TRAVELCENTERS OF AMERICA LLC
Form 10-Q
May 10, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2010

OR

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

Commission File Number 001-33274

TRAVELCENTERS OF AMERICA LLC

(Exact name of registrant as specified in its charter)

Delaware	**20-5701514**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

24601 Center Ridge Road, Suite 200, Westlake, OH 44145-5639

(Address of Principal Executive Offices)

(440) 808-9100

(Registrant s Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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

Number of Common Shares outstanding at May 7, 2010: 17,269,316 common shares.

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TRAVELCENTERS OF AMERICA LLC

FORM 10-Q

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As used herein the terms we , us , our and TA include TravelCenters of America LLC and its consolidated subsidiaries unless otherwise expressly stated or the context otherwise requires.

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Part I. Financial Information

Item 1. Financial Statements

TravelCenters of America LLC

Condensed Consolidated Balance Sheets (Unaudited)

(in thousands, except share data)

	March 31, 2010	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	$ 155,278	$ 155,632
Accounts receivable (less allowance for doubtful accounts of $3,308 as of March 31, 2010 and $2,901 as of December 31, 2009)	84,464	71,870
Inventories	124,596	129,185
Leasehold improvements receivable	5,080	6,768
Other current assets	48,505	47,143
Total current assets	417,923	410,598
Property and equipment, net	413,884	417,458
Intangible assets, net	28,138	28,885
Other noncurrent assets	28,519	28,419
Total assets	$ 888,464	$ 885,360
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	$ 128,393	$ 97,701
Other current liabilities	121,258	121,984
Total current liabilities	249,651	219,685
Capital lease obligations	100,552	101,248
Deferred rental allowance	79,530	81,222
Deferred rent	105,000	90,000
Other noncurrent liabilities	79,698	78,452
Total liabilities	614,431	570,607
Commitments and contingencies		
Shareholders equity:		
Common shares, no par value, 18,683,666 shares authorized at March 31, 2010 and December 31, 2009, and 17,269,316 and 17,269,646 shares issued and outstanding at March 31, 2010 and December 31, 2009, respectively	545,593	545,321
Accumulated other comprehensive income	1,039	815
Accumulated deficit	(272,599)	(231,383)
Total shareholders equity	274,033	314,753

Total liabilities and shareholders equity	$	888,464	$	885,360

The accompanying notes are an integral part of these condensed consolidated financial statements.

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TravelCenters of America LLC

Condensed Consolidated Statements of Operations and Comprehensive Income (Loss) (Unaudited)

(in thousands, except per share data)

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Revenues:		
Fuel	$ 1,118,569	$ 703,908
Nonfuel	261,759	259,361
Rent and royalties	3,291	3,360
Total revenues	1,383,619	966,629
Cost of goods sold (excluding depreciation):		
Fuel	1,068,336	643,447
Nonfuel	110,304	106,630
Total cost of goods sold (excluding depreciation)	1,178,640	750,077
Operating expenses:		
Site level operating	152,544	144,856
Selling, general & administrative	19,328	19,001
Real estate rent	58,538	58,469
Depreciation and amortization	10,394	9,690
Total operating expenses	240,804	232,016
Loss from operations	(35,825)	(15,464)
Equity in income of equity investees	77	75
Interest income	231	844
Interest expense	(5,529)	(3,282)
Loss before income taxes	(41,046)	(17,827)
Provision for income taxes	170	212
Net loss	(41,216)	(18,039)
Other comprehensive loss, net of tax:		
Foreign currency translation adjustments, net of taxes of $81 and $(70), respectively	224	(200)
Comprehensive income (loss)	$ (40,992)	$ (18,239)
Net loss per share:		
Basic and diluted	$ (2.39)	$ (1.08)

The accompanying notes are an integral part of these condensed consolidated financial statements.

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TravelCenters of America LLC

Condensed Consolidated Statements of Cash Flows (Unaudited)

(in thousands)

	Three Months Ended March 31, 2010		Three Months Ended March 31, 2009	
Cash flows from operating activities:				
Net loss	$	(41,216)	$	(18,039)
Adjustments to reconcile net loss to net cash provided by operating activities:				
Noncash rent expense		15,134		16,174
Share based compensation expense		272		204
Depreciation and amortization		10,394		9,690
Equity in income of equity investees		(77)		(75)
Amortization of deferred financing costs		70		590
Provision for doubtful accounts		403		(155)
Changes in assets and liabilities:				
Accounts receivable		(12,964)		(7,630)
Inventories		4,608		7,565
Other current assets		(1,436)		4,403
Accounts payable and other current liabilities		30,166		11,807
Cash received for tenant improvements		1,796		2,838
Other, net		(1,401)		1,389
Net cash provided by operating activities		5,749		28,761
Cash flows from investing activities:				
Investment in equity investees		(20)		(25)
Proceeds from asset sales		2		20
Capital expenditures		(6,102)		(6,407)
Net cash used in investing activities		(6,120)		(6,412)
Effect of exchange rate changes on cash		17		(9)
Net increase (decrease) in cash		(354)		22,340
Cash and cash equivalents at the beginning of the period		155,632		145,516
Cash and cash equivalents at the end of the period	$	155,278	$	167,856

The accompanying notes are an integral part of these condensed consolidated financial statements.

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TravelCenters of America LLC

Notes to Condensed Consolidated Financial Statements (Unaudited)

(in thousands, except share and per share amounts)

1. Basis of Presentation, Business Description and Organization

TravelCenters of America LLC, together with its subsidiaries, which we refer to as the Company, we, us and our, operates and franchises travel centers under the TravelCenters of America, TA and Petro brands primarily along the U.S. interstate highway system. Our customers include trucking fleets and their drivers, independent truck drivers and motorists. Our travel centers are typically 20 to 25 acre sites and provide our customers with diesel fuel and gasoline, as well as nonfuel products and services such as truck repair and maintenance services, full service restaurants, quick service restaurants, travel and convenience stores and various other driver services. We also collect rents and franchise royalties from our franchisees.

At March 31, 2010, our business included 229 travel centers in 41 states and in Canada, 166 of which were operated under the Travel Centers of America or TA brand names and 63 of which were operated under the Petro brand name. We operated 188 of these travel centers, which we refer to as Company operated sites, and our franchisees operated 41 of these travel centers, including 10 travel centers which our franchisees sublease from us and 31 travel centers which our franchisees own or lease from other lessors. We lease 145 of our TA branded sites and 40 of our Petro branded sites under leases with subsidiaries of Hospitality Properties Trust, which we refer to as the TA Lease and Petro Lease, respectively. See Note 5. We refer to Hospitality Properties Trust and its subsidiaries as HPT.

The accompanying condensed consolidated financial statements are unaudited. These unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles, or GAAP, applicable for interim financial statements. Therefore, the disclosures do not include all the information necessary for complete financial statements in accordance with GAAP. These unaudited interim financial statements should be read in conjunction with the consolidated financial statements and notes contained in our Annual Report on Form 10-K for the year ended December 31, 2009. In the opinion of our management, all adjustments, which include only normal recurring adjustments, considered necessary for a fair presentation have been included. While our revenues are modestly seasonal, the quarterly variations in our operating results may reflect greater seasonal differences because our rent and certain other costs do not vary seasonally. For this and other reasons, our operating results for interim periods are not necessarily indicative of the results that may be expected for the full year.

2. Recent Accounting Pronouncements

In June 2009 the Financial Accounting Standards Board, or FASB, issued new accounting guidance that eliminates some exceptions that were previously included in GAAP related to consolidating qualifying special purpose entities, contains new criteria for determining the primary beneficiary of a variable interest entity, and increases the frequency of required reassessments to determine whether a company is the primary beneficiary of a variable interest entity. The new guidance also contains a new requirement that any term, transaction, or arrangement that does not have a substantive effect on an entity s status as a variable interest entity, a company s power over a variable interest entity, or a company s obligation to absorb losses or its right to receive benefits of an entity must be disregarded in applying previously issued rules related to variable interest entities. The elimination of the qualifying special purpose entity concept and its consolidation exceptions means more entities will be subject to consolidation assessments and reassessments. These new requirements were effective for us as of January 1, 2010. The adoption of

this guidance did not have a material effect on our consolidated financial statements.

In February 2010, the FASB modified the disclosure requirement related to subsequent events to exclude the requirement to disclose the date through which an entity has evaluated subsequent events and whether that date represents the date the financial statements were issued or were available to be issued.

3. Earnings Per Share

We computed basic earnings per share for the three month periods ended March 31, 2010 and 2009, using the weighted average number of shares outstanding during those periods. We included the unvested shares granted under our equity incentive plan in the calculation of basic and diluted earnings per share as participating securities under the two class method. The total combined number of weighted average common shares and participating securities outstanding for the three month periods ended March 31, 2010 and 2009, were 17,269,426 and 16,631,545, respectively. The number of unvested shares included in the earnings per share calculations as participating securities for the three month periods ended March 31, 2010 and 2009, were 1,050,583 and 715,754, respectively.

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TravelCenters of America LLC

Notes to Condensed Consolidated Financial Statements (Unaudited)

(in thousands, except share and per share amounts)

4. Inventories

Inventories consisted of the following:

	March 31, 2010	December 31, 2009
Nonfuel merchandise	$ 97,254	$ 97,201
Petroleum products	27,342	31,984
Total inventories	$ 124,596	$ 129,185

5. Related Party Transactions

The following table summarizes the various amounts related to our leases with HPT that are reflected in our operating results and a reconciliation of those amounts to our consolidated financial statements

	Three Months Ended March 31, 2010	2009
Minimum base rent cash payments for TA Lease and Petro Lease	$ 42,127	$ 41,123
Rent for improvements sold to HPT	31	31
Rent for ground leases acquired by HPT	1,209	1,184
Total rent payments to HPT	43,367	42,338
Straight line rent adjustments	1,757	2,757
Difference between rent accrued and rent paid	429	476
Rent deferred under rent deferral agreement	15,000	15,000
Less capital lease obligation amortization	(696)	(613)
Less amounts of rent payments recognized as interest	(2,186)	(2,269)
Less deferred leasehold improvements allowance amortization	(1,692)	(1,692)
Rent to HPT recognized as rent expense	55,979	55,997
Expense related to rents paid to others	2,559	2,472
Total real estate rent expense	$ 58,538	$ 58,469

Other current liabilities in our consolidated balance sheets at March 31, 2010 and December 31, 2009, included $14,279 and $13,946, respectively, for rent due to HPT, excluding deferred rent.

During the three months ended March 31, 2010 and 2009, we received funding of $1,796 and $2,838, respectively, from HPT for qualifying tenant improvements we made. At March 31, 2010, $5,370 of the $125,000 total amount of the tenant improvements allowance remained available from HPT, which amount would be discounted in accordance with our amended lease with HPT to the extent that those funds are received on an accelerated basis.

Under the terms of our rent deferral agreement with HPT we have the option to defer our monthly rent payments to HPT by up to $5,000 per month until December 31, 2010. Beginning January 1, 2010, any deferred rent which remains unpaid accrues interest payable in cash to HPT monthly at the rate of 1% per month. During the first quarter of 2010, we recognized interest expense of $2,850 related to the deferred rent balance. No additional rent deferrals are permitted for rent periods after December 31, 2010. All deferred rent (and interest thereon) not previously paid is due to HPT on July 1, 2011. This rent deferral agreement has change of control covenants so that amounts deferred will be immediately payable to HPT in the event we experience a change of control, as defined in the agreement, while deferred rent is unpaid. As of March 31, 2010 and December 31, 2009, we had deferred an aggregate of $105,000 and $90,000, respectively, of rent payable to HPT.

In connection with our management and shared services agreement with Reit Management & Research LLC, or RMR, for the three months ended March 31, 2010 and 2009, we recognized expense of $1,925 and $1,983, respectively. These amounts are included in selling, general and administrative expenses in our consolidated financial statements.

TravelCenters of America LLC

Notes to Condensed Consolidated Financial Statements (Unaudited)

(in thousands, except share and per share amounts)

As of March 31, 2010, we have invested $5,174 in Affiliates Insurance Company, or Affiliates Insurance, concurrently with RMR and other companies to which RMR provides management services. All of our Directors are currently serving on the board of directors of Affiliates Insurance. At March 31, 2010, we owned approximately 14.29% of Affiliates Insurance. Although we own less than 20% of Affiliates Insurance, we use the equity method to account for this investment because we believe that we have significant influence over Affiliates Insurance because each of our Directors is a director of Affiliates Insurance. This investment is carried on our balance sheet in other noncurrent assets and had a carrying value of $4,992 and $5,000 as of March 31, 2010 and December 31, 2009, respectively. During the three months ended March 31, 2010, we recognized a loss of $28 as our share of Affiliates Insurance s net loss.

We own a 40% minority joint venture interest in Petro Travel Plaza Holdings LLC, or PTP, which owns two travel centers that we operate. This investment is accounted for under the equity method and is carried on our balance sheet in other noncurrent assets. The carrying value of this investment as of March 31, 2010 and December 31, 2009, was $17,849 and $17,744, respectively. During the three months ended March 31, 2010 and 2009, we recognized management and accounting fee income from PTP of $163 and $104, respectively. At March 31, 2010 and December 31, 2009, we had a receivable from PTP of $949 and $1,809, respectively. During the three months ended March 31, 2010 and 2009, we recognized income of $105 and $75, respectively, as our share of PTP s net income.

6. Commitments and Contingencies

Guarantees

In the normal course of our business we periodically enter into agreements that contain guarantees or indemnification provisions. While the maximum amount to which we may be exposed under such agreements cannot be estimated, we do not believe that any potential guaranty or indemnification will have a material adverse effect on our consolidated financial position or results of operations.

We offer a warranty of our workmanship in our truck repair shops, but we believe the annual warranty expense and corresponding liability are not material to us.

Environmental Matters

Our operations and properties are extensively regulated by environmental laws that (i) regulate our operations that may have adverse environmental effects, such as potentially hazardous discharges to air, soil and water, (ii) regulate our management of petroleum products and

other potentially hazardous substances, and (iii) impose liability for the costs of cleaning up sites affected by, and for damages resulting from, disposal or other releases of hazardous substances. We use underground and above ground storage tanks to store petroleum products and waste at our travel centers and we must comply with requirements of environmental laws regarding tank construction, integrity testing, leak detection and monitoring, overfill and spill control, contaminant release reporting, financial assurance and corrective action in the event of a release from a storage tank into the environment. We regularly conduct investigatory and/or remedial actions with respect to releases of hazardous substances at a number of our sites. We regularly receive notices of alleged violations of environmental laws at travel centers.

Under certain environmental agreements entered into as part of our predecessor s acquisitions of travel centers, prior owners of certain of our sites are required to indemnify us for certain environmental conditions. Certain of our remediation expenditures may be recovered from state government administered tank funds. In addition, we have insurance of up to $35,000 for environmental liabilities at certain of our travel centers that were known at the time the policies were issued, and up to $60,000 for unknown environmental liabilities, subject, in each case, to certain limitations and deductibles.

At March 31, 2010 and December 31, 2009, we had an accrued liability for environmental matters of $9,544 and $9,505, respectively, as well as a receivable for expected recoveries of certain of these estimated future expenditures and cash in an escrow account to fund certain of these estimated future expenditures, resulting in an estimated net amount of $3,350 and $3,916, respectively, to be funded by us in the future. Accrued liabilities related to environmental matters are recorded on an undiscounted basis. While it is not possible to quantify with certainty our environmental exposure, in our opinion, based upon the information now known to us, our potential liability for clean up and remediation in excess of the accrual we have recorded will not have a material adverse effect on our financial condition, results of operations or cash flows.

While the costs of our environmental compliance in the past have not had a material adverse impact on us, it is impossible to predict the ultimate effect changing circumstances and changing environmental laws may have on us in the future. We cannot be certain that additional contamination presently unknown to us does not exist at our sites, or that material liability will not be imposed on us in the future. If additional environmental matters arise or are discovered, or if additional environmental requirements are

TravelCenters of America LLC

Notes to Condensed Consolidated Financial Statements (Unaudited)

(in thousands, except share and per share amounts)

imposed by government agencies, increased environmental compliance or remediation expenditures may be required, and such costs could have a material adverse effect on us.

Pending Litigation

On February 1, 2008, a purported holder of our shares, Alan R. Kahn filed a purported derivative action in the Delaware Court of Chancery on behalf of us against members of our Board of Directors, HPT and RMR. This action alleges that our Directors breached their fiduciary duties in connection with our acquisition in 2007 of Petro Stopping Centers, LP., or the Petro Acquisition, and seeks an award of unspecified damages and reformation of the Petro Lease, which we entered with HPT in connection with the Petro Acquisition. This action also appears to allege that RMR and HPT aided and abetted our Directors. Under our limited liability company agreement and agreements with RMR and HPT, we are liable to indemnify our Directors, HPT and RMR for liabilities, costs and expenses incurred by them in connection with this litigation. On May 6, 2008, we moved to dismiss this complaint. On June 20, 2008 the plaintiff filed an amended complaint making additional allegations regarding the members of our Board of Directors and withdrawing his request for reformation of the Petro Lease. On July 2, 2008, we moved to dismiss the amended complaint. On October 30, 2008, Mr. Kahn s claims against RMR were voluntarily dismissed. On December 11, 2008, our motion to dismiss the amended complaint was denied and a previously imposed stay of discovery was lifted. On January 21, 2009, HPT sent a letter to the plaintiff demanding arbitration of his claims pursuant to the terms of the Petro Lease. We believe that the plaintiff and HPT have agreed to defer the arbitration demand. This case is now in the early stages of discovery. We continue to believe that the plaintiff s allegations are without merit.

In July 2008, Riverside and San Bernardino counties in the State of California each filed litigation against us in the Superior Court of California for Riverside and San Bernardino counties, respectively, seeking civil penalties and injunctive relief for alleged past violations of various state laws and regulations relating to our predecessor s management of underground storage tanks. In December 2009, we settled with San Bernardino County and agreed to a form of Stipulated Judgment. The Stipulated Judgment provides that TA is liable in the amount of $980 but credits TA $430 for certain improvements made by TA at its facilities located in San Bernardino County, such that the cash amount we paid was $550. The Stipulated Judgment also includes injunctive relief provisions requiring that TA comply with certain California environmental laws applicable to underground storage tank systems. The agreement also provides for the Superior Court to retain jurisdiction to enforce the injunctive relief provisions of the Stipulated Judgment for a period of five years from the date that the settlement is approved by the Court. In April 2009, the California Attorney General intervened in the action in Riverside County. The California Attorney General s complaint repeats many of the allegations made by Riverside County and adds allegations of past violations of state laws and regulations governing the management of hazardous wastes. The complaints by the Attorney General and the Riverside County District Attorney do not identify the amount of civil penalties sought. We disagree with these allegations and intend to defend this lawsuit.

Beginning in mid December 2006, a series of class action lawsuits was filed against numerous companies in the petroleum industry, including our predecessor and our subsidiaries, in United States district courts in over 20 states. Major petroleum refineries and retailers have been named as defendants in one or more of these lawsuits. The plaintiffs in the lawsuits generally allege that they are retail purchasers who purchased motor fuel at temperature greater than 60 degrees Fahrenheit at the time of sale. One theory alleges that the plaintiffs purchased smaller quantities of motor fuel than the amount for which defendants charged them because the defendants measured the amount of motor fuel they delivered by volumes which, at higher temperatures, contain less energy. A second theory alleges that fuel taxes are calculated in temperature

adjusted 60 degree gallons and are collected by governmental agencies from suppliers and wholesalers, who are reimbursed in the amount of the tax by the defendant retailers before the fuel is sold to consumers. These tax cases allege that, when the fuel is subsequently sold to consumers at temperatures above 60 degrees, the retailers sell a greater volume of fuel than the amount on which they paid tax, and therefore reap unjust benefit because the customers pay more tax than the retailer pays. We believe that there are substantial factual and legal defenses to the theories alleged in these so called hot fuel lawsuits. The temperature cases seek nonmonetary relief in the form of an order requiring the defendants to install temperature correcting equipment on their retail fuel pumps. They also seek monetary relief in the form of damages. The plaintiffs have not quantified the damages they seek. The tax cases also seek monetary relief. Plaintiffs have proposed a formula (which we dispute) to measure these damages as the difference between the amount of fuel excise taxes paid by defendants and the amount collected by defendants on motor fuel sales. Plaintiffs have taken the position in filings with the Court that under this approach, our damages for an eight-year period for one state would be approximately $10.7 million. We deny liability and disagree with this methodology, including the period over which these damages were calculated. The cases have been consolidated in the United States District Court for the District of Kansas pursuant to multi-district litigation procedures. Plaintiffs have moved for certification of their respective classes, which motions are currently pending. Because these motions are pending and discovery is not yet completed, we cannot estimate our ultimate exposure to loss or liability, if any, related to these lawsuits. However, the continued cost of litigating these cases could be expensive.

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TravelCenters of America LLC

Notes to Condensed Consolidated Financial Statements (Unaudited)

(in thousands, except share and per share amounts)

On April 6, 2009, five independent truck stop owners, who are plaintiffs in a purported class action suit against Comdata Network, Inc., or Comdata, in the United States District Court for the Eastern District of Pennsylvania, filed a motion to amend their complaint to add us as a defendant, which was allowed on March 25, 2010. The amended complaint also adds as defendants Ceridian Corporation, Pilot Travel Centers LLC, and Love s Travel Stops & Country Stores, Inc. Comdata markets fuel cards which are used for payments by trucking companies to truck stops. The amended complaint alleges antitrust violations arising out of Comdata s contractual relationships with truck stops in connection with its fuel cards. The plaintiffs are seeking unspecified damages and injunctive relief. This case is in the discovery stage. We believe that there are substantial factual and legal defenses to the plaintiffs claims against us, but that the costs to defend this case could be expensive.

In addition to the legal proceedings referenced above, we are involved from time to time in various other legal and administrative proceedings and threatened legal and administrative proceedings incidental to the ordinary course of our business, none of which we expect, individually or in the aggregate, to have a material adverse effect on our business, financial condition, results of operations or cash flows.

