

# MORNINGSTAR, INC.

## FORM 10-Q (Quarterly Report)

Filed 11/9/2006 For Period Ending 9/30/2006

|             |  |
|-------------|--|
| Address     | 225 WEST WACKER DRIVE<br>CHICAGO, Illinois 60606 |
| Telephone   | (312) 696-6000                                   |
| CIK         | 0001289419                                       |
| Industry    | Computer Services                                |
| Sector      | Technology                                       |
| Fiscal Year | 12/31  |

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington D.C. 20549

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**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006**

**OR**

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

For the transition period from        to

Commission File Number: 000-51280

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**MORNINGSTAR, INC.**

(Exact Name of Registrant as Specified in its Charter)

**Illinois**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**36-3297908**  
(I.R.S. Employer  
Identification Number)

**225 West Wacker Drive**  
**Chicago, Illinois**  
**60606-6303**  
(Address of Principal Executive Offices)

**(312) 696-6000**  
(Registrant's Telephone Number, Including Area Code)

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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  No

Indicate by check mark whether the Registrant is a large accelerated filer, accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of November 1, 2006, there were 41,772,625 shares of the Company's common stock, no par value, outstanding.

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**MORNINGSTAR, INC. AND SUBSIDIARIES  
INDEX**

**PART 1 FINANCIAL INFORMATION**

Item 1. Unaudited Condensed Consolidated Financial Statements

Unaudited Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2006 and 2005

Unaudited Condensed Consolidated Balance Sheets as of September 30, 2006 and December 31, 2005

Unaudited Condensed Consolidated Statements of Shareholders' Equity and Comprehensive Income for the nine months ended September 30, 2006

Unaudited Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2006 and 2005

Notes to Unaudited Condensed Consolidated Financial Statements

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

Item 3. Quantitative and Qualitative Disclosure about Market Risk

Item 4. Controls and Procedures

**PART 2 OTHER INFORMATION**

Item 1. Legal Proceedings

Item 1A. Risk Factors

Item 6. Exhibits

**SIGNATURE**





**Morningstar, Inc. and Subsidiaries**  
**Unaudited Condensed Consolidated Balance Sheets**

| (in thousands except share amounts)  | September 30<br>2006 | December 31<br>2005 |
|--|----------------------|---------------------|
| <b>Assets</b>  |                      |                     |
| Current assets:  |                      |                     |
| Cash and cash equivalents  | \$ 71,181            | \$ 92,367           |
| Investments  | 53,069               | 60,823              |
| Accounts receivable, less allowance of \$101 and \$418, respectively   | 57,893               | 47,530              |
| Deferred tax asset, net  | 61                   | —                   |
| Other  | 6,777                | 5,495               |
| Total current assets   | <u>188,981</u>       | <u>206,215</u>      |
| Property, equipment, and capitalized software, net of accumulated depreciation of \$46,382 and \$40,687, respectively  | 16,102               | 17,355              |
| Investments in unconsolidated entities   | 18,218               | 16,355              |
| Goodwill   | 84,542               | 17,500              |
| Intangible assets, net   | 77,876               | 7,251               |
| Deferred tax asset, net  | 8,907                | 29,729              |
| Other assets   | 2,263                | 1,906               |
| Total assets   | <u>\$ 396,889</u>    | <u>\$ 296,311</u>   |
| <b>Liabilities and shareholders' equity</b>  |                      |                     |
| Current liabilities:   |                      |                     |
| Accounts payable and accrued liabilities   | \$ 21,367            | \$ 13,664           |
| Accrued compensation   | 29,423               | 26,463              |
| Income tax payable   | 2,470                | 1,259               |
| Deferred revenue   | 92,750               | 71,155              |
| Deferred tax liability, net  | —                    | 833                 |
| Other  | 2,312                | 2,467               |
| Total current liabilities  | <u>148,322</u>       | <u>115,841</u>      |
| Accrued compensation   | 5,147                | 4,458               |
| Other long-term liabilities  | 3,471                | 2,298               |
| Total liabilities  | <u>156,940</u>       | <u>122,597</u>      |
| Shareholders' equity:  |                      |                     |
| Common stock, no par value, 200,000,000 shares authorized, of which 41,610,949 and 40,284,513 shares were outstanding as of September 30, 2006 and December 31, 2005, respectively | 4                    | 4                   |
| Treasury stock at cost, 233,334 shares as of September 30, 2006 and December 31, 2005  | (3,280)              | (3,280)             |
| Additional paid-in capital   | 254,466              | 226,593             |
| Accumulated deficit  | (12,457)             | (50,608)            |
| Accumulated other comprehensive income:  |                      |                     |
| Currency translation adjustment  | 1,287                | 1,130               |
| Unrealized losses on available for sale securities   | (71)                 | (125)               |
| Total accumulated other comprehensive income   | <u>1,216</u>         | <u>1,005</u>        |
| Total shareholders' equity   | <u>239,949</u>       | <u>173,714</u>      |
| Total liabilities and shareholders' equity   | <u>\$ 396,889</u>    | <u>\$ 296,311</u>   |

See notes to unaudited condensed consolidated financial statements.

**Morningstar, Inc. and Subsidiaries**  
**Unaudited Condensed Consolidated Statement of Shareholders' Equity and Comprehensive Income**  
**For the Nine Months Ended September 30, 2006**

| (in thousands, except share amounts)                            | Common Stock       |             | Treasury Stock    | Additional Paid-in Capital | Accumulated Deficit | Accumulated Other Comprehensive Income | Total Shareholders' Equity |
|---|--------------------|-------------|-------------------|----------------------------|---------------------|--|----------------------------|
|   | Shares Outstanding | Par Value   |                   |                            |                     |  |                            |
| <b>Balance, December 31, 2005</b>                               | 40,284,513         | \$ 4        | \$ (3,280)        | \$ 226,593                 | \$ (50,608)         | \$ 1,005                               | \$ 173,714                 |
| Comprehensive income:   |                    |             |                   |                            |                     |  |                            |
| Net income  |                    | —           | —                 | —                          | 38,151              | —                                      | 38,151                     |
| Unrealized gain on investments, net of income tax expense       |                    | —           | —                 | —                          | —                   | 54                                     | 54                         |
| Foreign currency translation adjustment                         |                    | —           | —                 | —                          | —                   | 157                                    | 157                        |
| Total comprehensive income                                      |                    | —           | —                 | —                          | 38,151              | 211                                    | 38,362                     |
| Issuance of common stock related to stock option exercises, net | 1,326,436          | —           | —                 | 13,212                     | —                   | —                                      | 13,212                     |
| Stock-based compensation  |                    | —           | —                 | 6,271                      | —                   | —                                      | 6,271                      |
| Cumulative effect of accounting change                          |                    | —           | —                 | (430)                      | —                   | —                                      | (430)                      |
| Tax benefit derived from stock option exercises                 |                    | —           | —                 | 8,820                      | —                   | —                                      | 8,820                      |
| <b>Balance, September 30, 2006</b>                              | <u>41,610,949</u>  | <u>\$ 4</u> | <u>\$ (3,280)</u> | <u>\$ 254,466</u>          | <u>\$ (12,457)</u>  | <u>\$ 1,216</u>                        | <u>\$ 239,949</u>          |

See notes to unaudited condensed consolidated financial statements.

**Morningstar, Inc. and Subsidiaries**  
**Unaudited Condensed Consolidated Statements of Cash Flows**

| (in thousands)   | Nine Months Ended September 30 |           |
|--|--------------------------------|-----------|
|  | 2006                           | 2005      |
| <b>Operating activities</b>  |                                |           |
| Net income   | \$ 38,151                      | \$ 21,024 |
| Adjustments to reconcile net income to net cash flows from operating activities: |                                |           |
| Cumulative effect of accounting change, net of tax                               | (259)                          | —         |
| Depreciation and amortization  | 10,440                         | 6,470     |
| Deferred income tax benefit  | (2,310)                        | (292)     |
| Stock-based compensation expense   | 6,271                          | 8,855     |
| Provision for bad debt   | 161                            | 243       |
| Equity in net income of unconsolidated entities                                  | (2,405)                        | (1,212)   |
| Foreign exchange loss  | 450                            | 124       |
| Excess tax benefits from stock option exercises                                  | (8,820)                        | 1,117     |
| Other, net   | 13                             | (160)     |
| Changes in operating assets and liabilities, net of effects of acquisitions:     |                                |           |
| Accounts receivable  | (2,375)                        | (3,461)   |
| Other assets   | 1,120                          | 366       |
| Accounts payable and accrued liabilities   | (473)                          | (104)     |
| Accrued compensation   | 2,431                          | (1,281)   |
| Income taxes payable   | 22,695                         | (1,926)   |
| Deferred revenue   | 3,589                          | 1,315     |
| Other liabilities  | 348                            | (1,193)   |
| Cash provided by operating activities  | 69,027                         | 29,885    |
| <b>Investing activities</b>  |                                |           |
| Purchases of investments   | (57,369)                       | (54,938)  |
| Proceeds from sale of investments  | 65,239                         | 55,830    |
| Capital expenditures   | (2,876)                        | (3,625)   |
| Acquisitions, net of cash acquired   | (116,859)                      | (8,192)   |
| Other, net   | (308)                          | 18        |
| Cash used for investing activities   | (112,173)                      | (10,907)  |
| <b>Financing activities</b>  |                                |           |
| Payments of long-term debt and capital lease obligations                         | —                              | (18)      |
| Proceeds from initial public offering  | —                              | 18,108    |
| Proceeds from stock option exercises   | 13,212                         | 3,964     |
| Excess tax benefits from stock option exercises                                  | 8,820                          | —         |
| Cash provided by financing activities  | 22,032                         | 22,054    |
| Effect of exchange rate changes on cash  | (72)                           | (166)     |
| Net increase (decrease) in cash and cash equivalents                             | (21,186)                       | 40,866    |
| Cash and cash equivalents — beginning of period                                  | 92,367                         | 35,907    |
| Cash and cash equivalents — end of period  | \$ 71,181                      | \$ 76,773 |
| <b>Supplemental disclosure of cash flow information:</b>                         |                                |           |
| Cash paid for taxes  | \$ 3,481                       | \$ 15,471 |
| <b>Supplemental information of non-cash investing and financing activities:</b>  |                                |           |
| Unrealized gain (loss) on available for sale investments                         | \$ 91                          | \$ (35)   |

See notes to unaudited condensed consolidated financial statements.

