Shaped as it is by the conventions of accounting, an institution’s annual financial report rarely reads like a novel. But the University’s financial report for fiscal year 2012 (ended last June 30), released today, manages to read like two novels—or at least two tellings of the same story, one in prose and one in the accountant’s formal language. Together, they definitively close the book on Harvard’s robust run during
the preceding decade, through fiscal 2008, and paint in attention-getting terms a sober portrait of the new circumstances since and ahead. First, the numbers.

The Year in Review

Revenue increased $130 million (a bit more than 3 percent), to just over $4.0 billion from $3.9 billion in fiscal 2011—but expenses increased a few million dollars more (also to more than $4.0 billion from $3.9 billion), yielding a negligible operating deficit of $4.5 million. (Note, as explained below, that the figures for both years reflect a reclassification; the administrative assessment—a decapitalization from endowment funds—is now treated as part of operating revenue, rather than as a separate nonoperating item. In the original reporting of fiscal 2011 results, these funds were excluded from operations, and the financial report showed an operating deficit of $130 million; with those funds now included in operations, fiscal 2011 is reported as an essentially break-even year, and fiscal 2012 shows a similar bottom line.)

These factors drove revenue growth in fiscal 2012:

- **Endowment distributions for operations** rose $100 million from the prior year (including the decapitalized assessment in the figures for both years), to more than $1.4 billion. This represented a significant turnaround from the reductions in endowment distributions for operations of $96 million and a further $129 million in fiscal 2010 and 2011, respectively (both figures exclude the recent reclassification)—following the financial crisis, recession, $11-billion decline in endowment funds, and $3 billion in other losses the University suffered in late 2008 and early 2009.

- **Student income** increased about $36 million (5 percent), to just more than three-quarters of a billion dollars (a sum that is, in financial reporting, shown after $357 million of scholarship awards to students is subtracted from tuition and fee revenue). Continuing and executive education was strong again (up 9 percent), as were graduate and professional degree programs; even undergraduate student income ticked up.

- **Gifts for current use** rose about $12 million, to $289 million. (Total giving, including corporate and foundation research grants, and capital sums for endowment—not operating revenue—edged up to $650 million from $639 million.)

- And miscellaneous other income rose slightly, to $557 million.

Offsetting these gains, in part: sponsored research support—a financial pillar in recent years, fueled by the now-ebbing wave of federal stimulus spending—declined by $19 million, to $833 million. Given the pressures on the federal budget, the caution light is flashing for research support, now the source of more than one-fifth of Harvard revenue. Investment income apart from the endowment also decreased.

Increases in expenses, characteristically, reflected higher compensation—the people costs that, in the aggregate, account for nearly half of Harvard’s annual spending. Salaries and wages rose $78 million (5.5 percent), to almost $1.5 billion, and employee benefits increased a reported $15 million (3.3 percent) to $476 million; a one-time reduction in retiree healthcare expenses (reflecting updated actuarial assumptions about future benefits) reduced this figure by $14 million, masking what was, effectively, an increase in employee-benefits expenses of more than 6 percent. (See below for more on employee benefits.)

Noncompensation expenses grew about 2 percent. Interest expense on Harvard debt declined—a welcome change, after tripling from the reported $97 million in fiscal 2005 to $296 million in fiscal 2011 (nearly 8 percent of expenses in that year). University borrowings, $1.3 billion at the end of fiscal 2000, increased steadily in the years following (even as the endowment more than doubled in value), and then mushroomed as Harvard scrambled for liquidity during the financial crisis, peaking at roughly $6.3 billion
in fiscal 2010 and 2011. During fiscal 2012, the University redeemed about $300 million of outstanding debt, ending the year with just over $6 billion of borrowings outstanding. The related interest expense accordingly declined about $10 million, to $285 million.

Other items of note:

- **Cash and related liquid balances** held outside the longer-term General Investment Account (the endowment and other assets) increased to $1.3 billion, up $200 million from the prior year—even after the University redeemed a portion of its debt.

