

1. INTRODUCTION AND BASIS OF PRESENTATION**THE MERGER**

On May 31, 1997, Morgan Stanley Group Inc. (“Morgan Stanley”) was merged with and into Dean Witter, Discover & Co. (“Dean Witter Discover”) (the “Merger”). At that time, Dean Witter Discover changed its corporate name to Morgan Stanley, Dean Witter, Discover & Co. (the “Company”). In conjunction with the Merger, the Company issued 260,861,078 shares of its common stock, as each share of Morgan Stanley common stock then outstanding was converted into 1.65 shares of the Company’s common stock (the “Exchange Ratio”). In addition, each share of Morgan Stanley preferred stock was converted into one share of a corresponding series of preferred stock of the Company. The Merger was treated as a tax-free exchange.

**THE COMPANY**

The Company’s consolidated financial statements include the accounts of Morgan Stanley, Dean Witter, Discover & Co. and its U.S. and international subsidiaries, including Morgan Stanley & Co. Incorporated (“MS&Co.”), Morgan Stanley & Co. International Limited (“MSIL”), Morgan Stanley Japan Limited (“MSJL”), Dean Witter Reynolds Inc. (“DWR”), Dean Witter InterCapital Inc. (“ICAP”), and NOVUS Credit Services Inc.

The Company, through its subsidiaries, provides a wide range of financial and securities services on a global basis and provides credit and transaction services nationally. Its securities and asset management businesses include securities underwriting, distribution and trading; merger, acquisition, restructuring, real estate, project finance and other corporate finance advisory activities; asset management; merchant banking and other principal investment activities; brokerage and research services; the trading of foreign exchange and commodities as well as derivatives on a broad range of asset categories, rates and indices; and global custody, securities clearance services and securities lending. The Company’s credit and transaction services businesses include the operation of the NOVUS Network, a proprietary network of merchant and cash access locations, and the issuance of the Discover® Card and other proprietary general purpose credit cards.

The Company’s services are provided to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals.

**BASIS OF FINANCIAL INFORMATION**

The consolidated financial statements give retroactive effect to the Merger, which was accounted for as a pooling of interests. The pooling of interests method of accounting requires the restatement of all periods presented as if Dean Witter Discover and Morgan Stanley had always been combined. The fiscal year end 1996, 1995 and 1994

In connection with the Merger, the Company incurred pre-tax expenses of \$74 million (\$63 million after tax) in the second fiscal quarter of 1997. These expenses consisted primarily of proxy solicitation costs, severance costs, financial advisory and accounting fees, legal costs and regulatory filing fees.

The consolidated financial statements are prepared in accordance with generally accepted accounting principles, which require management to make estimates and assumptions regarding certain trading inventory valuations, consumer loan loss levels, the potential outcome of litigation and other matters that affect the financial statements and related disclosures. Management believes that the estimates utilized in the preparation of the consolidated financial statements are prudent and reasonable. Actual results could differ materially from these estimates.

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

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### CONSOLIDATED STATEMENTS OF CASH FLOWS

For purposes of these statements, cash and cash equivalents consist of cash and highly liquid investments not held for resale with maturities, when purchased, of three months or less.

In connection with the fiscal 1997 purchase of Lombard Brokerage, Inc. ("Lombard"), the Company issued 1.9 million shares of common stock having a fair value on the date of acquisition of approximately \$63 million. In connection with the purchase of Miller Anderson & Sherrerd, LLP ("MAS") in fiscal 1996, the Company issued approximately \$66 million of notes payable, as well as 3.3 million shares of common stock having a fair value on the date of acquisition of approximately \$83 million. In addition, in connection with the purchase in fiscal 1996 of VK/AC Holding, Inc., the parent of Van Kampen American Capital, Inc. ("VKAC"), the Company assumed approximately \$162 million of long-term debt (see Note 16).

### CONSUMER LOANS

Consumer loans, which consist primarily of credit card and other consumer installment loans, are reported at their principal amounts outstanding, less applicable allowances. Interest on consumer loans is credited to income as earned.

Interest is 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 bankruptcies and fraudulent transactions, which are charged off earlier. 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.

### ALLOWANCE FOR CONSUMER LOAN LOSSES

The allowance for consumer loan losses is a significant estimate that is regularly evaluated by management for adequacy on a portfolio-by-portfolio basis and is established through a charge to the provision for loan losses. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans and current economic conditions that may affect the borrower's ability to pay.

The Company uses the results of these evaluations to provide an allowance for loan losses. The exposure for credit losses for owned loans is influenced by the performance of the portfolio and other factors discussed above, with the Company absorbing all related losses. The exposure for credit losses for securitized loans is represented by the Company retaining a contingent risk based on the amount of credit enhancement provided.

In fiscal 1996, the Company revised its estimate of the allowance for losses for loans intended to be securitized. This revision was based on the Company's experience with credit losses related to securitized loans in a mature asset

securitization market and the issuance of Statement of Financial Accounting Standards (“SFAS”) No. 125, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,” by the Financial Accounting Standards Board (“FASB”), which eliminated the uncertainty surrounding the appropriate accounting treatment for asset securitization transactions.

#### SECURITIZATION OF CONSUMER LOANS

The Company periodically sells consumer loans through asset securitizations and continues to service these loans. The revenues derived from servicing these loans are recorded in the consolidated statements of income as servicing fees over the term of the securitized loans rather than at the time the loans are sold. The effects of recording these revenues over the term of the securitized loans rather than at the time the loans were sold are not material.

#### FINANCIAL INSTRUMENTS USED FOR TRADING AND INVESTMENT

Financial instruments, including derivatives, used in the Company’s trading activities are recorded at fair value, and unrealized gains and losses are reflected in trading revenues. Interest revenue and expense arising from financial instruments used in trading activities are reflected in the consolidated statements of income as interest revenue or expense. The fair values of the trading positions generally are based on listed market prices. If listed market prices are not available or if liquidating the Company’s positions would reasonably be expected to impact market prices, fair value is determined based on other relevant factors, including dealer price quotations and price quotations for similar instruments traded in different markets, including markets located in different geographic areas. Fair values for certain derivative contracts are derived from pricing models which consider current market and contractual prices for the underlying financial instruments or commodities, as well as time value and yield curve or volatility factors underlying the positions. Purchases and sales of financial instruments are recorded in the accounts on trade date. Unrealized gains and losses arising from the Company’s dealings in over-the-counter (“OTC”) financial instruments, including derivative contracts related to financial instruments and commodities, are presented in the accompanying consolidated statements of financial condition on a net-by-counterparty basis, when appropriate.

Equity securities purchased in connection with merchant banking and other principal investment activities are initially carried in the consolidated financial statements at their original costs. The carrying value of such equity securities is adjusted when changes in the underlying fair values are readily ascertainable, generally as evidenced by listed market prices or transactions which directly affect the value of such equity securities. Downward adjustments relating to such equity securities are made in the event that the Company determines that the eventual realizable value is less than the carrying value. The carrying value of investments made in connection with principal real estate activities which do not involve equity securities are adjusted periodically based on independent appraisals, estimates prepared by the Company of discounted future cash flows of the underlying real estate assets or other indicators of fair value.

Loans made in connection with merchant banking and investment banking activities are carried at cost plus accrued interest less reserves, if deemed necessary, for estimated losses.

#### FINANCIAL INSTRUMENTS USED FOR ASSET AND LIABILITY MANAGEMENT

The Company has entered into various contracts as hedges against specific assets, liabilities or anticipated transactions. These contracts include interest rate swaps, foreign exchange forwards, foreign currency swaps and cost of funds agreements. The Company uses interest rate and currency swaps to manage the interest rate and currency exposure arising from certain borrowings and to match the repricing characteristics of consumer loans with

cumulative translation adjustments in shareholders' equity, net of tax effects, with the related unrealized amounts due from or to counterparties included in receivables from or payables to brokers, dealers and clearing organizations.

#### SECURITIES TRANSACTIONS

Clients' securities transactions are recorded on a settlement date basis with related commission revenues and expenses recorded on trade date. Securities purchased under agreements to resell (reverse repurchase agreements) and securities sold under agreements to repurchase (repurchase agreements), principally government and agency securities, are treated as financing transactions and are carried at the amounts at which the securities will subsequently be resold or reacquired as specified in the respective agreements; such amounts include accrued interest. Reverse repurchase and repurchase agreements are presented on a net-by-counterparty basis, when appropriate. It is the Company's policy to take possession of securities purchased under agreements to resell. The Company monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral. Where deemed appropriate, the Company's agreements with third parties specify its rights to request additional collateral.

Securities borrowed and securities loaned are carried at the amounts of cash collateral advanced and received in connection with the transactions. The Company measures the fair value of the securities borrowed and loaned against the collateral on a daily basis. Additional collateral is obtained as necessary to ensure such transactions are adequately collateralized.

#### INVESTMENT BANKING

Underwriting revenues and fees for mergers and acquisitions and advisory assignments are recorded when services for the transaction are substantially completed. Transaction-related expenses are deferred and later expensed to match revenue recognition.

#### OFFICE FACILITIES

Office facilities are stated at cost less accumulated depreciation and amortization. Depreciation and amortization of buildings and improvements are provided principally by the straight-line method, while depreciation and amortization of furniture, fixtures and equipment are provided by both straight-line and accelerated methods. Property and equipment are depreciated over the estimated useful lives of the related assets, while leasehold improvements are amortized over the lesser of the economic useful life of the asset or, where applicable, the remaining term of the lease.

#### INCOME TAXES

Income tax expense is provided for using the asset and liability method, under which deferred tax assets and liabilities are determined based upon the temporary differences between the financial statement and income tax bases of assets and liabilities, using currently enacted tax rates.

#### EARNINGS PER SHARE

The calculations of earnings per common share are based on the weighted average number of common shares and share equivalents outstanding and give effect to preferred stock dividend requirements. All per share and share amounts reflect stock splits effected by Dean Witter Discover and Morgan Stanley prior to the Merger, as well as the additional shares issued to Morgan Stanley shareholders pursuant to the Exchange Ratio.

