HARVARD | BUSINESS | SCHOOL

Annual Report

2007

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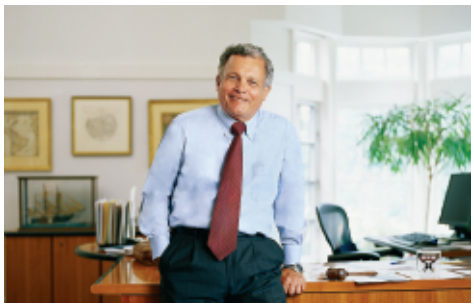
On the threshold of a second century of inventing—and reinventing—business education and the practice of management.



From the Dean

Harvard Business School begins its second century in 2008. This is an exciting time for all of us—an occasion not only to celebrate our legacy of innovation and achievement, but also to develop a vision that will guide the School's next hundred years. As we look to the future, it is clear we must find new ways to support our unique culture and community while building on the strengths that have made us distinctive for so long: remarkable faculty members who are dedicated teachers and outstanding researchers, engaged students who share a passion to make a difference in the world, and a residential campus that fosters learning and the exchange of ideas.

This is an era of change not only for HBS, but for Harvard as a whole. During 2007, Harvard inaugurated its 28th president, Drew Gilpin Faust, who has emphasized the importance of collaboration across the University's schools and faculties. Planning for Harvard's development of Allston is proceeding briskly, and we are determining how best to take advantage of the potential this unprecedented growth offers.

These changes represent an open invitation to share and extend knowledge. The exchange of ideas is more important than ever because of the complexity of the issues we study. A host of teaching and research collaborations strengthens the connection of our faculty and students to Harvard's full intellectual riches, and these ties will grow even closer as academic calendars are coordinated across the University.

As the pace of planning for Allston accelerates, HBS is working closely with Harvard's Allston Development Group. We have also recently completed our own campus planning effort, which is preparing us to extend our residential learning environment for the future. As always, we take the responsibilities of managing our operations and stewarding our resources very seriously.

As businesses cross geographic boundaries, and our students and faculty become more international, we need to build on our previous efforts and seek new ways to teach students how to lead in a globalized world. We have made significant progress in the classroom, and our regional research centers have helped enrich the global content of the curriculum. In addition, members of the MBA Class of 2009 come from nearly 70 countries, bringing a diversity of perspectives that has a profound influence on learning.

We are marking our centennial with a series of events grounded in the work of our faculty, rooted in the spirit of our classroom—whether in person or virtual—and based on our commitment to ideas with power in practice. We invite you to explore these events on our website and to participate in the Global Business Summit in October 2008. We look forward to keeping you informed about progress at the School during the coming year.

Sincerely,

Jay O. Light

Jay O. Light
Dean of the Faculty

Our History

1908 / At the request of President Charles W. Eliot, the Corporation of Harvard University voted to establish a school of business administration.

1908 / Edwin F. Gay was appointed the first dean, and HBS opened its doors on October 1 with a course of study, faculty of 15, 33 regular students, and 47 special students.

1911 / The "problem" method, the predecessor to the case method, was introduced to the classroom as businessmen were invited to present real problems to students.

1915 / A course titled "Social Factors in Business Enterprise" was added to the elective curriculum in the MBA Program, marking the beginning of the School's long history of incorporating issues surrounding business ethics into its research and teaching.

1922 / The *Harvard Business Review* was founded.

1924 / George Fisher Baker, president of the First National Bank of New York, donated $5 million to build a campus for the Business School on the Boston side of the Charles River.

1945 / A group of 60 executives and recently demobilized veterans enrolled in the School's first Executive Education program, named the Advanced Management Program, which was a continuation of a wartime retraining course launched in 1943.

1959 / Women graduates of the Harvard-Radcliffe Program in Business Administration were admitted to the second year of the MBA Program. These women earned their MBA degrees in 1960.

1973 / The International Senior Managers Program was initiated in Switzerland — the School's first program held outside the United States.

1993 / The Social Enterprise Initiative was established to generate and share knowledge that helps individuals and organizations create social value in the nonprofit, private, and public sectors.

1993 / HBS Publishing (HBSP) was formed.

1997 / The California Research Center opened in Silicon Valley; other regional research centers were opened in the Asia-Pacific region (1999), Latin America (2000), Japan (2002), Europe (2003), and India (2006).

2003 / The Arthur Rock Center for Entrepreneurship was established to support faculty, research, and course development in entrepreneurial studies at HBS.

2004 / The C. Roland Christensen Center for Teaching and Learning was established to promote and support teaching excellence and innovation within HBS and to provide leadership and expertise about case method teaching and participant-centered learning for instructors worldwide.

2005 / The Healthcare Initiative was launched as a multidisciplinary program dedicated to innovative thinking in the healthcare industry.

For nearly 100 years, Harvard Business School has been a leader in management education and in the creation of new knowledge about business. Driven by continuous innovation, this leadership integrates the latest technologies, advances in science, insights into society, and global perspectives—while remaining close to the practice of management.

"More than any course, the China Immersion gave the students a deeper sense of how the center of gravity in the world economy has moved to Asia, and specifically to China. By meeting with businesspeople, they saw firsthand how great the opportunities are, how focused the Chinese are on growth, and how rapdily the economy is developing. They also recognized the entry barriers in terms of language and culture. Having a structured intellectual component with faculty sharpened the focus and increased the value of the experience. This is a model we will expand in 2008 as we return to China and sponsor new Immersion programs in India, the Middle East, and Europe."

Professor Richard H.K. Vietor

The state maintains an enduring role in business. Families exert great influence, no matter what the organization chart says. Companies provide critical social support for employees. Welcome to doing business in China. These are among the realities that some 70 MBA students and three faculty members experienced firsthand in the China Immersion during January 2007. The School piloted three Immersion programs during the 2007 winter break, each combining elements of traditional student treks with faculty leadership and a structured academic experience.

Immersion programs enable MBA students to test new waters.

"Although I had heard so much about the explosive growth of the Chinese economy, I had to see the transformation for myself in order to truly understand it. Simply driving into Shanghai from the airport demonstrated the extent of their infrastructure. For me, the most valuable aspects of the immersion were the participation of the faculty, who provided so much context about the way business has developed in China, and the group experience of traveling and learning with other HBS students. As one of the three leaders of the Middle East Immersion planned for 2008, I'm using my experience in China as a model."

Firas Alkhatib
MBA '08

China Immersion 2007 Itinerary

- 6 cities in 11 days: Beijing, Hangzhou, Shanghai, Sanya, Shenzhen, and Hong Kong
- Academic and media panel presentations
- Visits to companies and interviews with executives
- Industries represented: auto parts, soft drinks, microchips, semiconductors, and petroleum
- A visit to the Beijing Olympic Games committee
- Networking with local HBS alumni
- Cultural tours and social events

Healthcare Focus at HBS

The Health Science and Business Immersion is a key learning resource for HBS students, whose interest in healthcare runs high:

- Nearly 10 percent of the MBA Class of 2005 have pursued jobs in healthcare fields, including biopharmaceuticals; healthcare delivery; and venture capital, private equity, or consulting.
- In the MBA Class of 2008, 100 students have indicated interest in a healthcare career.
- The MBA Healthcare Club is the second largest on campus, with 200 members.
- Over the past five years, 25 percent of the finalists in the HBS Business Plan Contest have been related to healthcare, and four have been healthcare winners.

"We were very fortunate to be able to draw on the University's resources and talent in designing the Immersion program. So when it came time to learn about cardiovascular disorders, for example, first we had a faculty member from Harvard Medical School outline the anatomy and physiology of the cardiovascular system and coronary disease. Then, two specialists from Brigham and Women's Hospital discussed the management of arrhythmias and treating and managing heart failure. To cap off the day, a venture capitalist spoke about a medical device company that had introduced new technology designed to deliver three-dimensional catheter control. It was an incredible experience."
Professor Richard Hamermesh

Close to Home

More than 55 first- and second-year MBA students—as well as HBS faculty and staff members—spent five days during January 2007 in one of the world's greatest medical centers, located in HBS's backyard. The Health Science and Business Immersion drew on the talents and expertise of Boston's renowned community of physicians and biomedical researchers representing major teaching hospitals, biomedical companies, and investment firms, to give MBA students a firm grounding in the intersection of science and business. The students tried their hands at surgical simulations, observed a virtual chemistry visualization, and debated ethical issues during the intensive weeklong program.

Leveraging Faculty Expertise and Enhancing the Curriculum

Richard Hamermesh, Richard Bohmer, Amy Edmondson, Regina Herzlinger, and Robert Huckman—faculty who bring a wide range of perspectives to understanding the challenges of modern healthcare—spearheaded the initial Health Science and Business Immersion. The program aimed to help students understand the focus of the major medical specialties and the companies and products emerging from each, as well as the macro trends affecting healthcare treatments and procedures. In the future, Immersion programs may be connected more closely to the curriculum, with students taking elective courses before or after the experience, or participating in selected field studies.

Joint-Degree Program Facts

- Approved in Spring 2007 to replace the concurrent degree program, the three-year program will admit the first students in Fall 2008.
- The program offers two degree options: Master in Business Administration/Master in Public Policy (MBA/MPP) and Master in Business Administration/Master in Public Administration – International Development (MBA/MPA – ID).
- Students must be admitted independently to both schools.
- The curriculum will be fully integrated and enriched with specialized research and case development.
- During their first summer in the program, students are expected to pursue internships based in public service or public policy, and to have a similar experience in the private, for-profit sector the following summer.

Global climate change. Hurricanes and tsunamis. Disintegrating infrastructure. Look no further than these recent headlines to see why HBS and Harvard University's Kennedy School of Government are inaugurating a fully integrated joint-degree program in business and government. Many of society's most complex and critical challenges do not fit neatly into sectors—they require collaboration among business, government, and nonprofit organizations. Harvard is uniquely equipped to frame the distinctive issues at this intersection and to prepare the business and public policy leaders who can resolve them.

Society's greatest challenges cross many borders. So should the solutions.

"These new joint degrees will prepare leaders who can advance solution building at the intersection of business, government, and NGOs. Today's most intractable issues cross these sector boundaries, and we are committed to producing a cadre of leaders who can reach across them respectfully and effectively. Think about all-eviating poverty, conquering diseases, rebuilding war-ravaged cities—and then imagine what the graduates of this program will be able to accomplish."
Professor Dutch Leonard

"We have the great advantage of access to scientists and social scientists across the University who can help us understand the environmental, economic, and social context of the business problems we study. This broad understanding informs our research and enables us to expand the scope of course development and put our students in touch with experts for field studies. Ultimately, it contributes to the way companies view opportunities and set strategy. Perhaps the best example is the attempt to put carbon emissions into a market framework—something that companies traditionally did not have to consider because the global atmosphere was 'free.'"
Professor Forest L. Reinhardt

"Learning to live and think within the context of the whole University."

This ideal is stated in the words of Drew Gilpin Faust, named Harvard's 28th president in February 2007, who is encouraging increased collaboration among the Schools and disciplines. In addition to the current joint-degree offerings—including the new programs with the Kennedy School, a longstanding four-year JD/MBA Program with the Harvard Law School, and an integrated five-year MD/MBA Program with the Harvard Medical School—HBS faculty for many years have partnered with colleagues around the University on topics ranging from energy and the environment to public education. Additionally, as Harvard moves to a coordinated academic calendar, opportunities to teach elsewhere within the University, and to engage faculty from other areas of the University in HBS's MBA, Doctoral, and Executive Education programs, will increase.

