1994

Report

of the

President

Rice

University

1994 Report of the President

Rice University

At the beginning of the new year, we traditionally measure the challenges facing us and consider how best to meet them. The annual report for this year focuses on the key issues, political and financial, that highly selective American colleges and universities must confront in the coming year, and how Rice may cope with those issues.

Malcolm Gillis

The American higher education system comprises 3,400 institutions that each year enroll about fifteen million students, or one-quarter of all the post-secondary students in the world.

The news is not all bad. American higher education is still, by any standard, the best in the world. While many Americans believe that Japan, or Germany, or some other nation now leads America in one field or another, no Japanese or European university compares with any of the top twenty-five universities in this country. In 1993, almost half a million foreign students enrolled in U.S. universities. These students came here for good reason, including superior faculties. The ninety-eight Japanese national universities, for example, have a total of fifty-six endowed chairs, none of them in natural sciences. Rice alone has more than one hundred endowed chairs, including eighteen in the natural sciences.

How has the U.S. retained its superiority in higher education? One of the greatest strengths of American higher education has traditionally been our rich variety of institutions. The higher education tent has proven large enough to enfold the huge California and Texas public systems, the private research universities, the small liberal arts colleges, a wide array of church-based schools, and hundreds of community colleges. All told, the American higher education system comprises 3,400 institutions that each year enroll about fifteen million students, or one-quarter of all the post-secondary students in the world.

Congress laid the foundation for America's academic diversity immediately after our independence. Several of our founding fathers tried and failed to persuade Congress to establish a national university. Had they prevailed, we would today labor under a cumbersome, centralized higher education system like those of most of Europe, all of Latin America, and Japan. These national systems, overrun by bureaucrats, are susceptible to pressures for conformity and mediocrity and vulnerable to capture by groups at either end of the political spectrum. In addition, in some countries, like Italy, centrally run systems have fallen prey to corruption, while in others, such as France, universities operate under a stream of unfathomable directives issued from distant capital cities.

Because the United States opted early on for decentralization and diversification in higher education, we have had no central authority looking over our shoulders, setting uniform standards, determining political correctness, dictating curricula, or regulating salaries. Until recently, the federal government has largely left us alone. While European and Japanese universities have had to depend for direction on the competence of bureaucrats in ministries of education, American higher education has relied on local leadership, experimentation, and open competition. As a result, American universities are much lighter on their feet than their European and East Asian counterparts, better able to respond to new developments, not only in the realm of technology, but in the areas of politics and culture as well. Our approach has enabled us, in spite of our failings, to remain responsive to the changing needs of our students and our society.

That is the good news about American higher education. The not-so-good news falls into two categories. First, despite the compelling lessons of American history, the federal government has recently attempted to become a more intrusive and disruptive presence in higher education. Second, many American universities are in financial distress because of rising costs.

Deep underpricing of services has long characterized American universities, both public and private. In the past, Americans and their elected representatives recognized this underpricing and the other contributions of research universities as a form of public service. Today, however, universities meet growing resentment over the rapidly increasing cost of higher education, and the political environment for universities is uncharitable at best.

Consider some recent actions of the federal government. Two years ago, Congress passed the Higher Education Amendments of 1992. Section H of those amendments established the State Post-secondary Review Entities (SPREs), funded by the U.S. Department of Education. The ostensible purpose of the SPREs was to correct fraud and other abuse, especially loan defaults, in the Federal Title IV student aid program.

Although default rates on federally supported loans have declined sharply over the past three years, about 10 percent of higher education institutions still experience annual defaults of 30 percent or more. These are indeed high figures, and Congress was right to seek remedies. In their rush to regulate, however, legislators overlooked the facts. More than 90 percent of the institutions with high loan default rates were for-profit, proprietary trade schools that train truck drivers, medical technicians, and others.

It was bad enough that distinguished four-year colleges and universities, with default rates on student loans running 5 percent or less, were tarred with the same legislative brush as the proprietary institutions. In 1993 and 1994, the Department of Education proposed regulations to implement Section H that far exceeded congressional language or intent. Armed with these regulations, the SPREs would have had the power to expand greatly state oversight of curricula and accreditation at all colleges and universities.

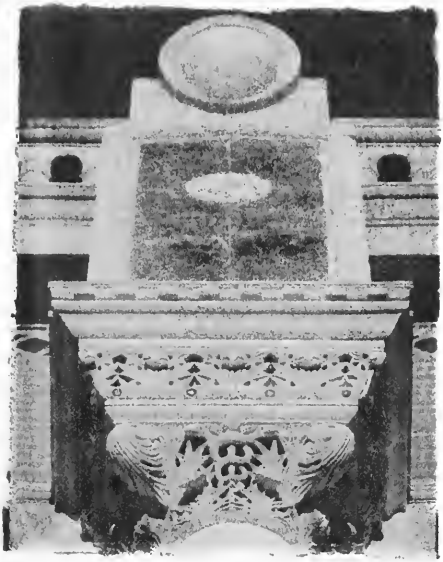
In April, following a sustained and angry outcry from the higher education community and the Congress, the Department of Education modified the regulations. As issued, the provisions were less onerous and intrusive than earlier versions. Still, the regulations presage the establishment of federal standards and procedures on curricula, academic practice, and accreditation. Clearly, there persists, within the federal bureaucracy, a widespread conviction that the central government ought to determine what college students should learn, measure what they have accomplished, and decide whether they have received value for their money, whether from public or private schools. This is the kind of intrusive oversight provided by ministries of education in Europe and Japan.