7. Income Taxes

The provisions (benefits) for income taxes included in our financial statements were as follows:

	Three Months Ended March 31,			
	2010		2009	
Current tax provision (benefit):				
Federal	$		$	
State		170		212
Foreign				
		170		212
Deferred tax provision (benefit):				
Federal		(15,254)		(6,225)
State		(1,814)		(728)
Foreign		(38)		(33)
		(17,106)		(6,986)
Total tax provision (benefit)		(16,936)		(6,774)
Change in valuation allowance		17,106		6,986
Net tax provision	$	170	$	212

Because of our short history and our operating losses, we do not currently recognize the benefit of all of our deferred tax assets, including tax loss carry forwards that may be used to offset future taxable income. We will, however, continue to assess our ability to generate sufficient taxable income during future periods in which our deferred tax assets may be realized. If and when we believe it is more likely than not that we will recover our deferred tax assets, we will record those assets as an income tax benefit in the consolidated statement of operations, which will affect our results of operations. As a result of the large volume of public trading in our shares during 2007, our use of our 2007 federal net operating loss of $50,470 and other tax credit carry forwards are generally not available to us for the purpose of offsetting future taxable income because of certain Internal Revenue Code, or IRC, provisions regarding changes in ownership of our common shares. As of December 31, 2009, our federal net operating loss carry forward that was not restricted by the IRC provisions was approximately $108,212. Our ability to utilize the federal net operating loss and other tax credit carry forwards generated after 2007 is currently not restricted by application of these IRC provisions, but could be subject to limitation based on changes in ownership of our common shares. Our net operating loss carry forwards will begin to expire in 2027.

Our effective tax rates for the three month periods ended March 31, 2010 and 2009, were provisions of 0.4% and 1.2%, respectively, which differed from the amount calculated at the statutory rate primarily due to recognition of a valuation allowance against our net deferred tax assets and to certain state income taxes that are due without regard to our net operating losses.

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TravelCenters of America LLC

Notes to Condensed Consolidated Financial Statements (Unaudited)

(in thousands, except share and per share amounts)

8. Supplemental Cash Flow Information.

	Three Months Ended March 31,	
	2010	2009
Supplemental disclosure of cash flow information:		
Interest paid (including rent classified as interest)	$ 4,597	$ 2,652
Income taxes paid (net of refunds)	101	(165)
Noncash investing and financing activities:		
Issuance of common shares under equity incentive plan	$ 272	$ 204

9. Other Information

Interest expense consisted of the following:

	Three Months Ended March 31,	
	2010	2009
HPT rent classified as interest	$ 2,186	$ 2,269
Interest on deferred rent payable to HPT	2,850	
Amortization of deferred financing costs	70	590
Other	423	423
Interest expense	$ 5,529	$ 3,282

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Overview (dollars in thousands)

The following discussion should be read in conjunction with the financial statements included elsewhere in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2009.

Our revenues and income are subject to potentially material changes as a result of the market prices of diesel fuel and gasoline, as well as the availability of these products. These factors are subject to the worldwide petroleum products supply chain, which historically has incurred price and supply shocks as a result of, among other things, severe weather, terrorism, political crises, wars and other military actions and variations in demand, which are often the result of changes in the macroeconomic environment. Over the past few years there has been significant volatility in the cost of fuel: first, as the world value of the U.S. dollar declined and as speculation in the price of petroleum commodities increased during 2007 and into 2008; then in the last half of 2008, as the price of fuel declined dramatically as the worldwide recession reduced demand for petroleum products. During 2009, fuel prices again rose and those increases continued throughout the first quarter of 2010. We expect that these significant changes in our costs for these products can largely be passed on to our customers, but often there are delays in passing on price increases that can affect our fuel gross margins. Also, increased volatility in the crude oil and refined products markets can result in negative effects on our sales and profitability and increases in our working capital requirements. We expect that the crude oil and refined product markets will continue to be volatile for the foreseeable future.

The trucking industry is the primary customer for our goods and services. Freight and trucking demand in the U.S. generally reflects the level of commercial activity in the U.S. economy. Accordingly, our financial results during the first quarter of 2010 were, and we expect that our financial results in future periods will be, affected by the condition of the U.S. economy generally, and the financial condition and activity of the trucking industry in the U.S. specifically. During the first quarter of 2010, although the U.S. economy showed increased activity, the generally difficult economic conditions in the U.S. continued to present TA with significant operating challenges. While our fuel sales volumes and nonfuel revenues in the first quarter of 2010 both increased on a same site basis over the prior year first quarter, we experienced increased losses. These increased losses were primarily a result of a decline in our fuel gross margin that we experienced because of increasing fuel costs. Further, while the level of economic activity may be improving, it is still well below pre-recession levels; and, despite our various cost cutting initiatives over the past few years, this lower level of sales activity has been insufficient to cover our fixed costs and certain cost increases we experienced.

While recently the U.S. economy has shown signs of stabilizing and growing, it is unclear whether these trends will continue. If the U.S. economy continues to operate as it has over the past few years or if it worsens, our financial results may not improve and may decline, resulting in our experiencing increased losses from our operations.

Flying J Inc., or Flying J, a competitor of ours, is currently pursuing a reorganization under Chapter 11 of the United States Bankruptcy Code. In connection with that reorganization, Flying J has announced an agreement to sell its interests in its travel centers to Pilot Travel Centers LLC, or Pilot, another one of our competitors. If the Flying J and Pilot combination is completed, we may see increased competitive pressure that could negatively impact our sales volumes and profitability. We are unable to determine the extent of the effect a combined Pilot-Flying J may have on our financial position, results of operations, or competitive position, although we would expect such a combination would significantly alter the competitive circumstances in the travel center industry.

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Summary of Travel Center Site Counts

The following table summarizes the changes in the composition of our business (company operated, franchisee leased and operated or franchisee owned and operated) from December 31, 2008 through March 31, 2010:

	Company Operated	Franchisee Operated	Franchisee Owned and Operated	Total
Number of travel centers at December 31, 2008	188	10	35	233
January - March 2009 Activity:				
No activity				
Number of travel centers at March 31, 2009	188	10	35	233
April - December 2009 Activity:				
New travel centers	1			1
Closed travel centers	(1)			(1)
Number of travel centers at December 31, 2009	188	10	35	233
January March 2010 Activity:				
Terminated franchised travel centers			(4)	(4)
Number of travel centers at March 31, 2010	188	10	31	229

Relevance of Fuel Revenues

Due to volatile pricing of fuel products and our pricing to fuel customers, we believe that fuel revenue is not a reliable metric for analyzing our results of operations from period to period. As a result solely of changes in fuel prices, our fuel revenue may increase or decrease, in both absolute amounts and on a percentage basis, without a comparable change in fuel sales volumes or in fuel gross margin per gallon. We consider fuel volumes and fuel gross margin to be better measures of comparative performance than fuel revenues.

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Results of Operations (dollars in thousands)

Three months ended March 31, 2010 compared to March 31, 2009

The following table summarizes our results for the three month periods ended March 31, 2010 and 2009.

(dollars in thousands)	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009	$ Change	% Change
Revenues:				
Fuel	$ 1,118,569	$ 703,908	$ 414,661	58.9%
Nonfuel	261,759	259,361	2,398	0.9%
Rent and royalties	3,291	3,360	(69)	-2.1%
Total revenues	1,383,619	966,629	416,990	43.1%
Cost of goods sold (excluding depreciation):				
Fuel	1,068,336	643,447	424,889	66.0%
Nonfuel	110,304	106,630	3,674	3.4%
Total cost of goods sold (excluding depreciation)	1,178,640	750,077	428,563	57.1%
Operating expenses:				
Site level operating expenses	152,544	144,856	7,688	5.3%
Selling, general & administrative expense	19,328	19,001	327	1.7%
Real estate rent	58,538	58,469	69	0.1%
Depreciation and amortization expense	10,394	9,690	704	7.3%
Total operating expenses	240,804	232,016	8,788	3.8%
Loss from operations	(35,825)	(15,464)	(20,361)	131.7%
Equity in income of equity investees	77	75	2	2.7%
Interest income	231	844	(613)	-72.6%
Interest expense	(5,529)	(3,282)	(2,247)	68.5%
Loss before income taxes	(41,046)	(17,827)	(23,219)	130.2%
Provision for income taxes	170	212	(42)	-19.8%
Net loss	$ (41,216)	$ (18,039)	$ (23,177)	128.5%

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Same Site Comparisons. As part of the discussion and analysis of our operating results we refer to increases and decreases in results on a same site basis. For purposes of these comparisons, a travel center is included in the following same site comparisons only if it was continuously operated by us or a franchisee from January 1, 2009, through March 31, 2010. Travel centers are not excluded from the same site comparisons as a result of expansions in their size or changes in the services offered.

(gallons and dollars in thousands)	**Three Months Ended March 31, 2010**	**2009**	**$ Change**	**% Change**
Number of company operated travel centers	186	186		
Fuel sales volume (gallons) (1)	483,432	443,136	40,297	9.1%
Fuel gross margin(1)	$ 50,068	$ 59,769	$ (9,701)	-16.2%
Total nonfuel revenues (1)	$ 261,715	$ 258,816	$ 2,899	1.1%
Operating expenses (1) (2)	$ 152,396	$ 144,099	$ 8,298	5.8%
Number of franchisee operated travel centers	41	41		
Rent and royalty revenues	$ 3,130	$ 3,116	$ 15	0.5%

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(1) *Includes fuel volume, fuel gross margin, revenues and expenses of company operated travel centers only.*

(2) *Excludes real estate rent expense.*

Revenues. Revenues for the three month period ended March 31, 2010, were $1,383,619, which represented an increase from the quarter ended March 31, 2009, of $416,990, or 43.1%, primarily related to an increase in fuel revenue.

Fuel revenues were 80.8% of total revenues for the quarter ended March 31, 2010, compared to 72.8% for the same period in 2009. Fuel revenues for the quarter ended March 31, 2010, were $1,118,569, an increase of $414,661, or 58.9%, compared to the same period in 2009. This increase was principally the result of increases in fuel prices and also resulted from increased fuel sales volume. The table below shows the changes in fuel revenues between periods that resulted from price and volume changes:

(gallons and dollars in thousands)	**Gallons Sold**	**Fuel Revenues**
Results for three months ended March 31, 2009	462,073	$ 703,908
Increase due to petroleum products price changes		323,290
Increase due to same site volume changes	40,297	89,532
Other changes, net	829	1,839
Net increase from prior year period	41,126	414,661
Results for three months ended March 31, 2010	503,199	$ 1,118,569

On a same site basis for our company operated sites, fuel sales volume increased by 40,297 gallons, or 9.1%, during the three months ended March 31, 2010, compared to the same period in 2009. We believe the same site fuel sales volume increase resulted primarily from a modest increase in trucking activity attributable to increasing economic activity in the U.S. during the first quarter of 2010, particularly the increase in the shipments of durable goods, including new home building supplies, as well as an increase in imports into the U.S. that are transported by truck. In addition, we believe that we have increased our market share of fuel sales as a result of our retail pricing strategies and marketing initiatives.

Nonfuel revenues were 18.9% of total revenues for the quarter ended March 31, 2010, compared to 26.8% for the same period in 2009. Nonfuel revenues for the three months ended March 31, 2010, were $261,759, an increase of $2,398, or 0.9%, compared to the same period in 2009. The change between years is primarily related to an increase in unit sales at those sites we operated continuously during both periods combined with price increases. On a same site basis for our company operated sites,

nonfuel revenues increased by $2,899, or 1.1% during the three months ended March 31, 2010, compared to the same period in 2009. We believe the same site nonfuel revenue increase reflects increased customer traffic in our travel centers as a result of many of the factors affecting our fuel sales volumes. We believe the increase in nonfuel revenues was lower than the increase in fuel volumes due to our customers continued conservative discretionary spending which began during the recent U.S. economic recession.

Rent and royalty revenues for the three months ended March 31, 2010, were $3,291, a decrease of $69, or 2.1%, compared to the same period in 2009. Lower royalties resulting from reduced nonfuel revenues at our franchisee locations and the termination of four franchise sites in the first quarter of 2010 were largely offset by scheduled increases in rent revenues at the ten franchisee operated locations we sublease to our franchisees.

Cost of goods sold (excluding depreciation). Cost of goods sold for the three months ended March 31, 2010, was $1,178,640, an increase of $428,563, or 57.1%, compared to the same period in 2009, which was primarily attributable to increased fuel costs and increased fuel sales volume. Fuel cost of goods sold for the quarter ended March 31, 2010, of $1,068,336 increased by $424,889, or 66.0% compared to the same period in 2009. This increase in fuel cost of goods sold primarily resulted from the increase in petroleum commodity prices and also resulted from the fuel sales volumes increase described above. Rising fuel prices during the first quarter had negative effects on our fuel gross margin, which was $9,701 lower in the first quarter of 2010 than the same period of 2009 on a same site basis.

Nonfuel cost of goods sold for the three months ended March 31, 2010, was $110,304, an increase of $3,674, or 3.4%, compared to the same period in 2009. Nonfuel cost of goods sold increased due to the nonfuel sales increases noted above, combined with increases in product unit costs. Nonfuel cost of goods sold as a percentage of nonfuel revenue was 42.1% for the quarter ended March 31, 2010, compared to 41.1% for the same period in 2009.

Site level operating expenses. Site level operating expenses for the three months ended March 31, 2010, were $152,544, an increase of $7,688, or 5.3%, compared to the same period in 2009. When compared to the prior year period, site level operating expenses increased due to higher employee healthcare insurance claims costs, workers compensation insurance claims costs and general liability insurance claims costs. While we have experienced approximately a $4,560 increase in these insurance claims costs when comparing the first quarter of 2010 to the first quarter of 2009, the claims levels seen in the first quarter of 2010 were in line with our experience in the second through fourth quarters of 2009. We also experienced increases in credit card transaction fees as a result of increased sales levels and rising fuel sales prices. Additionally, we incurred increased costs over the prior year period to maintain our operating locations. These increases were partially offset by decreases related to the closure of a company operated site in December 2009.

On a same site basis for our company operated sites, site level operating expenses increased by $8,298, or 5.8%, for the three months ended March 31, 2010, compared to the same period in 2009 and site level operating expenses as a percentage of nonfuel revenues for the quarter ended March 31, 2010, were 58.2%, compared to 55.7% for the same period in 2009. The increase in operating expenses as a percentage of nonfuel revenues resulted primarily from the changes in our insurance claims experience and site maintenance costs discussed above.

Selling, general and administrative expenses. Selling, general and administrative expenses for the three months ended March 31, 2010, were $19,328, an increase of $327, or 1.7%, compared to the same period in 2009. This increase primarily resulted from increased personnel costs.

Real estate rent expense. Rent expense for the three months ended March 31, 2010, was $58,538, an increase of $69 compared to the same period in 2009. Under our real estate leases, we paid rent of $45,858 during the three months ended March 31, 2010, of which $2,186 was recognized as interest expense and $696 was recognized as a reduction of our capital lease obligation. During the three months ended March 31, 2010, we accrued $2,254 of noncash rent expense to recognize rent expense on a straight line basis over the terms of those leases that include rent escalation provisions and amortized $1,692 of our tenant improvements allowance as a reduction of rent expense. In addition, during the three months ended March 31, 2010, we accrued $15,000 of rent expense that was not paid in cash pursuant to our rent deferral agreement with HPT.

Depreciation and amortization expense. Depreciation and amortization expense for the three months ended March 31, 2010, was $10,394, an increase of $704, or 7.3%, compared to the same period in 2009.

Loss from operations. Our loss from operations for the three months ended March 31, 2010, was $35,825, compared to loss from operations of $15,464 for the same period in 2009. This decline was the result of the changes in revenues and expenses described above, primarily the reduction of fuel gross margin.

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Interest income and expense. Interest income and expense consisted of the following:

(dollars in thousands)	Three Months Ended March 31, 2010	2009	$ Change
Accretion of leasehold improvement receivable	$ 108	$ 212	$ (104)
Other interest income	123	632	(509)
Total interest income	$ 231	$ 844	$ (613)
Rent expense classified as interest	$ 2,186	$ 2,269	$ (83)
Interest accrued on deferred rent	2,850		2,850
Amortization of deferred financing costs	70	590	(520)
Other interest expense	423	423	
Total interest expense	$ 5,529	$ 3,282	$ 2,247

Income tax provision. Our provisions for income taxes of $170 and $212 for the three months ended March 31, 2010 and 2009, respectively, differed from the amounts calculated at the statutory rate primarily due to recognition of a valuation allowance against our net deferred tax assets and to certain state income taxes that are due without regard to our net operating losses.

Seasonality

Assuming little variation in fuel prices, our revenues are usually lowest in the first quarter of the year when movement of freight by professional truck drivers and motorist travel are typically at their lowest levels of the year. Assuming little variation in fuel prices, our revenues in the fourth quarter of a year are often somewhat lower than those of the second and third quarters because, while the beginning of the fourth quarter is often positively impacted by increased movement of freight in preparation for various national holidays, that positive impact is often more than offset by a reduction in freight movement caused by vacation time associated with those holidays taken by professional truck drivers toward the end of the year. While our revenues are modestly seasonal, the quarterly variations in our operating results may reflect greater seasonal differences because our rent and certain other costs do not vary seasonally.

Inflation and Deflation

Inflation, or a general increase in prices, will likely have more negative than positive impacts on our business. Rising prices may allow us to increase revenues, but also will likely increase our operating costs. Also, rising prices for fuel and other products we sell increase our working capital requirements and have in the past caused some of our customers to reduce their purchases of our goods and services. Because significant components of our expenses are fixed, we may not be able to realize expense reductions which match declines in general price levels, or deflation.

Liquidity and Capital Resources (dollars in thousands)

Our principal liquidity requirements are to meet our operating expenses including rent and to fund our capital expenditures and other working capital requirements. Our sources of liquidity to meet these requirements are our operating cash flow, our cash balance, our credit facility, our ability to draw, without an increase in our rent, funding from HPT under the tenant improvements allowance, our ability to sell, with an increase in our rent, to HPT other tenant improvements we make to the sites we lease from HPT and our ability to defer $5,000 of rent payments to HPT each month through December 2010. All deferred rent (and interest thereon) not previously paid is due to HPT on July 1, 2011. We also own a portfolio of operating real estate and developable land which may be a source of additional liquidity over time to the extent it can be financed or sold.

The primary risks we face with respect to our operating cash flow are the current depressed demand for our products and services, the negative impact of the volatility and high level of prices for petroleum based products, and the difficult economic conditions in the U.S. and the trucking industry. A reduction of our revenue without an offsetting reduction in our operating expenses may cause us to use our cash at a rate that we cannot sustain for extended periods. Also, a significant increase in the prices we must pay to obtain fuel or decrease in the amount of time we have to pay our trade creditors may increase our working capital funding requirements materially. In addition, in light of the recent and current economic, industry and global credit market conditions and our historical operating losses, credit may be more expensive and difficult for us to obtain, which may limit the availability of our sources of financing.

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During the quarter ended March 31, 2010, we incurred a net loss of $41,216, had net cash inflows from operating activities of $5,749 and net cash outflows from investing activities of $6,120 and our cash and cash equivalents balance decreased by $354 to $155,278. During the quarter ended March 31, 2010, we deferred $15,000 of rent payable to HPT pursuant to our rent deferral agreement and received $1,796 of funding from HPT under the terms of the tenant improvements allowance. In light of the recent and current economic, industry and global credit market conditions and our historical operating losses, the availability and terms of any credit we may be able to obtain are unpredictable and uncertain, which may limit the availability of our sources of financing and affect our ability to repay deferred rent due to HPT by July 1, 2011. Despite this uncertainty regarding long term liquidity needs, we currently believe that, under current industry conditions, our business initiatives, our cash balance, our ability to draw improvements financing from HPT and our ability to defer $5,000 per month of rent to HPT through December 2010 will allow us to continue to meet all of our obligations in the near term. However, there can be no assurance that industry conditions or our operating results will improve or not decline further or that some other unidentified risk will not manifest itself in a manner which is material and adverse to our results of operations, liquidity or financial position or that our existing resources will be sufficient to allow us to meet our obligations.

Assets and Liabilities

At March 31, 2010 and December 31, 2009, we had cash and cash equivalents of $155,278 and $155,632, respectively. Our total current assets at March 31, 2010, were $417,923, compared to $410,598 at December 31, 2009. Our total current liabilities were $249,651 at March 31, 2010, compared to $219,685 at December 31, 2009. Changes in accounts receivable, accounts payable and accrued expenses were primarily the result of increased fuel and nonfuel sales levels in March 2010 compared to December 2009 as well as higher fuel prices in March 2010 compared to December 2009.

At March 31, 2010 and December 31, 2009, we had $31,359 and $31,289, respectively, of certificates of deposit and other cash deposits placed for the benefit of certain fuel tax authorities, vendors and others, included in other current assets in our consolidated financial statements.

There can be no assurance that industry conditions will not deteriorate or that any one or more of the risks identified under the section Risk Factors or Warning Regarding Forward Looking Statements in our Annual Report on Form 10-K for the year ended December 31, 2009, under Warning Regarding Forward Looking Statements or elsewhere in this Quarterly Report on Form 10-Q, or some other unidentified risk will not manifest itself in a manner which is material and adverse to our results of operations, cash flow or financial position.

Revolving Credit Facility

We have a $100,000 revolving credit agreement, or credit facility, with a group of commercial banks. Under this credit facility, a maximum of $100,000 may be drawn, repaid and redrawn until maturity in November 2012. At March 31, 2010 and December 31, 2009, there were no amounts outstanding under our revolving credit facility, but at March 31, 2010, we had outstanding $63,335 of letters of credit issued under this facility, securing certain purchases, insurance, fuel tax and other trade obligations. These letters of credit reduce the amount available for borrowing under our credit facility. The credit facility is collateralized principally by certain of our cash accounts, accounts receivable and inventory. Although the $72,519 of cash in the pledged cash accounts as of March 31, 2010, is not restricted as to withdrawal or usage, the withdrawal or usage of cash in pledged accounts to an amount below $19,158 as of March 31, 2010, would have resulted in a reduction in the maximum amount available to us under the credit facility.

Investment Activities

Our current capital plan for 2010 anticipates expenditures of approximately $63,000, some of which has been and may be funded by HPT under the lease agreements with HPT. During the three months ended March 31, 2010, we invested approximately $6,102 in capital projects.

During the three months ended March 31, 2010, we received funding of $1,796 from HPT for qualifying tenant improvements, without an increase in our rent. At March 31, 2010, $5,370 of the $125,000 total amount of the tenant improvements allowance remained available from HPT, which amount would be discounted in accordance with our amended lease with HPT to the extent those funds are received on an accelerated basis. Sales of qualified improvements by us to HPT in addition to those amounts, if any, will result in rent increases pursuant to our lease terms.

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Off Balance Sheet Arrangements (dollars in thousands)

We own a minority interest in a joint venture, Petro Travel Plaza Holdings LLC, or PTP, that owns two travel centers that we operate. These travel centers are encumbered by debt of approximately $19,693 as of March 31, 2010, that is secured by PTP s real property. We account for the investment in PTP under the equity method of accounting and, therefore, we have not recorded a liability for this debt. We are not directly liable for this debt, but the carrying value of our investment in this joint venture could be adversely affected if PTP defaulted on this debt and PTP s property was used to satisfy this debt. In connection with the loan agreement entered by PTP, we and our joint venture partner each agreed to indemnify the lender against liability from environmental matters related to PTP s sites.