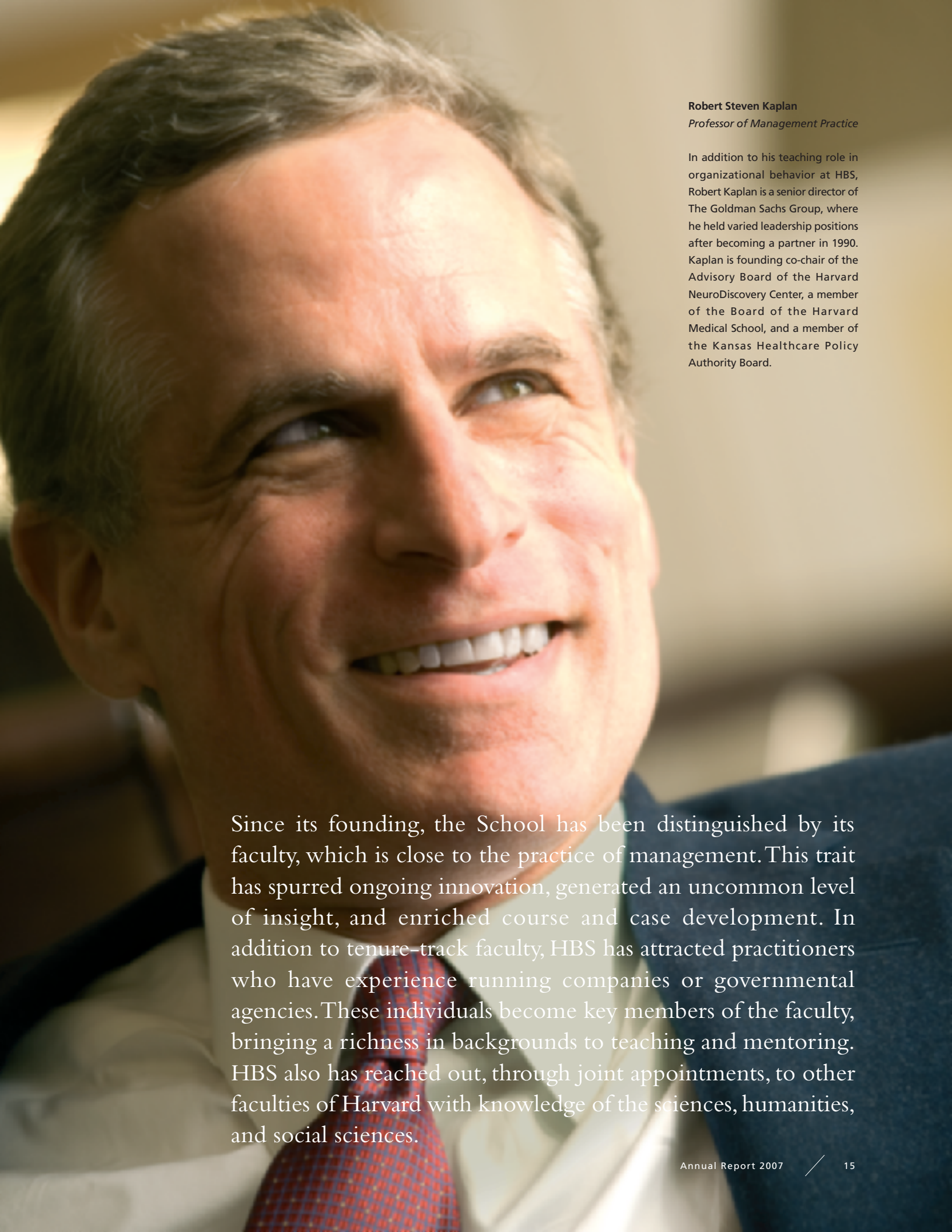
Focus on the Environment

With the environment on center stage, HBS is using its intellectual resources to address issues concerning the natural world in collaboration with other schools and entities within the University. Professor Forest L. Reinhardt, author of *Down to Earth: Applying Business Principles to Environmental Management*, has developed the half-courses—"Business and the Environment" and "Energy"—that are offered to participants in the Kennedy School's Corporate Social Responsibility Initiative as well as to MBA Program students. Reinhardt is also involved in the Harvard University Center for the Environment, which brings together scholars from varied disciplines to focus on research and education on the environment.

HBS faculty members are close to practice in diverse roles and contexts.

William C. Kirby
Professor

A world-renowned historian of modern Chinese economic and political development in an international context, William C. Kirby, Ph.D., is the Geisinger Professor of History, a Harvard University Distinguished Service Professor, and the director of the Fairbank Center for East Asian Research. He joined the HBS faculty in fall 2006 and worked with Warren McFarlan to develop a new course in the MBA elective curriculum, "Doing Business in China in the Early 21st Century."



Robert Steven Kaplan
Professor of Management Practice

In addition to his teaching role in organizational behavior at HBS, Robert Kaplan is a senior director of The Goldman Sachs Group, where he held varied leadership positions after becoming a partner in 1990. Kaplan is founding co-chair of the Advisory Board of the Harvard NeuroDiscovery Center, a member of the Board of the Harvard Medical School, and a member of the Kansas Healthcare Policy Authority Board.

Since its founding, the School has been distinguished by its faculty, which is close to the practice of management. This trait has spurred ongoing innovation, generated an uncommon level of insight, and enriched course and case development. In addition to tenure-track faculty, HBS has attracted practitioners who have experience running companies or governmental agencies. These individuals become key members of the faculty, bringing a richness in backgrounds to teaching and mentoring. HBS also has reached out, through joint appointments, to other faculties of Harvard with knowledge of the sciences, humanities, and social sciences.

Vicki L. Sato
Professor of Management Practice

A scientist and biotechnology business leader, Vicki L. Sato, Ph.D., is an advisor to enterprises in the biotechnology and pharmaceutical industries. She recently retired from Vertex Pharmaceuticals, where she served as president for seven years after holding other key positions within the company. She was formerly vice president of research at Biogen, Inc., and associate professor of biology at Harvard University. In addition to her role at HBS, she currently holds a similar appointment in Harvard's Department of Molecular and Cell Biology. Sato is co-teaching "Inventing Breakthroughs and Commercializing Science" in the MBA elective curriculum.

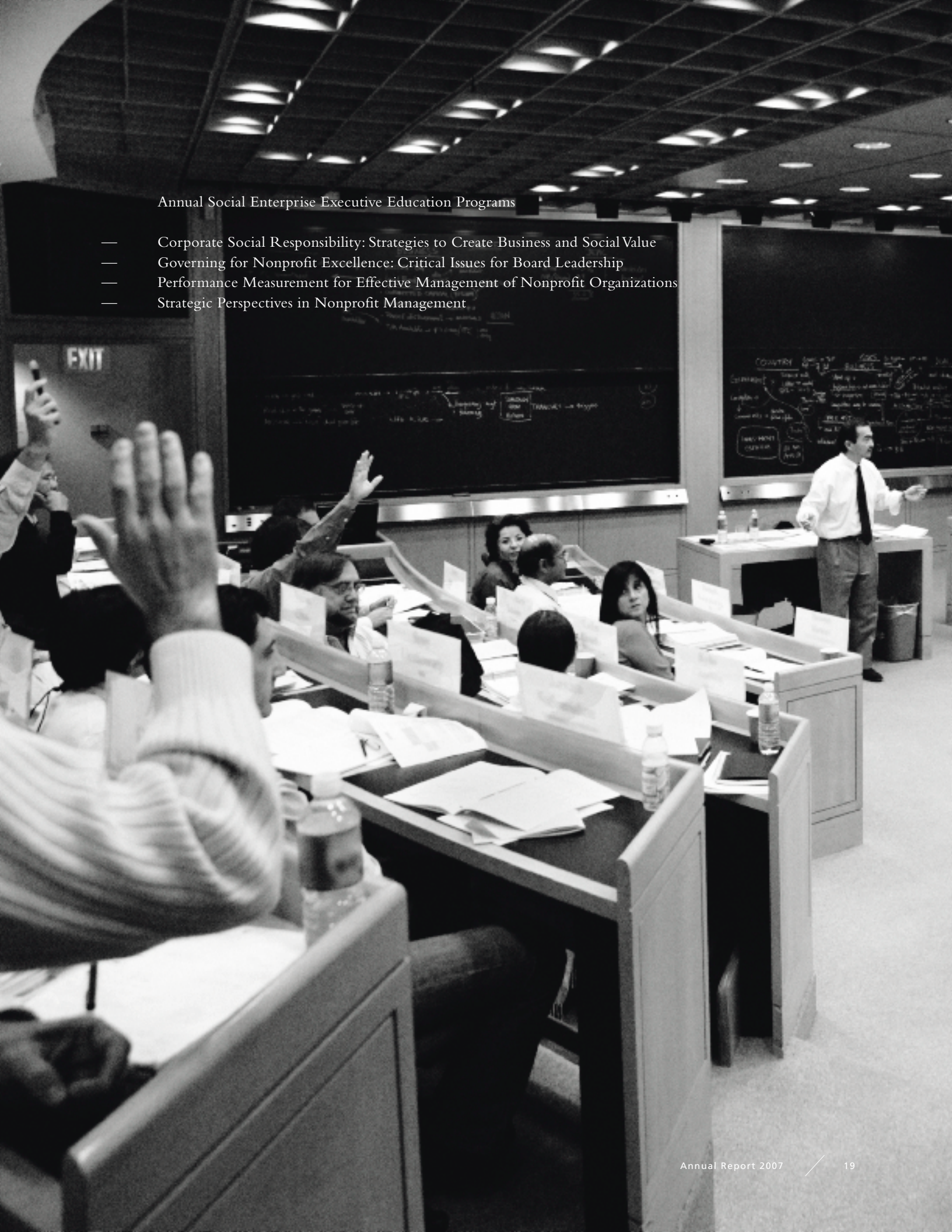
Clayton S. Rose
Senior Lecturer

Clayton Rose joined HBS after a 20-year career at JPMorgan Chase & Co., where he headed the Global Investment Banking and Global Equities divisions. In 2007, Rose completed a Ph.D. in sociology at the University of Pennsylvania. His dissertation examined how companies manage the racial composition of their boards and senior management teams. He also chairs Highbridge Capital Management, a $32 billion hedge fund, and has served as a director of financial services and life sciences companies.

HBS and the leading microfinance organization ACCION International collaborated on an Executive Education custom program for leaders of organizations that make small loans to poor entrepreneurs, primarily those in the developing world. The HBS – ACCION Program on Strategic Leadership for Microfinance is the first of its kind to provide high-level management and industry training to chief executive officers, executives, and key sector protagonists in this increasingly important industry. In April 2007, the program welcomed its second cohort of nearly 70 people from around the world.

Microfinance takes a leading role on the world stage—and in an Executive Education program.