**MORNINGSTAR, INC. AND SUBSIDIARIES**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation of Interim Financial Information**

The accompanying unaudited condensed consolidated financial statements of Morningstar, Inc. and subsidiaries (Morningstar, we, our, the Company) included herein have been prepared to conform to the rules and regulations of the Securities and Exchange Commission (SEC). The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amount of assets, liabilities, revenue, and expense. Actual results could differ from those estimates. In the opinion of management, the statements reflect all adjustments, which are of a normal recurring nature, necessary to present fairly our financial position, results of operations, stockholders' equity, and cash flows. These financial statements and notes should be read in conjunction with our Consolidated Financial Statements and Notes thereto as of December 31, 2005 included in our Annual Report on Form 10-K filed with the SEC on March 16, 2006.

In the first quarter of 2006, we changed our segment reporting by allocating stock-based compensation expense to each of our three business segments. Before 2006, stock-based compensation expense was recorded as a corporate item. We believe this change gives our chief operating decision maker a more complete picture of the profitability of each business segment after fully allocating stock-based compensation expense. We have reclassified the 2005 financial results for each segment to reflect this change.

**2. Summary of Significant Accounting Policies**

We discuss our significant accounting policies in Note 2 of our Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2005 filed with the SEC.

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123(R)), using the modified prospective transition method. Under this method, the provisions of SFAS No. 123(R) apply to all awards granted after the date of adoption and to any unrecognized expense of awards unvested at the date of adoption based on the fair value as of the date of grant. Prior to this date, we accounted for our stock options in accordance with the fair value provisions of SFAS No. 123, *Stock-Based Compensation* (SFAS No. 123). Under SFAS No. 123, we accounted for forfeitures of stock options as they occurred. SFAS No. 123(R) requires us to estimate expected forfeitures at the grant date and recognize compensation cost only for those awards expected to vest. Accordingly, in the first quarter of 2006, we recorded a cumulative effect of accounting change, net of tax, of \$259,000 to reverse the impact of stock-based compensation expense recorded in prior years related to outstanding stock options that we estimate will not vest. Besides recording this cumulative effect of accounting change, the adoption of SFAS No. 123(R) did not have a significant impact on our financial position or results of operations because we previously recognized stock-based compensation expense in accordance with SFAS No. 123.

Prior to our adoption of SFAS 123(R), we classified tax benefits arising from the exercise of stock options as operating cash flows. SFAS No. 123(R) requires that we classify the cash flows resulting from the tax benefit that arises when the tax deductions exceed the compensation cost recognized for those options (excess tax benefits) as financing cash flows. The excess tax benefits were \$8,820,000 in the first nine months of 2006, and \$1,117,000 in the first nine months of 2005. Refer to Note 8 of the Notes to our Unaudited Condensed Consolidated Financial Statements for more information regarding our adoption of SFAS No. 123(R) and our accounting for stock options and restricted stock units.

**3. Acquisitions, Goodwill, and Other Intangible Assets**

*Institutional Hedge Fund and Separate Accounts Database Division of InvestorForce, Inc.*

In August 2006, we acquired the institutional hedge fund and separate account database division of InvestorForce, Inc. (InvestorForce), a financial software and data integration company based in Wayne, Pennsylvania, for \$10,040,000 in cash, including expenses directly related to the acquisition. We have included the financial results of this acquisition in our Condensed Consolidated Financial Statements beginning on August 1, 2006. This acquisition includes both the Altvest database, one of the first and largest databases covering hedge funds, managers, and data, along with InvestorForce's extensive institutional separate account database. It also includes several online software applications for manager search, research, and reporting. We believe that this acquisition will strengthen our proprietary investment data and allow us to continue offering one of the largest, most comprehensive databases.

The following table summarizes our preliminary allocation of the purchase price to the estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition:

|                      | (\$000)          |
|----------------------|------------------|
| Accounts receivable  | \$ 353           |
| Intangible assets    | 5,180            |
| Goodwill             | 6,121            |
| Deferred revenue     | (1,614)          |
| Total purchase price | <u>\$ 10,040</u> |

The preliminary purchase price allocation includes \$5,180,000 of acquired intangible assets. These assets include technology-based assets of \$2,500,000 that will be amortized over a weighted average period of 5 years; customer-based assets of \$2,210,000 that will be amortized over a weighted average period of 5 years; trade names of \$420,000 that will be amortized over a weighted average period of 4 years; and a non-compete agreement of \$50,000 that will be amortized over 3 years. The preliminary purchase price allocation also includes \$6,121,000 of goodwill. Both the acquired intangible assets and the acquired goodwill are deductible for U.S. income tax purposes.

If the acquisition of the database division of InvestorForce had occurred as of January 1, 2005 and 2006, revenue, operating income, net income, and basic and diluted income per share would not have been significantly different from the amounts reported in the first nine months of 2006 and 2005, respectively.

#### *Aspect Huntley Pty Limited*

In July 2006, we acquired Aspect Huntley Pty Limited (Aspect Huntley), a leading provider of equity information, research, and financial trade publishing in Australia, for \$23,526,000. We have included the results of Aspect Huntley's operations in our Condensed Consolidated Financial Statements beginning on July 25, 2006. This acquisition fits with our growth strategy to expand our products and services internationally. The key benefit of this acquisition is the combination of Morningstar's expertise in fund research and information with Aspect Huntley's equity research, information, and financial media expertise in Australia. We believe this acquisition will significantly expand the breadth and quality of services we can deliver to individuals, advisors, and institutions and will offer Australian investors one place to obtain their investment information and research.

The purchase price represents Australian \$30,000,000 in cash (of which Australian \$2,000,000 will be paid in 2007) and our current estimate of certain post-closing adjustments. In the third quarter of 2006, the cash paid for Aspect Huntley, including transaction costs, was \$20,469,000 (net of cash acquired). Of the remaining purchase price of \$2,135,000, we anticipate that the majority will be paid in the third quarter of 2007. These remaining payments are subject to post-closing adjustments.

The following table summarizes our preliminary allocation of the purchase price to the estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition:

|                           | (\$000)          |
|---------------------------|------------------|
| Cash                      | \$ 922           |
| Accounts receivable       | 671              |
| Other current assets      | 324              |
| Fixed assets              | 273              |
| Intangible assets         | 14,490           |
| Goodwill                  | 13,926           |
| Deferred revenue          | (5,122)          |
| Other current liabilities | (1,850)          |
| Income taxes payable      | (108)            |
| Total purchase price      | <u>\$ 23,526</u> |

The preliminary purchase price allocation includes \$14,490,000 of acquired intangible assets. These assets include trade names of \$8,245,000 that will be amortized over a weighted average period of 10 years; technology-based assets (primarily including a database) of \$5,952,000 that will be amortized over a weighted average period of 19 years; and customer-related assets of \$293,000 that will be amortized over 10 years.

If the acquisition of Aspect Huntley had occurred as of January 1, 2005 and 2006, revenue, operating income, net income, and basic and diluted income per share would not have been significantly different from the amounts reported in the first nine months of 2006 and 2005, respectively.

*Ibbotson Associates, Inc.*

In March 2006, we acquired Ibbotson Associates, Inc. (Ibbotson), a privately held firm specializing in asset allocation research and services, for \$83,000,000 in cash, plus an additional \$3,474,000 in cash for working capital and other items. We have included the results of Ibbotson's operations in our Condensed Consolidated Financial Statements beginning on March 1, 2006. This acquisition fits several of Morningstar's growth strategies and broadens our reach in the areas of investment consulting, managed retirement accounts, and institutional and advisor software.

The following table summarizes our preliminary allocation of the purchase price to the estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition:

|                               | (\$000)          |
|-------------------------------|------------------|
| Cash                          | \$ 103           |
| Accounts receivable           | 6,629            |
| Income tax benefits, net      | 12,776           |
| Other current assets          | 1,530            |
| Fixed assets                  | 1,407            |
| Other assets                  | 166              |
| Intangible assets             | 55,280           |
| Goodwill                      | 47,009           |
| Deferred revenue              | (10,672)         |
| Accrued liabilities           | (4,885)          |
| Deferred tax liability        | (22,108)         |
| Other non-current liabilities | (761)            |
| Total purchase price          | <u>\$ 86,474</u> |

As part of the preliminary purchase price allocation, we recorded an asset of \$12,776,000, primarily for the income tax benefit related to payment for the cancellation of Ibbotson's stock options. This cash income tax benefit will reduce the amount of cash we pay for income taxes in 2006. This cash income tax benefit did not impact our income tax expense or net income in the first nine months of 2006.

The preliminary purchase price allocation also includes \$55,280,000 of acquired intangible assets. These assets include customer-related assets of \$34,200,000 that will be amortized over a weighted average period of 9 years; intellectual property (including patents and trade names) of \$17,710,000 that will be amortized over a weighted average period of 10 years; technology-based assets of \$3,070,000 that will be amortized over a weighted average period of 5 years; and a non-compete agreement of \$300,000 that will be amortized over 5 years. Because the amortization expense for these intangible assets is not deductible for U.S. income tax purposes, we recorded a deferred tax liability of \$21,971,000 based on these values.

Based on the preliminary purchase price allocation, we recorded \$47,009,000 of goodwill. The goodwill we recorded is not deductible for U.S. income tax purposes. SFAS No. 109, *Accounting for Income Taxes*, prohibits recognition of a deferred tax asset or liability for goodwill temporary differences if goodwill is not amortizable and deductible for tax purposes. The goodwill will be tested at least annually for impairment in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*.

Based on plans in place at the time of acquisition, we recorded a liability of \$596,000 for severance and \$761,000 for lease termination costs, net of estimated sub-lease income. As of September 30, 2006, we have made substantially all of the related severance payments. We expect to pay the lease termination costs beginning in March 2008, which is when we plan to vacate Ibbotson's office space.