- **Unfunded investment commitments** to outside investment managers continued to decline, as suggested in Harvard Management Company’s fiscal 2012 report [17]. The financial report gives a figure of $4.6 billion at the end of last June, down from $5.4 billion at the end of fiscal 2011, and a reduction of 50 percent since the worrisome obligation at the end of fiscal 2008 [18], when the endowment was about to shed 27 percent of its value and the flow of funds for future investment was about to be choked off. (The financial report also quantifies the endowment managers’ indicated enthusiasm for certain sectors of the private-equity and real estate, natural-resources, and commodities markets; investments in private equities appear to be about $800 million higher than they were two years ago, and holdings in the real-assets classes have risen by nearly $4 billion.)

- **Capital expenditures** during fiscal 2012 were $339 million, reflecting a handful of major projects, including the *Fogg Art Museum* reconstruction [19], the beginning of *undergraduate House renewal* [20], and the completion of Harvard Law School’s *Wasserstein Caspersen Clinical complex* [21]. This level of spending is similar to activity in the prior year—maintaining a pace of construction and acquisitions at about half the level of the period immediately after the turn of the millennium.

- **Further paring of interest-rate swaps** put in place to hedge borrowing costs early in the prior decade. During fiscal 2012, such agreements with a notional value of $208 million matured, and the University paid $135 million in cash to terminate such agreements with a notional value of $756 million. (In fiscal 2011, it expended $278 million to extinguish other interest-rate exchange agreements.) The result was to reduce the notional value of such swaps by nearly half in fiscal 2012, leaving a balance of about $1.1 billion. Unfortunately, given the further decline in interest rates during the year, the negative valuation of contracts still in place was reduced only modestly, from $400 million at the end of fiscal 2011 to about $380 million this past June.

- **Decapitalizations.** The Corporation authorized a very large volume of decapitalizations from appreciated endowment assets: $308.5 million in fiscal 2012, up from $105 million in the prior year. Typically, schools facing a large construction program or other investment may decapitalize funds rather than risk adverse endowment-investment results that could constrain their financial flexibility when they need to fund such projects. The *Faculty of Arts and Sciences* previously reported accounting for about half these fiscal 2012 decapitalizations [22], in advance of spending for House renewal. Similar items pertaining to other schools or central-administration-funded projects have not been detailed. Thus, the previously reported decline in the value of the endowment from $32 billion to $30.7 billion during the past year [17] reflects not only the modestly negative investment return and distributions for operations ($1.4 billion), but also this large level of decapitalizations ($300 million)—not disclosed until the annual financial report is released—offset by gifts received (about a quarter-billion dollars) and other items.
A Twice-Told Tale

President Drew Faust’s introductory message extolls some achievements of the University’s 375th-anniversary year [23]—launching a learning and teaching initiative [24], the iLab [25], and the edX online learning venture [26]—before pivoting to the external environment: financial crises in Washington, D.C., and in Europe, and other uncertainties “likely to prove even more destabilizing in the months ahead.” Adjusting to and planning for “new and sustained financial realities,” she concludes, “will be a significant priority for the entire University leadership team.” This proves to be the gentlest of introductions for the castor oil to come, in the form of the blandly titled “Financial Overview” from vice president for finance Daniel S. Shore, Harvard’s chief financial officer, and Corporation member James F. Rothenberg, University treasurer since 2004.

A fiscal roller-coaster ride. “Since Harvard thinks and acts in long-term timeframes,” Shore and Rothenberg begin, “we believe it is important not only to understand this year’s approximately breakeven operating result, but also to consider that result in the broader context of Harvard’s changed financial circumstances and prospects.” Examining the 10 years from 2002, “the University enjoyed substantial growth through fiscal 2008 driven by large increases in both net assets and debt.” Both elements matter: as an accompanying chart makes vividly clear, the endowment more than doubled from 2002 to 2008 (rising from $18 billion to $37 billion), but so did borrowings (from less than $2 billion to nearly $4 billion). The faculty ranks expanded 10 percent (after holding level in large units like the Faculty of Arts and Sciences [FAS] for the preceding four decades), and capital investments expanded campus facilities by more than four million square feet (20 percent). Much of that was funded with debt, as the FAS, for instance, borrowed heavily to build its Northwest Laboratory, Laboratory for Interface Science and Engineering, and other facilities—all of which in turn entailed continuing expenses for operations and maintenance. The financial-aid budget boomed.

