

MORGAN STANLEY
Form 10-Q
October 06, 2006
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended August 31, 2006

OR

.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 1-11758

Morgan Stanley

(Exact Name of Registrant as Specified in its Charter)

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Delaware
(State of Incorporation)

36-3145972
(I.R.S. Employer Identification No.)

1585 Broadway

New York, NY
(Address of Principal
Executive Offices)

10036
(Zip Code)

Registrant's telephone number, including area code: (212) 761-4000

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of September 30, 2006, there were 1,058,558,269 shares of the Registrant's Common Stock, par value \$.01 per share, outstanding.

Table of Contents

MORGAN STANLEY

INDEX TO QUARTERLY REPORT ON FORM 10-Q

Quarter Ended August 31, 2006

| | Page |
|-------------------------------------|-----------------------------------------------------------------------------------------------------------------------|
| Part I Financial Information | |
| Item 1. | Financial Statements (unaudited) |
| | <u>Condensed Consolidated Statements of Financial Condition August 31, 2006 and November 30, 2005.</u> |
| | <u>Condensed Consolidated Statements of Income Three and Nine Months Ended August 31, 2006 and 2005</u> |
| | <u>Condensed Consolidated Statements of Comprehensive Income Three and Nine Months Ended August 31, 2006 and 2005</u> |
| | <u>Condensed Consolidated Statements of Cash Flows Nine Months Ended August 31, 2006 and 2005</u> |
| | <u>Notes to Condensed Consolidated Financial Statements</u> |
| | <u>Report of Independent Registered Public Accounting Firm</u> |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> |
| Item 3. | <u>Quantitative and Qualitative Disclosures About Market Risk</u> |
| Item 4. | <u>Controls and Procedures</u> |
| | |
| Part II Other Information | |
| Item 1. | <u>Legal Proceedings</u> |
| Item 1A. | <u>Risk Factors</u> |
| Item 2. | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> |
| Item 6. | <u>Exhibits</u> |

Table of Contents

AVAILABLE INFORMATION

Morgan Stanley files annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission (the "SEC"). You may read and copy any document we file with the SEC at the SEC's public reference room at 100 F Street, NE, Washington, DC 20549. Please call the SEC at 1-800-SEC-0330 for information on the public reference room. The SEC maintains an internet site that contains annual, quarterly and current reports, proxy and information statements and other information that issuers (including Morgan Stanley) file electronically with the SEC. Morgan Stanley's electronic SEC filings are available to the public at the SEC's internet site, www.sec.gov.

Morgan Stanley's internet site is www.morganstanley.com. You can access Morgan Stanley's Investor Relations webpage through our internet site, www.morganstanley.com, by clicking on the "About Morgan Stanley" link to the heading "Investor Relations." You can also access our Investor Relations webpage directly at www.morganstanley.com/about/ir. Morgan Stanley makes available free of charge, on or through our Investor Relations webpage, its proxy statements, Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to those reports filed or furnished pursuant to the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. Morgan Stanley also makes available, through our Investor Relations webpage, via a link to the SEC's internet site, statements of beneficial ownership of Morgan Stanley's equity securities filed by its directors, officers, 10% or greater shareholders and others under Section 16 of the Exchange Act.

Morgan Stanley has a Corporate Governance webpage. You can access Morgan Stanley's Corporate Governance webpage through our internet site, www.morganstanley.com, by clicking on the "About Morgan Stanley" link to the heading "Inside the Company." You can also access our Corporate Governance webpage directly at www.morganstanley.com/about/inside/governance. Morgan Stanley posts the following on its Corporate Governance webpage:

Composite Certificate of Incorporation;

Bylaws;

Charters for our Audit Committee, Compensation, Management Development and Succession Committee and Nominating and Governance Committee;

Corporate Governance Policies;

Policy Regarding Communication with the Board of Directors;

Policy Regarding Director Candidates Recommended by Shareholders;

Policy Regarding Corporate Political Contributions;

Policy Regarding Shareholder Rights Plan; and

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Code of Ethics and Business Conduct.

