

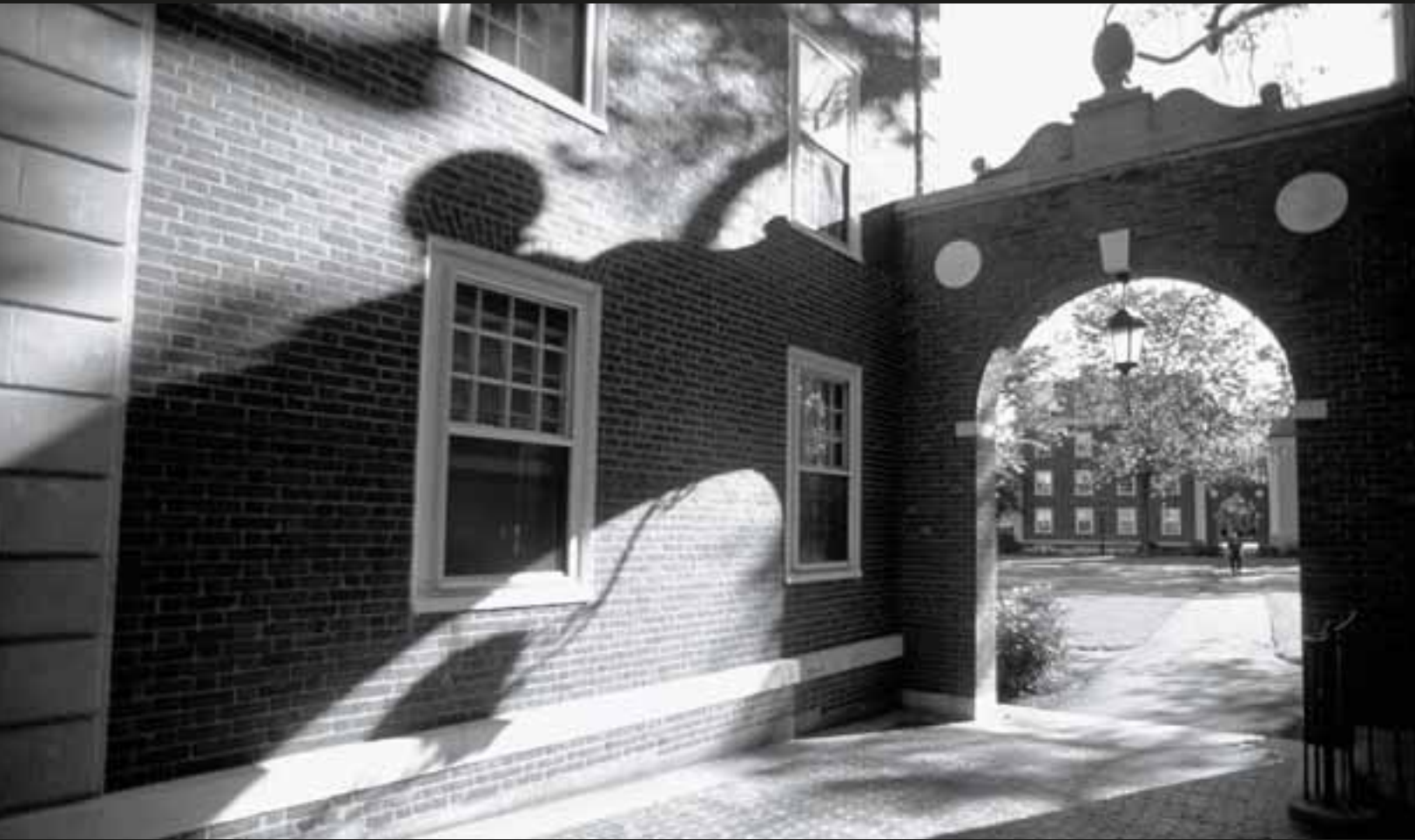


H A R V A R D | B U S I N E S S | S C H O O L

Annual Report

2004

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Our Mission

**To educate leaders
who make a difference
in the world.**

From the Dean

At Harvard Business School, we teach our students the importance of integrity—of aligning their actions with their conscience—and of instilling these principles in the organizations they lead. We encourage them to demonstrate high ethical standards, and to embody the values and larger purpose of the enterprise in society. They should be skillful and responsible in deploying financial resources. They should inspire trust and confidence in their colleagues and create a work environment where people thrive. They should be honest in their relationships with the investors and other external customers and constituents they serve.

The HBS community deserves the same accountability from the leaders of Harvard Business School. In the way we organize and operate the School, we aspire to uphold the highest standards of integrity and achieve nothing less than excellence as we marshal institutional resources in support of the HBS mission: to educate leaders who make a difference in the world. A primary goal in managing the School's financial resources is to preserve the legacy of both careful stewardship and visionary investment in the future, enabling us—when we see the right opportunities—to fulfill our mission in new and powerful ways. The purpose of this annual report is to provide a transparent look into the School's performance along these dimensions.

The pages that follow highlight accomplishments in key areas during the past fiscal year. We continued to focus on a number of long-term strategic initiatives at the School—including entrepreneurship, and building and supporting a world-class faculty. We also sought out, and invested in, new opportunities, including a full-term course, Leadership and Corporate Accountability, in the required curriculum of the MBA Program; outreach to China through the School's publishing unit; and unique fellowship and loan forgiveness programs for our graduating MBA students.

HBS begins fiscal 2005 well-prepared to advance the School's core commitments: educating students in the classroom, creating new knowledge, and communicating important ideas worldwide. We plan to launch and dedicate the C. Roland Christensen Center for Teaching and Learning, to provide a crucial resource for faculty—who come to us from a widening range of universities around the globe—to strengthen their understanding and mastery of the unique HBS learning model. We also have announced plans to establish a new research center in Mumbai, India, to support faculty research and course development efforts in this increasingly vital region. We are continuing to expand our portfolio of executive education offerings, and are developing an intensive, technology-enhanced four-week general management program. Doctoral Programs course offerings have grown substantially as well, and we look forward to strengthening our efforts to attract and support outstanding candidates. We also remain committed to initiatives in career services and lifelong learning designed to strengthen the alumni community.

Further investment in the HBS campus is a continuing priority. The dramatic renovation and restoration of Baker Library will be completed in summer 2005, and we will refurbish and enhance the remainder of Aldrich Hall, bringing all the MBA classrooms to an outstanding level of technological capability. Additionally, renovations to Hamilton Hall, one of the residence halls along the river (and untouched since 1927), are slated for summer 2005.

Our location on the Boston side of the Charles River places us at the heart of the University's extension into Allston. Although still at an early planning stage, possible activities and key priorities have emerged, including housing at the graduate and undergraduate levels, significant new space for the sciences, a potential move for two of the University's professional schools, and facilities for arts and culture. We anticipate continued and growing collaboration among the University's professional schools as a result, thus fostering the flow of ideas, faculty, and students across institutional and disciplinary boundaries, and helping to address difficult leadership issues facing the world in education, the market economy, and health care, among others. Given our faculty's focus on better understanding how to create and lead successful organizations in a dynamic and globally interdependent society, we believe HBS can contribute novel approaches to these complex problems.

Some work has begun in this area already. In spring 2004, we announced a five-year, fully integrated MD/MBA program with the Medical School, with the first students being accepted into the program for fall 2005. Moreover, we created a faculty health care initiative to leverage wide-ranging efforts among faculty, students, and an active alumni network. As work gets under way we will share updates on our progress.

This is a time of great promise for Harvard Business School. Ultimately, though, the difference the School makes institutionally is best measured one student at a time, as HBS graduates venture out individually to make the world a better place. As never before, HBS alumni are rising to positions of leadership not only in business, but in nonprofit and community organizations on every continent, whether in education, health care, the arts, community development, the environment, or government. The unparalleled scope of our graduates' influence—extending beyond companies, markets, and the global economy to include communities and nations as well—is the School's future legacy in the making. It is essential that we keep these broader needs for leadership in the world in mind as we plan our educational and research programs for the future.

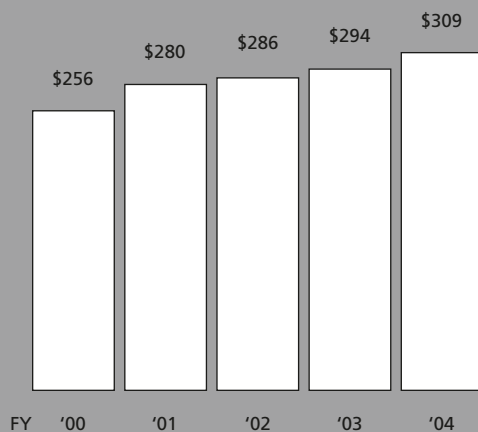


Dean Kim B. Clark

Fiscal 2004 Financial Highlights

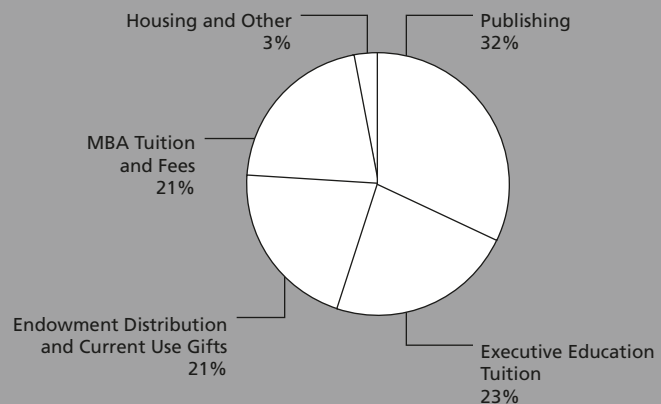
- Total revenues increased by \$15 million, or 5.1 percent, from last year to \$309 million, and were more than 4 percent above the School's forecast.
- MBA Program revenues grew by \$4 million to \$65 million due to normal increases in tuition and fees.
- Revenues from Executive Education and HBS Publishing (HBSP) increased by a combined \$9 million, or 5.6 percent, to \$169 million.
- Endowment income distributed for operations rose by \$3 million, or nearly 6 percent, to \$56 million, after rising 6 percent in fiscal 2003. The increased distribution was used primarily to fund financial aid awards and faculty research.
- Operating expenses increased by \$8 million, or 2.8 percent, to \$294 million.
- Cash from operations grew by \$7 million to \$15 million. In addition, gifts from prior years, available to be spent pursuant to the donors' specifications, added \$13 million to the School's cash flow, compared with \$14 million a year earlier. Cash before capital activities thus grew by \$6 million to \$28 million.
- Capital expenses for construction and renewal of campus facilities rose by \$15 million to \$54 million. Additional funding came from gift accounts for specific capital projects amounting to \$28 million, as well as \$7 million in new borrowings. The comparable fiscal 2003 amounts were \$27 million and \$7 million, respectively.