Related Party Transactions (dollars in thousands, except share amounts)

We were formerly a 100% subsidiary of HPT and currently HPT is our principal landlord and owns 1,540,000 of our outstanding common shares. One of our Managing Directors, Barry Portnoy, is also a Managing Trustee of HPT and is the Chairman and majority beneficial owner of RMR, our management and shared services provider. Thomas O Brien, our other Managing Director and our President and Chief Executive Officer, was a former executive officer of HPT and is also an executive vice president of RMR. Andrew Rebholz, our Executive Vice President, Chief Financial Officer and Treasurer, is a senior vice president of RMR. In addition to providing services to us, RMR also provides services to HPT. Barry Portnoy s son, Adam Portnoy, is the minority beneficial owner of RMR and serves as a director and the President and Chief Executive Officer of RMR. Adam Portnoy is also a Managing Trustee of HPT. Barry Portnoy s son-in-law is an officer of RMR and an executive officer of HPT. One of our Independent Directors, Arthur Koumantzelis, was a trustee of HPT at the time we were created and he resigned and ceased to be a trustee of HPT shortly before he joined our Board of Directors. As of March 31, 2010, we owned a 14.29% share of Affiliates Insurance Company, or Affiliates Insurance. The other shareholders of Affiliates Insurance are RMR, HPT and four other companies to which RMR provides management services, and all of our Directors are also directors of Affiliates Insurance. In addition to Affiliates Insurance, all of our Independent Directors and Barry Portnoy serve as directors or trustees of other companies to which RMR or its affiliate provides management services. We also own a 40% share of PTP. For these and other reasons, we consider HPT, RMR, Affiliates Insurance and PTP to be related parties of ours. For a description of certain relationships among us, HPT, RMR, Affiliates Insurance and PTP, please see the description of these relationships included in our Proxy Statement for our 2010 Annual Meeting of Shareholders and in the Management s Discussion and Analysis of Financial Condition and Results of Operations Related Party Transactions section of our Annual Report on Form 10-K for the year ended December 31, 2009, and the description of risks which may arise from these relationships included in the Risk Factors section of our Annual Report on Form 10-K for the year ended December 31, 2009, all of which documents are accessible at the website for the Securities and Exchange Commission, or the SEC, at www.sec.gov. In addition, copies of certain of our agreements with these parties are also publicly available as exhibits to our public filings with the SEC and accessible at the SEC website.

Significant recent related party transactions and balances included:

- During the three month periods ended March 31, 2010 and 2009, we paid cash rent to HPT of $43,367 and $42,338, respectively, and recognized real estate rent expense of $55,979 and $55,997, respectively, related to our leases with HPT. During the three month periods ended March 31, 2010, we recognized interest expense of $2,850 related to the deferred rent payable to HPT, and made cash interest payments of $1,850 to HPT.

- Other current liabilities in our consolidated balance sheets at March 31, 2010 and December 31, 2009, include $14,279 and $13,946, respectively, for rent due to HPT. As of March 31, 2010, we had deferred rent payments totaling $105,000 that are payable to HPT no later than July 1, 2011. At March 31, 2010, we had interest payable to HPT of $1,000.

- During the three month period ended March 31, 2010, we received funding of $1,796 from HPT for qualifying tenant improvements. At March 31, 2010, $5,370 of the $125,000 total amount of the tenant improvements allowance remained available from HPT, which amount would be discounted in accordance with our amended lease with HPT to the extent that those funds are received on an accelerated basis.

- We recognized expense of $1,925 and $1,983 for the three month periods ended March 31, 2010 and 2009, respectively, in connection with the payments made to RMR under our management and shared services agreement. This expense is included in our selling, general and administrative expenses.

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- As of March 31, 2010, we have invested $5,174 in Affiliates Insurance. This investment is carried on our balance sheet in other noncurrent assets and had a carrying value of $4,992 and $5,000 as of March 31, 2010 and December 31, 2009, respectively. During the three months ended March 31, 2010, we recognized a loss of $28 as our share of Affiliates Insurance s net loss.

- Our results for the three month periods ended March 31, 2010 and 2009, included management and accounting fee income of $163 and $104, respectively, earned in connection with our management of two travel centers owned by PTP. The carrying value of the investment in PTP as of March 31, 2010 and December 31, 2009, was $17,849 and $17,744, respectively. At March 31, 2010 and December 31, 2009, we had net receivables from PTP of $949 and $1,809, respectively. During the three months ended March 31, 2010 and 2009, we recognized income of $105 and $75, respectively, as our share of PTP s net income.

Environmental and Climate Change Matters (dollars in thousands)

Our operations and properties are extensively regulated by environmental laws. We may be required to investigate and clean up hazardous substances, including petroleum products, released at our owned and leased properties. We may be held liable to governmental entities or to third parties for property damage and personal injuries, and for investigation and clean up costs incurred in connection with any contamination. We use underground storage tanks and above ground storage tanks to store petroleum products and waste at our travel centers. We must comply with environmental laws regarding tank construction, integrity testing, leak detection and monitoring, overfill and spill control, release reporting and financial assurance for corrective action in the event of a release. At some locations we must also comply with environmental laws relative to vapor recovery or discharges to water.

From time to time we have received, and in the future likely will receive, notices of alleged violations of environmental laws or otherwise became aware of the need to undertake corrective actions to comply with environmental laws at our travel centers. Investigatory and remedial actions were, and regularly are, undertaken with respect to releases of hazardous substances at our travel centers. In some cases contributions were, and may be, received to partially offset environmental costs from insurers, from state funds established for environmental clean up associated with the sale of petroleum products or from indemnitors who agreed to fund certain environmental related costs at travel centers purchased from such indemnitors. To the extent we incur material amounts for environmental matters for which we do not receive insurance or other third party reimbursement or for which we have not set aside a reserve in prior years, our operating results may be materially adversely affected. In addition, to the extent we fail to comply with environmental laws and regulations, or we become subject to costs and requirements not similarly experienced by our competitors, our competitive position may be harmed. See the disclosure in Note 6 to the Notes to Condensed Consolidated Financial Statements (Unaudited) in Part I, Item 1 of this Quarterly Report on Form 10-Q.

As March 31, 2010, we had a reserve of $9,544 for known environmental matters for which we will be responsible, and we had a receivable for estimated insurance recoveries of these estimated future expenditures of $3,671 along with $2,522 of cash in an escrow account to fund certain of these estimated expenditures, leaving an estimated net amount of $3,350 to be funded by us in the future. We do not have a reserve for potential unknown current or future environmental matters. We cannot precisely know the ultimate costs we will incur in connection with currently known or future potential environmental related violations, corrective actions, investigation and remediation; however, based on our current knowledge we do not expect that the costs to be incurred at our travel centers, individually or in the aggregate, would be material to our financial condition, results of operations or cash flow.

Despite our present expectation, we cannot be certain that we are aware of all existing contamination present in our travel centers, or that material liability will not be imposed on us in the future. If additional environmental problems arise or are discovered, or if additional

environmental requirements are imposed by government agencies, increased environmental compliance or remediation expenditures may be required, which could have a material adverse effect on us. In addition, legislation and regulation regarding climate change, including greenhouse gas emissions, and other environmental matters may be adopted or administered and enforced differently in the future, which could require us to expend significant amounts. For instance, federal and state governmental requirements addressing emissions from trucks and other motor vehicles, such as the United States Environmental Protection Agency s gasoline and diesel sulfur control requirements that limit the concentration of sulfur in gasoline and diesel fuel, could negatively impact our business. Further, legislation and regulations that limit carbon emissions may cause our energy costs at our travel centers to increase.

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We have implemented and expect to continue programs to monitor and remediate our exposures to environmental liabilities. Also, we have insurance of up to $35,000 for unanticipated costs regarding certain known environmental liabilities and of up to $60,000 regarding certain unknown or future environmental liabilities, subject to certain limitations and deductibles. However, as noted above, we can provide no assurance that:

- we or a prior owner, operator or occupant of our travel centers did not create a material environmental condition not known to us at this time;
- future uses or circumstances (including changes in applicable environmental laws and regulations) will not result in the imposition of additional environmental liability upon us;
- we will be able to maintain similar environmental insurance coverage in the future on acceptable terms; or
- future environmental laws or regulations, including those regarding climate change, will not require us to expend significant amounts.

Under the terms of our leases, we generally have agreed to indemnify HPT for any environmental liabilities related to travel centers that we lease from HPT.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

For quantitative and qualitative disclosures about market risk affecting us, see Item 7A. Quantitative and Qualitative Disclosures About Market Risk in our Annual Report on Form 10-K for the year ended December 31, 2009, filed with the SEC on February 24, 2010. Our exposure to market risks has not changed materially from that set forth in our Annual Report on Form 10-K.

Item 4. Controls and Procedures

As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Exchange Act Rules 13a-15 and Rule 15d-15. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective.

There have been no changes in our internal control over financial reporting during the quarter ended March 31, 2010, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

On April 6, 2009, five independent truck stop owners, who are plaintiffs in a purported class action suit against Comdata Network, Inc., or Comdata, in the United States District Court for the Eastern District of Pennsylvania, filed a motion to amend their complaint to add us as a defendant, which was allowed on March 25, 2010. The amended complaint also adds as defendants Ceridian Corporation, Pilot Travel Centers LLC, and Love s Travel Stops & Country Stores, Inc. Comdata markets fuel cards which are used for payments by trucking companies to truck stops. The amended complaint alleges antitrust violations arising out of Comdata s contractual relationships with truck stops in connection with its fuel cards. The plaintiffs are seeking unspecified damages and injunctive relief. This case is in the discovery stage. We believe that there are substantial factual and legal defenses to the plaintiffs claims against us, but that the costs to defend this case could be expensive.

There have been no material developments in our other legal proceedings that we previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2009.

In addition to the legal proceedings referenced above, we are involved from time to time in various other legal and administrative proceedings and threatened legal and administrative proceedings incidental to the ordinary course of our business, none of which we expect, individually or in the aggregate, to have a material adverse effect on our business, financial condition, results of operations or cash flows.

Item 1A. Risk Factors

There have been no material changes during the period covered by this Quarterly Report on Form 10-Q to the risk factors previously disclosed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2009.

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Item 6. Exhibits

Exhibit 3.1	Certificate of Formation of TravelCenters of America LLC (Incorporated by reference to Exhibit 3.1 to our Registration Statement on Form S-1 filed on December 12, 2006, File No. 333-139272)
Exhibit 3.2	Amended and Restated Limited Liability Company Agreement of TravelCenters of America LLC (Incorporated by reference to Exhibit 3.2 to our Annual Report on Form 10-K for the year ended December 31, 2009, filed on February 24, 2010)
Exhibit 3.3	Amended and Restated Bylaws of TravelCenters of America LLC, as amended and restated on January 25, 2010 (Incorporated by reference to Exhibit 3.2 to our Current Report on Form 8-K filed on January 28, 2010)
Exhibit 4.1	Form of Share Certificate (Incorporated by reference to Exhibit 4.1 to our Annual Report on Form 10-K for the year ended December 31, 2009, filed on February 24, 2010)
Exhibit 10.1	Amended and Restated Business Management and Shared Services Agreement, dated as of January 25, 2010, by and between TravelCenters of America LLC and Reit Management & Research LLC (Incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on January 28, 2010)
Exhibit 12.1	Statement of Computation of Ratio of Earnings to Fixed Charges (filed herewith)
Exhibit 21.1	Subsidiaries of TravelCenters of America LLC (filed herewith)
Exhibit 31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer (filed herewith)
Exhibit 31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer (filed herewith)
Exhibit 32.1	Section 1350 Certification of Chief Executive Officer and Chief Financial Officer (furnished herewith)

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WARNING CONCERNING FORWARD LOOKING STATEMENTS

THIS QUARTERLY REPORT ON FORM 10-Q CONTAINS STATEMENTS THAT CONSTITUTE FORWARD LOOKING STATEMENTS WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 AND OTHER FEDERAL SECURITIES LAWS. ALSO, WHENEVER WE USE WORDS SUCH AS BELIEVE , EXPECT , ANTICIPATE , INTEND , PLAN , ESTIMATE OR SIMILAR EXPRESSIONS, WE ARE MAKING FORWARD LOOKING STATEMENTS. THESE FORWARD LOOKING STATEMENTS ARE BASED UPON OUR PRESENT INTENT, BELIEFS OR EXPECTATIONS, BUT FORWARD LOOKING STATEMENTS ARE NOT GUARANTEED TO OCCUR AND MAY NOT OCCUR. ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE CONTAINED IN OR IMPLIED BY OUR FORWARD LOOKING STATEMENTS AS A RESULT OF VARIOUS FACTORS. AMONG OTHERS, THE FORWARD LOOKING STATEMENTS WHICH APPEAR IN THIS QUARTERLY REPORT ON FORM 10-Q THAT MAY NOT OCCUR INCLUDE:

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MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

December 1, 2006, the Company elected early adoption of SFAS No. 159. As a result of the adoption of SFAS No. 159, the Company recorded a cumulative effect adjustment of approximately $166 million ($102 million after-tax) as an increase to the opening balance of Retained earnings as of December 1, 2006.

The following table presents information about the eligible instruments for which the Company elected the fair value option and for which a transition adjustment was recorded as of December 1, 2006:

	Carrying Value of Instrument at December 1, 2006	Transition Adjustment to Retained Earnings Gain/(Loss)	Carrying Value of Instrument at December 1, 2006 (After Adoption of SFAS No. 159)
		(dollars in millions)	
Financial instruments owned(1)	$ 8,587	$ 16	$ 8,603
Consumer loans(2)	1,258	7	1,265
Other assets(3)	1,305	13	1,318
Commercial paper and other short-term borrowings(4)	946	(1)	947
Deposits(5)	3,143	1	3,142
Long-term borrowings(4)	14,354	130	14,224
Pretax cumulative effect of adoption of the fair value option		166	
Deferred taxes		64	
Cumulative effect of adoption of the fair value option		$ 102	

The transition adjustments were primarily related to the following:

(1) Loans and loan commitments made in connection with the Company s corporate lending activities. The fair value option was elected for these positions as they are risk-managed on a fair value basis.

(2) Certain mortgage lending products which are risk-managed by the Institutional Securities business segment on a fair value basis. The Company did not elect the fair value option for other eligible instruments within Consumer loans that are managed by the Discover business segment.

(3) Certain investments that had been previously accounted for under the equity method, as well as certain interests in clearinghouses. The fair value option was elected only for positions that are risk-managed on a fair value basis.

(4) Structured notes and other hybrid long-term debt instruments. The fair value option was elected for these positions as they are risk-managed on a fair value basis. The fair value option was elected for all such instruments issued after December 1, 2006, and a portion of the portfolio of instruments outstanding as of December 1, 2006. The fair value option was not elected for the remaining portion of the portfolio that existed as of December 1, 2006 due to cost-benefit considerations, including the operational effort involved.

(5) Brokered and callable certificates of deposit issued by certain of the Company s bank subsidiaries. The fair value option was elected for these positions as they are risk-managed on a fair value basis. The Company did not elect the fair value option for other eligible instruments within Deposits that are managed by the Discover business segment.

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MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The following table presents gains and (losses) due to changes in fair value for items measured at fair value pursuant to election of the fair value option for the three months ended February 28, 2007:

	Principal Transactions: Trading	Principal Transactions: Investments	Net Interest Revenue	Gains/(Losses) Included in the Three Months Ended February 28, 2007(1)
	(dollars in millions)			
Consumer loans	$ 15	$	$ 16	$ 31
Other assets		128	3	131
Commercial paper and other short-term borrowings	(5)			(5)
Deposits	4			4
Long-term borrowings	136		(49)	87

(1) In addition to these amounts, as discussed in Note 2, the majority of the instruments within Financial instruments owned and Financial instruments sold, not yet purchased, are measured at fair value, either through the election of SFAS No. 159 or as required by other accounting pronouncements. Changes in the fair value of these instruments are recorded in Principal transactions trading revenues.

Interest income and expense and dividend income are recorded within the condensed consolidated statements of income depending on the nature of the instrument and related market conventions. When interest and dividends are included as a component of the change in the instruments fair value, interest and dividends are included within Principal transactions trading revenues. Otherwise, they are included within Interest and dividend income or Interest expense.

As of February 28, 2007, the aggregate contractual principal amount of loans and long-term receivables for which the fair value option was elected exceeded the fair value of such loans and long-term receivables by approximately $22,626 million. The aggregate fair value of loans that were 90 or more days past due as of February 28, 2007 was $2,174 million. The aggregate contractual principal amount of such loans exceeded their fair value by approximately $22,230 million.

For the quarter ended February 28, 2007, the estimated changes in the fair value of liabilities for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were not material. As of February 28, 2007, the aggregate contractual principal amount of long-term debt instruments for which the fair value option was elected exceeded the fair value of such instruments by approximately $577 million.

For the quarter ended February 28, 2007, changes in the fair value of loans and other receivables for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were estimated to be an immaterial unrealized loss.

Hybrid Financial Instruments. In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments (SFAS No. 155), which amends SFAS No. 133 and SFAS No. 140. SFAS No. 155 permits hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation to irrevocably be accounted for at fair value, with changes in fair value recognized in the statement of income. The fair value election may be applied on an instrument-by-instrument basis. SFAS No. 155 also eliminates a restriction on the passive derivative instruments that a qualifying special purpose entity may hold. The Company adopted SFAS No. 155 on December 1, 2006. Since SFAS No. 159 incorporates accounting and disclosure requirements that are similar to SFAS No. 155, the Company decided to apply SFAS No. 159, rather than SFAS No. 155, to its fair value elections for hybrid financial instruments.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

19. Other Accounting Developments.

In June 2005, the FASB ratified the consensus reached in EITF Issue No. 04-5, Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights (EITF Issue No. 04-5). Under the provisions of EITF Issue No. 04-5, a general partner in a limited partnership is presumed to control that limited partnership and, therefore, should include the limited partnership in its consolidated financial statements, regardless of the amount or extent of the general partner s interest unless a majority of the limited partners can vote to dissolve or liquidate the partnership or otherwise remove the general partner without having to show cause or the limited partners have substantive participating rights that can overcome the presumption of control by the general partner. EITF Issue No. 04-5 was effective immediately for all newly formed limited partnerships and existing limited partnerships for which the partnership agreements have been modified. For all other existing limited partnerships for which the partnership agreements have not been modified, the Company adopted EITF Issue No. 04-5 on December 1, 2006. The adoption of EITF Issue No. 04-5 on December 1, 2006 did not have a material impact on the Company s condensed consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for the Company as of December 1, 2007. The Company is currently evaluating the potential impact of adopting FIN 48.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS No. 158). Among other items, SFAS No. 158 requires recognition of the overfunded or underfunded status of an entity s defined benefit and postretirement plans as an asset or liability in the financial statements and requires the measurement of defined benefit and postretirement plan assets and obligations as of the end of the employer s fiscal year. SFAS No. 158 s requirement to recognize the funded status in the financial statements is effective for fiscal years ending after December 15, 2006, and its requirement to use the fiscal year-end date as the measurement date is effective for fiscal years ending after December 15, 2008. The Company is currently assessing the impact that SFAS No. 158 will have on its condensed consolidated financial statements.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Morgan Stanley:

We have reviewed the accompanying condensed consolidated statement of financial condition of Morgan Stanley and subsidiaries (the Company) as of February 28, 2007, and the related condensed consolidated statements of income, comprehensive income and cash flows for the three-month periods ended February 28, 2007 and 2006. These interim financial statements are the responsibility of the management of Morgan Stanley.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial condition of Morgan Stanley and subsidiaries as of November 30, 2006, and the related consolidated statements of income, comprehensive income, cash flows and changes in shareholders equity for the fiscal year then ended (not presented herein) included in Morgan Stanley s Annual Report on Form 10-K for the fiscal year ended November 30, 2006; and in our report dated February 12, 2007, which report contains an explanatory paragraph relating to the adoption, in fiscal 2005, of Statement of Financial Accounting Standards No. 123(R), Share-Based Payment and effective December 1, 2005, the change in accounting policy for recognition of equity awards granted to retirement-eligible employees and an explanatory paragraph relating to, in fiscal 2006, the application of Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statement , we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated statement of financial condition as of November 30, 2006 is fairly stated, in all material respects, in relation to the consolidated statement of financial condition from which it has been derived.

As discussed in Note 18 to the condensed consolidated interim financial statements, effective December 1, 2006, the Company adopted SFAS No. 157, Fair Value Measurement and SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115.

/s/ Deloitte & Touche LLP

New York, New York

April 5, 2007

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

Introduction.

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

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

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

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

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

On December 19, 2006, the Company announced that its Board of Directors had approved the spin-off of Discover (the Discover Spin-off) (see Discover Spin-off herein).

The discussion of the Company s results of operations below may contain forward-looking statements. These statements, which reflect management s beliefs and expectations, are subject to risks and uncertainties that may cause actual results to differ materially. For a discussion of the risks and uncertainties that may affect the Company s future results, please see Forward-Looking Statements immediately preceding Part I, Item 1, Competition and Regulation in Part I, Item 1, Risk Factors in Part I, Item 1A, Certain Factors Affecting Results of Operations in Part II, Item 7 and other items throughout the Company s Annual Report on Form 10-K for the fiscal year ended November 30, 2006 (the Form 10-K) and the Company s 2007 Current Reports on Form 8-K.

The Company s results of operations for the quarters ended February 28, 2007 and 2006 are discussed below. The results of Quilter Holdings Ltd. (Quilter), Global Wealth Management Group s mass affluent business in the U.K., are reported as discontinued operations for all periods presented through its sale on February 28, 2007. The results of the aircraft leasing business, which was sold on March 24, 2006, are also reported as discontinued operations for the three months ended February 28, 2006 (see Discontinued Operations herein).

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Results of Operations.

Executive Summary.

Financial Information.