#### CARDMEMBER REWARDS

Cardmember rewards, primarily the Cashback Bonus award, pursuant to which the Company annually pays Discover cardmembers and Private Issue cardmembers a percentage of their purchase amounts ranging up to one percent (up to two percent for the Private Issue Card), are based upon a cardmember's level of annual purchases. The liability for cardmember rewards expense, 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.

### STOCK-BASED COMPENSATION

SFAS No. 123, "Accounting for Stock-Based Compensation" encourages, but does not require, companies to record compensation cost for stock-based employee compensation plans at fair value. The Company has elected to continue to account for its stock-based compensation plans using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"). Under the provisions of APB No. 25, compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's common stock at the date of grant over the amount an employee must pay to acquire the stock.

### TRANSLATION OF FOREIGN CURRENCIES

Assets and liabilities of operations having non-U.S. dollar functional currencies are translated at year-end rates of exchange, and the income statements are translated at weighted average rates of exchange for the year. In accordance with SFAS No. 52, "Foreign Currency Translation," gains or losses resulting from translating foreign currency financial statements, net of hedge gains or losses and related tax effects, are reflected in cumulative translation adjustments, a separate component of shareholders' equity. Gains or losses resulting from foreign currency transactions are included in net income.

### GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill and other intangible assets are amortized on a straight-line basis over periods from five to 40 years, generally not exceeding 25 years, and are periodically evaluated for impairment. At November 30, 1997, goodwill of approximately \$1.4 billion was included in the Company's consolidated statements of financial condition as a component of Other Assets (see Note 16).

### NEW ACCOUNTING PRONOUNCEMENTS

As of January 1, 1997, the Company adopted SFAS No. 125, which was effective for transfers of financial assets made after December 31, 1996, except for transfers of certain financial assets for which the effective date has been delayed for one year. SFAS No. 125 provides financial reporting standards for the derecognition and recognition

of financial assets, including the distinction between transfers of financial assets which should be recorded as sales and those which should be recorded as secured borrowings. The adoption of the enacted provisions of SFAS No. 125 had no material effect on the Company's financial condition or results of operations. With respect to the provisions of SFAS No. 125 which became effective in 1998, the Company does not expect the impact of the adoption of the deferred provisions to be material to the Company's financial condition or results of operations.

In February 1997, the FASB issued SFAS No. 128, "Earnings per Share" ("EPS"), effective for periods ending after December 15, 1997, with restatement required for all prior periods. SFAS No. 128 replaces the current EPS categories of primary and fully diluted with "basic EPS," which reflects no dilution from common stock equivalents, and "diluted EPS," which reflects dilution from common stock equivalents and other dilutive securities based on the average price per share of the Company's common stock during the period. The adoption of SFAS No. 128 would not have had, and is not expected to have, a material effect on the Company's EPS calculations.

In June 1997, the FASB issued SFAS No. 130, "Reporting Comprehensive Income" and SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information." These statements, which are effective for fiscal years beginning after December 15, 1997, establish standards for the reporting and display of comprehensive income and the disclosure requirements related to segments.

## 3. CONSUMER LOANS

Consumer loans were as follows:

AT FISCAL YEAR-END (DOLLARS IN MILLIONS)	1997	1996
Credit card	\$20,914	\$22,062
Other consumer installment	3	2
	20,917	22,064
Less		
Allowance for loan losses	884	802
Consumer loans, net	\$20,033	\$21,262

Activity in the allowance for consumer loan losses was as follows:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Balance beginning of period	\$ 781 <sup>(2)</sup>	\$ 709	\$ 556
Additions			
Provision for loan losses	1,493	1,214	722
Purchase of loan portfolios	—	4	31
Total additions	1,493	1,218	753
Deductions			
Charge-offs	1,639	1,182	711
Recoveries	(196)	(155)	(120)
Net charge-offs	1,443	1,027	591
Other <sup>(1)</sup>	53	(98)	(9)
Balance end of period	\$ 884	\$ 802	\$ 709

<sup>(1)</sup> Primarily reflects net transfers related to asset securitizations.

<sup>(2)</sup> Beginning balance differs from the fiscal 1996 end of period balance due to the Company's change in fiscal year-end.

Interest accrued on loans subsequently charged off, recorded as a reduction of interest revenue, was \$301 million, \$181 million and \$115 million in fiscal 1997, 1996 and 1995.

At fiscal year-end 1997 and 1996, \$5,385 million and \$5,695 million of the Company's consumer loans had minimum contractual maturities of less than one year. Because of the uncertainty regarding consumer loan repayment patterns, which historically have been higher than contractually required minimum payments, this amount may not necessarily be indicative of the Company's actual consumer loan repayments.

At fiscal year-end 1997, the Company had commitments to extend credit in the amount of \$178.5 billion. Commitments to extend credit arise from agreements to extend to customers unused lines of credit on certain credit cards provided there is no violation of conditions established in the related agreement. These commitments, substantially all of which the Company can terminate at any time and which do not necessarily represent future cash requirements, are periodically reviewed based on account usage and customer creditworthiness.

The Company received proceeds from asset securitizations of \$2,783 million, \$4,528 million, and \$1,827 million in fiscal 1997, 1996 and 1995. The uncollected balances of consumer loans sold through asset securitizations were \$15,033 million and \$13,197 million at fiscal year-end 1997 and 1996.

The Company uses interest rate exchange agreements to hedge the risk from changes in interest rates on servicing fee revenues (which are derived from loans sold through asset securitizations). Gains and losses from these agreements are recognized as adjustments to servicing fees. Under these interest rate exchange agreements the Company primarily pays floating rates and receives fixed rates.

In connection with certain asset securitizations, the Company has written interest rate cap agreements with notional amounts of \$303 million and strike rates of 11%. Any settlement payments made under these agreements will generally be passed back to the Company through an adjustment of servicing fees, although this is subject to the risk of counterparty nonperformance. At fiscal year end 1997 and 1996, the fair values of these agreements were not material. No payments have been made by the Company under these agreements, which expire through 2000.

The estimated fair value of the Company's consumer loans approximated carrying value at fiscal year end 1997 and 1996. The Company's consumer loan portfolio, including securitized loans, is geographically diverse, with a distribution approximating that of the population of the United States.

#### 4. DEPOSITS

Deposits were as follows:

AT FISCAL YEAR-END (DOLLARS IN MILLIONS)	1997	1996
Demand, passbook and money market accounts	\$1,210	\$1,716
Consumer certificate accounts	1,498	1,354
\$100,000 minimum certificate accounts	6,285	4,143
Total	\$8,993	\$7,213

The weighted average interest rates of interest-bearing deposits outstanding during fiscal 1997 and 1996 were 6.2% and 6.3%.

At fiscal year-end 1997 and 1996, the notional amounts of interest rate exchange agreements that hedged deposits outstanding were \$535 million and \$495 million and had fair values of \$7 million and \$5 million. Under these interest rate exchange agreements the Company primarily pays floating rates and receives fixed



rates. At November 30, 1997, the weighted average interest rate of the Company's deposits including the effect of interest rate exchange agreements was 6.16%.

At November 30, 1997, certificate accounts maturing over the next five years were as follows:

(DOLLARS IN MILLIONS)	
1998	\$3,810
1999	1,579
2000	963
2001	819
2002	312

The estimated fair value of the Company's deposits, using current rates for deposits with similar maturities, approximated carrying value at fiscal year-end 1997 and 1996.

## 5. SHORT-TERM BORROWINGS

At fiscal year-end 1997 and 1996, commercial paper in the amount of \$15,447 million and \$18,890 million, with weighted average interest rates of 5.5% and 5.4%, was outstanding.

At fiscal year-end 1997 and 1996, the notional amounts of interest rate contracts that hedged commercial paper outstanding were \$732 million and \$808 million and had fair values of \$(5) million and \$(7) million. These interest rate contracts converted the commercial paper to fixed rates. These contracts had no material effect on the weighted average interest rates of commercial paper.

At fiscal year-end 1997 and 1996, other short-term borrowings of \$7,167 million and \$7,436 million were outstanding. These borrowings included bank loans, federal funds and bank notes.

In November 1997, the Company replaced the predecessor Dean Witter Discover and Morgan Stanley holding company senior revolving credit agreements with a senior revolving credit agreement with a group of banks to support general liquidity needs, including the issuance of commercial paper (the "MSDWD Facility"). Under the terms of the MSDWD Facility, the banks are committed to provide up to \$6.0 billion. The MSDWD Facility contains restrictive covenants which require, among other things, that the Company maintain shareholders' equity of at least \$8.3 billion at all times. The Company believes

that the covenant restrictions will not impair the Company's ability to pay its current level of dividends. At November 30, 1997, no borrowings were outstanding under the MSDWD Facility.

Riverwoods Funding Corporation ("RFC"), an entity included in the consolidated financial statements of the Company, maintains a senior bank credit facility to support the issuance of asset-backed commercial paper. In fiscal 1997, RFC renewed this facility and increased its amount to \$2.55 billion from \$2.1 billion. Under the terms of the asset-backed commercial paper program, certain assets of RFC were subject to a lien in the amount of \$2.6 billion at November 30, 1997. RFC has never borrowed from its senior bank credit facility.

The Company maintains a master collateral facility that enables MS&Co. to pledge certain collateral to secure loan arrangements, letters of credit and other financial accommodations (the "MS&Co. Facility"). As part of the MS&Co. Facility, MS&Co. also maintains a secured committed credit agreement with a group of banks that are parties to the master collateral facility under which such banks are committed to provide up to \$1.5 billion. The credit agreement contains restrictive covenants which require, among other things, that MS&Co. maintain specified levels of consolidated shareholders' equity and Net Capital, as defined. In January 1998, the MS&Co. Facility was renewed and the amount of the commitment of the credit agreement was increased to \$1.875 billion. At November 30, 1997, no borrowings were outstanding under the MS&Co. Facility.