The following unaudited pro forma information presents a summary of our consolidated statements of operations for the three and nine months ended September 30, 2006 and 2005 as if we had acquired Ibbotson as of January 1, 2005 and 2006, respectively. In calculating the pro forma information below, we made an adjustment to eliminate stock-based compensation expense previously recorded by Ibbotson based on the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. We also made an adjustment to record stock-based compensation expense for an estimated value of stock options assumed to be granted to Ibbotson employees. This adjustment assumes the stock option awards were made in May 2005, consistent with the timing of our annual equity grant, and vest over a four-year period. In 2005, we recorded stock-based compensation expense based on the recognition and measurement principles of SFAS No. 123, *Accounting for Stock-Based Compensation*.

| (\$000)  | Three Months Ended September 30 |           | Nine Months ended September 30 |            |
|--|---------------------------------|-----------|--------------------------------|------------|
|  | 2006                            | 2005      | 2006                           | 2005       |
| Revenue  | \$ 81,821                       | \$ 63,385 | \$ 235,529                     | \$ 196,693 |
| Operating income                                     | 20,537                          | 9,556     | 57,535                         | 30,514     |
| Income before cumulative effect of accounting change | 13,547                          | 5,535     | 37,867                         | 18,870     |
| Net income   | 13,547                          | 5,535     | 38,126                         | 18,870     |
| Basic income per share:                              |                                 |           |                                |            |
| Income before cumulative effect of accounting change | \$ 0.33                         | \$ 0.14   | \$ 0.93                        | \$ 0.48    |
| Net income   | \$ 0.33                         | \$ 0.14   | \$ 0.93                        | \$ 0.48    |
| Diluted income per share:                            |                                 |           |                                |            |
| Income before cumulative effect of accounting change | \$ 0.29                         | \$ 0.12   | \$ 0.81                        | \$ 0.43    |
| Net income   | \$ 0.29                         | \$ 0.12   | \$ 0.82                        | \$ 0.43    |

#### *Variable Annuity Research and Data Service*

In January 2005, we acquired Variable Annuity Research and Data Service (VARDS) from Finetre Corporation for \$8,192,000 in cash, including costs directly related to the acquisition. The results of VARDS' operations have been included in our Condensed Consolidated Financial Statements beginning in January 2005.

The following table summarizes the allocation of the purchase price to the estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition:

|   | (\$000)         |
|---|-----------------|
| Accounts receivable                     | \$ 639          |
| Other assets                            | 57              |
| Intangible assets                       | 6,370           |
| Goodwill                                | 3,084           |
| Liabilities, primarily deferred revenue | (1,958)         |
| Total purchase price                    | <u>\$ 8,192</u> |

The acquired intangible assets include \$5,700,000 of customer-related assets, consisting primarily of acquired customer contracts; \$430,000 for technology-based assets, consisting of a database and developed software; and \$240,000 related to supplier relationships. Both the acquired intangible assets and the acquired goodwill are deductible for U.S. income tax purposes.

#### *Goodwill*

The following table shows the changes in our goodwill balance from January 1, 2005 to September 30, 2006:

|   | (\$000)          |
|---|------------------|
| Balance as of January 1, 2005                                       | \$ 14,408        |
| Goodwill acquired related to VARDS                                  | 3,084            |
| Other, primarily currency translation adjustment                    | 8                |
| Balance as of December 31, 2005                                     | <u>\$ 17,500</u> |
| Goodwill acquired related to Ibbotson                               | 47,009           |
| Goodwill acquired related to Aspect Huntley                         | 13,926           |
| Goodwill acquired related to the database division of InvestorForce | 6,121            |
| Other, primarily currency translation adjustment                    | (14)             |
| Balance as of September 30, 2006                                    | <u>\$ 84,542</u> |

We did not record any impairment losses in the quarter or year-to-date periods ended September 30, 2006 or 2005, respectively.

## Intangible Assets

We amortize intangible assets using the straight-line method over their expected economic useful lives. The following table summarizes our intangible assets:

| (\$000)                   | As of September 30, 2006 |                          |                  | Weighted Average Useful Life (years) | As of December 31, 2005 |                          |                 | Weighted Average Useful Life (years) |
|---------------------------|--------------------------|--------------------------|------------------|--------------------------------------|-------------------------|--------------------------|-----------------|--------------------------------------|
|                           | Gross                    | Accumulated Amortization | Net              |                                      | Gross                   | Accumulated Amortization | Net             |                                      |
| Intellectual property     | \$ 27,456                | \$ (1,747)               | \$ 25,709        | 10                                   | \$ 1,132                | \$ (405)                 | \$ 727          | 7                                    |
| Customer-related assets   | 43,272                   | (3,166)                  | 40,106           | 10                                   | 6,571                   | (597)                    | 5,974           | 18                                   |
| Supplier relationships    | 240                      | (22)                     | 218              | 20                                   | 240                     | (12)                     | 228             | 20                                   |
| Technology-based assets   | 12,329                   | (798)                    | 11,531           | 12                                   | 430                     | (108)                    | 322             | 4                                    |
| Non-competition agreement | 350                      | (38)                     | 312              | 5                                    | —                       | —                        | —               | —                                    |
| Total intangible assets   | <u>\$ 83,647</u>         | <u>\$ (5,771)</u>        | <u>\$ 77,876</u> | 10                                   | <u>\$ 8,373</u>         | <u>\$ (1,122)</u>        | <u>\$ 7,251</u> | 16                                   |

Amortization expense was \$2,199,000 and \$172,000 for the three months ended September 30, 2006 and 2005, respectively, and \$4,653,000 and \$518,000 for the nine months ended September 30, 2006 and 2005, respectively.

As of September 30, 2006, we estimate that aggregate amortization expense for intangible assets will be \$7,066,000 in 2006; \$9,652,000 in 2007; \$9,578,000 in 2008; \$9,232,000 in 2009; \$8,300,000 in 2010; and \$7,624,000 in 2011.

## 4. Income Per Share

The numerator for both basic and diluted income per share is net income. The denominator for basic income per share is the weighted average number of common shares outstanding during the period. The dilutive effect of outstanding employee stock options and restricted stock units is reflected in the denominator for diluted income per share using the treasury stock method.

The following table shows how we reconcile the net income and the number of shares used in computing basic and diluted income per share:

| (in thousands, except per share amounts)  | Three Months Ended September 30 |                 | Nine Months Ended September 30 |                  |
|---|---------------------------------|-----------------|--------------------------------|------------------|
|   | 2006                            | 2005            | 2006                           | 2005             |
| <b>Basic income per share:</b>  |                                 |                 |                                |                  |
| Income before cumulative effect of accounting change                              | \$ 13,547                       | \$ 7,519        | \$ 37,892                      | \$ 21,024        |
| Cumulative effect of accounting change, net of tax                                | —                               | —               | 259                            | —                |
| Net income  | <u>\$ 13,547</u>                | <u>\$ 7,519</u> | <u>\$ 38,151</u>               | <u>\$ 21,024</u> |
| Weighted average common shares outstanding  | 41,448                          | 39,922          | 40,913                         | 39,151           |
| Income before cumulative effect of accounting change                              | \$ 0.33                         | \$ 0.19         | \$ 0.93                        | \$ 0.54          |
| Cumulative effect of accounting change, net of tax                                | —                               | —               | —                              | —                |
| Net income  | <u>\$ 0.33</u>                  | <u>\$ 0.19</u>  | <u>\$ 0.93</u>                 | <u>\$ 0.54</u>   |
| <b>Diluted income per share:</b>  |                                 |                 |                                |                  |
| Income before cumulative effect of accounting change                              | \$ 13,547                       | \$ 7,519        | \$ 37,892                      | \$ 21,024        |
| Cumulative effect of accounting change, net of tax                                | —                               | —               | 259                            | —                |
| Net income  | <u>\$ 13,547</u>                | <u>\$ 7,519</u> | <u>\$ 38,151</u>               | <u>\$ 21,024</u> |
| Weighted average common shares outstanding  | 41,448                          | 39,922          | 40,913                         | 39,151           |
| Net effect of dilutive stock options and restricted stock units                   | 5,130                           | 5,432           | 5,685                          | 4,788            |
| Weighted average common shares outstanding for computing diluted income per share | 46,578                          | 45,354          | 46,598                         | 43,939           |
| Income before cumulative effect of accounting change                              | \$ 0.29                         | \$ 0.17         | \$ 0.81                        | \$ 0.48          |
| Cumulative effect of accounting change, net of tax                                | —                               | —               | 0.01                           | —                |
| Net income  | <u>\$ 0.29</u>                  | <u>\$ 0.17</u>  | <u>\$ 0.82</u>                 | <u>\$ 0.48</u>   |

## 5. Segment and Geographical Area Information

We organize our operations based on products and services sold in three primary business segments: Individual, Advisor, and Institutional.

- *Individual segment.* Our Individual segment focuses on products and services for individual investors. The largest product in this segment is our U.S.-based Web site, Morningstar.com, which includes both paid Premium Membership service and sales of advertising space. Our Individual segment also includes Morningstar Equity Research, which we distribute through several channels. Investors can access our equity research through our Premium Membership offering on Morningstar.com. In addition, our equity research is currently distributed through six major investment banks to meet the requirements for independent research under the Global Analyst Research Settlement, as well as to several other companies who provide our research to their affiliated financial advisors or to individual investors. We also offer a variety of print publications on stocks and mutual funds, including our monthly newsletters, *Morningstar FundInvestor* and *Morningstar StockInvestor*, and our twice-monthly publication, *Morningstar Mutual Funds*. We sell several annual reference guides, including the *Morningstar Funds 500*, the *Morningstar Stocks 500*, the *Morningstar ETFs 100*, and the *Stocks, Bonds, Bills, and Inflation Yearbook*. Following our acquisition of Aspect Huntley in July 2006, this segment also includes several newsletters and other publications for investors in Australia.
- *Advisor segment.* Our Advisor segment focuses on products and services for financial advisors. Key products in this segment are Morningstar Advisor Workstation and Principia. Advisor Workstation is a Web-based investment planning system that provides financial advisors with a comprehensive set of tools for conducting their core business — including investment research, planning, and presentation tools. Advisor Workstation is available in two editions: the Office Edition for independent financial advisors and the Enterprise Edition for financial advisors affiliated with larger firms. Principia is our CD-ROM-based investment research and planning software for financial planners. In addition, we offer Morningstar Managed Portfolios, a fee-based discretionary asset management service that includes a series of mutual fund and exchange-traded fund portfolios tailored to meet a range of investment time horizons and risk levels that financial advisors can use for their clients' taxable and tax-deferred accounts. Through our acquisition of Ibbotson, we offer a series of NASD-reviewed Financial Communications materials that advisors can use to educate clients about asset allocation and demonstrate other key investment concepts, as well as data and graphs that financial advisors can license to use in published materials. Following our acquisition of Aspect Huntley, this segment also includes software that we sell to financial planners and other market participants in Australia as well as investment conferences.
- *Institutional segment.* Our Institutional segment focuses on products and services for institutions, including banks, insurance companies, mutual fund companies, brokerage firms, media outlets, and retirement plan providers and sponsors. Key products and services in this segment include Investment Consulting, which focuses on investment monitoring and asset allocation for funds of funds, including mutual funds and variable annuities; Licensed Data, a set of investment data spanning eight core databases, available through electronic data feeds; Retirement Advice, including the Morningstar Retirement Manager and Advice by Ibbotson platforms; Morningstar Direct, a Web-based institutional research platform that provides advanced research and tools on the complete range of securities in Morningstar's global database; Licensed Tools and Content, a set of online tools and editorial content designed for institutions to use in their Web sites and software; Investment Profiles & Guides, which are designed for institutions to use in communicating investment information to individual investors; the Morningstar Research Annuity Center (formerly VARDS Online); and EnCorr, an asset allocation software package (acquired with Ibbotson). Following our acquisition of Aspect Huntley, this segment now includes financial information and other data on Australian stocks. The Institutional segment also includes the hedge fund and separate account database division we acquired from InvestorForce in August 2006.

