

# Consolidated Statement of Financial Condition

*(Unaudited)*

**MAY 31, 2001**

Morgan Stanley DW Inc.  
(formerly Dean Witter Reynolds Inc.)

**CONSOLIDATED STATEMENT OF FINANCIAL CONDITION**  
**May 31, 2001 (Unaudited)**  
(In thousands of dollars)

**ASSETS**

Cash and cash equivalents	\$ 236,497
Cash and securities deposited with clearing organizations or segregated under federal and other regulations (securities at fair value of \$1,135,776)	1,376,561
Financial instruments owned:	
U.S. government and federal agency obligations	486,070
Corporate and other debt	1,187,435
Equities	167,708
Securities purchased under agreements to resell	2,491,384
Securities borrowed	381,156
Receivables:	
Customers, net of allowances	6,885,711
Brokers, dealers and clearing organizations	58,936
Office facilities, at cost, net of accumulated depreciation and amortization of \$461,860	306,855
Other assets	984,848
<b>Total assets</b>	<b>\$ 14,563,161</b>

**LIABILITIES AND STOCKHOLDER'S EQUITY**

Short-term borrowings – Affiliates	\$ 1,378,524
Financial instruments sold, not yet purchased:	
U.S. government and federal agency obligations	551,438
Corporate and other debt	158,078
Equities	23,712
Securities sold under agreements to repurchase	2,459,819
Securities loaned	2,639,377
Payables:	
Customers	2,876,961
Brokers, dealers and clearing organizations	124,915
Other liabilities and accrued expenses	1,315,706
Accrued compensation and benefits	469,272
 Subordinated liabilities	 11,997,802
Stockholder's equity	775,233
 Total liabilities and stockholder's equity	 <b>\$ 14,563,161</b>

See Notes to Consolidated Statement of Financial Condition.

**NOTES TO CONSOLIDATED STATEMENT OF FINANCIAL CONDITION**  
**May 31, 2001 (Unaudited)**  
(In thousands of dollars)

**Note 1 – Introduction and Basis of Presentation**

The consolidated statement of financial condition includes the accounts of Morgan Stanley DW Inc. (formerly Dean Witter Reynolds 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 wholly-owned by Morgan Stanley Dean Witter & Co. ("MSDW"). Morgan Stanley DW Inc. is also registered as a futures commission merchant with the Commodities Futures Trading Commission ("CFTC").

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

The consolidated statement of financial condition is prepared in accordance with accounting principles generally accepted in the United States of America, which require management to make estimates and assumptions regarding inventory valuations, the potential outcome of litigation and other matters that affect the financial statement and related disclosures. Management believes that the estimates utilized in the preparation of the consolidated statement of financial condition are prudent and reasonable. Actual results could differ materially from these estimates.

**Note 2 – Summary of Significant Accounting Policies**

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

Financial instruments used in the Company's trading activities are recorded at fair value. The fair values of trading positions are generally 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. Purchases and sales of financial instruments are recorded on trade date.

Customers' securities transactions are recorded on a settlement date basis. 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 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 to 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 recorded at the amount of cash collateral advanced or received in connection with the transactions. Securities borrowed transac-

tions require the Company to deposit cash or other collateral with the lender. With respect to securities loaned, the Company receives collateral in the form of cash or other collateral in an amount generally in excess of the market value of securities loaned.

The collateral received in connection with reverse repurchase agreements, securities borrowed transactions and customer margin loans are, in many cases, permitted to be sold or repledged to secure repurchase agreements, to enter into securities lending transactions or for delivery to counterparties to cover short positions. At May 31, 2001, the fair value of securities received as collateral, where the Company is permitted to sell or repledge the securities was approximately \$12,590,000, and the fair value of the portion that has been sold or repledged was approximately \$5,916,000.

The Company pledges its financial instruments owned to collateralize repurchase agreements. At May 31, 2001, U.S. Government and agency securities of approximately \$367,000 and Corporate and other debt securities of approximately \$926,000 have been pledged for such purposes where the counterparties do not have the right to sell or repledge the collateral.

Office facilities consist of fixed assets and leasehold improvements. Fixed assets are generally depreciated utilizing accelerated methods over useful lives of five to twelve years. Leasehold improvements are amortized on a straight line basis over the lesser of the lease term or useful life.

Income taxes are 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.

**Accounting Pronouncements**

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. In June 1999, the FASB issued SFAS No. 137 "Accounting for Derivative Instruments and Hedging Activities – Deferral of the Effective Date of FASB Statement No. 133." SFAS No. 137 deferred the effective date of SFAS No. 133 for one year to fiscal years beginning after June 15, 2000. In June 2000, the FASB issued SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities - an amendment of FASB Statement No. 133." The Company adopted SFAS No. 133, as amended by SFAS No. 138, effective December 1, 2000. The adoption of SFAS No. 133 was not material to the Company's consolidated financial condition.

In September 2000, the FASB issued SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities – a replacement of FASB Statement No. 125." While SFAS No. 140 carries over most of the provisions of SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities", it provides new guidelines for reporting financial assets transferred as collateral and new guidelines for the derecognition of financial assets, in particular transactions involving the use of special purpose entities. SFAS No. 140 also prescribes additional disclosures for collateral transactions and for securitization transactions accounted for as sales. The new guidelines for collateral transactions are

effective for fiscal years ending December 15, 2000, while the new guidelines for the derecognition of financial assets are effective for transfers made after March 31, 2001. The additional disclosure requirements for collateral and securitization transactions were effective for the second quarter of fiscal 2001 and are reflected in the Notes to the consolidated statement of financial condition. The adoption of SFAS No. 140 for financial assets transferred after March 31, 2001 did not have a material impact on the Company's consolidated statement of financial condition. The Company is in the process of evaluating the impact of the collateral guidelines of SFAS No. 140 on its consolidated financial statements for the fiscal year ending November 30, 2001.

