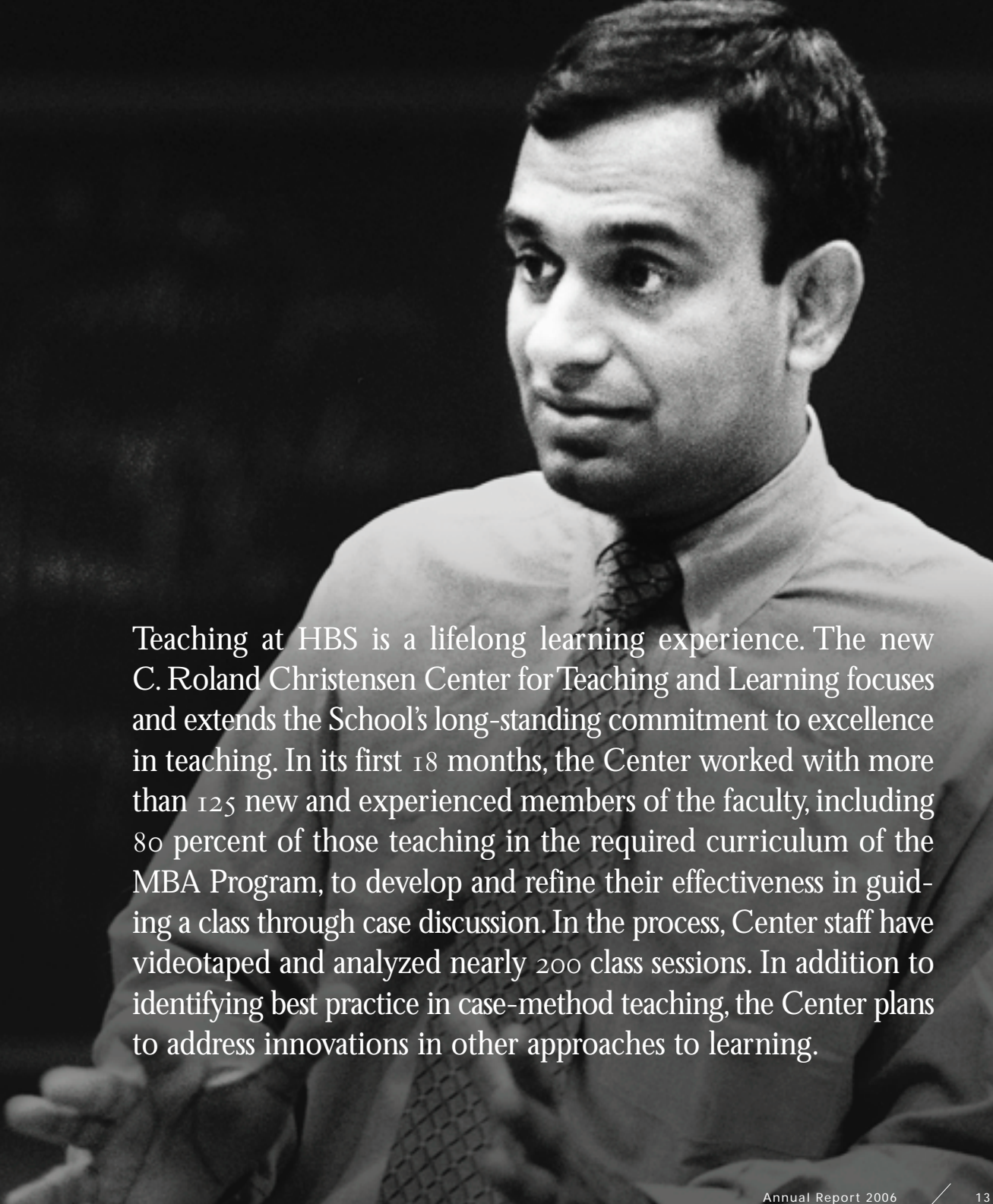
"Anyone who has ever tried to lead a discussion among 80 students will quickly realize that teaching by the case method is an art. But there are tools that can be taught, including approaches for opening a class, processes for helping structure the discussion, and ways of handling challenging situations. By sitting in on class sessions, using video, and through one-on-one follow-up sessions, we provide concrete feedback and help faculty develop their skills at every stage of their careers."

**Willis Emmons,**  
*Senior Lecturer, Director,  
C. Roland Christensen Center  
for Teaching and Learning*





# Making inspiration look effortless — teaching the art of case-method instruction.



Teaching at HBS is a lifelong learning experience. The new C. Roland Christensen Center for Teaching and Learning focuses and extends the School's long-standing commitment to excellence in teaching. In its first 18 months, the Center worked with more than 125 new and experienced members of the faculty, including 80 percent of those teaching in the required curriculum of the MBA Program, to develop and refine their effectiveness in guiding a class through case discussion. In the process, Center staff have videotaped and analyzed nearly 200 class sessions. In addition to identifying best practice in case-method teaching, the Center plans to address innovations in other approaches to learning.

The Program for Leadership Development, a new Executive Education program launched in fiscal 2006, focuses on the growing need for organizations to nurture the talents of early-career managers who are likely to emerge as key leaders. The program provides participants with an opportunity to step beyond the bounds of their workplace, enhancing their knowledge by interacting with peers from around the world and exposing themselves to real-world business lessons from a variety of industries and cultural perspectives. To minimize the time these individuals spend away from their organizations, the program includes two distance-learning modules interspersed with two two-week modules on campus. The off-campus modules make use of innovations developed at HBS such as interactive learning tools that allow participants to proceed at their own pace and tailor learning to their own needs. Another web tool allows groups of participants from diverse backgrounds and time zones to collaborate on projects as a virtual team during the time they are away from campus.

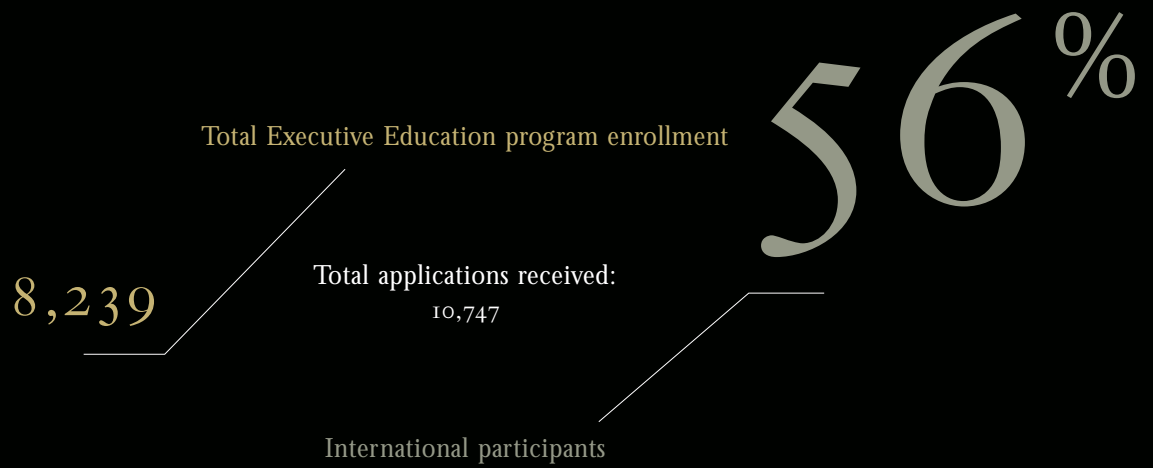
## Bringing market needs and faculty insight to executive education.

“Executive education at HBS is a laboratory for innovation. Many of our programs spring directly from new and emerging faculty research. In the classroom, ideas are tested, further refined by our participants, and translated to practice.”

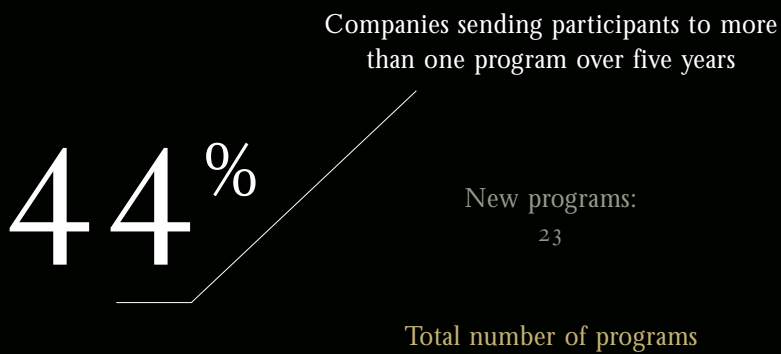
Professor David Yoffie,  
*Senior Associate Dean and  
Chair, Executive Education*

“Our longer Comprehensive Leadership Programs, targeted at individuals stepping into more senior management roles at key points in their careers, stress the need to take the time to gain a broader perspective before assuming greater responsibilities.”

Professor Bob Simons,  
*Chair, Advanced Management  
Program*

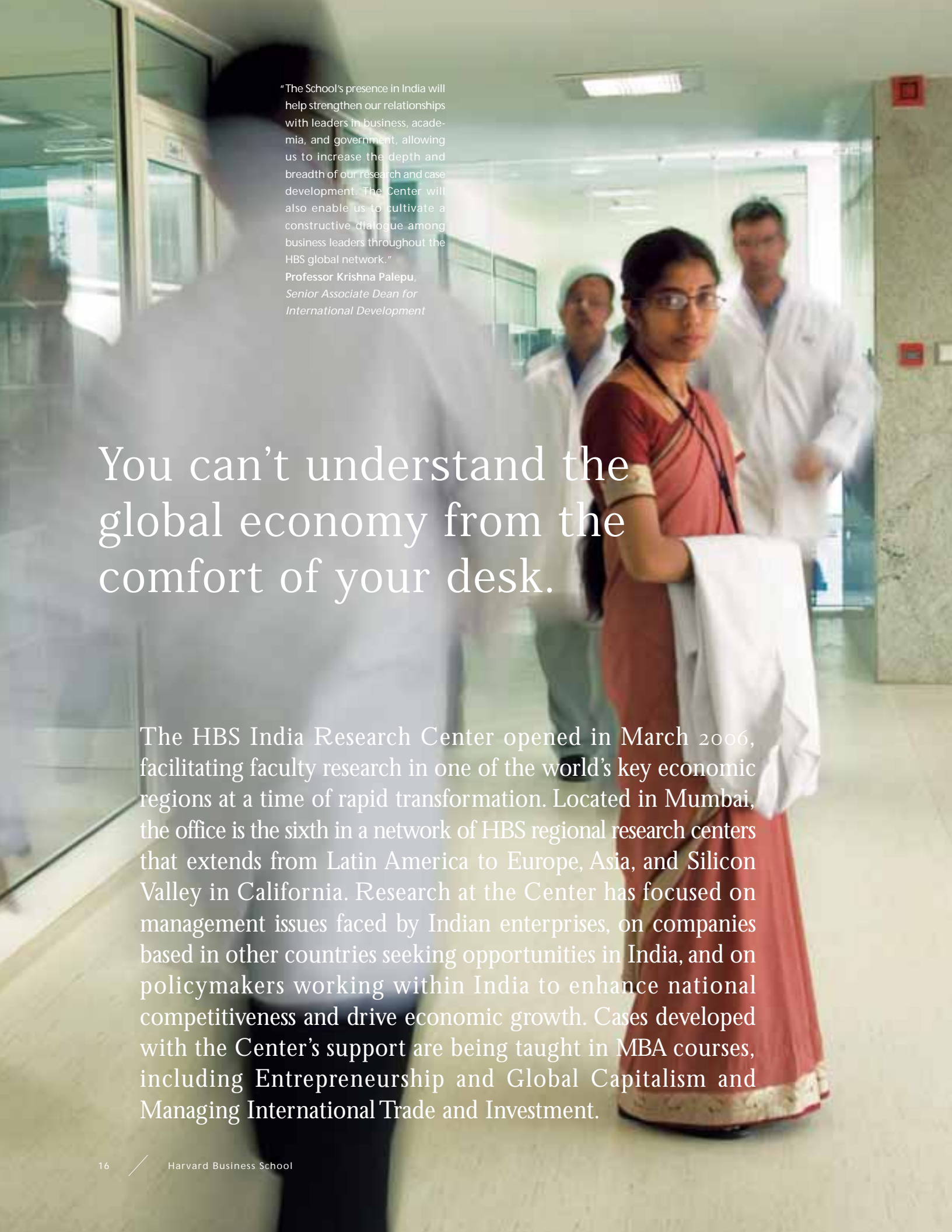


Number of companies sponsoring participants: 2,887



77





"The School's presence in India will help strengthen our relationships with leaders in business, academia, and government, allowing us to increase the depth and breadth of our research and case development. The Center will also enable us to cultivate a constructive dialogue among business leaders throughout the HBS global network."