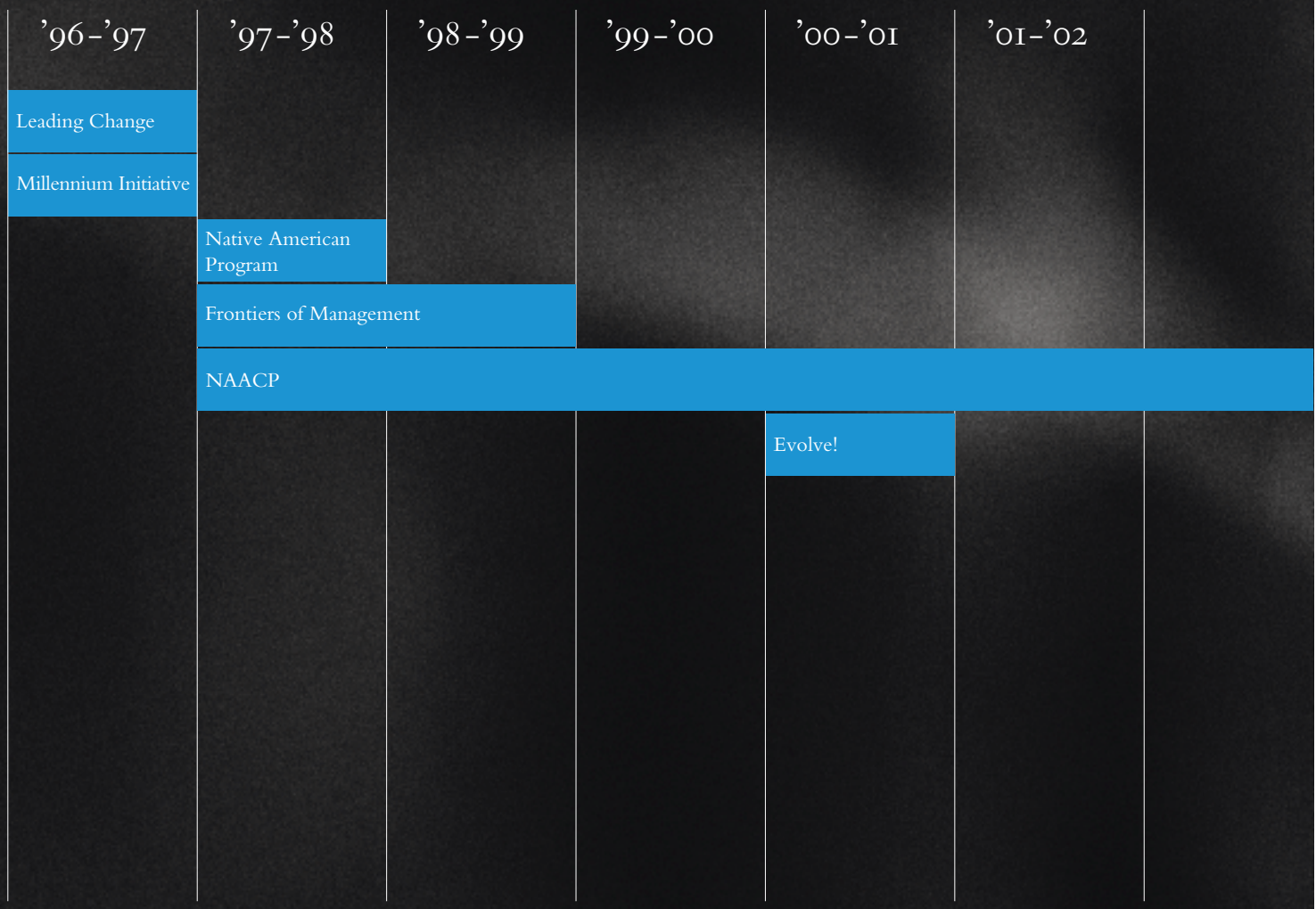
"Success in the last decade has been driven by the ability of microfinance institutions to manage operations well—tapping into capital markets and then deploying that capital in very large numbers of small transactions. In the next decade, these institutions will go from managing operations to leading strategically under conditions of very rapid change."
Senior Lecturer Michael Chu



Annual Social Enterprise Executive Education Programs

- Corporate Social Responsibility: Strategies to Create Business and Social Value
- Governing for Nonprofit Excellence: Critical Issues for Board Leadership
- Performance Measurement for Effective Management of Nonprofit Organizations
- Strategic Perspectives in Nonprofit Management

"The nonprofit sector is large and fragmented, and is served by few consulting organizations or intermediaries. The result is a critical knowledge gap. At Harvard Business School we are addressing this challenge through a new model, working with partners to develop and share knowledge."
Professor Kash Rangan



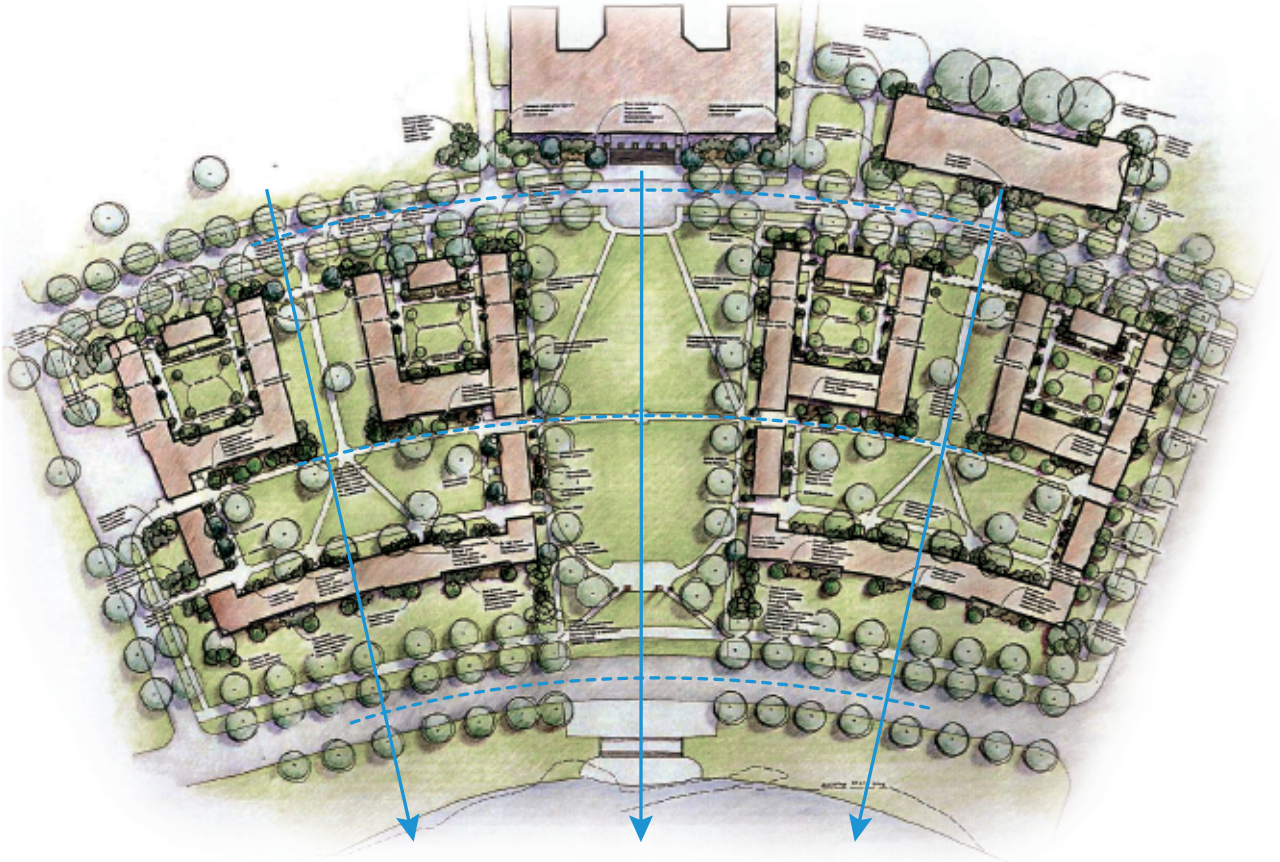
Social Enterprise in Executive Education

From the inception of the Social Enterprise Initiative, the faculty has placed a priority on engaging with leaders in the nonprofit sector. In fact, the initial offering in the Executive Education Social Enterprise portfolio has been taught since 1993.

'02–'03
'03–'04
'04–'05
'05–'06
'06–'07

Through strategic planning for the future, HBS sustains its unique environment.

From the beginning, the learning experience at HBS has been shaped by the residential character of the School. The campus has been designed to help students interact freely, learn from one another, and meet with faculty. To ensure and enhance the sense of community, HBS has created a campus-planning process together with a model of stewardship that consistently guides development, even as new innovations are introduced and the external environment changes. Today, the School incorporates overall environmental sustainability into its decision making. The HBS sustainability initiative has generated substantial change and cost savings by concentrating on four critical areas: energy conservation, waste reduction, best practices, and behavioral change.



1926

The original McKim, Mead & White plan established the overall design principles that continue to make the HBS campus distinctive today: an orientation toward the Charles River, an axial alignment of buildings, and a focus on open space as well as on buildings. This plan called for "outdoor rooms" for events and ceremonial occasions as well as to provide opportunities for interaction in daily life. HBS continues this tradition by maintaining open spaces, creating new ones, and emphasizing a walking rather than a vehicular environment.

To a remarkable extent, today's HBS campus reflects the original 1926 plan by McKim, Mead & White, despite the School's growth and adoption of cutting-edge technologies. Building on that strong initial planning effort, HBS inaugurated a cycle of 10-year master plans in 1986, 1996, and 2006. The latest effort, undertaken in the context of Harvard University's planning for its expansion in Allston, emphasizes the School's commitment to the ongoing stewardship of its physical resources.

The majority of the campus was built in one ambitious effort beginning in 1926. In recognition of the School's intent to provide a cohesive academic experience for students, the original plan specified a gymnasium and a nondenominational chapel. These buildings were not actually realized until after the 1986 plan, when Shad Hall and the Class of 1959 Chapel were constructed.

1986

The 1986 plan returned the campus to its original pedestrian orientation by limiting vehicular traffic in the interior and creating a formal entry with expanded parking on the Western Avenue edge. This effort also produced the current athletic facility and chapel, brought faculty offices together in the vicinity of Baker Library and Morgan Hall, and increased housing for Executive Education.

1996

In 1996, a new planning effort defined the need for a student hub, resulting in Spangler Center. The plan also called for completing Executive Education housing, the renovation and expansion of Baker Library, and the renovation of the residence halls—all either finished or nearly so in 2007.

Sustainable Campus Initiative

Formally launched in May 2005, this initiative has had a major impact:

- HBS has completed more than 25 energy conservation projects, resulting in annual savings of more than $550,000. These projects include a smart lawn sprinkler that monitors weather and operates only when water is needed and a cogeneration plant in Shad Hall that produces on-site electricity and uses the waste heat from the engine to produce hot water. The estimated savings from each of these two examples is over $50,000 per year.
- By maximizing utility rebates, HBS has saved more than $640,000 in utility costs annually.
- Conservation efforts resulted in offsetting of more than 5 million pounds of carbon dioxide emissions annually.
- In fiscal 2007, 54 percent of the School's daily-use waste was recycled, against a Harvard-wide goal of 50 percent and up 16 percent from fiscal 2005.
- Leadership in Energy and Environmental Design (LEED) certification is being pursued for five recently renovated buildings.