REVENUES



In millions

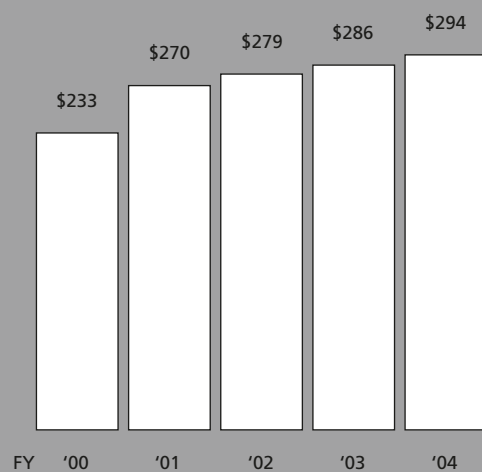
REVENUE COMPONENTS FY 2004



- Total debt outstanding at June 30, 2004, declined to \$70 million from \$71 million a year earlier.
- Unrestricted reserves were steady at \$56 million at the end of fiscal 2004. In addition, several years ago HBS established an unrestricted endowment with surplus reserves. At year-end, this endowment was valued at \$30 million.
- The market value of the HBS endowment and current use funds increased by more than 19 percent to \$1.8 billion as of June 30, 2004, from \$1.5 billion a year earlier, reflecting both strong returns and new endowment gifts. Total return on the endowment for fiscal 2004 was +21.1 percent.

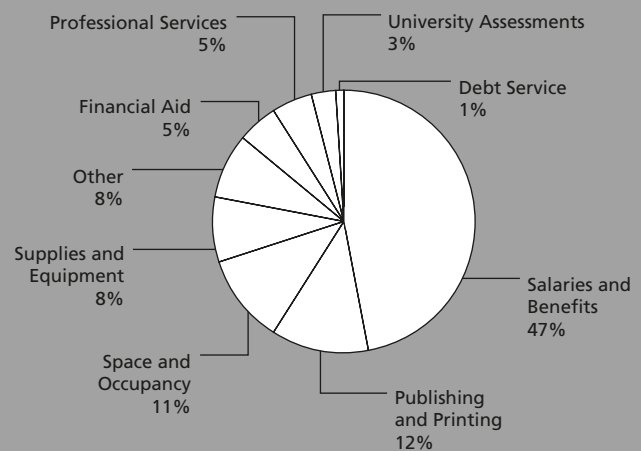
- HBS alumni and friends continued to be exceptionally generous in fiscal 2004. As the School's capital campaign continued, cash from gifts increased by \$6 million, or more than 6 percent, from fiscal 2003 to \$98 million, and pledge balances increased from \$97 million to \$122 million. This generosity remained vital in fiscal 2004, as current use gifts and endowment distribution together generated 21 percent of the School's revenues, the same proportion as last year. Approximately 31 percent of the School's MBA alumni made a gift to the School in fiscal 2004.

EXPENSES



In millions

EXPENSE COMPONENTS FY 2004



Five-Year Summary

SUMMARY FINANCIAL DATA

In millions

For the year ended June 30,

	2000	2001	2002	2003	2004
Revenues	\$ 256	\$ 280	\$ 286	\$ 294	\$ 309
Expenses	233	270	279	286	294
Cash from Operations	23	10	7	8	15
Capital Investments	51	54	34	39	54
Debt Outstanding	58	83	91	71	70
Unrestricted Reserves	68	68	70	56	56
Endowment and Current Use Funds	1,393	1,374	1,339	1,485	1,766
Total Assets	1,805	1,874	1,895	2,038	2,367

KEY FACTS

MBA Program

Applications	8,124	8,893	10,382	8,540	7,139
% Admitted	13%	12%	10%	12%	15%
Yield	84%	87%	89%	90%	87%
Enrollment	1,759	1,773	1,822	1,800	1,800

Doctoral Programs

Applications	741	729	782	821	744
% Admitted	2%	3%	3%	3%	4%
Yield	83%	82%	83%	74%	70%
Enrollment	88	95	94	91	98

Executive Education

Enrollment ¹	6,002	7,296	6,798	6,982	7,360
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Faculty

Faculty Positions ²	192	188	196	207	204
Teaching Materials Produced	649	714	640	653	588
Research Articles Published	118	141	133	119	127
Books Published	18	40	34	24	23

Staff Positions²

	900	1,043	1,117	1,066	1,017
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HBS Publishing

Cases Sold	6,220,000	6,488,000	6,434,000	6,663,000	6,999,000
HBS Press Books Sold	1,118,000	1,078,000	1,010,000	771,000	1,180,000
HBR Circulation	246,000	240,000	238,000	247,000	240,000
HBR Reprints Sold	3,156,000	3,342,000	2,924,000	2,908,000	2,910,000

Campus

Number of Buildings	31	32	33	33	33
Square Feet	1,300,191	1,421,241	1,470,241	1,476,041	1,476,041

¹ Programs range from two days to nine weeks

² On a full-time equivalent basis

FULFILLING *the* MISSION: *Case Studies*

The mission of Harvard Business School is to educate leaders who make a difference in the world—people who are grounded in strong values and high standards, global in perspective, and entrepreneurial in spirit. The School fulfills its mission through three deeply intertwined core activities.



Building new knowledge—Research at the School focuses on building new knowledge with power in practice. The faculty achieve this through an emphasis on field-based research that connects them with business operations worldwide. Their research provides the basis for business cases and teaching materials for use at HBS and other schools around the globe, new courses in the School's educational programs, and new ideas and insights with broad application in businesses and other organizations throughout the world.

Teaching the art and science of general management—Central to the School's success is a faculty that is close to practice, has a deep understanding of business, and teaches with skill and passion. Drawing largely on the case method of teaching, the faculty create an intense, interactive experience in the classroom for MBA and doctoral students, and executive education participants. The approach is carefully designed to provide not only skills, knowledge, and tools, but also a framework for sound judgment and strong leadership in a challenging, rapidly changing world.

Communicating important ideas—Faculty at HBS regularly disseminate their ideas and insights beyond the classroom through an array of channels ranging from scholarly journals and academic conferences to the business press. More broadly, HBS Publishing serves as a global resource for materials and activities on management issues, including *Harvard Business Review*, cases and other teaching materials, conferences, newsletters, and books.



The following case studies illustrate how these interrelated activities drive the continuing innovation that sustains the School's leadership among business schools worldwide.

Gathering faculty from different disciplines to create a new first-year MBA course as far-reaching as Leadership and Corporate Accountability is something that couldn't happen at any other school.

LEADERSHIP *and* CORPORATE ACCOUNTABILITY

“Gathering faculty from different disciplines to create a new first-year MBA course as far-reaching as Leadership and Corporate Accountability is something that couldn’t happen at any other school. The deeply rooted HBS focus on general management and practice allowed us to draw broadly from economics, law, psychology, and organizational behavior; to be eclectic in approaching course design; and to bring to bear a tremendous inventory of existing HBS case materials and intellectual output. The result is a broad, integrative course aimed at creating deep understanding for students, as well as knowledge that business leaders can truly mobilize in practice.”

LYNN S. PAINE

John G. McLean Professor of Business Administration

Reflecting the School’s long-standing commitment to preparing its students for the full range of responsibilities they will face as leaders in society, HBS introduced Leadership and Corporate Accountability (LCA) as a required first-year MBA course in winter 2004. LCA involves students in a semester-long study encompassing three central aspects of corporate accountability: responsibility to organizational constituencies; organizational design and governance; and approaches for resolving conflicts among personal, organizational, and societal values.

Although many of the School’s courses touch on these issues, the faculty team that designed LCA decided that problems of ethics and governance justify a dedicated full-semester course. Professor Lynn Paine, coleader of the LCA design team, says the faculty’s experience with MBA students made it clear that many had little education in this arena. “Their understanding of the ethical dimensions of leadership tended to be anecdotal rather than systematic,” she notes. “Many students lacked a framework for thinking about concepts such as fiduciary responsibility, conflict of interest, duty of care, transparency, fairness, and citizenship—and why these concepts matter.”

LCA starts with a simple premise: When men and women assume positions of leadership, they take on a distinctive set of responsibilities. Through cases that involve topics from hostile takeovers to the global AIDS crisis, students use a tripartite framework of ethics, law, and economics to make decisions and develop practical plans of action that meet the enterprise's responsibilities to key constituencies—including shareholders, customers, employees, suppliers, communities, and society as a whole. Reflecting the increasingly global nature of the market economy, LCA includes situations where conflicts may have cross-cultural roots.

The next part of the course looks at external and internal governance. Immersed in cases ranging from the rise and fall of Enron to Johnson & Johnson's handling of the Tylenol poisonings in the 1980s, students explore basic aspects of human nature and examine the tools leaders use to instill responsible conduct throughout a company. The final part of the course turns to the personal side of leadership, where students consider the personal attributes required to make good decisions in the face of ambiguity, stress, and fast-changing circumstances. Throughout the course, students learn the importance of integrating the ethical, legal, and economic aspects of their decisions.

