



Morgan Stanley DW Inc.

# Consolidated Statement of Financial Condition

(Unaudited)  
May 31, 2003

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

## Morgan Stanley DW Inc. Consolidated Statement of Financial Condition

May 31, 2003 (Unaudited)  
(In thousands of dollars)

### Assets

Cash and cash equivalents	\$251,487
Cash and securities deposited with clearing organizations or segregated under federal and other regulations (including securities at fair value of \$2,129,090)	2,160,830
Financial instruments owned (\$49,771 was pledged to various parties):	
U.S. government and federal agency	860,858
Corporate and other debt	1,338,994
Equities	297,517
Securities purchased under agreements to resell	2,812,965
Securities borrowed	887,562
Receivables:	
Customers (net of allowances of \$20,469)	4,296,422
Brokers, dealers and clearing organizations	57,196
Office facilities, at cost (less accumulated depreciation and amortization of \$398,103)	196,204
Other assets	953,298
Total assets	<u>\$14,113,333</u>

### Liabilities and Stockholders' Equity

Short-term borrowings—Affiliates	\$842,343
Financial instruments sold, not yet purchased:	
U.S. government and federal agency	785,208
Corporate and other debt	254,953
Equities	12,323
Securities sold under agreements to repurchase	3,149,636
Securities loaned	1,053,990
Payables:	
Customers	3,608,289
Brokers, dealers and clearing organizations	279,917
Other liabilities and accrued expenses	1,843,504
	<u>11,830,163</u>
Subordinated liabilities	900,000
Stockholders' equity	1,383,170
Total liabilities and stockholders' equity	<u>\$14,113,333</u>

See Notes to Consolidated Statement of Financial Condition.

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

As of May 31, 2003 (Unaudited)  
(In thousands of dollars except share data)

### Note 1—Introduction and Basis of Presentation

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 wholly-owned by Morgan Stanley (the "Parent"), formerly named Morgan Stanley Dean Witter & Co. The Company is also registered as a futures commission merchant with the Commodity 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 certain trading inventory valuations, 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.

### 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, and unrealized 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 distressed sale. A substantial percentage of the fair value of the Company's financial instruments, owned and sold, 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 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 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.

Office facilities consist of fixed assets, leasehold improvements, and capitalized software. Capitalized software is amortized utilizing the straight-line method over the useful life of three years. Fixed assets placed into service prior to June 30, 2002 are depreciated utilizing accelerated methods. Leasehold improvements placed into service prior to June 30, 2002 are amortized utilizing either accelerated or straight-line methods. For all fixed assets and leasehold improvements placed in service after July 1, 2002, the Company prospectively changed its depreciation policy from an accelerated method to the straight-line method. The Company has assessed the manner in which the assets contribute to the Company's operations, and believe the straight-line method best represents the manner in which the assets are now being consumed over their useful lives. The effect of the change in depreciation method on the consolidated financial statement was immaterial for the quarter ended May 31, 2003. 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.

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.

Prior to the Company's adoption of Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets" on December 1, 2001, goodwill was amortized on a straight-line basis over periods from five to 40 years, generally not exceeding 25 years. The Company early adopted the provision of SFAS No. 142, discontinuing the amortization of goodwill effective December 1, 2001. During the first quarter of fiscal 2003,

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 statement of financial condition. At May 31, 2003, goodwill of approximately \$159,283 was included in the Company's consolidated statement of financial condition as a component of other assets.

### Accounting Pronouncements

In July 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 146, "Accounting for Costs Associated with Exits or Disposal Activities," which supercedes prior accounting guidance, Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit and Activity (including Certain Costs Incurred in a Restructuring)." SFAS No. 146 prescribes new guidelines for recognition of costs associated with exit or disposal activities. The provisions of SFAS No. 146 are effective for disposal activities initiated after December 31, 2002.

### 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 may pledge 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, 2003

Financial instruments owned by category:

U. S. government and agency securities	\$39,528
Corporate and other debt	1,947
Corporate equities	8,296
Total	<u>\$49,771</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, 2003, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$10,819,138, and the fair value of the portion that has been sold or repledged was \$7,168,317.