2006

The most recent plan focuses on enhancing communication and social interaction through the creation of green space flowing east-west between the original and new sections of the campus. Along Western Avenue, the plan moves parking underground to create room for growth—including a formal entrance from the south and new buildings to house faculty and staff, as well as additional classrooms and smaller breakout spaces.

"Important elements of our strategy and competitive advantage are based on location, so a robust campus-planning process is essential to our future. The most recent plan features functional elements that fulfill our responsibility. This plan creates a new 'heart' for the campus, describes a formal entrance, gives us flexibility by utilizing underground space, and addresses our near- and mid-term needs. Ultimately, it will help us articulate our relationship to the University and to the Allston neighborhood."
Professor Peter Tufano

Harvard Business School is dedicated to excellence in operational management and resource stewardship.The School's financial strategy is designed to provide the capacity for innovation as well as the pursuit of enduring goals. Both are crucial to the teaching, learning, and knowledge creation that enable the School to make a difference in the world.

Five-Year Financial Data Summary

In millions

For the fiscal year (FY) ended June 30,	2003	2004	2005	2006	2007
Revenues	$ 294	$ 309	$ 331	$ 368	$ 405
Expenses	286	294	307	345	375
Cash from Operations	8	15	24	23	30
Capital Investments	39	54	79	49	20
Building Debt Outstanding	71	70	74	108	108
Unrestricted Reserves	56	56	52	60	65
Endowment	1,485	1,766	2,065	2,340	2,821
Total Assets	2,038	2,367	2,693	3,018	3,500

Key Facts

	2003	2004	2005	2006	2007
MBA Program					
Applications	8,540	7,139	6,559	6,716	7,438
Percent Admitted	12%	15%	16%	15%	14%
Yield	90%	87%	89%	91%	89%
Enrollment	1,800	1,800	1,794	1,822	1,806
Tuition	$31,800	$33,650	$35,600	$37,500	$39,600
Average Fellowship Aid per Student	$10,472	$11,543	$13,299	$15,647	$ 17,605
Doctoral Programs					
Applications	821	744	587	611	694
Percent Admitted	3%	4%	4%	5%	5%
Yield	74%	70%	80%	64%	57%
Enrollment	91	98	98	101	103
Executive Education					
Enrollment	6,982	7,360	8,133	8,239	9,281
Faculty					
Faculty Positions (full-time equivalents)	207	204	201	215	206
Teaching Materials Produced	653	588	561	606	602
Research Articles Published	119	127	103	130	145
Books Published	24	23	36	31	24
Staff					
Staff Positions (full-time equivalents)	1,066	1,017	1,044	1,077	1,109
Publishing					
Cases Sold	6,663,000	6,999,000	6,958,000	7,428,000	7,785,000
HBS Press Books Sold	771,000	1,180,000	1,272,000	1,409,000	1,882,000
HBR Circulation	247,000	240,000	240,000	243,000	248,000
HBR Reprints Sold	2,908,000	2,910,000	2,929,000	3,112,000	3,061,000
Campus					
Buildings	33	33	33	33	33
Square Feet	1,476,041	1,476,041	1,512,753	1,512,753	1,512,753

Financial Highlights

Total Revenues

Total revenues increased by $37 million, or 10.1 percent, from last year to $405 million. Total revenues have grown at a compound annual growth rate of 7.2 percent for the past five years.

MBA Program Revenues

MBA Program revenues grew by $4 million, or 5.5 percent, to $77 million due to normal increases in tuition and fees, and increased enrollment in prematriculation programs and new activity in Immersion programs.

Executive Education and HBS Publishing Revenues

Revenues from Executive Education and HBS Publishing (HBSP) increased by a combined $19 million, or 9.5 percent, to $219 million. Executive Education saw strong returns on a recent investment in corporate relations and marketing, and successfully transitioned part of its Comprehensive Leadership Programs portfolio to new modular programs. HBSP completed a reorganization from a product-oriented organization to a market-oriented organization. HBSP revenue growth was led by $4 million of increased press activity and strong performance across all products and customer segments.

Endowment Income

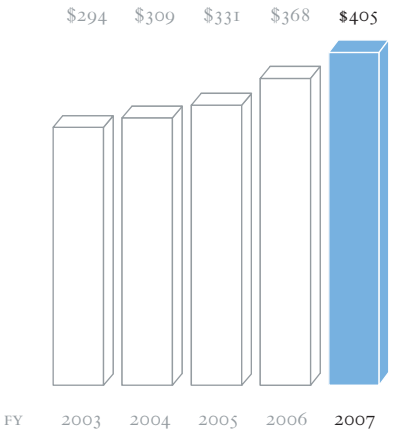
Endowment income distributed for operations rose by $7 million, or 9.9 percent, the result of higher-than-usual increases in the endowment payout related to superior performance by the Harvard Management Company. The increased distribution was used primarily to fund financial aid awards and faculty research.

Operating Expenses

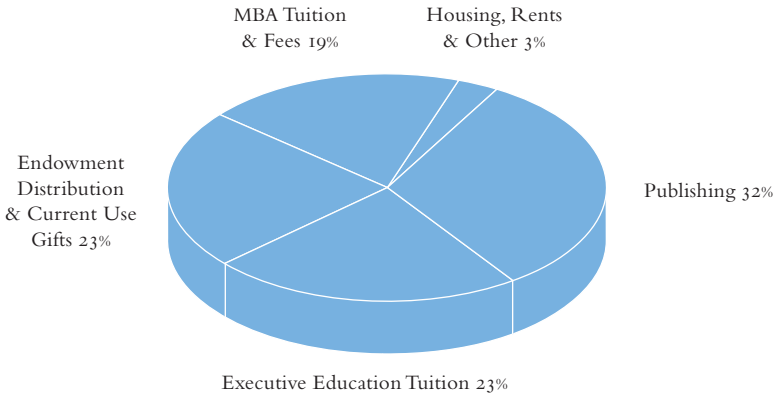
Operating expenses increased by $30 million, or 8.7 percent, to $375 million, largely reflecting an increase in variable costs due to increased activity in Executive Education and HBSP, as well as a 15.8 percent increase in total fellowship support.

Cash from Operations

Cash from operations increased by $7 million to $30 million. Gifts from prior years, available to be spent pursuant to the donors' specifications, added $14 million to the School's cash flow, level with the prior year. Cash before capital activities thus increased by $7 million, from $37 million to $44 million.



Revenue
(Dollars in millions)



Revenue Components, FY 2007

Capital Expenses

Capital expenses for construction and renewal of campus facilities decreased by $29 million to $20 million. The primary capital costs were renewal projects for the McCollum classrooms and Wyss House, the large Aldrich classroom, and upgrades to the Technology Operations Center and HVAC systems. Additional funding came from gift accounts for specific capital projects amounting to $3 million, as well as $7 million in new borrowings. The new debt primarily reflects debt funding for the McCollum and Aldrich work. The comparable fiscal 2006 amounts were $12 million and $38 million, respectively.

Debt

Building debt outstanding at June 30, 2007, was level at $108 million, as new debt of $7 million was offset by $7 million of principal repayments.

Reserves

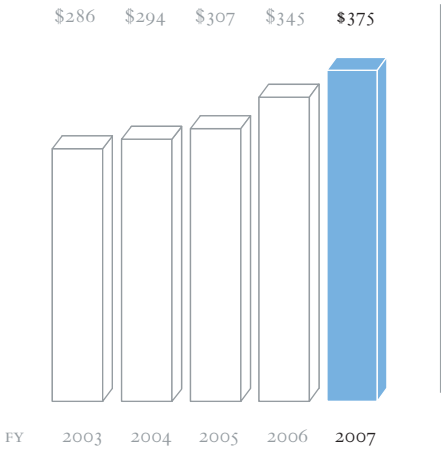
Unrestricted reserves increased $5 million to $65 million at the end of fiscal 2007. In addition, HBS maintains endowment reserves, with a June 30, 2007, end-of-year value of approximately $94 million, including a $25 million transfer performed in fiscal 2007 (related to the $22 million in "Other Activity").

Endowment

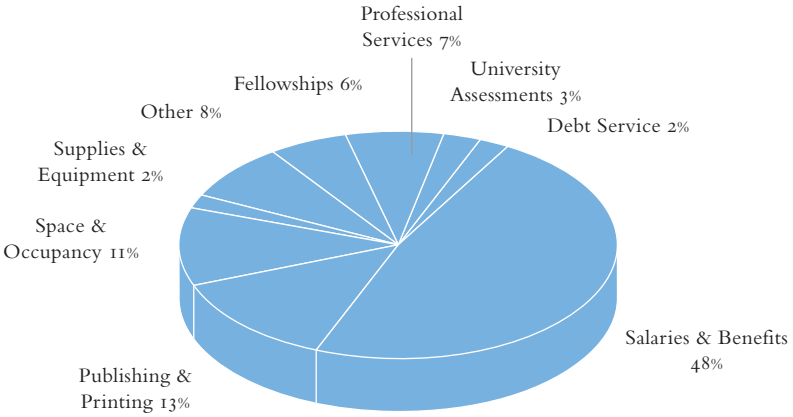
The market value of the HBS endowment and current use funds increased by nearly 21 percent to $2.8 billion at June 30, 2007, from $2.3 billion a year earlier, reflecting both strong returns and new endowment gifts. Total return on the endowment for fiscal 2007 was +23 percent.

Gifts

Alumni and friends continued to be generous in fiscal 2007. As the School's capital campaign came to a close, cash from gifts decreased to $56 million from the campaign's peak of $123 million in fiscal 2005, but increased by $10 million over the pre-campaign total of $46 million in fiscal 2000. This generosity remained vital in fiscal 2007, as current use gifts and endowment distribution together generated 23 percent of the School's revenues, up from 22 percent last year. Approximately 30 percent of the School's MBA alumni made a gift to the School in fiscal 2007.



Expenses
(Dollars in millions)



Expense Components, FY 2007

From the Chief Financial Officer

Driven by continued growth in the global economy and strong demand for management education and research, fiscal 2007 proved to be an excellent financial and operational year for Harvard Business School (HBS).

Consolidated revenue increased by $37 million, or 10.1 percent, from $368 million in fiscal 2006 to $405 million. The School's revenue has risen at a compound annual rate of 7.2 percent for the past five years, and fiscal 2007 was the second year in a row of double-digit revenue growth.

Executive Education and Harvard Business School Publishing (HBSP) together generated $19 million of the top-line growth this year. Publishing revenue grew by $9 million, driven by increased circulation and foreign-edition royalties at *Harvard Business Review*; higher sales of cases, teaching materials, and HBS Press books; and continued expansion in HBSP's eLearning business. Executive Education revenue was up by $10 million, reflecting positive market response to programs introduced during the year.

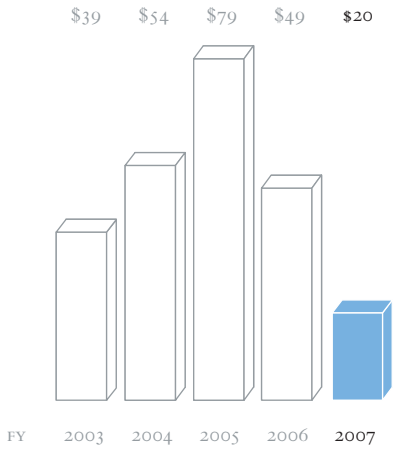
About $7 million of this year's revenue growth came from increased distributions from the HBS endowment, which continued its record of strong investment returns. For the first time in the School's history, endowment distributions exceeded MBA Program income.

