

Morgan Stanley DW Inc.

Consolidated Statement of Financial Condition

(Unaudited) May 31, 2004

Investments and services are offered through Morgan Stanley DW Inc., member SIPC.

Morgan Stanley DW Inc.
Consolidated Statement of Financial Condition

May 31, 2004 (Unaudited)
(In thousands of dollars)

Assets

Cash	\$291,270
Cash and securities deposited with clearing organizations or segregated under federal and other regulations (securities at fair value of \$3,237,602)	3,277,073
Financial instruments owned (\$56,831 was pledged to various parties):	
U.S. government and federal agency	866,378
Corporate and other debt	970,831
Corporate equities	263,160
Securities purchased under agreements to resell	3,229,300
Securities borrowed	597,377
Receivables:	
Customers (net of allowances of \$18,087)	4,690,517
Brokers, dealers and clearing organizations	109,137
Office facilities, at cost (less accumulated depreciation and amortization of \$411,748)	150,412
Other assets	880,025
Total assets	<u>\$15,325,480</u>

Liabilities and Stockholder's Equity

Financial instruments sold, not yet purchased:	
U.S. government and federal agency	\$624,078
Corporate and other debt	307,301
Corporate equities	28,622
Securities sold under agreements to repurchase	3,308,745
Securities loaned	1,101,930
Payables:	
Customers	4,624,571
Brokers, dealers and clearing organizations	324,195
Affiliates	1,148,975
Other liabilities and accrued expenses	1,591,075
	<u>13,059,492</u>
Subordinated liabilities	<u>750,000</u>
Stockholder's equity:	
Common stock	1,100
Paid-in capital	768,626
Retained earnings	746,262
Total stockholder's equity	<u>1,515,988</u>
Total liabilities and stockholder's equity	<u>\$15,325,480</u>

See Notes to Consolidated Statement of Financial Condition.

Morgan Stanley DW Inc.
Notes to Consolidated Statement of Financial Condition

As of May 31, 2004 (Unaudited)
(In thousands of dollars, except share data)

Note 1—Introduction and Basis of Presentation

The Company

The consolidated statement of financial condition includes the accounts of Morgan Stanley DW Inc., a broker-dealer registered with the Securities and Exchange Commission ("SEC"), and its wholly-owned subsidiaries (the "Company"). The Company serves the investment needs of its customers by providing a wide range of investment products and advice through its sales organization located throughout the United States. The Company is also registered as a futures commission merchant with the Commodity Futures Trading Commission ("CFTC"). The Company is a wholly-owned subsidiary of Morgan Stanley (the "Parent").

Basis of Financial Information

The consolidated statement of financial condition is prepared in accordance with accounting principles generally accepted in the U.S., which require the Company to make estimates and assumptions regarding the valuation of certain financial instruments, the potential outcome of litigation and other matters that affect the consolidated financial statement and related disclosures. The Company believes that the estimates utilized in the preparation of the consolidated financial statement are prudent and reasonable. Actual results could differ materially from these estimates.

All material intercompany accounts and transactions have been eliminated in consolidation.

Related Party Transactions

At May 31, 2004, balances with affiliates included securities borrowed and reverse repurchase agreements of \$597,377 and \$191,906, respectively, and securities loaned of \$1,068,434 and repurchase agreements of \$155,938.

In the normal course of its securities business, the Company enters into transactions with affiliates including securities underwriting, mutual fund distribution and research activities.

Payable to affiliates on the statement of financial condition includes net payable to the Parent of \$1,063,605 and other affiliates of \$85,370. The net payable to the Parent includes net deferred taxes payable of \$857,584, borrowings of \$187,518 and other payables of \$18,503; payables to the

Parent are unsecured, bear interest at prevailing market rates and are payable on demand. Included in other assets on the statement of financial condition is a net receivable from affiliates of \$14,117.

The Company sells certain of its receivables to an affiliate. For the six months ended May 31, 2004, \$37,048 of receivables were sold to the affiliate without recourse.

Note 2—Summary of Significant Accounting Policies

Financial instruments owned and financial instruments sold, not yet purchased used in the Company's trading activities are recorded at fair value in the consolidated statement of financial condition, and gains and losses are reflected in principal transactions revenue. Fair value is the amount at which financial instruments could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. A substantial percentage of the fair value of the Company's financial instruments owned and sold, not yet purchased is based on observable market prices, observable market parameters, or is derived directly from such prices or parameters. Purchases and sales of financial instruments are recorded in the accounts on trade date.