Paine explains that these lessons are best conveyed by confronting students with real dilemmas. Through the case method, students are able to examine in detail a wide array of business situations in order to determine—and to defend—a course of action. By wrestling with actual situations, with all their complexities, trade-offs, and unexpected subtleties, students can grasp the dimensions of the challenges they will face, and internalize the knowledge and judgment required to deal with them.

“Students are coming to LCA at an inflection point in their lives,” says Paine. “If the teaching and learning are successful, our graduates will emerge with both a stronger sense of what it means to be a responsible leader, and the tools to act on this understanding.”

The School's newest first-year MBA course, Leadership and Corporate Accountability (LCA), prepares > students for the ethical challenges they will face as leaders. HBS faculty began conceptualizing aspects of LCA in the late 1990s in response to the organizational accountability issues arising from globalization and privatization. LCA immerses students in case-method experiences related to governance and ethics, just as other courses at HBS focus on problem solving in subjects such as finance and operations. Hendrik Almstadt, Moran Bar-Kochva, Yasmine Brihi, Pablo Jenkins, and Ruben Kliksberg (right)—all HBS '05—were members of a study group that met during the winter 2004 LCA course. “Before I took LCA,” says Kliksberg, “I didn't believe it was possible to meaningfully teach ethics in the classroom. My experience has proven me wrong.”



Entrepreneurship is the engine that drives innovation and job creation. Through our research and teaching, this is what we want to understand more deeply and foster in practice.

THE ROCK CENTER

“Early research on entrepreneurship focused primarily on the psychological characteristics of company founders. More than 20 years ago, HBS changed everything by defining it as a business process that can take place in a wide range of settings. That opened up the possibility of thinking about entrepreneurship more broadly as a set of general management concepts, principles, and skills geared toward the pursuit of business opportunity. Entrepreneurship is the engine that drives innovation and job creation. Through our research and teaching, this is what we want to understand more deeply and foster in practice.”

MICHAEL J. ROBERTS
Senior Lecturer and Executive Director
Arthur Rock Center for Entrepreneurship

Teaching and research in entrepreneurship at HBS extend back to 1937, when Professor Georges F. Doriot started exploring the issue in his Manufacturing course. Professor Myles L. Mace introduced the School's first MBA course on entrepreneurship in 1947. Since then, entrepreneurship has become part of the fabric of HBS for students, faculty, and alumni, and it is a distinctive competence of the School.

Completing its first full year of operation in fiscal 2004, the Arthur Rock Center for Entrepreneurship serves as the focal point for all related teaching, research, and worldwide outreach from across the entire School. Under the Rock Center's aegis, 31 faculty members collectively taught 19 elective courses on entrepreneurship during the year, as well as two required courses that form the core of the first-year MBA curriculum. One of these courses, The Entrepreneurial Manager, looks at management issues through the eyes of company founders as well as entrepreneurial managers in established firms, and is a popular required MBA course at HBS.

“We are unusual in having an entire faculty unit focused solely on entrepreneurial management,” says Rock Center Executive Director Mike Roberts. In addition to teaching in the classroom, faculty work closely with students on activities such as field studies and business plans. Several successful companies trace their origins back to the Center's annual student business plan contest.

The Rock Center's mission is to shape scholarship, education, and the practice of entrepreneurship through outstanding empirical research, course development, and teaching for academics and practitioners. The Center's faculty view entrepreneurship as a unique form of general management, and believe that studying its core concepts and principles creates a valuable knowledge base for all students—even those who may choose careers in large, established firms. Rock Center faculty combine theoretical and methodological rigor with insights derived from immersion in the field and, in many cases, their own experience as practicing entrepreneurs.

The Center also works with entrepreneurial organizations across the country to arrange internships after the students' first and second years, and provides fellowships to help students with entrepreneurial plans offset the lower salaries associated with start-up enterprises. In addition to teaching courses at the MBA level, the faculty offer a doctoral course and Executive Education programs on entrepreneurship.

Since 1993, Rock Center faculty have published nearly 400 journal articles, more than 100 books, and over 230 cases, and they have been recognized with a wide range of academic awards. In January 2004, the United States Association for Small Business and Entrepreneurship selected the School's MBA Program as the most outstanding in the country for entrepreneurship.

A priority for the Rock Center, according to Roberts, is to build stronger ties with the School's extensive community of alumni entrepreneurs. "Bringing graduates back together with our faculty can help alumni become more effective in their entrepreneurial roles, and assist the School in developing opportunities for research, student projects, and internships." Holding its first Entrepreneurs Forum this past year, the Rock Center gathered 30 alumni to meet with a smaller group of established venture capitalists to discuss mutual perceptions and misperceptions. Similar sessions are planned for fiscal 2005, as is the initiation of the Rock Center's Entrepreneur in Residence program.

Entrepreneurship is central to the HBS curriculum and the lives of the School's alumni. Nearly half of all MBA graduates have founded or cofounded at least one company—from products to services (right). Through the case method, as well as exposure to the entrepreneurs themselves who frequently attend class when their case is being taught, HBS students see that entrepreneurship takes many forms, and that the entrepreneur is, in many senses, the consummate general manager. This experience helps students develop skills that are practical and transferable, no matter what career they choose. >



We encourage faculty to make big bets on studying phenomena that confront top managers, but aren't being addressed effectively by current research.

INVESTING *in* RESEARCH

“The top business schools all have unity of purpose in their research, typically driven by a particular academic methodology. At HBS, our unity of purpose is defined by the nature of the problems we work on, and their connection with our teaching. We encourage faculty to make big bets on studying phenomena that confront top managers, but aren’t being addressed effectively by current research. Faculty leverage research to develop innovative courses and case materials. From the classroom to the field and back again, the resulting new knowledge is rigorous, inspirational for students, and powerful in practice.”

KRISHNA G. PALEPU

Ross Graham Walker Professor of Business Administration
Senior Associate Dean, Director of Research

Harvard Business School has long been known for its innovative approach to knowledge creation. Its faculty actively engage in a mix of field research, experimental and empirical methods, and work based on analytical modeling to produce new understanding that is both rigorous and powerful in practice. HBS stands alone among top business schools in considering case writing as integral to research, according to Professor Krishna Palepu. “What we do is inductive theory building, but more importantly, the case method allows us to take problems that are real and link the research with our teaching. That’s a connection few business schools are able to make effectively.”

The case method turns HBS classrooms into laboratories where students help faculty test and refine new ideas. In this way, HBS students not only gain early exposure to innovative business practice, but also have the opportunity to collaborate with faculty in shaping this new knowledge and, eventually, to disseminate it in practice. In many instances, faculty research leads to the creation of MBA, doctoral, and executive courses that anticipate emerging challenges in the marketplace, and inspire students to apply novel approaches to the challenges they face.

The exceptional research environment at HBS arises from the School’s unique model for research funding and governance. Research funding draws on a nearly 100-year legacy of alumni generosity, coupled with income generated internally through the School’s educational programs and publishing operation.

These assets enable HBS to independently finance faculty innovation much like a venture capital firm provides funding for emerging companies.

This internally generated venture capital frees HBS faculty from the distraction of raising funds for projects, as well as from the constraints that typically accompany third-party-sponsored grants. It enables the School to be unusually flexible and patient in supporting novel, ambitious, multiyear faculty research endeavors. In addition, HBS can place large bets on promising young faculty with innovative ideas at early stages in their careers, instead of waiting for their initial work to gain the recognition typically necessary to attract funding from outside sources.

The School has invested more than \$70 million in each of the past three years in faculty research. Projects funded span a wide range of topics, from finance to marketing and from organizational behavior to strategy. Work under way includes studies on the consumer psychology of price, the role local institutions play in attracting capital flows, asset allocation for long-term investors, and the role organizations play in causing variations in medical productivity.

The School provides faculty with a wide range of support services, including IT resources, research associates, and case writers, as well as access to the extensive materials housed within Baker Library. To assist faculty in developing relationships with industry, government, and academia around the world, and to help them conduct international research, the School has established a global network of regional research centers in California (Silicon Valley), Latin America (Buenos Aires), the Asia-Pacific (Hong Kong), Japan (Tokyo), and Europe (Paris).

Leveraging these resources, faculty develop new ideas and insights, which then become the means to replenish the model. In addition to enriching the School's MBA and doctoral classrooms, the knowledge reaches managers who come from around the globe to attend HBS Executive Education programs. The School also disseminates the faculty's research to worldwide business and academic markets in cases, books, periodicals, and eLearning materials produced by HBS Publishing. This global outreach, in turn, lays the groundwork for continued research advances.

The HBS research funding model frees the School's faculty to tackle large, interdisciplinary problems, often working on a multiyear horizon. HBS faculty spend unusually large amounts of time in the field, involved day-to-day with enterprises and practicing managers around the world. The School's approach is straightforward: ask faculty what they need to be productive, provide the resources, and then let them do their work. According to Director of Research Krishna Palepu (right), "We're not looking for a short-term ROI on every research dollar—we're encouraging ideas that inform and affect society in a larger way."



HBS Publishing can extend the reach of the School by an order of magnitude beyond the campus. No region offers more opportunity for this today than China.

HBSP *in* CHINA

“HBS Publishing can extend the reach of the School by an order of magnitude beyond the campus. No region offers more opportunity for this today than China. In just the past five years, MBA education in China has expanded from a handful of programs in Shanghai and Beijing to more than 100 across the country. Because of this lightning-fast growth, the supply line of skilled faculty and quality instructional content is way overstretched. We’re helping key Chinese ministries and publishers respond to these needs by creating periodicals, books, and eLearning products for educating China’s next generation of managers and leaders.”