Then, they continue:

“The global financial crisis changed the University’s financial profile in a sudden and consequential way, beginning a more turbulent second chapter.” As reported, the endowment crumpled, Harvard incurred $3 billion in additional losses on various financial and investment transactions, and the University had to take on additional debt. Endowment funds for operations—the schools’ largest source of revenue—suddenly declined, rather than continuing on an ever-upward trajectory, and interest costs doubled to nearly $300 million in the short period from fiscal 2008 to fiscal 2011. Worsening matters, “over the past 10 years the University experienced only minimal inflation-adjusted growth in key non-endowment sources of revenue. As an example, our cumulative investments in financial aid have meant that net tuition has not been a source of meaningful support for new initiatives within Harvard. In fact, undergraduate net tuition actually has declined on an inflation-adjusted basis during the past decade at an average rate of 5 percent. Excluding the counter-cyclical benefits of federal government American Recovery and Reinvestment Act awards, federal sponsored research revenue has had an inflation-adjusted compound annual growth rate of only 2 percent since 2002, and non-federal sponsored research has fared worse. Meanwhile, on the expense side of the ledger, benefits expense has more than doubled in the past decade to $476 million in fiscal 2012.”

The net result: a sense of vulnerability in Harvard’s finances, highlighted by “endowment dependence and volatility, federal government dependence, non-endowment revenue stagnation, and a highly fixed cost structure.”

The near-term response has been a period of retrenchment: the tighter staffing and attempts to rationalize information technology, purchasing, and the decentralized libraries structure reported in the past few years. But given the larger, longer-term challenges they now emphasize, Shore and Rothenberg say that actions taken to date are merely a prologue to “an even more fundamental examination of our activities
with the goal of more crisply prioritizing what we do and what we are willing to forgo.”

**An accounting adjustment.** As reported above, the 2012 financial statements reclassify for this year and last the “administrative assessment” (an annual decapitalization, equal to 0.5 percent of the endowment’s value) from a capital item to an operating expense—a different way of presenting about $129 million of funds in fiscal 2011 and slightly more in the latest year. That change in fact tells a story about Harvard’s altered financial circumstances, a useful accompaniment to the Shore and Rothenberg narrative.

First, a bit of history. In 2001, during the last months of his presidency, Neil L. Rudenstine and the Corporation put in place what was called the “strategic infrastructure fund.” [27] As explained during rancorous debate in FAS, to prepare for campus development in Allston, the administration would invest in necessary infrastructure and improvements from its funds; schools’ endowments would be tapped to the tune of 0.5 percent annually, for five years, to yield $500 million to indirectly reimburse these costs, from which all of Harvard would presumably benefit as new facilities were funded by their tenant schools and created in coming decades. As the fiscal 2002 and 2003 annual financial reports disclosed, the funding mechanism yielded $85 million and $80 million, respectively, toward the specified costs. Separate reporting for the item ceased in fiscal 2004, but the assessment yielded $89 million that year.