Customers' securities transactions are recorded on a settlement date basis with related commission revenues and expenses recorded on trade date.

Asset management and administration fees include revenues from asset management services, including fees for promoting and distributing mutual funds ("12b-1 fees"), fees for investment management services provided to segregated customer accounts pursuant to various contractual arrangements, and revenues from customers electing a fee-based pricing arrangement. The Company receives 12b-1 fees for services it provides in promoting and distributing certain open-ended mutual funds. These 12b-1 fees are based on either the average daily fund net asset balances or average daily aggregate net fund sales and are affected by changes in the overall level and mix of assets under management or supervision.

Investment banking revenues are derived from the Company's distribution of equity, fixed income securities and unit investment trust products underwritten by affiliates. Investment banking revenues are recorded when services for the transaction are substantially completed.

Office facilities consist of fixed assets, leasehold improvements and capitalized software. Fixed assets placed into service on or prior to June 30, 2002 are depreciated utilizing accelerated methods. Leasehold improvements

placed into service on or prior to June 30, 2002 are amortized utilizing either accelerated or straight-line methods. Fixed assets and leasehold improvements placed in service after June 30, 2002, are depreciated/amortized utilizing the straight-line method. All fixed assets are depreciated over their useful lives of two to nine years, and leasehold improvements are amortized over the lesser of the lease term or useful life. Capitalized software is amortized utilizing the straight-line method over the useful life of three years.

Income tax expense is provided 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.

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," the amortization of goodwill and indefinite-lived intangible assets is not permitted. Instead, those assets must be reviewed annually (or more frequently under certain circumstances) for impairment. During the first quarter of fiscal 2004, the Company completed the annual goodwill impairment test, which did not indicate any goodwill impairment and therefore did not have an effect on the Company's consolidated financial condition. At May 31, 2004, goodwill of approximately \$159,283 was included in the Company's consolidated statement of financial condition as a component of other assets.

Note 3—Securities Financing Transactions

Securities purchased under agreements to resell ("reverse repurchase agreements") and securities sold under agreements to repurchase ("repurchase agreements"), principally U.S. government and federal agency securities, are treated as financing transactions and are carried at the amounts at which the securities subsequently will 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. Securities borrowed and securities loaned are also treated as financing transactions and are carried at the amounts of cash collateral advanced and received in connection with the transactions.

The Company pledges its financial instruments owned to collateralize repurchase agreements and other securities financing. Pledged securities that can be resold or repledged by the secured party are identified as financial instruments owned (pledged to various parties) on the consolidated statement of financial condition. The carrying value

and classification of financial instruments owned by the Company that have been loaned or pledged to counterparties, where those parties do not have the right to sell or repledge the collateral, were approximately:

May 31, 2004

Financial instruments owned:

U.S. government and agency securities	\$557,362
Corporate and other debt	837,271
Total	<u>\$1,394,633</u>

The Company enters into reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions to, among other things, finance the Company's inventory positions, acquire securities to cover short positions and settle other securities obligations, and accommodate customers' needs. The Company also engages in securities financing transactions for customers through margin lending. Under these agreements and transactions, the Company either receives or provides collateral, including U.S. government and agency securities, corporate and other debt, and corporate equities. The Company receives collateral in the form of securities in connection with reverse repurchase agreements, securities borrowed transactions and customer margin loans. In many cases, the Company is permitted to sell or repledge these securities held as collateral and use the securities to secure repurchase agreements, to enter into securities lending transactions or for the delivery to counterparties to cover short positions. At May 31, 2004, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$10,295,477, and the fair value of the portion that has been sold or repledged was \$5,943,865.

The Company manages credit exposure arising from reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions by, in appropriate circumstances, entering into master netting agreements and collateral arrangements with counterparties that provide the Company, in the event of a customer default, the right to liquidate collateral and the right to offset a counterparty's rights and obligations. The Company also 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 to ensure such transactions are adequately collateralized. Where deemed appropriate, the Company's agreements with third parties specify its rights to request additional collateral. Customer receivables generated from margin lending activity are collateralized by customer-owned securities held by the Company. For these transactions, the Company's collateral policies significantly limit the Company's credit exposure in the event of

customer default. The Company may request additional margin collateral from customers, if appropriate, and if necessary may sell securities that have not been paid for or purchase securities sold but not delivered from customers.