The Company also maintains a revolving committed financing facility that enables MSIL to secure committed funding from a syndicate of banks by providing a broad range of collateral under repurchase agreements (the "MSIL Facility"). Such banks are committed to provide up to an aggregate of \$1.85 billion available in 12 major currencies. The facility agreements contain restrictive covenants which require, among other things, that MSIL maintain specified levels of Shareholders' Equity and Financial Resources, each as defined. At November 30, 1997, no borrowings were outstanding under the MSIL Facility.

The Company anticipates that it will utilize the MSDWD Facility, the MS&Co. Facility or the MSIL Facility for short-term funding from time to time.

## 6. LONG-TERM BORROWINGS

### MATURITIES AND TERMS

Long-term borrowings at fiscal year-end consist of the following:

(DOLLARS IN MILLIONS)	U.S. DOLLAR			NON-U.S. DOLLAR <sup>(1)</sup>		AT FISCAL YEAR-END	
	FIXED RATE	FLOATING RATE	INDEX/EQUITY LINKED	FIXED RATE	FLOATING RATE	1997 TOTAL	1996 TOTAL
Due in fiscal 1997	\$ –	\$ –	\$ –	\$ –	\$ –	\$ –	\$ 4,057
Due in fiscal 1998	1,190	3,488	747	468	277	6,170	5,616
Due in fiscal 1999	774	2,474	488	200	757	4,693	3,218
Due in fiscal 2000	774	1,501	22	48	73	2,418	1,686
Due in fiscal 2001	1,335	719	68	52	108	2,282	2,226
Due in fiscal 2002	1,077	1,097	91	17	341	2,623	1,299
Thereafter	5,460	140	194	774	38	6,606	4,540
Total	\$10,610	\$9,419	\$1,610	\$1,559	\$1,594	\$24,792	\$22,642
Weighted average coupon at fiscal year-end	7.1%	5.9%	n/a	5.3%	5.0%	6.1%	6.2%

<sup>(1)</sup> Weighted average coupon was calculated utilizing non-U.S. dollar interest rates.

### MEDIUM-TERM NOTES

Included in the table above are medium-term notes of \$14,049 million and \$13,272 million at fiscal year-end 1997 and 1996. The effective weighted average interest rate on all medium-term notes was 5.9% in fiscal 1997 and 5.8% in fiscal 1996. Maturities of these notes range from fiscal 1998 through fiscal 2023.

### STRUCTURED BORROWINGS

U.S. dollar index/equity linked borrowings include various structured instruments whose payments and redemption values are linked to the performance of a specific index (i.e., Standard & Poor's 500), a basket of stocks or a specific equity security. To minimize the exposure resulting from movements in the underlying equity position or index, the Company has entered into various equity swap contracts and purchased options which effectively convert the borrowing costs into floating rates based upon London Interbank Offered Rates ("LIBOR"). These instruments are included in the preceding table at their redemption values based on the performance of the underlying indices, baskets of stocks, or specific equity securities at fiscal year-end 1997 and 1996.

### OTHER BORROWINGS

U.S. dollar contractual floating rate borrowings bear interest based on a variety of money market indices, including LIBOR and Federal Funds rates. Non-U.S. dollar contractual floating rate borrowings bear interest based on Euro floating rates.

Included in the Company's long-term borrowings are subordinated notes of \$1,302 million and \$1,325 million at fiscal year-end 1997 and 1996 respectively. The effective weighted average interest rate on these subordinated notes was 7.2% in fiscal 1997 and 7.0% in fiscal 1996. Maturities of the subordinated notes range from fiscal 1999 to fiscal 2016.

Certain of the Company's long-term borrowings are redeemable prior to maturity at the option of the holder. These notes contain certain provisions which effectively enable noteholders to put the notes back to the Company and therefore are scheduled in the foregoing table to mature in fiscal 1998 through fiscal 1999. The stated maturities of these notes, which aggregate \$1,495 million, are from fiscal 1998 to fiscal 2004.

MS&Co., a registered U.S. broker-dealer subsidiary of the Company, has outstanding approximately \$313 million of 6.81% fixed rate subordinated Series C notes,



\$96 million of 7.03% fixed rate subordinated Series D notes, \$82 million of 7.28% fixed rate subordinated Series E notes and \$25 million of 7.82% fixed rate subordinated Series F notes. These notes have maturities from 2001 to 2016. The terms of such notes contain restrictive covenants which require, among other things, that MS&Co. maintain specified levels of Consolidated Tangible Net Worth and Net Capital, each as defined.

#### ASSET AND LIABILITY MANAGEMENT

A portion of the Company's fixed rate long-term borrowings is used to fund highly liquid marketable securities, short-term receivables arising from securities transactions and consumer loans. The Company uses interest rate swaps to more closely match the duration of these borrowings to the duration of the assets being funded and to minimize interest rate risk. These swaps effectively convert certain of the Company's fixed rate borrowings into floating rate obligations. In addition, for non-U.S. dollar currency borrowings that are not used to fund assets in the same currency, the Company has entered into currency swaps which effectively convert the borrowings

into U.S. dollar obligations. The Company's use of swaps for asset and liability management reduced its interest expense and effective average borrowing rate as follows:

AT FISCAL YEAR-END (DOLLARS IN MILLIONS)	1997	1996	1995
Net reduction in interest expense from swaps for the fiscal year	\$21	\$29	\$20
Weighted average coupon of long-term borrowings at fiscal year-end <sup>(1)</sup>	6.1%	6.2%	6.6%
Effective average borrowing rate for long-term borrowings after swaps at fiscal year-end <sup>(1)</sup>	6.0%	6.1%	6.4%

<sup>(1)</sup> Included in the weighted average and effective average calculations are non-U.S. dollar interest rates.

The effective weighted average interest rate on the Company's index/equity linked notes, which is not included in the table above, was 5.7% and 5.6% in fiscal 1997 and fiscal 1996, respectively, after giving effect to the related hedges.

The table below summarizes the notional or contract amounts of these swaps by maturity and weighted average interest rates to be received and paid at fiscal year end 1997. Swaps utilized to hedge the Company's structured borrowings are presented at their redemption values:

(DOLLARS IN MILLIONS)	U.S. DOLLAR			NON-U.S. DOLLAR <sup>(1)</sup>			NOV. 30, 1997 TOTAL	AT FISCAL YEAR-END 1996 TOTAL
	RECEIVE FIXED PAY FLOATING	RECEIVE FLOATING PAY FLOATING	INDEX/EQUITY LINKED	RECEIVE FIXED PAY FLOATING	RECEIVE FLOATING PAY FLOATING <sup>(2)</sup>			
Maturing in fiscal 1997	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1,878
Maturing in fiscal 1998	974	320	747	468	235	2,744	2,744	2,411
Maturing in fiscal 1999	542	375	488	187	380	1,972	1,972	1,668
Maturing in fiscal 2000	375	120	22	48	73	638	638	379
Maturing in fiscal 2001	924	5	68	52	33	1,082	1,082	1,093
Maturing in fiscal 2002	720	-	91	17	3	831	831	533
Thereafter	3,434	-	194	774	38	4,440	4,440	2,227
Total	\$6,969	\$820	\$1,610	\$1,546	\$762	\$11,707	\$11,707	\$10,189
Weighted average at fiscal year-end <sup>(3)</sup>								
Receive rate	6.72%	6.17%	n/a	5.06%	3.67%			
Pay rate	5.83%	5.96%	n/a	5.87%	6.75%			

<sup>(1)</sup> The differences between the receive rate and the pay rate may reflect differences in the rate of interest associated with the underlying currency.

<sup>(2)</sup> These amounts include currency swaps used to effectively convert borrowings denominated in one currency into obligations denominated in another currency.

<sup>(3)</sup> The table was prepared under the assumption that interest rates remain constant at year-end levels. The variable interest rates to be received or paid will change to the extent that rates fluctuate. Such changes may be substantial. Variable rates presented generally are based on LIBOR or Treasury bill rates.

As noted above, the Company uses interest rate and currency swaps to modify the terms of its existing borrowings. Activity during the periods in the notional value of the swap contracts used by the Company for asset and liability management (and the unrecognized gain at period end) is summarized in the table below:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996
Notional value at beginning of period	\$10,189	\$ 7,355
Additions	3,567	4,137
Matured	(1,657)	(1,068)
Terminated	(216)	(157)
Effect of foreign currency translation on non-U.S. dollar notional values and changes in redemption values on structured borrowings	(176)	(78)
Notional value at fiscal year-end	\$11,707	\$10,189
Unrecognized gain at fiscal year-end	\$ 104	\$ 139

The Company also uses interest rate swaps to modify certain of its repurchase financing agreements. The Company had interest rate swaps with notional values of approximately \$1.8 billion and \$1.1 billion at fiscal year end 1997 and 1996, and unrecognized gains of approximately \$13 million and \$14 million as of fiscal year end 1997 and 1996, for such purpose. The unrecognized gains on these swaps were offset by unrecognized losses on certain of the Company's repurchase financing agreements.

The estimated fair value of the Company's long-term borrowings approximated carrying value based on rates available to the Company at year-end for borrowings with similar terms and maturities.

Cash paid for interest for the Company's borrowings and deposits approximated interest expense in fiscal 1997, 1996 and 1995.

## 7. COMMITMENTS AND CONTINGENCIES

The Company has non-cancelable operating leases covering office space and equipment. At fiscal year-end 1997, future minimum rental commitments under such leases (net of subleases, principally on office rentals) were as follows:

(DOLLARS IN MILLIONS)	
1998	\$309
1999	268
2000	240
2001	210
2002	183
Thereafter	701

Occupancy lease agreements, in addition to base rentals, generally provide for rent and operating expense escalations resulting from increased assessments for real estate taxes and other charges. Total rent expense, net of sublease rental income, was \$262 million, \$264 million and \$271 million in fiscal 1997, 1996 and 1995, respectively.