DAVID WAN

President and Chief Executive Officer
Harvard Business School Publishing

HBS Publishing (HBSP) has embarked on a strategy aimed at supporting the development of management education and practice in one of the world’s most powerful emerging economies—the People’s Republic of China. Already publishing three Chinese versions of *Harvard Business Review*, HBSP is looking beyond periodicals toward establishing the School as a major presence in China’s academic book market. The Commercial Press, China’s principal state-owned publishing group, has agreed to produce up to 150 HBS Press titles in the next three years. The first 50 books have already been identified, and translation is under way.

Demand for MBA and executive education is exploding in China, and its Ministry of Education has responded by creating accreditation standards and curriculum guidelines. Although the ministry encourages Chinese business schools to emphasize the case method of instruction, faculties outside the largest industrial centers have had little exposure to case teaching, case writing, and the process of selecting cases for a specific course. To address this need, HBSP is forging a relationship with a second publishing company aimed at creating a series of inexpensive booklets, each containing 10 to 12 HBS cases relevant to managers in China. The cases in each booklet will be selected by HBS faculty with an eye toward creating a rewarding educational experience, as well as meeting China’s MBA course content requirements.

HBSP's China strategy extends beyond the printed word. CNBC Asia is now working with HBSP to produce *Strategic Decisions*, a series of general management courses airing on Shanghai Television. Each program focuses on an HBS case discussion, and involves a live audience of students from China's top business schools and a panel of global business experts. The programs feature video clips of an HBS faculty member discussing key elements of the case. HBSP is also expanding its eLearning business in China. Harvard ManageMentor, an online resource offering information on key management topics, is now available in a Chinese language version.

Reinforcing this outreach, for many years the School's Colloquium on Participant-Centered Learning (CPCL) has attracted senior faculty from top business schools in emerging economies to the HBS campus for a 10-day program on case-method instruction. Leading faculty from China participated in fiscal 2004, and faculty from China, Hong Kong, and Taiwan will be invited to attend a special East Asia CPCL during the summer of 2005.

In addition to forging relationships with academic institutions worldwide, HBS has long reached out through Executive Education to practicing executives and managers in every corner of the globe. Approximately 45 percent of program participants each year come to the campus from outside North America, and HBS is offering an increasing number of executive programs overseas. In fiscal 2004, for example, in addition to coteaching Restructuring for the Global Economy with faculty at Tsinghua University in Beijing, the School delivered an innovative program to senior executives from the Middle East that featured modules in both Boston and Sharm El Sheikh, Egypt.

These and other global activities complement the relationships developed by the School's research centers—with alumni, academic institutions, and companies around the world. With their focus on creating intellectual capital, the centers facilitate faculty research on large, complex problems that ultimately makes its way back into the School's classrooms and seeks to improve business practice worldwide.

The People's Republic of China, along with Hong Kong and Taiwan, represents the world's largest > emerging market for the kinds of intellectual capital produced by HBS. Three versions of *Harvard Business Review* are edited and produced in China: A version printed in traditional Chinese ideograms is distributed in Taiwan (right), while editions destined for markets in Hong Kong and mainland China are published in simplified Chinese. The Chinese edition is also printed in English. To enhance the magazine's relevance, up to 30 percent of the content originates locally.

The Service Leadership Fellows Program offered me a unique opportunity to use my MBA skills to really have an impact on an organization that I believed in.

EXPANDING CAREER CHOICES

“The Service Leadership Fellows Program offered me a unique opportunity to use my MBA skills to really have an impact on an organization that I believed in. Financial analysis, strategy, and marketing are important, but what I use most are the leadership skills I learned at HBS: being action oriented, defining clear objectives, and inspiring people to accomplish something that will make a real impact. SLFP does more than help HBS graduates like me work toward more personally meaningful goals. It’s leading the public and nonprofit sectors to create MBA-level positions that didn’t exist before.”

STEPHANIE JACOBY
MBA '03

Stephanie Jacoby arrived at HBS after three years at Goldman Sachs. After her first year in the MBA Program, she was inspired by a summer internship at a venture philanthropy fund to set her career sights on the public sector. At the end of her second year, the School selected Jacoby to be a Service Leadership Fellow, and she accepted a position at Phipps Houses in New York City. Working directly with the president, she spent her fellowship year developing a new business line focused on preserving affordable housing by acquiring, financing, and rehabilitating older, privately owned apartment buildings. Following her year at Phipps Houses, Jacoby went on to become senior policy advisor in New York City’s Office of Economic Development and Rebuilding.

The Service Leadership Fellows Program (SLFP), offered by HBS to encourage students who want to experience leadership in the nonprofit and public sectors early in their careers, is based on a unique partnership with dozens of nonprofit and government organizations. Participating organizations agree to employ an outstanding HBS MBA graduate in a challenging senior-level position for one year at a competitive salary. The School shares roughly half of this annual compensation cost by providing Service Leadership Fellows with one-year grants.

Jacoby says she enjoyed working in financial services prior to attending HBS, but her summer internship awakened a need to fulfill other goals that were meaningful for her. She says the School not only helped her succeed in exploring new careers, but that nearly every aspect of her MBA education has proven to be applicable in her postgraduation work. From real estate to strategy to marketing, the rigorously analytical aspects of her education at HBS have helped Jacoby make better decisions. She also uses leadership skills learned at the School every day—how to lead teams and how to develop and motivate a high-performance staff.

The School's ability to launch programs such as SLFP demonstrates the breadth of its relationships with leaders in business and government worldwide. Identifying outstanding nonprofit and public-sector organizations that can offer rewarding experiences for HBS graduates is a significant challenge. To find these opportunities, the School leverages the strong ties it has developed with business leaders, corporations, and the School's large and active alumni community.

Rapid increases in the cost of living have resulted in higher levels of student debt after graduation. Looking ahead to the prospect of servicing this debt, many MBA graduates may see their career opportunities narrowing. HBS is working to sustain and broaden the range of career paths that are financially feasible.

Another initiative helps MBA students who are considering private-sector careers in industries or regions where starting salaries tend to be low. Starting with the MBA Class of 2003, the School has increased the availability of special Supplemental Fellowships for this purpose. Supplemental Fellowships reduce graduates' need-based loan balances if they have accepted a job in the private sector with total compensation that is significantly below the MBA average. HBS awarded 42 Supplemental Fellowships to members of the MBA Class of 2004, 21 of whom planned to work outside the United States. The average award was approximately \$20,000.

As an HBS Service Leadership Fellow at Phipps Houses, the nation's oldest and largest nonprofit affordable housing organization, Stephanie Jacoby (MBA '03) worked with the president on key initiatives designed to strengthen less-advantaged communities in the New York metropolitan area. She has since gone on to a full-time position with the City of New York. The Service Leadership Fellows Program chooses fellows for employment at select social enterprise organizations, and provides grants that enable fellows to receive competitive salaries. HBS is committed to supporting its graduates and nonprofit and public-sector organizations as they together address some of the most challenging issues facing society. >



Letter from the Chief Financial Officer

Dear Alumni, Students, and Friends,

Harvard Business School executed well on its management objectives in fiscal 2004. Accelerating revenue growth in Executive Education and HBS Publishing (HBSP), combined with continued focus on fiscal discipline and productivity improvement, produced the School's strongest operating and financial results since fiscal 2001. At the same time, HBS provided additional funds for faculty initiatives in research and teaching, which are core to its mission.

With more than 50 percent of the School's revenue derived from economically sensitive, variable sources, long-term trends in business growth and worldwide corporate spending are key considerations as the School plans its financial affairs. Both of these trends were more favorable than in fiscal 2003, leading to a strong year for HBS from a top-line perspective.

Total revenue grew by \$15 million, or 5.1 percent, to \$309 million—more than 4 percent higher than our forecast. Executive Education and HBSP generated more than \$9 million of this revenue growth. Another \$3 million of the top-line increase was attributable to increased endowment distributions, driven to a significant extent by endowment giving through The Campaign for Harvard Business School.

Although the School's revenue growth rebounded in fiscal 2004, inflation continued to be more problematic for higher education than most other economic sectors. During the revenue-constrained 2002 and 2003 fiscal years, HBS tightened its already strict limits on hiring and staffing levels, and we maintained this discipline in fiscal 2004. Despite sharply rising health-care and pension costs, total expenses for salaries and benefits rose only 3 percent from last year.

The School's administrative departments have responded to the drive for budget discipline by continuing to improve their operational efficiency and productivity. Staffing levels in the economically sensitive HBSP and Executive Education units were brought into line with market demand, and we consolidated the HBS Interactive custom program segment within Executive Education. As a result, fiscal 2004 was the second consecutive year in which the School's total administrative staff levels declined. HBS concluded fiscal 2004 with 100 fewer administrative positions than two years ago—a reduction of nearly 10 percent.

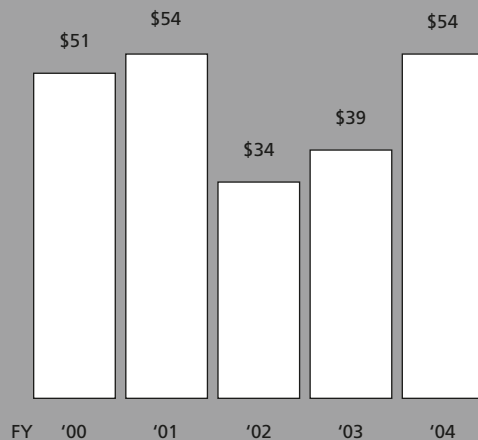
Non-personnel expenses have also been tightly controlled. New spending proposals receive approval at HBS only when there is compelling reason to expect they will further the School's educational mission. Everything else is subject to trimming or elimination from the budget. In addition, despite widespread inflationary pressures HBS is doing more with less in managing the campus. Through myriad steps ranging from maintenance re-scheduling to the Harvard Green Campus Initiative, which encourages new approaches to energy conservation, the School has maintained the distinctive quality of its physical environment while holding space and occupancy expenses essentially flat for the past three years.