	Three Months Ended February 28,	
	2007	2006(1)
Net revenues (dollars in millions):		
Institutional Securities	$ 7,631	$ 5,551
Global Wealth Management Group	1,490	1,266
Asset Management	905	705
Discover	1,025	1,089
Intersegment Eliminations	(53)	(59)
Consolidated net revenues	$ 10,998	$ 8,552
Income before taxes (dollars in millions)(2):		
Institutional Securities	$ 3,031	$ 1,775
Global Wealth Management Group	220	15
Asset Management	236	172
Discover	372	479
Intersegment Eliminations	5	19
Consolidated income before taxes	$ 3,864	$ 2,460
Consolidated net income (dollars in millions)	$ 2,672	$ 1,574
Earnings applicable to common shareholders (dollars in millions)(3)	$ 2,655	$ 1,574
Earnings per basic common share:		
Income from continuing operations	$ 2.52	$ 1.57
Gain/(loss) on discontinued operations	0.11	(0.03)
Earnings per basic common share	$ 2.63	$ 1.54
Earnings per diluted common share:		
Income from continuing operations	$ 2.40	$ 1.51
Gain/(loss) on discontinued operations	0.11	(0.03)
Earnings per diluted common share	$ 2.51	$ 1.48
Statistical Data.		
Book value per common share(4)	$ 34.71	$ 28.12
Average common equity (dollars in billions)(5)(6):		
Institutional Securities	$ 20.3	$ 16.2
Global Wealth Management Group	1.7	3.3
Asset Management	2.7	2.0
Total from securities businesses	24.7	21.5
Discover	5.5	4.6

Total from operating segments	30.2	26.1
Discontinued operations	0.2	0.2
Unallocated capital	5.1	3.2
Consolidated	$ 35.5	$ 29.5

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Statistical Data (Continued).

	Three Months Ended February 28,	
	2007	2006(1)
Return on average common equity(5)(6):		
Consolidated	30%	21%
Institutional Securities	40%	29%
Global Wealth Management Group	32%	1%
Asset Management	20%	21%
Discover	17%	26%
Effective income tax rate	33.1%	32.8%
Worldwide employees	57,845	53,870
Consolidated assets under management or supervision by asset class (dollars in billions):		
Equity	$ 317	$ 288
Fixed income	111	105
Money market	90	82
Alternative investments	29	18
Real estate	76	45
Subtotal	623	538
Unit trusts	15	12
Other(7)	59	52
Total assets under management or supervision(8)	697	602
Share of minority interest assets(9)	5	
Total	$ 702	$ 602
Institutional Securities:		
Mergers and acquisitions completed transactions (dollars in billions)(10):		
Global market volume	$ 141.5	$ 107.8
Market share	33.7%	26.1%
Rank	2	3
Mergers and acquisitions announced transactions (dollars in billions)(10):		
Global market volume	$ 147.0	$ 139.2
Market share	25.9%	29.4%
Rank	6	9
Global equity and equity-related issues (dollars in billions)(10):		
Global market volume	$ 6.0	$ 4.8
Market share	6.0%	6.0%
Rank	8	5
Global debt issues (dollars in billions)(10):		
Global market volume	$ 66.4	$ 76.1
Market share	5.6%	6.7%
Rank	6	3
Global initial public offerings (dollars in billions)(10):		
Global market volume	$ 1.7	$ 1.5
Market share	7.2%	6.5%
Rank	5	4
Pre-tax profit margin(11)	40%	32%

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Statistical Data (Continued).

	Three Months Ended February 28,	
	2007	2006(1)
Global Wealth Management Group:		
Global representatives	7,993	8,913
Annualized net revenue per global representative (dollars in thousands)(12)	$ 748	$ 552
Client assets by segment (dollars in billions)(12):		
$10 million or more	$ 210	$ 166
$1 million $10 million	248	220
Subtotal $1 million or more	458	386
$100,000 $1 million	174	177
Less than $100,000	26	32
Client assets excluding corporate and other accounts	658	595
Corporate and other accounts	32	29
Total client assets	$ 690	$ 624
Fee-based assets as a percentage of total client assets	29%	28%
Client assets per global representative (dollars in millions)(13)	$ 86	$ 70
Bank deposit program (dollars in millions)(14)	$ 16,364	$ 7,319
Pre-tax profit margin(11)	15%	1%
Asset Management:		
Assets under management or supervision (dollars in billions)(15)	$ 500	$ 442
Percent of fund assets in top half of Lipper rankings(16)	48%	60%
Pre-tax profit margin(11)	26%	24%
Discover (dollars in millions, unless otherwise noted)(17):		
Period-end credit card loans Owned	$ 22,410	$ 19,924
Period-end credit card loans Managed	$ 50,730	$ 47,825
Average credit card loans Owned	$ 24,672	$ 21,976
Average credit card loans Managed	$ 51,390	$ 47,575
Net principal charge-off rate Owned	3.78%	4.54%
Net principal charge-off rate Managed	4.05%	5.06%
Return on average receivables Owned	3.84%	5.54%
Return on average receivables Managed	1.84%	2.56%
Transaction volume (dollars in billions):		
Net sales	$ 25.1	$ 22.5
Other transaction volume	5.2	4.3
Total	$ 30.3	$ 26.8
Payment services transaction volume (millions of transactions):		
Discover network	361	339
PULSE network	521	425
Total network transaction volume	882	764
Pre-tax profit margin(11)	36%	44%

(1) Certain prior-period information has been reclassified to conform to the current period s presentation.
(2) Amounts represent income from continuing operations before losses from unconsolidated investees, income taxes and gain (loss) from discontinued operations.
(3) Earnings applicable to common shareholders are used to calculate earnings per share information.
(4) Book value per common share equals common shareholders equity of $36,854 million at February 28, 2007 and $30,103 million at February 28, 2006, divided by common shares outstanding of 1,062 million at February 28, 2007 and 1,070 million at February 28, 2006.
(5) The computation of average common equity for each business segment is based upon an economic capital model that the Company uses to determine the amount of equity capital needed to support the risk of its business activities and to ensure that the Company remains adequately capitalized. Economic capital is defined as the amount of capital needed to run the business through the business cycle and

satisfy the requirements of regulators, rating agencies and the market. The Company s methodology is based on an approach that assigns economic capital to each segment based on regulatory capital usage plus additional capital for stress losses, goodwill and intangible assets, and principal investment risk. The economic capital model and allocation methodology may be enhanced over time in response to changes in the business and regulatory environment. The effective tax rates used in the computation of segment return on average common equity were determined on a separate entity basis.

(6) For the quarter ended February 28, 2007, the Company reassessed the amount of capital required to support the market risks and credit risks in its Global Wealth Management Group business segment.

(7) Amounts include assets under management or supervision associated with the Global Wealth Management Group business segment.

(8) Revenues and expenses associated with these assets are included in the Company s Asset Management, Global Wealth Management Group and Institutional Securities business segments.

(9) Amount represents Asset Management s proportional share of assets managed by entities in which it owns a minority interest.

(10) Source: Thomson Financial, data as of March 7, 2007 The data for the three months ended February 28, 2007 and 2006 are for the periods from January 1 to February 28, 2007 and January 1 to February 28, 2006, respectively, as Thomson Financial presents these data on a calendar-year basis.

(11) Percentages represent income from continuing operations before losses from unconsolidated investees and income taxes as a percentage of net revenues.

(12) Annualized net revenue per global representative amounts equal Global Wealth Management Group s net revenues divided by the quarterly average global representative headcount for the periods presented.

(13) Client assets per global representative equal total period-end client assets divided by period-end global representative headcount.

(14) Bank deposits are held at certain of the Company s Federal Deposit Insurance Corporation insured depository institutions for the benefit of retail clients through their brokerage accounts.

(15) Amount includes Asset Management s proportional share of assets managed by entities in which it owns a minority interest.

(16) Source: Lipper, one-year performance excluding money market funds as of February 28, 2007 and 2006, respectively.

(17) The Company analyzes its financial performance on both a managed loan basis and as reported under U.S. Generally Accepted Accounting Principles. Managed data include owned and securitized credit card loans. For an explanation of managed data and a reconciliation of credit card loan and asset quality data, see Discover Managed General Purpose Credit Card Loan Data herein.

First Quarter 2007 Performance.

Company Results. The Company achieved record net income of $2,672 million and record quarterly diluted earnings per share of $2.51 for the quarter ended February 28, 2007, both increases of 70% from the comparable fiscal 2006 period. Net revenues (total revenues less interest expense and the provision for loan losses) increased 29% to a record $10,998 million and the annualized return on average common equity was 29.9% compared with 21.3% in the first quarter of last year. Income from continuing operations was $2,559 million, an increase of 60% from a year ago. Diluted earnings per share from continuing operations were a record $2.40 compared with $1.51 in last year s first quarter. The annualized return on average common equity from continuing operations was 28.8% compared with 21.9% in the first quarter of last year.

Non-interest expenses of $7,134 million increased 17% from the prior year period, primarily due to higher compensation costs resulting from higher net revenues, partially offset by the incremental compensation expense ($395 million) related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006 (see Other Items Stock-Based Compensation herein).

The Company s effective income tax rate was 33.1% for the first quarter of fiscal 2007 and 32.8% for the first quarter of fiscal 2006.

The current quarter s results included a gain of $168 million ($109 million after-tax) in discontinued operations related to the sale of Quilter on February 28, 2007. Discontinued operations in the first quarter of fiscal 2006 included a loss of $125 million ($75 million after-tax) related to the sale of the Company s aircraft leasing business (see Other Items Discontinued Operations herein).

Institutional Securities. Institutional Securities achieved record income from continuing operations before losses from unconsolidated investees and income taxes of $3,031 million, a 71% increase from last year s first quarter. Net revenues rose 37% to a record $7,631 million driven by record fixed income and equity sales and trading revenues, along with higher investment banking revenues. Non-interest expenses increased 22% to $4,600 million, reflecting higher compensation accruals resulting from higher net revenues, as well as higher compensation costs associated with certain employee deferred compensation plans (see Other Items Deferred Compensation Plans herein), partially offset by Institutional Securities share ($270 million) of the incremental compensation expense related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006. Non-compensation expenses increased as a result of higher levels of business activity.

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Investment banking revenues increased 16% from last year s first quarter to $1,049 million. Underwriting revenues rose 20% from last year s first quarter to $659 million. Advisory fees from merger, acquisition and restructuring transactions were $390 million, an increase of 10% from last year s first quarter.

Fixed income sales and trading revenues were a record $3,566 million, up 31% from the previous record in the first quarter of fiscal 2006. The increase was driven by strong performances in credit products and interest rate and currency products. Credit products had record revenues, primarily due to favorable positioning in the residential mortgage markets, improved corporate credit trading and strong customer flows. Interest rate and currency product revenues benefited from improved interest rate trading and emerging market revenues. Commodities revenues decreased from last year s record first quarter, reflecting lower trading results in electricity, natural gas products and oil liquids. Equity sales and trading revenues increased 36% to a record $2,243 million. The increase was broad based and included higher revenues from derivatives products, prime brokerage, financing products, principal trading strategies and equity cash products.

Principal transaction net investment revenues were $801 million in the quarter compared with $312 million a year ago. The increase was primarily related to net gains associated with certain of the Company s investments, including both realized and unrealized gains from investments in the Company s real estate funds. The current quarter also included higher revenues related to certain employee deferred compensation plans (see Other Items Deferred Compensation Plans herein).

Global Wealth Management Group. The Global Wealth Management Group recorded income from continuing operations before income taxes of $220 million compared with $15 million in the first quarter of fiscal 2006. Net revenues increased 18% from last year s first quarter to $1,490 million reflecting higher transactional revenues due to increased underwriting activity, higher asset management revenues reflecting growth in fee-based products and higher net interest revenue from the bank deposit sweep program. Total non-interest expenses increased 2% from a year ago to $1,270 million. Compensation and benefits expense increased, primarily reflecting higher incentive-based compensation accruals related to higher net revenues, partially offset by Global Wealth Management Group s share ($80 million) of the incremental compensation expense related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006. Non-compensation costs decreased, primarily due to lower costs associated with legal and regulatory matters. Total client assets increased to $690 billion, up 11% from last year s first quarter. In addition, client assets in fee-based accounts rose 17% to a record $202 billion at February 28, 2007 and increased to 29% as a percentage of total client assets from 28% a year ago. At quarter-end, the number of global representatives was 7,993, a decline of 920 from a year ago, resulting largely from planned sales force reductions completed in the second quarter of fiscal 2006 and attrition.

Asset Management. Asset Management recorded income before income taxes of $236 million, a 37% increase from last year s first quarter. Net revenues increased 28% from last year s first quarter to $905 million driven by higher investment revenues, primarily in the private equity business, and higher asset management, distribution and administration fees, primarily due to an increase in assets under management and higher performance fees from the alternatives business. Non-interest expenses increased 26% to $669 million, largely due to higher incentive-based compensation accruals associated with increased revenues and business investment, partially offset by Asset Management s share ($28 million) of the incremental compensation expense related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006. Assets under management or supervision within Asset Management of $500 billion were up $58 billion, or 13%, from the first quarter of last year, primarily due to market appreciation, acquisitions and investments in minority stakes. In fiscal 2007, the Company expects that Asset Management s profit margins will be affected by its continued investments in its core business, alternative products and private equity.

Discover. Discover recorded income before losses from unconsolidated investees and income taxes of $372 million, a decrease of 22% from the first quarter of fiscal 2006. The first quarter of fiscal 2006 benefited from the effect of a sharp decline in consumer bankruptcy receipts following the October 2005 enactment of new U.S. bankruptcy legislation, resulting in an increase in the value of the Company s residual interests in securitization transactions and a decrease in the allowance for consumer loan losses. Net revenues of $1,025 million were

6% lower than a year ago, primarily due to lower Servicing and securitization income and a higher Provision for consumer loan losses, partially offset by higher net interest revenues. Non-interest expenses of $653 million increased 7% from a year ago, primarily due to higher marketing and business development expenses, higher professional services expenses and incremental costs as a result of the acquisition of Goldfish in February 2006. The managed credit card net principal charge-off rate decreased 101 basis points to 4.05% from the same period a year ago. The managed over-30-day delinquency rate was unchanged at 3.45% from a year ago, and the managed over-90-day delinquency rate was 8 basis points higher than a year ago at 1.69%. Managed credit card loans were $50,730 million at quarter-end, a 6% increase from a year ago.

Global Market and Economic Conditions in the Quarter Ended February 28, 2007.

In the U.S., the moderate pace of economic growth that occurred during the second half of fiscal 2006 continued during the first quarter of fiscal 2007, reflecting, among other things, generally lower energy prices, although the slowdown in the residential real estate market persisted. The U.S. unemployment rate increased slightly to 4.6% at the end of the quarter from 4.5% at the end of fiscal 2006. Conditions in the U.S. equity markets were generally favorable, and major equity market indices rose during most of the quarter and were supported by strong corporate earnings. Equity markets declined sharply at quarter-end, however, due to concerns about the residential real estate market and conditions in China s equity markets. The Federal Reserve Board (the Fed) left interest rates unchanged during the quarter and has not raised interest rates since June 2006. Inflationary pressures appeared to be contained, although it continued to be a primary concern of the Fed.

In Europe, economic growth during the first quarter of fiscal 2007 continued to be strong. Major equity market indices in Europe increased during much of the quarter, reflecting strong corporate earnings as well as merger and acquisition activity and generally favorable economic conditions. The European Central Bank (the ECB) raised the benchmark interest rate by 0.25% during the quarter. In March 2007, the ECB raised the benchmark interest rate by an additional 0.25%. The Bank of England raised the benchmark interest rate by 0.25% during the quarter.

In Japan, moderate economic growth continued to be driven by exports and domestic demand. The level of unemployment also remained relatively low, and Japanese equity market indices increased during the quarter. The Bank of Japan raised the benchmark interest rate from 0.25% to 0.50% during the quarter. Economies elsewhere in Asia also expanded, particularly in China, which benefited from strength in exports, domestic demand and continued globalization. Although equity market indices in China rose sharply during much of the quarter, they declined at quarter-end. In March 2007, the People s Bank of China raised the benchmark interest rate by 0.27%.

Business Segments.

The remainder of Results of Operations is presented on a business segment basis before discontinued operations. Substantially all of the operating revenues and operating expenses of the Company can be directly attributed to its business segments. Certain revenues and expenses have been allocated to each business segment, generally in proportion to its respective revenues or other relevant measures.

As a result of treating certain intersegment transactions as transactions with external parties, the Company includes an Intersegment Eliminations category to reconcile the segment results to the Company s consolidated results. Income before taxes in Intersegment Eliminations represents the effect of timing differences associated with the revenue and expense recognition of commissions paid by Asset Management to the Global Wealth Management Group associated with sales of certain products and the related compensation costs paid to the Global Wealth Management Group s global representatives. Income before taxes recorded in Intersegment Eliminations was $5 million in the quarter ended February 28, 2007 and $19 million in the quarter ended February 28, 2006.

Certain reclassifications have been made to prior-period amounts to conform to the current period s presentation, including the reporting of Quilter within discontinued operations for all periods presented.

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INSTITUTIONAL SECURITIES

INCOME STATEMENT INFORMATION

	Three Months Ended February 28, 2007	2006
	(dollars in millions)	
Revenues:		
Investment banking	$ 1,049	$ 903
Principal transactions:		
Trading	4,029	2,963
Investments	801	312
Commissions	691	610
Asset management, distribution and administration fees	88	43
Servicing and securitization income	35	
Interest and dividends	13,961	9,789
Other	145	96
Total revenues	20,799	14,716
Interest expense	13,168	9,165
Net revenues	7,631	5,551
Total non-interest expenses	4,600	3,776
Income from continuing operations before losses from unconsolidated investees and income taxes	3,031	1,775
Losses from unconsolidated investees	43	68
Provision for income taxes	942	531
Income from continuing operations	$ 2,046	$ 1,176

Investment Banking. Investment banking revenues for the quarter ended February 28, 2007 increased 16% from the comparable period of fiscal 2006. The increase was primarily due to higher revenues from equity underwriting transactions and merger, acquisition and restructuring activities. Advisory fees from merger, acquisition and restructuring transactions were $390 million, an increase of 10% from the comparable period of fiscal 2006. Underwriting revenues were $659 million, an increase of 20% from the comparable period of fiscal 2006. Equity underwriting revenues increased 52% to $300 million, reflecting an increase in industry-wide transaction activity. Fixed income underwriting revenues increased 2% to $359 million.

At February 28, 2007, the backlog of merger, acquisition and restructuring transactions and equity and fixed income underwriting transactions was higher as compared with the first quarter of fiscal 2006. The backlog of merger, acquisition and restructuring transactions and equity and fixed income underwriting transactions is subject to the risk that transactions may not be completed due to unforeseen economic and market conditions, adverse developments regarding one of the parties to the transaction, a failure to obtain required regulatory approval or a decision on the part of the parties involved not to pursue a transaction.

Sales and Trading. Sales and trading revenues are composed of principal transaction trading revenues, commissions and net interest revenues (expenses). In assessing the profitability of its sales and trading activities, the Company views principal trading, commissions and net interest revenues in the aggregate. In addition, decisions relating to principal transactions are based on an overall review of aggregate revenues and costs associated with each transaction or series of transactions. This review includes, among other things, an assessment of the potential gain or loss associated with a transaction, including any associated commissions, dividends, the interest income or expense associated with financing or hedging the Company s positions and other related expenses.

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Total sales and trading revenues increased 31% from the comparable period of fiscal 2006, reflecting record fixed income and equity sales and trading revenues.

Sales and trading revenues include the following:

	Three Months Ended February 28,	
	2007(1)	2006(1)
	(dollars in millions)	
Equity	$ 2,243	$ 1,654
Fixed income(2)	3,566	2,724

(1) Amounts exclude sales and trading revenues of $(296) million and $(181) million for the three months ended February 28, 2007 and 2006, respectively, which relate to unallocated net revenues, net revenues associated with corporate lending activities and certain other adjustments.

(2) Amounts include interest rate and currency products, credit products and commodities. Amounts exclude corporate lending activities.

Equity sales and trading revenues increased 36% to a record $2,243 million in the first quarter of fiscal 2007. The increase was broad based and included higher revenues from derivatives products, prime brokerage, financing products, principal trading strategies and equity cash products. Derivative revenues increased due to strong customer flows, new transaction activity and principal risk taking. Revenues from financing and equity cash products also benefited from increased client activity. Prime brokerage generated record revenues reflecting continued growth in global client asset balances. Global equity markets trended higher during much of the quarter and created favorable opportunities for principal trading strategies. Although commission revenues increased, revenues continued to be affected by intense competition, particularly in the U.S., and a continued shift toward electronic trading.

Fixed income sales and trading revenues increased 31% to a record $3,566 million driven by strong performances in credit products and interest rate and currency products. Credit product revenues increased 94%, primarily due to higher revenues from securitized products. Trading revenues benefited from favorable positioning in the residential mortgage markets, improved corporate credit trading and strong customer flows. Interest rate and currency product revenues increased 17% benefiting from improved interest rate trading and emerging market revenues. Commodities decreased 26% from last year s record first quarter, reflecting lower trading results in electricity, natural gas products and oil liquids.

In addition to the equity and fixed income sales and trading revenues discussed above, sales and trading revenues include the net revenues from the Company s corporate lending activities. In the quarter ended February 28, 2007, revenues from corporate lending activities decreased by approximately $10 million from the first quarter of fiscal 2006, reflecting the impact of mark-to-market valuations on a higher level of new loans made in the quarter, partially offset by higher revenues from principal trading strategies.

Principal Transactions-Investments. Principal transaction net investment revenues aggregating $801 million were recognized in the quarter ended February 28, 2007 as compared with $312 million in the quarter ended February 28, 2006. The increase was primarily related to net gains associated with certain of the Company s investments, including both realized and unrealized gains from investments in the Company s real estate funds, Grifols S.A. and IntercontinentalExchange. The current quarter also included revenues of $237 million related to certain employee deferred compensation plans (see Other Items Deferred Compensation Plans herein). Principal transaction net investment revenues for the first quarter of fiscal 2006 included $130 million from the Company s investment in IntercontinentalExchange.

Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees increased $45 million from the comparable period of fiscal 2006, reflecting higher fees associated with certain real estate fund investments.

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Servicing and Securitization Income. Servicing and securitization income of $35 million recognized in the first quarter of fiscal 2007 was primarily attributable to Saxon Capital, Inc. (Saxon), which the Company acquired on December 4, 2006.

Other. Other revenues increased 51%. The increase was primarily attributable to revenues related to the operation of pipelines, terminals and barges and the distribution of refined petroleum products associated with TransMontaigne Inc. (TransMontaigne), which the Company acquired on September 1, 2006, and higher sales of benchmark indices and risk management analytic products.