You can request a copy of these documents, excluding exhibits, at no cost, by contacting Investor Relations, 1585 Broadway, New York, NY 10036 (212-761-4000). The information on Morgan Stanley's internet site is not incorporated by reference into this report.

ii

Table of Contents**Item 1.****MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION****(dollars in millions, except share data)**

| | August 31, 2006 | November 30, 2005 |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------|------------------------------|
| | (unaudited) | |
| Assets | | |
| Cash and cash equivalents | \$ 18,546 | \$ 29,414 |
| Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements (including securities at fair value of \$25,162 at August 31, 2006 and \$30,223 at November 30, 2005) | 43,986 | 40,130 |
| Financial instruments owned (approximately \$105 billion and \$93 billion were pledged to various parties at August 31, 2006 and November 30, 2005, respectively): | | |
| U.S. government and agency securities | 38,981 | 31,742 |
| Other sovereign government obligations | 27,848 | 22,750 |
| Corporate and other debt | 142,162 | 105,381 |
| Corporate equities | 74,794 | 52,238 |
| Derivative contracts | 48,753 | 45,894 |
| Physical commodities | 3,134 | 2,610 |
| | <u>335,672</u> | <u>260,615</u> |
| Total financial instruments owned | 335,672 | 260,615 |
| Securities received as collateral | 58,170 | 43,557 |
| Collateralized agreements: | | |
| Securities purchased under agreements to resell | 171,547 | 174,330 |
| Securities borrowed | 283,024 | 244,241 |
| Receivables: | | |
| Consumer loans (net of allowances of \$811 at August 31, 2006 and \$838 at November 30, 2005) | 23,261 | 22,916 |
| Customers | 59,474 | 50,979 |
| Brokers, dealers and clearing organizations | 4,913 | 5,030 |
| Fees, interest and other | 8,490 | 6,137 |
| Office facilities, at cost (net of accumulated depreciation of \$3,498 at August 31, 2006 and \$3,196 at November 30, 2005) | 3,409 | 2,733 |
| Aircraft held for sale | 2,943 | 3,145 |
| Goodwill and net intangible assets | 2,943 | 2,500 |
| Other assets | 15,437 | 12,796 |
| | <u>\$ 1,028,872</u> | <u>\$ 898,523</u> |
| Total assets | \$ 1,028,872 | \$ 898,523 |

Table of Contents**MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION (Continued)**

(dollars in millions, except share data)

| | August 31, 2006 | November 30, 2005 |
|---------------------------------------------------------------------------------------------|--------------------|----------------------|
| | (unaudited) | |
| Liabilities and Shareholders Equity | | |
| Commercial paper and other short-term borrowings | \$ 25,998 | \$ 31,120 |
| Deposits | 25,175 | 18,663 |
| Financial instruments sold, not yet purchased: | | |
| U.S. government and agency securities | 17,879 | 20,425 |
| Other sovereign government obligations | 28,392 | 25,355 |
| Corporate and other debt | 8,614 | 5,480 |
| Corporate equities | 50,143 | 45,936 |
| Derivative contracts | 47,017 | 44,952 |
| Physical commodities | 934 | 4,852 |
| | <u>152,979</u> | <u>147,000</u> |
| Obligation to return securities received as collateral | 58,170 | 43,557 |
| Collateralized financings: | | |
| Securities sold under agreements to repurchase | 246,952 | 237,274 |
| Securities loaned | 138,998 | 120,454 |
| Other secured financings | 37,942 | 23,534 |
| Payables: | | |
| Customers | 138,494 | 112,246 |
| Brokers, dealers and clearing organizations | 10,824 | 4,789 |
| Interest and dividends | 4,996 | 3,338 |
| Other liabilities and accrued expenses | 20,742 | 16,835 |
| Long-term borrowings | 133,364 | 110,465 |
| | <u>994,634</u> | <u>869,275</u> |
| Capital Units | 66 | 66 |
| Commitments and contingencies | | |
| Shareholders equity: | | |
| Preferred stock | 1,100 | |
| Common stock, \$0.01 par value; | | |
| Shares authorized: 3,500,000,000 at August 31, 2006 and November 30, 2005; | | |
| Shares issued: 1,211,701,552 at August 31, 2006 and November 30, 2005; | | |
| Shares outstanding: 1,058,664,567 at August 31, 2006 and 1,057,677,994 at November 30, 2005 | 12 | 12 |
| Paid-in capital | 1,971 | 2,389 |
| Retained earnings | 39,519 | 35,185 |
| Employee stock trust | 4,693 | 3,060 |
| Accumulated other comprehensive income (loss) | 32 | (190) |
| Common stock held in treasury, at cost, \$0.01 par value; | | |
| 153,036,985 shares at August 31, 2006 and 154,023,558 shares at November 30, 2005 | (8,462) | (8,214) |
| Common stock issued to employee trust | (4,693) | (3,060) |