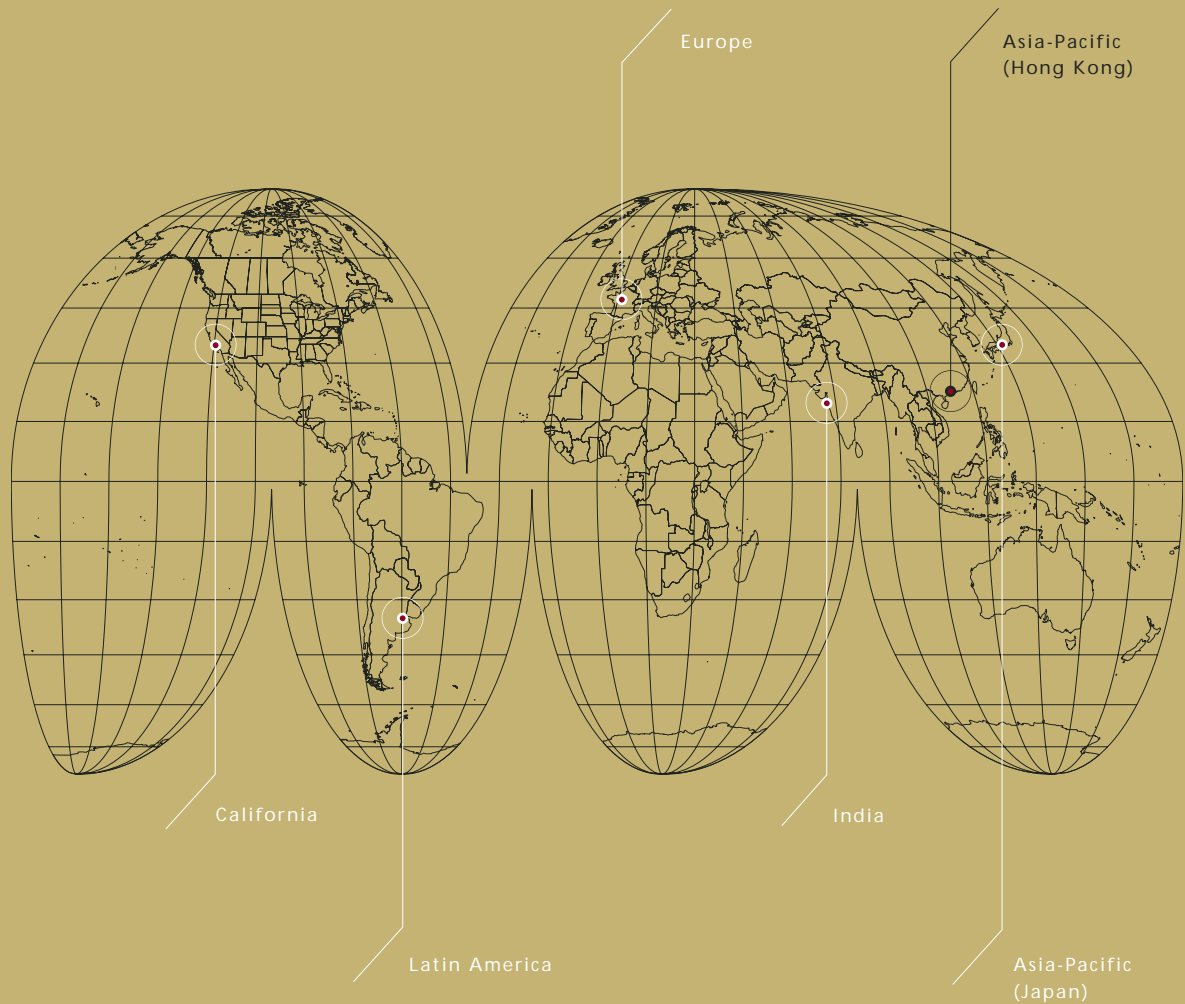
Professor Krishna Palepu,  
Senior Associate Dean for  
International Development

## You can't understand the global economy from the comfort of your desk.

The HBS India Research Center opened in March 2006, facilitating faculty research in one of the world's key economic regions at a time of rapid transformation. Located in Mumbai, the office is the sixth in a network of HBS regional research centers that extends from Latin America to Europe, Asia, and Silicon Valley in California. Research at the Center has focused on management issues faced by Indian enterprises, on companies based in other countries seeking opportunities in India, and on policymakers working within India to enhance national competitiveness and drive economic growth. Cases developed with the Center's support are being taught in MBA courses, including Entrepreneurship and Global Capitalism and Managing International Trade and Investment.

“China’s government is making big bets on small and medium-sized enterprise as the country’s main engine for growth in jobs. If Americans believe that the only advantage entrepreneurs have in China is low-cost labor, they are going to be shocked when they see what’s coming in their direction,” says Professor Bill Sahlman (Senior Associate Dean for External Relations). In June 2006, the School’s Asia-Pacific Research Center arranged a weeklong immersion program with Chinese entrepreneurs, venture capitalists, business school faculty, and government officials for Sahlman and nine other faculty in the School’s Entrepreneurial Management unit.

### HBS Regional Research Centers





- 10% of first-year MBA cases relate to healthcare
- The HBS Health Industry Alumni Association has more than 700 members
- More than 400 healthcare cases are available through HBS Publishing
- 20% of the faculty have a research interest in healthcare issues

## Mobilizing resources to improve quality and efficiency in healthcare.

The recently launched Healthcare Initiative was formed to coordinate and expand the School's contributions to one of the most complex and important arenas of our time. The Initiative is engaging an interdisciplinary community of business and healthcare leaders, faculty, students, and alumni from around the world, building on the unique strengths of HBS, Harvard University, and the Boston area — one of the world's great centers of healthcare research and delivery. As it develops, it will address all segments of the industry, including how new technologies are identified, developed, and brought to the marketplace; how healthcare products and services are marketed and sold; and how healthcare is delivered to the individual.



# 100

students in the MBA Class of 2008  
are interested in healthcare




"All business leaders, regardless of industry, need to understand the major ideas and trends in healthcare in order to engage in the types of activities that can make a difference for their companies and employees. We are strengthening our research as well as our MBA and Executive Education programs to keep the School at the leading edge of this rapidly expanding field."

**Professor Richard Hamermesh,**  
*Chair, HBS Healthcare Initiative*

# 10%

of the MBA Class of 2006  
chose jobs in healthcare






According to recent World Bank statistics, nearly half the world's population — about 2.8 billion people — survive on less than \$2 a day, with nearly 20 percent living on less than \$1 a day. In December 2005, 120 academics and leaders in the business, nonprofit, and government sectors from around the world converged on the HBS campus to explore how serving bottom-of-the-pyramid markets can be profitable while helping improve the lives of the world's impoverished populations. Building on earlier field research by HBS faculty, "A Conference on Global Poverty: Business Solutions and Approaches" focused on successful business models, the role of civil society and government, and the ethical and operational challenges faced by enterprises that seek out the poor as customers. Important new research streams were identified and next steps were explored, including an ongoing seminar series. A book will be published in 2007 summarizing the event's findings.

Changing lives at the  
bottom of the pyramid.





1.5<sup>B</sup>

people living in extreme  
poverty in 1985

"The fundamental premise of our work at the School is that business acts to improve the quality of life. But the global market system serves only about one-third of the world's 6.2 billion people. With an issue as complex and multilayered as global poverty and inequality, academia can serve most effectively as a galvanizing force — helping forge cross-sector partnerships with business, government, and NGOs that achieve scalable results."

**Professor Kash Rangan,**  
*Co-Chair, HBS Social Enterprise Initiative*

1.1<sup>B</sup>

people still living in extreme  
poverty in 2005



"I wrote my last book on the politics of the Internet, and inevitably people would ask me: What is the next cycle of technology that will have the same effect? A technology so radical that it creates a market that didn't exist before, and people jump into it and do all kinds of wacky things because there are no rules — though people will eventually want them. It hit me that the answer was reproductive medicine. What scientists are now able to do in terms of high-tech reproduction has created a market for conception that never existed before."

Professor Debora Spar,  
*Author, The Baby Business: How Money, Science, and Politics Drive the Commerce of Conception, Harvard Business School Press, January 2006*

"Participants in the healthcare system have competed to shift costs, accumulate bargaining power, and restrict services rather than create value for patients. This zero-sum competition takes place at the wrong level — among health plans, networks, and hospitals — rather than where it matters most: in diagnosing, treating, and preventing specific health conditions. We believe that by focusing the healthcare system on delivering patient value, hospitals, doctors, health plans, employers, and policymakers can move to a positive-sum competition that will unleash lasting improvements in quality and efficiency."

Professor Michael Porter,  
*Author, with Elizabeth Olmsted Teisberg, Redefining Health Care: Creating Value-Based Competition on Results, Harvard Business School Press, May 2006*

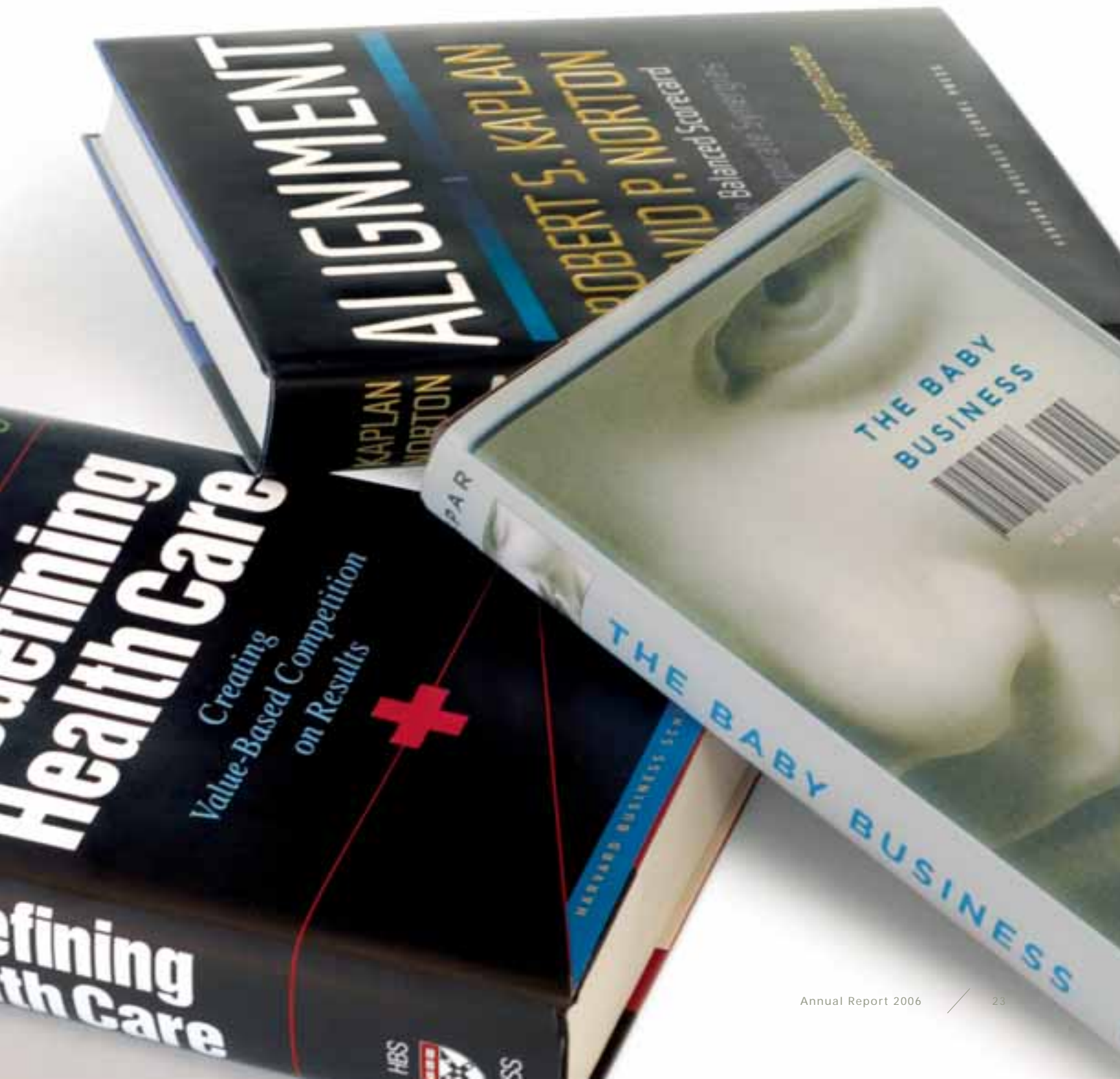
"Ask the CEO at any multiunit enterprise and you will hear about initiatives to generate interunit synergies. But few CEOs use a systematic process to capture potential scale and scope economies. Our research demonstrates that diversified companies have the potential to realize a new source of 'enterprise-derived value' from their business units. Using new approaches to organizational alignment, it is possible to create synergy not only within the company but between the firm and its board of directors, investors, customers, and suppliers."