Last spring, senior Department of Education officials assured research universities and liberal arts colleges alike that the SPREs were only intended to combat loan fraud and would never adversely affect us, a statement acceptable only to the credulous. The SPREs are better seen as the camel's nose in the tent of higher education. They represent the first step in a surreptitious effort to exert federal control over matters properly outside federal control. Despite the department's assurance, the first year of the unwieldy SPRE review process entailed high-handed disregard for respectable colleges and universities across the nation, including many in Texas. In July and August of 1994, dozens of institutions received lengthy, officious letters notifying them that they had been referred to their state SPREs for review, even though SPREs in most states were not yet functional.

A typical case involved a highly selective liberal arts college in the midwest, a school usually mentioned in the same breath with Williams and Amherst Colleges. The Department of Education mistakenly referred this school to the Minnesota SPRE for failing to file an audit report for 1990. The president spoke for much of higher education when he said, in a letter to one of his senators:

> *Even the IRS has the decency to write and ask if they are mistaken in what their records show about one's filings with them—no such courtesy from the Department of Education . . . They do not ask if their records are incomplete—they tell us we have 'triggered' a review by the Minnesota SPRE—a review which would be impossible in any case, since the process has not yet been decided upon.*
>
> *Institutions should be accountable; we expect to be accountable; we <u>are</u> accountable. What is maddening is the time, energy, and cost devoted to needless—and I mean needless—correspondence and documentation.*

Indeed, the Department of Education never needed the SPREs to curtail abuses in student loan programs; other, better tools exist. The department has always had the option of seeking higher appropriations for its own inspector-general to ensure the aggressive pursuit of violators through appropriate civil and criminal action. Instead, it opted to create a demonstrably clumsy and unresponsive bureaucracy to meddle in affairs well beyond its competence. Through the SPREs, the Department of Education, whose expressed aim is to promote educational excellence, has seemed determined to make itself not a part of the solution



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Since 1988, episodes of

acute budgetary distress

have beset about

fifteen private members

of the prestigious

American Association of Universities,

to which Rice belongs.

1994

Financial

Report

of the

University

Report of Independent Public Accountants

To the Board of Governors, William Marsh Rice University:

We have audited the accompanying balance sheet of William Marsh Rice University (a nonprofit Texas corporation) as of June 30, 1994, and the related statements of changes in fund balances and current funds revenues, expenditures and other changes for the year then ended. These financial statements are the responsibility of the University's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of William Marsh Rice University as of June 30, 1994, and the changes in fund balances and the current funds revenues, expenditures and other changes for the year then ended in conformity with generally accepted accounting principles.

Arthur Andersen LLP

Houston, Texas

October 28, 1994

William Marsh Rice University
Balance Sheet

June 30, 1994, with comparative totals at June 30, 1993
(Dollars in Thousands)

	1994						1993
Assets	Current Funds	Endowment and Similar Funds	Annuity and Life Income Funds	Plant Funds	Loan Funds	Combined	Combined
Cash, Receivables and Other Assets:							
Cash	$ 541	$ -	$ -	$ -	$ -	$ 541	$ 13
Accounts receivable	7,593	14,072	1,091	99	-	22,855	16,199
Loans, net of allowance for doubtful accounts of $624 in 1994 and $614 in 1993	-	-	-	-	5,882	5,882	5,503
Other assets	1,866	350	-	-	-	2,216	2,298
	10,000	14,422	1,091	99	5,882	31,494	24,013
Interfund Receivable (payable):							
Interest-bearing endowment fund advances	(141)	4,204	-	(3,319)	(744)	-	-
Noninterest-bearing advances	40,558	(36,253)	(474)	(6,313)	2,482	-	-
	40,417	(32,049)	(474)	(9,632)	1,738	-	-
Investments, at cost	301	810,899	78,269	-	-	889,469	842,127
Educational Plant, net	-	-	-	198,446	-	198,446	189,319
Total assets	$50,718	$793,272	$78,886	$188,913	$7,620	$1,119,409	$1,055,459
Liabilities and Fund Balances							
Liabilities:							
Accounts payable and accrued liabilities	$15,502	$ 5,648	$ 509	$ 768	$ -	$ 22,427	$ 13,410
Annuities and life income payable	-	-	10,191	-	-	10,191	10,522
Assets held in trust for others	-	-	17,902	-	-	17,902	8,962
Total liabilities	15,502	5,648	28,602	768	-	50,520	32,894
Fund Balances:							
U.S. Government and private grants refundable	-	-	-	-	4,902	4,902	4,597
Annuity and life income funds	-	-	50,284	-	-	50,284	45,230
University funds—							
Unrestricted	4,645	-	-	-	-	4,645	3,440
Internally designated	17,412	-	-	-	-	17,412	15,346
Restricted	13,159	-	-	-	2,718	15,877	14,251
Income unrestricted endowment	-	388,747	-	-	-	388,747	381,280
Income restricted endowment	-	255,176	-	-	-	255,176	242,030
Unrestricted funds functioning as endowment	-	98,273	-	-	-	98,273	87,390
Restricted funds functioning as endowment	-	45,428	-	-	-	45,428	47,631
Unexpended plant funds	-	-	-	1,377	-	1,377	4,487
Net investment in plant	-	-	-	186,768	-	186,768	176,883
Total fund balances	35,216	787,624	50,284	188,145	7,620	1,068,889	1,022,565
Total liabilities and fund balances	$50,718	$793,272	$78,886	$188,913	$7,620	$1,119,409	$1,055,459

The accompanying notes are an integral part of these financial statements.