We measure the operating results of these segments based on operating income (loss), including an allocation of corporate costs. We include intersegment revenue and expenses in segment information. We sell services and products between segments at predetermined rates primarily based on cost. The recovery of intersegment cost is shown as "Intersegment revenue."

In the first quarter of 2006, we changed our segment reporting by allocating stock-based compensation expense to each of our three business segments; before 2006, stock-based compensation expense was recorded as a corporate item. We believe this change gives our chief operating decision maker a more complete picture of the profitability of each business segment. The 2005 financial results for each segment have been reclassified to reflect this change.

Our segment accounting policies are the same as those described in Note 2 to our Consolidated Financial Statements as of December 31, 2005 included in our Annual Report on Form 10-K, except for the capitalization and amortization of internal product development costs and amortization of intangible assets. We exclude these items from our operating segment results to provide our chief operating decision maker with a better indication of each segment's ability to generate cash flow. This information is one of the criteria used by our chief operating decision maker in determining how to allocate resources to each segment. We include the capitalization and amortization of internal product development costs, the amortization of intangible assets, and the elimination of intersegment revenue and expense in the Corporate Items and Eliminations category to arrive at the consolidated financial information. Our segment disclosures include the business segment information provided to our chief operating decision maker on a recurring basis, and, therefore, we do not present balance sheet information, including goodwill or other intangibles, by

segment.

The following tables show selected segment data for the three and nine months ended September 30, 2006 and 2005:

| (\$000)   | Three months ended September 30, 2006 |           |               |                                | Total     |
|---|---------------------------------------|-----------|---------------|--------------------------------|-----------|
|   | Individual                            | Advisor   | Institutional | Corporate Items & Eliminations |           |
| <b>Revenue:</b>   |                                       |           |               |                                |           |
| External customers  | \$ 19,515                             | \$ 24,367 | \$ 37,939     | \$ —                           | \$ 81,821 |
| Intersegment  | 874                                   | 30        | 630           | (1,534)                        | —         |
| Total revenue   | 20,389                                | 24,397    | 38,569        | (1,534)                        | 81,821    |
| Operating expense, excluding stock-based compensation expense, depreciation, and amortization | 13,976                                | 15,545    | 27,288        | (2,050)                        | 54,759    |
| Stock-based compensation expense  | 555                                   | 716       | 987           | —                              | 2,258     |
| Depreciation and amortization   | 349                                   | 417       | 633           | 2,868                          | 4,267     |
| Operating income (loss)   | \$ 5,509                              | \$ 7,719  | \$ 9,661      | \$ (2,352)                     | \$ 20,537 |
| Capital expenditures  | \$ 117                                | \$ 98     | \$ 307        | \$ 331                         | \$ 853    |
| U.S. revenue  |                                       |           |               |                                | \$ 69,517 |
| Non-U.S. revenue  |                                       |           |               |                                | \$ 12,304 |

| (\$000)   | Three months ended September 30, 2005 |           |               |                                | Total     |
|---|---------------------------------------|-----------|---------------|--------------------------------|-----------|
|   | Individual                            | Advisor   | Institutional | Corporate Items & Eliminations |           |
| <b>Revenue:</b>   |                                       |           |               |                                |           |
| External customers  | \$ 14,808                             | \$ 18,593 | \$ 23,526     | \$ —                           | \$ 56,927 |
| Intersegment  | 681                                   | —         | 537           | (1,218)                        | —         |
| Total revenue   | 15,489                                | 18,593    | 24,063        | (1,218)                        | 56,927    |
| Operating expense, excluding stock-based compensation expense, depreciation, and amortization | 11,034                                | 13,461    | 17,086        | (1,253)                        | 40,328    |
| Stock-based compensation expense  | 606                                   | 624       | 800           | —                              | 2,030     |
| Depreciation and amortization   | 301                                   | 394       | 551           | 976                            | 2,222     |
| Operating income (loss)   | \$ 3,548                              | \$ 4,114  | \$ 5,626      | \$ (941)                       | \$ 12,347 |
| Capital expenditures  | \$ 57                                 | \$ 148    | \$ 342        | \$ 751                         | \$ 1,298  |
| U.S. revenue  |                                       |           |               |                                | \$ 49,391 |
| Non-U.S. revenue  |                                       |           |               |                                | \$ 7,536  |

| Nine months ended September 30, 2006  |            |           |               |                                |                       |
|---|------------|-----------|---------------|--------------------------------|-----------------------|
| (\$000)   | Individual | Advisor   | Institutional | Corporate Items & Eliminations | Total                 |
| <b>Revenue:</b>   |            |           |               |                                |                       |
| External customers  | \$ 56,232  | \$ 70,435 | \$ 101,471    | \$ —                           | \$ 228,138            |
| Intersegment  | 2,660      | 33        | 1,966         | (4,659)                        | —                     |
| Total revenue   | 58,892     | 70,468    | 103,437       | (4,659)                        | 228,138               |
| Operating expense, excluding stock-based compensation expense, depreciation, and amortization | 39,001     | 47,102    | 73,487        | (5,357)                        | 154,233               |
| Stock-based compensation expense  | 1,738      | 1,920     | 2,613         | —                              | 6,271                 |
| Depreciation and amortization   | 860        | 1,250     | 1,663         | 6,667                          | 10,440                |
| Operating income (loss)   | \$ 17,293  | \$ 20,196 | \$ 25,674     | \$ (5,969)                     | \$ 57,194             |
| Capital expenditures  | \$ 237     | \$ 278    | \$ 967        | \$ 1,394                       | \$ 2,876              |
| U.S. revenue  |            |           |               |                                | \$ 197,879            |
| Non-U.S. revenue  |            |           |               |                                | \$ 30,259             |
|   |            |           |               |                                | <b>Sept. 30, 2006</b> |
| U.S. long-lived assets  |            |           |               |                                | \$ 11,955             |
| Non-U.S. long-lived assets  |            |           |               |                                | \$ 4,147              |

| Nine months ended September 30, 2005  |            |           |               |                                |                       |
|---|------------|-----------|---------------|--------------------------------|-----------------------|
| (\$000)   | Individual | Advisor   | Institutional | Corporate Items & Eliminations | Total                 |
| <b>Revenue:</b>   |            |           |               |                                |                       |
| External customers  | \$ 44,696  | \$ 53,868 | \$ 67,810     | \$ —                           | \$ 166,374            |
| Intersegment  | 1,929      | —         | 1,586         | (3,515)                        | —                     |
| Total revenue   | 46,625     | 53,868    | 69,396        | (3,515)                        | 166,374               |
| Operating expense, excluding stock-based compensation expense, depreciation, and amortization | 32,476     | 39,151    | 50,799        | (3,746)                        | 118,680               |
| Stock-based compensation expense  | 2,750      | 2,668     | 3,437         | —                              | 8,855                 |
| Depreciation and amortization   | 876        | 1,113     | 1,513         | 2,968                          | 6,470                 |
| Operating income (loss)   | \$ 10,523  | \$ 10,936 | \$ 13,647     | \$ (2,737)                     | \$ 32,369             |
| Capital expenditures  | \$ 222     | \$ 475    | \$ 993        | \$ 1,935                       | \$ 3,625              |
| U.S. revenue  |            |           |               |                                | \$ 144,739            |
| Non-U.S. revenue  |            |           |               |                                | \$ 21,635             |
|   |            |           |               |                                | <b>Sept. 30, 2005</b> |
| U.S. long-lived assets  |            |           |               |                                | \$ 13,200             |
| Non-U.S. long-lived assets  |            |           |               |                                | \$ 1,931              |

## 6. Investments

We monitor the concentration, diversification, maturity, and liquidity of our investment portfolio, which is primarily invested in fixed-income securities. We classify our investment portfolio as follows:

| (\$000)            | September 30, 2006 | December 31, 2005 |
|--------------------|--------------------|-------------------|
| Available for sale | \$ 50,564          | \$ 58,761         |
| Held to maturity   | 810                | 420               |
| Trading securities | 1,695              | 1,642             |
| Total              | \$ 53,069          | \$ 60,823         |

## 7. Investments In Unconsolidated Entities

*Morningstar Japan K.K.* In April 1998, we entered into an agreement with Softbank Corporation to form a joint venture, Morningstar Japan K.K. (MJKK), which develops and markets products and services customized for the Japanese market. In June 2000, MJKK became a public company, and its shares are traded on the Osaka Stock Exchange, "Hercules Market," using the ticker number 4765. Subsequent to MJKK's initial public offering, the joint venture agreement between us and Softbank Corporation was terminated, but we continued to hold shares of MJKK stock. As of September 30, 2006 and December 31, 2005, we owned approximately 35% of MJKK. We account for our investment in MJKK using the equity method. Our investment in MJKK totaled \$16,566,000 and \$14,884,000 as of September 30, 2006 and December 31, 2005, respectively. MJKK's market value was approximately Japanese Yen 29.5 billion (approximately U.S. \$250,263,000) as of September 30, 2006 and Japanese Yen 27.8 billion (approximately U.S. \$235,625,000) as of December 31, 2005.