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| | | |
|--------------------------------------------|--------------|------------|
| Total shareholders' equity | 34,172 | 29,182 |
| Total liabilities and shareholders' equity | \$ 1,028,872 | \$ 898,523 |

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(dollars in millions, except share and per share data)

| | Three Months Ended August 31, | | Nine Months Ended August 31, | |
|----------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------|---------------|---------------------------------|---------------|
| | 2006 | 2005 | 2006 | 2005 |
| | (unaudited) | | (unaudited) | |
| Revenues: | | | | |
| Investment banking | \$ 1,138 | \$ 992 | \$ 3,252 | \$ 2,627 |
| Principal transactions: | | | | |
| Trading | 2,824 | 2,150 | 9,469 | 5,790 |
| Investments | 202 | 103 | 1,206 | 482 |
| Commissions | 888 | 804 | 2,822 | 2,452 |
| Fees: | | | | |
| Asset management, distribution and administration | 1,326 | 1,249 | 3,938 | 3,699 |
| Merchant, cardmember and other | 312 | 357 | 878 | 983 |
| Servicing and securitization income | 565 | 398 | 1,812 | 1,315 |
| Interest and dividends | 12,670 | 6,998 | 33,333 | 18,876 |
| Other | 130 | 106 | 368 | 332 |
| Total revenues | 20,055 | 13,157 | 57,078 | 36,556 |
| Interest expense | 11,835 | 5,986 | 31,328 | 16,172 |
| Provision for consumer loan losses | 232 | 224 | 517 | 568 |
| Net revenues | 7,988 | 6,947 | 25,233 | 19,816 |
| Non-interest expenses: | | | | |
| Compensation and benefits | 3,149 | 3,165 | 11,033 | 8,641 |
| Occupancy and equipment | 255 | 239 | 724 | 803 |
| Brokerage, clearing and exchange fees | 339 | 267 | 971 | 803 |
| Information processing and communications | 371 | 349 | 1,083 | 1,040 |
| Marketing and business development | 292 | 276 | 828 | 831 |
| Professional services | 549 | 505 | 1,521 | 1,322 |
| Other | 366 | 404 | 942 | 1,396 |
| September 11 th related insurance recoveries, net | | | | (251) |
| Total non-interest expenses | 5,321 | 5,205 | 17,102 | 14,585 |
| Income from continuing operations before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net | | | | |
| | 2,667 | 1,742 | 8,131 | 5,231 |
| Losses from unconsolidated investees | 2 | 105 | 174 | 245 |
| Provision for income taxes | 814 | 471 | 2,666 | 1,540 |
| Income from continuing operations before cumulative effect of accounting change, net | 1,851 | 1,166 | 5,291 | 3,446 |
| Discontinued operations: | | | | |
| Loss from discontinued operations | | (1,700) | (42) | (1,698) |
| Income tax benefit | | 678 | 17 | 677 |