An extraordinary increase in unrestricted giving accounted for $5 million in additional revenue in fiscal 2007. Unrestricted current use gifts are the School's major source of funds for strategic innovation. Over the past two years, unrestricted current use giving has more than doubled.

Of the remaining $6 million in incremental revenue that HBS realized in fiscal 2007, the planned 5.6 percent increase in MBA tuition and fees provided $4 million. The other $2 million was generated by growth in interest income.

Total operating expenses grew by $30 million, or 8.7 percent, in fiscal 2007 to $375 million from $345 million in fiscal 2006. As in the prior year, the increase in total expenses was primarily driven by spending designed to strengthen product portfolios and marketing capabilities in Executive Education and HBSP. Growth in faculty compensation and fellowships also contributed to the increase in operating expenses.

Faculty
(Full-time equivalents)



Capital Investment
(Dollars in millions)

We continued our tight control over spending in non-revenue-generating functions in fiscal 2007. As a result, we again were successful in countering the impact of inflation on many of the School's fixed costs, and cash from operations rose by $7 million year-over-year to $30 million. This increase resulted from a combination of expense control and the larger endowment distribution and income from unrestricted current use gifts.

A five-year period of intensive construction activity on the HBS campus peaked in fiscal 2005, when capital expenses reached $79 million. Fiscal 2007 was a year of relatively modest construction activity, as we focused on developing the comprehensive campus plan that will serve as the framework for the School's future capital investments. As a result, capital expenses declined from $49 million in fiscal 2006 to $20 million this year.

The decline in major building renewal activity meant that more than 50 percent of fiscal 2007 capital spending was directed toward the School's long-term program of baseline facilities maintenance. In addition to the usual multitude of small maintenance projects, we began upgrading the Technology Operations Center, and modernized HVAC systems in many of the School's buildings. These projects were financed by accessing reserves.

Thanks to continued strength in cash from operations, the School's reserves balance at the end of fiscal 2007 increased by $5 million from last year to $65 million. This is comfortably within our long-term optimal range, and at a level that should enable HBS to continue innovating academically, investing in strategic opportunities, and maintaining the physical integrity of the campus.

A Look Ahead

The School's fiscal 2007 strategic investments position us for continued operational and financial strength in the year ahead. Although the economic outlook is not as uniformly positive as it was 12 months ago, we have yet to see signs of slowing demand for our programs and products.

HBS operates on a unique business model, which is described more fully in the following pages of this report. It starts with a faculty close to practice. The faculty's research brings them into contact with managers and leaders of organizations around the world. HBSP and Executive Education transform the resulting ideas into new products and programs. The income generated by this business activity is used to fund the faculty's research, thus completing the cycle and allowing it to begin anew.

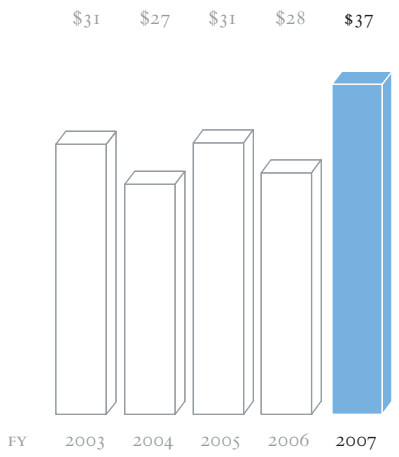
HBSP and Executive Education began fiscal 2008 with highly competitive product portfolios and strong momentum in corporate and academic markets worldwide. This bodes well for the School's revenue performance, and the resulting availability of funding for education and research activity in the year ahead. In addition, the University has announced significant endowment distribution increases for fiscal 2008. These increases reflect improved investment returns on the University endowment and adjustments to the payout policy.

We expect to leverage the income growth from these market-sensitive sources in ways that further strengthen the teaching, learning, and knowledge creation that take place at HBS in the year ahead. The School's fiscal 2008 operating budget projects an increase in total expenses of 9.6 percent to $411 million, from actual fiscal 2007 spending of $375 million. In line with Dean Light's priorities, the incremental spending will focus on our long-term strategy to expand the HBS community's global reach and impact.

The School's publishing unit also will be focusing on global expansion in fiscal 2008. Among HBSP's targets for increased investment are initiatives related to new business development and partner support in China. HBSP also plans to grow its direct and distribution channel sales capabilities in the U.K. and European markets, bring new global perspectives to its content portfolio, and integrate its product portfolio more effectively with Executive Education in both China and India.

Fiscal 2008 will be another year of growth in MBA fellowship spending, which we expect to increase by 17 percent. Including awards for MBA students and Doctoral candidates, fellowship spending is budgeted to grow by $4 million, or 18.2 percent, in fiscal 2008 to $26 million. The School remains keenly committed to ensuring that growth in fellowship awards outpaces growth in tuition, thus lowering the net cost of attendance for students who receive financial assistance.

The competition for outstanding business school faculty is becoming increasingly intense. Accomplishing the academic mission of HBS thus depends to a greater extent than ever on our ability to be progressive and aggressive in the compensation packages offered by the School to members of the faculty. Competing globally for top faculty talent also drives spending imperatives in related areas such as faculty development and leave opportunities, international travel, and research support.



IT Investment
(Dollars in millions)

Fiscal 2007 was an exceptionally successful year for faculty recruiting at the School. As a result, faculty FTEs will grow from 206 this past year to 219 in fiscal 2008, and we have budgeted a commensurate fiscal 2008 increase in compensation and faculty development expenses. The School did not see comparable growth in enrollment in the Doctoral Programs in fiscal 2007, as a result of lower admissions yield. Increasing the number of Doctoral candidates remains an important objective for HBS going forward.

HBS invested $92 million in fiscal 2007 to support the faculty's work in research and course development, and spending in this area will continue to be a strategic priority in fiscal 2008. In addition to providing faculty with the resources they need to remain close to practice on an increasingly global scale, these investments will be designed to enhance research productivity across the School by further strengthening the research infrastructure and support staff services available to faculty on campus. The School's investment in faculty research is budgeted to grow in excess of 13 percent in fiscal 2008 to more than $104 million.

Our capital budget for fiscal 2008 is $45 million—an increase of $25 million from capital expenses last year. In addition to the facilities upkeep necessary to prevent the accumulation of deferred maintenance, about $21 million of the fiscal 2008 capital budget is earmarked for the renovation of MBA residence space in Gallatin Hall. One of the School's original McKim, Mead & White buildings, Gallatin has not been the focus of significant renovation since its construction in the 1920s.

Other large renewal projects planned for fiscal 2008 include the second phase of executive program classroom modernization in McCollum Hall and renovations to Morris Hall, an MBA residence facility. The fiscal 2008 capital budget also includes the completion of the Technology Operations Center and HVAC system upgrades that began in fiscal 2007; ongoing replacement of IT equipment across the campus; and more than $6 million in routine facilities maintenance.

Longer term, the School's capital investment strategy will be shaped by the comprehensive campus plan undertaken this past year. The plan establishes a development framework consistent with the School's evolving and emerging strategic priorities, including fostering an increasingly team-based and technology-infused MBA learning experience; environmental stewardship; and a desire to strengthen the integrity, quality, and residential character of the School's unique campus. The University's Allston development strategy provides the long-term backdrop for the HBS campus plan—and an unprecedented opportunity to advance the mission of the School.

We have translated the School's strategic objectives into a capital investment plan for the next few years. Our MBA Program priorities are residence hall construction and renovation, and the creation of new spaces for team-based learning. The plan also focuses on adding Executive Education housing and dining capacity. New office facilities will be required to accommodate growth in the size of the faculty. In addition, we are planning to address the School's chronic shortage of assembly spaces—from small seminar rooms to large auditoriums.

The expanding community of HBS alumni and friends continues its tradition of exceptional generosity, providing the School with a strong financial foundation upon which to build. Our obligation is to be responsible and effective stewards of this legacy, and we remain dedicated to fulfilling it.

Richard P. Melnick, MBA '92
Chief Financial Officer
September 30, 2007

Financial Review

Financial Review

Business Model

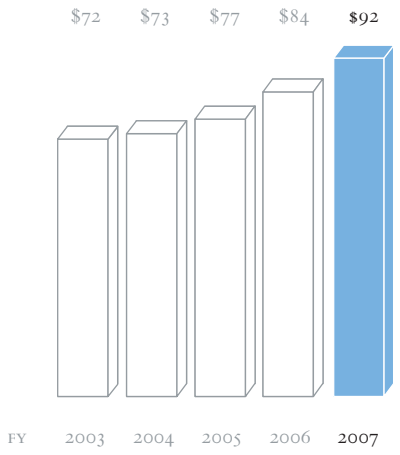
Harvard Business School's core activities—educating students, conducting pathbreaking research, and communicating new ideas and insights worldwide—are funded with a unique mix of revenue sources.

More than 50 percent of the School's revenue comes from Harvard Business School Publishing (HBSP) and Executive Education, and thus originates in sales of products and services in markets that are highly competitive. Gifts to HBS, through distributions from the endowment and revenue from unrestricted current use giving, account for nearly a quarter of revenue. Nineteen percent of the School's revenue comes from MBA tuition and fees.

Fiscal 2007 was the first time in the School's history that endowment distributions and current use gifts contributed a larger percentage of revenue than MBA tuition. Reflecting the success of the School's campaign earlier in this decade and Harvard University's extraordinary investment returns, the endowment has become a major source of funding for the School's operations. In addition, unrestricted giving by HBS alumni and friends has set new records in each of the past two years. Unrestricted gifts provide flexible funding for new research and teaching initiatives.

Unlike other Harvard University schools, faculty at HBS do not seek grants from external sponsors such as government agencies, foundations, and corporations. Instead, their research is funded primarily by the School with revenue from HBSP and Executive Education. This business model allows faculty to pursue the research opportunities they believe have the greatest potential to create new knowledge and advance the practice of management.

In a self-sustaining cycle, Executive Education and HBSP disseminate the knowledge produced by the faculty through programs and through periodicals, books, cases, and eLearning products, respectively, enabling the School to influence the practice of management on a global scale, while generating significant operating margins. These margins complete the cycle by providing vital funding for the faculty's research.



Investment in Research
(Dollars in millions)

Revenues

In fiscal 2007, the School's total revenue increased by $37 million, or 10.1 percent, to $405 million from $368 million in fiscal 2006. Consolidated revenue has risen at a compound annual rate of 7.2 percent for the past five years.

Growth in HBSP sales and Executive Education tuition generated about half of the fiscal 2007 revenue increase. This continues a trend that began several years ago when the United States emerged from its last recession. As market-driven businesses, HBSP and Executive Education continued to benefit from favorable economic conditions.

Reflecting positive dynamics in the capital markets, coupled with strong investment returns, a larger distribution of income from the School's endowment contributed to the fiscal 2007 revenue increase, as did exceptional growth in unrestricted current use giving. As in prior years, MBA tuition and fees rose as well.

MBA Tuition and Fees

Tuition and fees revenue from the School's core academic program rose to $77 million in fiscal 2007 from $73 million last year, primarily due to the planned 5.6 percent increase in tuition. The School continues to set tuition at levels that recover rising program delivery costs and investments in programs designed to enrich the HBS educational experience.