William Marsh Rice University
Statement of Changes in Fund Balances

For the year ended June 30, 1994, with comparative totals for 1993

(Dollars in Thousands)

	1994										1993
	Current Funds			Endowment and Similar Funds		Annuity and Life Income Funds	Plant Funds				
	Unrestricted	Internally Designated	Restricted	Endowment	Functioning as Endowment		Unexpended	Investment in Plant	Loan Funds	Combined	Combined
Revenues and Other Additions:											
Investment income	$ 37,682	$ 63	$15,265	$ 234	$ 1,361	$ 1,021	$ 294	$ -	$ 70	$ 55,990	$ 59,986
Realized gains on investments	-	-	-	23,372	8,534	2,604	-	-	-	34,510	36,790
Gifts and bequests	3,760	-	6,108	19,894	-	1,828	2,014	217	-	33,821	42,884
Tuition and fees	34,715	3,941	-	-	-	-	-	-	-	38,656	34,994
Grants and contracts	7,149	-	30,206	-	-	-	-	-	-	37,355	33,935
Unrestricted revenues of auxiliary enterprises	18,182	1,031	-	-	-	-	-	-	-	19,213	18,008
Additions to investment in plant—											
Direct expenditures (including $12,887 charged to current funds expenditures in 1994)	-	-	-	-	-	-	-	20,630	-	20,630	15,855
Repayment of advances from endowment funds	-	-	-	-	-	-	-	396	-	396	374
Interest on loans receivable	-	-	-	-	-	-	-	-	178	178	180
Other	902	4,163	-	-	20	-	487	367	201	6,140	4,657
Total revenues and other additions	102,390	9,198	51,579	43,500	9,915	5,453	2,795	21,610	449	246,889	247,663
Expenditures and Other Deductions:											
Educational and general expenditures	92,868	10,095	55,446	-	-	-	-	-	-	158,409	145,577
Auxiliary enterprises expenditures	20,571	917	456	-	-	-	-	-	-	21,944	20,181
Expended for plant facilities	-	-	-	-	4,708	-	3,035	-	-	7,743	7,306
Repayment of advances from endowment funds	-	-	-	-	-	-	396	-	-	396	374
Interest on endowment fund advances	-	-	-	-	-	-	248	-	47	295	315
Depreciation of plant facilities, including auxiliary and educational service facilities	-	-	-	-	-	-	-	11,387	-	11,387	11,765
Retirement of plant assets	-	-	-	-	-	-	-	338	-	338	438
Other	-	-	-	-	-	-	-	-	53	53	504
Total expenditures and other deductions	113,439	11,012	55,902	-	4,708	-	3,679	11,725	100	200,565	186,460
Transfers Among Funds— Additions (Deductions):											
Mandatory—											
Loan fund matching grants	-	-	-	-	(35)	-	-	-	35	-	-
Undesignated gifts	(26)	-	-	26	-	-	-	-	-	-	-
Provision for plant improvements	(3,623)	-	-	-	3,623	-	-	-	-	-	-
Funding of unrestricted current expenditures for equipment	3,623	-	-	-	(3,623)	-	-	-	-	-	-
Funding of principal and interest payments for plant additions	(644)	-	-	-	-	-	644	-	-	-	-
Matured annuity and life income funds	-	-	-	415	-	(415)	-	-	-	-	-
Other voluntary transfers, net	12,924	3,880	5,870	(23,328)	3,508	16	(2,870)	-	-	-	-
Total transfers	12,254	3,880	5,870	(22,887)	3,473	(399)	(2,226)	-	35	-	-
Net Increase (Decrease) for the Year	1,205	2,066	1,547	20,613	8,680	5,054	(3,110)	9,885	384	46,324	61,203
Fund Balance at Beginning of Year	3,440	15,346	11,612	623,310	135,021	45,230	4,487	176,883	7,236	1,022,565	961,362
Fund Balance at End of Year	$4,645	$17,412	$13,159	$643,923	$143,701	$50,284	$1,377	$186,768	$7,620	$1,068,889	$1,022,565

The accompanying notes are an integral part of these financial statements.