Professor Bob Kaplan,  
*Author, with David P. Norton (DBA '73), Alignment: Using the Balanced Scorecard to Create Corporate Synergies, Harvard Business School Press, April 2006*

# Pathbreaking faculty research, disseminated worldwide.



HBS has long been recognized for its thought leadership. Building on the foundation of their research and experience, the faculty publish a wide range of books each year on a broad spectrum of topics. Many of these publications become classics in their field, changing the way we view the world and transforming the practice of business.





In 1996, Kari Stefánsson launched an improbable business from an unlikely spot. Based in Iceland, a rocky island of 270,000 people, deCODE Genetics planned to identify the individual genetic markers for common illnesses — such as heart disease, cancer, and asthma — that are not purely genetic but result from a complex interplay of genes and environment. To do so, Stefánsson set out to create an unrivaled database of genetic and medical information, drawing on Iceland’s unique genealogical records and patient information from a countrywide medical database.

Published in February 2006, *deCODE Genetics: Hunting for Genes to Develop Drugs* is taught in the MBA and Executive Education programs and probes the political and ethical questions that arise when businesses use individuals’ medical records.

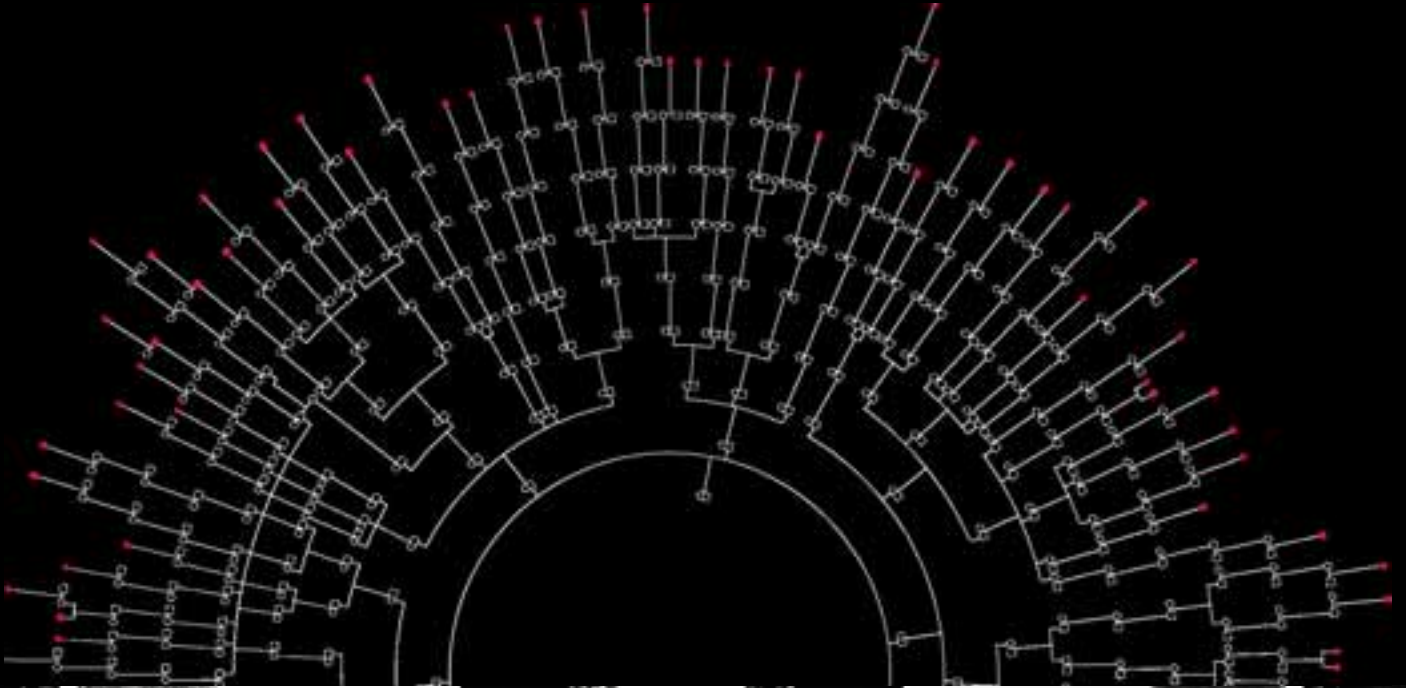
**From genes to jets: MBA students analyze more than 500 cases in their two years at HBS; about a third of the cases taught in fiscal 2006 were new.**

In 2005, United Parcel Service CEO Michael Eskew asked the company’s corporate strategy group to recommend process changes designed to sustain transformation at UPS over the next several years. These changes revolved around scenario planning techniques, as well as the development of the company charter, strategic planning, strategic decision-making, and strategy implementation.

*Strategic Planning at United Parcel Service*, taught in the spring 2006 session of the Advanced Management Program, explores the roles of the various players in the strategic planning process, focusing especially on the CEO and corporate staff, and the use of scenario planning techniques to stimulate creative thinking.

“Stefánsson was not returning to Iceland for its rustic charms, or to escape the pressures of city life. Instead, he had realized that scale and isolation had blessed Iceland with an intriguing genetic advantage. Iceland’s populace, most of whom were descended from the

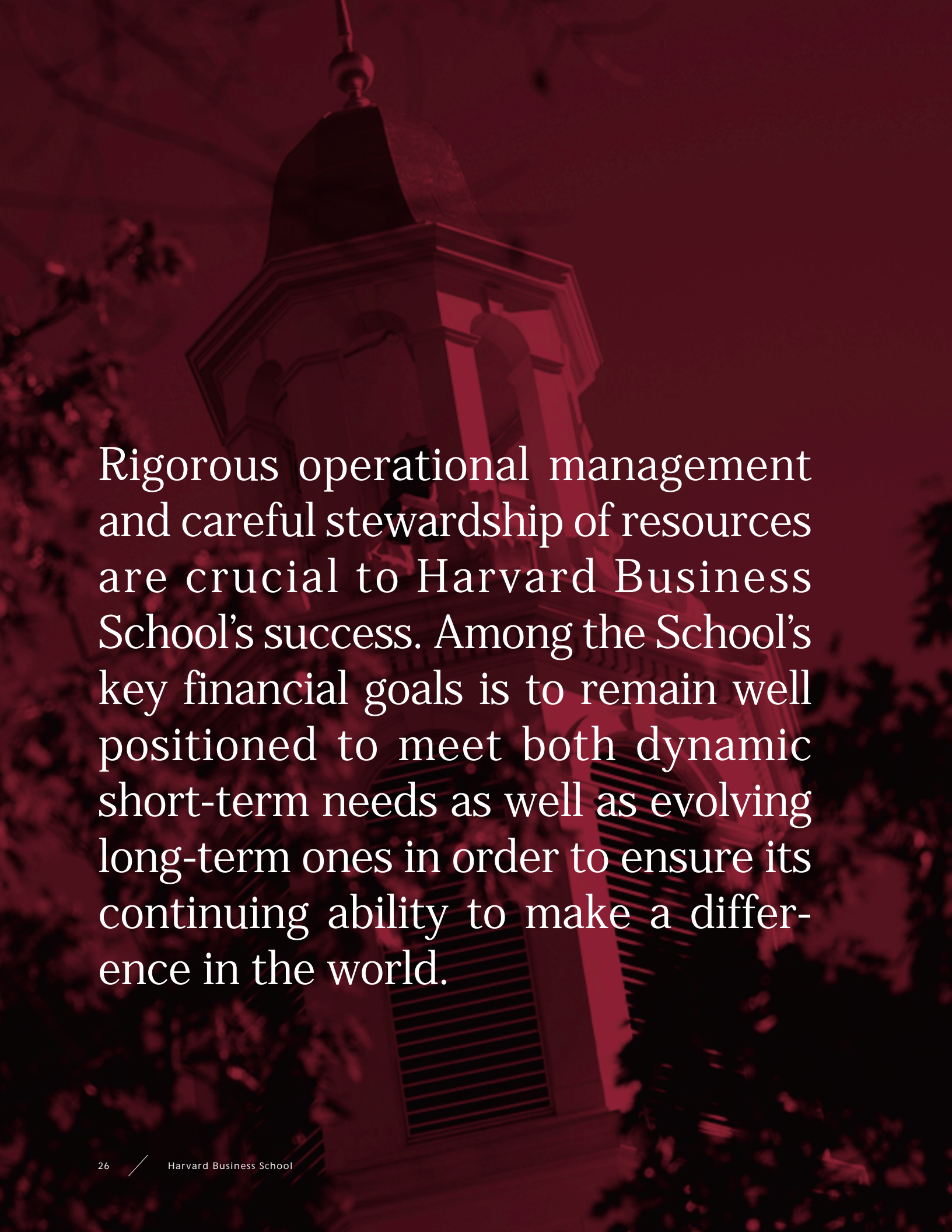
same small band of settlers who had moved to the island between 874 and 1000, was relatively homogeneous, and genealogy was a kind of national obsession.”  
*deCODE Genetics: Hunting for Genes to Develop Drugs*



“More tactical, operationally minded members of the Management Committee questioned the worth of the exercise. They found the exercise too abstract and difficult to apply. These managers, one executive observed, tended to see

the exercise as ‘pipe dreams, day-dreaming, and happy talk.’ They had a hard time suspending disbelief long enough to free up their thinking.”  
*Strategic Planning at United Parcel Service*



A photograph of a building's dome, likely a clock tower or bell tower, with a red overlay. The dome is octagonal and has a small cupola on top. The background shows some foliage.

Rigorous operational management and careful stewardship of resources are crucial to Harvard Business School's success. Among the School's key financial goals is to remain well positioned to meet both dynamic short-term needs as well as evolving long-term ones in order to ensure its continuing ability to make a difference in the world.

## Five-Year Financial Data Summary

In millions

For the fiscal year ended June 30,	2002	2003	2004	2005	2006
Revenues	\$ 286	\$ 294	\$ 309	\$ 331	\$ 368
Expenses	279	286	294	307	345
Cash from Operations	7	8	15	24	23
Capital Investments	34	39	54	79	49
Debt Outstanding	91	71	70	74	108
Unrestricted Reserves	70	56	56	52	60
Endowment	1,339	1,485	1,766	2,065	2,340
Total Assets	1,895	2,038	2,367	2,693	3,018

## Key Facts

	2002	2003	2004	2005	2006
<b>MBA Program</b>					
Applications	10,382	8,540	7,139	6,559	6,716
Percent Admitted	10%	12%	15%	16%	15%
Yield	89%	90%	87%	89%	91%
Enrollment	1,822	1,800	1,800	1,794	1,822
Tuition	\$30,050	\$31,800	\$33,650	\$35,600	\$37,500
Average Fellowship Aid Per Student	\$ 9,001	\$ 10,472	\$ 11,543	\$ 13,299	\$ 15,647
<b>Doctoral Programs</b>					
Applications	782	821	744	587	611
Percent Admitted	3%	3%	4%	4%	5%
Yield	83%	74%	70%	80%	64%
Enrollment	94	91	98	98	101
<b>Executive Education</b>					
Enrollment	6,798	6,982	7,360	8,133	8,239
<b>Faculty</b>					
Faculty Positions (full-time equivalent)	196	207	204	201	215
Teaching Materials Produced	640	653	588	561	606
Research Articles Published	133	119	127	103	130
Books Published	34	24	23	36	31
<b>Staff</b>					
Staff Positions (full-time equivalent)	1,117	1,066	1,017	1,044	1,077
<b>Publishing</b>					
Cases Sold	6,434,000	6,663,000	6,999,000	6,958,000	7,428,000
HBS Press Books Sold	1,010,000	771,000	1,180,000	1,272,000	1,409,000
<i>HBR</i> Circulation	238,000	247,000	240,000	240,000	243,000
<i>HBR</i> Reprints Sold	2,924,000	2,908,000	2,910,000	2,929,000	3,112,000
<b>Campus</b>					
Number of Buildings	33	33	33	33	33
Square Feet	1,470,241	1,476,041	1,476,041	1,512,753	1,512,753

# Financial Highlights

## Total Revenues

Total revenues increased by \$37 million, or 11.2 percent, from last year to \$368 million, and were more than 6.9 percent above the School's forecast.

## MBA Program Revenues

MBA Program revenues grew by \$5 million, or 7.4 percent, to \$73 million due to normal increases in tuition and fees and higher admissions yield.

## Executive Education and HBS Publishing Revenues

Revenues from Executive Education and HBS Publishing (HBSP) increased by a combined \$18 million, or 9.9 percent, to \$200 million.

## Endowment Income

Endowment income distributed for operations rose by \$9 million, or 14.5 percent, the result of an increase in the endowment payout and new gifts from the capital campaign. The increased distribution was used primarily to fund financial aid awards and faculty research.