First-year MBA tuition in fiscal 2007 was $39,600—near the midpoint among the 10 comparable schools tracked by the School—compared with $37,500 last year. MBA tuition and fees amounted to 19 percent of the School's total revenues in fiscal 2007, compared with 19.8 percent a year earlier.

Executive Education

Tuition revenue from executive programs grew by 12.3 percent to $91 million in fiscal 2007, from $81 million last year. Executive Education tuition represented 22.5 percent of total revenue, compared with 22 percent in fiscal 2006.

In fiscal 2007, HBS reaped the benefits of large strategic investments made in the previous fiscal year in product development, marketing, and corporate relations. Demand for the newly launched Comprehensive Leadership Programs portfolio and expanded offerings in both the focused and custom program portfolios combined to drive solid revenue growth.

The Executive Education unit continued to broaden its worldwide footprint in fiscal 2007, strengthening its presence in China and moving forward with plans to establish programs in India, Europe, and California in concert with the established network of HBS regional research centers.

Applications to the School's executive programs increased by 13.8 percent in fiscal 2007 to more than 12,200. Total enrollment was up by more than 1,000 to nearly 9,300, compared with enrollment growth of approximately 100 in fiscal 2006.

This was a strong year for the School's custom programs, with 11 new corporate clients and 16 percent growth in the number of participants. Enrollment in the School's open-enrollment programs grew 10 percent. Revenue from custom programs rose by 20 percent to $24 million, and open-enrollment revenue increased by 9.8 percent to $67 million.

Publishing

Revenue from HBSP's sales of periodicals, books, cases, and eLearning products increased by 7.6 percent in fiscal 2007 to $128 million, from $119 million last year. The publishing operation generated 31.6 percent of the School's total revenue, compared with 32.3 percent in fiscal 2006.

HBSP is strategically transforming its domestically focused publishing operation into a global, web-based digital information business. Continued product innovation enabled HBSP to further improve its penetration of global corporate and academic markets in fiscal 2007.

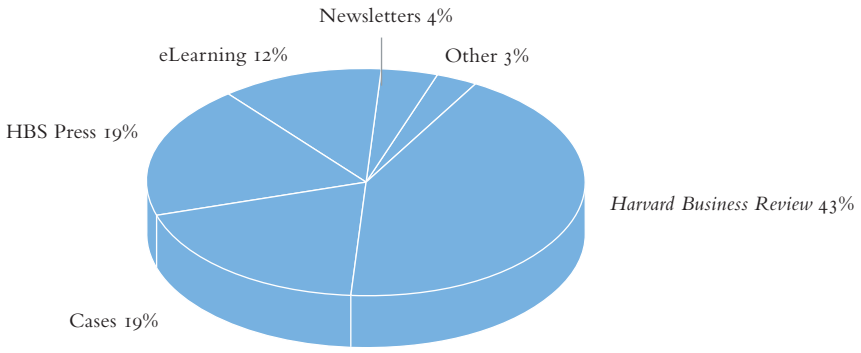
Despite sharing in an industry-wide decline in advertising revenue, the School's flagship publication, *Harvard Business Review* (*HBR*), posted its third consecutive record year. *HBR* is expanding its portfolio of customized product offerings to better satisfy the preferences of individual users worldwide. Broader circulation and higher foreign-edition royalties in fiscal 2007 drove revenues to $44 million, from $42 million a year earlier.

Reflecting continued solid demand in the academic market, HBS case and teaching materials' revenue grew for the sixth consecutive year in fiscal 2007 to a record $26 million. Sales of HBS Press books grew 19 percent to $25 million, fueled by strong sales of backlist titles in the individual/retail market.

Revenue from sales of HBSP eLearning products grew 13.4 percent to $15 million in fiscal 2007. International sales were strong, particularly in Western Europe and India. It was also a good year for growth in eLearning's base of large clients, as well as for customer retention.

HBSP continued investing in R&D in fiscal 2007. Chief among its future products is a line of computer-based simulations on pricing and leadership/team dynamics. HBSP also is developing a series of short cases complemented by online tools.

Looking to secure its positioning for growth in the long term, HBSP established the Harvard Business Digital unit to strengthen its web presence and advance its digital product road map. The publishing operation also continued to build the portfolio of international distribution relationships it leverages to market HBS-branded products globally.



Publishing Revenues, FY 2007

Gifts and Endowment

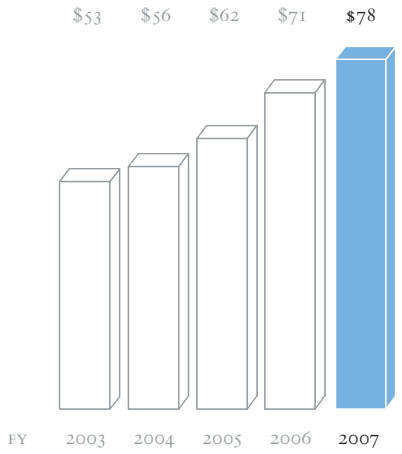
The annual distribution of income from the School's endowment, together with revenue from unrestricted current use gifts, accounted for $95 million in funding in fiscal 2007, or 23.4 percent of the School's total revenue. This compares with $83 million in fiscal 2006, or 22.6 percent of total revenue.

Endowment distributions increased by 9.9 percent to $78 million in fiscal 2007 from $71 million last year. This growth was made possible by continued strength in the University's investment returns and its 14 percent increase in the annual endowment distribution rate. Endowment distributions have represented approximately 18 to 19 percent of the School's total revenue in each of the past five years.

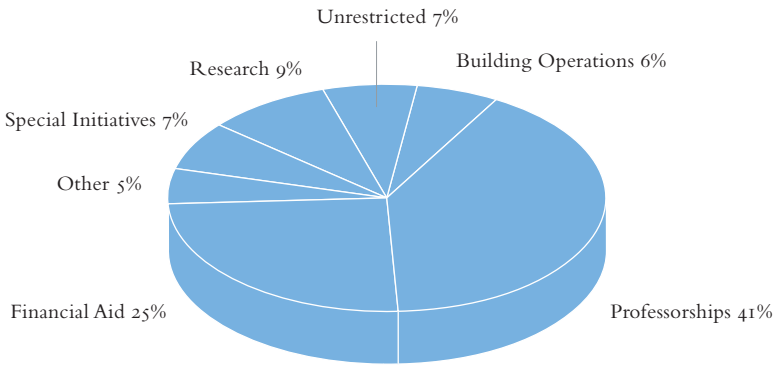
After the fiscal 2007 distribution, the School's endowment and current use funds totaled $2.8 billion at year-end, up $481 million, or 20.5 percent, from June 30, 2006. The increase in the market value of the endowment for fiscal 2007 reflects $31 million in endowment gifts received by HBS during the year, as well as net appreciation in endowment principal of $450 million. Total investment return was +23 percent in fiscal 2007, net of all expenses and fees, compared with +16.7 percent last year.

Unrestricted current use gifts are the School's primary source of innovation funding. Encouraging this type of giving has been a key fundraising focus at HBS since the School's campaign concluded in fiscal 2006. Unrestricted current use gifts rose by 41.7 percent in fiscal 2007 to a new record of $17 million, from $11.7 million in fiscal 2006. This extraordinary growth was largely the result of an increase in the number of MBA classes making unrestricted gifts. Over the past five years, unrestricted current use giving to HBS has generated more than $53 million in revenue.

Total cash received from gifts grew to $56.4 million in fiscal 2007, from $55 million a year earlier. HBS received gifts from nearly 13,000 individual donors in fiscal 2007, including alumni of the MBA, Doctoral, and Executive Education programs. Nearly 30 percent of the School's MBA alumni gave to HBS in fiscal 2007—a participation rate equal to those seen during the campaign years.



Endowment Distribution
(Dollars in millions)



Endowment Components, FY 2007

Expenses

Summary

In fiscal 2007, the School's total operating expenses increased by $30 million, or 8.7 percent, to $375 million, from $345 million in fiscal 2006.

In committing to the expansion of the School's global activities, HBS has accepted the challenge of managing a larger enterprise while continuing to generate positive cash flow. The School's cash from operations is largely reinvested in the campus, providing critical funding for facilities maintenance, infrastructure, and IT upgrades, as well as debt service for building renewal projects.

The relatively high rate of inflation in the higher education sector heightens the budgetary challenge. While spending and investing strategically to further the mission of the School, HBS has placed equal emphasis on countering the impacts of inflation by tightly controlling operating costs. These efforts have produced excellent results. Although the School's operational footprint has grown substantially since fiscal 2002, total expenses have grown at a compound annual rate of 6.1 percent.

HBSP and Executive Education consume a significant portion of the operating budget, as does faculty research. Expenses in these areas cut across numerous line items in the School's "Statement of Activity and Cash Flows." Expenses include direct costs for staff compensation, specialized outside professional services in areas such as Information Technology (IT) and marketing, and residence expenses for executive program participants. These expenses have risen in line with growth in the HBSP and Executive Education product portfolios, and in the physical scope of their operations. In recent years, this broadened base of activity has delivered substantial increases in revenue contributions to the School. By successfully controlling their fixed costs, both HBSP and Executive Education have delivered margins on the incremental revenue. These margins have been reinvested to fund the School's research activities.

Faculty research expense includes a significant portion of faculty compensation, as well as direct costs for research support staff, travel, and IT services. Also included in the cost of faculty research are allocated expenses for Baker Library resources, as well as campus facilities, technology, and administration. When viewed in this way, the School's annual investment in faculty research has increased at a compound annual rate of 5.6 percent for the past five years, rising from $70 million in fiscal 2002 to $92 million in fiscal 2007.

Salaries and Benefits

Compensation for faculty and staff is the School's largest expense. Amid increasing global competition for outstanding faculty, HBS recruits aggressively and seeks creative ways to generate appropriate long-term growth in the size of the faculty, as measured in full-time equivalents (FTEs). The ability to offer highly attractive salary and benefits packages is crucial to successful competition in the marketplace for academic talent.

While growing the faculty remains a priority at the School, the total number of faculty FTEs can increase or decrease in any given year as a result of retirements, departures, and normal fluctuations in recruiting activity. The School's fiscal 2007 faculty compensation expense remained essentially level with the prior year, reflecting a decline in FTEs to 206 from 215 in fiscal 2006.

Administrative staff levels remained carefully controlled in fiscal 2007, growing by 32 FTEs to a total of 1,109, from 1,077 FTEs at the end of fiscal 2006. Although the operational scope of the School has expanded over the past five years, HBS concluded fiscal 2007 with essentially the same total number of administrative positions as in fiscal 2002. The staff organization, however, has changed considerably since then, reflecting a continual process of new hiring and redeployment focused on strengthening the administrative functions critical to the School's teaching and research mission.

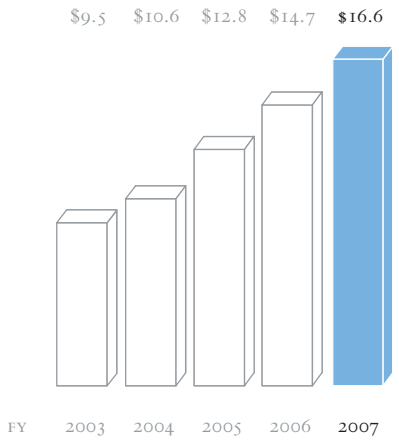
Including both faculty and administrative staff, employee salaries and benefits expense has grown at a compound annual rate of 6.6 percent for the past five years. In fiscal 2007, these costs rose by $12 million, or 7.2 percent, from the prior year, to $179 million, and represented 48 percent of total operating expenses. The major cost drivers were compensation and FTE increases in HBSP, faculty salary growth and retirement payments, and program costs in Executive Education. Salaries and benefits for faculty and their research associates represented more than 40 percent of the School's employee compensation costs in fiscal 2007, or approximately 19 percent of total expenses.

