Financial Overview
From the Executive Vice President and the Treasurer

We write to report on the University’s financial position and results for the fiscal year ended June 30, 2014. The University’s operating surplus was $2.7 million, which includes the impact of a one-time benefits-related charge of almost $46 million. Excluding this one-time charge, the University’s operating surplus would have been approximately $49 million. While this represents an improvement over last year’s deficit, in relative terms, this operating surplus is just over 1% of the University’s operating revenue. Just as last year’s $34 million deficit was not cause for undue alarm, so is this year’s surplus not cause for excessive optimism. We are heartened by the University’s marginal budgetary improvements, but continue to believe that Harvard, like many other colleges and universities, is facing ongoing foundational financial pressures.

This year’s financial report offers much to like. The Harvard Campaign has thus far exceeded initial expectations, and has had a very positive impact on current use giving (24% increase), receipts from philanthropy (46% increase), and year-end pledges receivable (29% increase). Moreover, the overall quality of philanthropy has been quite promising, in terms of the alignment we are achieving between donors’ interests and the University’s core needs. The most extraordinary examples of such alignment include Kenneth Griffin’s $150 million endowment pledge, which is substantially dedicated to undergraduate financial aid, and the more recent unrestricted endowment pledge of $350 million from The Morningside Foundation for the benefit of the Harvard T. H. Chan School of Public Health. We are grateful for and humbled by the energetic engagement of our broad community of alumni and friends in the Campaign, and we are increasingly confident that the Campaign ultimately will yield fundamental improvements in the University’s finances and financial prospects.

At the same time, the University continues to recognize the importance of further actions that we must take to counteract pressures on Harvard’s revenues and expenses. With respect to revenue, the University achieved meaningful growth in continuing and executive education, driven in part by the opening of Tata Hall, which increased the capacity of executive education programs at Harvard Business School. Even more noteworthy was the encouraging growth in corporate-sponsored research. This is of particular importance to the University in light of a continuing decline in research funding from the federal government.

Cost management has been more challenging, both at Harvard and across higher education more broadly, due to the people- and space-intensive nature of teaching and research. With approximately half of Harvard’s budget allocated to compensation, we have been focusing our efforts in recent years on initiatives to control staff growth, to opportunistically seek efficiencies in our business practices, and to evaluate the University’s benefits offerings relative to both peers and the local market. We continue to make progress on all of these dimensions, yet in many cases considerable time and resources are required to effect change – particularly where greater efficiencies are being sought by aggregating activities that previously had been undertaken in highly decentralized configurations.

Beyond the University’s operating result, we are pleased with the overall growth of $4.6 billion in Harvard’s net assets, much of which is attributable to net growth in the market value of the endowment. At $36.4 billion, the endowment is within 2% of its 2008 peak – but with a significantly improved risk and liquidity profile. Harvard’s endowment, like those of our peers, still must recapture its lost purchasing power so that future generations of students and scholars will receive the same important support that has been available to past generations. The University has made great progress since the global financial crisis of 2008-2009 in our management and stewardship of this critical asset, and we thank Jane Mendillo and her team at the Harvard Management Company for their successful efforts in this regard.

Despite the financial progress we have made, there are several continuing forces of countervailing pressure, requiring us to remain vigilant and disciplined:

• The prospect of continued volatility in capital markets, after a nearly unprecedented duration of consistent gains in the United States equity market;
• The continuing pressure on the federal budget, which once again can be seen in this year’s 5% decline in the University’s federal sponsored revenue; 
• Ongoing stagnation in median household income growth, coupled with the University’s industry – leading financial aid program – both of which put increasing pressure on grant aid expenditures; and 
• Harvard’s need to make sizable capital investments to maintain and enhance its leading position, including the ongoing renovation of undergraduate houses, the expansion of our School of Engineering and Applied Sciences and its longer-term relocation to Allston, and our continuing exploration of transformative improvements in online teaching and learning.

It is in this difficult context that the University considers equally difficult choices, such as recently announced changes in Harvard’s health plan offerings to faculty and non-union staff. Change is never easy and is particularly difficult when the broader operating environment provides both positive and negative signals regarding the future. We must undertake as a community the most thoughtful choices we can, in order to create incremental resources for our current teaching and research, and to ensure that future generations of students and scholars will have opportunities to excel and thrive. Harvard’s community of faculty, students and staff has risen admirably to the challenge thus far, and we expect to see still more of their remarkable diligence, thoughtfulness and creativity in the coming months and years. The strength of this community is indeed one of Harvard’s greatest competitive advantages.

We hope this introduction provides you with a helpful context for evaluating the University’s financial report.

Katherine N. Lapp  
EXECUTIVE VICE PRESIDENT

Paul J. Finnegan  
TREASURER

November 7, 2014
FINANCIAL OVERVIEW

The University ended fiscal 2014 with an operating surplus of $2.7 million (which includes a one-time benefits adjustment) compared to an operating deficit of $33.7 million in fiscal 2013. The University’s net assets increased by $4.6 billion to $43.2 billion at June 30, 2014, driven mainly by positive endowment returns.

OPERATING REVENUE

Total operating revenue increased 5% to $4.4 billion. An increase in gifts for current use as a result of The Harvard Campaign and an increase in the annual distribution from the endowment were the largest drivers. The University continues to focus on diversifying its sources of revenue which is reflected in the growth in income from continuing and executive education programs, corporate sponsors and publishing and royalty revenue.

Current use gifts increased by 24% to $419 million in fiscal 2014, and total receipts from giving, including gifts designated as endowment, increased 46% to $1.2 billion (see Note 16 of the audited financial statements). The significant increase in giving is a result of the generosity of our alumni and supporters in their contributions to the University’s first capital campaign in over a decade. We are extremely grateful for this support.