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| | | | | | |
|---------------------------------------------|----|---------------|---------------|---------------|---------------|
| Loss on discontinued operations | | (1,022) | (25) | (1,021) | |
| Cumulative effect of accounting change, net | | | | 49 | |
| Net income | \$ | 1,851 | \$ 144 | \$ 5,266 | \$ 2,474 |
| Earnings per basic share: | | | | | |
| Income from continuing operations | \$ | 1.83 | \$ 1.12 | \$ 5.21 | \$ 3.26 |
| Loss on discontinued operations | | | (0.98) | (0.02) | (0.97) |
| Cumulative effect of accounting change, net | | | | | 0.05 |
| Earnings per basic share | \$ | 1.83 | \$ 0.14 | \$ 5.19 | \$ 2.34 |
| Earnings per diluted share: | | | | | |
| Income from continuing operations | \$ | 1.75 | \$ 1.09 | \$ 5.01 | \$ 3.19 |
| Loss on discontinued operations | | | (0.96) | (0.02) | (0.95) |
| Cumulative effect of accounting change, net | | | | | 0.05 |
| Earnings per diluted share | \$ | 1.75 | \$ 0.13 | \$ 4.99 | \$ 2.29 |
| Average common shares outstanding: | | | | | |
| Basic | | 1,010,468,365 | 1,045,874,085 | 1,014,846,804 | 1,056,211,084 |
| Diluted | | 1,055,664,392 | 1,072,033,275 | 1,055,811,711 | 1,080,279,276 |

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(dollars in millions)

| | Three Months Ended | | Nine Months Ended | |
|------------------------------------------------|--------------------|--------|-------------------|----------|
| | August 31, | | August 31, | |
| | 2006 | 2005 | 2006 | 2005 |
| | (unaudited) | | (unaudited) | |
| Net income | \$ 1,851 | \$ 144 | \$ 5,266 | \$ 2,474 |
| Other comprehensive income (loss), net of tax: | | | | |
| Foreign currency translation adjustments | 22 | 25 | 152 | (20) |
| Net change in cash flow hedges | (10) | 1 | 70 | (49) |
| Comprehensive income | \$ 1,863 | \$ 170 | \$ 5,488 | \$ 2,405 |

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(dollars in millions)

| | Nine Months Ended August 31, | |
|-----------------------------------------------------------------------------------------------------------------------------|-----------------------------------------|-----------------|
| | 2006 | 2005 |
| | (unaudited) | |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | \$ 5,266 | \$ 2,474 |
| Adjustments to reconcile net income to net cash used for operating activities: | | |
| Cumulative effect of accounting change, net | | (49) |
| Compensation payable in common stock and options | 1,362 | 638 |
| Depreciation and amortization | 538 | 690 |
| Provision for consumer loan losses | 517 | 568 |
| Lease adjustment | | 109 |
| Insurance settlement | | (251) |
| Aircraft-related charges | 125 | 1,655 |
| Changes in assets and liabilities: | | |
| Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements | (3,856) | (7,111) |
| Financial instruments owned, net of financial instruments sold, not yet purchased | (68,667) | (15,634) |
| Securities borrowed, net of securities loaned | (20,239) | (1,149) |
| Receivables and other assets | (10,279) | (4,494) |
| Payables and other liabilities | 38,318 | 1,565 |
| Securities sold under agreements to repurchase, net of securities purchased under agreements to resell | 12,461 | (9,825) |
| Net cash used for operating activities | <u>(44,454)</u> | <u>(30,814)</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Net proceeds from (payments for): | | |
| Office facilities and aircraft under operating leases | 1,327 | (416) |
| Purchase of Goldfish | (1,676) | |
| Purchase of PULSE, net of cash acquired | | (323) |
| Net principal disbursed on consumer loans | (10,145) | (7,126) |
| Sales of consumer loans | 10,603 | 5,742 |
| Sale of interest in POSIT | | 90 |
| Insurance settlement | | 220 |
| Net cash provided by (used for) investing activities | <u>109</u> | <u>(1,813)</u> |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Net (payments for) proceeds from: | | |
| Short-term borrowings | (5,122) | 1,526 |
| Derivatives financing activities | 1,002 | 1,093 |
| Other secured financings | 14,408 | 13,045 |
| Deposits | 6,512 | 6,045 |