The Company has an agreement with IBM, under which the Company receives information processing, data networking and related services. Under the terms of the agreement, the Company has an aggregate minimum annual commitment of \$166 million subject to annual cost of living adjustments.

During fiscal 1995, the Company recognized a pre-tax charge of \$59 million (\$39 million after tax, which reduced primary and fully diluted earnings per share by \$0.06). The charge was in connection with the relocation of the majority of Morgan Stanley's New York City employees from leased space at 1221 and 1251 Avenue of the Americas to space in the Company's buildings at 1585 Broadway and 750 Seventh Avenue that were purchased in fiscal 1993 and fiscal 1994, respectively, as well as a move to new leased office space in Tokyo. The charge specifically covered the Company's termination of certain leased office space and the write-off of remaining leasehold improvements in both cities.

In the normal course of business, the Company has been named as a defendant in various lawsuits and has been involved in certain investigations and proceedings. Some of these matters involve claims for substantial amounts. Although the ultimate outcome of these matters cannot be ascertained at this time, it is the opinion of management, after consultation with outside counsel, that the resolution of such matters will not have a material adverse effect on the consolidated financial condition of the Company, but may be material to the Company's operating results for any particular period, depending upon the level of the Company's income for such period.

The Company had approximately \$5.5 billion of letters of credit outstanding at November 30, 1997 to satisfy various collateral requirements.

Financial instruments sold, not yet purchased represent obligations of the Company to deliver specified financial instruments at contracted prices, thereby creating commitments to purchase the financial instruments in the market at prevailing prices. Consequently, the Company's ultimate obligation to satisfy the sale of financial instruments sold, not yet purchased may exceed the amounts recognized in the consolidated statements of financial condition.

The Company also has commitments to fund certain fixed assets and other less liquid investments, including at November 30, 1997, approximately \$150 million in connection with its merchant banking and other principal investment activities. Additionally, the Company has provided and will continue to provide financing, including margin lending and other extensions of credit to clients (including subordinated loans on an interim basis to leveraged companies associated with its investment banking and its merchant banking and other principal investment activities), that may subject the Company to increased credit and liquidity risks.

## 8. TRADING ACTIVITIES

### TRADING REVENUES

The Company's trading activities include providing securities brokerage, derivatives dealing, and underwriting services to clients. While trading activities are generated by client order flow, the Company also takes proprietary positions based on expectations of future market movements and conditions. The Company's trading strategies rely on the integrated management of its client-driven and proprietary transactions, along with the hedging and financing of these positions.

The Company manages its trading businesses by product groupings and therefore has established distinct, worldwide trading divisions having responsibility for equity, fixed income, foreign exchange and commodities products. Because of the integrated nature of the markets for such products, each product area trades cash instruments as well as related derivative products (i.e., options, swaps, futures, forwards and other contracts with respect to such underlying instruments or commodities). Revenues related to principal trading are summarized below by trading division:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Equities	\$1,310	\$1,181	\$ 728
Fixed Income	1,187	1,172	710
Foreign Exchange	500	169	177
Commodities	194	137	70
Total principal trading revenues	\$3,191	\$2,659	\$1,685

Interest revenue and expense are integral components of trading activities. In assessing the profitability of trading activities, the Company views net interest and principal trading revenues in the aggregate.

The Company's trading portfolios are managed with a view toward the risk and profitability of the portfolios to the Company. The nature of the equities, fixed income, foreign exchange and commodities activities conducted by the Company, including the use of derivative products in these businesses, and the market, credit and concentration risk management policies and procedures covering these activities are discussed below.

## EQUITIES

The Company makes markets and trades in the global secondary markets for equities and convertible debt and is a dealer in equity warrants, exchange traded and OTC equity options, index futures, equity swaps and other sophisticated equity derivatives. The Company's activities as a dealer primarily are client-driven, with the objective of meeting clients' needs while earning a spread between the premiums paid or received on its contracts with clients and the cost of hedging such transactions in the cash or forward market or with other derivative transactions. The Company limits its market risk related to these contracts, which stems primarily from underlying equity/index price and volatility movements, by employing a variety of hedging strategies, such as delta hedging (delta is a measure of a derivative contract's price movement based on the movement of the price of the security or index underlying the contract). The Company also takes proprietary positions in the global equity markets by using derivatives, most commonly futures and options, in addition to cash positions, intending to profit from market price and volatility movements in the underlying equities or indices positioned.

Equity option contracts give the purchaser of the contract the right to buy (call) or sell (put) the equity security or index underlying the contract at an agreed-upon price (strike price) during or at the conclusion of a specified period of time. The seller (writer) of the contract is subject to market risk, and the purchaser is subject to market risk (to the extent of the premium paid) and credit risk. Equity swap contracts are contractual agreements whereby one counterparty receives the appreciation (or pays the depreciation) on an equity investment in return for paying another rate, often based upon equity index movements or interest rates. The counterparties to the Company's equity transactions include commercial banks, investment banks, broker-dealers, investment funds and industrial companies.

## FIXED INCOME

The Company is a market-maker for U.S. and non-U.S. government securities, corporate bonds, money market instruments, medium-term notes and Eurobonds, high-yield securities, emerging market securities, mortgage-

and other asset-backed securities, preferred stock and tax-exempt securities. In addition, the Company is a dealer in interest rate and currency swaps and other related derivative products, OTC options on U.S. and foreign government bonds and mortgage-backed forward agreements ("TBA"), options and swaps. In this capacity, the Company facilitates asset and liability management for its customers in interest rate and currency swaps and related products and OTC government bond options.

Swaps used in fixed income trading are, for the most part, contractual agreements to exchange interest payment streams (i.e., an interest rate swap may involve exchanging fixed for floating interest payments) or currencies (i.e., a currency swap may involve exchanging yen for U.S. dollars in one year at an agreed-upon exchange rate). The Company profits by earning a spread between the premium paid or received for these contracts and the cost of hedging such contracts. The Company seeks to manage the market risk of its swap portfolio, which stems from interest rate and currency movements and volatility, by using modeling that quantifies the sensitivity of its portfolio to movements in interest rates and currencies and by adding positions to or selling positions from its portfolio as needed to minimize such sensitivity. Typically, the Company adjusts its positions by entering into additional swaps or interest rate and foreign currency futures, foreign currency forwards and by purchasing or selling additional underlying government bonds. The Company manages the risk related to its option portfolio by using a variety of hedging strategies such as delta hedging, which includes the use of futures and forward contracts to hedge market risk. The Company also is involved in using debt securities to structure products with multiple risk/return factors designed to suit investor objectives.

The Company is an underwriter of and a market-maker in mortgage-backed securities and collateralized mortgage obligations ("CMO") as well as commercial, residential and real estate loan products. The Company also structures mortgage-backed swaps for its clients, enabling them to derive the cash flows from an underlying mort-

gage-backed security without purchasing the cash position. The Company earns the spread between the premium inherent in the swap and the cost of hedging the swap contract through the use of cash positions or TBA contracts. The Company also uses TBAs in its role as a dealer in mortgage-backed securities and facilitates customer trades by taking positions in the TBA market. Typically, these positions are hedged by offsetting TBA contracts or underlying cash positions. The Company profits by earning the bid-offer spread on such transactions. Further, the Company uses TBAs to ensure delivery of underlying mortgage-backed securities in its CMO issuance business. As is the case with all mortgage-backed products, market risk associated with these instruments results from interest rate fluctuations and changes in mortgage prepayment speeds. The counterparties to the Company's fixed income transactions include investment advisors, commercial banks, insurance companies, investment funds and industrial companies.

#### FOREIGN EXCHANGE

The Company is a market-maker in a number of foreign currencies. In this business, it actively trades currencies in the spot and forward markets earning a dealer spread. The Company seeks to manage its market risk by entering into offsetting positions. The Company conducts an arbitrage business in which it seeks to profit from inefficiencies between the futures, spot and forward markets. The Company also makes a market in foreign currency options. This business largely is client-driven and involves the purchasing and writing of European and American style options and certain sophisticated products to meet specific client needs. The Company profits in this business by earning spreads between the options' premiums and the cost of the hedging of such positions. The Company limits its market risk by using a variety of hedging strategies, including the buying and selling of the currencies underlying the options based upon the options' delta equivalent. Foreign exchange option contracts give the purchaser of the contract the right to buy (call) or sell (put) the currency underlying the contract at an agreed-upon strike price at or over a specified period of time. Forward contracts and futures represent commitments to purchase or sell the underlying currencies

at a specified future date at a specified price. The Company also takes proprietary positions in currencies to profit from market price and volatility movements in the currencies positioned.

The majority of the Company's foreign exchange business relates to major foreign currencies such as deutsche marks, yen, pound sterling, French francs, Swiss francs, Italian lire and Canadian dollars. The balance of the business covers a broad range of other currencies. The

its from this business by earning a spread between the premiums paid or received for these derivatives and the cost of hedging such derivatives.

The Company also maintains proprietary trading positions in commodity derivatives, including futures, forwards and options in addition to physical commodities, to profit from price and volatility movements in the underlying commodities markets.

Forward, option and swap contracts on commodities are structured similarly to like-kind derivative contracts for cash financial instruments. The counterparties to OTC commodity contracts include precious metals producers, refiners and consumers as well as shippers, central banks, and oil, gas and electricity producers.

The following discussions of risk management, market risk, credit risk, concentration risk and customer activities relate to the Company's trading activities.

#### RISK MANAGEMENT

Risk management at the Company is a multi-faceted process with independent oversight which requires constant communication, judgment and knowledge of specialized products and markets. The Company's senior management takes an active role in the risk management process and has developed policies and procedures that require specific administrative and business functions to assist in the identification, assessment and control of various risks. In recognition of the increasingly varied and complex nature of the financial services business, the Company's risk management policies and procedures are evolutionary in nature and are subject to ongoing review and modification. Many of the Company's risk management and control practices are subject to periodic review by the Company's internal auditors as well as to interactions with various regulatory authorities.