Non-Interest Expenses. Non-interest expenses increased 22%. Compensation and benefits expense increased 21% primarily reflecting higher incentive-based compensation costs resulting from higher net revenues as well as higher compensation costs associated with certain employee deferred compensation plans (see Other Items Deferred Compensation Plans herein). The increase was partially offset by Institutional Securities share ($270 million) of the incremental compensation expense related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006 (see Other Items Stock-Based Compensation herein). Excluding compensation and benefits expense, non-interest expenses increased 25%. Occupancy and equipment expense increased 35%, primarily due to higher rent and occupancy costs, including additional costs associated with TransMontaigne, the Heidmar Group of companies (Heidmar), and a new office building in New York City. The Company acquired TransMontaigne and Heidmar in September 2006 and the office building in June 2006. Brokerage, clearing and exchange fees increased 29%, primarily reflecting increased equity and fixed income trading activity. Marketing and business development expense increased 32%, primarily due to a higher level of business activity. Professional services expense increased 20%, primarily due to higher consulting and legal costs. Other expenses increased 34%, reflecting costs associated with TransMontaigne and Heidmar.

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GLOBAL WEALTH MANAGEMENT GROUP

INCOME STATEMENT INFORMATION

	Three Months Ended February 28, 2007	2006
	(dollars in millions)	
Revenues:		
Investment banking	$ 166	$ 67
Principal transactions:		
Trading	129	125
Investments	(2)	1
Commissions	315	310
Asset management, distribution and administration fees	702	638
Interest and dividends	274	203
Other	44	37
Total revenues	1,628	1,381
Interest expense	138	115
Net revenues	1,490	1,266
Total non-interest expenses	1,270	1,251
Income from continuing operations before income taxes	220	15
Provision for income taxes	83	6
Income from continuing operations	$ 137	$ 9

Investment Banking. Investment banking revenues increased 148%, driven by robust equity underwriting results primarily related to a closed end fund offering in the quarter. The increase also reflected strong results from fixed income underwriting and unit trusts.

Principal Transactions Trading. Principal transaction trading revenues increased 3%, as higher revenues from corporate fixed income securities, foreign exchange products and equity linked notes were partially offset by lower revenues from government and municipal fixed income securities.

Principal Transactions Investments. Principal transaction net investment losses aggregating $2 million were recognized in the quarter ended February 28, 2007 as compared with net gains aggregating $1 million in the comparable period. The results in both periods were primarily related to investments in exchanges.

Commissions. Commission revenues increased 2% as compared with the prior-year period reflecting improved market conditions. Commission revenues were limited by growth in other product areas, such as underwritten products, which are included within investment banking revenues.

Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees increased 10%, primarily reflecting higher client assets in fee-based accounts.

Client assets in fee-based accounts rose 17% to $202 billion at February 28, 2007 and increased as a percentage of total client assets to 29% of total client assets from 28% in the prior-year period. Client asset balances increased to $690 billion at February 28, 2007 from $624 billion at February 28, 2006, primarily due to market appreciation. Client asset balances in accounts greater than $1 million increased to $458 billion at February 28, 2007 from $386 billion at February 28, 2006.

Net Interest. Net interest revenues increased 55%, primarily related to increased account balances in the bank deposit program. Balances in the bank deposit program rose to $16,364 million at February 28, 2007 as compared with $7,319 million at February 28, 2006.

Non-Interest Expenses. Non-interest expenses increased 2%. Compensation and benefits expense increased 7%, primarily reflecting higher incentive-based compensation accruals related to higher net revenues, partially offset by Global Wealth Management Group s share ($80 million) of the incremental compensation expense related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006 (see Other Items Stock-Based Compensation herein). Excluding compensation and benefits expense, non-interest expenses decreased 9%. Occupancy and equipment expense increased 9%, primarily due to higher rental charges. Professional services expense decreased 6%, largely due to lower costs for outside legal counsel and consulting fees, partially offset by higher sub-advisory fees associated with growth in fee-based assets. Marketing and business development expense increased 27%, primarily due to higher costs associated with a new advertising campaign that was launched in the first quarter of fiscal 2007. Other expenses decreased 37%, primarily resulting from lower costs associated with legal and regulatory matters, which declined by approximately $40 million.

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ASSET MANAGEMENT

INCOME STATEMENT INFORMATION

	Three Months Ended February 28,	
	2007	2006
	(dollars in millions)	
Revenues:		
Investment banking	$ 14	$ 12
Principal transactions:		
Investments	121	36
Commissions	6	7
Asset management, distribution and administration fees	732	640
Interest and dividends	13	5
Other	34	7
Total revenues	920	707
Interest expense	15	2
Net revenues	905	705
Total non-interest expenses	669	533
Income before income taxes	236	172
Provision for income taxes	96	67
Net income	$ 140	$ 105

Investment Banking. Investment banking revenues increased 17%, primarily reflecting a higher volume of equity unit trust sales.

Principal Transactions-Investments. Principal transaction net investment gains aggregating $121 million were recognized in the first quarter of fiscal 2007 as compared with $36 million in the prior-year period. The increase was primarily related to higher net gains on certain investments in the Company s private equity portfolio and investments in the Company s alternatives products.

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Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees increased 14%, primarily due to higher fund management and administration fees associated with a 12% increase in average assets under management and higher performance fees from the alternatives business, including those associated with the acquisition of FrontPoint Partners (FrontPoint) (see Other Items Business and Other Acquisitions herein).

Asset Management s period-end and average customer assets under management or supervision were as follows:

	At February 28,		Average for the Three Months Ended February 28,	
	2007	2006(1)	2007	2006(1)
	(dollars in billions)			
Assets under management or supervision by distribution channel:				
Americas Retail Morgan Stanley brand	$ 61	$ 64	$ 61	$ 66
Americas Retail Van Kampen brand	96	90	96	90
Americas Intermediary(2)	61	47	60	46
U.S. Institutional	95	88	94	88
Non-U.S.	97	75	92	71
Total long-term assets under management or supervision	410	364	403	361
Institutional money markets/liquidity	52	37	51	35
Retail money markets	33	41	34	43
Total money markets	85	78	85	78
Total assets under management or supervision	495	442	488	439
Share of minority interest assets(3)	5		5	
Total	$ 500	$ 442	$ 493	$ 439

	At February 28,		Average for the Three Months Ended February 28,	
	2007	2006(1)	2007	2006(1)
	(dollars in billions)			
Assets under management or supervision by asset class:				
Equity	$ 245	$ 230	$ 244	$ 226
Fixed income	94	90	93	91
Money market	85	78	85	78
Alternative investments	29	18	27	19
Real estate	27	14	25	13
Subtotal	480	430	474	427
Unit trusts	15	12	14	12
Total assets under management or supervision	495	442	488	439
Share of minority interest assets(3)	5		5	
Total	$ 500	$ 442	$ 493	$ 439

(1) Certain prior-period information has been reclassified to conform to the current period s presentation.
(2) Americas Intermediary channel primarily represents client flows through defined contribution, insurance and bank trust platforms.
(3) Amount represents Asset Management s proportional share of assets managed by entities in which it owns a minority interest.

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Activity in Asset Management s customer assets under management or supervision were as follows:

	Three Months Ended February 28,	
	2007	2006
	(dollars in billions)	
Balance at beginning of period	$ 478	$ 431
Net flows by distribution channel:		
Americas Retail Morgan Stanley brand	(2)	(3)
Americas Retail Van Kampen brand		(1)
Americas Intermediary(1)	1	2
U.S. Institutional		(4)
Non-U.S.	5	1
Net inflows/(outflows) excluding money markets	4	(5)
Money market net flows:		
Institutional	3	4
Retail	(2)	(6)
Total money market net flows	1	(2)
Net market appreciation	10	18
Total net increase	15	11
Acquisitions	6	
Net increase in share of minority interest assets(2)	1	
Balance at end of period	$ 500	$ 442

(1) Americas Intermediary channel primarily represents client flows through defined contribution, insurance and bank trust platforms.
(2) Amount represents Asset Management s proportional share of assets managed by entities in which it owns a minority interest.

Net inflows (excluding money markets) in the quarter ended February 28, 2007 were primarily associated with positive flows into Non-U.S. products, partially offset by outflows in Americas Retail Morgan Stanley branded products. For the quarter ended February 28, 2007, positive flows into institutional liquidity assets were partially offset by outflows from certain money market funds that were impacted by the growth of Global Wealth Management Group s bank deposit program.

Other. Other revenues were $34 million for the fiscal quarter ended February 28, 2007 as compared with $7 million in the prior-year period. The increase was primarily due to revenue recognized from the Company s minority stakes in Avenue Capital Group and Lansdowne Partners, which were acquired in the fourth quarter of fiscal 2006.

Non-Interest Expenses. Non-interest expenses increased 26%. Compensation and benefits expense increased 45%, primarily reflecting higher incentive-based compensation accruals due to higher net revenues and investments in the business, particularly in alternatives. The increase was partially offset by Asset Management s share ($28 million) of the incremental compensation expense related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006 (see Other Items Stock-Based Compensation herein). Excluding compensation and benefits expense, non-interest expenses increased 9%. Brokerage, clearing and exchange fees decreased 12%, primarily reflecting lower amortization expense associated with certain open-ended funds. The decrease in amortization expense reflected a lower level of deferred costs in recent periods due to a decrease in sales of certain open-ended funds. Professional services expense increased 15%, primarily due to higher sub-advisory, consulting and legal fees. Other expenses increased 113%, primarily due to the amortization of intangible assets associated with the acquisition of FrontPoint.

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DISCOVER

INCOME STATEMENT INFORMATION

	Three Months Ended February 28,	
	2007	2006
	(dollars in millions)	
Merchant, cardmember and other fees, net	$ 297	$ 289
Servicing and securitization income	521	596
Other revenue	9	4
Total non-interest revenues	827	889
Interest revenue	680	586
Interest expense	287	231
Net interest income	393	355
Provision for consumer loan losses	195	155
Net credit income	198	200
Net revenues	1,025	1,089
Total non-interest expenses	653	610
Income before losses from unconsolidated investees and income taxes	372	479
Losses from unconsolidated investees	1	1
Provision for income taxes	138	178
Net income	$ 233	$ 300

On December 19, 2006, the Company announced that its Board of Directors had approved the spin-off of Discover (see Other Items Discover Spin-off herein).

Merchant, Cardmember and Other Fees, Net. Merchant, cardmember and other fees, net, increased 3%, primarily due to higher cardmember and other fees and higher merchant discount revenues, partially offset by higher cardmember rewards. The increase in cardmember and other fees was primarily related to higher balance transfer fees and higher credit protection revenues. The increase in merchant discount revenue was due to higher sales volume, partially offset by higher allocations of interchange revenue to securitization transactions. The allocation of interchange revenue has the effect of decreasing Merchant, cardmember and other fees, net, and increasing Servicing and securitization income. During the quarter ended February 28, 2007, the Company had a higher level of outstanding securitization transactions receiving interchange allocations than in the comparable prior-year period. The increase in sales volume reflected the acquisition of Goldfish in February 2006 and increased cardmember usage in the U.S. The increase in cardmember rewards reflected higher sales volume and the impact of promotional programs.

Servicing and Securitization Income. The table below presents the components of servicing and securitization income:

	Three Months Ended February 28,	
	2007	2006
	(dollars in millions)	
Merchant, cardmember and other fees, net	$ 255	$ 230
Other revenue	(4)	139
Total non-interest revenues	251	369
Interest revenue	919	889
Interest expense	362	310
Net interest income	557	579
Provision for consumer loan losses	287	352
Net credit income	270	227
Servicing and securitization income	$ 521	$ 596

Servicing and securitization income decreased 13%, primarily due to a decrease in Other revenue and lower net interest income, partially offset by a lower provision for consumer loan losses and higher Merchant, cardmember and other fees, net. Other revenue for the quarter ended February 28, 2006 benefited from an increase in the fair value of the Company s retained interests in securitized receivables resulting from lower projected charge-offs following the enactment of new bankruptcy legislation in October 2005. The decrease in Other revenues also reflected a lower level of new general purpose credit card securitization transactions in the quarter ended February 28, 2007. The decrease in net interest income was attributable to a lower net interest spread rate, partially offset by a higher level of average securitized general purpose credit card loans. The lower provision for consumer loan losses was primarily attributable to a lower rate of net principal charge-offs on the securitized general purpose credit card portfolio. The increase in Merchant, cardmember and other fees, net primarily reflected a higher level of outstanding securitization transactions that received interchange allocations.

The net proceeds received from general purpose credit card asset securitizations were $1,578 million in the quarter ended February 28, 2007 and $6,613 million in the quarter ended February 28, 2006. The credit card asset securitization completed in the quarter ended February 28, 2007 has an expected maturity of approximately three years from the date of issuance.

Net Interest Income. Net interest income increased 11% due to an increase in interest revenue, partially offset by an increase in interest expense. The increase in interest revenue was due to a higher yield and an increase in average owned general purpose credit card loans. The increase in average owned general purpose credit card loans was due to the acquisition of Goldfish and higher sales volume, partially offset by a higher level of average securitized general purpose credit card loans. The increase in interest expense was primarily due to an increase in the Company s average cost of borrowings and a higher level of average interest bearing liabilities, primarily to support the increase in average owned general purpose credit card loans.

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The following tables present analyses of Discover s average balance sheets and interest rates for the quarters ended February 28, 2007 and 2006 and changes in net interest income during those periods:

Average Balance Sheet Analysis.

	Three Months Ended February 28,					
	2007			2006		
	Average Balance	Rate	Interest	Average Balance	Rate	Interest
	(dollars in millions)					
ASSETS						
Interest earning assets:						
General purpose credit card loans	$ 24,672	10.44%	$ 635	$ 21,976	9.87%	$ 535
Other consumer loans	96	6.56	2	306	7.52	6
Investment securities	80	5.14	1	39	3.70	
Other	2,983	5.76	42	4,033	4.65	45
Total interest earning assets	27,831	9.91	680	26,354	9.02	586
Allowance for loan losses	(832)			(838)		
Non-interest earning assets	3,110			2,157		
Total assets	$ 30,109			$ 27,673		
LIABILITIES AND SHAREHOLDER S EQUITY						
Interest bearing liabilities:						
Interest bearing deposits						
Savings	$ 3,453	5.27%	$ 45	$ 820	3.86%	$ 8
Brokered	9,920	5.05	123	12,394	4.46	136
Other time	1,570	4.87	19	1,783	4.40	19
Total interest bearing deposits	14,943	5.08	187	14,997	4.42	163
Other borrowings	7,243	5.57	100	6,001	4.55	68
Total interest bearing liabilities	22,186	5.24	287	20,998	4.46	231
Shareholder s equity/other liabilities	7,923			6,675		
Total liabilities and shareholder s equity	$ 30,109			$ 27,673		
Net interest income			$ 393			$ 355
Net interest margin(1)			5.73%			5.47%
Interest rate spread(2)		4.67%			4.56%	

(1) Net interest margin represents net interest income as a percentage of total interest earning assets.
(2) Interest rate spread represents the difference between the rate on total interest earning assets and the rate on total interest bearing liabilities.

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Rate/Volume Analysis.

Increase/(Decrease) due to Changes in:	Three Months Ended February 28, 2007 vs. 2006		
	Volume	Rate	Total
	(dollars in millions)		
Interest Revenue			
General purpose credit card loans	$ 65	$ 35	$ 100
Other consumer loans	(4)		(4)
Investment securities	1		1
Other	(12)	9	(3)
Total interest revenue	33	61	94
Interest Expense			
Interest bearing deposits:			
Savings	25	12	37
Brokered	(27)	14	(13)
Other time	(2)	2	
Total interest bearing deposits	(1)	25	24
Other borrowings	14	18	32
Total interest expense	13	43	56
Net interest income	$ 20	$ 18	$ 38

Provision for Consumer Loan Losses. The provision for consumer loan losses increased 26%. The increase reflected a lower net reduction of reserves as compared with the prior-year period, partially offset by lower net charge-offs. The net reduction in reserves was $38 million in the quarter ended February 28, 2007 as compared with a net reduction of $97 million in the comparable prior-year period. The decrease in net charge-offs primarily reflects a decline in bankruptcy filings following the federal bankruptcy legislation effective in October 2005, partially offset by higher contractual charge-offs in the U.S. as well as higher charge-offs in the U.K., reflecting increased bankruptcy charge-offs and the Goldfish acquisition.

Delinquencies and Charge-offs. Delinquency rates in both the over 30- and over 90-day categories were higher for the owned portfolio, primarily reflecting higher delinquencies in the U.K. Net principal charge-off rates were lower in both the owned and managed portfolios, reflecting portfolio credit quality and the continued favorable impact following the enactment of federal bankruptcy legislation (see Managed General Purpose Credit Card Loan Data herein). While the Company expects credit costs to continue to rise, the Company expects charge-off rates to remain relatively low and reach between 4.0% and 4.5% by the end of fiscal 2007.

In response to industry-wide regulatory guidance, the Company has increased minimum payment requirements on certain general purpose credit card loans. Bank regulators have discretion to interpret the guidance or its application, and changes in such guidance or its application by the regulators could impact minimum payment requirements. Increases in minimum payment requirements could negatively impact future levels of general purpose credit card loans and related interest and fee revenue and charge-offs.

The Company s future charge-off rates and credit quality are subject to uncertainties that could cause actual results to differ materially from what has been discussed above. Factors that influence the provision for consumer loan losses include the level and direction of general purpose credit card loan delinquencies and charge-offs, changes in consumer spending and payment behaviors, bankruptcy trends, regulatory changes or new guidance, the seasoning of the Company s general purpose credit card loan portfolio, interest rate movements and their impact on consumer behavior and changes in the Company s general purpose credit card loan portfolio, including the overall mix of accounts, products and loan balances within the portfolio.

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Non-Interest Expenses. Non-interest expenses increased 7% and reflected incremental costs as a result of the acquisition of Goldfish in February 2006. Compensation and benefits expense decreased 6%, primarily reflecting Discover s share ($17 million) of the incremental compensation expense related to equity awards to retirement-eligible employees in the first quarter of fiscal 2006 (see Other Items Stock-Based Compensation herein), partially offset by an increase in salaries and wages in the first quarter of fiscal 2007. Excluding compensation and benefits expense, non-interest expenses increased 16%. Marketing and business development expenses increased 19%, primarily due to higher marketing costs associated with account acquisition and higher holiday promotional spending. Professional services expenses increased 27%, primarily due to higher legal and consulting fees. Other expenses increased 20%, primarily due to an increase in certain operating expenses, including higher accruals for losses associated with fraud and an increase in the amortization of intangible assets.

Managed General Purpose Credit Card Loan Data. The Company analyzes its financial performance on both a managed loan basis and as reported under U.S. Generally Accepted Accounting Principles (U.S. GAAP) (owned loan basis). Managed loan data assume that the Company s securitized loan receivables have not been sold and present the results of the securitized loan receivables in the same manner as the Company s owned loans. The Company operates its Discover business and analyzes its financial performance on a managed basis. Accordingly, underwriting and servicing standards are comparable for both owned and securitized loans. The Company believes that managed loan information is useful to investors because it provides information regarding the quality of loan origination and credit performance of the entire managed portfolio and allows investors to understand the related credit risks inherent in owned loans and retained interests in securitizations. In addition, investors often request information on a managed basis, which provides a more meaningful comparison with industry competitors.

The following table provides a reconciliation of owned and managed average loan balances, returns on receivables, interest yields and interest rate spreads for the periods indicated:

Reconciliation of General Purpose Credit Card Loan Data (dollars in millions)

	Three Months Ended February 28,							
	2007				2006			
	Average Balance	Return on Receivables(1)	Interest Yield	Interest Rate Spread	Average Balance	Return on Receivables(1)	Interest Yield	Interest Rate Spread
General Purpose Credit Card Loans:								
Owned	$ 24,672	3.84%	10.44%	5.20%	$ 21,976	5.54%	9.87%	5.41%
Securitized	26,718	3.55%	13.96%	8.39%	25,599	4.75%	14.08%	9.20%
Managed	$ 51,390	1.84%	12.27%	6.85%	$ 47,575	2.56%	12.13%	7.44%

(1) Return on receivables is equal to Discover annualized income divided by average owned, securitized or managed credit card receivables, as applicable.

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The following tables present a reconciliation of owned and managed general purpose credit card loans and delinquency and net charge-off rates:

Reconciliation of General Purpose Credit Card Loan Asset Quality Data (dollars in millions)

	Three Months Ended February 28,					
	2007			2006		
		Delinquency Rates			Delinquency Rates	
	Period-End Loans	Over 30 Days	Over 90 Days	Period-End Loans	Over 30 Days	Over 90 Days
General Purpose Credit Card Loans:						
Owned	$ 22,410	3.16%	1.56%	$ 19,924	2.97%	1.36%
Securitized	28,320	3.67%	1.79%	27,901	3.79%	1.79%
Managed	$ 50,730	3.45%	1.69%	$ 47,825	3.45%	1.61%

	Three Months Ended February 28,	
	2007	2006
Net Principal Charge-offs:		
Owned	3.78%	4.54%
Securitized	4.30%	5.51%
Managed	4.05%	5.06%
Net Total Charge-offs (inclusive of interest and fees):		
Owned	5.01%	5.64%
Securitized	6.16%	7.86%
Managed	5.61%	6.83%

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Other Items.

Deferred Compensation Plans.

The Company maintains various deferred compensation plans for the benefit of certain employees. Beginning in the quarter ended February 28, 2007, increases or decreases in assets or earnings associated with such plans are reflected in net revenues, and increases or decreases in liabilities associated with such plans are reflected in compensation expense. Previously, the increases or decreases in assets and liabilities associated with these plans were both recorded in net revenues. Prior periods have been reclassified to conform to the current presentation. The amount of the reclassification that was recorded in the three months ended February 28, 2007 and February 28, 2006 was $245 million and $94 million, respectively.

Stock-Based Compensation.

For stock-based awards issued prior to the adoption of SFAS No. 123R, Share-Based Payment (SFAS No. 123R) as of December 1, 2004, the Company s accounting policy for awards granted to retirement-eligible employees was to recognize compensation cost over the service period specified in the award terms. The Company accelerates any unrecognized compensation cost for such awards if and when a retirement-eligible employee leaves the Company.

For fiscal 2005 year-end stock-based compensation awards that were granted to retirement-eligible employees in December 2005, the Company recognized the compensation cost for such awards on the date of grant instead of over the service period specified in the award terms. As a result, the Company recorded non-cash incremental compensation expenses of approximately $395 million in the first quarter of fiscal 2006 for stock-based awards granted to retirement-eligible employees as part of the fiscal 2005 year-end award process and for awards granted to retirement-eligible employees, including new hires, in the first quarter of fiscal 2006. These incremental expenses were included within Compensation and benefits expense and reduced income before taxes within the Institutional Securities ($270 million), Global Wealth Management Group ($80 million), Asset Management ($28 million) and Discover ($17 million) business segments.