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| | | |
|---------------------------------------------------|-------------------|-------------------|
| Tax benefits associated with stock-based awards | 60 | 277 |
| Net proceeds from: | | |
| Issuance of preferred stock | 1,097 | |
| Issuance of common stock | 390 | 296 |
| Issuance of long-term borrowings | 33,263 | 23,175 |
| Payments for: | | |
| Repayments of long-term borrowings | (14,888) | (14,570) |
| Repurchases of common stock | (2,381) | (2,501) |
| Cash dividends | (864) | (889) |
| | <u> </u> | <u> </u> |
| Net cash provided by financing activities | 33,477 | 27,497 |
| | <u> </u> | <u> </u> |
| Net decrease in cash and cash equivalents | (10,868) | (5,130) |
| Cash and cash equivalents, at beginning of period | 29,414 | 32,811 |
| | <u> </u> | <u> </u> |
| Cash and cash equivalents, at end of period | \$ 18,546 | \$ 27,681 |
| | <u> </u> | <u> </u> |

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Introduction and Basis of Presentation.

The Company. Morgan Stanley (the Company) is a global financial services firm that maintains significant market positions in each of its business segments Institutional Securities, Global Wealth Management Group, Asset Management and Discover. The Company, through its subsidiaries and affiliates, provides its products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. A summary of the activities of each of the segments follows:

Institutional Securities includes capital raising; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; corporate lending; sales, trading, financing and market-making activities in equity securities and related products and fixed income securities and related products, including foreign exchange and commodities; benchmark indices and risk management analytics; research; and investment activities.

Global Wealth Management Group provides brokerage and investment advisory services covering various investment alternatives; financial and wealth planning services; annuity and insurance products; credit and other lending products; banking and cash management and credit solutions; retirement services; and trust and fiduciary services.

Asset Management provides global asset management products and services in equity, fixed income and alternative investment products to institutional and retail clients through proprietary and third-party retail distribution channels, intermediaries and the Company's institutional distribution channel. Asset Management also engages in investment activities.

Discover offers Discover®-branded credit cards and other consumer products and services, and includes the operations of Discover Network, which operates a merchant and cash access network for Discover Network-branded cards, and PULSE EFT Association LP, an automated teller machine/debit and electronic funds transfer network. The Discover business segment also includes consumer finance products and services in the U.K., including Morgan Stanley-branded, Goldfish-branded and various other credit cards issued on the MasterCard and Visa networks.

Basis of Financial Information. The condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the U.S., which require the Company to make estimates and assumptions regarding the valuations of certain financial instruments, consumer loan loss levels, the outcome of litigation and tax matters, incentive-based compensation accruals and other matters that affect the condensed consolidated financial statements and related disclosures. The Company believes that the estimates utilized in the preparation of the condensed consolidated financial statements are prudent and reasonable. Actual results could differ materially from these estimates.

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The condensed consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries and other entities in which the Company has a controlling financial interest. The Company's policy is to consolidate all entities in which it owns more than 50% of the outstanding voting stock unless it does not control the entity. The Company also consolidates any variable interest entities for which it is deemed to be the primary beneficiary (see Note 11). For investments in companies in which the Company has significant influence over operating and financial decisions (generally defined as owning a voting or economic interest of 20% to 50%), the Company applies the equity method of accounting.

The Company's U.S. and international subsidiaries include Morgan Stanley & Co. Incorporated (MS&Co.), Morgan Stanley & Co. International Limited (MSIL), Morgan Stanley Japan Securities Co., Ltd. (MSJS), Morgan Stanley DW Inc. (MSDWI), Morgan Stanley Investment Advisors Inc. and NOVUS Credit Services Inc.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The Company, in accordance with Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108), adjusted its opening retained earnings for fiscal 2006 and financial results for the first two quarters of fiscal 2006 (included in the nine month period ended August 31, 2006 in the accompanying condensed consolidated financial statements) to reflect a change in its hedge accounting under Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivatives Instruments and Hedging Activities*, as amended (SFAS No. 133). The same periods also reflect the adjustments of two compensation and benefit accruals. See Note 18 for additional information on SAB 108.