In the third quarter of 2006, MJKK recorded a gain related to the sale of shares in a subsidiary's initial public offering. Our share of the pre-tax gain was approximately \$990,000.

*Morningstar Korea, Ltd.* In June 2000, we entered into a joint venture agreement with Shinheung Securities Co., Ltd. and SOFTBANK Finance Corporation to establish a Korean limited liability company Morningstar Korea Ltd. (Morningstar Korea). Morningstar Korea develops, markets, and sells products and services to assist in the analysis of financial portfolios and provides financial information and services for investors in South Korea. Our ownership interest and profit and loss sharing interest in Morningstar Korea was 40% as of September 30, 2006 and December 31, 2005. We account for this investment using the equity method. Our investment totaled \$1,270,000 and \$1,129,000 as of September 30, 2006 and December 31, 2005, respectively.

*Other Investments in Unconsolidated Entities.* As of September 30, 2006 and December 31, 2005, the book value of our other investments in unconsolidated entities totaled \$382,000 and \$342,000, respectively, and consist primarily of our investments in Morningstar Danmark A/S (Morningstar Denmark) and Morningstar Sweden AB (Morningstar Sweden). In August 2001, we entered into a joint venture agreement with Phosphorus A/S to establish Morningstar Denmark, which develops and markets products and services customized for the Danish market. In April 2001, we entered into a joint venture agreement with Stadsposten Citygate AB to establish Morningstar Sweden, which develops and markets products and services customized for the Swedish market. Our ownership interest in both Morningstar Denmark and Morningstar Sweden was approximately 25% as of September 30, 2006 and December 31, 2005. We account for our investments in Morningstar Denmark and Morningstar Sweden using the equity method.

The following table shows condensed combined unaudited financial information for our investments in unconsolidated entities:

| (\$000)          | Three months ended September 30 |          | Nine months ended September 30 |           |
|------------------|---------------------------------|----------|--------------------------------|-----------|
|                  | 2006                            | 2005     | 2006                           | 2005      |
| Revenue          | \$ 4,201                        | \$ 3,417 | \$ 13,921                      | \$ 10,421 |
| Operating income | \$ 951                          | \$ 554   | \$ 3,836                       | \$ 2,037  |
| Net income       | \$ 2,954                        | \$ 339   | \$ 6,073                       | \$ 2,034  |

## 8. Stock-Based Compensation

### *Stock-Based Compensation Plans*

Prior to November 2004, we granted stock options under various plans including the 1993 Stock Option Plan (the 1993 Plan), the 2000 Morningstar Stock Option Plan (the 2000 Plan), and the 2001 Morningstar Stock Option Plan (the 2001 Plan). In general, options granted under the 1993 Plan vest ratably over a five-year period and options granted under the 2000 Plan and the 2001 Plan vest ratably over a four-year period; options under all three plans expire 10 years after the date of grant.

In November 2004, we adopted the 2004 Stock Incentive Plan. The 2004 Stock Incentive Plan amends and restates the 1993 Plan, the 2000 Plan, and the 2001 Plan (collectively, the Prior Plans). Under the 2004 Stock Incentive Plan, we will not grant any additional options under any of the Prior Plans, and any shares subject to an award under any of the Prior Plans that are forfeited, canceled, settled, or otherwise terminated without a distribution of shares, or withheld by us in connection with the exercise of options or in payment of any required income tax withholding, will not be available for awards under the 2004 Stock Incentive Plan. The 2004 Stock Incentive Plan provides for grants of options, stock appreciation rights, restricted stock, restricted stock units, and performance shares. All of our employees are eligible for awards under the 2004 Stock Incentive Plan. Our non-employee directors are also eligible for awards under the 2004 Stock Incentive Plan. Joe Mansueto, our chairman and chief executive officer, does not participate in the 2004 Stock Incentive Plan or the Prior Plans.

Since the adoption of the 2004 Stock Incentive Plan, we have granted stock options and, beginning in 2006, restricted stock units. Stock options granted under the 2004 Stock Incentive Plan generally vest ratably over a four-year period and expire 10 years after the date of grant. Almost all of the options granted under the 2004 Stock Incentive Plan have a premium feature in which the exercise

price increases over the term of the option at a rate equal to the 10-year Treasury bond yield as of the date of grant. Restricted stock units represent the right to receive a share of Morningstar common stock when that unit vests. Restricted stock units granted under the 2004 Stock Incentive Plan generally vest ratably over a four-year period. The number of shares available for future grants under our 2004 Stock Incentive Plan as of September 30, 2006 and December 31, 2005 was 2,829,046 and 2,989,322, respectively.

In February 1999, we entered into an Incentive Stock Option Agreement and a Nonqualified Stock Option Agreement under the 1999 Incentive Stock Option Plan (the 1999 Plan) with Don Phillips, an officer of Morningstar. Under these agreements, we granted Don options to purchase 1,500,000 shares of common stock at an exercise price of \$2.77 per share, equal to the fair value at the grant date. These options are fully vested and expire in February 2009. On the date of grant, 1,138,560 options were fully exercisable and an additional 36,144 were scheduled to become exercisable each year from 1999 through 2008. As of September 30, 2006 and December 31, 2005, there were 789,174 and 869,174 options remaining to be exercised, respectively.

#### *Accounting for Stock-Based Compensation Awards*

Effective January 1, 2006, we adopted SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123(R)), using the modified prospective transition method. Prior to this date, we accounted for our equity plans in accordance with the fair value provisions of SFAS No. 123, *Stock-Based Compensation* (SFAS No. 123). Under SFAS No. 123, we accounted for forfeitures of stock options as they occurred. SFAS No. 123(R) requires us to estimate expected forfeitures at the grant date and recognize compensation cost only for those awards expected to vest. Accordingly, in the first quarter of 2006, we recorded a cumulative effect of accounting change, net of tax, of \$259,000 to reverse the impact of stock-based compensation expense recorded in prior years related to outstanding stock options that we estimate will not vest. Other than recording this cumulative effect of accounting change, the adoption of SFAS No. 123(R) did not have a significant impact on our financial position or results of operations because we previously recognized stock-based compensation expense in accordance with SFAS No. 123.

Prior to our adoption of SFAS 123(R), we presented the tax benefit of deductions arising from the exercise of stock options as operating cash flows in our Condensed Consolidated Statement of Cash Flows. SFAS No. 123(R) requires that we classify the cash flows resulting from the tax benefit that arises when the tax deductions exceed the compensation cost recognized for those options (excess tax benefits) as financing cash flows. The excess tax benefits classified as financing cash flows were \$8,820,000 in the first nine months of 2006; the excess tax benefits classified as operating cash flows were \$1,117,000 in the first nine months of 2005.

Prior to our initial public offering in May 2005, we accounted for stock options granted under the 1993 Plan and the 1999 Plan using the liability method in accordance with SFAS No. 123 because these plans allowed for cash settlement at the option holder's election, subject to certain conditions. Under the liability method, we accounted for options as a liability that was measured each period using the fair value per share of our common stock. We recorded changes in the liability, resulting from changes in the fair value of our common stock, in our Consolidated Statements of Operations. As a result of our initial public offering, we are no longer required to settle options under the 1993 Plan and the 1999 Plan in cash. Upon our initial public offering, we valued the liability using a fair value of \$18.50 per share, which was equivalent to the fair value of our common stock at the time of our initial public offering. We reclassified stock options accounted for as current liabilities of \$16,707,000 and long-term liabilities of \$24,882,000 to additional paid-in capital. In addition, because all of the options previously accounted for under the liability method were fully vested by March 31, 2005, we have not recorded any additional expense for these options in subsequent periods.

#### *Stock-Based Compensation Expense*

The following table summarizes stock-based compensation expense (including expense for both stock options and restricted stock units) recorded in our Consolidated Statements of Operations:

| (\$000)   | Three months ended September 30 |                 | Nine months ended September 30 |                 |
|---|---------------------------------|-----------------|--------------------------------|-----------------|
|   | 2006                            | 2005            | 2006                           | 2005            |
| Stock-based compensation expense under the liability method | \$ —                            | \$ —            | \$ —                           | \$ 2,810        |
| Stock-based compensation expense under the equity method    | 2,258                           | 2,030           | 6,271                          | 6,045           |
| <b>Total stock-based compensation expense</b>               | <b>\$ 2,258</b>                 | <b>\$ 2,030</b> | <b>\$ 6,271</b>                | <b>\$ 8,855</b> |

The deferred tax benefit related to the stock-based compensation expense above was \$831,000 and \$742,000 for the three months ended September 30, 2006 and 2005, respectively, and \$2,221,000 and \$2,201,000 for the nine months ended September 30, 2006 and 2005, respectively.

We estimate forfeitures of all employee stock-based awards and recognize compensation cost only for those awards expected to vest. We determine forfeiture rates based on historical experience. Estimated forfeitures are adjusted to actual forfeiture experience as needed.

## Restricted Stock Units

We measure the fair value of our restricted stock units on the date of grant based on the market price of the underlying common stock as of the close of trading on the day prior to grant. We amortize that value to stock-based compensation expense, net of estimated forfeitures, ratably over the vesting period. We granted restricted stock units for the first time in May 2006. The total grant date fair value of restricted stock units granted through September 30, 2006 was approximately \$11,351,000.

The following table summarizes restricted stock unit activity in the first nine months of 2006:

| Restricted Stock Units              | Nine months ended September 30, 2006 |    | Weighted<br>Average<br>Grant Date<br>Fair Value |
|-------------------------------------|--------------------------------------|----|---|
|                                     | Shares                               |    |   |
| Nonvested shares—January 1, 2006    | —                                    |    | —   |
| Granted                             | 259,223                              | \$ | 43.79   |
| Vested                              | —                                    |    | —   |
| Forfeited                           | (16,985)                             | \$ | 42.67   |
| Nonvested shares—September 30, 2006 | 242,238                              | \$ | 43.86   |

As of September 30, 2006, the total amount of unrecognized stock-based compensation expense related to restricted stock units was approximately \$8,215,000, which is expected to be recognized over an average period of approximately 44 months.