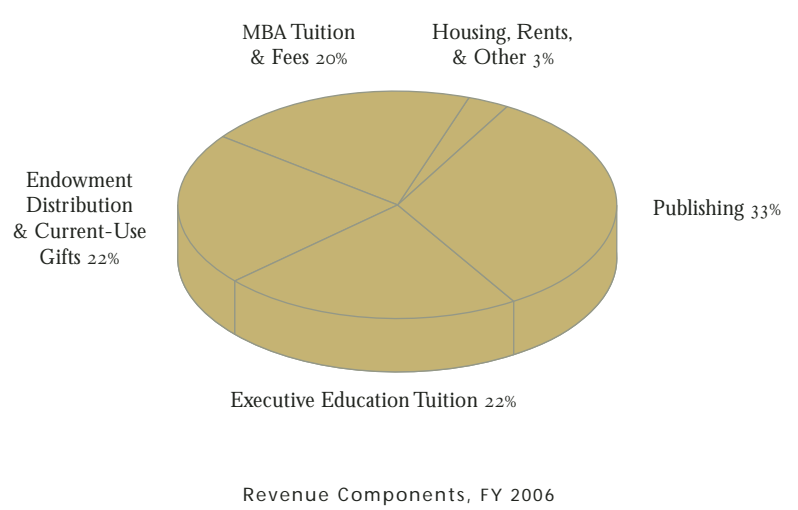
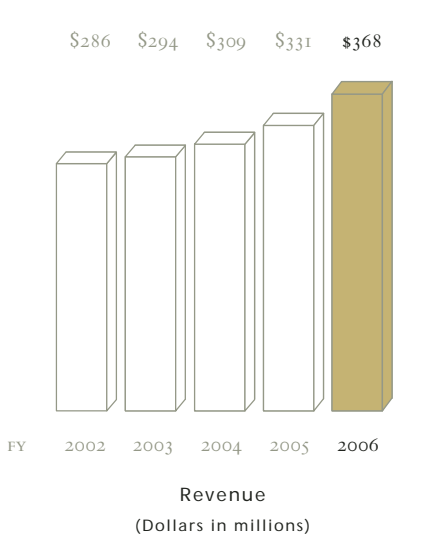
## Operating Expenses

Operating expenses increased by \$38 million, or 12.4 percent, to \$345 million, largely reflecting greater variable costs due to increased activity in Executive Education and HBSP, as well as higher costs related to a 7 percent increase in faculty full-time equivalents (FTE).

## Cash from Operations

Cash from operations decreased by \$1 million to \$23 million. In addition, gifts from prior years, available to be spent pursuant to the donors' specifications, added \$14 million to the School's cash flow, \$1 million greater than the prior year. Cash before capital activities was thus level at \$37 million.





#### Capital Expenses

Capital expenses for construction and renewal of campus facilities decreased by \$30 million to \$49 million. The primary capital costs were the conclusion of the Aldrich Hall and Baker Library projects, as well as the Hamilton Hall renovation. Additional funding came from gift accounts for specific capital projects amounting to \$12 million, as well as \$38 million in new borrowings. The new debt includes debt taken in fiscal 2006 replacing other funding from fiscal 2005 (related to the \$26 million in other activity). The comparable fiscal 2005 amounts were \$49 million and \$7 million, respectively.

#### Debt

Total building debt outstanding at June 30, 2006, increased to \$108 million, from \$74 million a year earlier.

#### Reserves

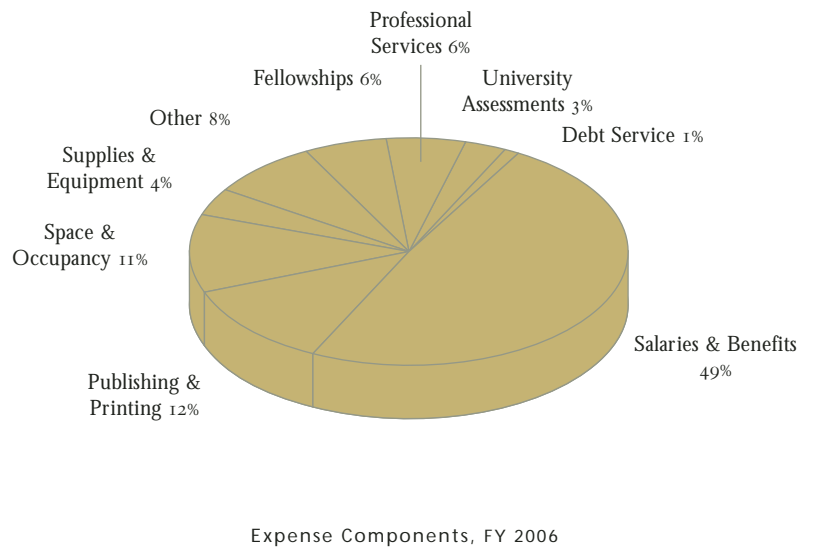
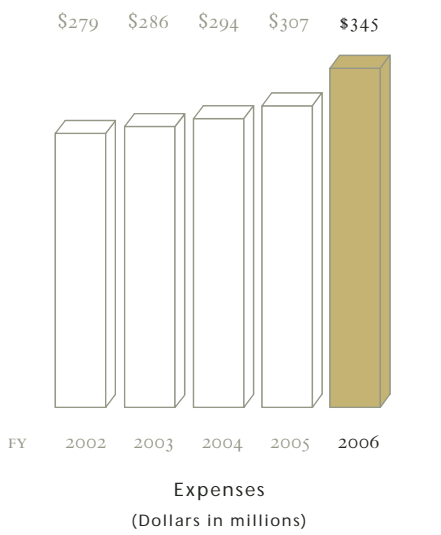
Unrestricted reserves increased by \$8 million to \$60 million at the end of fiscal 2006. In addition, HBS maintains endowment reserves, with a June 30, 2006, end-of-year value of approximately \$56 million.

#### Endowment

The market value of the HBS endowment increased by 13 percent to \$2.3 billion as of June 30, 2006, from \$2.1 billion a year earlier, reflecting both strong returns and new endowment gifts. Total return on the endowment for fiscal 2006 was +16.7 percent.

#### Gifts

Alumni and friends continued to be generous in fiscal 2006. As the School's capital campaign came to a close, cash from gifts decreased to \$55 million from the campaign's peak of \$123 million in fiscal 2005. This generosity remained vital in fiscal 2006, as current-use gifts and endowment distribution together generated 22 percent of the School's revenues, up from 21 percent last year. Approximately 30 percent of MBA alumni made a gift to the School in fiscal 2006.





## From the Chief Financial Officer

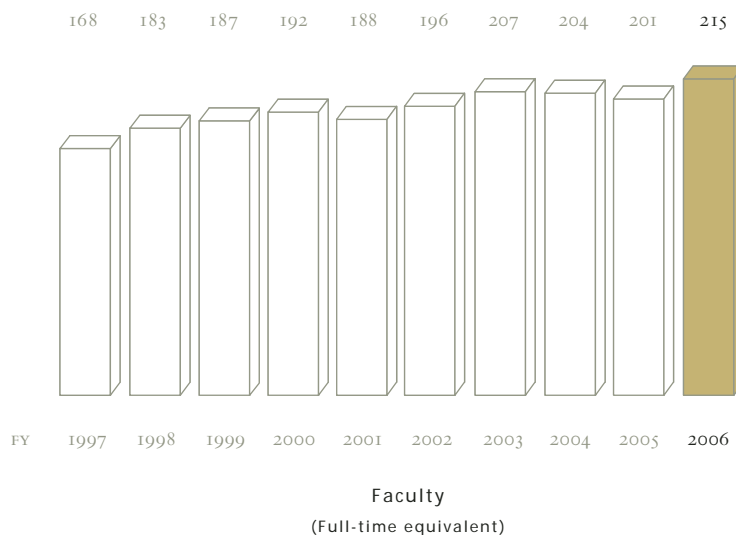
Fiscal 2006 marked the conclusion of both the Campaign for Harvard Business School and five years of significant investment in campus expansion and renewal. It was a good year for the global economy, and a period of increasing worldwide demand for management education and knowledge. The School's fiscal 2006 financial results mirrored these dynamics.

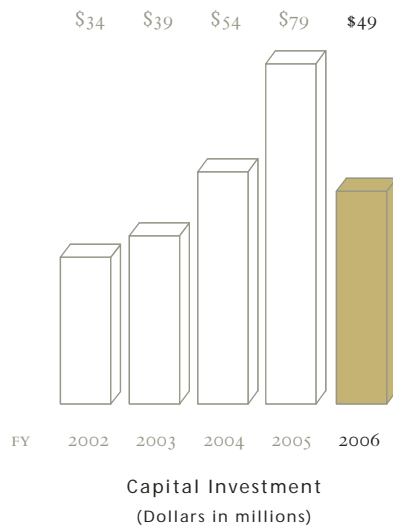
Consolidated revenue grew by \$37 million, or 11.2 percent, from fiscal 2005 to \$368 million. This was roughly double the average top-line growth experienced by the School over the past five years. More than \$18 million of this year's revenue growth came from the School's Executive Education and Harvard Business School Publishing (HBSP) units. About \$13 million was attributable to growth in unrestricted gifts and larger distributions of income from the HBS endowment. The planned increase in MBA tuition and fees, coupled with modestly larger MBA class sizes resulting from a higher admissions yield, accounted for \$5 million of the remaining \$6 million in revenue growth.

Total operating expenses rose by \$38 million in fiscal 2006, or 12.4 percent — more than twice the five-year compounded rate — to a total of \$345 million. The growth in expenses primarily reflected increased investment in our Executive Education and HBSP businesses and inflationary pressure on some of our fixed costs — employee compensation chief among them.

Operating expenses in Executive Education and HBSP, excluding employee compensation, accounted for about \$14 million of this year's increase. Both units experienced higher direct costs as their operations expanded and revenues grew. The expense increase also reflected strategic investments in marketing, corporate relations, and product development aimed at driving future business growth.

About \$14 million of the expense increase for fiscal 2006 was related to employee salaries and benefits — the School's largest cost and nearly 50 percent of our budget. The higher amount this year was due mainly to growth in the size of the faculty and salary rate increases for faculty and staff. Benefits expense was up 10 percent in fiscal 2006, compared with a 29.5 percent increase in the prior year, primarily a result of additional FTEs (full-time equivalents). MBA financial aid spending, which the School reports as an expense, accounted for another \$2 million of our fiscal 2006 expense growth, with the remaining \$8 million attributable to increased faculty research investment, higher utility and energy costs, and other costs associated with the School's larger scope of activity.





After a half decade of large construction projects on the HBS campus, capital expenses declined from a peak of \$79 million last year to \$49 million in fiscal 2006. The School's capital activity centered on completing the renewal of classroom space in Aldrich Hall and the renovation of residential facilities for MBA students at Hamilton Hall. In addition, we made the fourth payment of a multiyear commitment to support the School's role in the University's development in Allston. The School also invested in several smaller projects, including the renovation of Sherman Hall (renamed Wyss House), which houses our doctoral programs.

HBS finances capital projects with cash from unrestricted current-use gifts, by accessing reserves, and through borrowings. For major campus construction and renewal projects, the School's long-standing policy is to use leverage, rather than using gifts or accessing reserves, when market conditions make it preferable to accept the incremental debt service obligation.

Comparing current interest rates with potential future investment returns on the HBS endowment, in fiscal 2006 we decided to increase the School's borrowings over the next few years. This new debt was used to finance scheduled residence hall and classroom renovations (including Hamilton Hall and Aldrich Hall) as well as other capital projects. New borrowings for fiscal 2006 increased to \$38 million from \$7 million last year, and building debt rose to \$108 million from \$74 million in fiscal 2005. As a result, the School's debt service obligation for fiscal 2007 is expected to rise to \$8 million from \$4 million in fiscal 2006. The University functions as a banker for HBS, as it does for each of the other Harvard schools.

The School's reserves balance at year-end 2006 increased by \$8 million to \$60 million. This is comfortably within our long-term target range and at a level that should enable HBS to continue investing in new strategic opportunities.

**A Look Ahead**

Executive Education and HBSP begin the new fiscal year with solid operational and market momentum. Alumni interest in unrestricted giving has been strong, and we hope to see this continue. In addition, reflecting continued strength in investment returns, the University has announced a further modest increase in the endowment distribution rate for fiscal 2007. Applying this rate to the \$2.3 billion fiscal 2006 year-end value of the HBS endowment, we are likely to see the fiscal 2007 endowment distribution exceed the MBA Program as a revenue source for the first time in the School's history.