Certain reclassifications have been made to prior-period amounts to conform to the current period's presentation. All material intercompany balances and transactions have been eliminated.

The condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2005 (the Form 10-K). The condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) that are, in the opinion of management, necessary for the fair statement of the results for the interim period. The results of operations for interim periods are not necessarily indicative of results for the entire year.

Discontinued Operations. The Company's aircraft leasing business was classified as held for sale prior to its sale on March 24, 2006, and associated revenues and expenses through the date of sale have been reported as discontinued operations for all periods presented. Prior to being reclassified as discontinued operations, the results of the Company's aircraft leasing business were included in the Institutional Securities business segment. See Note 15 for additional information on discontinued operations.

Revenue Recognition.

Investment Banking. Underwriting revenues and fees for mergers, acquisitions and advisory assignments are recorded when services for the transactions are determined to be completed, generally as set forth under the terms of the engagement. Transaction-related expenses, primarily consisting of legal, travel and other costs directly associated with the transaction, are deferred and recognized in the same period as the related investment banking transaction revenue. Underwriting revenues are presented net of related expenses. Non-reimbursed expenses associated with advisory transactions are recorded within Non-interest expenses.

Commissions. The Company generates commissions from executing and clearing client transactions on stock, options and futures markets. Commission revenues are recorded in the accounts on trade date.

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Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees are recognized over the relevant contract period, generally quarterly or annually. In certain management fee arrangements, the Company is entitled to receive performance fees when the return on assets under management exceeds certain benchmark returns or other performance targets. In such arrangements, performance fee revenue is accrued quarterly based on measuring account/fund performance to date versus the performance benchmark stated in the investment management agreement.

Merchant, Cardmember and Other Fees. Merchant, cardmember and other fees include revenues from fees charged to merchants on credit card sales (net of interchange fees paid to banks that issue cards on the Company's merchant and cash access network), transaction fees on debit card transactions as well as charges to cardmembers for late payment fees, overlimit fees, balance transfer fees, credit protection fees and cash advance fees, net of cardmember rewards. Merchant, cardmember and other fees are recognized as earned. Cardmember rewards include various reward programs, including the Cashback Bonus® reward program, pursuant to which

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

the Company pays certain cardmembers a percentage of their purchase amounts based upon a cardmember's level and type of purchases. The liability for cardmember rewards, included in Other liabilities and accrued expenses, is accrued at the time that qualified cardmember transactions occur and is calculated on an individual cardmember basis. In determining the liability for cardmember rewards, the Company considers estimated forfeitures based on historical account closure, charge-off and transaction activity. The Company records the cost of its cardmember reward programs as a reduction of Merchant, cardmember and other fees.

Consumer Loans. Consumer loans, which consist primarily of general purpose credit card, mortgage and consumer installment loans, are reported at their principal amounts outstanding less applicable allowances. Interest on consumer loans is recorded to income as earned. Interest is generally accrued on credit card loans until the date of charge-off, which generally occurs at the end of the month during which an account becomes 180 days past due, except in the case of cardmember bankruptcies, probate accounts, and fraudulent transactions. Cardmember bankruptcies and probate accounts are charged off at the end of the month 60 days following the receipt of notification of the bankruptcy or death, but not later than the 180-day contractual time frame. Fraudulent transactions are reported in consumer loans at their net realizable value upon receipt of notification of the fraud through a charge to operating expenses and are subsequently written off at the end of the month 90 days following notification, but not later than the contractual 180-day time frame. The interest portion of charged-off credit card loans is written off against interest revenue. Origination costs related to the issuance of credit cards are charged to earnings over periods not exceeding 12 months.

The Company classifies a portion of its consumer loans as held for sale. Loans held for sale include the lesser of loans eligible for securitization or sale, or loans that management intends to securitize within three months, net of amortizing securitizations. These loans are carried at the lower of aggregate cost or fair value.