Discontinued Operations.

Quilter. On February 28, 2007, the Company sold Quilter, which was formerly included within the Global Wealth Management Group business segment. The results of Quilter are included within discontinued operations for all periods presented. The results for discontinued operations in the quarter ended February 28, 2007 also included a pre-tax gain of $168 million ($109 million after-tax) on disposition (see Note 15 to the condensed consolidated financial statements).

Aircraft Leasing. On March 24, 2006, the Company sold its aircraft leasing business to Terra Firma, a European private equity group. The results for discontinued operations in the quarter ended February 28, 2006 included a loss of $125 million ($75 million after-tax) related to the impact of the finalization of the sales proceeds and balance sheet adjustments related to the closing (see Note 15 to the condensed consolidated financial statements and Financial Statements and Supplementary Data Note 18 in Part II, Item 8 of the Form 10-K for further information).

Discover Spin-off.

On December 19, 2006, the Company announced that its Board of Directors had approved the spin-off of Discover in order to enhance shareholder value. The Discover Spin-off will allow the Company to focus its efforts on more closely aligned firm-wide strategic priorities within its Institutional Securities, Global Wealth Management Group and Asset Management business segments. The Discover Spin-off is subject to regulatory approval and other customary conditions and is expected to occur in the third quarter of fiscal 2007. At the time of the Discover Spin-off, shareholders of the Company will receive shares in Discover on a generally tax-free basis.

Business and Other Acquisitions.

JM Financial. On February 22, 2007, the Company announced that it would dissolve its India joint venture with JM Financial. The Company has reached an agreement in principle to purchase the joint venture s

institutional equities sales, trading and research platform by acquiring JM Financial s 49% interest and to sell the Company s 49% interest in the joint venture s investment banking, fixed income and retail operation to JM Financial.

CityMortgage Bank. On December 21, 2006, the Company acquired CityMortgage Bank (CityMortgage), a Moscow-based mortgage bank that specializes in originating, servicing and securitizing residential mortgage loans in the Russian Federation. Since the acquisition date, the results of CityMortgage have been included within the Institutional Securities business segment.

Olco Petroleum Group Inc. On December 15, 2006, the Company acquired a 60% equity stake in Olco Petroleum Group Inc. (Olco), a petroleum products marketer and distributor based in eastern Canada. Since the acquisition date, the results of Olco have been included within the Institutional Securities business segment.

Saxon Capital, Inc. On December 4, 2006, the Company acquired Saxon, a servicer and originator of residential mortgages. Since the acquisition date, the results of Saxon have been included within the Institutional Securities business segment.

FrontPoint Partners. On December 4, 2006, the Company acquired FrontPoint, a provider of absolute return investment strategies. Since the acquisition date, the results of FrontPoint have been included within the Asset Management business segment.

Coleman Litigation.

In the first quarter of fiscal 2005, the Company recorded a $360 million charge related to the Coleman litigation matter (see Note 8 to the condensed consolidated financial statements). For further information, refer to Legal Proceedings in Part II, Item 1 of this report on Form 10-Q, Legal Proceedings in Part I, Item 3 of the Form 10-K and Financial Statements and Supplementary Data Note 9 in Part II, Item 8 of the Form 10-K.

On March 21, 2007, the District Court of Appeal for the Fourth District of Florida issued an opinion reversing the trial court s award for compensatory and punitive damages and remanding the case to the trial court for entry of a judgment for the Company. The opinion will become final upon disposition of any timely filed motions for rehearing.

Income Tax Examinations.

The Company is under continuous examination by the Internal Revenue Service (the IRS) and other tax authorities in certain countries, such as Japan and the U.K., and states in which the Company has significant business operations, such as New York. The tax years under examination vary by jurisdiction; for example, the current IRS examination covers 1999-2005. The Company regularly assesses the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years examinations. The Company has established tax reserves that the Company believes are adequate in relation to the potential for additional assessments. Once established, the Company adjusts tax reserves only when more information is available or when an event occurs necessitating a change to the reserves. The Company believes that the resolution of tax matters will not have a material effect on the condensed consolidated financial condition of the Company, although a resolution could have a material impact on the Company s condensed consolidated statement of income for a particular future period and on the Company s effective income tax rate for any period in which such resolution occurs.

Accounting Developments.

Limited Partnerships. In June 2005, the Financial Accounting Standards Board (FASB) ratified the consensus reached in Emerging Issues Task Force (EITF) Issue No. 04-5, Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights (EITF Issue No. 04-5). Under the provisions of EITF Issue No. 04-5, a general

partner in a limited partnership is presumed to control that limited partnership and, therefore, should include the limited partnership in its consolidated financial statements, regardless of the amount or extent of the general partner s interest unless a majority of the limited partners can vote to dissolve or liquidate the partnership or otherwise remove the general partner without having to show cause or the limited partners have substantive participating rights that can overcome the presumption of control by the general partner. EITF Issue No. 04-5 was effective immediately for all newly formed limited partnerships and existing limited partnerships for which the partnership agreements have been modified. For all other existing limited partnerships for which the partnership agreements have not been modified, the Company adopted EITF Issue No. 04-5 on December 1, 2006. The adoption of EITF Issue No. 04-5 on December 1, 2006 did not have a material impact on the Company s condensed consolidated financial statements.

Accounting for Certain Hybrid Financial Instruments. In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments (SFAS No. 155), which amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended (SFAS No. 133) and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS No. 140). SFAS No. 155 permits hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation to irrevocably be accounted for at fair value, with changes in fair value recognized in the statement of income. The fair value election may be applied on an instrument-by-instrument basis. SFAS No. 155 also eliminates a restriction on the passive derivative instruments that a qualifying special purpose entity may hold. The Company adopted SFAS No. 155 on December 1, 2006. Since SFAS No. 159 incorporates accounting and disclosure requirements that are similar to SFAS No. 155, the Company decided to apply SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159), rather than SFAS No. 155, to its fair value elections for hybrid financial instruments.

Accounting for Servicing of Financial Assets. In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140 (SFAS No. 156). SFAS No. 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. The standard permits an entity to subsequently measure each class of servicing assets or servicing liabilities at fair value and report changes in fair value in the statement of income in the period in which the changes occur. The Company adopted SFAS No. 156 on December 1, 2006 and has elected to fair value servicing rights held as of the date of adoption. This election did not have a material impact on the Company s opening balance of Retained earnings as of December 1, 2006. The Company also elected to fair value servicing rights acquired after December 1, 2006.

Accounting for Uncertainty in Income Taxes. In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for the Company as of December 1, 2007. The Company is currently evaluating the potential impact of adopting FIN 48.

Fair Value Measurements. In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. In addition, SFAS No. 157 disallows the use of block discounts for large holdings of unrestricted financial instruments where quoted prices are readily and regularly available in an active market, and nullifies select guidance provided by EITF Issue No. 02-3, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities (EITF Issue No. 02-3), which prohibited the recognition of trading gains or losses at the inception of a derivative contract, unless the fair value of such derivative is obtained from a quoted market price, or other valuation technique that incorporates observable market data. SFAS No. 157 also requires the Company to consider its own credit spreads when measuring the fair value of liabilities, including

derivatives. Effective December 1, 2006, the Company elected early adoption of SFAS No. 157. In accordance with the provisions of SFAS No. 157 related to block discounts and EITF Issue No. 02-3, the Company recorded a cumulative effect adjustment of approximately $80 million after-tax as an increase to the opening balance of Retained earnings as of December 1, 2006, which was primarily associated with EITF Issue No. 02-3. The impact of considering the Company s own credit spreads when measuring the fair value of liabilities, including derivatives, did not have a material impact on fair value measurements at the date of adoption. With the adoption of SFAS No. 157, the Company will no longer apply the revenue recognition criteria of EITF Issue No. 02-3.

Employee Benefit Plans. In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS No. 158). Among other items, SFAS No. 158 requires recognition of the overfunded or underfunded status of an entity s defined benefit and postretirement plans as an asset or liability in the financial statements and requires the measurement of defined benefit and postretirement plan assets and obligations as of the end of the employer s fiscal year. SFAS No. 158 s requirement to recognize the funded status in the financial statements is effective for fiscal years ending after December 15, 2006, and its requirement to use the fiscal year-end date as the measurement date is effective for fiscal years ending after December 15, 2008. The Company is currently assessing the impact that SFAS No. 158 will have on its condensed consolidated financial statements.

Fair Value Option. In February 2007, the FASB issued SFAS No. 159. SFAS No. 159 provides a fair value option election that allows companies to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities, with changes in fair value recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. Effective December 1, 2006, the Company elected early adoption of SFAS No. 159. As a result of the adoption of SFAS No. 159, the Company recorded a cumulative effect adjustment of approximately $102 million after-tax as an increase to the opening balance of Retained earnings as of December 1, 2006.

Critical Accounting Policies.

The Company s condensed consolidated financial statements are prepared in accordance with U.S. GAAP, which requires the Company to make estimates and assumptions (see Note 1 to the condensed consolidated financial statements). The Company believes that of its significant accounting policies (see Note 2 to the consolidated financial statements for the fiscal year ended November 30, 2006 included in the Form 10-K), the following may involve a higher degree of judgment and complexity.

Fair Value.

The Company s financial assets and financial liabilities are primarily recorded at fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

As a result of the Company s adoption of SFAS No. 159 on December 1, 2006, the Company elected the fair value option for certain instruments. Such instruments included loans and other financial instruments held by subsidiaries that are not registered broker-dealers as defined in the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities,* or that are held by investment companies as defined in the AICPA Audit and Accounting Guide, *Investment Companies*. A substantial portion of these positions, as well as the financial instruments included within Other secured financings, had been accounted for by the Company at fair value prior to the adoption of SFAS No. 159. Changes in the fair value of these positions are included within Principal transactions trading revenues in the Company s condensed consolidated statements of income.

Financial instruments owned and Financial instruments sold, not yet purchased, which include cash and derivative products, are recorded at fair value in the condensed consolidated statements of financial condition, and gains and losses are reflected net in Principal transactions trading revenues in the condensed consolidated statements of income.

The fair value of the Company s financial instruments are generally based on or derived from bid prices or parameters for Financial instruments owned and ask prices or parameters for Financial instruments sold, not yet purchased.

A substantial percentage of the fair value of the Company s financial instruments used for trading and investment is based on observable market prices, observable market parameters, or is derived from such prices or parameters. The availability of observable market prices and pricing parameters can vary from product to product. Where available, observable market prices and pricing parameters in a product (or a related product) may be used to derive a price without requiring significant judgment. In certain markets, such as for products that are less actively traded, observable market prices or market parameters are not available for all products, and fair value is determined using techniques appropriate for each particular product. These techniques involve some degree of judgment.

In the case of financial instruments transacted on recognized exchanges, the observable prices represent quotations for completed transactions from the exchange on which the financial instrument is principally traded. Also, as a result of the adoption of SFAS No. 157 on December 1, 2006, the Company no longer utilizes block discounts in cases where it has large holdings of unrestricted financial instruments with quoted prices that are readily and regularly available in an active market.

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

transparency for actively quoted instruments may be reduced for periods of time during periods of market dislocation. Alternatively, in thinly quoted markets, the participation of market-makers willing to purchase and sell a product provides a source of transparency for products that otherwise are not actively quoted or during periods of market dislocation. For further information on the observability of the pricing inputs used to determine the fair value of the Company s financial instruments, see Note 18 to the condensed consolidated financial statements.

The Company s cash products include securities issued by the U.S. government and its agencies, other sovereign debt obligations, certain corporate and other debt securities, corporate equity securities, exchange traded funds and physical commodities. The fair value of these products is based principally on observable market prices or is derived using observable market parameters. These products generally do not entail a significant degree of judgment in determining fair value. Examples of products for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters include securities issued by the U.S. government and its agencies, exchange traded corporate equity securities, most municipal debt securities, most corporate debt securities, most high-yield debt securities, physical commodities, certain tradable loan products and most mortgage-backed securities.

In certain circumstances, principally involving loan products and other financial instruments held for securitization transactions, the Company determines fair value from within the range of bid and ask prices such that fair value indicates the value likely to be realized in a current market transaction. Bid prices reflect the price that the Company and others pay, or stand ready to pay, to originators of such assets. Ask prices represent the prices that the Company and others require to sell such assets to the entities that acquire the financial instruments for purposes of completing the securitization transactions. Generally, the fair value of such acquired assets is based upon the bid price in the market for the instrument or similar instruments. In general, the loans and similar assets are valued at bid pricing levels until structuring of the related securitization is substantially complete and such that the value likely to be realized in a current transaction is consistent with the price that a securitization entity will pay to acquire the financial instruments. Factors affecting securitized value and investor demand relating specifically to loan products include, but are not limited to, loan type, underlying property type and geographic location, loan interest rate, loan to value ratios, debt service coverage ratio, investor demand and credit enhancement levels.

In addition, some cash products exhibit little or no price transparency, and the determination of fair value requires more judgment. Examples of cash products with little or no price transparency include certain high-yield debt, certain collateralized mortgage obligations, certain tradable loan products, distressed debt securities (i.e., securities of issuers encountering financial difficulties, including bankruptcy or insolvency) and equity securities that are not publicly traded. Generally, the fair value of these types of cash products is determined using one of several valuation techniques appropriate for the product, which can include cash flow analysis, revenue or net income analysis, default recovery analysis (i.e., analysis of the likelihood of default and the potential for recovery) and other analyses applied consistently.

The Company s derivative products include exchange traded and OTC derivatives. Exchange traded derivatives have valuation attributes similar to the cash products valued using observable market prices or market parameters described above. OTC derivatives, whose fair value is derived using pricing models, include a wide variety of instruments, such as interest rate swap and option contracts, foreign currency option contracts, credit and equity swap and option contracts, and commodity swap and option contracts.

The following table presents the fair value of the Company s exchange traded and OTC derivatives included within Financial instruments owned and Financial instruments sold, not yet purchased (dollars in millions):

	At February 28, 2007		At November 30, 2006	
	Assets	Liabilities	Assets	Liabilities
Exchange traded	$ 12,446	$ 16,390	$ 12,554	$ 17,094
OTC	38,506	35,184	42,889	40,397
Total	$ 50,952	$ 51,574	$ 55,443	$ 57,491

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The fair value of OTC derivative contracts is derived primarily using pricing models, which may require multiple market input parameters. Where appropriate, valuation adjustments are made to account for credit quality and market liquidity. These adjustments are applied on a consistent basis and are based upon observable market data where available. The Company also uses pricing models to manage the risks introduced by OTC derivatives. Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be modeled using a series of techniques, including closed-form analytic formulae, such as the Black-Scholes option pricing model, simulation models or a combination thereof, applied consistently. In the case of more established derivative products, the pricing models used by the Company are widely accepted by the financial services industry. Pricing models take into account the contract terms, including the maturity, as well as market parameters such as interest rates, volatility and the creditworthiness of the counterparty. As a result of the Company s adoption of SFAS No. 157 on December 1, 2006, the impact of the Company s own credit spreads are also considered when measuring the fair value of liabilities, including certain OTC derivative contracts.

Prior to the adoption of SFAS No. 157 on December 1, 2006, the Company followed the provisions of EITF Issue No. 02-3 (see Other Items Accounting Developments herein). Under EITF Issue No. 02-3, in the absence of observable market prices or parameters in an active market, observable prices or parameters of other comparable current market transactions, or other observable data supporting a fair value based on a pricing model at the inception of a contract, revenue recognition at the inception of an OTC derivative financial instrument was not permitted. Such revenue was recognized in income at the earlier of when there was market value observability or at the end of the contract period. In the absence of observable market prices or parameters in an active market, observable prices or parameters of other comparable current market transactions, or other observable data supporting a fair value based on a pricing model at the inception of a contract, fair value was based on the transaction price. With the adoption of SFAS No. 157, the Company is no longer applying the revenue recognition criteria of EITF Issue No. 02-3.

Many pricing models do not entail material subjectivity because the methodologies employed do not necessitate significant judgment, and the pricing inputs are observed from actively quoted markets, as is the case for generic interest rate swap and option contracts. A substantial majority of OTC derivative products valued by the Company using pricing models fall into this category. Other derivative products, typically the newest and most complex products, will require more judgment in the implementation of the modeling technique applied due to the complexity of the modeling assumptions and the reduced price transparency surrounding the model s market parameters. The Company manages its market exposure for OTC derivative products primarily by entering into offsetting derivative contracts or other related financial instruments. The Company s trading divisions, the Financial Control Department and the Market Risk Department continuously monitor the price changes of the OTC derivatives in relation to the offsetting positions. For a further discussion of the price transparency of the Company s OTC derivative products, see Quantitative and Qualitative Disclosures about Market Risk Risk Management Credit Risk in Part II, Item 7A of the Form 10-K.

Substantially all equity and debt investments purchased in connection with private equity and other investment activities are valued at fair value and are included within Other assets in the condensed consolidated statements of financial condition, and gains and losses are reflected in Principal transactions investment revenues. The carrying value of such investments reflects expected exit values based upon appropriate valuation techniques applied on a consistent basis. Such techniques employ various market, income and cost approaches to determine fair value at the measurement date. The Company s partnership interests, including general partnership and limited partnership interests in real estate funds, are included within Other assets in the condensed consolidated statements of financial condition and are recorded at fair value based upon changes in the fair value of the underlying partnership s net assets.

The Company employs control processes to validate the fair value of its financial instruments, including those derived from pricing models. These control processes are designed to assure that the values used for financial reporting are based on observable market prices or market-based parameters wherever possible. In the event that market prices or parameters are not available, the control processes are designed to assure that the valuation

approach utilized is appropriate and consistently applied and that the assumptions are reasonable. These control processes include reviews of the pricing model s theoretical soundness and appropriateness by Company personnel with relevant expertise who are independent from the trading desks. Additionally, groups independent from the trading divisions within the Financial Control and Market Risk Departments participate in the review and validation of the fair values generated from pricing models, as appropriate. Where a pricing model is used to determine fair value, recently executed comparable transactions and other observable market data are considered for purposes of validating assumptions underlying the model. Consistent with market practice, the Company has individually negotiated agreements with certain counterparties to exchange collateral (margining) based on the level of fair values of the derivative contracts they have executed. Through this margining process, one party or both parties to a derivative contract provides the other party with information about the fair value of the derivative contract to calculate the amount of collateral required. This sharing of fair value information provides additional support of the Company s recorded fair value for the relevant OTC derivative products. For certain OTC derivative products, the Company, along with other market participants, contributes derivative pricing information to aggregation services that synthesize the data and make it accessible to subscribers. This information is then used to evaluate the fair value of these OTC derivative products. For more information regarding the Company s risk management practices, see Quantitative and Qualitative Disclosures about Market Risk Risk Management in Part II, Item 7A of the Form 10-K.

Allowance for Consumer Loan Losses.

The allowance for consumer loan losses in the Company s Discover business is established through a charge to the provision for consumer loan losses. Provisions are made to reserve for estimated losses in outstanding loan balances. The allowance for consumer loan losses is a significant estimate that represents management s estimate of probable losses inherent in the consumer loan portfolio. The allowance for consumer loan losses is primarily applicable to the owned homogeneous consumer credit card loan portfolio and is evaluated quarterly for adequacy.

In estimating the allowance for consumer loan losses, the Company uses a systematic and consistently applied approach. This process starts with a migration analysis (a technique used to estimate the likelihood that a consumer loan will progress through the various stages of delinquency and ultimately charge-off) of delinquent and current consumer credit card accounts in order to determine the appropriate level of the allowance for consumer loan losses. The migration analysis considers uncollectible principal, interest and fees reflected in consumer loans. In evaluating the adequacy of the allowance for consumer loan losses, management also considers factors that may impact credit losses, including current economic conditions, recent trends in delinquencies and bankruptcy filings, account collection management, policy changes, account seasoning, loan volume and amounts, payment rates and forecasting uncertainties. A provision for consumer loan losses is charged against earnings to maintain the allowance for consumer loan losses at an appropriate level. The use of different estimates or assumptions could produce different provisions for consumer loan losses (see Discover Provision for Consumer Loan Losses herein).

Legal, Regulatory and Tax Contingencies.

In the normal course of business, the Company has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the issuers that would otherwise be the primary defendants in such cases are bankrupt or in financial distress.

The Company is also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental and self-regulatory agencies regarding the Company s business, including, among other matters, accounting and operational matters, certain of which may result in adverse judgments,

settlements, fines, penalties, injunctions or other relief. The number of these reviews, investigations and proceedings has increased in recent years with regard to many firms in the financial services industry, including the Company.

Reserves for litigation and regulatory proceedings are generally determined on a case-by-case basis and represent an estimate of probable losses after considering, among other factors, the progress of each case, prior experience and the experience of others in similar cases, and the opinions and views of internal and external legal counsel. Given the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss, if any, related to such matters, how such matters will be resolved, when they will ultimately be resolved or what the eventual settlement, fine, penalty or other relief, if any, might be.

The Company is subject to the income and indirect tax laws of the U.S., its states and municipalities and those of the foreign jurisdictions in which the Company has significant business operations. These tax laws are complex and subject to different interpretations by the taxpayer and the relevant governmental taxing authorities. The Company must make judgments and interpretations about the application of these inherently complex tax laws when determining the provision for income taxes and the expense for indirect taxes and must also make estimates about when in the future certain items affect taxable income in the various tax jurisdictions. Disputes over interpretations of the tax laws may be settled with the taxing authority upon examination or audit. The Company regularly assesses the likelihood of assessments in each of the taxing jurisdictions resulting from current and subsequent years examinations, and tax reserves are established as appropriate.

The Company establishes reserves for potential losses that may arise out of litigation, regulatory proceedings and tax audits to the extent that such losses are probable and can be estimated in accordance with SFAS No. 5, Accounting for Contingencies (SFAS No. 5). Once established, reserves are adjusted when there is more information available or when an event occurs requiring a change. Significant judgment is required in making these estimates, and the actual cost of a legal claim, tax assessment or regulatory fine/penalty may ultimately be materially different from the recorded reserves, if any.

See Notes 8 and 17 to the condensed consolidated financial statements for additional information on legal proceedings and income tax examinations.

Special Purpose Entities.