Fellowships

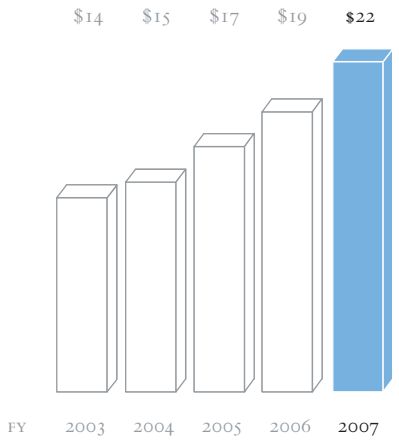
HBS characterizes student fellowship spending as an expense. One of the School's strategic objectives is to increase support for MBA students in need of financial aid at a rate that exceeds the rise in tuition and fees. The prospect of entering the workforce with high levels of debt can deter strong 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 those whose early career paths have not enabled them to reduce their undergraduate loans.

The generosity of the School's alumni and friends has resulted in strong growth in endowed fellowship funds. This has enabled HBS to increase fellowship awards for incoming MBA classes at a compound annual rate of 14.4 percent for the past five years. Total fellowship expense, including those for Doctoral candidates and MBA students, compounded annually, has risen 12.9 percent since fiscal 2002.

Looking back at the past five fiscal years, the average two-year MBA fellowship award grew from $19,524 for the Class of 2003 to $35,400 for the Class of 2008. Total fellowship spending for fiscal 2007 increased by $3 million, or 15.8 percent, from last year to a record $22 million. Because of this growth, the average MBA loan balance at graduation in fiscal 2007 fell to $77,550, compared with $83,310 in fiscal 2006. HBS continues to seek ways to assist MBA students in alleviating this burden, and thus broaden their career opportunities in both the private and the public sectors.



MBA Fellowship Spending
(Dollars in millions)



Total Fellowship Spending
(Dollars in millions)

Publishing and Printing

Publishing and printing expense includes HBSP production costs as well as a small amount of spending to produce the School's other printed materials and publications. Increases in these expenses were modest from fiscal 2002 through fiscal 2005, mainly due to lower costs for printing and paper, marketing, and author royalties at HBSP.

Reflecting the marketing investments and FTE growth at HBSP that have fueled the publishing unit's recent revenue growth, publishing and printing expenses have increased significantly in the past two fiscal years, rising by $9 million to $51 million in fiscal 2007. Approximately $3 million of this increase was related to market-driven HBSP spending, and the balance was caused by a shift in accounting for these costs from the supplies and equipment line item.

Space and Occupancy

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 HBS campus currently includes 33 buildings encompassing more than 1.5 million square feet. Space and occupancy expense includes costs 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. Residence expenses for executive program participants—equivalent to the cost of goods sold in Executive Education—also are reported under space and occupancy.

HBS has constructed approximately 43,000 square feet of occupied space since fiscal 2002, enlarging the size of the campus by 3.5 percent, while renovating approximately 268,000 square feet of space. Reflecting this facilities' expansion and increased utilities and energy costs, in the past five years space and occupancy expenses have risen at a compound annual rate of 5.9 percent. The increase in fiscal 2007 was $2 million, or 5.3 percent, slightly lower than the five-year average as a result of slower growth in expenses for utilities and energy.

Supplies and Equipment

The School tightly controls expenses for supplies and equipment, and the underlying cost level in this area has remained stable for the past two years. As a result of the shift of some costs to HBSP in fiscal 2007, supplies and equipment expense, as reported, declined by approximately $6 million from a year earlier.

Professional Services

Professional services expenses increased to $25 million in fiscal 2007, from $22 million in fiscal 2006. The increase mainly reflected greater use of outsourcing to supplement the School's internal capabilities as HBSP deployed new IT infrastructure in its migration toward a digital product platform.

University Assessments

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. University assessments increased by $1 million in fiscal 2007 to $11 million.

Debt Service

The School's debt service, which consists of interest payments to the University on building and other University debt, rose in fiscal 2007 to $7 million from $4 million in fiscal 2006. Debt service had remained essentially level for several years prior to fiscal 2007, as new borrowings for campus renewal and construction were offset by debt principal repayments made possible by alumni gifts. A general decline in the interest-rate paid by the School to the University also contributed to stable debt service levels. This rate is determined annually by the University, and is based on the University's weighted average debt rate.

Other Expenses

Other expenses rose to $31 million in fiscal 2007, from $28 million last year. The School incurred higher costs in fiscal 2007 as a result of the faculty's increased international travel, as well as executive program enhancements. Other expenses in the prior year were reduced by a one-time credit to a reserve account.

Debt service increased in fiscal 2007 due to the accounting transfer of large amounts of debt from construction-in-progress to placed-in-service. This transfer reflected prior investment in three of the School's largest recent capital projects: the renovation and restoration of Baker Library and the renovation of Hamilton Hall and Aldrich Hall.

Cash from Operations

Cash from operations varies according to the health of the business cycle. Levels of revenue from HBSP and Executive Education, income from investment returns on the endowment, and unrestricted giving all reflect short-term economic trends. Nevertheless, HBS plans its operations on a long-term strategic basis—for example, adding faculty, broadening and deepening its research activity, and investing in its revenue-generating businesses and campus infrastructure. The School's expenses track this growth. As a result, cash from operations can fluctuate widely from year to year.

Looking back to the beginning of this decade, cash from operations remained stable for several years following the recession in 2001. The subsequent launch of The Campaign for Harvard Business School coincided with the start of an economic recovery, producing strong growth in revenue from gifts, HBSP, and Executive Education.

The School's operating cash flow nearly doubled year-over-year in fiscal 2004 to $15 million, and reached a plateau of $24 million and $23 million in fiscal 2005 and 2006, respectively. Cash from operations increased by $7 million, or 30.4 percent, in fiscal 2007 to $30 million, primarily as a result of the larger endowment distribution and income from unrestricted current use gifts.

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. Amounting to $14 million in fiscal 2007, use of endowment principal and appreciation has remained essentially level for the past three years.

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 a $37 million plateau in fiscal 2005 and 2006. Mirroring the increase in cash from operations, cash available for capital activities rose by $7 million in fiscal 2007 to $44 million.

Cash flow exceeded net capital expenses in fiscal 2007, reversing the trend of the past few years. The School anticipated the possibility of this reversal, given that fiscal 2007 was planned as a comparatively soft year for capital spending. Looking forward, HBS expects to see a return to the previous pattern of cash from operations falling short of net capital expenses. As in the past, HBS will ensure through its financial planning that sufficient resources are available to service the School's debt and execute on its long-term capital plan.

Capital Expenses

Marking the peak in a five-year period of significant investment in the HBS campus, capital expenses reached $79 million in fiscal 2005. As the major projects initiated earlier in the decade reached and neared completion, capital expenses declined to $49 million in fiscal 2006, and declined further in fiscal 2007 to $20 million. This past year's $29 million decline reflected the completion of the Baker Library project, as well as the winding down of the renovation work on Aldrich Hall and Hamilton Hall.

Large capital projects in fiscal 2007 included the renewal of classroom space for executive programs in McCollum Hall, and the final stages of the Aldrich Hall and Wyss House renewal projects. The School's investment in these projects totaled approximately $7.2 million—significantly less than the aggregate $12.8 million spent on renewal and maintenance of buildings, facilities, and IT infrastructure across the campus.

In addition to the myriad small projects necessary to protect the long-term value of the School's physical plant, the major maintenance projects in fiscal 2007 included an upgrading of the Technology Operations Center and replacement of outdated and inefficient HVAC systems. In addition, HBS made the final payment in a multiyear commitment to support the School's role in the earliest phases of the University's development in Allston.

The $20 million in fiscal 2007 capital expenses was funded with $10 million in internally generated cash, substantially all of the School's $7 million in new borrowings, and $3 million in gifts for capital projects. The new borrowings were used primarily to fund classroom renovations at McCollum Hall. In fiscal 2006, sources of funding for capital expenditures included gift payments for specific capital projects totaling $12 million and new borrowings of $38 million, as well as internally generated cash.

Balance Sheet

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.

In fiscal 2006, HBS decided to increase borrowings on a multiyear basis to finance scheduled residence hall renovations and other major capital projects. This reflected the favorable interest-rate environment at the time, as well as anticipated returns from the School's endowment. New borrowings increased to $38 million in fiscal 2006, and building debt rose to $108 million.

Reflecting the modest level of capital investment this past year, new borrowings declined to $7 million in fiscal 2007, and debt principal payments rose from $4 million for the prior year to $7 million. Building debt for fiscal 2007 remained level at $108 million.

Since fiscal 2006, the School's balance sheet has included other University debt, which 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. Other University debt increased by $1 million in fiscal 2007 to $26 million.

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. The School's balance sheet remains modestly leveraged. Total debt has averaged only 3.5 percent of total assets for the past five years. The interest portion of the School's debt service amounted to 1.9 percent of total operating expenses in fiscal 2007, compared with 1.2 percent in fiscal 2006. At June 30, 2007, the School's building debt-to-asset ratio was 3.1 percent.

Liquid assets, consisting of cash and reserves, decreased to $81 million at June 30, 2007, from $85 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

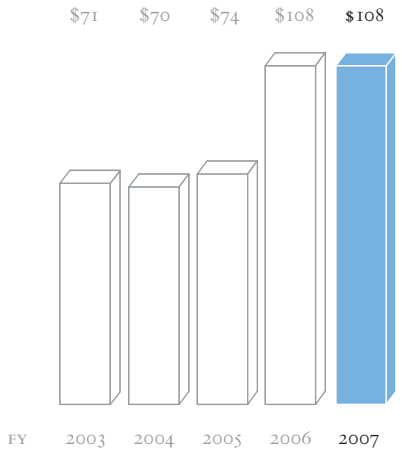
in fiscal 2006 reflected stronger cash from operations, lower capital expenses, and the higher level of new borrowings determined as part of the School's long-term financial plan.

The $4 million decrease in liquid assets in fiscal 2007 was due to investments in HBSP. The ratio of liquid assets to current liabilities was 0.9 for fiscal 2007. As in prior years, however, the majority of the School's operating expenses were paid, as incurred, out of current cash flow.

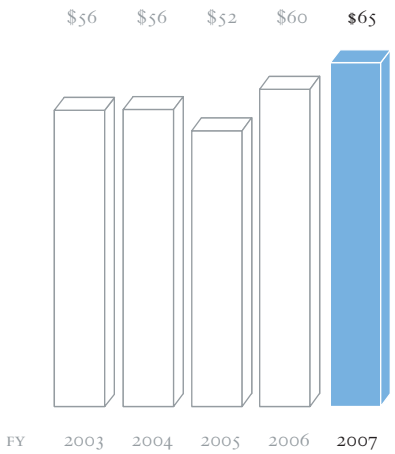
Endowment

The market value of the HBS endowment and current use funds grew to $2.8 billion, or approximately 8 percent of total University endowment assets, as of June 30, 2007, from $2.3 billion at the end of fiscal 2006. The total return on the endowment was +23 percent, net of all expenses and fees, following a +16.7 percent return in fiscal 2006.