The Management Committee, composed of the Company's most senior officers, establishes the overall risk management policies for the Company and reviews the Company's performance relative to these policies. The Management Committee has created several Risk Committees to assist it in monitoring and reviewing the Company's risk management practices. These Risk Committees, among other things, review the general

framework, levels and monitoring procedures relating to the Company's market and credit risk profile, general sales practice policies, legal enforceability and operational and systems risks. The Controllers, Treasury, Law, Compliance and Governmental Affairs and Market Risk Departments, which are all independent of the Company's business units, assist senior management and the Risk Committees in monitoring and controlling the Company's risk profile. In addition, the Internal Audit Department, which also reports to senior management, evaluates the Company's operations and control environment through periodic examinations of business operational areas. The Company continues to be committed to employing qualified personnel with appropriate expertise in each of its various administrative and business areas to implement effectively the Company's risk management and monitoring systems and processes.

#### MARKET RISK

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, volatilities, correlations or other market factors, such as liquidity, will result in losses for a specified position or portfolio.

The Company manages the market risk associated with its trading activities Company-wide, on a trading division level worldwide and on an individual product basis. Market risk guidelines and limits have been approved for the Company and each trading division of the Company worldwide. Discrete market risk limits are assigned to trading divisions and trading desks within trading areas which are compatible with the trading division limits. Trading division risk managers, desk risk managers and the Market Risk Department all monitor market risk measures against limits and report major market and position events to senior management.

The Market Risk Department independently reviews the Company's trading portfolios on a regular basis from a market risk perspective utilizing Value-at-Risk and other quantitative and qualitative risk measurements and analyses. The Company may use measures,



such as rate sensitivity, convexity, volatility and time decay measurements, to estimate market risk and to assess the sensitivity of positions to changes in market conditions. Stress testing, which measures the impact on the value of existing portfolios of specified changes in market factors, for certain products is performed periodically and is reviewed by trading division risk managers, desk risk managers and the Market Risk Department.

#### CREDIT RISK

The Company's exposure to credit risk arises from the possibility that a counterparty to a transaction might fail to perform under its contractual commitment, resulting in the Company incurring losses. The Company has credit guidelines which limit the Company's credit exposure to any one counterparty. Specific credit risk limits based on the credit guidelines are also in place for each type of counterparty (by rating category) as well as for secondary positions of high-yield and emerging market debt.

The Credit Department administers and monitors the credit limits among trading divisions on a worldwide basis. In addition to monitoring credit limits, the Company manages the credit exposure relating to the Company's trading activities by reviewing counterparty financial soundness periodically, by entering into master netting agreements and collateral arrangements with counterparties in appropriate circumstances and by limiting the duration of exposure. In certain cases, the Company also may close out transactions or assign them to other counterparties to mitigate credit risk.

#### CONCENTRATION RISK

The Company is subject to concentration risk by holding large positions in certain types of securities or commitments to purchase securities of a single issuer, including sovereign governments and other entities, issuers located in a particular country or geographic area, public and private issuers involving developing countries or issuers engaged in a particular industry. Financial instruments owned by the Company include U.S. government and agency securities and securities issued by other sovereign governments (principally Japan and Italy), which, in the aggregate, represented approximately 12% of the Company's total assets at fiscal year end 1997. In addition,

substantially all of the collateral held by the Company for resale agreements or bonds borrowed, which together represented approximately 34% of the Company's total assets at fiscal year end 1997, consists of securities issued by the U.S. government, federal agencies or other sovereign government obligations. Positions taken and commitments made by the Company, including positions taken and underwriting and financing commitments made in connection with its merchant banking and principal investment activities, often involve substantial amounts and significant exposure to individual issuers and businesses, including non-investment grade issuers. The Company seeks to limit concentration risk through the use of the systems and procedures described in the preceding discussions of market and credit risk.

#### CUSTOMER ACTIVITIES

The Company's customer activities involve the execution, settlement, custody and financing of various securities and commodities transactions on behalf of customers. Customer securities activities are transacted on either a cash or margin basis. Customer commodities activities, which include the execution of customer transactions in commodity futures transactions (including options on futures), are transacted on a margin basis.

The Company's customer activities may expose it to off-balance sheet credit risk. The Company may have to purchase or sell financial instruments at prevailing market prices in the event of the failure of a customer to settle a trade on its original terms or in the event cash and securities in customer margin accounts are not sufficient to fully cover customer losses. The Company seeks to control the risks associated with customer activities by requiring customers to maintain margin collateral in compliance with various regulations and Company policies.

#### NOTIONAL/CONTRACT AMOUNTS AND FAIR VALUES OF DERIVATIVES

The gross notional or contract amounts of derivative instruments and fair value (carrying amount) of the related assets and liabilities at fiscal year-end 1997 and 1996, as

well as the average fair value of those assets and liabilities for fiscal year 1997 and 1996, are presented in the table which follows. Fair value represents the cost of replacing these instruments and is further described in Note 2. Future changes in interest rates, foreign currency exchange rates or the fair values of the financial instruments, commodities or indices underlying these contracts may ultimately result in cash settlements exceeding fair value amounts recognized in the consolidated statements

of financial condition. Assets represent unrealized gains on purchased exchange traded and OTC options and other contracts (including interest rate, foreign exchange and other forward contracts and swaps) net of any unrealized losses owed to these counterparties on offsetting positions in situations where netting is appropriate. Similarly, liabilities represent net amounts owed to counterparties. These amounts will vary based on changes in the fair values of underlying financial instruments and/or the volatility of such underlying instruments:

FISCAL YEAR-END GROSS NOTIONAL/CONTRACT AMOUNT <sup>(1)(2)</sup>			FISCAL YEAR-END FAIR VALUES <sup>(3)</sup>				AVERAGE FAIR VALUES <sup>(3)(4)</sup>			
(DOLLARS IN BILLIONS, AT FISCAL YEAR-END)			ASSETS		LIABILITIES		ASSETS		LIABILITIES	
1997	1996		1997	1996	1997	1996	1997	1996	1997	1996
\$1,042	\$ 622	Interest rate and currency swaps and options (including caps, floors and swap options)	\$ 7.1	\$ 4.9	\$ 6.3	\$ 5.0	\$ 4.8	\$4.2	\$ 5.9	\$3.8
1,035	362	Foreign exchange forward and futures contracts and options	4.6	2.2	4.2	2.0	3.4	1.6	3.2	1.6
42	31	Mortgage-backed securities forward contracts, swaps and options	.3	.2	—	.1	.3	.2	—	.1
220	178	Other fixed income securities contracts (including futures contracts and options)	—	.2	.1	.2	—	.2	—	.4
112	61	Equity securities contracts (including equity swaps, futures contracts, and warrants and options)	3.8	2.3	3.8	1.5	2.6	1.6	2.6	1.1
78	63	Commodity forwards, futures, options and swaps	1.3	1.4	1.2	1.2	1.1	1.3	.9	.7
\$2,529	\$1,317	Total	\$17.1	\$11.2	\$15.6	\$10.0	\$12.2	\$9.1	\$12.6	\$7.7

<sup>(1)</sup> The notional amounts of derivatives have been adjusted to reflect the effects of leverage, where applicable.

<sup>(2)</sup> Notional amounts include purchased and written options of \$572 billion and \$549 billion, respectively, at fiscal year-end 1997, and \$247 billion and \$193 billion, respectively, at fiscal year-end 1996.

<sup>(3)</sup> These amounts represent carrying value (exclusive of collateral) at fiscal year-end 1997 and 1996, respectively, and do not include receivables or payables related to exchange traded futures contracts.

<sup>(4)</sup> Amounts are calculated using a monthly average.

The gross notional or contract amounts of these instruments are indicative of the Company's degree of use of derivatives for trading purposes but do not represent the Company's exposure to market or credit risk. Credit risk arises from the failure of a counterparty to perform according to the terms of the contract. The Company's exposure to credit risk at any point in time is represented by the fair value of the contracts reported as assets. These amounts are presented on a net-by-counterparty basis when appropriate, but are not reported net of collateral, which the Company obtains with respect to

certain of these transactions to reduce its exposure to credit losses. The Company monitors the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral when deemed necessary. The Company believes that the ultimate settlement of the transactions outstanding at fiscal year-end 1997 will not have a material effect on the Company's financial condition.

The remaining maturities of the Company's swaps and other derivative products at fiscal year-end 1997 and 1996 are summarized in the following table, showing notional values by year of expected maturity:

(DOLLARS IN BILLIONS)	LESS THAN 1 YEAR	1 TO 3 YEARS	3 TO 5 YEARS	MORE THAN 5 YEARS	TOTAL
<b>AT FISCAL YEAR-END 1997</b>					
Interest rate and currency swaps and options (including caps, floors and swap options)	\$ 210	\$318	\$209	\$305	\$1,042
Foreign exchange forward and futures contracts and options	1,026	7	2	–	1,035
Mortgage-backed securities forward contracts, swaps and options	20	1	4	17	42
Other fixed income securities contracts (including futures contracts and options)	109	80	26	5	220
Equity securities contracts (including equity swaps, futures contracts, and warrants and options)	87	17	7	1	112
Commodity forwards, futures options and swaps	58	14	4	2	78
Total	\$1,510	\$437	\$252	\$330	\$2,529
Percent of total	60%	17%	10%	13%	100%
<b>AT FISCAL YEAR-END 1996</b>					
Interest rate and currency swaps and options (including caps, floors and swap options)	\$ 132	\$191	\$119	\$180	\$ 622
Foreign exchange forward and futures contracts and options	338	20	4	–	362
Mortgage-backed securities forward contracts, swaps and options	20	1	2	8	31
Other fixed income securities contracts (including futures contracts and options)	132	39	6	1	178
Equity securities contracts (including equity swaps, futures contracts, and warrants and options)	50	9	2	–	61
Commodity forwards, futures options and swaps	50	10	2	1	63
Total	\$ 722	\$270	\$135	\$190	\$1,317
Percent of total	55%	21%	10%	14%	100%