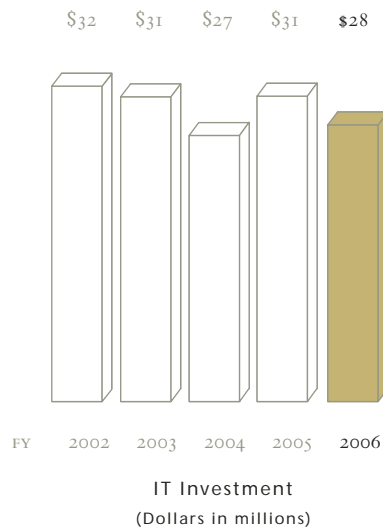
As a result, we are looking forward to another year of revenue growth for HBS — growth that will be deployed to enhance teaching and learning across the School. The MBA curriculum will provide more opportunities for student-faculty interaction, with Immersion Programs in China, New Orleans, and Boston (in healthcare) during the January break. Starting with student orientation the first day on campus, and including refinements in the Learning Team concept introduced last year, team-based activities will be strengthened throughout the MBA Program. With the increased endowment distribution, the School is planning a 15 percent increase in MBA fellowship awards to further the student diversity that enhances the richness of classroom discussions and residential life at HBS.

Supporting the faculty’s research and course development will continue to be one of the School’s highest strategic priorities in fiscal 2007. HBS invested nearly \$84 million in faculty research in fiscal 2006, enabling the faculty to remain close to practice globally and providing a range of services designed to enhance research productivity across the School.

In addition to the global network of HBS regional research centers, the School provides faculty with an extensive on-campus research infrastructure and a wide range of outstanding support staff services. The Computer Lab for Experimental Research and the Faculty Research Computing Center, for example, provide faculty with the resources they need to pursue ambitious, multiyear, and often cross-disciplinary research projects. The School’s investment in faculty research is budgeted to grow more than 9 percent in fiscal 2007 to nearly \$92 million.

In fall 2006, Executive Education launched its new portfolio of Comprehensive Leadership Programs, targeted at specific career stages. Our objective for the year ahead is to leverage this momentum to attract high-quality participants to all of the School’s executive programs. At the same time, our executive education footprint will continue to expand globally. Following the introduction of the Global CEO and Senior Executive Programs for China this past year, the School’s future executive program pipeline includes potential new offerings for business managers in India, Latin America, and Europe, in addition to China.

Recent strong results in our executive programs for the corporate market have enabled the faculty to strengthen their commitment to programs for underserved markets overseas, as well as for not-for-profit organizations in the United States. For example, as part of the School’s Healthcare Initiative, a program





for senior executives from major teaching hospitals was held for the first time this past year. Looking ahead, the faculty has identified interesting intellectual challenges in other markets and sectors that traditionally have not been able to afford premium executive education for their future leaders.

In fiscal 2006, HBSP completed an internal realignment, replacing its long-standing, product-focused structure with a more flexible, customer-focused approach to organizing its operations. As a result, HBSP begins fiscal 2007 with a comprehensive, multiyear strategy for investing in the growth of its existing portfolio, including the *Harvard Business Review* and HBS cases. HBSP also is pursuing new geographic and product platform opportunities, as well as enhanced integration with Executive Education. Executing this strategy are cross-functional groups newly formed to address the needs of the higher education, corporate learning, and individual manager markets.

Expanding HBSP's presence in the Greater China and India/South Asia markets will continue to be a strategic focus for growth in fiscal 2007. Under licensing agreements signed this past year, HBSP plans to launch *Harvard Business Review South Asia* and to relaunch *HBR — Complex Characters* for the Taiwan market. HBSP also is developing a new strategy for Western Europe. In addition, plans are under way to enhance HBSP's online customer experience and enable customer-driven packaging of HBSP's content in multiple languages. HBSP remains strongly positioned in multimedia. As we begin fiscal 2007, its most successful product in this category is *Harvard ManageMentor*, which is available in an expanded array of 43 modules.

Our fiscal 2007 operating budget projects an increase in total expenses of 7.5 percent to \$371 million, from actual fiscal 2006 spending of \$345 million. The additional expenses for fiscal 2007 primarily reflect costs associated with the expanded scope of the School's operations. Our capital budget for fiscal 2007 is \$25 million — about half the amount invested in fiscal 2006.

The restoration and expansion of Baker Library, completed this past year, was the last in a series of large capital projects initiated with construction of Spangler Center, which opened in fiscal 2001. Included in the School's capital plan for fiscal 2007 are the last phases of the Hamilton and Aldrich renewal projects, numerous building maintenance and campus infrastructure priorities, as well as the final payment to the University associated with development in Allston.

Looking forward, faculty and staff are preparing a campus master plan that will serve as the framework for the School's capital investments over the next 10 years. Although the University's Allston development strategy provides the long-term context for this planning — and an unprecedented opportunity to advance the mission of the School — the campus plan will reflect the long-term aspirations of HBS and our community's desire to maintain the integrity and residential character of the School's unique campus. Over the next few years, we anticipate a significant increase in campus construction and renewal activity with commensurate growth in capital investment.

Thanks to generations of support from our generous alumni and friends, Harvard Business School continues to have the financial capacity to accomplish its educational mission. We are committed to sustaining the School's legacy of innovative and thoughtful resource stewardship in the year ahead.



Richard P. Melnick, MBA '92  
Chief Financial Officer  
October 31, 2006

LOEB

# Financial Review

# Financial Review

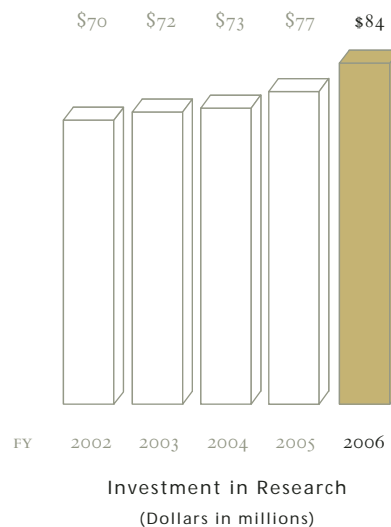
## Business Model

In its mix of income sources, Harvard Business School is unlike other parts of Harvard University and unique in American higher education. More than 50 percent of the School's revenue is generated by Harvard Business School Publishing (HBSP) and Executive Education. Because these businesses operate in competitive, customer-driven markets, the School's income stream is unusually subject to the influence of near-term economic conditions.

The HBS business model is further differentiated by the School's policy of supporting faculty research with internally generated funds, rather than grants from government agencies or other third parties. This policy creates an academic environment in which faculty are free to pursue the research opportunities that they believe have the greatest potential to create knowledge and advance the practice of management, and liberates them from the administrative duties associated with sponsored research grants.

Over the past five years, faculty research investment has consumed an average of 25 percent of the School's total operating budget. Research spending includes a significant portion of faculty compensation, as well as direct costs for research support staff, fieldwork, and IT services. Also included in faculty research expenses are allocated costs for Baker Library resources, campus facilities, technology, and administration.

HBSP and Executive Education disseminate the knowledge that results from the faculty's research in corporate and academic markets around the world. In a self-sustaining cycle, HBS reinvests the internally generated revenue from its executive programs, periodicals, books, cases, and eLearning materials to support the faculty's work in creating intellectual capital. Surpluses generated by these businesses also support the School's MBA and Doctoral programs.





## Revenues

Funding for the School's operations is derived from four primary sources:

- MBA Program tuition and fees. Revenue from the School's core academic program increased to \$73 million in fiscal 2006, from \$68 million in fiscal 2005.
- Executive Education tuition and fees. Total revenue, comprising tuition and fees from open-enrollment and custom executive programs, grew to \$81 million in fiscal 2006, from \$76 million in fiscal 2005.
- Publishing revenue. In fiscal 2006, revenue from sales of periodicals, books, cases, and eLearning products by HBSP increased to \$119 million, from \$106 million the previous year.
- Endowment distribution and unrestricted current-use gifts. The annual distribution from the School's endowment and revenue from current-use giving accounted for \$83 million in funding in fiscal 2006, compared with \$70 million last year. Driven by strong investment returns, the HBS endowment has become an increasingly important source of funding for the School's operations. Over the past five years, the annual distribution from the endowment has grown from 17 percent to 19 percent of the School's total revenues.

The School's total revenues have increased at a compound average rate of 5.6 percent annually for the past five fiscal years. In fiscal 2006, total revenues increased \$37 million, or 11.2 percent, to \$368 million, from \$331 million last year. Continuing the recent trend, market-driven growth in HBSP sales and Executive Education tuition generated over half of this year's revenue increase. A strong flow of unrestricted gifts and larger distributions of income from the School's endowment also contributed to the year-over-year revenue growth. In addition, growth in MBA tuition and fee income was slightly in excess of the underlying rate of inflation for the higher education sector.

### MBA Tuition and Fees

MBA Program tuition and fees increased to \$73 million in fiscal 2006, from \$68 million last year.

MBA tuition and fees amounted to 19.8 percent of the School's total revenues in fiscal 2006, compared with 20.5 percent a year earlier. After remaining level for the past three years at approximately 900 students per class, total MBA enrollment for fiscal 2006 increased to 1,822 students. This increase was due to a higher admissions yield for the Class of 2007 and a lower attrition rate for the Class of 2006. The fiscal 2006 growth in MBA revenue also resulted from a 5.3 percent tuition increase. This reflected inflation in program delivery costs, as well as incremental costs for the innovation necessary to continue enriching the HBS educational experience. First-year MBA tuition in fiscal 2006 was \$37,500 — near the midpoint among the 10 comparable schools tracked by the School — compared with \$35,600 last year.

### Executive Education

Executive Education programs generated \$81 million in tuition revenue in fiscal 2006, up 6.6 percent from \$76 million last year. Executive Education income represented 22 percent of the School's total revenues in fiscal 2006, compared with 23 percent in fiscal 2005.

Executive Education fulfills two objectives at HBS. The first is to strengthen the leadership capacity of individuals who can make a difference in their organizations and in their communities. The second is to provide the School's faculty with opportunities to explore the key business challenges faced by practicing managers today. The knowledge thus gained by the faculty enhances the quality of MBA education and improves business practice on a global scale. Executive Education is working to accomplish these objectives across an increasingly diverse range of geographies and industries.

Fiscal 2006 was a transitional year for Executive Education, as significant staff and funding resources were focused on driving future business growth. The School made a large investment in marketing to support an aggressive launch of the new portfolio of Comprehensive Leadership Programs for fiscal 2007. At the same time, the unit continued its global expansion, enrolling a larger number of international participants and increasing the number of offshore programs in its emerging markets portfolio.

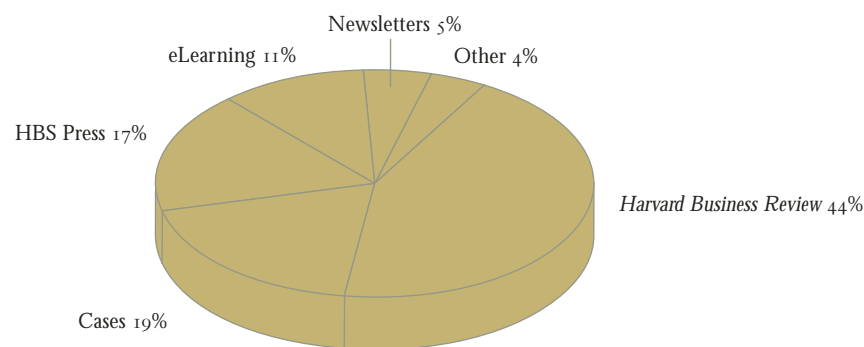
Executive Education continued to see growth in applications and enrollment in fiscal 2006. Applications rose to nearly 10,750 — up approximately 1 percent from fiscal 2005. Total enrollment increased by approximately 100 to nearly 8,240. As in the prior year, growth in fiscal 2006 occurred primarily in the School's core open-enrollment programs. Open-enrollment revenue grew to \$61 million, from \$56 million in fiscal 2005. Revenue from custom programs was \$20 million — level with the previous peak reached in fiscal 2005.

#### Publishing

Revenue from the School's publishing operation increased 12.3 percent in fiscal 2006 to \$119 million, from \$106 million last year. HBSP generated nearly 33 percent of the School's total revenues in fiscal 2006, approximately the same proportion as in fiscal 2005.

HBSP leverages the knowledge created by the School's faculty and other thought leaders to improve the practice of management worldwide. To increase the School's presence and penetration in the global business and higher education markets, HBSP continually enhances its relevance with new offerings — not only traditional products such as the *Harvard Business Review*, books, cases, and reprints, but also an expanding catalog of eLearning materials. The School's publishing operation also works to build affiliations and relationships with strong international partners, marketing HBS Press-branded publications, books, and multimedia products around the world.