Note 4—Subordinated Liabilities

Subordinated liabilities consist of a Cash Subordination Agreement and a Subordinated Revolving Credit Agreement with the Parent.

The Cash Subordination Agreement is for \$750,000, bears interest at 2.14% per annum and has a maturity date of June 30, 2018. Additionally, there is no balance outstanding under the Company's \$1,000,000 Subordinated Revolving Credit Agreement which has a commitment termination date and maturity date of June 30, 2006 and June 30, 2007, respectively. Interest on this borrowing is payable at rates based upon the federal funds rate or the London Interbank Offered Rate.

Note 5—Commitments and Contingencies

Leases

The Company has non-cancelable operating leases covering office space and equipment. At May 31, 2004, future minimum rental commitments under such leases (net of subleases, principally on office rentals) were as follows:

May 2005	\$169,066
May 2006	150,587
May 2007	128,239
May 2008	101,671
May 2009	84,203
Thereafter	<u>197,020</u>
Total	<u>\$830,786</u>

Included in the table above are \$65,535 of future minimum rental commitments (net of actual sublease income) related to closed or downsized branch offices and support space for which the present value was included in the restructuring charges taken during the year ended November 30, 2002 ("fiscal 2002").

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.

Other Commitments and Contingencies

The Company had approximately \$22,510 of letters of credit outstanding at May 31, 2004 to satisfy various collateral requirements.

In the normal course of business, the Company has been named as a defendant in various legal actions, including arbitrations, arising in connection with its activities as a diversified financial services institution. Certain of the legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. The Company is also involved, from time to time, in investigations and proceedings by governmental and self-regulatory agencies. Certain of these legal actions, investigations and proceedings may result in adverse judgments, penalties or fines. The number of these investigations and proceedings has increased in recent years to many firms, including the Company.

In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases in which claimants seek substantial or indeterminate damages, the Company cannot predict with certainty what the eventual loss or range of loss related to such matters will be. The Company believes, based on current knowledge and after consultation with counsel, that the outcome of such matters will not have a material adverse effect on the consolidated financial condition of the Company, although the outcome could be material to the Company's operating results for a particular period, depending, upon other things, on the level of the Company's income for such period.

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 statement of financial condition.

At May 31, 2004, the Company had commitments to enter into reverse repurchase and repurchase agreements of approximately \$500,000 and \$700,000, respectively.

The Company is a member of various U.S. exchanges and clearinghouses that trade and clear securities and/or futures contracts. Associated with its membership, the Company may be required to pay a proportionate share of the financial obligations of another member who may default on its obligations to the exchange or the clearinghouse. While the rules governing different exchange or clearinghouse memberships vary, in general the Company's guarantee obligations would arise only if the exchange or clearinghouse had previously exhausted its resources.

In addition, any such guarantee obligation would be apportioned among the other non-defaulting members of the exchange or clearinghouse. Any potential contingent liability under these membership agreements cannot be estimated. The Company has not recorded any contingent liability in the consolidated statement of financial condition for these agreements and believes that any potential requirement to make payments under these agreements is remote.

Note 6 — Trading Activities

The Company's trading activities are primarily generated by customer order flow and such customer activities involve the execution, settlement and financing of various customer securities and commodities transactions.

The Company's securities brokerage activities involve certain market and credit risks. Customer securities activities are transacted on either a cash or margin basis and customer commodity transactions are generally transacted on a margin basis subject to individual exchange regulations. These transactions include the purchase and sale of securities, the writing of options and the purchase and sale of commodity futures and forward contracts. These activities may expose the Company to off-balance sheet risk from customers that may fail to satisfy their obligations, requiring the Company to purchase or sell financial instruments at prevailing market prices.

The Company's exposure to credit risk associated with these transactions is measured on an individual basis, as well as by groups that share similar attributes. The Company services a diverse group of domestic and foreign corporations, governments and institutional and individual investors. Credit risk may be impacted by trading market volatility. The Company seeks to control risks associated with its customers' activities by requiring customers to maintain collateral in compliance with internal and regulatory guidelines. The Company monitors required margin levels and established credit limits daily and, pursuant to such guidelines, requires customers to deposit additional collateral, or reduce positions, when necessary.

Note 7 — Employee Benefit Plans

Pension Plans

Substantially all of the employees of the Company are covered by a non-contributory pension plan that is qualified under Section 401(a) of the Internal Revenue Code (the "Qualified Plan") which is sponsored by an affiliate. The employees of the Company have a distinct benefit structure within this plan. Plan assets are available to pay all benefits of all participants; however, for purposes of financial

reporting, assets are allocated to the Company as if the Company maintained a separate plan. An unfunded supplemental plan (the "Supplemental Plan") covers certain executives. 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.