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—Related Party Transactions

At May 31, 2003, balances with affiliates included securities borrowed and reverse repurchase agreements of \$887,527 and \$15,608, respectively, and securities loaned of \$1,035,655.

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 5—Subordinated Liabilities

The Company maintains a revolving note and cash subordination agreement with the Parent which entitles it to borrow up to \$1,000,000 on or before June 30, 2007. The amount outstanding at May 31, 2003 was \$900,000 bearing a variable interest rate of 2.83%, based on the Fed fund rate, and is due on June 30, 2008.

## Note 6—Stockholders' Equity and Regulatory Requirements

At May 31, 2003, 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, 2003, Morgan Stanley DW Inc.'s Net Capital was \$1,095,756, which exceeded the minimum requirement by \$1,002,508.

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 7—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 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.

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 8—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 410(a) of the Internal Revenue Code (the "Qualified 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. 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 Supplementary Plan are accrued by the Company and are funded when paid to the beneficiaries. At November 30, 2002, the projected benefit obligation and the prepaid pension cost were \$899,724 and \$354,934 respectively.

During 2002, the qualified plan was amended to change the mortality table for lump sum distribution as mandated by IRS Revenue Ruling 2001-62. Effective September 1, 2002, the Qualified Plan of the Company was merged into the qualified pension plan of an affiliate. The merged plan is sponsored by an affiliate, however, the Company continues to maintain its own discrete benefit structure.

The weighted average discount rate and the rate of increase in future compensation levels used in determining the actuarial present value of the projected benefit obligation were 6.75% and 5%, respectively. The expected long-term rate of return on plan assets was 8.50%.

### Post Retirement Benefits

The Company has unfunded postretirement benefit plans that provide medical and life insurance for eligible

retirees, employees and dependents. At November 30, 2002, the Company's accrued post retirement benefit cost was \$42,228.

### Other Plans

Certain employees of the Company participate in several of the Parent's equity-based stock compensation plans. The Parent applies the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations in accounting for stock options. In August 2002, the Parent as a member of the Financial Services Forum, announced that beginning in fiscal 2003 it will expense employee stock options in accordance with SFAS No. 123, "Accounting for Stock Based Compensation." Under SFAS No. 123, compensation expense will be recognized based on the fair value of stock options on the date of grant. The Company is in process of evaluating the impact of adopting the fair value based method of accounting for stock-based employee compensation plan under SFAS No. 123.

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 9—Commitments and Contingencies

### Leases

The Company has non-cancelable operating leases covering office space and equipment. At May 31, 2003, future minimum rental commitments under such leases (net of subleases, principally on office rentals) were as follows:

May 2004	\$180,919
May 2005	157,268
May 2006	136,206
May 2007	113,867
May 2008	87,405
Thereafter	<u>197,306</u>
Total	<u>\$872,971</u>

Included in the table above are \$54,500 of future minimum rental commitments related to branch offices and support space, for which the present value was included in the restructuring charges taken during the fourth quarter of fiscal 2002. (see footnote 12).

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, 2003 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. Some 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. Some of these legal actions, investigations and proceedings may result in adverse judgments, penalties, or fines. 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, 2003, the Company had commitments to enter into reverse repurchase and repurchase agreements of approximately \$500,000 and \$150,000, respectively.

## Note 10—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, 2003 totaled approximately \$210,300.

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 11—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.

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.

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 12—Restructuring and Other Charges

In the fourth quarter of fiscal 2002, the Company initiated a restructuring and recorded liabilities of approximately \$59,300 and \$6,300 for space-related costs and severance, respectively, and disposed of assets with a net book value of approximately \$26,100. The restructuring reflects the decision to reduce excess capacity. The space-related accrual and dispositions were attributable to the closure or subletting of excess branch office and support space. The space-related costs consisted of the present value of future rental charges and the asset write-offs related to furniture, fixtures, and other fixed assets at the affected office locations. The severance-related costs were attributable to workforce reductions. The majority of the severance-related accruals consisted of severance payments and outplacement costs provided to the affected individuals. The consolidation of branch locations and other space actions are expected to be substantially completed by the third quarter of fiscal 2003. The Company expects that remaining payments related to space and severance will be funded by cash from operations.

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.