Fiscal 2006 was another outstanding year for HBS Press book sales, as revenue grew 27 percent, including 36 percent growth in sales of backlist titles. It was another strong year for the School's flagship publication, the *Harvard Business Review*, where growth in advertising revenue again outpaced the industry. In the corporate learning sector, an expanded and reconfigured corporate sales force; the introduction of an eLearning product for new managers, *Stepping Up to Management*; and the creation of integrated programs of HBSP content drawn from across the various publishing platforms contributed to revenue growth in excess of 25 percent. In addition, HBS case revenue grew for the fifth consecutive year.



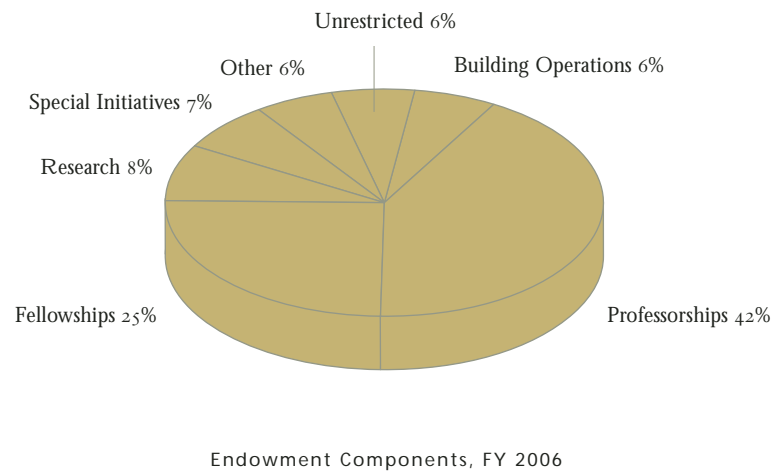
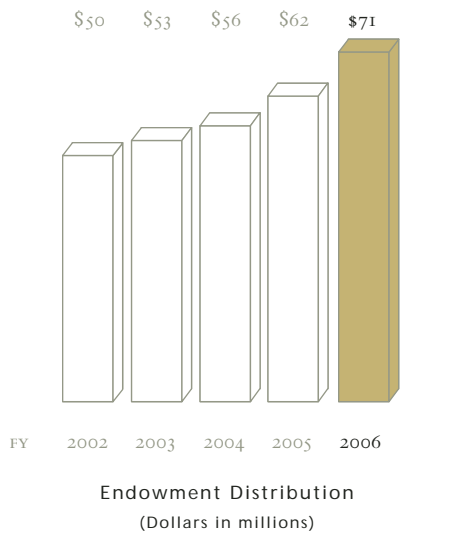
Publishing Revenues, FY 2006

#### Gifts and Endowment

The annual distribution of income from the School's endowment, together with revenue from unrestricted current-use gifts, accounted for \$83 million in funding in fiscal 2006, or 22.6 percent of the School's total revenues. This compares with \$70 million in fiscal 2005, or 21.1 percent of total revenues. The proceeds from the endowment increased by 14.5 percent to \$71 million in fiscal 2006, from \$62 million last year. Unrestricted current-use gifts, which provide crucial support for the School's operations, grew to \$11.7 million in fiscal 2006, from \$8.3 million in fiscal 2005.

The growth in endowment distributions was made possible by the University's extraordinary investment returns and an increase in the annual endowment distribution rate, as well as growth in the size of the endowment resulting from alumni giving to the Campaign for Harvard Business School, which concluded in fiscal 2006. In fiscal 2006, fundraising at the School focused on encouraging unrestricted giving as a means of supporting innovation. The HBS community responded generously. A significant portion of the increase in unrestricted giving in fiscal 2006 was due to several MBA classes making gifts of this type, rather than the restricted funds traditionally given as class gifts.

Endowment distributions have represented between 17 and 19 percent of the School's total revenues in each of the past five fiscal years. After the fiscal 2006 distribution, the School's endowment totaled \$2.3 billion at year-end, up \$275 million, or 13 percent, from June 30, 2005. The increase in the market value of the endowment for fiscal 2006 reflects \$31 million in endowment gifts received by HBS during the year, as well as endowment principal appreciation of \$244 million. Total investment return was +16.7 percent in fiscal 2006, net of all expenses and fees, compared with +19.2 percent for the prior fiscal year. The School's strategy for managing its gifts and endowment is discussed on pages 47 through 49 of this report.





## Expenses

HBS spends and invests strategically in order to achieve its organizational mission. The School's recent incremental spending has primarily occurred in five areas where HBS has significantly expanded the scale and scope of its operations.

During the past five fiscal years:

- MBA fellowship spending has increased dramatically. The generosity of the School's alumni and friends has resulted in strong growth in endowed financial aid funds. As a result, spending for MBA financial aid has risen at a compound annual rate of 14.4 percent.
- The number of faculty has grown at a compound annual rate of 2.7 percent. To offset a period of generational turnover in the School's faculty and intense competition for outstanding candidates, HBS has recruited aggressively and sought creative ways to modestly expand the size of the faculty, as measured in full-time equivalents (FTEs). In order to further strengthen its position in the market for academic talent, the School has enhanced faculty compensation at the same time.
- Annual investment in faculty research has increased at a compound annual rate of 5.3 percent. Due to the School's Global Initiative and new research and educational initiatives on campus, the faculty has dramatically increased the scope of their fieldwork around the world. HBS has added locations in Japan, Europe, and India to its network of regional research centers. At Soldiers Field, the School has established the Arthur Rock Center for Entrepreneurship, enhanced its Doctoral Programs, and expanded activity within Baker Library and in the fields of social enterprise, leadership, corporate governance, and healthcare. The School has assisted the faculty's work in these areas with increased administrative staff and support services.
- HBSP and Executive Education have expanded their product offerings and entered new markets, delivering substantially larger annual revenue contributions to the School. Although combined expenses for the two units have risen at a compound annual rate of 2.6 percent, their compound annual growth in revenue contribution was 4.1 percent. By successfully controlling their fixed costs, both businesses have delivered solid margins on incremental revenue. These margins have been reinvested to fund the School's teaching and research activities.
- HBS has constructed more than 91,000 square feet of occupied space, enlarging the size of the campus by 6.4 percent, while renovating about 373,000 square feet of space. Reflecting this facilities expansion and increased utility and energy costs, space and occupancy expenses have risen at a compound annual rate of 5.6 percent.

In committing to a long-term strategy of educating leaders and creating knowledge for an entrepreneurial, technology-driven, global economy, HBS accepted the challenge of managing a larger enterprise while generating modest annual operating surpluses. The relatively high underlying rate of inflation in the higher education sector has made this task a challenging one. Nonetheless, the School's efforts to enhance operational efficiency, closely manage administrative staff levels, and tightly control campus facilities expenses have been successful.

Although the operational scope of the School has grown significantly since fiscal 2001, total expenses have increased at a rate of only 5 percent, compounded annually. Fiscal 2006 was a year of unusually aggressive strategic expansion in the School's market-sensitive businesses. Total operating expenses increased at more than twice the five-year compounded rate, rising by \$38 million, or 12.4 percent, from fiscal 2005 to a total of \$345 million.

HBSP and Executive Education accounted for \$16.7 million of the increase, while together generating more than \$18 million in year-over-year revenue growth. Reflecting a larger number of faculty FTEs and higher benefits rates, faculty compensation increased by \$6.1 million from fiscal 2005. Utilities and facility expense increased by \$4 million, primarily as a result of higher energy costs. The increase in total expenses for fiscal 2006 also reflected \$2 million in additional MBA financial aid.

Compensation for faculty and staff is the largest area of expense for HBS. In line with the expanding scope of the School's teaching and research, the size of the faculty has grown by more than 14 percent since fiscal 2001. In any given year, however, the total number of faculty FTEs can increase or decrease due to retirements, departures, and normal fluctuations in recruiting activity. After declining slightly in fiscal 2004 and 2005, faculty FTEs increased from 201 in fiscal 2005 to 215 in fiscal 2006. This reflected a year of successful tenure track faculty recruiting, as well as short-term appointments. Anticipated faculty retirements and departures should result in a modest decline in faculty FTEs for fiscal 2007.

Because so much of the School's revenue stream is sensitive to economic conditions, HBS exercises a great deal of caution in determining administrative staff levels. Despite the ongoing growth in the scale of its operations, the School has maintained a tight rein on administrative hiring. Staff hiring has largely been focused on the School's revenue-generating HBSP and Executive Education operations, aligned with the market-driven requirements of these business units.

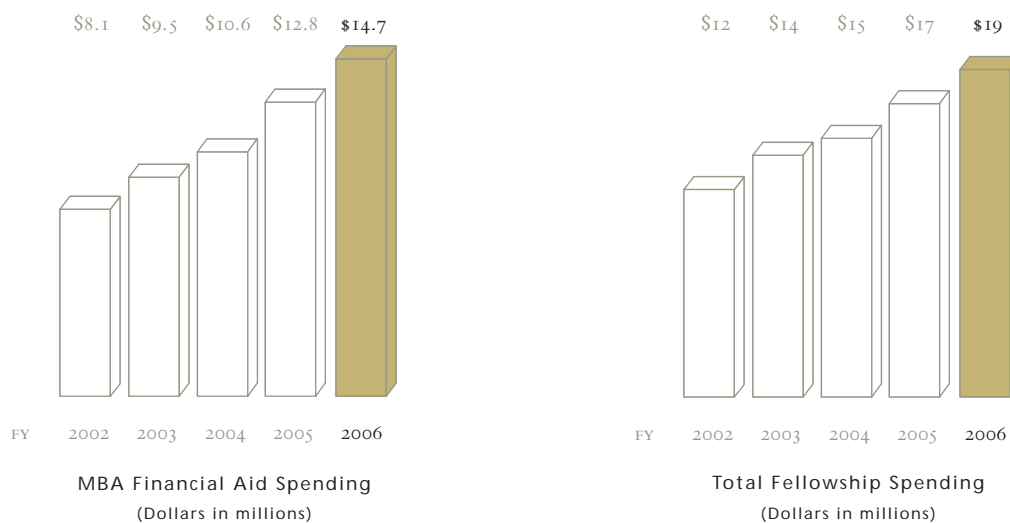
After decreasing slightly from fiscal 2002 through fiscal 2004, administrative staff FTEs have increased for the past two years, with the majority of new hiring centered in HBSP and Executive Education. In fiscal 2006, the School's administrative staff grew by 33 FTEs (including 22 at HBSP and 11 at Executive Education), who were primarily added to support sales and corporate relations initiatives. The School concluded fiscal 2006 with a total of 1,077 administrative FTEs, compared with 1,044 at the end of last year.

Employee salaries and benefits expenses have grown at a compound annual rate of 7.4 percent for the past five years. In fiscal 2006, these costs grew by \$14 million, or 9 percent, from the prior year, to \$167 million, and represented nearly 50 percent of total operating expenses. Unlike the four prior years, during which rising healthcare and pension benefits were the major cost drivers, growth in faculty FTEs and salaries, as well as additional administrative staff FTEs and cost-of-living increases, were the primary reasons for the fiscal 2006 increase in employee compensation expense. Salaries and benefits for faculty and their research associates represent nearly 40 percent of the School's employee compensation costs in fiscal 2006, or approximately 20 percent of total expenses.

Excluding salaries and benefits, the School's operating costs for the past five years have grown at a compound annual rate of 3.1 percent. This includes the strategic increase in fellowships, or financial aid, which HBS categorizes as an expense. The School's objective is to increase financial aid support for MBA and doctoral students at a rate that exceeds the rise in tuition and fees. The prospect of entering the workforce with high levels of debt can deter strong candidates from applying to HBS and restrict their career choices upon graduation. This is particularly true for students with fewer years in the workplace, those from outside the United States, and students whose early career paths have not enabled them to reduce their undergraduate loans.

Generous giving by HBS alumni and friends has enabled the School to significantly increase MBA fellowship spending. Financial aid awards for the incoming MBA class have risen at a compound annual rate of 14.4 percent during the past five years. Total financial aid expense, including fellowships for doctoral candidates as well as MBA students, compounded annually, has grown 11.6 percent.

The average MBA fellowship award grew from \$9,001 in fiscal 2002 to \$15,647 in fiscal 2006. Total fellowship spending for fiscal 2006 increased by \$2 million, or 11.8 percent, from last year to a record \$19 million. Despite this growth, the average MBA loan balance at graduation in fiscal 2006 was \$83,310, compared with \$81,100 in fiscal 2005. HBS continues to seek ways to assist MBA students in alleviating this burden, and thus broaden their career opportunities in the private and public sectors.



Excluding employee compensation and fellowships, the School's operating expenses for the past five years have increased at a compound annual rate of 2.3 percent. This includes costs incurred by HBSP in disseminating the knowledge created by the faculty to the marketplace. The margins HBSP generates through this activity provide incremental funding for the School's teaching and research. The School's printing and publishing expenses include HBSP's cost of goods sold and operations and marketing expenses, along with all costs for the School's other publications.