The credit quality of the Company's trading-related derivatives at fiscal year-end 1997 and 1996 is summarized in the table below, showing the fair value of the related assets by

counterparty credit rating. The actual credit ratings are determined by external rating agencies or by equivalent ratings used by the Company's Credit Department:

(DOLLARS IN MILLIONS)	AAA	AA	A	COLLATERALIZED NON- INVESTMENT BBB	GRADE	OTHER NON- INVESTMENT GRADE	TOTAL
<b>AT FISCAL YEAR-END 1997</b>							
Interest rate and currency swaps and options (including caps, floors and swap options)	\$ 740	\$2,757	\$2,534	\$ 434	\$ 26	\$ 560	\$ 7,051
Foreign exchange forward contracts and options	788	2,504	1,068	72	–	176	4,608
Mortgage-backed securities forward contracts, swaps and options	156	90	50	2	–	10	308
Other fixed income securities contracts (including options)	14	4	10	2	7	8	45
Equity securities contracts (including equity swaps, warrants and options)	1,141	917	567	233	780	152	3,790
Commodity forwards, options and swaps	70	425	380	312	12	145	1,344
Total	\$2,909	\$6,697	\$4,609	\$1,055	\$825	\$1,051	\$17,146
Percent of total	17%	39%	27%	6%	5%	6%	100%
<b>AT FISCAL YEAR-END 1996</b>							
Interest rate and currency swaps and options (including caps, floors and swap options)	\$ 739	\$1,393	\$1,977	\$ 674	\$ 25	\$ 152	\$ 4,960
Foreign exchange forward contracts and options	727	824	539	28	–	50	2,168
Mortgage-backed securities forward contracts, swaps and options	66	65	64	19	–	5	219
Other fixed income securities contracts (including options)	53	52	41	22	6	31	205
Equity securities contracts (including equity swaps, warrants and options)	1,074	274	408	60	426	43	2,285
Commodity forwards, options and swaps	95	318	318	280	72	300	1,383
Total	\$2,754	\$2,926	\$3,347	\$1,083	\$529	\$ 581	\$11,220
Percent of total	24%	26%	30%	10%	5%	5%	100%

The Company has also obtained assets posted as collateral by investment grade counterparties amounting to \$1,219

million and \$948 million at fiscal year-end 1997 and fiscal year-end 1996, respectively.

## 9. PREFERRED STOCK AND CAPITAL UNITS

Preferred stock is composed of the following issues:

(DOLLARS IN MILLIONS)	SHARES OUTSTANDING AT FISCAL YEAR-END		BALANCE AT FISCAL YEAR-END	
	1997	1996	1997	1996
ESOP Convertible Preferred Stock, liquidation preference \$35.88	3,646,664	3,699,302	\$131	\$ 133
Series A Fixed/Adjustable Rate Cumulative Preferred Stock, stated value \$200	1,725,000	1,725,000	345	345
7-% Cumulative Preferred Stock, stated value \$200	1,000,000	1,000,000	200	200
7-% Cumulative Preferred Stock, stated value \$200	1,000,000	1,000,000	200	200
8.88% Cumulative Preferred Stock, stated value \$200	–	975,000	–	195
8-% Cumulative Preferred Stock, stated value \$200	–	750,000	–	150
Total			\$876	\$1,223

Each issue of outstanding preferred stock ranks in parity with all other outstanding preferred stock of the Company.

During fiscal 1997, the Company redeemed all 975,000 shares of its 8.88% Cumulative Preferred Stock at a redemption price of \$201.632 per share, which reflects the stated value of \$200 per share together with an amount equal to all dividends accrued and unpaid to, but excluding, the redemption date. During fiscal 1997, the Company also redeemed all 750,000 shares of its 8- $\frac{3}{4}$ % Cumulative Preferred Stock at a redemption price of \$200 per share, which was equal to the stated value of \$200 per share.

The Company has Capital Units outstanding which were issued by the Company and Morgan Stanley Finance plc ("MS plc"), a U.K. subsidiary. A Capital Unit consists of (a) a Subordinated Debenture of MS plc guaranteed by the Company and having maturities from 2013 to 2017 and (b) a related Purchase Contract issued by the Company, which may be accelerated by the Company beginning approximately one year after the issuance of each Capital Unit, requiring the holder to purchase one Depositary Share representing shares (or fractional shares) of the Company's Cumulative Preferred Stock. The aggregate amount of Capital Units outstanding was \$999 million at fiscal year end 1997 and \$865 million at fiscal year end 1996.

During fiscal 1997, the Company and MS plc issued 8.03% Capital Units in the aggregate amount of \$134 million which mature in 2017.

The estimated fair value of the Capital Units approximated carrying value at fiscal year-end 1997 and fiscal year-end 1996.

## 10. COMMON STOCK AND SHAREHOLDERS' EQUITY

In conjunction with the Merger, the Company increased the number of authorized common shares to 1,750 million and changed the number of authorized preferred shares to 30 million.

Prior to the consummation of the Merger, both Morgan Stanley and Dean Witter Discover rescinded their respective outstanding share repurchase authorizations. At the time of the Merger, 5,902,751 shares of Morgan Stanley common stock which had been held in treasury were retired.

MS&Co. and DWR are registered broker-dealers and registered futures commission merchants and, accordingly, subject to the minimum net capital requirements of the Securities Exchange Commission, the New York Stock Exchange and the Commodity Futures Trading Commission. MS&Co. and DWR have consistently operated in excess of these requirements. MS&Co.'s net capital totaled \$2,186 million at November 30, 1997 which exceeded the amount required by \$1,753 million. DWR's net capital totaled \$764 million at November 30, 1997 which exceeded the amount required by \$643 million. MSIL, a London-based broker-dealer subsidiary, is subject to the capital requirements of the Securities and Futures Authority, and MSJL, a Tokyo-based broker-dealer, is subject to the capital requirements of the Japanese Ministry of Finance. MSIL and MSJL have consistently operated in excess of their respective regulatory capital requirements.

Under regulatory net capital requirements adopted by the Federal Deposit Insurance Corporation ("FDIC") and other regulatory capital guidelines, FDIC-insured financial institutions must maintain (a) 3% to 5% of Tier 1

Inc., the Company's triple-A rated derivative products subsidiary, also has established certain operating restrictions which have been reviewed by various rating agencies.

The regulatory capital requirements referred to above, and certain covenants contained in various agreements governing indebtedness of the Company, may restrict the Company's ability to withdraw capital from its subsidiaries. At November 30, 1997, approximately \$4,303 million of net assets of consolidated subsidiaries may be restricted as to the payment of cash dividends and advances to the Company.

Cumulative translation adjustments include gains or losses resulting from translating foreign currency financial statements from their respective functional currencies to U.S. dollars, net of hedge gains or losses and related tax effects. The Company uses foreign currency contracts and designates certain non-U.S. dollar currency debt as hedges to manage the currency exposure relating to its net monetary investments in non-U.S. dollar functional currency subsidiaries. Increases or decreases in the value of the Company's net foreign investments generally are tax-deferred for U.S. purposes, but the related hedge gains and losses are taxable currently. Therefore, the gross notional amounts of the contracts and debt designated as hedges exceed the Company's net foreign investments to result in effective hedging on an after-tax basis. The Company attempts to protect its net book value from the effects of fluctuations in currency exchange rates on its net monetary investments in non-U.S. dollar subsidiaries by selling the appropriate non-U.S. dollar currency in the forward market. However, under some circumstances, the Company may elect not to hedge its net monetary investments in certain foreign operations due to market conditions, including the availability of various currency contracts at acceptable costs. Information relating to the hedging of the Company's net monetary investments in

non-U.S. dollar functional currency subsidiaries and their effects on cumulative translation adjustments is summarized below:

(DOLLARS IN MILLIONS)	AT FISCAL YEAR-END	
	1997	1996
Net investments in non-U.S. dollar functional currency subsidiaries	\$1,128	\$1,279
Gross notional amounts of foreign exchange contracts and non-U.S. dollar debt designated as hedges <sup>(1)</sup>	\$1,881	\$2,247
Cumulative translation adjustments resulting from net investments in subsidiaries with a non-U.S. dollar functional currency	\$ 6	\$ 100
Cumulative translation adjustments resulting from realized or unrealized gains or losses on hedges, net of tax	\$ (15)	\$ (111)
Total cumulative translation adjustments	\$ (9)	\$ (11)

<sup>(1)</sup> Notional amounts represent the contractual currency amount translated at respective fiscal year-end spot rates.

## 11. EMPLOYEE COMPENSATION PLANS

The Company has adopted a variety of compensation plans for certain of its employees as well as the Company's non-employee directors. These plans are designed to facilitate a pay-for-performance policy, provide compensation commensurate with other leading financial services companies and provide for internal ownership in order to align the interests of employees with the long-term interests of the Company's shareholders. These plans are summarized below.

### EQUITY-BASED COMPENSATION PLANS

The Company is authorized to issue up to approximately 260 million shares of its common stock in connection with awards under its equity-based compensation plans. At November 30, 1997, approximately 164 million shares were available for future grant under these plans.

#### Stock Option Awards

Stock option awards have been granted pursuant to several equity-based compensation plans. Each plan provides for the granting of stock options having an exercise price not less than the fair value of the Company's common stock (as defined in the plan) on the date of grant. Such options generally become exercisable over a one to five year period and expire seven to 10 years from the date of grant.



The following table presents information relating to the Company's stock options outstanding at November 30, 1997 (share data in millions):

RANGE OF	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
	NUMBER	WEIGHTED AVERAGE EXERCISE	AVERAGE REMAINING LIFE	NUMBER	WEIGHTED AVERAGE EXERCISE

The discount to fair value was \$2 million for both fiscal 1997 and fiscal 1996 and \$1 million in fiscal 1995. The plan is “non-compensatory” under APB No. 25, and, accordingly, no charge to earnings has been recorded for the amount of the discount to fair value.