Financial Instruments Used for Trading and Investment. Financial instruments owned and Financial instruments sold, not yet purchased, which include cash and derivative products, are recorded at fair value in the condensed consolidated statements of financial condition, and gains and losses are reflected net in Principal transactions trading and investment revenues in the condensed consolidated statements of income. Loans and lending commitments associated with the Company's corporate lending activities also are primarily recorded at fair value. Fair value is the amount at which financial instruments could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

The fair value of the Company's Financial instruments owned and Financial instruments sold, not yet purchased are generally based on observable market prices, observable market parameters or derived from such prices or parameters based on bid prices or parameters for Financial instruments owned and ask prices or parameters for Financial instruments sold, not yet purchased. In the case of financial instruments transacted on recognized exchanges, the observable prices represent quotations for completed transactions from the exchange on which the financial instrument is principally traded. Bid prices represent the highest price a buyer is willing to pay for a financial instrument at a particular time. Ask prices represent the lowest price a seller is willing to accept for a financial instrument at a particular time.

A substantial percentage of the fair value of the Company's Financial instruments owned and Financial instruments sold, not yet purchased is based on observable market prices, observable market parameters, or is derived from such prices or parameters. The availability of observable

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market prices and pricing parameters can vary from product to product. Where available, observable market prices and pricing parameters in a product (or a related product) may be used to derive a price without requiring significant judgment. In certain markets, observable market prices or market parameters are not available for all products, and fair value is determined using techniques appropriate for each particular product. These techniques involve some degree of judgment. The price transparency of the particular product will determine the degree of judgment involved in determining the

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

fair value of the Company's financial instruments. Price transparency is affected by a wide variety of factors, including, for example, the type of product, whether it is a new product and not yet established in the marketplace, and the characteristics particular to the transaction. Products for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. By contrast, products that are thinly traded or not quoted will generally have reduced to no price transparency.

The fair value of over-the-counter (OTC) derivative contracts is derived primarily using pricing models, which may require multiple market input parameters. Where appropriate, valuation adjustments are made to account for credit quality and market liquidity. These adjustments are applied on a consistent basis and are based upon observable market data where available. The Company follows the provisions of Emerging Issues Task Force (EITF) Issue No. 02-03, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*. Under EITF Issue No. 02-03, in the absence of observable market prices or parameters in an active market, observable prices or parameters of other comparable current market transactions, or other observable data supporting a fair value based on a pricing model at the inception of a contract, revenue recognition at the inception of an OTC derivative financial instrument is not permitted. Such revenue is recognized in income at the earlier of when there is market value observability or at the end of the contract period. In the absence of observable market prices or parameters in an active market, observable prices or parameters of other comparable current market transactions, or other observable data supporting a fair value based on a pricing model at the inception of a contract, fair value is based on the transaction price. The Company also uses pricing models to manage the risks introduced by OTC derivatives. Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be modeled using a series of techniques, including closed-form analytic formulae, such as the Black-Scholes option pricing model, simulation models or a combination thereof, applied consistently. In the case of more established derivative products, the pricing models used by the Company are widely accepted by the financial services industry. Pricing models take into account the contract terms, including the maturity, as well as market parameters such as interest rates, volatility and the creditworthiness of the counterparty.

Purchases and sales of financial instruments and related expenses are recorded in the accounts on trade date. Unrealized gains and losses arising from the Company's dealings in OTC financial instruments, including derivative contracts related to financial instruments and commodities, are presented in the accompanying condensed consolidated statements of financial condition on a net-by-counterparty basis, when appropriate.

The Company nets cash collateral paid or received against its derivatives inventory under credit support annexes, which the Company views as conditional contracts, to legally enforceable master netting agreements.