### Note 3 – Related Party Transactions

At May 31, 2001, balances with affiliates included securities borrowed of \$229,457 and securities loaned of \$4,507,962. In the normal course of its securities business, the Company enters into transactions with affiliates including securities underwriting, mutual fund distribution and research activities.

Short-term borrowings from affiliates are unsecured, bear interest at prevailing market rates and are payable on demand.

### Note 4 – Subordinated Liabilities

Morgan Stanley DW Inc. maintains a revolving note and cash subordination agreement with MSDW which entitles it to borrow up to \$1,000,000 on or before June 30, 2002. The amount outstanding at May 31, 2001 was \$600,000 bearing a variable interest rate of 5.19% and is due on June 30, 2003. At May 31, 2001, amounts subordinated under deferred compensation plans totaled \$175,233 and mature on various dates through 2005.

### Note 5 – Stockholder's Equity and Regulatory Requirements

At May 31, 2001, eleven thousand shares of one hundred dollar par value common stock were authorized and outstanding. One thousand shares of preferred stock were authorized. No shares of preferred stock have been issued.

The Company 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, the Company 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, 2001, the Company's Net Capital was \$1,330,304, which exceeded the minimum requirement by \$1,185,344.

Advances to MSDW 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.

During the year, the Company performed the computation for assets in the proprietary accounts of its introducing brokers (commonly referred to as "PAIB") in accordance with the customer reserve computation set forth under the SEC Rule 15c 3-3 (the Customer Reserve Formula).

### Note 6 – Income Taxes

The Company is included in the consolidated federal income tax return filed by MSDW. Federal, state and local income taxes have been provided on a separate entity basis. The Company is included in the combined state and local income tax returns with MSDW and certain other subsidiaries of MSDW.

In accordance with the terms of the Tax Allocation Agreement with MSDW, all current and deferred taxes are offset with all other intercompany balances with MSDW.

Deferred income taxes reflect the net 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.

### Note 7 – Employee Benefit Plans

#### Pension Plans

Substantially all of the employees of the Company are covered by non-contributory defined benefit pension plans. 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. The Company's policy is to contribute at least the amounts sufficient to meet minimum funding requirements under applicable employee benefit and tax regulations. At November 30, 2000, the projected benefit obligation and the pre-paid pension cost were \$699,374 and \$48,721, respectively.

#### Postretirement Benefits

The Company has unfunded postretirement benefit plans that provide medical and life insurance for eligible retirees, employees and dependents. At November 30, 2000, the Company's accrued postretirement benefit cost was \$40,171.

#### Other Plans

Certain employees of the Company participate in several MSDW equity-based stock compensation plans. MSDW applies the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations in accounting for stock options.

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 - Commitments and Contingencies

#### Leases

The Company has non-cancelable operating leases covering office space and equipment. At May 31, 2001, the future minimum rental commitments under such leases (net of subleases, principally on office rentals) were as follows:

May 2002	\$ 220,412
May 2003	203,453
May 2004	179,733
May 2005	159,199
May 2006	139,593
Thereafter	234,843
Total	<u>\$ 1,137,233</u>

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 \$86,704 of letters of credit outstanding at May 31, 2001 to satisfy various collateral requirements.

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 counsel, that the resolution of such matters will not have a material adverse effect on the consolidated financial condition of the Company.

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.

### Note 9 – 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 also takes positions in forward mortgage-backed security agreements ("TBAs") to facilitate customer trades. The gross notional amount of TBAs at May 31, 2001 totaled approximately \$52,000.

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.

The Company's customer financing and securities settlement activities may require the Company to pledge customer securities as collateral (1) in support of various secured financing sources such as bank loans, securities loaned and repurchase agreements and

(2) to satisfy margin requirements on various exchanges. In the event the counterparty is unable to meet its contractual obligation to return the customer securities pledged as collateral, the Company may be exposed to the risk of acquiring the securities at prevailing market prices in order to satisfy its customer obligations. The Company controls this risk by monitoring the market value of securities pledged on a daily basis and by requiring adjustments of collateral levels in the event of excess market exposure. Additionally, the Company establishes credit limits for such activities and monitors compliance on a daily basis.

### Note 10 – Financial Instruments Fair Value Information

The estimated fair value amounts of financial instruments have been 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.

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

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.

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.

Short-term borrowings, other liabilities and subordinated liabilities are carried at cost which, when estimated using current market rates, approximate the fair value.

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Securities and cash held in customer accounts at Morgan Stanley DW Inc. are protected up to the total net equity balance in the accounts. This coverage includes \$500,000 of protection (including up to \$100,000 for cash) provided by the Securities Investor Protection Corporation (SIPC), created by an Act of Congress to protect clients of SIPC member firms. The additional coverage is provided by Travelers Casualty and Surety Co. of America ("Travelers"). The Travelers coverage follows the conditions and limitations of SIPC. Neither the SIPC nor the Travelers coverage applies to shares in mutual funds or money market funds, which are custodied outside Morgan Stanley DW Inc. accounts.