William Marsh Rice University
Statement of Current Funds Revenues, Expenditures and Other Changes

For the year ended June 30, 1994, with comparative totals for 1993

(Dollars in Thousands)

	1994				1993
	Unrestricted	Internally Designated	Restricted	Combined	Combined
Revenues:					
Educational and general—					
Endowment income	$ 37,682	$ 63	$20,012	$ 57,757	$ 58,413
Tuition and fees	34,715	3,941	-	38,656	34,994
Government grants and contracts	5,840	-	25,816	31,656	28,576
Private grants and contracts	1,309	-	4,390	5,699	5,239
Gifts and bequests	3,760	-	5,228	8,988	7,782
Departmental sales and services	410	3,966	-	4,376	3,290
Other sources	492	197	-	689	651
Total educational and general	84,208	8,167	55,446	147,821	138,945
Auxiliary enterprises	18,182	1,031	456	19,669	18,520
Total revenues	102,390	9,198	55,902	167,490	157,465
Expenditures:					
Educational and general—					
Instruction and departmental research	39,331	7,604	18,981	65,916	59,630
Sponsored research	-	-	26,815	26,815	24,450
Other sponsored programs	-	-	2,735	2,735	2,375
Library	7,151	620	284	8,055	7,710
Scholarships and fellowships	13,953	222	5,488	19,663	17,958
Student services	4,165	298	40	4,503	4,108
Operation and maintenance of plant	11,651	-	569	12,220	11,956
General administration	10,800	834	176	11,810	11,305
Institutional development	5,817	517	358	6,692	6,085
Total educational and general	92,868	10,095	55,446	158,409	145,577
Auxiliary enterprises	20,571	917	456	21,944	20,181
Total expenditures	113,439	11,012	55,902	180,353	165,758
Transfers and Additions (Deductions):					
Mandatory transfers—					
Undesignated gifts	(26)	-	-	(26)	(178)
Provision for plant improvements	(3,623)	-	-	(3,623)	(3,932)
Voluntary transfers, net	15,903	3,880	5,870	25,653	18,571
Other additions (deductions)—					
Prior years' restricted receipts recognized as current-year revenue	-	-	(4,323)	(4,323)	(1,895)
Refunded to grantor	-	-	-	-	(60)
Net transfers and additions	12,254	3,880	1,547	17,681	12,506
Net increase in fund balances	$ 1,205	$ 2,066	$ 1,547	$ 4,818	$ 4,213

The accompanying notes are an integral part of these financial statements.

William Marsh Rice University
Notes to Financial Statements
June 30, 1994

1. Summary of Significant Accounting Policies:

Basis of Accounting

The financial statements of William Marsh Rice University (the University) have been prepared in accordance with generally accepted accounting principles for colleges and universities. Accordingly, the accompanying financial statements have been prepared on the accrual basis of accounting. Limitations and restrictions placed on the use of available resources are recognized in the accompanying financial statements through the use of fund accounting. Fund accounting is a procedure by which resources are classified for accounting and reporting purposes into separate funds in accordance with specified objectives or activities. Funds having similar characteristics together with all related financial transactions have been combined into fund groups in the accompanying financial statements.

The financial information shown for 1993 in the accompanying financial statements is included to provide a basis for comparison with 1994 and presents summarized totals only. Certain reclassifications of 1993 information have been made to conform to the 1994 presentation.

Current Funds

The statement of current funds revenues, expenditures and other changes is a statement of financial activities of current funds related to the current reporting period. It does not purport to present the net income or loss for the period as would a statement of income or a statement of revenues and expenses.

The unrestricted current fund is used to account for those transactions related to the University's operating budget as approved by the Board of Governors. With the exception of auxiliary fund balances, any net increase in the unrestricted current fund balance after providing for funding of certain outstanding commitments and planned future activities is transferred to unrestricted funds functioning as endowment.

Certain resources which have been designated for specific purposes by the University's management are presented under the internally designated caption.

The restricted current fund is used to account for funds expended for current operations but restricted by donors or other external sources for specific purposes. In the statement of current funds revenues, expenditures and other changes, restricted current fund receipts are reported as revenues when expended.

Current funds used to purchase equipment are accounted for as expenditures of the current funds. Certain equipment expenditures of the unrestricted current fund are funded by a transfer from that portion of unrestricted funds functioning as endowment described in Note 4.

Endowment and Similar Funds

Endowment funds are subject to the restrictions of gift instruments requiring that the principal be invested in perpetuity and that only the income be spent. Gains and losses realized on investment transactions are recorded as increases or decreases to the endowment fund. Income from endowment funds may be restricted or unrestricted as stipulated by the donor. Investment income from restricted endowments may be expended only for the purpose specified by the donor; income from unrestricted endowments may be expended for any purpose approved by the Board of Governors.

The Board of Governors has designated certain restricted and unrestricted funds to function as endowment funds. Restricted funds functioning as endowment are comprised of (a) restricted current gifts transferred by the Board of Governors, (b) the excess of restricted investment income over current fund expenditures and (c) gains realized on the investment of the above amounts. The principal of restricted funds functioning as endowment may be expended, but only in accordance with the restrictions of the gift instruments. Investment income from these funds is also subject to the same restrictions as the original gifts.

Unrestricted funds functioning as endowment are comprised of (a) unrestricted current funds transferred at the discretion of the Board of Governors and (b) gains realized on the investment of these amounts. Unrestricted funds functioning as endowment may be expended for any purpose approved by the Board of Governors.