During 2003 and 2004, President Lawrence H. Summers outlined a sweeping, accelerated development vision for Allston [28], with significant science laboratories, new homes for the schools of education and of public health, housing, cultural facilities, and even additional undergraduate residences. In light of the “very substantial capital costs” that effort would entail, the “strategic infrastructure fund” in early 2004 was extended from five years to the “first phase” of Allston development—25 years—and its allowable uses were broadened [29] beyond land acquisition, site clearance, and construction of infrastructure to include both the cost of new buildings there and the renovation of other campus facilities vacated by units relocating to the new campus. Given the endowment value then (about $19 billion), the administrative assessment would yield an additional $2 billion over its extended life, even if the endowment did not appreciate (and there were those, throughout the booming middle years of the decade, who saw it doubling and doubling again, to $75 billion or beyond)—a sum that could support billions of addition borrowing to build in Allston. At the same time, as Shore and Rothenberg noted, the University was already increasing its debt financing substantially. Centrally managed liquid funds were invested long term, alongside the endowment, to take advantage of the bull market and benefit from further financial resources. And Harvard put in place the interest-rate exchange agreements that were meant to stabilize the costs of the anticipated future borrowings for the Allston work. In fiscal 2008—just before the deluge—the administrative assessment yielded $168 million. [30]

From the perspective of 2012, none of the assumptions equating the administrative assessment with capital investment in Allston development remain:

- The University is too indebted to contemplate borrowing substantially (if it wishes to retain its AAA/Aaa credit ratings), and has much higher, continuing debt-service costs.
- The endowment remains one-sixth smaller than it was at its peak in fiscal 2008, all the while supporting that larger faculty, physical plant, and financial-aid budget.
- Having absorbed punishing losses on the interest-rate swaps and from the investment alongside the endowment of certain centrally held funds—some of which were intended for near-term uses—the University is pursuing a much more cautious, more liquid, lower-return strategy for managing those funds, and Harvard Management Company is pursuing investment strategies much more closely attuned to risk and liquidity.
- The central expenses that the University must now support with that more cautious investment strategy include not only past Allston-related costs (including for the suspended science complex [31]), but also the extra, University-wide debt service.
- And most tangibly, the new Allston master-planning proposal, just submitted to Boston
regulators for review, as informed by the Allston Work Team, is on a scale vastly reduced from prior plans. Third-party developers are involved to create new housing and a hotel-conference center; much acreage is set aside for a future commercial research park; Harvard Business School and the athletics department are expected to pursue their own projects through philanthropic financing, and almost all the rest of the land is now a blank slate, for potential academic use a decade, or decades, in the future.

Thus, treating the 2001 assessment mechanism as an Allston-related decapitalization item no longer makes sense; rather, it is an assessment on endowment assets that defrays central operating expenses, and so, from an accounting sense, is an operating item: a financial-reporting change that reflects, in fact, almost revolutionary upheaval in Harvard’s fiscal assumptions, operations, and position.

The Future

Shore and Rothenberg sketch the conditions suggesting the need for a new economic model for Harvard and other private research universities. They observe:

We are challenged by volatility in the capital markets due to our endowment dependence and disproportionately fixed cost structure. We depend considerably on the federal government’s funding of biomedical research at a time when the government’s projected deficits and accumulated debt create enormous pressure to reduce such discretionary dollars. The University’s sizable campus requires significant annual funding to maintain and still more funding to address deferred maintenance.

Employee benefits. Having earlier pointed to employee-benefit costs, they revisit that issue twice, in unusually strong language, terming the increase “unsupportable... relative to actual and expected growth in the University’s revenue” and then declaring that “with those costs continuing to increase at unsustainable rates, Harvard—like its peers and indeed like most other businesses—cannot simply continue with the status quo.”

Although healthcare is the largest component of employee benefits, several factors appear to contribute to rising expenses. The trend factor—utilization and the costs of medical care—is increasing, although apparently not at the double-digit rates of a decade ago. The workforce is expanding, and salaries and wages are increasing, making for higher payroll taxes. Interest rates have fallen, making it much more expensive to pay for unfunded pension and retiree healthcare costs.

In the near term, the University is addressing those costs largely by effecting changes in healthcare benefits (employee and retiree costs for co-insurance and deductibles rose during calendar 2012), and by increasing the share of premiums that higher-paid employees will bear in calendar 2013. (Nonunion employees earning less than $70,000 have paid about 15 percent of the cost of health insurance; those earning $70,000 to $95,000 have paid about 20 percent; and those earning more than $95,000 have paid about 25 percent. As of January 1, the University is increasing the share of costs for those two upper tiers by about 2 to 3 percentage points.)