The Company enters into a variety of transactions with special purpose entities (SPE), primarily in connection with securitization activities. The Company engages in securitization activities related to commercial and residential mortgage loans, U.S. agency collateralized mortgage obligations, corporate bonds and loans, municipal bonds, credit card loans and other types of financial instruments. In most cases, these SPEs are deemed to be variable interest entities (VIE). Unless a VIE is determined to be a qualifying special purpose entity (QSPE), the Company is required under accounting guidance to perform an analysis of each VIE at the date upon which the Company becomes involved with it to determine whether the Company is the primary beneficiary of the VIE, in which case the Company must consolidate the VIE. QSPEs are not consolidated. The determination of whether an SPE meets the accounting requirements of a QSPE requires significant judgment, particularly in evaluating whether the permitted activities of the SPE are significantly limited and in determining whether derivatives held by the SPE are passive and nonexcessive. In addition, the analysis involved in determining whether an entity is a VIE, and in determining the primary beneficiary of a VIE, also requires significant judgment.

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Liquidity and Capital Resources.

The Company s senior management establishes the overall liquidity and capital policies of the Company. Through various risk and control committees, the Company s senior management reviews business performance relative to these policies, monitors the availability of alternative sources of financing, and oversees the liquidity and interest rate and currency sensitivity of the Company s asset and liability position. These committees, along with the Company s Treasury Department and other control groups, also assist in evaluating, monitoring and controlling the impact that the Company s business activities have on its condensed consolidated balance sheet, liquidity and capital structure, thereby helping to ensure that its business activities are integrated with the Company s liquidity and capital policies.

The Company s liquidity and funding risk management policies are designed to mitigate the potential risk that the Company may be unable to access adequate financing to service its financial obligations when they come due without material, adverse franchise or business impact. The key objectives of the liquidity and funding risk management framework are to support the successful execution of the Company s business strategies while ensuring ongoing and sufficient liquidity through the business cycle and during periods of financial distress. The principal elements of the Company s liquidity framework are the cash capital policy, the liquidity reserve and stress testing through the contingency funding plan. Comprehensive financing guidelines (collateralized funding, long-term funding strategy, surplus capacity, diversification, staggered maturities and committed credit facilities) support the Company s target liquidity profile.

For a more detailed summary of the Company s Liquidity and Capital Policies and funding sources, including committed credit facilities and off-balance sheet funding, refer to Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources in Part II, Item 7 of the Form 10-K.

The Balance Sheet.

The Company monitors and evaluates the composition and size of its balance sheet. Given the nature of the Company s market-making and customer financing activities, the size of the balance sheet fluctuates from time to time. A substantial portion of the Company s total assets consists of highly liquid marketable securities and short-term receivables arising principally from its Institutional Securities sales and trading activities. The highly liquid nature of these assets provides the Company with flexibility in financing and managing its business.

The Company s total assets increased to $1,182,061 million at February 28, 2007 from $1,121,192 million at November 30, 2006. The increase was primarily due to increases in financial instruments owned (largely driven by increases in corporate and other debt and corporate equities), securities received as collateral and securities purchased under agreements to resell, partially offset by a decrease in securities borrowed. The increases were largely the result of an increase in client business opportunities.

Balance sheet leverage ratios are one indicator of capital adequacy when viewed in the context of a company s overall liquidity and capital policies. The Company views the adjusted leverage ratio as a more relevant measure of financial risk when comparing financial services firms and evaluating leverage trends. The Company has adopted a definition of adjusted assets that excludes certain self-funded assets considered to have minimal market, credit and/or liquidity risk. These low-risk assets generally are attributable to the Company s matched book and securities lending businesses. Adjusted assets are calculated by reducing gross assets by aggregate resale agreements and securities borrowed less non-derivative short positions and assets recorded under certain provisions of SFAS No. 140 and FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities (FIN 46R). The adjusted leverage ratio reflects the deduction from shareholders equity of the amount of equity used to support goodwill and intangible assets (as the Company does not view this amount of equity as available to support its risk capital needs). In addition, the Company views junior subordinated debt issued to capital trusts as a component of its capital base given the inherent characteristics of

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the securities. These characteristics include the long-dated nature (e.g., some have final maturity at issuance of 30 years extendible at the Company s option by a further 19 years, others have a 60-year final maturity at issuance), the Company s ability to defer coupon interest for up to 20 consecutive quarters and the subordinated nature of the obligations in the capital structure. The Company also receives rating agency equity credit for these securities.

The following table sets forth the Company s total assets, adjusted assets and leverage ratios as of February 28, 2007 and November 30, 2006 and for the average month-end balances during the quarter ended February 28, 2007:

	Balance at		Average Month-End Balance
	February 28, 2007	November 30, 2006	For the Quarter Ended February 28, 2007
	(dollars in millions, except ratio data)		
Total assets	$ 1,182,061	$ 1,121,192	$ 1,166,926
Less: Securities purchased under agreements to resell	(192,038)	(174,866)	(188,409)
Securities borrowed	(277,093)	(299,631)	(294,859)
Add: Financial instruments sold, not yet purchased	157,807	183,119	165,189
Less: Derivative contracts sold, not yet purchased	(51,574)	(57,491)	(52,523)
Subtotal	819,163	772,323	796,324
Less: Segregated customer cash and securities balances	(21,264)	(16,782)	(18,640)
Assets recorded under certain provisions of SFAS No. 140 and FIN 46R	(124,163)	(100,236)	(113,151)
Goodwill and net intangible assets(1)	(4,262)	(3,443)	(4,045)
Adjusted assets	$ 669,474	$ 651,862	$ 660,488
Common equity	$ 36,854	$ 34,264	35,516
Preferred equity	1,100	1,100	1,100
Shareholders equity	37,954	35,364	36,616
Junior subordinated debt issued to capital trusts	4,885	4,884	4,884
Subtotal	42,839	40,248	41,500
Less: Goodwill and net intangible assets(1)	(4,262)	(3,443)	(4,045)
Tangible shareholders equity	$ 38,577	$ 36,805	$ 37,455
Leverage ratio(2)	30.6x	30.5x	31.2x
Adjusted leverage ratio(3)	17.4x	17.7x	17.6x

(1) Effective December 1, 2006, mortgage servicing rights have been included in net intangible assets. Amounts as of November 30, 2006 have been reclassified to conform with the current presentation.
(2) Leverage ratio equals total assets divided by tangible shareholders equity.
(3) Adjusted leverage ratio equals adjusted assets divided by tangible shareholders equity.

Activity in the Quarter Ended February 28, 2007.

The Company s total capital consists of shareholders equity, long-term borrowings (debt obligations scheduled to mature in more than 12 months) and junior subordinated debt issued to capital trusts. At February 28, 2007, total capital was $177,270 million, an increase of $15,136 million from November 30, 2006. The Company redeemed all $66 million of its outstanding Capital Units on February 28, 2007.

During the quarter ended February 28, 2007, the Company issued senior notes with a carrying value at quarter-end aggregating $22.2 billion, including non-U.S. dollar currency notes aggregating $10.3 billion. In connection

with the note issuances, the Company has entered into certain transactions to obtain floating interest rates based primarily on short-term London Interbank Offered Rates (LIBOR) trading levels. At February 28, 2007, the aggregate outstanding principal amount of the Company s Senior Indebtedness (as defined in the Company s senior debt indentures) was approximately $186 billion (including guaranteed obligations of the indebtedness of subsidiaries). The weighted average maturity of the Company s long-term borrowings, based upon stated maturity dates, was approximately 5.5 years at February 28, 2007.

During the quarter ended February 28, 2007, the Company purchased approximately $1.2 billion of its common stock (approximately 15 million shares) through open market purchases at an average cost of $82.02 (see also Unregistered Sales of Equity Securities and Use of Proceeds in Part II, Item 2). In December 2006, the Company announced that its Board of Directors had authorized the repurchase of up to $6 billion of the Company s outstanding common stock. This share repurchase authorization replaces the Company s previous repurchase authorizations with one repurchase program for capital management purposes that will consider, among other things, business segment capital needs, as well as equity-based compensation and benefit plan requirements. The Company expects to exercise the authorization over 12-18 months at prices the Company deems appropriate, subject to its unallocated capital position, market conditions and regulatory considerations.

Economic Capital.

The Company uses an economic capital model to determine the amount of equity capital needed to support the risk of its business activities and to ensure that the Company remains adequately capitalized. The Company calculates economic capital on a going-concern basis, which is defined as the amount of capital needed to run the business through the business cycle and satisfy the requirements of regulators, rating agencies and the market. Business unit economic capital allocations are evaluated by benchmarking to similarly rated peer firms by business segment. The Company believes this methodology provides an indication of the appropriate level of capital for each business segment as if each were an independent operating entity.

Economic capital requirements are allocated to each business segment and are sub-allocated to product lines as appropriate. This process is intended to align equity capital with the risks in each business, provide business managers with tools for measuring and managing risk, and allow senior management to evaluate risk-adjusted returns (such as return on economic capital and shareholder value added) to facilitate resource allocation decisions.

The Company s methodology is based on a going-concern approach that assigns equity to each business unit based on regulatory capital usage plus additional capital for stress losses, including principal investment risk. Regulatory capital, including additional capital assigned for goodwill and intangible assets, is a minimum requirement to ensure the Company s access to funding and credibility in the market. The Company believes it must be able to sustain stress losses and maintain capital substantially above regulatory minimums while supporting ongoing business activities. The difference between the Company s consolidated book equity and aggregate equity requirements denotes the Company s unallocated capital position, which is not currently reflected in business segment performance metrics.

The Company assesses stress loss capital across various dimensions of market, credit, business and operational risks. Stress losses are defined at the 90% to 95% confidence interval in order to capture worst potential losses in 10 to 20 years. Stress loss calculations are tangible and transparent and avoid reliance on extreme loss statistical models.

Market risk scenarios capture systematic, idiosyncratic and random market risk through the use of internal market stress data. Credit risk is included in the form of idiosyncratic counterparty default events. Business risk incorporates earnings volatility due to variability in revenue flows, with estimates on the mix of fixed versus variable expenses at various points in the business cycle. Operational stress losses primarily reflect legal risk across the Company.

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The Company may enhance the economic capital model and allocation methodology over time in response to changes in the business and regulatory environment to ensure that the model continues to reflect the risks inherent in the Company s business activities and to reflect changes in the drivers of the level and cost of required capital.

In the first quarter of fiscal 2007, economic capital requirements have been met by regulatory Tier 1 equity (including common shareholders equity, certain preferred stock, eligible hybrid capital instruments and deductions of goodwill and certain intangible assets and deferred tax assets), subject to regulatory limits.

The following table presents the Company s allocated average Tier 1 equity (economic capital) for the quarter ended February 28, 2007 and average common equity during the quarters ended February 28, 2007 and 2006:

	Three Months Ended February 28,		
	2007		2006
	Average Tier 1 equity	Average common equity	Average common equity
	(dollars in billions)		
Institutional Securities	$ 21.3	$ 20.3	$ 16.2
Global Wealth Management Group	1.5	1.7	3.3
Asset Management	2.0	2.7	2.0
Securities business	24.8	24.7	21.5
Discover	4.6	5.5	4.6
Capital surplus (unallocated)	5.1	5.1	3.2
Total continuing operations	34.5	35.3	29.3
Discontinued operations		0.2	0.2
Consolidated	$ 34.5	$ 35.5	$ 29.5

The increase in economic capital allocated to Institutional Securities from the prior year reflects the increased risk profile that has resulted from the Company s decisions to invest in key businesses. The Company expects this growth to continue, provided market opportunities continue to warrant such investments. For the quarter ended February 28, 2007, the Company reassessed the amount of capital required to support the market risks and credit risks in its Global Wealth Management Group business segment. The incremental equity capital allocated to Asset Management and Discover represents primarily capital required for acquisitions and seed investments and increased managed receivables, respectively. The $1.9 billion of incremental unallocated capital under the new methodology is due to the inclusion of eligible hybrid capital instruments, which is partially offset by the inclusion of certain deferred tax assets.

The Company currently anticipates that unallocated capital will be used for organic growth, additional acquisitions and other capital needs, including repurchases of common stock.

During fiscal 2007, the Company s shareholders equity has been affected by the adoption of SFAS No. 157 and SFAS No. 159 (see Other Items Accounting Developments herein).

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Liquidity Management Policies.

The primary goal of the Company s liquidity and funding activities is to ensure adequate financing over a wide range of potential credit ratings and market environments. Given the highly liquid nature of the Company s balance sheet, day-to-day funding requirements are largely fulfilled through the use of stable collateralized financing. The Company has centralized management of credit-sensitive unsecured funding sources in the Treasury Department. In order to meet target liquidity requirements and withstand an unforeseen contraction in credit availability, the Company has designed a liquidity management framework.

Liquidity Management Framework:	Designed to:
Contingency Funding Plan	Ascertain the Company s ability to manage a prolonged liquidity contraction and provide a course of action over a one-year time period to ensure orderly functioning of the businesses. The contingency funding plan sets forth the process and the internal and external communication flows necessary to ensure effective management of the contingency event. Analytical processes exist to periodically evaluate and report the liquidity risk exposures of the organization under management-defined scenarios.
Cash Capital	Ensure that the Company can fund its balance sheet while repaying its financial obligations maturing within one year without issuing new unsecured debt. The Company attempts to achieve this by maintaining sufficient cash capital (long-term debt and equity capital) to finance illiquid assets and the portion of its securities inventory that is not expected to be financed on a secured basis in a credit-stressed environment.
Liquidity Reserve	Maintain, at all times, a liquidity reserve composed of immediately available cash and cash equivalents and a pool of unencumbered securities that can be sold or pledged to provide same-day liquidity to the Company. The reserve is periodically assessed and determined based on day-to-day funding requirements and strategic liquidity targets. The liquidity reserve averaged approximately $52 billion for the quarter ended February 28, 2007, of which approximately $46 billion on average was held at the parent company.

Liquidity Reserve.

The Company seeks to maintain a target liquidity reserve that is sized to cover daily funding needs and to meet strategic liquidity targets, including coverage of a significant portion of expected cash outflows over a short-term horizon in a potential liquidity crisis. This liquidity reserve is held in the form of cash deposits with banks and a pool of unencumbered securities. The Company manages the pool of unencumbered securities, against which funding can be raised, on a global basis, and securities for the pool are chosen accordingly. The U.S. and non-U.S. components, held in the form of a reverse repurchase agreement at the parent company, consist of U.S. and European government bonds and other high-quality collateral and at February 28, 2007 were approximately $49 billion and averaged approximately $38 billion for the quarter ended February 28, 2007. The parent company cash component of the liquidity reserve at February 28, 2007 was approximately $3 billion and averaged approximately $8 billion for the quarter ended February 28, 2007. The Company believes that diversifying the form in which its liquidity reserve (cash and securities) is maintained enhances its ability to quickly and efficiently source funding in a stressed environment. The Company s funding requirements and target liquidity reserve may vary based on changes in the level and composition of its balance sheet, timing of specific transactions, client financing activity, market conditions and seasonal factors.

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Credit Ratings.

The Company s reliance on external sources to finance a significant portion of its day-to-day operations makes access to global sources of financing important. The cost and availability of unsecured financing generally are dependent on the Company s short-term and long-term credit ratings. Factors that are significant to the determination of the Company s credit ratings or that otherwise affect its ability to raise short-term and long-term financing include the Company s level and volatility of earnings, relative positions in the markets in which it operates, geographic and product diversification, retention of key personnel, risk profile, risk management policies, cash liquidity, capital structure, corporate lending credit risk, and legal and regulatory developments. In addition, continuing consolidation in the credit card industry presents Discover with stronger competitors that may challenge future growth. A deterioration in any of the previously mentioned factors or combination of these factors may lead rating agencies to downgrade the credit ratings of the Company, thereby increasing the cost to the Company in obtaining unsecured funding. In addition, the Company s debt ratings can have a significant impact on certain trading revenues, particularly in those businesses where longer term counterparty performance is critical, such as OTC derivative transactions, including credit derivatives and interest rate swaps.

In connection with certain OTC trading agreements and certain other agreements associated with the Institutional Securities business, the Company would be required to provide additional collateral to certain counterparties in the event of a downgrade by either Moody s Investors Service or Standard & Poor s. At February 28, 2007, the amount of additional collateral that would be required in the event of a one-notch downgrade of the Company s senior debt credit rating was approximately $643 million. Of this amount, $554 million relates to bilateral arrangements between the Company and other parties where upon the downgrade of one party, the downgraded party must deliver incremental collateral to the other. These bilateral downgrade arrangements are a risk management tool used extensively by the Company as credit exposures are reduced if counterparties are downgraded.

As of March 31, 2007, the Company s credit ratings were as follows:

	Commercial Paper	Senior Debt
Dominion Bond Rating Service Limited	R-1 (middle)	AA (low)
Fitch Ratings(1)	F1+	AA-
Moody s Investors Service	P-1	Aa3
Rating and Investment Information, Inc.	a-1+	AA
Standard & Poor s(2)	A-1	A+

(1) On December 19, 2006, Fitch Ratings changed the outlook on the Company s senior debt ratings from Stable to Negative.
(2) On October 27, 2006, Standard & Poor s changed the outlook on the Company s senior debt ratings from Stable to Positive.

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Commitments.

The Company s commitments associated with outstanding letters of credit, other financial guarantees, investment activities, and corporate lending and financing commitments as of February 28, 2007 are summarized below by period of expiration. Since commitments associated with letters of credit, other financial guarantees, and corporate lending and financing arrangements may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements:

	Years to Maturity				
	Less than 1	1-3	3-5	Over 5	Total
	(dollars in millions)				
Letters of credit and other financial guarantees(1)	$ 7,164	$ 38	$	$	$ 7,202
Investment activities	403	305	8	184	900
Investment grade corporate lending commitments(2)	5,174	5,836	18,638	5,077	34,725
Non-investment grade corporate lending commitments(2)	7,144	2,096	3,237	11,864	24,341
Commitments for secured lending transactions(3)	11,658	6,854	33	2,646	21,191
Commitments to purchase mortgage loans(4)	1,889				1,889
Commitments to originate mortgage loans(5)	901				901
Other commitments(6)	279	303	2		584
Total(7)	$ 34,612	$ 15,432	$ 21,918	$ 19,771	$ 91,733

(1) This amount represents the Company s outstanding letters of credit and other financial guarantees, which are primarily used to satisfy various collateral requirements.
(2) The Company s investment grade and non-investment grade primary and secondary lending commitments are made in connection with corporate lending and other business activities. Credit ratings for primary commitments are determined by the Company s Institutional Credit Department using methodologies generally consistent with those employed by external rating agencies. Credit ratings of BB+ or lower are considered non-investment grade.
(3) This amount represents lending commitments extended by the Company to companies that are secured by assets of the borrower. Loans made under these arrangements typically are at variable rates and generally provide for over-collateralization based upon the creditworthiness of the borrower.
(4) This amount represents the Company s forward purchase contracts involving mortgage loans.
(5) This amount represents residential mortgage loan commitments to individuals.
(6) This amount includes commercial loan commitments to small businesses and commitments related to securities-based lending activities.
(7) See Note 8 to the condensed consolidated financial statements.

As of February 28, 2007, the Company had commitments for secured lending transactions to subprime lenders of $5.2 billion, of which $2.3 billion was funded and fully collateralized. The unfunded commitments were $2.9 billion, which is included within commitments for secured lending transactions in the table above. As of March 31, 2007, the amount that was funded and fully collateralized to subprime lenders was $2.5 billion, and the amount of the unfunded commitments was $1.1 billion.

The table above does not include commitments to extend credit for consumer loans of approximately $273 billion. Such commitments arise primarily from agreements with customers for 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. In addition, in the ordinary course of business, the Company guarantees the debt and/or certain trading obligations (including obligations associated with derivatives, foreign exchange contracts and the settlement of physical commodities) of certain subsidiaries. These guarantees generally are entity or product specific and are required by investors or trading counterparties. The activities of the subsidiaries covered by these guarantees (including any related debt or trading obligations) are included in the Company s condensed consolidated financial statements.

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At February 28, 2007, the Company had commitments to enter into reverse repurchase and repurchase agreements of approximately $129 billion and $101 billion, respectively.

Principal Investments.

Principal investing activities are capital investments in companies, generally for proprietary purposes, to maximize total returns to the Company. The Company has committed to increasing its principal investing activity. At February 28, 2007, the Company had aggregate principal investments with a carrying value of approximately $2.4 billion, which are included within Other assets in the condensed consolidated statement of financial condition.

Regulatory Requirements.

Effective December 1, 2005, the Company became a consolidated supervised entity (CSE) as defined by the SEC. As such, the Company is subject to group-wide supervision and examination by the SEC and to minimum capital requirements on a consolidated basis. As of February 28, 2007, the Company was in compliance with the CSE capital requirements.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Market Risk.

The Company uses Value-at-Risk (VaR) as one of a range of risk management tools. VaR values should be interpreted in light of the method s strengths and limitations. A small proportion of market risk generated by trading positions is not included in VaR, and the modeling of the risk characteristics of some positions relies upon approximations that, under certain circumstances, could produce significantly different VaR results from those produced using more precise measures. For a further discussion of the Company s VaR methodology and its limitations, and the Company s risk management policies and control structure, see Quantitative and Qualitative Disclosures about Market Risk Risk Management in Part II, Item 7A of the Form 10-K.

The tables below present the following: the Company s quarter-end Aggregate (Trading and Non-trading), Trading, and Non-trading VaR (see Table 1 below); the Company s quarterly average, high, and low Trading VaR (see Table 2 below); and the VaR statistics that would result if the Company were to adopt alternative parameters for its calculations, such as the reported confidence level (95% vs. 99%) for the VaR statistic or a shorter historical time series (four years vs. one year) of market data upon which it bases its simulations (see Table 3 below). Aggregate Trading and Non-trading VaR incorporates certain non-trading positions that are not included in Trading VaR; these include (a) the funding liabilities related to institutional trading positions and (b) public-company equity positions recorded as investments by the Company. Investments made by the Company that are not publicly traded are not reflected in the VaR results below. Aggregate Trading and Non-trading VaR also excludes certain funding liabilities primarily related to fixed and other non-trading assets. As of February 28, 2007, the notional amount of funding liabilities related to non-trading assets (including office facilities and other equipment, goodwill, deferred tax assets, and intangible assets) was approximately $7.9 billion, with a duration of approximately 7.2 years.

The table below presents 95%/one-day VaR for each of the Company s primary risk exposures and on an aggregate basis at February 28, 2007 and November 30, 2006.

Table 1: 95% Total VaR	**Aggregate (Trading and Non-trading) 95%/One-Day VaR at**		**Trading 95%/One-Day VaR at**		**Non-trading 95%/One-Day VaR at**	
	February 28,	**November 30,**	**February 28,**	**November 30,**	**February 28,**	**November 30,**
Primary Market Risk Category	**2007**	**2006**	**2007**	**2006**	**2007**	**2006**
			(dollars in millions)			
Interest rate and credit spread	$ 37	$ 41	$ 38	$ 38	$ 11	$ 13
Equity price	42	58	39	55	6	5
Foreign exchange rate	13	9	13	9		
Commodity price	36	31	36	31		
Subtotal	128	139	126	133	17	18
Less diversification benefit(1)	50	50	50	48	4	3
Total VaR	$ 78	$ 89	$ 76	$ 85	$ 13	$ 15

(1) Diversification benefit equals the difference between Total VaR and the sum of the VaRs for the four risk categories. This benefit arises because the simulated one-day losses for each of the four primary market risk categories occur on different days; similar diversification benefits also are taken into account within each category.