The School's investment in campus facilities renewal and construction grew nearly 39 percent in fiscal 2004 to \$54 million from \$39 million in fiscal 2003. In addition to \$28 million in gifts earmarked for these projects, HBS funded this investment with cash generated from operations, new borrowings, and use of endowment appreciation. As a result, the School's reserves balance remained stable and at a level that provides enough flexibility to capitalize on strategic opportunities.

A Look Ahead

Early results suggest that the School's revenue growth will continue at a modest pace in fiscal 2005. The fourth quarter of fiscal 2004 was stronger than expected for both HBSP and Executive Education. Our ability to sustain this momentum will depend in no small measure on the health of the economy in the coming quarters, and the economy's vital signs are anything but clear. In addition, the University is cautioning the Harvard community not to expect future endowment distributions to increase as dramatically as they did this past year, when growth in the endowment's income was unusually robust.

CAPITAL INVESTMENT



In millions

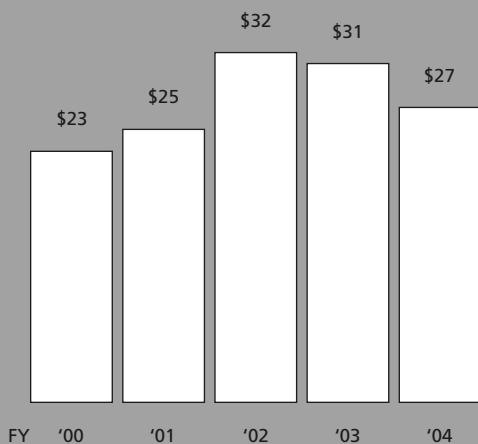
Nonetheless, the School's commitment to its mission is as strong as ever. Balancing strategic priorities with financial reality, HBS is operating on an ambitious, but not aggressive, revenue and expense plan for the year ahead. The School's plans for research, teaching, and faculty development include the establishment of the C. Roland Christensen Center for Teaching and Learning, as well as a regional research center in India. The School also will be examining ways to continue strengthening its doctoral programs, which have long been an important source of faculty for HBS and other leading management schools.

HBS will extend its commitment to information technology in fiscal 2005, maintaining its recent annual average of \$28 million in technology spending. In the classroom, these investments are deepening the learning experience as course materials

increasingly employ interactive content to bring real-life business situations closer to students. A major focus for the School's IT spending in fiscal 2005 will be MBA courseware development, as well as in-class support to help the faculty better leverage newly deployed technologies.

At the same time, we will continue to accelerate the School's efforts to focus strategically on increasing financial aid for MBA students. Our objectives are to remove the financial barriers that prevent strong MBA candidates from attending HBS, and to help graduating students pursue their careers of choice. As in fiscal 2003 and 2004, HBS will focus its incremental fellowship spending on supplemental fellowship funds that help students accept private-sector salaries, both in the United States and abroad, that are significantly below the MBA average. These supplemental awards directly reduce students' debt burdens prior to graduation.

IT INVESTMENTS



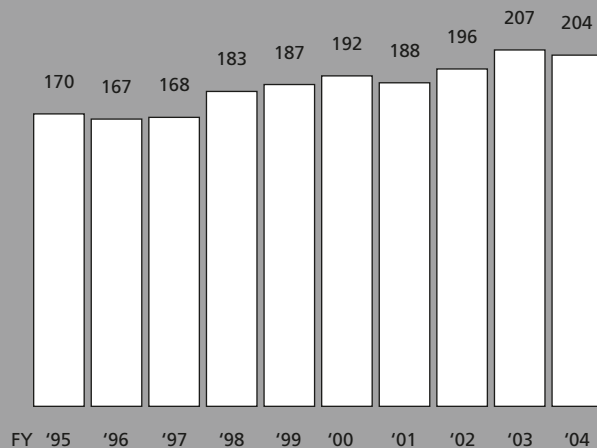
In millions

Our ability to fund new initiatives such as these while balancing the budget in fiscal 2005 will continue to depend on our success in generating incremental revenue and carefully controlling costs. The School's total expenses for fiscal 2005 are projected to be \$312 million, up 6.1 percent from actual spending of \$294 million in fiscal 2004.

Our fiscal 2005 expense budget reflects a University-wide 30 percent increase in employee benefits expense, largely attributable to inflation in health-care and pension costs. As a result, carefully managing non-personnel expenses, as well as the size of the School's administrative staff, remains an important priority for the year ahead.

HBS frames its operational planning with a proven faculty and staff allocation process that looks far into the future. The School's goals for teaching and research will require moderate growth in the size of the faculty for the next several years. Staff additions in Executive Education and HBSP will be limited to positions justified by rising revenue and market demand. On the administrative staffing front, current vacancies will remain unfilled wherever possible, and staff additions will be centered on operations that directly support the School's educational mission.

FACULTY (ON A FULL-TIME EQUIVALENT BASIS)



In addition to tightly controlling the School's human resource levels in fiscal 2005, we have budgeted a zero increase in non-personnel expense.

Driving continued revenue growth from Executive Education and HBSP is core to our financial strategy for fiscal 2005 and beyond. While our current growth expectations for these operations are less aggressive than five years ago, they are still very ambitious. Both units are moving forward on customer-focused innovations in products and distribution channels. Their goal is to increase not only the School's global impact, but also its share of the increasingly competitive worldwide market for corporate and academic learning.

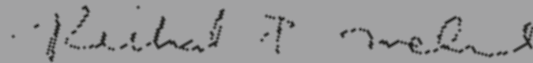
HBSP will continue to seek and exploit opportunities to generate revenue from new media platforms, and through outreach to growing markets such as those in the Asia-Pacific region. Executive Education will be launching an innovative four-week course in general management, as well as programs that match the faculty's evolving areas of interest with the management challenges that most concern the corporate community.

Letter from the Chief Financial Officer

Campus investments in fiscal 2005 are projected to increase to a record \$66 million. The restoration and renovation of Baker Library that began in fiscal 2003 will continue to be the School's largest capital project. Another major initiative will be the ongoing renovation of Aldrich Hall, incorporating new technology and refurbishments to enhance the in-class learning environment. HBS will also be making a further payment to the University for space that will become available when public broadcasting station WGBH moves to new headquarters in Brighton. Future major capital projects include the renewal of residential space at Hamilton and Gallatin Halls, the former of which is currently slated for completion in fiscal 2007.

The School's long-term financial plan includes strategic use of debt to support capital investment. In anticipation of this higher level of capital activity in fiscal 2005, we are considering an increase in the School's debt level. As with each of the other Harvard schools, the University functions as a banker for HBS. The School's long-standing policy is to use leverage conservatively and only for qualified capital projects, and this policy will not change. Our decisions regarding management of the School's debt in fiscal 2005 will depend on the interest rate environment and our expectations for the Harvard endowment's investment return.

The unusual HBS approach to value creation—its self-sustaining circle of research, teaching, and global outreach—makes the School's financial health highly dependent on performance in the marketplace. This means that HBS must continue to create valuable new ideas, and translate this intellectual capital into superb teaching and marketable products which, in turn, support the research that leads to new knowledge. As stewards of the HBS legacy, our responsibility is to ensure that the School will always have the financial resources to make this happen. We consider this responsibility a privilege, and we will continue working tirelessly to honor it.



Richard P. Melnick, MBA '92
Chief Financial Officer
November 15, 2004

Managing the School's Gifts and Endowment

Fueled in part by the momentum of the School's capital campaign, which was launched publicly in fiscal year 2003, cash received from gifts (including new gifts and payments on prior year's pledges) reached a high of \$98 million in fiscal 2004, surpassing previous record levels of \$92 million and \$60 million in fiscal 2003 and 2002, respectively. Current use gifts and gifts directed to endowment support the operations of the School as well as strategic initiatives. On an annual basis, gifts account for approximately 21 percent of the School's annual revenue.

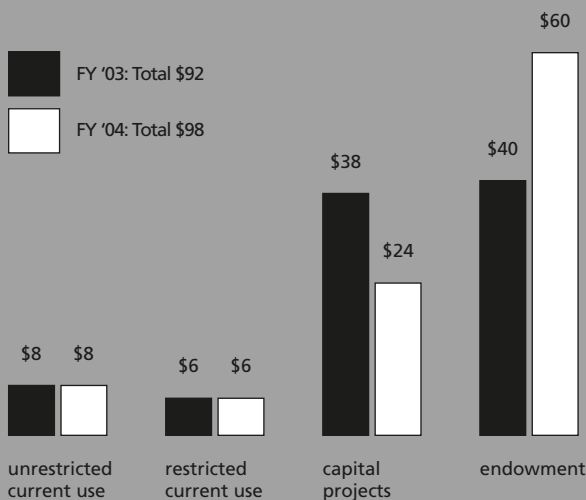
The Campaign for Harvard Business School is a comprehensive effort to raise \$500 million for key initiatives, including fellowships for MBA and doctoral students, global research, technology, faculty development, and renewal of the residential Soldiers Field campus. The campaign provides new funding for work that is essential to fulfilling the

School's mission in an economy that is technology-driven and worldwide in scope. As of June 30, 2004, the campaign raised more than \$475 million. Most gifts and pledges have been made to support endowment accounts and, as such, will provide important long-term funding for strategic initiatives.

While individual gifts in excess of \$1 million have increased as a percentage of total giving during the past three years, class reunion and annual giving drives continue to provide critical support. More than 75 percent of the School's MBA graduates have participated in giving at some point in their lifetime. In fiscal 2004, HBS received gifts from more than 12,000 individuals: 10 percent were first-time donors, and 20 percent increased their level of giving over the previous year. Approximately 31 percent of MBA alumni made gifts to the School in fiscal year 2004, sustaining the previous year's level, itself a 4 percent increase over fiscal 2002. Sustained growth in alumni participation is a key goal of the campaign.