In a vivid sign of the rising pressures, disagreements about appropriate compensation and the incidence of healthcare costs have become contentious issues between the University and the Harvard Union of Clerical and Technical Workers (HUCTW), its largest union. Normally, a new contract has been negotiated and approved before the expiry of an existing agreement. But this year, since the contract expired on June 30, the union workers have led demonstrations and disseminated increasingly detailed statements about their negotiating position, and the University has countered with unprecedented public discussion of its own proposals—including a flat rejection of the HUCTW’s proposal to make employees’ share of healthcare costs more progressive by introducing a new tier for workers earning $50,000 or less (which, Harvard says, would shift $1.5 million of costs to higher-paid workers—atop the increased cost the University is already
imposing, discussed above).

**Endowment distributions.** As noted, increased distributions from the endowment were the largest source of additional operating revenue for Harvard in fiscal 2012—a welcome reprieve from the two prior years of reduced distributions. For fiscal 2013, the Corporation approved a further 5 percent increase in the distribution. But the outlook for fiscal 2014 is nowhere near so promising. To counter the volatile economic and investment environment, the Corporation now uses a multiyear smoothing formula to set future endowment distributions. Following two years of robust recovery in fiscal 2010 and 2011—which brought the endowment’s value, after distributions, from $26.1 billion (at the end of fiscal 2009) to $32 billion—the slightly negative investment return and spending in fiscal 2012 reduced the endowment to $30.7 billion. That suggests that growth from this largest source of revenue will flatten, or even head back down, in the future.

**“Rapid, disorienting change.”** Shore and Rothenberg foresee a lasting shift from “many decades of growth and stability” to “rapid, disorienting change” buffeting higher education. They restate the case for “integration opportunities” (continuing to wring out costs through the library reorganization, centralizing information technology and purchasing, and other, unspecified initiatives; attacking “generous employee benefit offerings”; and “exploring incremental revenue.” Among the latter steps they point to “more creative strategies to leverage the University’s space and its vast intellectual resources for additional monies that can be reinvested in our teaching and research aspirations.” And, of course, “a fundraising Campaign—which would be Harvard’s first in more than a decade.” (See the discussion of the capital campaign [60]here.) In that vein, the one unreservedly positive note in the financial report’s footnotes covers “pledges receivable”: $909 million at the end of fiscal 2012, up from $758 million a year earlier—early evidence that the current, quiet phase of fundraising is bearing fruit.

Even with that initial progress in mind, Shore and Rothenberg, as they draw on Harvard’s long history and traditions, conclude on a decidedly cautionary note about current conditions and fundamental alterations in the University’s environment:

> The need for change in higher education is clear given the emerging disconnect between ever-increasing aspirations and universities’ ability to generate the new resources to finance them. Certain aspirations more closely resemble imperatives and will require universities to make decisive and inevitably difficult choices from among competing priorities. We can be successful if we equate change with the opportunity to improve and move forward.

> The road ahead will present any number of challenges and opportunities including, without doubt, a few surprises. Success will require a tolerance for ambiguity, an openness to different ways of doing things, a commitment to experimentation, an underlying confidence in our ability to implement a sustainable economic model, and an abiding passion for the University and its impact in the world. These are the same success factors that have enabled Harvard to thrive throughout the centuries, and we expect to achieve similar results in the future.

Shore and executive vice president Katie Lapp provide perspective on these issues, in the context of Harvard’s changes in financial management and governance, in this Gazette interview. [37]

**Updated November 2, 2012, at 4:45 p.m. to incorporate minor wording changes regarding the valuation of interest-rate swaps and the operation of the administrative assessment. Further updated to correct the percentage increase in continuing and executive education revenue, and to correct the explanation for the one-time reduction in retiree healthcare expenses during fiscal 2012.**