The University has adopted an endowment earnings distribution policy based on total investment returns, as permitted by the Texas Uniform Management of Institutional Funds Act. Under this policy, the Board of Governors approves a distribution for expenditure which is based on the earnings distribution of the preceding year and the market value of the endowment assets. Sources of this distribution for each restricted endowment fund, in the order utilized, are (a) earned income as traditionally defined (interest, dividends and rents), (b) reinvested earned income from prior years and (c) capital gains where not prohibited by the gift document. Sources of this distribution for the unrestricted general endowment fund, in the order utilized, are (a) earned income as traditionally defined (interest, dividends and rents) and (b) capital gains. When the approved distribution for a fund exceeds earned income as traditionally defined, the difference is shown as a voluntary transfer of endowment and similar funds to the current fund.

For fiscal 1992 and 1993, the University recorded sources of the unrestricted general endowment fund distribution as (a) earned income as traditionally defined (interest, dividends and rents) and (b) reinvested earned income from prior years. In fiscal 1994, the University made a voluntary transfer of $13,633,000 from unrestricted endowment fund capital gains to unrestricted funds functioning as endowment to conform to the distribution order now in effect.

Generally, income from unrestricted endowment and similar funds is reported as revenue of the unrestricted current fund. However, 27-1/2 percent of the net receipts from oil and gas royalties is retained in the unrestricted endowment fund after the related properties are fully amortized. Income from restricted endowment and similar funds is generally reported in the fund to which it is restricted. However, income which exceeds the budgeted distribution is recognized in the endowment and similar funds.

Annuity and Life Income Funds

Annuity and life income funds arise from gifts which are subject to the requirement that the University or its subsidiary act as trustee for the donated assets and periodically pay specified amounts to the designated beneficiaries. Generally, beneficiary payments are fixed for annuity funds and based on the income earned on the donated assets for life income funds. At a date specified in the gift instruments, usually the beneficiary's date of death, ownership of the donated assets will transfer to the University and the beneficiary payments will cease. Annuity and life income funds also include gift annuities which arise from gifts for which the University takes ownership of the assets at the date of gift with an obligation to periodically pay specified amounts to designated beneficiaries. Annuities and life income payable includes the discounted annuities obligation and undistributed life income fund earnings. Also included in the annuity and life income funds are certain agency funds classified as assets held in trust for others, for which the University serves as custodian.

Plant Funds

Plant funds consist of amounts in the educational plant together with unexpended gifts, grants, income and funds designated by university management which are held for acquisition, replacement or construction of physical properties. The educational plant is stated at cost for purchased assets and fair market value at the date of donation in the case of gifts. The University depreciates its educational plant assets (excluding library books and works of art) using the straight-line method over their estimated useful lives.

Certain capital projects and major maintenance projects for auxiliary enterprises are funded with interest-bearing advances from unrestricted funds functioning as endowment. The advances for capital and major maintenance projects bear interest ranging from 4 percent to 19 percent.

Loan Funds

Loan funds include (a) gifts and grants which are limited by donors for the purpose of making loans to students, (b) federal student loan programs financed primarily by the federal government and administered by the University and (c) advances to the loan funds from unrestricted funds functioning as endowment. The interest received on student loans financed by advances from unrestricted funds functioning as endowment is treated as endowment income.

Recent Accounting Pronouncements

In June 1993, the Financial Accounting Standards Board issued Statement No. 116, "Accounting for Contributions Received and Made," and Statement No. 117, "Financial Statements of Not-For-Profit Organizations." Statement No. 116 may require that pledges receivable be recorded to a greater extent than previously and that grant commitments to others, if any, may also be recorded. Statement No. 117 will have a significant impact on the format of the University's financial statements, requiring all funds to be aggregated into one of three categories: unrestricted, temporarily restricted or permanently restricted.The University plans to implement the statements in fiscal 1996.

2. Gifts and Bequests:

It is the policy of the University to include gifts as revenues or additions to the appropriate fund balances only when received. Gifts and bequests without any designated obligatory use are required to be added to endowment, according to a legal interpretation of the University's charter. These gifts are recorded as revenues of the unrestricted current fund and as mandatory transfers to the endowment and similar funds.

Pledges outstanding at June 30, 1994, which will be recorded as revenues upon receipt of the gifts, are as follows:

Current funds		
	Unrestricted	$ 1,450,000
	Restricted	7,672,000
	Total current funds	9,122,000
Endowment funds		15,830,000
Plant funds		18,593,000
	Total pledges	$43,545,000

3. Investments:

Investments are recorded at cost at date of acquisition or fair market value at date of donation in the case of gifts. Investments in wholly owned corporations are accounted for in the endowment and similar funds under the equity method. Property taxes and maintenance costs on certain undeveloped real estate interests in the endowment have been capitalized (accumulated costs of approximately $2,895,000 at June 30, 1994).

Virtually all endowment funds and all funds functioning as endowment participate in one common investment pool of marketable securities which is operated on a market value basis. Investments are made within guidelines authorized by the board of governors.

Investments (at cost) at June 30 are as follows:

	1994	1993
Marketable securities (market value of $1,241,711,000 in 1994 and $1,268,422,000 in 1993)	$850,315,000	$798,096,000
Developed real estate	25,601,000	25,805,000
Undeveloped real estate	5,868,000	7,722,000
Mortgage loans	3,334,000	6,290,000
Oil and gas properties (net of accumulated amortization of $25,660,000 in 1994 and $26,130,000 in 1993)	945,000	829,000
Wholly owned corporations, at underlying equity	3,406,000	3,385,000
	$889,469,000	$842,127,000

Marketable securities in the table above include annuity and life income funds securities of $91,560,000 and $84,219,000, market value, for the respective years.