Effective January 1, 2003, the lump sum option for benefits that accrue after December 31, 2002 under the Qualified Plan was eliminated. Also effective January 1, 2003, the Morgan Stanley Financial Advisor Pension Protection Program ("FAPPP") was established as a nonqualified plan to guarantee selected financial advisors that their lump sum benefit on pre-2003 qualified plan accruals will be calculated using the qualified plan's lump sum rate or 4.93%, whichever produces a higher benefit. It also guarantees a lump sum death benefit. Any difference between the benefits calculated under the FAPPP and the benefits calculated under the Qualified Plan rate will be paid under the FAPPP from Company assets. Effective January 1, 2004, pensionable earnings under the Qualified Plan will be limited to \$170 (unindexed for inflation).

For the Qualified Plan, the Company's policy is to contribute at least the amounts sufficient to meet minimum funding requirements under applicable employee benefit and tax regulations. Liabilities for benefits payable under the Supplemental Plan and FAPPP are accrued by the Company and are funded when paid to the beneficiaries.

The weighted-average discount rate, the rate of increase in future compensation levels and the expected long-term rate of return on plan assets used in determining the benefit obligation were 6.20%, 5.00% and 7.50%, respectively.

The following table provides a reconciliation of the changes in the benefit obligation and fair value of plan assets for fiscal 2003 as well as a summary of the funded status of the plans as of November 30, 2003:

	Qualified Plans	Supplemental Plan	FAPPP Plan
Reconciliation of benefit obligation:			
Benefit obligation at beginning of year	\$895,916	\$3,808	\$ —
Service cost	47,033		
Interest cost	56,644	241	325
Actuarial (gain) loss	101,555	253	(4,116)
Benefits paid	(99,964)	(451)	
Plan amendment	(44,435)		6,434
Benefit obligation at end of year	<u>956,749</u>	<u>3,851</u>	<u>2,643</u>

Reconciliation of the fair value of plan assets:

Fair value of plan assets at beginning of year	819,347	—	—
Actual return on plan assets	133,726		
Employer contributions	60,000	451	
Benefits paid	(99,964)	(451)	
Fair value of plan assets at end of year	<u>913,109</u>	<u>—</u>	<u>—</u>

Funded status:

Funded status	(43,640)	(3,851)	(2,643)
Unrecognized (gain) loss	436,680	632	(4,116)
Unrecognized prior service cost	(20,936)	394	5,594
Adjustment to recognize additional minimum liability		75	
Prepaid (accrued) benefit cost	<u>\$372,104</u>	<u>\$(2,750)</u>	<u>\$(1,165)</u>

Postretirement Benefits

The Company has unfunded postretirement benefit plans that provide medical and life insurance for eligible retirees, employees and dependents. At November 30, 2003, the Company's accrued postretirement benefit cost was \$3,992.

Compensation Plans

Effective December 1, 2002, the Parent adopted SFAS No. 123, "Accounting for Stock-Based Compensation," as amended, using the prospective adoption method. The Company now records compensation expense based upon the fair value of stock-based awards.

The Parent has recently completed an extensive analysis of its stock-based compensation program and revised elements of its program to encourage and incent long-term performance, enhance employee retention, and better align employee and shareholder interests. The revisions to fiscal 2003 awards included extending the time period over which vesting and non-compete provisions apply to generally to 3 to 4 years including the year of grant, and raising the eligibility requirements to participate in such awards.

Compensation costs are allocated to the Company by the Parent based upon the relative compensation of Company employees participating in the Parent's equity-based compensation programs.

Employees of the Company are eligible to participate in the Company's 401(k) plan upon meeting certain eligibility requirements. The Company matches a portion of each participant's contribution based upon the Company's performance.

Note 8—Income Taxes

The Company is included in the consolidated federal income tax return filed by the Parent. Federal income taxes have been provided on a separate entity basis. The Company is included in the combined state and local income tax returns with the Parent and certain other subsidiaries of the Parent. State and local income taxes have been provided on separate entity income at the effective tax rate of the Company's combined filing group.

In accordance with the terms of the Tax Allocation Agreement with the Parent, all current and deferred taxes are offset with all other intercompany balances with the Parent. The Company and its affiliates are considering a change to their tax allocation methodology which could impact the allocation of certain state and local income taxes associated with unitary and combined tax filings. The impact to the Company has not yet been determined.