Equity and debt investments purchased in connection with private equity and other principal investment activities initially are carried in the condensed consolidated financial statements at their original costs, which approximate fair value. The carrying value of such investments is adjusted when changes in the underlying fair values are readily ascertainable, generally as evidenced by observable market prices or transactions that directly affect the value of such investments. Downward adjustments relating to such investments are made in the event that the Company determines that the fair value is less than the carrying value. The Company's partnership interests, including general partnership and limited partnership interests in real estate funds, are included within Other assets in the condensed consolidated statements of financial condition and are recorded at fair value based upon changes in the fair value of the underlying partnership's net assets.

Financial Instruments Used for Asset and Liability Management. The Company enters into various derivative financial instruments for non-trading purposes. These instruments are included within Financial instruments owned derivative contracts or Financial instruments sold, not yet purchased derivative contracts within the

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

condensed consolidated statements of financial condition and include interest rate swaps, foreign currency swaps, equity swaps and foreign exchange forwards. The Company uses interest rate and currency swaps and equity derivatives to manage interest rate, currency and equity price risk arising from certain liabilities. The Company also utilizes interest rate swaps to match the repricing characteristics of consumer loans with those of the borrowings that fund these loans. Certain of these derivative financial instruments are designated and qualify as fair value hedges, which hedge the changes in fair value of assets, liabilities or firm commitments and cash flow hedges, which hedge the variability of future cash flows from forecasted transactions and floating rate assets and liabilities.

The Company's designated fair value hedges consist primarily of hedges of fixed rate borrowings, including fixed rate borrowings that fund consumer loans.

For qualifying fair value hedges, the changes in the fair value of the derivative and the gain or loss on the hedged asset or liability relating to the risk being hedged are recorded currently in earnings. These amounts are recorded in Interest expense and provide offset of one another. For qualifying cash flow hedges, the changes in the fair value of the derivative are recorded in Accumulated other comprehensive income (loss) in Shareholders' equity, net of tax effects, and amounts in Accumulated other comprehensive income (loss) are reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Ineffectiveness relating to fair value and cash flow hedges, if any, is recorded within Interest expense. The impact of hedge ineffectiveness on the condensed consolidated statements of income was not material for all periods presented.

In connection with the sale of the aircraft financing business (see Note 15), the Company de-designated the interest rate swaps associated with this business effective August 31, 2005 and no longer accounts for them as cash flow hedges. Amounts in Accumulated other comprehensive income (loss) related to those interest rate swaps, which were designated as hedges of the Company's variable rate long-term borrowings, are being reclassified to earnings when the hedged forecasted transactions impact earnings, as these transactions are still probable of occurring.

The Company also utilizes foreign exchange forward contracts to manage the currency exposure relating to its net monetary investments in non-U.S. dollar functional currency operations. The gain or loss from revaluing these contracts is deferred and reported within Accumulated other comprehensive income (loss) in Shareholders' equity, net of tax effects, with the related unrealized amounts due from or to counterparties included in Financial instruments owned or Financial instruments sold, not yet purchased. The interest elements (forward points) on these foreign exchange forward contracts are recorded in earnings.

Securitization Activities. The Company engages in securitization activities related to commercial and residential mortgage loans, corporate bonds and loans, U.S. agency collateralized mortgage obligations, credit card loans and other types of financial assets (see Notes 3 and 4). The Company may retain interests in the securitized financial assets as one or more tranches of the securitization, undivided seller's interests, accrued interest receivable subordinate to investors' interests (see Note 4), cash collateral accounts, servicing rights, rights to any excess cash flows remaining after payments to investors in the securitization trusts of their contractual rate of return and reimbursement of credit losses, and other retained interests. The exposure to credit losses from securitized loans is limited to the Company's retained contingent risk, which represents the Company's retained interest in securitized loans, including any credit enhancement provided. The gain or loss on the sale of financial assets

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depends in part on the previous carrying amount of the assets involved in the transfer, and each subsequent transfer in revolving structures, allocated between the assets sold and the retained interests based upon their respective fair values at the date of sale. To obtain fair values, observable market prices are used if available. However, observable market prices are generally not available for retained interests so the Company estimates fair value based on the present value of expected future cash flows using its best estimates of the key