The following tabulation summarizes investment income and net realized gains (losses) for the year ended June 30, 1994:

	Investment Income				Realized Gains (Loses), Net	
	Current Funds	Endowment and Similar Funds	Annuity and Life Income Funds	Other Funds	Endowment and Similar Funds	Annuity and Life Income Funds
Marketable securities	$43,606,000	$1,555,000	$ 961,000	$364,000	$23,858,000	$2,924,000
Oil and gas properties	2,822,000	1,084,000	2,000	-	30,000	-
Wholly owned corporations	5,097,000	(747,000)	-	-	-	-
Other investments	1,607,000	(297,000)	58,000	-	8,018,000	(320,000)
	$53,132,000	$1,595,000	$1,021,000	$364,000	$31,906,000	$2,604,000

Investment income for annuity and life income funds of $4,412,000 was distributed to beneficiaries during the year. The above tabulation includes $122,000 of investment income in the current funds earned by auxiliary enterprise investments.

4. Educational Plant:

Property and equipment of the educational plant at June 30, 1994, are as follows:

	Estimated Useful Lives (Years)	Recorded Amount
Land	-	$ 9,656,000
Buildings and improvements	20-50	169,375,000
Equipment, furniture and library books	2-20	145,400,000
Construction in progress	-	5,479,000
Less-accumulated depreciation		(131,464,000)
		$ 198,446,000

Approximately 10 percent of unrestricted endowment income is transferred each year from unrestricted current funds to unrestricted funds functioning as endowment to fund a portion of plant improvements.

5. Retirement Plans:

Substantially all employees are eligible to participate in defined contribution retirement plans, which are administered by outside agencies. The contributions of the University and the plan participants are applied to annuity contracts. The University's contributions to these plans of $6,280,000 in 1994 were recorded as expenditures of the unrestricted current fund.

6. Commitments and Contingencies:

There are several suits and claims pending against the University, the effect of which cannot be estimated at this time; however, officials of the University and legal counsel believe that the ultimate uninsured liability, if any, will not be material to the University's financial position.

The University was committed under contracts at June 30, 1994, for capital improvements and major maintenance of approximately $6,247,000 to be financed primarily from funds functioning as endowment and gifts. Commitments of $2,410,000 in the unrestricted current funds and $1,867,000 in the restricted current fund were also outstanding at June 30, 1994.

Rice University Board of Governors

(as of March 1995)

to the problems facing higher education, but one of the chief problems facing higher education.

Fortunately, as this report went to press, news from Washington indicated that vigorous protests from throughout higher education have compelled the Department of Education to reconsider the role of the SPREs, so that they address only the problem of delinquent student loans. Should this reversal occur, we will be grateful to the many members of the Texas congressional delegation who provided timely help. In the meantime, we must remain watchful.

The second challenge to American higher education comes in the form of widespread financial distress. While most state-supported institutions have recovered somewhat in 1994, the years from 1988 to 1993 were difficult for many. More than two-thirds of the states cut financial support to state colleges and universities during those five years. As recently as 1993, the *Chronicle of Higher Education* reported that twenty states had made mid-year cuts in higher education funding.

Private universities, including many of the best in the nation, have felt the same pressures. Since 1988, episodes of acute budgetary distress have beset about fifteen private members of the prestigious American Association of Universities, to which Rice belongs. Stanford has reduced its $461 million operating budget by $80 million since 1991. MIT has not only taken steps to reduce faculty size by 5 percent, but has considered enacting a parking fee, a highly unpopular act on any campus.

Higher education has faced financial troubles before, notably during the depression, and surmounted them. But today's situation is especially grave. Universities must seek new ways to improve the efficiency of their operations. While goals and incentives differ in important respects at universities and business firms, their operations have some features in common. It may be appropriate, in a limited sense, to view university operations through the business optic. What then would be the principal business of American higher education?

Universities prepare students for a lifetime of learning. Their business is to deliver a product in the form of two types of knowledge: embodied and disembodied. Embodied knowledge, imbedded in the cerebrums of our graduates, is intangible. Disembodied knowledge, on the other hand, is tangible when it appears as information in journals and books, and on compact discs. Universities generate both kinds of knowledge through teaching and research. In this production process,[1] we use highly specialized resources, such as faculty and research assistants, and semispecialized resources, like office staff, equipment, and bricks and mortar. Finally, to support teaching and research, universities offer a wide range of central services such as building maintenance and repair, catering, and record-keeping.

Production relationships in higher education are no less complex than in manufacturing. Higher education, however, is a labor intensive service industry. Salaries and benefits are typically about 55 to 60 percent of costs at schools like Rice, Duke, Stanford, and Harvard. By contrast, labor costs seldom exceed 8 percent of sales of large manufacturers. It is more difficult to increase productivity in higher education than in industry, where a chief source of productivity gains has been provision of steadily increasing amounts of capital per worker.