#### *Non-Employee Director Awards*

The Company sponsors a stock plan for non-employee directors under which shares of the Company’s common stock have been authorized for issuance in the form of option grants, stock awards or deferred compensation. The effect of these grants on results of operations was not material.

### OTHER COMPENSATION PLANS

#### *Capital Accumulation Plan*

Under the Capital Accumulation Plan (“CAP”), vested units consisting of unsecured rights to receive payments based on notional interests in existing and future risk-capital investments made directly or indirectly by the Company (“CAP Units”) are granted to key employees. The value of the CAP Units awarded for services rendered in fiscal 1997, 1996 and 1995 was approximately \$14 million, \$7 million and \$12 million, respectively, all of which relate to vested units.

#### *Carried Interest Plans*

Under various Carried Interest Plans, certain key employees effectively participate in a portion of the Company’s realized gains from certain of its equity investments in merchant banking transactions. Compensation expense for fiscal 1997, 1996 and 1995 related to these plans aggregated \$38 million, \$0.2 million and \$14 million, respectively.

#### *Real Estate Fund Plans*

Under the Real Estate Compensation Plan and the Real Estate Profits Participation Plan, select employees and consultants may participate in certain gains realized by the Company’s real estate funds. Compensation expense relating to these plans aggregated \$8 million, \$13 million and \$9 million for fiscal 1997, fiscal 1996 and fiscal 1995, respectively.

#### *Profit Sharing Plans*

The Company sponsors qualified profit sharing plans covering substantially all U.S. employees and also provides cash payment of profit sharing to employees of its international subsidiaries. Contributions are made to eligible employees at the discretion of management based upon the financial performance of the Company. Total profit sharing expense for fiscal 1997, fiscal 1996 and fiscal 1995 (excluding Company contributions to the Employee Stock Ownership Plan, which increased in fiscal 1995) was \$113 million, \$72 million and \$51 million, respectively.

#### *Employee Stock Ownership Plan*

The Company has a \$140 million leveraged employee stock ownership plan, funded through an independently managed trust. The Employee Stock Ownership Plan (“ESOP”) was established to broaden internal ownership of the Company and to provide benefits to its employees in a cost-effective manner. Each of the 3,646,664 preferred shares outstanding at fiscal year end 1997 is held by the ESOP trust, is convertible into 3.3 shares of the Company’s common stock and is entitled to annual dividends of \$2.78 per preferred share. The ESOP trust funded its stock purchase through a loan of \$140 million from the Company. The ESOP trust note, due September 19, 2010 (extendable at the option of the ESOP trust to September 19, 2015), bears a 10-3/4% interest rate per annum with principal payable without penalty on or before the due date. The ESOP trust expects to make principal and interest payments on the note from funds provided by dividends on the shares of convertible preferred stock and contributions from the Company. The note receivable from the ESOP trust is reflected as a reduction in the Company’s shareholders’ equity. Shares allocated to employees generally may not be withdrawn until the employee’s death, disability, retirement or termination. Upon withdrawal, each share of ESOP preferred stock generally will be converted into 3.3 shares of the Company’s common stock. If the fair value of such 3.3 common shares at conversion is less than the \$35.88 liquidation value of an ESOP preferred share, the Company will pay the withdrawing employee the difference in additional common shares or cash.

Contributions to the ESOP by the Company and allocation of ESOP shares to employees are made annually at the discretion of the Board of Directors. The cost of shares allocated to participants' accounts amounted to \$8 million in fiscal 1997, \$9 million in fiscal 1996 and \$13 million in fiscal 1995. The ESOP debt service costs for fiscal 1997, fiscal 1996 and fiscal 1995 were paid from dividends received on preferred stock held by the plan and from Company contributions.

#### PRO FORMA EFFECT OF SFAS NO. 123

Had the Company elected to recognize compensation cost pursuant to SFAS No. 123 for its stock option plans and the Employee Stock Purchase Plan, net income would have been reduced by \$196 million, \$41 million and \$147 million for fiscal 1997, 1996 and 1995. Primary and fully diluted earnings per common share would have been reduced by \$0.36, \$0.08 and \$0.25 for fiscal 1997, 1996 and 1995.

The weighted average fair value at date of grant for stock options granted during fiscal 1997, 1996 and 1995 was \$16.76, \$9.08 and \$7.27 per option, respectively. The fair value of stock options at date of grant was estimated using the Black-Scholes option pricing model utilizing the following weighted average assumptions:

FISCAL YEAR	1997	1996	1995
Risk-free interest rate	6.0%	5.5%	7.4%
Expected option life in years	6.0	5.3	8.1
Expected stock price volatility	28.0%	27.5%	29.7%
Expected dividend yield	1.3%	1.6%	1.9%

## 12. EMPLOYEE BENEFIT PLANS

The Company sponsors various pension plans for the majority of its worldwide employees. The Company provides certain other postretirement benefits, primarily health care and life insurance, to eligible employees. The Company also provides certain benefits to former or inactive employees prior to retirement. The following summarizes these plans:

#### *Pension Plans*

Substantially all of the U.S. employees of the Company and its U.S. affiliates are covered by non-contributory pension plans that are qualified under Section 401(a) of the Internal Revenue Code (the "Qualified Plans"). Unfunded supplementary plans (the "Supplemental

Plans") cover certain executives. In addition to the Qualified Plans and the Supplemental Plans (collectively, the "U.S. Plans"), ten of the Company's international subsidiaries also have pension plans covering substantially all of their employees. These pension plans generally provide pension benefits that are based on each employee's years of credited service and on compensation levels specified in the plans. For the Qualified Plans and the other international plans, the Company's policy is to fund at least the amounts sufficient to meet minimum funding requirements under applicable employee benefit and tax regulations. Liabilities for benefits payable under the Supplemental Plans are accrued by the Company and are funded when paid to the beneficiaries.

The Company also maintains a separate pension plan which covers substantially all employees of the Company's U.K. subsidiaries (the "U.K. Plan"). During fiscal 1996, the benefit structure of the U.K. Plan was changed from a defined benefit plan to a defined contribution plan. Under the defined contribution plan, benefits are determined by the purchasing power of the accumulated value of contributions paid. Under the defined benefit plan, benefits were expressed as a proportion of earnings at or near retirement based on years of service. In fiscal 1997 and 1996, the Company's expense related to the defined contribution U.K. Plan was \$15 million and \$3 million, respectively.

The following tables present information for the Dean Witter Discover predecessor pension plans and Morgan Stanley predecessor pension plans on an aggregate basis.

Pension expense includes the following components:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
U.S. Plans			
Service cost, benefits earned during the period	\$ 54	\$ 48	\$ 35
Interest cost on projected benefit obligation	67	58	50
Return on plan assets	(170)	(111)	(103)
Difference between actual and expected return on assets	104	53	51
Net amortization	1	2	(1)
Total U.S. Plans	56	50	32
International plans	9	12	13
Total pension expense	\$ 65	\$ 62	\$ 45

The following table provides the assumptions used in determining the projected benefit obligation for the U.S. Plans:

FISCAL YEAR	1997	1996
Weighted average discount rate	7.25%	7.50-7.75%
Rate of increase in future compensation levels	5.00%	5.00%
Expected long-term rate of return on plan assets	9.00%	9.00%

The following table sets forth the funded status of the U.S. Plans:

	1997		1996	
AT FISCAL YEAR-END (DOLLARS IN MILLIONS)	QUALIFIED	SUPPLEMENTAL	QUALIFIED	SUPPLEMENTAL
Actuarial present value of vested benefit obligation	\$ (735)	\$ (34)	\$ (592)	\$ (38)
Accumulated benefit obligation	\$ (807)	\$ (71)	\$ (636)	\$ (59)
Effect of future salary increases	(181)	(30)	(140)	(19)
Projected benefit obligation	(988)	(101)	(776)	(78)
Plan assets at fair market value (primarily listed stocks and bonds)	1,006	—	785	—
Projected benefit obligation less than or (in excess of) plan assets	18	(101)	9	(78)
Unrecognized net (gain) or loss	(4)	27	(15)	13
Unrecognized prior service cost	31	(4)	5	(4)
Unrecognized net transition obligation	3	5	—	5
Prepaid (accrued) pension cost at fiscal year-end	\$ 48	\$ (73)	\$ (1)	\$ (64)

## POSTRETIREMENT BENEFITS

The Company has unfunded postretirement benefit plans that provide medical and life insurance for eligible retirees, employees and dependents. At fiscal year end 1997 and 1996, the Company's accrued postretirement benefit costs were \$91 million and \$85 million.

## POSTEMPLOYMENT BENEFITS

Postemployment benefits include, but are not limited to, salary continuation, supplemental unemployment benefits, severance benefits, disability-related benefits, and continuation of health care and life insurance coverage provided to former or inactive employees after employment but before retirement. These benefits were not material to the consolidated financial statements in fiscal 1997, 1996 and 1995.