## Stock Option Fair Value

We measure the fair value of our stock options on the date of grant using a Black-Scholes option-pricing model and amortize that value to stock-based compensation expense ratably over the option's vesting period. The weighted average fair value of options granted during the first nine months of 2006 and 2005 using this model was \$14.16 per share and \$9.62 per share, respectively. We estimated the fair value of the options granted in the first nine months of 2006 and 2005 on the date of grant using the following weighted average assumptions:

|                         | 2006     | 2005     |
|-------------------------|----------|----------|
| Expected life (years)   | 6.25     | 7.0      |
| Expected volatility (%) | 43.0 %   | 50.0 %   |
| Dividend yield (%)      | —        | —        |
| Interest rate (%)       | 4.33 %   | 4.04 %   |
| Expected exercise price | \$ 45.31 | \$ 26.20 |

*Expected life.* The expected life represents the period over which the stock options are expected to be outstanding. Because we have limited historical information regarding stock option exercises since becoming a public company in May 2005, we have determined the expected life using the "shortcut method" described in Staff Accounting Bulletin Topic 14.D.2, which is based on a calculation to arrive at the midpoint between the vesting date and the end of the contractual term.

*Expected volatility.* The volatility factor used in our assumptions is based on an average of the historical stock prices of a group of our peers over the most recent period commensurate with the expected life of the stock option award. As a recently public company with limited historical data on the price of our stock, we do not base our volatility assumption on our own stock price.

*Dividend yield.* We do not intend to pay dividends on our common stock for the foreseeable future. Accordingly, we used a dividend yield of zero in our assumptions.

*Interest rate.* We based the risk-free interest rate used in our assumptions on the implied yield available on U.S. Treasury zero-coupon issues with a remaining term that approximates the stock option award's expected life.

*Expected exercise price.* Options granted in 2006 have initial exercise prices that will increase over the term of the options at a rate equal to the 10-year Treasury bond rate as of the date of grant. The expected exercise price included in the option pricing models for these options was calculated using an estimated life of 6.25 years and the applicable 10-year Treasury bond rate.

## Stock Option Activity

The following tables summarize stock option activity for our various stock option grants. The first table includes activity for options granted at an exercise price below the fair value per share of our common stock on the grant date; the second table includes activity for all other option grants.

|   | Nine months ended September 30, 2006 |                                 |
|---|--------------------------------------|---------------------------------|
| Options Granted At an Exercise Price Below the Fair Value Per Share on the Grant Date | Underlying Shares                    | Weighted Average Exercise Price |
| Options outstanding—January 1, 2006   | 3,338,959                            | \$ 10.50                        |
| Canceled  | (64,464)                             | 15.26                           |
| Exercised   | (171,643)                            | 9.34                            |
| Options outstanding—September 30, 2006  | 3,102,852                            | \$ 10.68                        |
| Options exercisable—September 30, 2006  | 2,307,127                            | \$ 9.32                         |

|   | Nine months ended September 30, 2006 |                                 |
|---|--------------------------------------|---------------------------------|
| All Other Option Grants, Excluding Activity Shown Above | Underlying Shares                    | Weighted Average Exercise Price |
| Options outstanding—January 1, 2006                     | 7,795,848                            | \$ 11.96                        |
| Canceled  | (76,977)                             | 21.33                           |
| Exercised   | (1,158,069)                          | 10.03                           |
| Granted   | 46,451                               | 34.64                           |
| Options outstanding—September 30, 2006                  | 6,607,253                            | \$ 12.44                        |
| Options exercisable—September 30, 2006                  | 5,643,264                            | \$ 11.34                        |

The total intrinsic value (difference between the market value of our stock on the date of exercise and the exercise price of the option) of options exercised in the nine months ended September 30, 2006 and 2005 was \$41,717,000 and \$7,044,000, respectively.

## Stock Options Outstanding and Exercisable

The table below shows additional information for options outstanding and options exercisable as of September 30, 2006:

| Range of Exercise Prices          | Options Outstanding |   |                                 |                                   | Options Exercisable |   |                                 |                                   |
|-----------------------------------|---------------------|---|---------------------------------|-----------------------------------|---------------------|---|---------------------------------|-----------------------------------|
|                                   | Outstanding Shares  | Weighted Average Contractual Life (years) | Weighted Average Exercise Price | Aggregate Intrinsic Value (\$000) | Exercisable Shares  | Weighted Average Contractual Life (years) | Weighted Average Exercise Price | Aggregate Intrinsic Value (\$000) |
| \$2.00 - \$2.77                   | 1,981,108           | 1.95                                      | \$ 2.54                         | \$ 68,073                         | 1,901,247           | 1.93                                      | \$ 2.53                         | \$ 65,342                         |
| \$ 8.57 - \$14.70                 | 5,391,367           | 4.28                                      | 12.58                           | 131,109                           | 5,213,123           | 4.20                                      | 12.72                           | 126,065                           |
| \$15.88 - \$35.78                 | 2,337,630           | 8.37                                      | 18.18                           | 43,757                            | 836,021             | 8.29                                      | 17.17                           | 16,494                            |
| \$2.00 - \$35.78                  | 9,710,105           | 4.79                                      | \$ 11.88                        | \$ 242,939                        | 7,950,391           | 4.09                                      | \$ 10.75                        | \$ 207,901                        |
| <b>Vested or Expected to Vest</b> |                     |   |                                 |                                   |                     |   |                                 |                                   |
| \$2.00 - \$35.78                  | 9,613,730           | 4.75                                      | \$ 11.81                        | \$ 241,165                        |                     |   |                                 |                                   |

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on our closing stock price of \$36.90 on September 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date.

As of September 30, 2006, the total amount of unrecognized stock-based compensation expense related to stock options was approximately \$13,081,000, which is expected to be recognized over a weighted average period of approximately 25 months.

## 9. Related Party Transactions

In 1989, under our 1989 Nonqualified Stock Option Plan (the 1989 Plan), we granted options to purchase 1,500,000 shares of common stock at an exercise price of \$0.075 per share, equal to the fair value at date of issue, to Don Phillips, an officer of Morningstar. These options were not exercised and expired in February 1999. In February 1999, in conjunction with the expiration of options granted under the 1989 Plan, we entered into a Deferred Compensation Agreement (the Agreement) with Don. Under the terms of the Agreement, on any date that he exercises the right to purchase shares under the 1999 Plan, we shall pay to him \$2.69 per share

in the form of cash or, at our election, shares of common stock. If on the date of purchase the fair value of Morningstar's stock is below \$2.77 per share, the amount paid per share will be reduced based on the terms of the Agreement. Our obligation to pay deferred compensation will not be increased by any imputed interest or earnings amount.

In May 2006, Don entered into a Rule 10b5-1 plan contemplating the sale of up to 450,000 shares to be acquired through stock option exercises during 2006 and 2007. Upon exercise of these stock options, we will make payments to him, as prescribed by the Agreement, which, if all 450,000 stock options are exercised, would total approximately \$1,200,000. These payments would reduce the liability associated with the Agreement. In the first nine months of 2006, Don exercised 80,000 options and we made corresponding payments to him in accordance with the Agreement. As of September 30, 2006 and December 31, 2005, a liability of \$2,151,000 and \$2,340,000, respectively, for the Agreement is recorded in our Consolidated Balance Sheets, primarily classified as other current liabilities.

## 10. Income Taxes

The following table shows our effective income tax expense rate for the three and nine months ended September 30, 2006 and 2005:

| (\$000)   | Three months ended September 30 |           | Nine months ended September 30 |           |
|---|---------------------------------|-----------|--------------------------------|-----------|
|   | 2006                            | 2005      | 2006                           | 2005      |
| Income before income taxes, equity in net income of unconsolidated entities, and cumulative effect of accounting change | \$ 21,675                       | \$ 13,193 | \$ 59,937                      | \$ 34,329 |
| Equity in net income of unconsolidated entities   | 1,100                           | 183       | 2,405                          | 1,212     |
| Total   | \$ 22,775                       | \$ 13,376 | \$ 62,342                      | \$ 35,541 |
| Income tax expense  | \$ 9,228                        | \$ 5,857  | \$ 24,450                      | \$ 14,517 |
| Effective income tax expense rate   | 40.5 %                          | 43.8 %    | 39.2 %                         | 40.8 %    |

Our effective income tax expense rate in the third quarter of 2006 decreased 3.3 percentage points compared with the same period in 2005. In the first nine months of 2006, our effective income tax expense rate decreased 1.6 percentage points compared with the prior-year period. Our effective tax rate in both the third quarter and year-to-date periods reflects an increase in the benefits we received related to disqualifying dispositions for incentive stock options. A disqualifying disposition occurs when the option holder sells shares within one year of exercising an incentive stock option. We receive a tax benefit in the period that the disqualifying disposition occurs. Additional income tax expense related to certain operations outside of the United States recorded in the second quarter of 2006 partially offset the tax benefit of the disqualifying dispositions.

The effective tax rate in the first nine months of 2005 reflects the fact that in the first quarter of 2005, we recorded stock-based compensation expense related to incentive stock options but we did not record a corresponding tax benefit. This had the impact of increasing our effective income tax rate above the U.S. Federal rate of 35%. Because the incentive stock options were fully vested by March 31, 2005 and because we no longer account for options under the liability method subsequent to our initial public offering, we did not record any stock-based compensation expense related to incentive stock options in the first nine months of 2006. The impact of incentive stock options was partially offset by a deferred income tax benefit of \$0.7 million we recorded in the second quarter of 2005 related to research and development expenses due to a change in U.S. tax regulations, resulting in a one-time reduction of our effective income tax expense rate in 2005.

In 2006 and 2005, our effective income tax expense rate reflects the fact that we are not recording an income tax benefit related to losses recorded by certain of our non-U.S. operations. In the year these non-U.S. entities record a loss, we do not record a corresponding tax benefit, thus increasing our effective tax rate. The foreign net operating losses may become deductible in certain non-U.S. tax jurisdictions to the extent these non-U.S. operations become profitable. For each of our operations, we evaluate whether it is more likely than not that the tax benefits related to net operating losses will be realized. As part of this evaluation, we consider evidence such as tax planning strategies, historical operating results, forecasted taxable income, and recent financial performance.