Reunion and annual giving is important because much of this generosity is in the form of unrestricted current use gifts. With only the income from endowment funds available to the School, cash from unrestricted annual giving is vital to HBS operations. During the past three fiscal years, unrestricted annual giving has produced a total of \$25 million in revenue, an amount equivalent to the income from a \$220 million endowment.

GIFTS RECEIVED



In millions

Managing the School's Gifts and Endowment

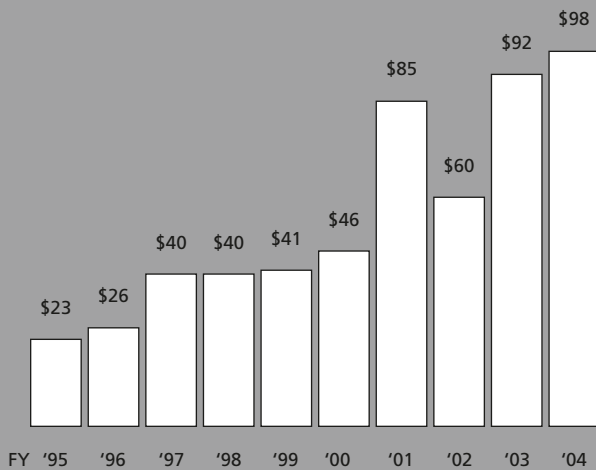
The HBS endowment consists of more than 900 individual funds established by individual donors, corporations, foundations, and reunion classes. The vast majority of endowment funds are designated for specific uses, and access to individual funds is often specified or restricted. The assets within these funds, 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.

While most endowment gifts are made in perpetuity, allowing little or no access to principal, some allow access to principal to provide the School flexibility in achieving the purposes for which they are designated.

For example, class reunion gifts from MBA classes typically are spent over a five-year period. HBS expects to continue using the principal and capital appreciation associated with prior-year gifts in line with donor intentions to support key initiatives.

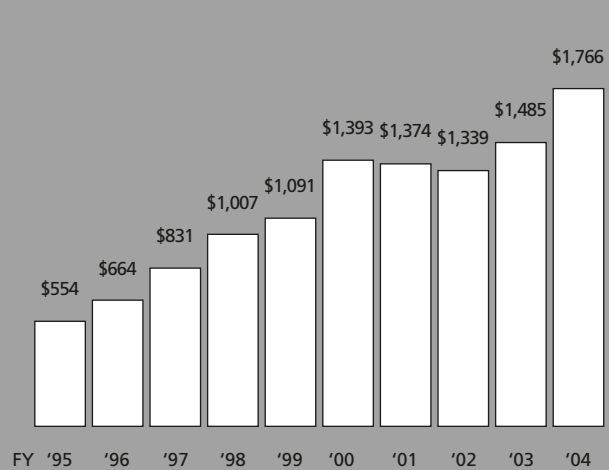
The aggregate amount distributed from the endowment each year is determined according to a disciplined annual payout policy that reflects HMC's projections of future endowment returns. The University's investment goal is to fund current initiatives while preserving principal, protecting against inflation, and building capital for the future by achieving superior risk-adjusted returns.

CASH RECEIVED FROM GIFTS



In millions

ENDOWMENT GROWTH

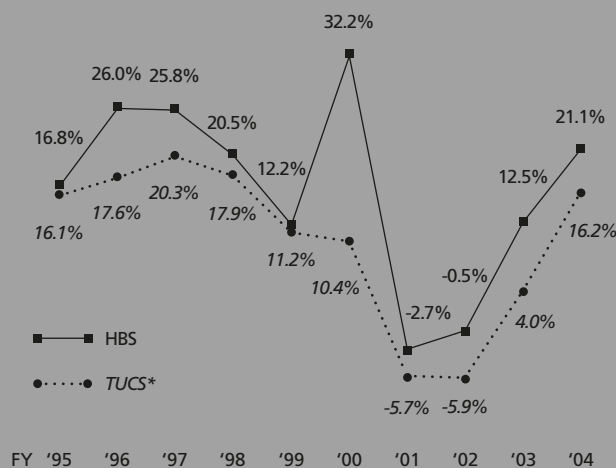


In millions

Given this goal, the University's objective is to distribute an average of 4 to 5 percent of the endowment's market value annually. The endowment's performance over the past five years has supported a substantial increase in the annual distribution to HBS. Endowment distributions grew from \$38 million in fiscal 2000 to \$56 million in fiscal 2004, and represented an average 17 percent of the School's revenue.

Benchmarks for the endowment's performance are provided by the Trust Universe Comparison Service (TUCS), which evaluates comparative performance of large institutional funds. During the past one-, five-, and ten-year periods, the University's endowment has produced annualized total returns of 21.1 percent, 11.8 percent, and 15.9 percent, respectively, outperforming the TUCS median by 4.9 percent, 8.0 percent, and 5.8 percent, respectively. At year-end, the

ANNUAL ENDOWMENT RETURNS



*Large fund median performance measured by Trust Universe Comparison Service

University endowment was valued at \$22.6 billion, an increase of \$3.3 billion from \$19.3 billion at June 30, 2003. If the Harvard endowment had earned median returns over the past 10 years—which is what one would expect from a large, diversified institutional fund—its value would be approximately half of what it is today.

As of June 30, 2004, the HBS endowment represented approximately 8 percent of the University endowment. Reflecting both investment return and new gifts, in fiscal 2004 the combined market value of the School's endowment and current use funds grew by approximately \$300 million, or nearly 20 percent, to \$1.8 billion, from \$1.5 billion in fiscal 2003.

The endowment's investment results over the past 10 years have been sufficiently strong to provide some cushion against future volatility in market returns. The large size and excellent performance of the endowment do not, however, insulate HBS from financial pressures. While the endowment's recent strong annual returns mark a reversal from the negative returns of fiscal 2001 and 2002, the long-term outlook is significantly more modest.

MULTIYEAR ENDOWMENT RETURNS

	Harvard	TUCS*
Five-Year Performance	11.8%	3.8%
Ten-Year Performance	15.9%	10.1%

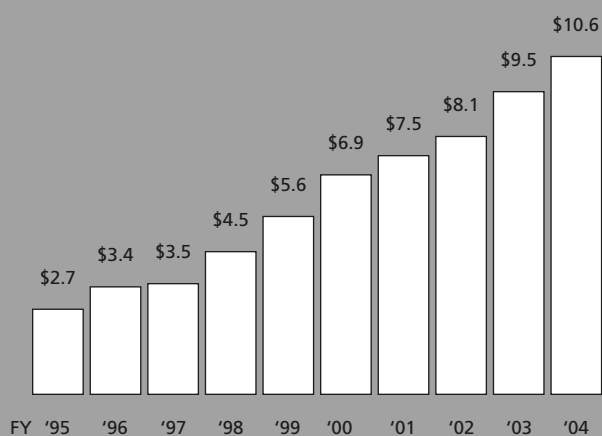
Financial Review

Revenue Overview

HBS derives funding for its operations from three primary sources:

- Academic program revenue, consisting of tuition and fees from MBA and Executive Education programs. Revenue from academic programs increased to \$136 million in fiscal 2004, from \$128 million last year.
- HBS Publishing revenue, generated through sales of periodicals, books, cases, and eLearning products. Revenue from HBS Publishing increased to \$98 million in fiscal 2004, from \$93 million last year.
- Endowment distribution and unrestricted current use gifts. The annual distribution from the School's endowment and revenue from current use giving accounted for \$64 million in funding in fiscal 2004, compared with \$61 million last year.

MBA FINANCIAL AID SPENDING



In millions

In fiscal 2004, the School's total revenue increased \$15 million, or 5.1 percent, to \$309 million, from \$294 million in fiscal 2003. While MBA tuition and fees grew in line with underlying inflation in higher education delivery costs, market-driven revenue from Executive Education and HBS Publishing rose faster. Rising distributions of endowment income also contributed to the revenue gains. These increases were made possible by the endowment's strong investment returns, as well as growth in the size of the endowment resulting from alumni giving.

MBA Tuition & Fees

MBA Program tuition and fees increased to \$65 million in fiscal 2004, from \$61 million last year, and represented 21 percent of the School's total revenue.

Although it is not the primary source of revenue, educating MBA students is the School's core activity. HBS has held the size of its MBA classes essentially level at approximately 900 students for the past two years. The fiscal 2004 increase in MBA tuition and fee revenue reflected underlying inflation in program delivery costs, as well as investments in faculty development, campus facilities, and technology. Annual MBA tuition for fiscal 2004 was \$33,650—near the midpoint among the 10 comparable schools tracked by the School—compared with \$31,800 for the prior year.

Executive Education

Revenue from the School's Executive Education programs grew 6 percent in fiscal 2004 to \$71 million, from \$67 million last year, and represented 23 percent of the School's total revenue.

Fiscal 2004 was a strong year for the School's Executive Education operation. Applications rose 6.5 percent from fiscal 2003, and the number of participants enrolled grew 5.4 percent to a record 7,360. The \$71 million in fiscal 2004 revenue matched Executive Education's previous peak, achieved in 2001.

Virtually all of the Executive Education revenue growth this past year was attributable to an increase in custom programs. While revenue from the School's core open-enrollment programs was flat at \$52 million, revenue from custom programs increased by more than 30 percent to \$19

million. This nearly matched the previous record of \$20 million in custom program revenue set in fiscal 2001.