## 13. INCOME TAXES

The provision for income taxes consists of:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Current			
U.S. federal	\$1,079	\$1,096	\$ 730
U.S. state and local	348	290	205
Non-U.S.	338	177	104
	1,765	1,563	1,039
Deferred			
U.S. federal	(45)	(326)	(120)
U.S. state and local	(17)	(74)	(54)
Non-U.S.	(15)	(26)	(38)
	(77)	(426)	(212)
Provision for income taxes	\$1,688	\$1,137	\$ 827

The following table reconciles the provision to the U.S. federal statutory income tax rate:

FISCAL YEAR	1997	1996	1995
U.S. federal statutory income tax rate	35.0%	35.0%	35.0%
U.S. state and local income taxes, net of U.S. federal income tax benefits	5.1	4.6	4.2
Lower tax rates applicable to non-U.S. earnings	(1.1)	(1.7)	(2.9)
Reduced tax rate applied to dividends	(.1)	(.1)	(.2)
Other	.6	(1.3)	—
Effective income tax rate	39.5%	36.5%	36.1%

As of November 30, 1997 the Company had approximately \$2.2 billion of earnings attributable to foreign subsidiaries for which no tax provisions have been recorded for income tax that could occur upon repatriation. Except to the extent such earnings can be repatriated tax efficiently, they are permanently invested abroad. It is not practicable to determine the amount of income taxes payable in the event all such foreign earnings are repatriated. Deferred income taxes reflect the net tax effects of temporary differences between the financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when such differences are expected to reverse. Significant components of the Company's deferred tax assets and liabilities at fiscal year-end 1997 and 1996 are as follows:

AT FISCAL YEAR-END (DOLLARS IN MILLIONS)	1997	1996
Deferred tax assets		
Employee compensation and benefit plans	\$1,168	\$1,061
Loan loss allowance	459	437
Other valuation and liability allowances	545	448
Other	180	100
Total deferred tax assets	2,352	2,046
Deferred tax liabilities		
Prepaid commissions	233	200
Valuation of inventory, investments and receivables	298	225
Other	265	169
Total deferred tax liabilities	796	594
Net deferred tax assets	\$1,556	\$1,452

Cash paid for income taxes were \$1,251 million, \$1,190 million and \$887 million in fiscal 1997, 1996 and 1995.

#### 14. GEOGRAPHIC AREA DATA

Total revenues, net revenues, income before taxes and identifiable assets of the Company's operations by geographic area are as follows:

(DOLLARS IN MILLIONS)	TOTAL REVENUES			NET REVENUES		
	FISCAL 1997	FISCAL 1996	FISCAL 1995	FISCAL 1997	FISCAL 1996	FISCAL 1995
International						
Europe	\$ 6,468	\$ 5,616	\$ 4,551	\$ 1,757	\$ 1,429	\$ 1,079
Asia	952	768	748	866	700	626
Total	7,420	6,384	5,299	2,623	2,129	1,705
North America	28,711	24,235	18,110	12,519	10,193	8,374
Eliminations	(8,999)	(8,448)	(4,677)	(309)	(299)	(259)
Total	\$27,132	\$22,171	\$18,732	\$ 14,833	\$ 12,023	\$ 9,820
(DOLLARS IN MILLIONS)	INCOME BEFORE TAXES			IDENTIFIABLE ASSETS		
	FISCAL 1997	FISCAL 1996	FISCAL 1995	FISCAL 1997	FISCAL 1996	FISCAL 1995
International						
Europe	\$ 399	\$ 328	\$ 237	\$ 126,138	\$ 113,734	\$ 85,393
Asia	240	161	158	30,656	21,561	17,363
Total	639	489	395	156,794	135,295	102,756
North America	3,635	2,628	1,897	307,728	242,510	178,009
Eliminations	-	-	-	(162,235)	(138,945)	(98,804)
Total	\$ 4,274	\$ 3,117	\$ 2,292	\$ 302,287	\$ 238,860	\$181,961

Because of the international nature of the financial markets and the resulting geographic integration of the Company's business, the Company manages its business

with a view to the profitability of the enterprise as a whole, and, as such, profitability by geographic area is not necessarily meaningful.

## 15. SEGMENT INFORMATION

The Company is in the business of providing financial services, and operates in two business segments — Securities and Asset Management and Credit and Transaction Services. Securities and Asset Management engages in delivering a broad range of financial products and services, including asset management, to individual and institutional investors. Credit and Transaction Services is engaged in the issuance and servicing of general purpose credit cards, consumer lending and electronic transaction processing services.

The following table presents certain information regarding these business segments:

FISCAL YEAR (DOLLARS IN MILLIONS)	1997	1996	1995
Total revenues			
Securities & Asset Management	\$ 21,499	\$ 17,136	\$ 14,523
Credit & Transaction Services	5,633	5,035	4,209
Income before income taxes <sup>(1)</sup>			
Securities & Asset Management	3,597	2,426	1,591
Credit & Transaction Services	751	691	701
Identifiable assets at end of period <sup>(2)</sup>			
Securities & Asset Management	277,878	213,967	159,318
Credit & Transaction Services	24,409	24,893	22,643

<sup>(1)</sup> Excludes merger-related expenses of \$74 million.

<sup>(2)</sup> Corporate assets have been fully allocated to the Company's business segments.

## 16. ACQUISITIONS AND DISPOSITION

In January 1997, the Company acquired Lombard, a company which provides discount trading services, principally to individual investors, through its Internet site, an automated telephone system, and a core group of registered representatives. Subsequent to the date of acquisition, Lombard's corporate name was changed to Discover Brokerage Direct, Inc.

In April 1997, the Company acquired the institutional global custody business of Barclays PLC ("Barclays"). The amount of consideration for this business is to be fixed over a period of time based on account retention. Barclays has agreed to provide global subcustodial services to the Company for a period of time after completion of the acquisition.

In July 1997, the Company sold the DWR institutional futures business to Carr Futures, Inc., a subsidiary of Credit Agricole Indosuez. This sale did not have a material effect on the Company's results of operations or financial position.

In fiscal 1996, the Company completed its purchase of MAS, an institutional investment manager, for \$350 million, payable in a combination of cash, notes and common stock of the Company. The Company's fiscal 1996 results include the results of MAS since January 3, 1996, the date of acquisition.

In fiscal 1996, the Company completed its purchase of VKAC for \$1.175 billion. The consideration for the purchase of the equity of VKAC consisted of cash and approximately \$26 million of preferred securities issued by one of the Company's subsidiaries and exchangeable into common stock of the Company. The Company's fiscal 1996 results include the results of VKAC since October 31, 1996, the date of acquisition.



## 17. QUARTERLY RESULTS (UNAUDITED)

(DOLLARS IN MILLIONS, EXCEPT SHARE AND PER SHARE DATA)	1997				1996			
	FISCAL QUARTER				FISCAL QUARTER			
	FIRST	SECOND	THIRD	FOURTH	FIRST	SECOND	THIRD	FOURTH
<b>Revenues</b>								
Investment banking	\$ 522	\$ 581	\$ 818	\$ 773	\$ 464	\$ 599	\$ 477	\$ 650
Principal transactions:								
Trading	869	722	778	822	823	679	534	623
Investments	56	136	206	65	(7)	38	29	26
Commissions	490	484	559	553	455	463	412	446
Fees:								
Asset management, distribution and administration	587	610	656	652	397	429	427	479
Merchant and cardmember	436	424	433	411	319	346	379	461
Servicing	202	184	196	180	198	189	220	202
Interest and dividends	3,369	3,197	3,570	3,447	2,794	2,809	3,038	2,647
Other	29	38	41	36	30	37	23	36
Total revenues	6,560	6,376	7,257	6,939	5,473	5,589	5,539	5,570
Interest expense	2,709	2,478	2,765	2,854	2,250	2,245	2,419	2,020
Provision for consumer loan losses	379	376	385	353	224	270	302	418
Net revenues	3,472	3,522	4,107	3,732	2,999	3,074	2,818	3,132
<b>Non-interest expenses</b>								
Compensation and benefits	1,490	1,505	1,849	1,175	1,275	1,303	1,171	1,322
Occupancy and equipment	128	127	134	137	119	120	122	132
Brokerage, clearing and exchange fees	95	113	130	122	77	79	76	85
Information processing and communications	270	267	249	294	232	239	249	276
Marketing and business development	288	274	293	324	229	243	247	308
Professional services	93	99	127	132	60	80	85	109
Other	180	180	219	191	167	166	160	175
Merger-related expenses	—	74	—	—	—	—	—	—
Total non-interest expenses	2,544	2,639	3,001	2,375	2,159	2,230	2,110	2,407
Income before income taxes	928	883	1,106	1,357	840	844	708	725
Provision for income taxes	357	356	428	547	322	304	250	261
Net income	\$ 571	\$ 527	\$ 678	\$ 810	\$ 518	\$ 540	\$ 458	\$ 464
Earnings applicable to common shares <sup>(1)</sup>	\$ 552	\$ 509	\$ 663	\$ 796	\$ 502	\$ 523	\$ 443	\$ 446
Per common share <sup>(2)</sup>								
Primary earnings <sup>(3)</sup>	\$ .93	\$ .85	\$ 1.11	\$ 1.33	\$ .83	\$ .87	\$ .75	\$ .76
Fully diluted earnings <sup>(3)</sup>	\$ .91	\$ .83	\$ 1.09	\$ 1.30	\$ .81	\$ .86	\$ .73	\$ .74
Dividends to common shareholders	\$ .14	\$ .14	\$ .14	\$ .14	\$ .11	\$ .11	\$ .11	\$ .11
Book value	\$18.70	\$19.37	\$20.25	\$22.11	\$15.86	\$16.42	\$16.93	\$18.43
Average common and equivalent shares <sup>(2)</sup>								
Primary	593,495,440	598,282,535	597,921,853	600,038,489	606,585,943	600,219,450	591,882,036	587,117,776
Fully diluted	606,621,425	611,724,590	610,187,894	612,255,249	620,807,404	612,616,954	604,879,722	601,438,805
Stock price range <sup>(4)</sup>	\$32.19-43.75	\$34.50-41.50	\$41.00-53.88	\$47.31-58.75	\$22.50-29.00	\$25.56-31.06	\$24.13-28.88	\$27.56-34.38

<sup>(1)</sup> Amounts shown are used to calculate primary earnings per share.

<sup>(2)</sup> Per share and share data have been restated to reflect the Company's two-for-one stock split.

<sup>(3)</sup> Summation of the quarters' earnings per common share may not equal the annual amounts due to the averaging effect of the number of shares and share equivalents throughout the year.

<sup>(4)</sup> Prices represent the range of sales per share on the New York Stock Exchange for the periods indicated. The number of stockholders of record at November 30, 1997 approximated 192,440. The number of beneficial owners of common stock is believed to exceed this number.