Deferred income taxes reflect the net tax effects of temporary differences between the financial reporting and tax bases of assets and liabilities and are primarily attributable to various accruals, including deferred compensation and litigation reserves.

Note 9—Stockholder's Equity and Regulatory Requirements

At May 31, 2004, 11,000 shares of \$100 par value common stock were authorized and outstanding. The Company also had 1,000 shares of preferred stock authorized. No shares of preferred stock have been issued.

Morgan Stanley DW Inc. is a registered broker-dealer and futures commission merchant and, accordingly, is subject to the Net Capital rules of the SEC, the CFTC and the New York Stock Exchange, Inc. ("NYSE"). Under these rules, Morgan Stanley DW Inc. is required to maintain minimum Net Capital of not less than the greater of 2% of aggregate debit items arising from customer transactions, as defined, plus excess margin collateral on securities purchased under agreements to resell or 4% of funds required to be segregated for customers' regulated commodity accounts,

as defined. The NYSE may require a member firm to reduce its business if net capital is less than 4% of such aggregate debit items and may prohibit a firm from expanding its business if net capital is less than 5% of such aggregate debit items. At May 31, 2004, Morgan Stanley DW Inc.'s Net Capital was \$1,185,061, which exceeded the minimum requirement by \$1,056,911.

Advances to the Parent and its affiliates, repayment of subordinated liabilities, dividend payments and other equity withdrawals are subject to certain notification and other provisions of the Net Capital rules of the SEC.

Note 10—Financial Instruments Fair Value Information

The estimated fair value amounts of financial instruments are determined by the Company using available market information and appropriate valuation methodologies. Considerable judgment is required to develop estimates of fair value. Accordingly, the estimates are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different assumptions or estimation methodologies may have a material effect on the estimated fair value amounts.

Assets including cash and cash equivalents, cash and securities segregated under federal and other regulations and receivables are carried at cost which approximates fair value due to their short-term maturities.

Financial instruments owned and financial instruments sold, not yet purchased are carried at fair value using market quotes obtained from various sources, including the major securities exchanges and dealers, observable market parameters, or are derived directly from such prices or parameters.

Customer receivables, primarily consisting of floating rate loans collateralized by margin securities, are charged interest at rates similar to other such loans made throughout the industry.

Other liabilities and subordinated liabilities are carried at cost which, when estimated using current market rates, approximates the fair value.

Substantially all other financial instruments on the Company's consolidated statement of financial condition are carried at fair value or at amounts which approximate fair value.

Note 11—Restructuring and Other Charges

In fiscal 2002, the Company recorded liabilities of \$65,600. This reflected several actions that were intended to resize and refocus the Company in order to respond to decreased retail investor participation in the equity markets.

The fiscal 2002 liability consisted of space-related accruals of \$59,300 and severance-related accruals of \$6,300. The space-related accruals were attributable to the closure or subletting of office space, in an effort to consolidate the number of branch locations and support space. The space-related accruals consisted of the present value of future rental charges net of actual and estimated sublease income and asset write-offs related to furniture, fixtures and other fixed assets at the affected office locations. The severance-related accruals were attributable to workforce reductions and were comprised of severance payments and outplacement costs provided to the affected individuals.

At May 31, 2004, the remaining liability was approximately \$37,303, which was included in other liabilities and accrued expenses in the Company's consolidated statement of financial condition. The decrease from the original liability of \$65,600 was due to severance-related cash payments and net rental payments on the affected offices. In the year ending November 30, 2004, the liability is expected to decline by an additional \$10,363 due to the continuing payment of net rentals on these locations. The liability will continue to be reduced through November 30, 2012 as these leases expire.

Securities and cash held in Morgan Stanley accounts are protected up to their full net equity value by a combination of coverage provided by the Securities Investor Protection Corporation ("SIPC") a non-profit organization created by an Act of Congress and additional protection purchased from a private insurer by Morgan Stanley (the "Excess Coverage"). SIPC protects up to \$500,000 of each customer's securities of which up to \$100,000 may be uninvested cash. Excess Coverage provides additional protection up to the full net equity value of each account including unlimited coverage for uninvested cash. SIPC and Excess Coverage apply only to securities and cash in the exclusive possession and control of Morgan Stanley and do not protect against losses due to market fluctuations. If you would like more information, ask your Financial Advisor for a detailed brochure.

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