In fiscal 2014, the endowment distribution increased 3% to $1.5 billion. Growth in the endowment distribution was a result of the annual Corporation-approved increase, as well as the impact of new gifts. In the aggregate, Harvard’s endowment payout rate (i.e., the dollars withdrawn annually for operations and for one-time or time-limited strategic purposes, as a percentage of the endowment’s prior year-end market value) was 5.6% compared to the University’s targeted payout rate range of 5.0-5.5% and the 5.5% payout rate in fiscal 2013.

Revenue from federal and non-federal sponsored funding declined by $13 million or 2% to $819 million in fiscal 2014. Federal funding, which accounted for approximately 75% of the total sponsored revenue in fiscal 2014, declined 5% compared to the University’s targeted payout rate range of 5.0-5.5% and the 5.5% payout rate in fiscal 2013.

FISCAL 2014 SOURCES OF OPERATING REVENUE

<table>
<thead>
<tr>
<th>Major academic units</th>
<th>University</th>
<th>Endowment income made available for operations</th>
<th>Student income</th>
<th>Sponsored support</th>
<th>Gifts for current use</th>
<th>Other</th>
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<td>University</td>
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non-federal funding increased 9% to $209 million. The decline resulted from the continuing depletion of American Recovery and Reinvestment Act funding coupled with a decrease in funding from federal sponsors, primarily the National Institute of Health, which is the University’s largest source of federal funding. The 9% increase in revenue recorded from non-federal funding, most notably industry sponsors, helped to mitigate the decline in federal funding, which is expected to continue over time.

Total student revenue increased approximately 7% to $878 million in fiscal 2014, driven principally by 11% growth in revenue from continuing and executive education programs. The completion of Tata Hall at the Business School created additional executive education capacity for new offerings and expanded enrollment. Several other schools expanded their course offerings and enrollment as well. Net revenue from undergraduate and graduate students grew 6%, driven by modest increases in rate and enrollment partly offset by a continued commitment to financial aid.

OPERATING EXPENSES
Total operating expenses increased by 4% to $4.4 billion. Compensation expense (i.e., salaries, wages and benefits), which represents approximately half of the University’s total operating expense, increased 5% from $2.1 billion in fiscal 2013 to $2.2 billion in fiscal 2014. Salaries and wages increased by 6%, or $87 million, to $1.6 billion in fiscal 2014 due to the University’s budgeted merit programs as well as additional faculty and staff to support strategic areas of focus such as online learning, information technology investments, and continuing and executive education programs.

Employee benefits expense (excluding a $46 million one-time adjustment for a change in valuation methodology for the defined benefit plan) decreased 5%, or $23 million to $484 million. The decrease was mainly driven by a reduction in annual expense for both the University’s defined benefit pension and postretirement health plans due to favorable changes in actuarial assumptions that were set when establishing the obligation on the University’s Balance Sheet at the end of fiscal year 2013. In addition, plan changes slowed the rate of growth in postretirement health benefits costs. Conversely, the University’s active employee health plan expense increased 5%, primarily resulting from an increase in total enrollment and health care cost inflation. In order to moderate health cost increases, the University is making changes to its active employee health benefits offering, effective January 1, 2015.

BALANCE SHEET
Investments
In fiscal 2014, the endowment earned an investment return of 15.4% and its value (after the net impact of distributions from the endowment for operations and the addition of new gifts to the endowment during the year) increased from $32.7 billion at the end of fiscal 2013 to $36.4 billion at the end of fiscal 2014. More information can be found in the Message from the CEO of Harvard Management Company (HMC), found on page 8 of this report.

The University’s holdings of liquid investments (e.g., cash and treasuries) outside of the General Investment Account (GIA) increased from $1.5 billion at June 30, 2013 to $2.1 billion at June 30, 2014. Over the past several years, the University has increased the amount of liquid, low risk investments held outside the GIA to enhance liquidity and financial flexibility.
Debt
Outstanding debt decreased from $5.7 billion at June 30, 2013 to $5.6 billion at June 30, 2014. The University engaged in no new debt issuance over the past fiscal year, and is currently limiting the use of new debt in order to allow for future flexibility in the financing of major initiatives.

The University is rated AAA by Standard & Poor’s Ratings Services (re-affirmed in fiscal 2014) and Aaa by Moody’s Investors Service. Additional detail regarding the University’s debt portfolio can be found in Note 12 of the audited financial statements.

Accrued Retirement Obligations
The University’s accrued retirement obligations increased by $83 million or 11% to $837 million at June 30, 2014. The valuation of these obligations is sensitive to interest rates (i.e., lower interest rates result in an increase in future obligations). At June 30, 2014, rates had decreased as compared to interest rates at June 30, 2013, resulting in an increase in both the defined benefit pension and postretirement obligations. These increases coupled with a one-time valuation methodology adjustment of $46 million to the defined benefit pension plan drove the increase in the obligation.

Capital Expenditures
The University invested $465 million in capital projects during fiscal 2014, an increase of approximately 15% versus fiscal 2013. This enabled progress on several significant projects including:

- Completion of the Harvard Art Museums’ renovation and expansion, which when opened in the fall of 2014, will result in greater accessibility to the University’s world-renowned collections;
- Undergraduate long-term house renewal initiative: completion of Leverett’s-McKinlock Hall renovation, onset of the Dunster Hall project, and renovation of the Inn at Harvard, which will be used as swing space;
- Completion of Tata Hall, to support the Business School’s portfolio of executive education programs;
- Relocations and preparation for the Barry’s Corner Residential Commons project, undertaken in partnership with a third-party developer.

This concludes the summary of the key financial highlights for fiscal 2014. We encourage you to read the audited financial statements and related notes for more information regarding the financial position and results of the University.