Publishing and printing expenses include HBSP's production costs as well as a small amount of spending to produce printed materials across the rest of the School. These expenses remained essentially flat from fiscal 2002 through fiscal 2005, mainly due to lower costs for printing and paper, marketing, and author royalties at HBSP. Expenses for publishing and printing increased to \$42 million this year, from \$35 million in fiscal 2005. Fiscal 2006 was a year of higher operating costs for HBSP, primarily reflecting increases in FTEs and marketing expenses during a year of strong top-line growth, as well as inflation in printing and paper costs.

HBS is responsible for managing its own campus; facilities maintenance and construction are not centralized University responsibilities as they are at many other schools. The School's campus currently includes 33 buildings encompassing more than 1.5 million square feet. Space and occupancy costs include expenses related to maintaining and operating these buildings and associated campus infrastructure. In addition, facilities improvement and renovation costs that do not qualify as capital expenses are categorized as space and occupancy costs. Also included are expenses related to dining facilities and other campus services, as well as costs associated with leased space that houses HBSP's operations.

The School's space and occupancy expenses have increased faster than the general rate of inflation during the past five years. This has largely resulted from higher energy, utility, and security costs, as well as new construction that added nearly 100,000 square feet to the occupied space on campus.

After rising significantly in fiscal 2001 to \$29 million, largely reflecting new operating costs for Spangler Center, which opened that year, space and occupancy expenses remained essentially level for the next three years at \$30 million to \$31 million. The restoration and expansion of Baker Library removed much of that major facility from service during that time, which moderated growth in operating expenses. Space and occupancy expense increased to \$35 million



in fiscal 2005, largely due to an accounting reclassification. In fiscal 2006, space and occupancy expense rose to \$38 million, primarily reflecting an unexpectedly large increase in utility rates and energy prices, as well as operating costs for the expanded Baker Library, which opened during the year.

Expenses for supplies and equipment remained level at \$15 million for fiscal 2006, reflecting the School's ongoing cost control programs in this area.

Other expenses grew to \$28 million in fiscal 2006, from \$22 million last year. The increase was primarily related to Executive Education marketing, outreach activities across the School, and higher travel and IT operations costs.

Professional services expenses increased to \$22 million in fiscal 2006, from \$16 million in fiscal 2005. The increase mainly reflected the larger number of faculty appointed on a short-term basis, whose compensation expenses are paid to their home institutions. Greater use of outside technology and marketing support services also contributed to the increase.

Expenses for University assessments are calculated as a percent of the School's total expenses on a two-year lagged basis. These assessments cover essential services provided to HBS by the University, including payroll and benefits administration, processing of accounts receivable and payable, and legal services. For fiscal 2006, University assessments expense remained level with the prior year at \$10 million.

Debt service, which consists of interest payments to the University on building and other University debt, has remained essentially level for the past five years. New borrowings for campus renewal and construction have been offset by debt principal repayments made possible by alumni gifts, as well as a general decline in the interest rate paid by the School to the University. This rate is determined annually by the University, and is based on the University's weighted average debt rate.

#### **Cash from Operations**

The School's ability to generate operating revenue is largely a function of activity in HBSP and Executive Education, and investment returns on the endowment. Each of these sources of income is deeply influenced by cyclical economic trends. Unrestricted current-use gifts also contribute significantly to operating revenue, and giving of this nature can vary from year to year. Nonetheless, HBS plans its operations on a long-term, strategic basis.

As a result, cash from operations tends to be one of the School's more variable financial metrics. Cash from operations remained stable during the three years following the economic slowdown in 2001. Reflecting the economic recovery that gained strength in 2003 and the Campaign for Harvard Business School, operating cash flow nearly doubled in fiscal 2004 to \$15 million, increased 60 percent to \$24 million in fiscal 2005, and remained nearly level at \$23 million in fiscal 2006.

#### **Use of Endowment Principal and Appreciation**

HBS regularly funds key initiatives with principal and related capital appreciation of gifts made in prior years intended for these purposes. These funds vary from year to year depending on the type of gifts available, the purposes for which these gifts were given, the status of the School's initiatives related to these purposes, and the available appreciation. Use of endowment principal and appreciation remained essentially level in fiscal 2006, at \$14 million, compared with \$13 million last year.

#### Cash Available for Capital Activities

HBS must generate sufficient cash flow to cover capital expenses and any related debt service over the long term. Cash generated before capital activities closely tracks operating cash flow. After remaining stable from fiscal 2001 through fiscal 2003, cash before capital activities grew to \$37 million in fiscal 2005 and remained level at \$37 million in fiscal 2006. Although cash flow has fallen short of net capital expenses in recent years, and we expect this to continue for the foreseeable future, HBS will ensure through its financial planning that the School has sufficient resources to service its debt and execute on its long-term capital plan.

#### Capital Expenses

A five-year period of unprecedented capital investment in the HBS campus wound down in fiscal 2006, and capital expenses declined to \$49 million, from a record \$79 million at the peak in fiscal 2005. The restoration and expansion of Baker Library was substantially completed by the end of fiscal 2005, and in fiscal 2006 the School neared the completion of its long-term projects to renew classroom space in Aldrich Hall and residential facilities at Hamilton Hall.

Capital spending for fiscal 2006 also included investments in a number of smaller projects, including the renovation of Sherman Hall — renamed Wyss House — which houses the School's Doctoral Programs. In addition, HBS made the fourth payment of a multiyear commitment to support the School's role in the University's development in Allston.

The \$49 million in fiscal 2006 capital expenses was funded with \$12 million in gifts for capital projects and substantially all of the School's \$38 million in new borrowings. The new debt includes debt taken in fiscal 2006 replacing other funding from fiscal 2005 (related to the \$26 million in other activity). The new borrowings were used for renovations of Aldrich Hall and Hamilton Hall. In fiscal 2005, sources of funding for capital expenditures included gift payments for specific capital projects totaling \$49 million, new borrowings of \$7 million, internally generated cash, and reserves.

#### Debt

HBS uses debt strategically as a means of optimizing its capital structure. The School borrows only on qualified capital projects, carefully considering the interest rate environment and expectations for the performance of the Harvard endowment. The School's policy is to borrow when market conditions make accepting the incremental debt service obligation preferable to using endowment principal and appreciation.

The School's debt level rose from \$83 million in fiscal 2001 to a record \$91 million at the end of fiscal 2002, reflecting financing requirements for the newly launched campus construction and renewal program. For the next three years, continued strength in cash from operations, coupled with gifts to the Campaign, enabled HBS to reduce its reliance on debt for funding campus renovations. New borrowings declined from \$15 million in fiscal 2002 to \$7 million in fiscal 2003 and remained at essentially this level through fiscal 2005.

Given the current interest rate environment and anticipated returns from the School's endowment, in fiscal 2006 HBS decided to increase borrowings over the next few years to finance scheduled residence hall renovations and other major capital projects. Consequently, new borrowings for fiscal 2006 increased to \$38 million, from \$7 million in fiscal 2005, and building debt rose to \$108 million, from \$74 million in fiscal 2005. Reflecting the modest level of capital investment planned for the near term, new borrowings are expected to decline in fiscal 2007.

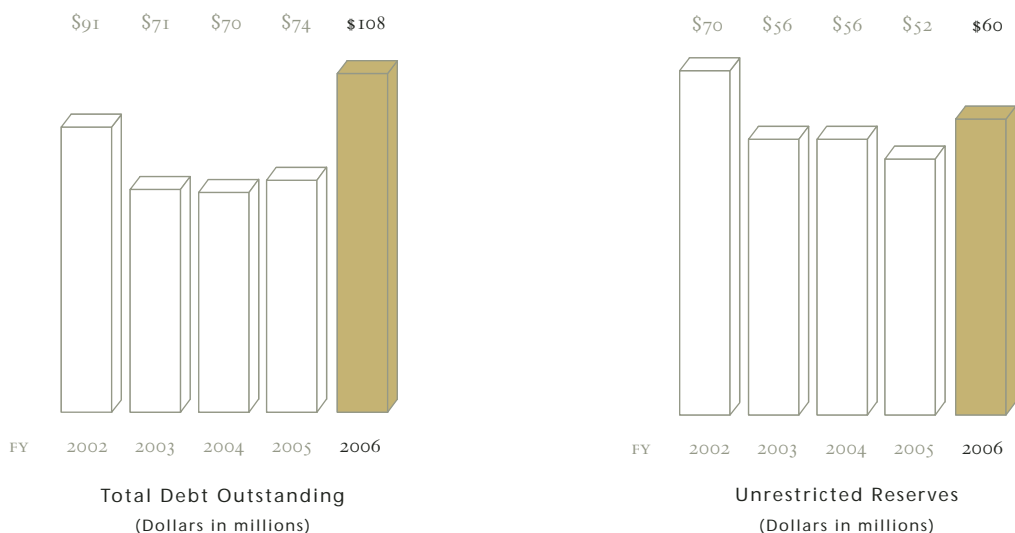
The School's fiscal 2006 balance sheet includes "Other Debt Owed to University" for the first time. The \$25 million year-end balance for this item primarily reflects repayment obligations to the University for mortgage loans made by the School as a faculty recruiting incentive. In prior years, these obligations were netted against "Receivables, Loans, and Other Assets."

The University functions as a banker for HBS, as well as for each of the other Harvard schools, allowing HBS to borrow on a triple-A-rated tax-exempt basis. The School's balance sheet remains modestly leveraged. Total debt has averaged only 3.4 percent of total assets for the past five years. The interest portion of the School's debt service amounted to 1.2 percent of total operating expenses in fiscal 2006, compared with 1.3 percent in fiscal 2005. At June 30, 2006, the School's building debt-to-asset ratio was 3.6 percent.

Liquid assets, consisting of cash and reserves, increased to \$85 million at June 30, 2006, from \$73 million a year earlier. For the five-year period ending in fiscal 2005, the School's liquid assets were confined to a range of \$70 million to \$78 million, covering current liabilities an average of 1.3 times for the period. The increase in fiscal 2006 reflected stronger cash from operations, lower capital expenses, and the higher level of new borrowings determined as part of the School's long-term financial plan. The ratio of liquid assets to current liabilities was 1.1 for fiscal 2006. As in prior years, however, the majority of the School's operating expenses were paid, as incurred, out of current cash flow.

#### Endowment

The market value of the HBS endowment grew to \$2.3 billion, or approximately 8 percent of the total University endowment assets, as of June 30, 2006, from \$2.1 billion at the end of fiscal 2005. The total return on the endowment was +16.7 percent, net of all expenses and fees, following a +19.2 percent return in fiscal 2005. Harvard Management Company continues to outperform the market. As measured by the Trust Universe Comparison Service (TUCS), a universe of institutional funds with assets greater than \$1 billion, the performance of the University's endowment has exceeded its benchmark and the median return of other large institutional funds in each of the past five years, placing Harvard in the top 5 percent of all institutional funds.



#### Unrestricted Reserves

HBS relies on unrestricted reserves as a resource for responding to unforeseen opportunities and — as part of the mix with gifts, internally generated cash, and debt — to finance capital projects. Reflecting the School's ambitious campus construction and renewal activities, reserves generally declined at a measured rate from fiscal 2001 through fiscal 2005. In fiscal 2006, the School's year-end reserves balance grew by \$8 million to \$60 million. HBS is considering making further investments in the unrestricted endowment reserve established several years ago. The market value of this reserve was \$55.7 million at June 30, 2006, compared with \$49.6 million in fiscal 2005. As fiscal 2007 begins, HBS remains confident that its reserves are sufficient to provide funding for future capital projects and to leverage emerging opportunities to deliver on the School's mission of educating leaders.



## Managing the School's Gifts and Endowment

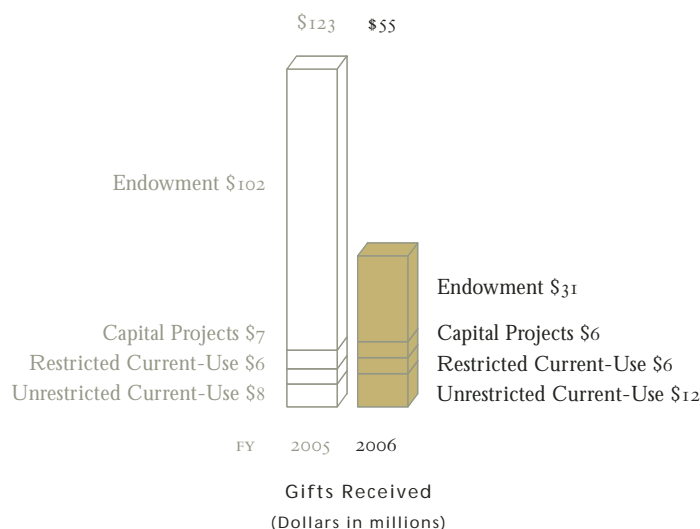
Harvard Business School closed fiscal 2006 with strong fundraising results. The year marked the conclusion of the five-year Campaign for Harvard Business School (as of December 31, 2005) and saw a new record in unrestricted annual giving. In fiscal 2006, cash received from gifts, including new cash gifts and payments on prior years' pledges, totaled \$55 million. While this is lower than the previous years' record totals during the Campaign, it is well above gift revenue in the pre-Campaign period. Of the total raised, a record \$11.7 million represented unrestricted giving.