## 11. Contingencies

### *Morningstar Australia*

In 2001, Mr. Graham Rich, the then managing director and chief executive officer of Morningstar Research Pty Limited (Morningstar Australia), and one of two companies controlled by Mr. Rich, filed a suit in the Supreme Court of New South Wales, Australia against Morningstar and certain of its officers and nominee directors on the board of Morningstar Australia. Mr. Rich was also a beneficial owner of shares in Morningstar Australia. Mr. Rich and his company originally sought an injunction which, if granted, would have precluded Morningstar Australia from terminating the services of Mr. Rich and from issuing additional shares to Morningstar in exchange for the provision of further funding by Morningstar to Morningstar Australia. Further, Mr. Rich and his company sought an order that a provisional liquidator be appointed for Morningstar Australia. The court rejected this injunction application, observing that Morningstar Australia would be insolvent without financial backing from Morningstar. The application for the appointment of a

provisional liquidator also failed. The services of Mr. Rich were terminated in November 2001. Mr. Rich and his company were ordered to pay Morningstar's costs of the injunction proceedings.

Mr. Rich and the two companies controlled by Mr. Rich have additional pending claims, alleging, among other things, breaches by Morningstar of contracts and statutory and general law duties, misleading, deceptive, and unconscionable conduct by Morningstar, oppression by Morningstar and its nominee directors, claims under the Industrial Relations Act of New South Wales, breaches of directors' duties by Morningstar's nominee directors, and conflict of interest. The claims seek various forms of relief, including monetary damages in the amount of Australian \$25,000,000, the setting aside of transactions which resulted in Morningstar obtaining control of Morningstar Australia, and an order either setting aside Morningstar's acquisition of the shares formerly beneficially owned by Mr. Rich and his companies or determining a different price for this acquisition. In the alternative, Mr. Rich and his companies seek an order that they be entitled to purchase the shares in Morningstar Australia at a price to be determined by the court or book value (as defined in the Morningstar Australia shareholders agreement). Morningstar has denied the claims and filed counter-claims against Mr. Rich and certain of his companies, alleging breaches of statutory, general law, and contractual duties.

In July 2004, the court decided Morningstar's application for security for its potential additional costs in the litigation by ordering the two companies controlled by Mr. Rich to provide approximately Australian \$925,000 to the court as security for these potential costs. Morningstar has been paid some of its costs and will be entitled to be paid costs in the future only if the court makes a determination to that effect. The court stayed the proceedings pending its receipt of the security and indicated that it would entertain an application by Morningstar for additional security at a later time in the proceedings.

In May 2005, Mr. Rich obtained conditional leave of the court to begin a proceeding in the name of Morningstar Australia against Morningstar and its nominee directors. The leave was, however, subject to the following conditions: (i) Mr. Rich must pay and bear, and indemnify Morningstar Australia against, all costs, charges, and expenses of and incidental to the bringing and continuation of the proceeding (except as the court may otherwise direct or allow) and may not seek contribution or indemnity from Morningstar Australia for any of these costs, charges, or expenses; (ii) Morningstar Australia, or Mr. Rich on its behalf, together with the two companies controlled by Mr. Rich were required to provide to the court, as security for Morningstar's costs, approximately Australian \$925,000 as described in the preceding paragraph; and (iii) approximately Australian \$100,000 in costs owed by Mr. Rich and one of his companies to Morningstar in respect of the 2001 injunction proceedings was required to be paid to Morningstar. These conditions have been satisfied.

In September 2005, Mr. Rich and his companies filed a Second Further Amended Statement of Claim, consolidating the claims. Morningstar filed a Defence to that pleading and an Amended Cross-Claim against Mr. Rich, both his companies, and a third Australian company controlled by Mr. Rich.

The parties have discussed settling the claims but have been unable to reach an agreement. In the fourth quarter of 2003, Morningstar offered to settle all claims for Australian \$1,250,000, which then approximated U.S. \$942,000, and, in accordance with SFAS No. 5, *Accounting for Contingencies* (SFAS No. 5), Morningstar recorded a reserve in this amount. In December 2005, Morningstar increased its offer to settle all claims to approximately Australian \$2,500,000, which at September 30, 2006 approximates U.S. \$1,900,000, and, in accordance with SFAS No. 5, Morningstar has a reserve recorded in this amount. While Morningstar is vigorously contesting the claims against it, we cannot predict the outcome of the proceeding.

*Morningstar Associates, LLC Subpoenas from New York Attorney General's Office, Securities and Exchange Commission, and Department of Labor*

In December 2004, Morningstar Associates, LLC, a wholly owned subsidiary of Morningstar, Inc., received a request in the form of a subpoena from the New York Attorney General's office, seeking information and documents from Morningstar Associates related to an investigation the New York Attorney General's office is conducting. While the subpoena is very broad, it specifically asks for information and documents about the investment consulting services Morningstar Associates offers to retirement plan providers, including fund lineup recommendations for retirement plan sponsors. Shortly after the New York Attorney General's office issued the subpoena in December 2004, the SEC notified Morningstar Associates and Morningstar Investment Services, Inc. that it had begun an examination. In February 2005, the SEC issued a request to Morningstar Associates for the voluntary production of documents. The request is similar in scope to the New York Attorney General's subpoena. In May 2005, Morningstar Associates received a request in the form of a subpoena from the United States Department of Labor, seeking information and documents from Morningstar Associates related to an investigation the Department of Labor is conducting. While the Department of Labor subpoena is very broad, it is substantially similar in scope to the New York Attorney General subpoena and the SEC request. In July 2005, the SEC issued a subpoena to Morningstar Associates. The subpoena is virtually identical to the SEC's February 2005 request. We have been fully cooperating with the New York Attorney General's office, the SEC, and the Department of Labor. Although we believe the focus of these investigations is on Morningstar Associates, information and documents pertaining to Morningstar, Inc. and Morningstar Investment Services have also been requested. We cannot predict the scope, timing, or outcome of these matters, which may include the institution of administrative, civil injunctive, or criminal proceedings, the imposition of fines and penalties, and other remedies and sanctions, any of which could lead to an adverse impact on our stock price, the inability to attract or retain key

employees, and the loss of customers. We also cannot predict what impact, if any, these matters may have on our business, operating results, or financial condition.

In addition to these proceedings, we are involved in legal proceedings and litigation that have arisen in the normal course of our business. Although the outcome of a particular proceeding can never be predicted, we do not believe that the result of any of these matters will have a material adverse effect on our business, operating results, or financial condition.

## **12. Recently Issued Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 157, *Fair Value Measurements* (SFAS No. 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years; therefore, we will adopt SFAS No. 157 in the first quarter of 2008. We are in the process of determining the effect the adoption of SFAS No. 157 will have on our financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 addresses quantifying the financial statement effects of misstatements, specifically, how the effects of prior year uncorrected errors must be considered in quantifying misstatements in the current year financial statements. SAB 108 is effective for fiscal years ending after November 15, 2006; therefore, we will adopt SAB 108 in the fourth quarter of 2006. We do not anticipate that SAB 108 will have an impact on our financial statements.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48), which prescribes the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, and disclosure for uncertain tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006; therefore, we will adopt FIN 48 in the first quarter of 2007. We are in the process of determining the effect, if any, the adoption of FIN 48 will have on our financial statements.

In June 2006, the Emerging Issues Task Force (EITF) ratified EITF Issue No. 06-2, *Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, "Accounting for Compensation Absence"* (EITF No. 06-2), which requires that a liability for employees' sabbatical benefits be accrued over the period required for employees to earn the right to sabbatical leave. EITF No. 06-2 is effective for fiscal years beginning after December 15, 2006; therefore, we will adopt EITF No. 06-2 in the first quarter of 2007. We are in the process of determining the effect the adoption of EITF No. 06-2 will have on our financial statements.

In June 2006, the EITF ratified EITF Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement* (EITF No. 06-3), which concludes that companies have the option to report taxes that are externally imposed on a revenue producing transaction between a seller and a customer either gross within revenue or net. This is, it may include charges to customers for taxes within revenues and the charge for taxes from the taxing authority within cost of sales, or alternatively, it may net the charge to the customer and the charge from the taxing authority. In addition, if these taxes are significant, disclosure of the accounting policy used is required. EITF No. 06-3 is effective for fiscal years beginning after December 15, 2006; therefore, we will adopt EITF No. 06-3 in the first quarter of 2007. We do not anticipate that EITF No. 06-3 will have an impact on our financial statements.

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

*The discussion included in this section, as well as other sections of this Quarterly Report on Form 10-Q, contains forward-looking statements. These statements relate to future events or to our future financial performance and involve known and unknown risks, uncertainties, and other factors that may cause our actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by these forward-looking statements. In some cases, you can identify forward-looking statements by the use of words such as "may," "could," "expect," "intend," "plan," "seek," "anticipate," "believe," "estimate," "predict," "potential," or "continue" or the negative of these terms or other comparable terminology. You should not place undue reliance on forward-looking statements because they involve known and unknown risks, uncertainties, and other factors that are, in some cases, beyond our control and that could materially affect actual results, levels of activity, performance, or achievements.*

*Other factors that could materially affect actual results, levels of activity, performance, or achievements can be found in our other filings with the SEC, including our Annual Report on Form 10-K for the year ended December 31, 2005. If any of these risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may vary significantly from what we projected. Any forward-looking statement you read in this Quarterly Report on Form 10-Q reflects our current views with respect to future events and is subject to these and other risks, uncertainties, and assumptions relating to our operations, results of operations, growth strategy, and liquidity. We assume no obligation to publicly update or revise these forward-looking statements for any reason, whether as a result of new information, future events, or otherwise.*

### **Understanding our Company**

#### **Our Business**

Our mission is to create great products that help investors reach their financial goals. We offer an extensive line of Internet, software, and print-based products for individual investors, financial advisors, and institutional clients. We also offer asset management services for advisors and institutional clients. We have historically generated recurring revenue because many of our products are sold through subscriptions or license agreements. We believe that while the investments in our business are significant, the variable cost of adding customers is considerably lower, particularly as our products and services focus more on Internet-based platforms and assets under management. We strive to realize this operating leverage by selling a wide variety of products and services to multiple investor segments, through multiple media, and in many geographic markets.