Another significant difference between a research university and a manufacturing firm pertains to pricing. The prices that we charge, even at private schools, for teaching and research services fall well below the costs of providing them. Moreover, we keep these prices low deliberately. For example, the annual cost of educating a Rice student, counting capital costs, is nearly $40,000. This is comparable to costs at Princeton, Williams, Swarthmore, and other highly regarded colleges and universities. But at Rice, where less than half our students pay full tuition, even those who are charged the full amount pay only about one-quarter the cost of providing that education. At schools with much higher tuition, fees may cover about half the cost, but all private as well as public universities underprice undergraduate education.

For many years, we have also underpriced our other principal product, research and associated technology. We have often charged nothing for significant discoveries, and until recently, we have collected only nominal fees for technology trans-

[1] *The concept of production in higher education comes from Paul Hare and Geoffrey Wyatt, "Economics of Academic Research and Its Implications for Higher Education,"* Oxford Review of Economic Policy, *volume 8, number 2. Pp. 48-60.*

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fer. Not until the Bayh-Dole Act of 1980 liberalized the licensing of university-patented inventions did some universities begin to collect appreciable royalties on their discoveries, including those financed by federal research funds.

Meanwhile, the costs of investments critical for sustaining educational quality have risen rapidly. The costs of library books and journals have consistently outpaced inflation, and the instrumentation and equipment essential for good science are now appallingly expensive. For new faculty members in chemistry, start-up costs for laboratory renovation and equipment range from about $500,000 to $1.7 million *per hire*. The figures for computer science and biology are comparable. These costs can be avoided only by hiring mediocre chemists, computer scientists, and biologists.

In addition, the backlog of deferred maintenance has risen alarmingly at many universities. The cost of restoring dangerously under-maintained plant and equipment is ultimately larger for having been long delayed. A few universities have a deferred maintenance backlog of well over $500 million, and many have backlogs of $100 million. At the same time, virtually all research universities operate with higher real levels of debt than they did twenty years ago. Rare is the private research university that has not accumulated the permitted maximum of $150 million in non-hospital tax-free debt. With higher debt comes a higher burden of debt service.

Many of the same legislative, regulatory and legal factors that affect the costs of business firms also impact universities. The cost of providing health care benefits for staff and faculty has mushroomed. Compliance with steadily growing federal mandates in dozens of fields is no less expensive for universities than for firms, and, like firms, research universities, even those without medical centers, have experienced startling growth in litigation claims and costs.

A major source of cost pressure has been financial aid. These expenditures have increased sharply in the past decade at many private universities, growing at about three times the rate of inflation. At Princeton, the financial aid budget increased by 30 percent between 1990 and 1993. At Duke, financial aid grew at an average compound rate of nearly 16 percent from 1984 to 1993. At Rice, financial aid expenses grew by 13 percent annually between 1987 and 1993.

The reasons for this explosion in financial aid costs are apparent. First, thanks to the recession of 1990-91 and the subsequent less than robust recovery through 1993 and 1994, more families than ever have qualified for aid. Second, student demographics have been changing. Fewer students each year come from two-parent, middle income families, yet the government still bases financial aid on this model. Moreover, actions to reduce the federal deficit, while generally welcome, have diminished aid to university students. In response, universities have sought to replace lost government support by raising the tuition charged wealthier families. Higher tuition, however, means that more students become eligible for aid. We have, then, a vicious circle: the shortfall in federal aid leads to increased tuition, which in turn leads to greater outlays for financial aid by universities, which leads to pressure for higher tuition, and so on.

Finally, we must acknowledge that during the past few decades management at universities has often been lax, and university leadership has given inadequate attention to cost control. By some accounts, administrative staff in higher education grew ten times faster than faculty between 1975 and 1985. (This was, however, not the case at Rice.) But today's financial troubles cannot be attributed primarily to mismanagement.

This brings us to the revenue side, and to a closer examination of tuition. Throughout most of the 1980s, the growth rate of university costs, and of tuition, closely tracked the growth rate of family income. But since the late 1980s, growth in real family incomes has stagnated, while both university costs and tuition have grown substantially in real terms. Higher education has become less affordable for many families, and universities cannot count on tuition increases to meet rising costs.

While future growth in tuition income is likely to be slow, other sources of university revenue also remain under severe pressure. These include federal funding of research, long a significant source of income for universities, public and private; federal funding of university research increased, in inflation-adjusted dollars, thirteen-fold between 1955 and 1990. Today, growth in this area of support has come to a halt.

The only other important sources of revenue are endowment income and annual gifts. Growth in endowment income has slowed palpably since the 1980s. Moreover, private universities now encounter increased competition for endowments, since public institutions now aggressively pursue many of the same dollars. And all leading universities are straining to increase annual giving, an effort impeded by recent modest growth in the real disposable income of American families.

To be sure, over the next twenty-five years, resourceful use of the new information technology may enable universities to achieve reductions in the costs of teaching and research with no loss in quality. But we cannot assume that new technology will have a significant near-term impact on productivity in academia. Of course, universities could secure major gains by increasing class size. At Rice, we could double the student body while keeping faculty size constant. The average class size would rise from fifteen to thirty. Measured productivity might double. But there would be a clear decline in educational quality, a decline we will not accept.