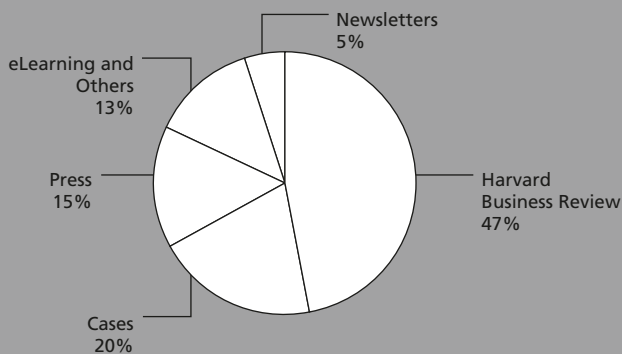
In addition to educating practicing managers from around the world, HBS executive courses enrich faculty development across the School by serving as an on-campus laboratory in which faculty test their current research ideas. Executive Education's growth demonstrates the relevance of the faculty's work, and the practical importance of the ideas generated at HBS.

Publishing

Revenue from publishing operations increased 5.4 percent in fiscal 2004 to a record \$98 million, from \$93 million last year, and represented 31.7 percent of the School's total revenue.

HBS Publishing's growth in fiscal 2004 was driven primarily by HBS Press, which enjoyed success across its product line and included two highly successful new titles during the year. Sales of cases and reprints increased as well. Strong demand for these product lines more than offset continued softness in advertising and circulation revenue from *Harvard Business Review*.

PUBLISHING REVENUES FY 2004



HBS Publishing leverages and expands the reach of the knowledge created by the School's faculty and other thought leaders to global audiences. The publishing unit has worked to enhance its relevance and market share by supplementing its traditional print media offerings with an expanding catalogue of CD/DVD-based and Web-based multimedia materials, as well as conference development.

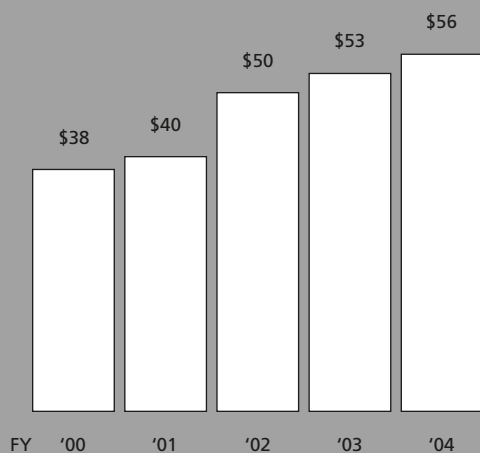
Gifts & Endowment

The annual distribution of income from the School's endowment and revenue from unrestricted current use gifts accounted for \$64 million in funding in fiscal 2004, or 20.7 percent of the School's total revenue. This compares with \$61 million in fiscal 2003, which also represented 20.7 percent of total revenue.

Alumni giving—both unrestricted current use gifts and gifts to the endowment—plays an increasingly important role in supporting the School's operations. The community of HBS alumni and friends extended its record of tremendous generosity in fiscal 2004. Cash from gifts increased by \$6 million, or more than 6 percent, to \$98 million, from \$92 million in fiscal 2003. Overall, The Campaign for Harvard Business School raised more than \$475 million by year-end.

While current use gifts provide critical support for the School's operations, distributions of endowment income represent a larger source of funding. The distribution from the HBS endowment rose 5.7 percent to \$56 million in fiscal 2004, from \$53 million last year, and represented 18.1 percent of the School's revenue. In fiscal 2003, the endowment distribution accounted for 18.0 percent of total revenue.

ENDOWMENT DISTRIBUTION



In millions

After this fiscal 2004 distribution, the School's endowment and current use funds totaled \$1.8 billion at year-end, up nearly \$300 million, or 20 percent, from fiscal 2003. The increase in the market value of the endowment for fiscal 2004 reflects \$60 million in endowment gifts received by HBS during the year, as well as endowment principal appreciation of \$221 million. Total investment return was +21.1 percent in fiscal 2004, net of all expenses. The School's strategy for managing its gifts and endowment is discussed on pages 33-35 of this report.

Expenses

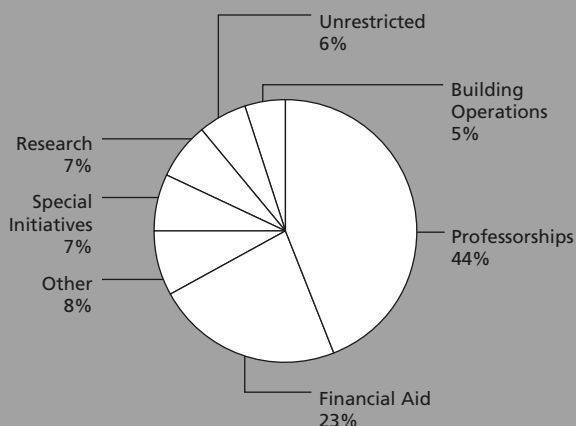
The School's strategic initiatives have expanded its presence as a force in global business, added value to the HBS educational experience, and made this experience financially accessible for a broader range of students. Growth in the resources and research services required to support this expansion has driven significant increases in operating expense. In addition, the higher education sector continues to encounter greater expense inflation than the general economy, as have similar service industries such as health care.

HBS has responded by enhancing operational efficiency, boosting productivity, reducing administrative staff levels, delaying certain projects, and holding a tight rein on campus facilities expenses. As a result, in recent years the School's operating expenses have grown at a substantially slower rate than

the consumer price index for education. For fiscal 2004, despite double-digit increases in benefits expenses and utility rates, the School's total expenses grew by only \$8 million to \$294 million—an increase of 2.8 percent from last year.

As in all people-intensive businesses, employee compensation is the School's largest expenditure, representing 47 percent of total operating expenses in fiscal 2004. Upward pressure on compensation expense was especially intense this past year, as employee health-care and pension benefits costs increased nearly \$3 million, or 14 percent, from fiscal 2003. By leaving vacant positions unfilled and postponing new hires, the School reduced its administrative staff full-time equivalent positions (FTEs) by a total of 49 from last year, partially offsetting the increased benefits expense. Over the past two years, the School's staff level has declined by 100 FTEs, or 9.0 percent.

ENDOWMENT COMPONENTS FY 2004



To support its educational programs and research agenda, for the past several years HBS has been working to gradually expand the faculty. The total number of faculty FTEs can increase or decrease in any given year due to faculty retirements, departures, and normal fluctuations in recruiting activity. The School's faculty FTEs declined to 204 in fiscal 2004, from 207 last year.

With lower staff and faculty FTEs partially offsetting higher benefits costs and modest salary rate increases, employee compensation expenses grew in fiscal 2004 by \$4 million, or 3.0 percent, to \$139 million. This followed an increase of \$5 million, or 3.8 percent, in fiscal 2003.

HBS categorizes the cost of fellowships, or financial aid, as an expense. The School's objective, however, 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 work force with high education loan balances can deter strong candidates from applying to HBS and narrow their career choices upon graduation. This is particularly true for younger students, those from outside the United States, and students whose early career paths have not enabled them to reduce their undergraduate loans.

Over the past three years, generous giving by the School's alumni and friends has enabled HBS to increase fellowship spending at a compound annual rate of 10.9 percent. The School's fellowship spending for fiscal 2004 increased by nearly \$1 million, or 7 percent, from last year, to a record \$15 million. Despite the increase in fellowships, the average MBA loan balance at graduation in fiscal 2004 was \$78,000. The School continues to seek ways to assist MBA students in mitigating this burden.

Publishing and printing expenses include cost of goods sold and operations and marketing expenses incurred by HBS Publishing, along with all costs for the School's publications. While pursuing new market opportunities in recent years, both the School and the publishing unit have streamlined their operations in numerous ways. In fiscal 2004, higher unit volume and page counts at HBS Press increased cost of goods sold. However, improvements in operational efficiency offset this increase, and publishing and printing expenses remained level at \$35 million.

In contrast to many other schools where facilities maintenance and construction are centralized University activities, HBS is responsible for managing its own campus. The HBS campus currently includes 33 buildings encompassing nearly 1.5 million square feet. Space and occupancy costs include expenses related to maintaining and operating these buildings, as well as 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 HBS Publishing's operations.

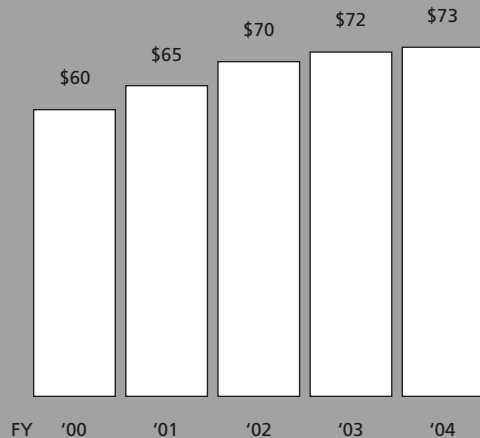
The underlying costs of operating and maintaining the campus have grown faster than inflation in recent years, especially for energy, utilities, and security. The HBS staff has responded by working vigorously to contain operational expenses while responding to new student and faculty initiatives. In addition, reconstruction of Baker Library reduced operating expense for that facility in fiscal 2004. As a result, space and occupancy costs remained level at \$31 million. The School's space and occupancy expenses have risen by only \$2 million since fiscal 2001.

Expenses for supplies and equipment increased by \$1 million in fiscal 2004. The increase was attributable to variable costs related to the higher level of revenue-producing activity in HBS Publishing and Executive Education.

Other expenses, which primarily includes travel, telecommunications, and postage costs, increased by \$2 million in fiscal 2004. This largely reflected the establishment of a reserve of \$2.6 million for amortizing the School's share of costs associated with CitiAssist—its partnership with Citibank established six years ago to enable students to finance an HBS education. Since 1998, this guaranteed financing has made HBS accessible to a wider range of students.

Professional services expenses were flat in fiscal 2004. These costs primarily include payments to faculty who teach custom programs in Executive Education, as well as expenses for outside technology contractors and publication services. Although Executive Education custom program activity increased in fiscal 2004, the resulting increase in professional services expense was offset by further declines in outside services costs.