Gifts to the Campaign totaled \$598 million, nearly 20 percent above the initial goal, and results exceeded the School's targets for each priority area. Campaign giving consisted primarily of gifts to the HBS endowment. The additional capital provided by these endowment gifts will generate increased income to support new educational and research initiatives. It also enhances financial stability, augmenting the School's capacity to pursue its mission over the long term.

Among the areas strengthened through endowment giving to the Campaign were the Doctoral Programs (\$25 million), entrepreneurship (\$25 million), the Global Initiative (\$15 million), and the Leadership Initiative (\$10 million). Campaign gifts for MBA financial aid totaled \$109 million. As a result of this generosity, during the five years since the Campaign began, the School has been able to establish more than 150 new fellowship funds. Annual fellowship spending grew by nearly 60 percent from \$12 million in fiscal 2002 to \$19 million in fiscal 2006. During this period, the average MBA fellowship award grew from \$9,001 to \$15,647.

While individual gifts of \$1 million or more have increased as a percentage of total giving during the span of the Campaign, the generosity of alumni and friends through class reunion and annual giving, over the long term, also contributes significantly to the School's success. In fiscal 2006, HBS received gifts from more than 11,000 individual donors, including alumni of the MBA, Doctoral, and Executive Education programs, as well as friends of the School. Approximately 30 percent of MBA alumni made gifts to the School in fiscal 2006. MBA participation was consistent with participation rates during the Campaign, compared with 25 percent in the pre-Campaign years.

Due in large part to the HBS community's class reunion and annual giving, revenue from unrestricted current-use gifts grew by 41 percent to a record \$11.7 million in fiscal 2006, from \$8.3 million in fiscal 2005. Unrestricted gifts support every area of activity at the School — from technology to case writing to faculty salaries — providing



stability and fostering innovation and new initiatives. Gifts available for current use often serve as the equivalent of venture funding, allowing HBS to accelerate successful emerging programs and invest in new opportunities. Over the past five years, unrestricted current-use giving to HBS has generated more than \$44 million in revenue, an amount equivalent to the income from a \$387 million endowment.

#### Endowment Returns and Performance

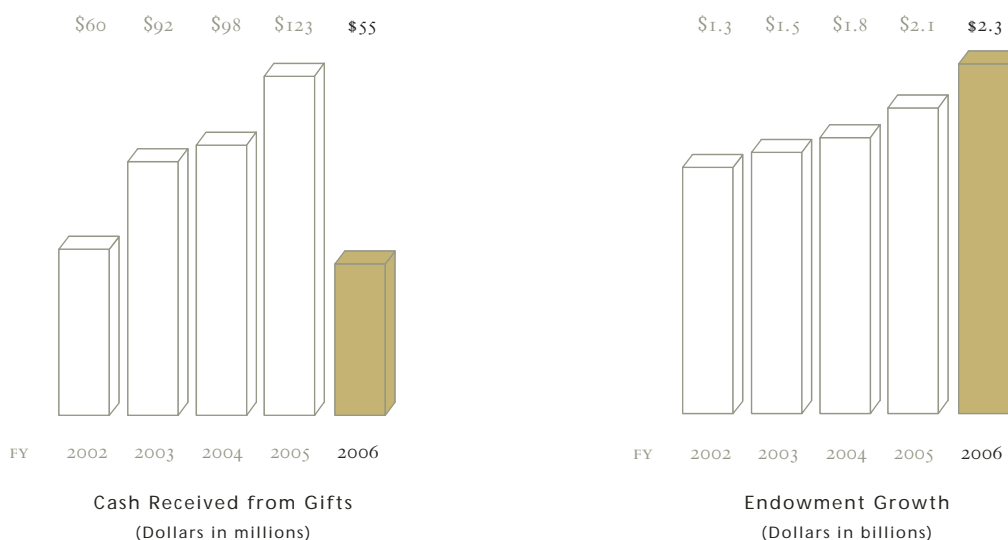
The HBS endowment consists of approximately 800 individual funds established over the years by individual donors, corporations, foundations, and reunion classes. Approximately 94 percent of the School’s endowment funds have been designated by the donors for specific uses. In fiscal 2006, roughly 50 percent of the endowment income distributed for the School’s operations supported professorships and faculty research, and 25 percent supported student fellowships. Nineteen percent was used for existing strategic initiatives, building operations, and other ongoing activities of the School. The remaining 6 percent was available for new opportunities at the discretion of the Dean.

The assets within the HBS endowment, along with the University’s other endowments, are managed by Harvard Management Company (HMC), a wholly owned subsidiary of the University. HMC was founded in 1974 to manage the University’s endowment, pension assets, working capital, and deferred giving accounts. The President and Fellows of Harvard College appoint a Board of Directors that governs HMC.

Most endowment gifts are made in perpetuity, allowing little or no access to principal, while some allow access to principal to provide the School flexibility in achieving the purposes for which they are designated. HBS also uses the principal and capital appreciation associated with prior-year gifts in line with donor intentions to support key initiatives.

The aggregate amount distributed from the endowment each year is determined according to a disciplined annual payout policy that reflects Harvard Management Company’s projections of future endowment returns. The University’s investment goals are to fund current initiatives while preserving principal, to protect the purchasing power of the endowment from erosion by inflation, and to build capital for the future by achieving superior risk-adjusted returns.

Given these goals, the University’s objective is to distribute an average of 4 to 5 percent of the endowment’s market value annually. In years of strong investment performance, the University distributes a smaller percentage of the endowment’s market value. In years when returns are less robust, a larger percentage is distributed. The distribution rate has remained within a range of 3.3 percent to 5.1 percent since fiscal 1995.



The endowment's performance over the past five years has supported a substantial increase in the annual distribution to HBS. Endowment distributions grew from \$50 million in fiscal 2002 to \$71 million in fiscal 2006, and for the period represented between 17 and 19 percent of the School's revenue.

Following the endowment's strong investment returns for fiscal years 2003, 2004, and 2005, the University chose to embark on a long-term program of supplemental distribution increases beginning in fiscal 2006. These additional funds draw from the pool of incremental capital generated by the endowment's exceptional long-term performance, and are designed to support additional spending on the highest strategic priorities at each of the Harvard schools. The supplemental distribution available to HBS for fiscal 2006 of approximately \$1 million was used for additional MBA fellowship awards. These funds have the potential to become a more significant source of income for the School in the years ahead.

After including all gifts and distributions, at the end of fiscal 2006 the University endowment was valued at \$29.2 billion, compared with \$25.9 billion at June 30, 2005. Annual endowment performance is measured not only in terms of net value, but also by tracking Harvard's investments against benchmarks in 11 relevant asset classes.

The University's total investment return for fiscal 2006 amounted to +16.7 percent, net of all expenses and fees, outperforming benchmarks in nine of these asset classes. Emerging markets posted the year's highest total return, while commodities achieved the best performance relative to benchmark. In aggregate, Harvard Management Company outperformed its composite benchmark by 3.7 percentage points, translating into \$900 million of added value for the endowment.

Endowment performance benchmarks are also provided by the Trust Universe Comparison Service (TUCS), which evaluates comparative performance of large institutional funds. The Harvard endowment's fiscal 2006 investment return exceeded the TUCS median of 10.8 percent by 5.9 percentage points. During the past five- and ten-year periods, the University's endowment has produced annualized total returns of 13.5 and 15.2 percent, respectively, compared with the TUCS median returns of 6.7 and 8.7 percent.

As of June 30, 2006, the HBS endowment represented approximately 8 percent of the total University endowment assets. Reflecting both investment return and new gifts, in fiscal 2006 the combined market value of the School's endowment grew by approximately \$275 million, or 13 percent, to \$2.3 billion from \$2.1 billion in fiscal 2005.





# Statement of Activity and Cash Flows\*

In millions

For the fiscal year ended June 30,

	2006	2005	2004
<b>Revenues</b>			
MBA Tuition and Fees	\$ 73	\$ 68	\$ 65
Executive Education Tuition	81	76	71
Publishing	119	106	98
Endowment Distribution	71	62	56
Unrestricted Current-Use Gifts	12	8	8
Housing, Rents, and Other	9	9	8
Interest Income	3	2	3
Total Revenues	<u>\$368</u>	<u>\$331</u>	<u>\$309</u>
<b>Expenses</b>			
Salaries and Benefits	\$ 167	\$ 153	\$ 139
Publishing and Printing	42	35	35
Space and Occupancy	38	35	31
Supplies and Equipment	15	15	24
Professional Services	22	16	14
Fellowships	19	17	15
University Assessments	10	10	10
Debt Service	4	4	4
Other Expense	28	22	22
Total Expenses	<u>\$345</u>	<u>\$307</u>	<u>\$294</u>
Cash from Operations	\$ 23	\$ 24	\$ 15
Use of Endowment Gifts or Appreciation	14	13	13
Cash Before Capital Activities	<u>\$ 37</u>	<u>\$ 37</u>	<u>\$ 28</u>
Capital Expenses	\$ (49)	\$ (79)	\$ (54)
Use of Gifts for Capital Projects	12	49	28
Net Capital Expenses	<u>\$ (37)</u>	<u>\$ (30)</u>	<u>\$ (26)</u>
New Borrowings	\$ 38	\$ 7	\$ 7
Debt Principal Payments	(4)	(3)	(8)
Other Activity	(26)	(15)	(1)
Net Debt and Other	<u>\$ 8</u>	<u>\$ (11)</u>	<u>\$ (2)</u>
Change in Unrestricted Reserves	\$ 8	\$ (4)	\$ 0
Beginning Balance, Unrestricted Reserves	\$ 52	\$ 56	\$ 56
Ending Balance, Unrestricted Reserves	\$ 60	\$ 52	\$ 56

\* This statement presents a managerial view of Harvard Business School operations focused primarily on cash available for use. It is not intended to present the financial results in accordance with generally accepted accounting principles (GAAP). A presentation in accordance with GAAP would report higher operating revenues for gifts and endowment distribution and would include depreciation expense, yielding income from operations of \$12 million in fiscal 2006. Cash flows, however, would be equivalent under GAAP.

# Consolidated Balance Sheet

In millions

For the fiscal year ended June 30,

	2006	2005	2004
<b>Assets</b>			
Cash	\$ 25	\$ 21	\$ 14
Unrestricted Reserves	60	52	56
Receivables, Loans, and Other Assets	178	165	195
Invested Funds:			
Endowment Investments	2,190	1,924	1,603
Current Fund Investments	18	17	43
Interest in Trusts Held by Others	132	124	120
Facilities, Net of Accumulated Depreciation	415	390	336
Total Assets	<u>\$3,018</u>	<u>\$ 2,693</u>	<u>\$ 2,367</u>
<b>Liabilities</b>			
Deposits, Advances, and Other	\$ 39	\$ 30	\$ 30
Deferred Revenue	36	34	32
Other Debt Owed to University	25	-	-
Building Debt	108	74	70
Total Liabilities	<u>\$ 208</u>	<u>\$ 138</u>	<u>\$ 132</u>
<b>Composition of Net Assets</b>			
Unrestricted Reserves	\$ 60	\$ 52	\$ 56
Undistributed Income and Other	36	28	14
Pledge Balances	56	83	122
Student Loan Funds	11	11	11
Investment in Facilities	307	316	266
Endowment and Other Invested Funds	2,340	2,065	1,766
Total Assets Net of Liabilities	<u>\$2,810</u>	<u>\$ 2,555</u>	<u>\$ 2,235</u>

Harvard Business School  
Soldiers Field  
Boston, MA 02163

This document is intended to provide insight into the way Harvard Business School manages its resources, and plans strategically for its future. Further information about the School can be found at [www.hbs.edu](http://www.hbs.edu).

This report can be viewed and downloaded online at [www.hbs.edu/annualreport](http://www.hbs.edu/annualreport).

Harvard Business School is led by the Dean of the Faculty in conjunction with various advisory and oversight groups comprising faculty, staff, alumni, academics, and business practitioners. Harvard University appoints a Visiting Committee to review Harvard Business School's strategic goals and objectives and to provide advice and input to the Dean. The group meets annually and reports to Harvard University's Board of Overseers.

We welcome questions and comments from our readers. They should be directed to Richard Melnick, Chief Financial Officer: [rmelnick@hbs.edu](mailto:rmelnick@hbs.edu) or to the Office of the Dean: [officedean@hbs.edu](mailto:officedean@hbs.edu).

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