The financial problems I have outlined are occurring at a time of swift and portentous change. As a nation, we have historically adjusted well to continuous modifications in science, in the economy, and in our culture. Now, however, university graduates confront a world of sudden, discontinuous changes: of rapidly growing economic interdependence; major geopolitical realignments; strong demographic shifts; and revolutions in electronics and informational technology, molecular science, and biomedicine. It is a world where the discipline of biology, no longer the passive study of life processes, can alter life. Regrettably, it is also a world where a college degree, even from a highly selective school, holds out diminished promise for challenging, remunerative employment. Job prospects for new graduates and even for Ph.D.s in some fields are more uncertain now than at any time in the post-war period.

Many of us can recall periods when universities had to deal with one or two of these problems. But there has never been a time when higher education had to meet all of them at once, plus new problems originating in the federal government. The last thing universities need now is unwarranted federal encroachment into university teaching and learning. Unless the Department of Education intends to hobble higher education, it would do well to abandon its ill-advised efforts to promote the SPREs at a time when colleges and universities face significant challenges from all sides.

At Rice, we must contend with some, but not all, of these vexing problems. While most top-echelon universities have incurred about $150 million in long-term debt, Rice has no debt outstanding. Unlike many of our sister institutions, we have not built up tens of millions of dollars in deferred maintenance; we should be proud that we have taken good care of our physical plant. Our tuition, at about half that of other top-echelon private universities, makes us much more accessible than most universities to students from middle income families, and our graduates fare quite well in competition for jobs and for positions in graduate and professional schools.

Above all, even under adverse circumstances, we remain strongly committed to excellence. We are pleased that others have recognized this commitment. Rice, along with Caltech, is one of the two smallest research universities, but *U.S. News & World Report* ranks us time and again among the top fifteen research universities (twelfth this year). *Money* magazine ranks Rice first among research universities for providing more diploma for the money. They describe Rice as the best educational bargain among all universities, public or private. Only a small state institution, New College, in Sarasota, is considered a better bargain, but New College is not a university. While we are grateful for this recognition, we do not plan our programs to elicit encomiums from magazines. We serve more important constituencies that insist Rice remain at the forefront of teaching and research. Those constituencies are our students, our faculty and staff, our alumni, and our board.

We will

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Our students demand quality, as well they should. For several years, our freshman class has had the highest percentage of national merit finalists of any university in the nation. Last year, Rice was the university with the highest proportion of seniors winning prestigious National Science Foundation Fellowships. Every year, 40 to 45 percent of our seniors apply to graduate or professional school for the next fall. Every year, virtually 100 percent of those applying enter Ph.D. programs, highly regarded business, law, and medical schools.

Our faculty exemplifies quality. Rice is disproportionately represented in the prestigious National Academies of Science and Engineering, with more members than universities two and three times larger. Faculty in economics and history have recently won coveted national prizes. Last year, Stanford, Berkeley, and Princeton, among others, made determined efforts to lure away six distinguished members of departments including chemistry and history. We did not lose a single one.

Our alumni and our board, imbued with President Lovett's vision, have always recognized and maintained quality. They have constantly heeded President Lovett's succinct statement of Rice's mission: to aspire to university standing of the highest grade, and to assign no upper limit to our educational endeavor.

All of our constituencies agree on standards. The question is: how will we maintain them, when we are faced with the threat of increased governmental interference as well as rising costs and constrained revenues?

There are several steps we will not take. First, our tuition remains about half that of comparable private institutions. We are committed to affordable education. We must take measures to assure that our tuition does not spiral upward to levels inaccessible to middle income families. Second, we will not play games with our budgets by postponing needed maintenance on our buildings, grounds, and equipment, leaving future generations of board members, alumni, and students to shoulder past-due bills. Third, we will not allow the quality of a Rice education to decline by targeting sizable increases in either class size or enrollment. Fourth, we will not abandon our policy of need-blind admission in order to save on financial aid.

We will admit students regardless of their financial standing, and we will find ways to provide the financial aid that will enable them to attend. We will redouble our fund-raising efforts in the knowledge that while excellence cannot be bought, it must be paid for. Foundations in Texas, and especially in Houston, played a vital role in Rice's emergence as a first-rank research university. We must now intensify our approach to national foundations, even as we take other measures to broaden our donor base. We intend both to make the Rice Annual Fund one of the strongest among all universities and to expand the university's endowment.

We will also continue to resist unwarranted federal intrusions that threaten the autonomy and integrity of American universities. Perhaps most important, we will clarify our understanding of what we, at Rice, can accomplish. We cannot be all things to all people. We are relatively small, and we choose to remain so. But we can make optimal use of our resources by joining forces with other institutions to tackle specific issues. We have already expressed our readiness to collaborate with our sister institutions and with other entities in Houston and throughout Texas. We will continue to cooperate with the Texas Medical Center on teaching and research in ethics, and we will also build on our successful joint programs with Baylor College of Medicine, with Houston Advanced Research Center (HARC), and with the National Aeronautics and Space Administration (NASA).

It will not be easy to accomplish the mission set forth by President Lovett. But as Rice delivers an intangible product, knowledge, so the university possesses two great intangible assets, continuity and community. Since its founding, Rice has shown a consistent sense of purpose and an enduring appreciation of excellence. Moreover, Rice is the focus of an active, extended community that includes students, faculty, staff, and alumni, not only in Houston, but across the country. We will summon our collective strength and act with the determination that is the legacy of William Marsh Rice, and we will achieve our goals.

Photography by Tommy LaVergne

Mr. Ruben Prado
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