INVESTMENT IN RESEARCH



In millions

Expenses for University assessments increased to \$10 million in fiscal 2004 from \$9 million last year. These assessments cover essential services provided to HBS by the University, including payroll and benefits administration, accounts receivable and payable processing, and legal services. The assessment is calculated as a percent of the School's total expenses on a two-year lagged basis. The growth, therefore, relates to the growth in the School's overall expense base.

Debt service, which consists of interest payments to the University on building debt, declined to \$4 million in fiscal 2004 from \$5 million last year. The decrease in debt service was largely attributable to a \$25 million debt pay-down that took place near the end of fiscal 2003. The lower level of debt service in fiscal 2004 also reflected a 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 past three years have been favorable for HBS from a cash generation perspective. The School’s investments in research, technology, and campus facilities have increased substantially. Nonetheless, operating revenue growth and tight controls on expenses have combined to produce increases in cash from operations each year. In fiscal 2004, cash from

operations increased by \$7 million, or 87.5 percent, to \$15 million. This represented 4.9 percent of total revenue, compared with 2.7 percent and 2.4 percent in fiscal 2003 and 2002, respectively.

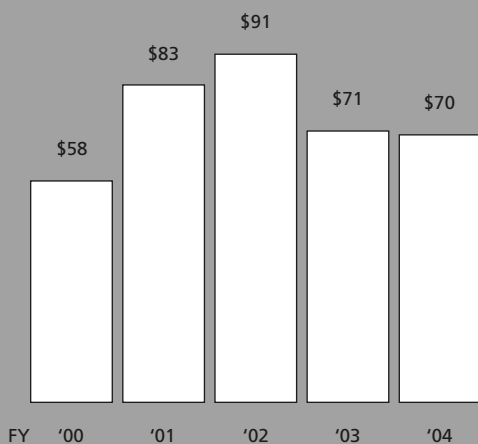
Use of Endowment Gifts or Appreciation

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. HBS used \$13 million of endowment principal and appreciation in fiscal 2004, compared with \$14 million last year.

Cash Available for Capital Activities

It is essential that HBS generate sufficient cash flow to cover capital expenses and any related debt service over the long term. Cash generated before capital activities has increased in each of the past three years, rising from \$20 million to \$22 million to \$28 million in fiscal 2002, 2003, and 2004, respectively. Although cash flow has fallen short of net capital expenses in each of these years, HBS expects that future operations, which include planned reductions in capital spending, together with the School’s reserves, will provide sufficient resources to service its debt and execute on its long-term capital plan.

TOTAL DEBT OUTSTANDING



In millions

Capital Expenses

Capital expenditures for campus facilities construction and renewal increased to \$54 million in fiscal 2004 from \$39 million last year. Similar to last year, the School's large capital projects included the ongoing reconstruction of Baker Library and the renewal of classroom space in Aldrich Hall. HBS also made the second annual payment in a multiyear effort to reimburse the University for space the School will occupy when broadcasting station WGBH vacates its current headquarters in Allston.

The School funded these fiscal 2004 capital expenses with \$28 million in gift payments for specific projects, new borrowings of \$7 million, and internally generated cash. In fiscal 2003, sources of funding for capital expenditures included gift payments for specific capital projects of \$27 million and new borrowings of \$7 million, as well as internally generated cash.

Balance Sheet

The HBS balance sheet reflects a conservative but flexible approach to managing the School's financial resources. Liquid assets, consisting of cash and reserves, totaled \$70 million, \$71 million, and \$78 million at fiscal year-end 2004, 2003, and 2002, respectively. The School's liquid assets covered current liabilities an average of 1.1 times for the period. However, the majority of the School's operating expenses are paid, as incurred, out of current cash flow. The School's balance sheet is moderately leveraged, with a debt-to-asset ratio of only 3 percent as of June 30, 2004.

Debt

HBS borrows only on qualified capital projects, giving careful consideration to 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. Total debt has averaged only 3.7 percent of total assets for the past three years. The interest portion of the School's debt service amounted to 1.4 percent of total operating expenses in fiscal 2004.

Since fiscal 2001, HBS has been executing on a multiyear plan to finance the aggressive program of building renewal and renovation taking place across the campus. As a result, the School's debt level rose to a record \$91 million at the end of fiscal 2002. Since then, continued strength in cash from operations, coupled with successful fundraising, have enabled HBS to reduce its reliance on debt for funding campus renovations. After reaching a peak of \$15 million in fiscal 2002, new borrowings declined to \$7 million in fiscal 2003 and remained at this level in fiscal 2004.

HBS will continue to use debt strategically as a means of optimizing its capital structure. The School is considering an increase in borrowings over the next few years to finance planned residence hall renovations and other major capital projects. The University functions as a banker for HBS, as well as the other Harvard schools, allowing HBS to borrow on a triple-A-rated tax-exempt basis. For operational borrowing, the rate in fiscal 2004 was 5.6 percent.

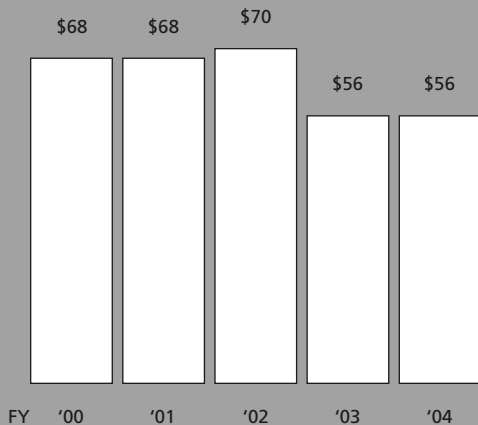
For large capital projects that are in the construction phase, the University offers an attractive short-term borrowing option at rates that mirror the current yield on Treasury bills of comparable maturity. The interest rate on such “construction-in-progress” loans averaged 1.12 percent in fiscal 2004, and substantially all of the School’s new borrowings consisted of this type of debt.

Once the School’s current construction projects have been completed, this debt will be serviced at the University’s prevailing long-term interest rate. In the accompanying balance sheet, building debt has been restated to include construction-in-progress debt.

Endowment and Current Use Funds Value

The market value of the HBS endowment and current use funds grew to \$1.8 billion, or approximately 8 percent of total University endowment assets, as of June 30, 2004, from \$1.5 billion a year earlier. The total return on the endowment was +21.1 percent, net of all expenses, following a +12.5 percent return in fiscal 2003. Harvard Management Company continues to outperform the market. As measured by the Trust Universe Comparison Service (TUCS), a universe of 129 institutional funds with assets greater than \$1 billion, the performance of the University’s endowment in both fiscal 2004 and fiscal 2003 exceeded its benchmark and the median return of other large institutional funds.

UNRESTRICTED RESERVES



In millions

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. The School’s reserves balance remained level at \$56 million in fiscal 2004. In addition, HBS established an unrestricted endowment reserve several years ago. The market value of this reserve was \$29.8 million at June 30, 2004, compared with \$25.8 million a year earlier.

Statement of Activity and Cash Flows*

<i>In millions</i>	<i>For the year ended June 30,</i>		
	2004	2003	2002
Revenues			
MBA Tuition & Fees	\$ 65	\$ 61	\$ 58
Executive Education Tuition	71	67	64
Publishing	98	93	92
Endowment Distribution	56	53	50
Unrestricted Current Use Gifts	8	8	9
Housing Rents & Other	8	8	8
Interest Income	3	4	5
Total Revenues	309	294	286
Expenses			
Salaries & Benefits	\$139	\$135	\$130
Publishing & Printing	35	35	38
Space & Occupancy	31	31	30
Supplies & Equipment	24	23	19
Professional Services	14	14	17
Fellowships	15	14	12
University Assessments	10	9	8
Debt Service	4	5	5
Other Expenses	22	20	20
Total Expenses	294	286	279
Cash from Operations	15	8	7
Use of Endowment Gifts or Appreciation	13	14	13
Cash Before Capital Activities	28	22	20
Capital Expenses	(54)	(39)	(34)
Use of Gifts for Capital Projects	28	27	10
Net Capital Expenses	(26)	(12)	(24)
New Borrowings	7	7	15
Debt Principal Payments	(8)	(33)	(7)
Other Activity	(1)	2	(2)
Net Debt & Other	(2)	(24)	6
Change in Unrestricted Reserves	–	(14)	2
Unrestricted Reserves, Beginning Balance	56	70	68
Unrestricted Reserves, Ending Balance	\$ 56	\$ 56	\$ 70

* This Statement of Activity and Cash Flows presents a managerial view of HBS 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 \$8 million in fiscal 2004. Cash flows, however, would be equivalent under GAAP.

Consolidated Balance Sheet

In millions

For the year ended June 30,

	2004	2003
Assets		
Cash	\$ 14	\$ 15
Unrestricted Reserves	56	56
Receivables, Loans, & Other Assets	195	173
Invested Funds:		
Endowment Investments	1,603	1,331
Current Fund Investments	43	45
Interest in Trusts Held by Others	120	109
Facilities, Net of Accumulated Depreciation	336	309
Total Assets	\$2,367	\$2,038
Liabilities		
Deposits, Advances, & Other	\$ 30	\$ 21
Deferred Revenue	32	34
Building Debt	70	71
Total Liabilities	132	126
Assets Net of Liabilities	\$2,235	\$1,912
Composition of Net Assets:		
Unrestricted Reserves	\$ 56	\$ 56
Undistributed Income	14	19
Pledge Balances	122	97
Student Loan Funds	11	17
Investment in Facilities	266	238
Endowment & Current Use Funds	1,766	1,485
Total Assets Net of Liabilities	\$2,235	\$1,912

Harvard Business School



This document is intended to provide transparent insight into the way Harvard Business School accumulates its resources, uses those resources, and plans strategically for its future. Further information about the School can be found at www.hbs.edu.

Data in this report can be viewed and downloaded at www.hbs.edu/about/financial.html.

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:

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