Harvard Management Company, a wholly owned subsidiary of the University, 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.



Building Debt Outstanding
(Dollars in millions)



Unrestricted Reserves
(Dollars 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. With the decline in capital projects, in fiscal 2006 the School's year-end reserves balance grew by $8 million to $60 million.

In fiscal 2007, HBS transferred $25 million of current use reserves to the unrestricted endowment reserve established several years ago in order to capture higher investment returns. Reflecting these additional funds and the performance of the endowment, the market value of this reserve grew to $94.4 million at June 30, 2007, from $55.7 million a year earlier.

Looking ahead to fiscal 2008 and future years, 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

As with other Harvard University schools, HBS raises its own endowment and current use funds, and independently budgets the use of its endowment distributions to support operations, according to the terms of each gift.

Reflecting both strong investment return and new endowment gifts, in fiscal 2007 the combined market value of the School's endowment and current use funds grew by $481 million, or 20.5 percent, from $2.3 billion a year earlier to $2.8 billion at June 30, 2007. This $2.8 billion represented 8 percent of the total University endowment.

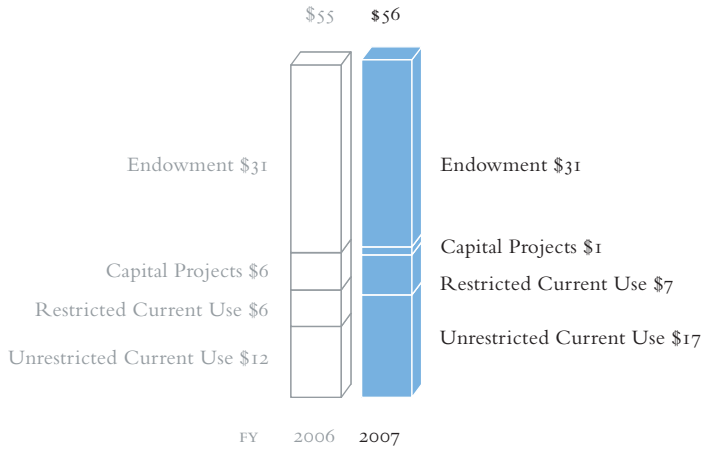
The market value of the HBS endowment and current use funds has grown at a compound annual rate of 16.1 percent for the past five years. Mirroring this growth, investment return on the endowment has become an increasingly important source of operating income for the School.

Since fiscal 2002, endowment distributions for operations, together with revenue from unrestricted current use gifts, have risen at a compound annual rate of 10 percent—significantly faster than inflation in higher education—from $59 million, or 20.6 percent of the School's total revenue, to $95 million, or 23.4 percent of total revenue, in fiscal 2007.

The School's endowment consists of more than 1,000 discrete funds established over the years by individual donors, corporations, foundations, and reunion classes. The assets in these funds were intended to be preserved for the benefit of many generations. Approximately 93 percent of the funds are designated, or "restricted," by the donors for specific uses, and must be spent according to each donor's intent.

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

Approximately 50 percent of the HBS endowment has been earmarked by the donors to support professorships and faculty research, and 25 percent is in funds designated to provide income for MBA and Doctoral student fellowships. Another 18 percent is restricted to existing strategic initiatives, building operations, and other ongoing operations of the School.



Gifts Received
(Dollars in millions)

The remaining 7 percent of the HBS endowment is available for discretionary investment in new opportunities. For this reason, annual unrestricted gifts remain the School's primary funding source for new initiatives. In fiscal 2007, income from unrestricted current use gifts totaled $17 million, or 4.2 percent of total revenue. These funds are used to nurture and accelerate new programs that are not endowed, and to support the School's emerging initiatives in research and teaching.

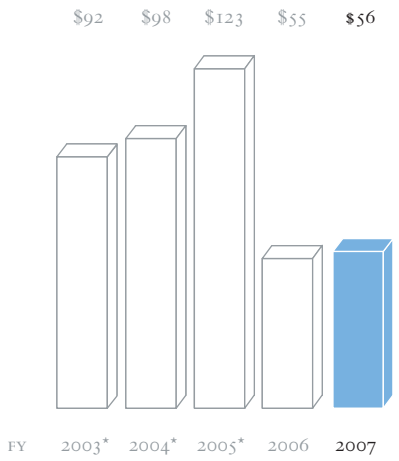
The assets within the HBS endowment, along with the University's other endowments, are managed by Harvard Management Company (HMC), a wholly owned subsidiary of the University. HMC was founded in 1974 to manage the University's endowment, pension assets, working capital, and deferred giving accounts.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

The HBS endowment works like a trust fund. The assets are managed to ensure that growth in the purchasing power of the gift principal exceeds the long-term rate of inflation. This means that great care must be exercised in determining the amount that can safely be drawn from the endowment to spend in any given year.

Each year, the University determines the aggregate amount to be distributed from the endowment according to a disciplined annual payout policy that reflects HMC's projections of future endowment returns. The 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.

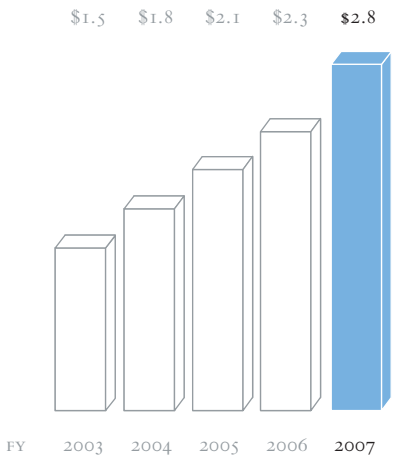
Given these goals, the University's long-term target has been to distribute between 4.5 and 5 percent of the endowment's market value annually. Following the endowment's strong investment returns from fiscal 2003 through 2005, the University chose to embark on a long-term program of supplemental distribution increases beginning in fiscal 2006. The University may now authorize distributions up to a level of 5.25 percent in the next several years.

These additional funds are designed to support increased spending on the highest strategic priorities at each of the Harvard schools. The supplemental distribution available to HBS for fiscal 2007 grew to approximately $2.5 million, from $1 million last year. As in fiscal 2006, the School used these incremental funds to provide additional fellowship awards.



Cash Received from Gifts
(Dollars in millions)

* Years coincide with The Campaign for Harvard Business School.



Endowment Growth
(Dollars in billions)

After including all gifts received, netted against annual distributions, at the end of fiscal 2007 the University endowment was valued at $34.9 billion, compared with $29.2 billion at June 30, 2006. The University's total investment return for fiscal 2007 amounted to +23 percent, net of all expenses and fees. The absolute return this year exceeded the average annual returns the endowment achieved over the past five and ten years of 18.4 percent and 15 percent, respectively.

Fiscal 2007 was also a strong year for the University endowment in terms of relative performance, which is measured against other institutional funds and benchmarks in 11 relevant non-cash asset classes. As compared with the average institutional fund, the Harvard endowment outperformed by 5.3 percentage points the total return achieved by the median of 151 institutional funds with assets of more than $1 billion tracked by the Trust Universe Comparison Service (TUCS). The University endowment's fiscal 2007 investment return also exceeded the 20.9 percent that marked the top-five percentile for this sample.

HMC maintained its record of delivering long-term value added across the asset classes in which the University invests. Consistent with global economic developments, the main drivers of absolute return in fiscal 2007 included the endowment's exposures in the emerging market, international, and domestic equity classes. Emerging market bonds also performed well, as did the absolute return/special opportunities and real estate classes, which provided diversification during a period of market volatility.

The total investment return on the University endowment outperformed HMC's policy portfolio aggregate benchmark by 580 basis points. This translates into more than $1.7 billion of additional value for the endowment.

The absolute return earned in fiscal 2007 was greater than 2.5 times the long-term expected return set by the University for HMC. This expected return is determined in order to maintain the long-term purchasing power of the endowment after distribution and the impact of inflation. As a result, in fiscal 2008, the University's schools, including HBS, will see endowment distributions rising from approximately $930 million this past year to $1.1 billion, or more than three times the level of 10 years ago.

Endowment Returns

Statement of Activity and Cash Flows*

In millions For the fiscal year ended June 30,	2007	2006	2005
Revenues			
MBA Tuition and Fees	$ 77	$ 73	$ 68
Executive Education Tuition	91	81	76
Publishing	128	119	106
Endowment Distribution	78	71	62
Unrestricted Current Use Gifts	17	12	8
Housing, Rents, and Other	9	9	9
Interest Income	5	3	2
Total Revenues	$405	$368	$331
Expenses			
Salaries and Benefits	$179	$167	$153
Publishing and Printing	51	42	35
Space and Occupancy	40	38	35
Supplies and Equipment	9	15	15
Professional Services	25	22	16
Fellowships	22	19	17
University Assessments	11	10	10
Debt Service	7	4	4
Other Expense	31	28	22
Total Expenses	$375	$345	$307
Cash from Operations	$ 30	$ 23	$ 24
Use of Endowment Gifts or Appreciation	14	14	13
Cash Before Capital Activities	$ 44	$ 37	$ 37
Capital Expenses	$ (20)	$ (49)	$ (79)
Use of Gifts for Capital Projects	3	12	49
Net Capital Expenses	$ (17)	$ (37)	$ (30)
New Borrowings	$ 7	$ 38	$ 7
Debt Principal Payments	(7)	(4)	(3)
Other Activity	(22)	(26)	(15)
Net Debt and Other	$ (22)	$ 8	$ (11)
Change in Unrestricted Reserves	$ 5	$ 8	$ (4)
Beginning Balance, Unrestricted Reserves	$ 60	$ 52	$ 56
Ending Balance, Unrestricted Reserves	$ 65	$ 60	$ 52

* 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 $22 million in fiscal 2007. Cash flows, however, would be equivalent under GAAP.

Consolidated Balance Sheet

In millions

For the fiscal year ended June 30,	2007	2006	2005
Assets			
Cash	$ 16	$ 25	$ 21
Unrestricted Reserves	65	60	52
Receivables, Loans, and Other Assets	182	178	165
Invested Funds:			
Endowment Investments	2,654	2,190	1,924
Current Fund Investments	16	18	17
Interest in Trusts Held by Others	151	132	124
Facilities, Net of Accumulated Depreciation	416	415	390
Total Assets	$3,500	$3,018	$2,693
Liabilities			
Deposits, Advances, and Other	$ 39	$ 39	$ 30
Deferred Revenue	50	36	34
Other Debt Owed to University	26	25	–
Building Debt	108	108	74
Total Liabilities	$ 223	$ 208	$ 138
Composition of Net Assets			
Unrestricted Reserves	$ 65	$ 60	$ 52
Undistributed Income and Other	34	36	28
Pledge Balances	40	56	83
Student Loan Funds	10	11	11
Investment in Facilities	308	307	316
Endowment and Other Invested Funds	2,821	2,340	2,065
Total Assets Net of Liabilities	$3,277	$2,810	$2,555

Harvard Business School
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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.

This report can be viewed and downloaded online at 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. Please direct correspondence to Richard Melnick, Chief Financial Officer: rmelnick@hbs.edu or to the Office of the Dean: officedean@hbs.edu.

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