The Company s Aggregate VaR and Trading VaR at February 28, 2007 were $78 million and $76 million, respectively, compared with $89 million and $85 million, respectively, at November 30, 2006. The decrease in Aggregate VaR and Trading VaR was primarily driven by a decrease in equity and interest rate exposures, as the Company reduced its risk profile toward the end of the quarter.

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The Company views average Trading VaR over a period of time as more representative of trends in the business than VaR at any single point in time. Table 2 below, which presents the high, low and average 95%/one-day Trading VaR during the quarters ended February 28, 2007 and November 30, 2006, represents substantially all of the Company s trading activities. Certain market risks included in the year-end Aggregate VaR discussed above are excluded from these measures (e.g., equity price risk in public company equity positions recorded as investments by the Company and certain funding liabilities related to trading positions).

Average Trading VaR for the quarter ended February 28, 2007 increased to $90 million from $61 million for the quarter ended November 30, 2006, reflecting increases in all primary market risk categories. The increase in equity price VaR was predominately driven by increased exposure to equity products. The increase in commodity price VaR was predominately driven by increased exposure to gas and electricity products. The increase in interest rate and credit spread VaR was predominately driven by increased exposure to interest rate sensitive products. The increase in foreign exchange rate VaR was predominately driven by increased directional exposure to foreign currencies.

Table 2: 95% High/Low/Average Trading VaR	Daily 95%/One-Day VaR for the Quarter Ended February 28, 2007			Daily 95%/One-Day VaR for the Quarter Ended November 30, 2006		
Primary Market Risk Category	High	Low	Average	High	Low	Average
	(dollars in millions)					
Interest rate and credit spread	$ 46	$ 36	$ 39	$ 40	$ 29	$ 34
Equity price	53	37	45	55	24	32
Foreign exchange rate	19	10	15	23	8	12
Commodity price	48	28	40	35	26	30
Trading VaR	$ 99	$ 76	$ 90	$ 85	$ 49	$ 61

VaR Statistics Under Varying Assumptions.

VaR statistics are not readily comparable across firms because of differences in the breadth of products included in each firm s VaR model, in the statistical assumptions made when simulating changes in market factors, and in the methods used to approximate portfolio revaluations under the simulated market conditions. These differences can result in materially different VaR estimates for similar portfolios. As a result, VaR statistics are more reliable and relevant when used as indicators of trends in risk taking within a firm rather than as a basis for inferring differences in risk taking across firms. Table 3 below presents the VaR statistics that would result if the Company were to adopt alternative parameters for its calculations, such as the reported confidence level (95% versus 99%) for the VaR statistic or a shorter historical time series (four years versus one year) for market data upon which it bases its simulations:

Table 3: Average 95% and 99% Trading VaR with Four-Year/One-Year Historical Time Series	Average 95%/One-Day VaR for the Quarter Ended February 28, 2007		Average 99%/One-Day VaR for the Quarter Ended February 28, 2007	
Primary Market Risk Category	Four-Year Factor History	One-Year Factor History	Four-Year Factor History	One-Year Factor History
	(dollars in millions)			
Interest rate and credit spread	$ 39	$ 32	$ 65	$ 51
Equity price	45	57	69	103
Foreign exchange rate	15	17	22	28
Commodity price	40	45	61	59
Trading VaR	$ 90	$ 101	$ 137	$ 146

In addition, if the Company were to report Trading VaR (using a four-year historical time series) with respect to a 10-day holding period, the Company s 95% and 99% Average Trading VaR for the quarter ended February 28, 2007 would have been $284 million and $433 million, respectively.

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Distribution of VaR Statistics and Net Revenues for the quarter ended February 28, 2007.

As shown in Table 2 above, the Company s average 95%/one-day Trading VaR for the quarter ended February 28, 2007 was $90 million. The histogram below presents the distribution of the Company s daily 95%/one-day Trading VaR for the quarter ended February 28, 2007. The most frequently occurring value was between $87 million and $96 million, while for approximately 83% of trading days during the quarter, VaR ranged between $78 million and $96 million.

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One method of evaluating the reasonableness of the Company s VaR model as a measure of the Company s potential volatility of net revenue is to compare the VaR with actual trading revenue. Assuming no intra-day trading, for a 95%/one-day VaR, the expected number of times that trading losses should exceed VaR during the fiscal year is 13, and, in general, if trading losses were to exceed VaR more than 21 times in a year, the accuracy of the VaR model could be questioned. Accordingly, the Company evaluates the reasonableness of its VaR model by comparing the potential declines in portfolio values generated by the model with actual trading results. The histogram below shows the distribution of daily net revenue during the quarter ended February 28, 2007 for the Company s trading businesses (including net interest and non-agency commissions but excluding primary, fee-based and prime brokerage revenue credited to the trading businesses). There were no days during the quarter ended February 28, 2007 in which the Company incurred daily trading losses in excess of the 95%/one-day Trading VaR. Additionally, there were no days during the quarter where the largest one-day loss exceeded the lowest 95% One-day Aggregate Trading VaR reported in Table 2 above.

As of February 28, 2007, interest rate risk exposure associated with the Company s consumer lending activities, included within Discover, as measured by the reduction in pre-tax income resulting from a hypothetical, immediate 100 basis point increase in interest rates, had not changed significantly from November 30, 2006.

Credit Risk.

For a further discussion of the Company s credit risks, see Quantitative and Qualitative Disclosures about Market Risks Credit Risk in Part II, Item 7A of the Form 10-K.

Credit Exposure-Corporate Lending**.** In connection with certain of its Institutional Securities business activities, the Company provides loans or lending commitments (including bridge financing) to selected clients. The borrowers may be rated investment grade or non-investment grade. These loans and commitments have varying terms, may be senior or subordinated, may be secured or unsecured, are generally contingent upon representations, warranties and contractual conditions applicable to the borrower, and may be syndicated or traded by the Company. At February 28, 2007 and November 30, 2006, the aggregate value of primary investment grade loans and financial accommodations was $6.2 billion and $6.4 billion, respectively, and the aggregate value of primary non-investment grade loans and positions was $3.9 billion and $3.4 billion, respectively. At February 28, 2007 and November 30, 2006, the aggregate value of primary lending

commitments outstanding was $53.2 billion and $49.2 billion, respectively. In connection with these business activities (which include corporate funded loans and lending commitments), the Company had hedges with a notional amount of $29.9 billion and $26.5 billion at February 28, 2007 and November 30, 2006, respectively, including both internal and external hedges utilized by the lending business. The table below shows the Company s credit exposure from its corporate lending positions and commitments as of February 28, 2007. Since commitments associated with these business activities may expire unused, they do not necessarily reflect the actual future cash funding requirements:

Corporate Lending Commitments and Funded Loans

Credit Rating(1)	Years to Maturity Less than 1	1-3	3-5	Over 5	Total Corporate Lending Exposure(2)	Corporate Loans
	(dollars in millions)					
AAA	$ 371	$	$ 268	$	$ 639	$
AA	2,802	2,103	2,402	815	8,122	1,155
A	1,363	2,519	6,601	1,024	11,507	294
BBB	2,015	2,696	10,387	1,173	16,271	4,749
Non-investment grade	7,794	2,658	3,570	12,753	26,775	3,930
Total	$ 14,345	$ 9,976	$ 23,228	$ 15,765	$ 63,314	$ 10,128
Notional amount of hedges owned					$ 29,856	

(1) Obligor credit ratings are determined by Institutional Credit using methodologies generally consistent with those employed by external rating agencies.
(2) Total corporate lending exposure includes both primary lending commitments and funded loans.

Credit Exposure-Derivatives. The table below presents a summary by counterparty credit rating and remaining contract maturity of the fair value of OTC derivatives in a gain position at February 28, 2007. Fair value represents the risk reduction arising from master netting agreements, where applicable, and, in the final column, net of collateral received (principally cash and U.S. government and agency securities):

OTC Derivative Products Financial Instruments Owned(1)

Credit Rating(2)	Years to Maturity Less than 1	1-3	3-5	Over 5	Cross-Maturity and Cash Collateral Netting(3)	Net Exposure Post-Cash Collateral	Net Exposure Post-Collateral
	(dollars in millions)						
AAA	$ 1,443	$ 930	$ 855	$ 2,673	$ (1,970)	$ 3,931	3,875
AA	6,525	5,005	4,736	14,126	(16,959)	13,433	12,426
A	3,358	2,509	2,126	5,941	(6,696)	7,238	6,355
BBB	2,014	2,079	2,722	1,689	(2,389)	6,115	4,355
Non-investment grade	2,973	1,797	2,551	2,307	(3,379)	6,249	3,183
Unrated(4)	688	666	172	510	(496)	1,540	342
Total	$ 17,001	$ 12,986	$ 13,162	$ 27,246	$ (31,889)	$ 38,506	$ 30,536

(1) Fair values shown present the Company s exposure to counterparties related to the Company s OTC derivative products. The table does not include the effect of any related hedges utilized by the Company. The table also excludes fair values corresponding to other credit exposures, such as those arising from the Company s lending activities.

(2) Obligor credit ratings are determined by Institutional Credit using methodologies generally consistent with those employed by external rating agencies.
(3) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within such maturity category, where appropriate. Cash collateral received is netted on a counterparty basis, provided legal right of offset exists.

(4) In lieu of making an individual assessment of the creditworthiness of unrated companies, the Company makes a determination that the collateral held with respect to such obligations is sufficient to cover a substantial portion of its exposure. In making this determination, the Company takes into account various factors, including legal uncertainties and market volatility.

The following tables summarize the fair values of the Company s OTC derivative products recorded in Financial instruments owned and Financial instruments sold, not yet purchased by product category and maturity at February 28, 2007, including on a net basis, where applicable, reflecting the fair value of related non-cash collateral for financial instruments owned:

OTC Derivative Products Financial Instruments Owned

	Years to Maturity				Cross-Maturity and Cash Collateral	Net Exposure Post-Cash	Net Exposure Post-
Product Type	**Less than 1**	**1-3**	**3-5**	**Over 5**	**Netting(1)**	**Collateral**	**Collateral**
	(dollars in millions)						
Interest rate and currency swaps, interest rate options, credit derivatives and other fixed income securities contracts	$ 4,129	$ 5,132	$ 8,172	$ 25,413	$ (23,606)	$ 19,240	$ 16,165
Foreign exchange forward contracts and options	4,215	698	78	8	(645)	4,354	3,714
Equity securities contracts (including equity swaps, warrants and options)	3,761	2,447	743	238	(2,535)	4,654	2,449
Commodity forwards, options and swaps	4,896	4,709	4,169	1,587	(5,103)	10,258	8,208
Total	$ 17,001	$ 12,986	$ 13,162	$ 27,246	$ (31,889)	$ 38,506	$ 30,536

(1) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity and product categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within the maturity category, where appropriate. Cash collateral received is netted on a counterparty basis, provided legal right of offset exists.

OTC Derivative Products Financial Instruments Sold, Not Yet Purchased(1)

	Years to Maturity				Cross-Maturity and Cash Collateral	
Product Type	**Less than 1**	**1-3**	**3-5**	**Over 5**	**Netting(2)**	**Total**
	(dollars in millions)					
Interest rate and currency swaps, interest rate options, credit derivatives and other fixed income securities contracts	$ 4,529	$ 5,261	$ 6,915	$ 16,269	$ (19,779)	$ 13,195
Foreign exchange forward contracts and options	4,667	502	77	24	(659)	4,611
Equity securities contracts (including equity swaps, warrants and options)	3,889	3,006	1,876	688	(1,434)	8,025
Commodity forwards, options and swaps	6,941	5,086	1,430	1,499	(5,603)	9,353
Total	$ 20,026	$ 13,855	$ 10,298	$ 18,480	$ (27,475)	$ 35,184

(1) Since these amounts are liabilities of the Company, they do not result in credit exposures.
(2) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity and product categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within the maturity category, where appropriate. Cash collateral paid is netted on a counterparty basis, provided legal right of offset exists.

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The Company s derivatives (both listed and OTC) at February 28, 2007 and November 30, 2006 are summarized in the table below, showing the fair value of the related assets and liabilities by product:

Product Type	At February 28, 2007		At November 30, 2006	
	Assets	Liabilities	Assets	Liabilities
	(dollars in millions)			
Interest rate and currency swaps, interest rate options, credit derivatives and other fixed income securities contracts	$ 19,300	$ 13,284	$ 19,444	$ 15,688
Foreign exchange forward contracts and options	4,354	4,610	7,325	7,725
Equity securities contracts (including equity swaps, warrants and options)	16,409	23,421	16,705	23,155
Commodity forwards, options and swaps	10,889	10,259	11,969	10,923
Total	$ 50,952	$ 51,574	$ 55,443	$ 57,491

Each category of OTC derivative products in the above tables includes a variety of instruments, which can differ substantially in their characteristics. Instruments in each category can be denominated in U.S. dollars or in one or more non-U.S. currencies.

The Company determines the fair values recorded in the above tables using various pricing models. For a discussion of fair value as it affects the condensed consolidated financial statements, see Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies in Part I, Item 2 and Note 1 to the condensed consolidated financial statements. As discussed under Critical Accounting Policies, the structure of the transaction, including its maturity, is one of several important factors that may impact the price transparency. The impact of maturity on price transparency can differ significantly among product categories. For example, single currency and multi-currency interest rate derivative products involving highly standardized terms and the major currencies (e.g., the U.S. dollar or the euro) will generally have greater price transparency from published external sources even in maturity ranges beyond 20 years. Credit derivatives with highly standardized terms and liquid underlying reference instruments can have price transparency from published external sources in a maturity ranging up to 10 years, while equity and foreign exchange derivative products with standardized terms in major currencies can have price transparency from published external sources within a two-year maturity range. Commodity derivatives with standardized terms and delivery locations can have price transparency from published external sources within various maturity ranges up to 10 years, depending on the commodity. In most instances of limited price transparency based on published external sources, dealers in these markets, in their capacities as market-makers and liquidity providers, provide price transparency beyond the above maturity ranges.

Country Exposure. The Company monitors its credit exposure and risk to individual countries. Credit exposure to a country arises from the Company s lending activities and derivatives activities in a country. At February 28, 2007, approximately 5% of the Company s credit exposure (for credit exposure arising from primary corporate loans and lending commitments and current exposure arising from the Company s OTC derivatives contracts) was to emerging markets, and no one emerging market country accounted for more than 1% of the Company s credit exposure. Country credit ratings are derived using methodologies generally consistent with those employed by external rating agencies.

Industry Exposure. The Company also monitors its credit exposure and risk to individual industries. At February 28, 2007, the Company s material credit exposure (for credit exposure arising from primary corporate loans and lending commitments and current exposure arising from the Company s OTC derivatives contracts) was to entities engaged in the following industries: utilities, financial institutions, sovereign-related entities, media, transportation, consumer-related entities and healthcare.

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Item 4. Controls and Procedures

Under the supervision and with the participation of the Company s management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act)). Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

No change in the Company s internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) occurred during the period covered by this report that materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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Part II OTHER INFORMATION

Item 1. Legal Proceedings

In addition to the matters described in the Company s Annual Report on Form 10-K for the fiscal year ended November 30, 2006 (the Form 10-K) and those described below, in the normal course of business, the Company has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the issuers that would otherwise be the primary defendants in such cases are bankrupt or in financial distress.

The Company is also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental and self-regulatory agencies regarding the Company s business, including, among other matters, accounting and operational matters, certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief. The number of these reviews, investigations and proceedings has increased in recent years with regard to many firms in the financial services industry, including the Company.

The Company contests liability and/or the amount of damages in each pending matter. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss, if any, related to such matters, how or if such matters will be resolved, when they will ultimately be resolved, or what the eventual settlement, fine, penalty or other relief, if any, might be. Subject to the foregoing, and except for the *Coleman Litigation* (see also Note 8 in Notes to Condensed Consolidated Financial Statements in Part I, Item 1), the Company believes, based on current knowledge and after consultation with counsel, that the outcome of the pending matters will not have a material adverse effect on the consolidated financial condition of the Company, although the outcome of such matters could be material to the Company s operating results for a particular future period, depending on, among other things, the level of the Company s revenues or income for such period.

The following developments have occurred with respect to certain matters previously reported in the Form 10-K.

Coleman Litigation.

On March 21, 2007, the District Court of Appeal for the Fourth District of Florida issued an opinion reversing the trial court s award for compensatory and punitive damages and remanding the matter to the trial court for entry of judgment for the Company. The opinion will become final upon disposition of any timely filed motions for rehearing.

Global Wealth Management Group Employment Matters.

Wage and Hour Matters. On January 19, 2007, a putative class action, captioned *Christopher D. Bart and Eric N. Wulff v. Morgan Stanley DW Inc.*, seeking to recover unpaid overtime for a class of financial advisors was filed in the U.S. District Court for the Northern District of Ohio, Eastern District Cleveland.

Gender Matters. On February 22, 2007, in *Joanne Augst-Johnson et al. v. Morgan Stanley DW Inc.*, the Company reached agreement to resolve the matter. The agreement, which is subject to, among other things, court approval, will resolve all of the class-wide and individual plaintiffs claims raised in the complaint.

On March 21, 2007, in *Daisy Jaffe v. Morgan Stanley DW Inc.*, the court issued an order extending the stay until April 15, 2007.

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AOL Time Warner Litigation.

In February 2007 and March 2007, the parties entered into settlement agreements that resolved all claims in the coordinated California action, the Ohio action and the West Virginia Action, with the exception of plaintiffs claims against Ernst & Young.

Item 1A. Risk Factors

For a discussion of the risk factors affecting the Company, see Risk Factors in Part I, Item 1A of the Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The table below sets forth the information with respect to purchases made by or on behalf of the Company of its common stock during the quarterly period ended February 28, 2007.

Issuer Purchases of Equity Securities

(dollars in millions, except per share amounts)

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased As Part of Publicly Announced Plans or Programs (D)	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
Month #1				
(December 1, 2006 December 31, 2006)				
Share Repurchase Program (A)	986,000	$ 80.50	986,000	$ 5,920,626,462
Employee Transactions (B)	455,692	$ 80.83	N/A	N/A
Odd-Lot Tender Shares (C)	184,604	$ 78.41	184,604	N/A
Month #2				
(January 1, 2007 January 31, 2007)				
Share Repurchase Program (A)	7,485,067	$ 81.88	7,485,067	$ 5,307,745,610
Employee Transactions (B)	1,023,829	$ 81.62	N/A	N/A
Odd-Lot Tender Shares (C)	25,816	$ 80.40	25,816	N/A
Month #3				
(February 1, 2007 February 28, 2007)				
Share Repurchase Program (A)	6,071,415	$ 82.43	6,071,415	$ 4,807,283,856
Employee Transactions (B)	92,510	$ 79.64	N/A	N/A
Odd-Lot Tender Shares (C)	2,359	$ 81.70	2,359	N/A
Total				
Share Repurchase Program (A)	14,542,482	$ 82.02	14,542,482	$ 4,807,283,856
Employee Transactions (B)	1,572,031	$ 81.28	N/A	N/A
Odd-Lot Tender Shares (C)	212,779	$ 78.69	212,779	N/A

(A)

On December 19, 2006, the Company announced that its Board of Directors authorized the repurchase of up to $6 billion of the Company s outstanding stock under a new share repurchase program (the Share Repurchase Program). The Share Repurchase Program replaces the Company s Equity Anti-dilution Program and Capital Management Program with one repurchase program for capital management purposes that will consider, among other things, business segment capital needs, as well as equity-based compensation and benefit plan requirements. The Company expects to exercise the authorization over 12-18 months at prices the Company deems appropriate, subject to its unallocated capital position, market conditions and regulatory considerations.

(B) Includes: (1) shares delivered or attested to in satisfaction of the exercise price and/or tax withholding obligations by holders of employee stock options (granted under employee stock compensation plans) who exercised options; (2) restricted shares withheld (under the terms of grants under employee stock compensation plans) to offset tax withholding obligations that occur upon vesting and release of restricted shares; and (3) shares withheld (under the terms of grants under employee stock compensation plans) to offset tax withholding obligations that occur upon the delivery of outstanding shares underlying restricted stock units. The Company s employee stock compensation plans provide that the value of the shares delivered or attested, or withheld, shall be valued using the fair market value of the Company common stock on the date the relevant transaction occurs, using a valuation methodology established by the Company.

(C) Repurchases by the Company pursuant to an odd lot tender offer authorized by the Company s Board of Directors on September 19, 2006. Pursuant to the offer, which ended in March 2007, the Company offered to purchase all shares of common stock held by stockholders holding less than 100 shares of common stock.

(D) Share purchases under publicly announced programs are made pursuant to open-market purchases, Rule 10b5-1 plans or privately negotiated transactions (including with employee benefit plans) as market conditions warrant and at prices the Company deems appropriate.

Item 6. Exhibits

An exhibit index has been filed as part of this Report on Page E-1.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MORGAN STANLEY

(Registrant)

By: /s/ DAVID H. SIDWELL
David H. Sidwell,

Principal Financial Officer

By: /s/ PAUL C. WIRTH
Paul C. Wirth,

Controller and Principal Accounting Officer

Date: April 5, 2007

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EXHIBIT INDEX

MORGAN STANLEY

Quarter Ended February 28, 2007

Exhibit No.	Description
3	Amended and Restated Certificate of Incorporation, as amended to date.
10	Amendment to Morgan Stanley 401(k) Plan.
11	Statement Re: Computation of Earnings Per Common Share (The calculation of per share earnings is in Part I, Item 1, Note 8 to the Condensed Consolidated Financial Statements (Earnings per Share) and is omitted in accordance with Section (b)(11) of Item 601 of Regulation S-K).
12	Statement Re: Computation of Ratio of Earnings to Fixed Charges and Computation of Earnings to Fixed Charges and Preferred Stock Dividends.
15	Letter of awareness from Deloitte & Touche LLP, dated April 5, 2007, concerning unaudited interim financial information.
31.1	Rule 13a-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) Certification of Chief Financial Officer.
32.1	Section 1350 Certification of Chief Executive Officer.
32.2	Section 1350 Certification of Chief Financial Officer.

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