Our decentralized structure includes three global business segments: Individual, Advisor, and Institutional. In all three of these segments, we believe our work helps individual investors make better investment decisions. We consolidate the results of our majority-owned operations. We account for our minority-owned investments in Japan, Korea, Denmark, and Sweden using the equity method.

#### **Industry Overview**

##### *Investment Landscape, Research, and Data*

Performance in the U.S. equity markets rebounded strongly in the third quarter after second-quarter declines. The Morningstar U.S. Market Index, a broad market benchmark, posted a total return of 4.6% for the quarter. Total U.S. mutual fund assets increased to about \$9.72 trillion as of September 30, 2006 based on data from Investment Company Institute, compared with about \$9.33 trillion as of March 31, 2006. The number of mutual funds remained stable during the quarter.

The Securities and Exchange Commission (SEC) issued interpretive guidance in July regarding the use of soft dollar payments, which are arrangements in which investment advisors receive research or other services from broker-dealers in exchange for executing trades through that broker. The SEC specified that these bundled payments may be used for third-party research but not for other costs such as overhead and office equipment. Following this guidance, some investment management firms have voiced concern that hedge fund firms aren't subject to the same restrictions. The Investment Company Institute recently issued a statement recommending that the SEC apply the same guidance to all investment advisors, including hedge funds.

Also related to soft dollars, asset managers in the United Kingdom recently began disclosing the amount of brokerage commissions used for transaction costs and research, and industry leaders in France have said they intend to follow this example. Trade associations for fund managers and brokers based in France recently issued recommendations to government regulators related to the amount and usage of brokerage commissions.

We believe these developments are important because they underscore a longer-term trend toward greater pricing transparency and are prompting debate about the cost and value of securities research. In addition, we believe the trend toward unbundled commissions may place additional pressure on budgets for sell-side research, leading to further cuts in coverage lists and increased demand for independent research from companies such as Morningstar.

In September 2006, President Bush signed the Credit Agency Reform Act, which will allow companies that meet certain standards to register with the SEC as rating organizations, broadening competition from current restrictions that only allow credit ratings by five firms currently designated as nationally recognized rating agencies. We believe that increased competition in the credit ratings industry would be favorable for investors, and we're continuing to monitor the potential impact of this development on our business.

Despite the high-profile problems experienced by some hedge funds, we continued to see strong interest in alternative asset classes, including hedge funds, in the third quarter of 2006. Based on data from Hedge Fund Research, hedge funds had net inflows of \$45 billion during the third quarter of 2006, compared with \$42 billion in the second quarter of 2006.

Several firms, including Moody's, Standard & Poor's, and Fitch, recently announced plans to introduce hedge-fund ratings in response to investor interest in this area. We continue to monitor developments in the industry and have continued to expand our analyst coverage on hedge funds. We're evaluating the possibility of providing a rating system for hedge funds, but we don't have any definitive plans or timetable.

Following an appeals court ruling that overturned a previous SEC rule requiring hedge funds to register as investment advisors, numerous hedge fund firms have withdrawn their previous registrations. At the same time, losses experienced by individual funds have led some industry leaders to call for increased regulation. The SEC has also voiced concern about potential insider trading on the part of hedge funds. As debate about hedge fund regulation goes on, we plan to continue our efforts to make the industry more transparent for investors.

In the exchange-traded funds (ETF) area, assets increased about 35% to reach about \$350 billion as of September 2006, compared with \$259 billion as of September 2005, based on data from the Investment Company Institute. Exchange-traded funds have gained share from mutual funds in some specialized areas of the market thanks to their lower annual costs, particularly in passive investing strategies. To meet greater investor demand for information on exchange-traded funds, we have continued to increase our analyst coverage in this area and recently introduced a new investor newsletter covering these funds.

In response to rapid growth in the exchange-traded fund arena, management firm Amvescap recently completed its acquisition of ETF specialist PowerShares Capital Management. We believe this development underscores the strong degree of interest in these funds both among individual investors and institutional firms.

#### *Individual Investor Market*

Despite the strong equity markets, some indications have suggested that the environment for online advertising sales weakened during the third quarter of 2006. We believe this development is consistent with typical seasonal trends, in which spending for ad sales often slows during the third quarter and then picks up again in the fourth quarter as marketers try to spend their budgets.

Based on research from Nielsen/NetRatings, page views to most retail investment Web sites remained fairly consistent during the third quarter of 2006. Page views to Yahoo! Finance declined, but the site maintained a dominant share of total page views and user visits compared with other retail investment Web sites. We continue to define Morningstar.com as a targeted site that appeals to experienced and engaged investors. During the quarter, page views to Morningstar.com were lower than those of supersites such as Yahoo! Finance, AOL Money & Finance, and MSN Money, but the time spent per visit and average page views per visit statistics remained higher than those of competing sites.

#### *Financial Advisor Market*

The greater need for information and advice on retirement income planning has remained an important trend in the advisor market, largely driven by demographic trends. As baby boomers reach retirement age, millions of Americans will face the need to manage income during retirement. We believe that advisors will begin seeking tools that support their work in this area, as well as resources that help them educate clients about the importance of retirement income planning. So far this year, we've launched two retirement income solutions for financial advisors. The Retirement Income Education Center is a hosted Web site offering educational content advisors can use to discuss retirement risks with clients. Retirement Income Strategist is a financial planning application that helps advisors create comprehensive reports analyzing retirement income for investors who are nearing or in retirement.

Based on our research, we believe that financial advisors have also continued to look for integrated portfolio tools. To meet this market need, we recently introduced an integrated portfolio accounting system that includes extensive importing capabilities, portfolio tracking, portfolio performance reporting, and accounting functionality to Morningstar Advisor Workstation Office Edition, our platform for independent financial advisors. The new system allows financial advisors to merge client accounting reports with Morningstar investment data and portfolio analytics.

We believe regulatory compliance has been another ongoing theme in the financial advisor market. Broker-dealer firms have

continued working to interpret and apply point-of-sale disclosure requirements. Morningstar currently provides tools to help advisors with share class suitability and breakpoint analysis, and we recently introduced a 529 Suitability Manager tool to help advisors communicate the fees and state tax benefits associated with 529 college savings plans.

### *Institutional Market*

In August 2006, President Bush signed the Pension Protection Act of 2006, which includes provisions for offering investment advice programs for participants in defined contribution plans. The investment advice provision is scheduled to go into effect for employer-sponsored retirement plans on January 1, 2007.

Among other things, the new act will allow plan service providers, mutual fund companies, and brokerage firms to offer investment advice to plan participants using their own computer models (including advising them to invest in their own proprietary funds), subject to certification of the computer model by an independent expert. We're continuing to monitor the potential impact of this provision on our business. Although more companies may rely on retirement plan providers to offer investment advice to their employees, we believe there will be ongoing demand for third-party advice as well. In particular, we believe there may be opportunities for us to continue to license our computer-driven advice model to plan providers.

The legislation also contains provisions that some industry experts have predicted will increase the use of automatic enrollment. The bill sets a deadline of mid-February 2007 for the Department of Labor to issue guidance on appropriate default investment options for defined contribution plan participants. Some of these default investment options may involve managed retirement accounts. Therefore, we believe this development may have a positive impact on the managed retirement accounts that we offer through Morningstar Associates and Ibbotson Associates.

Continuing an industry-wide trend toward separating the manufacturing and distribution of investment portfolios, the parent company of Putnam Investments (Marsh & McLennan Companies) recently confirmed that it may sell its asset-management unit. In addition, Principal Financial recently completed its acquisition of Washington Mutual's mutual fund management arm, along with its distributor and shareholder-services business. We believe these developments are important because they may lead to stronger performance for the funds, as well as potentially lower fees. We also continue to monitor mergers and acquisitions in the asset management industry because of their potential impact on specific areas of our business.

### *International Markets*

In Canada, the Canadian Securities Administrators recently announced new rules intended to improve oversight of investment funds in Canada, including open-end funds, closed-end funds, retirement funds, and commodity pools. The funds will be required to have an independent review committee to oversee management and monitor potential conflicts of interest. We believe this development is important because it may improve fund governance in Canada, which has had year-over-year growth in mutual fund assets of about 20% over the past several quarters.

Mutual fund assets in Japan have expanded so far in 2006, fueled by low interest rates on savings accounts and investors' increasing acceptance of investment risk. We currently have a presence in Japan through our minority ownership position in Morningstar Japan K.K. as well as through Ibbotson Associates.

Similar to the trend we have seen in the United States, exchange-traded funds have shown dramatic asset growth outside the United States, particularly in Europe. Our international database includes coverage of exchange-traded funds, and we're planning to expand our coverage on these funds in response to investor interest in this area.

### **Third Quarter 2006 Acquisitions**

In July 2006, we completed our acquisition of Aspect Huntley Pty Limited (Aspect Huntley), and in August 2006, we completed our acquisition of the institutional hedge fund and separate accounts database division of InvestorForce, Inc. (InvestorForce). Aspect Huntley's investment publications are now included as part of our Individual segment. Aspect Huntley's software and investment conferences are now included in our Advisor segment. Aspect Huntley's financial information and other data on Australian stocks is now included in our Institutional segment. The database division of InvestorForce is also included in our Institutional segment.

## Three and Nine Months Ended September 30, 2006 vs. Three and Nine Months Ended September 30, 2005

### Consolidated Results

| Key Metrics (\$000)                   | Three Months Ended September 30 |           |         | Nine Months Ended September 30 |            |         |
|---------------------------------------|---------------------------------|-----------|---------|--------------------------------|------------|---------|
|                                       | 2006                            | 2005      | Change  | 2006                           | 2005       | Change  |
| Revenue                               | \$ 81,821                       | \$ 56,927 | 43.7 %  | \$ 228,138                     | \$ 166,374 | 37.1 %  |
| Operating income                      | 20,537                          | 12,347    | 66.3 %  | 57,194                         | 32,369     | 76.7 %  |
| Operating margin                      | 25.1 %                          | 21.7 %    | 3.4 pp  | 25.1 %                         | 19.5 %     | 5.6 pp  |
| Stock-based compensation expense      | \$ 2,258                        | \$ 2,030  | 11.2 %  | \$ 6,271                       | \$ 8,855   | (29.2)% |
| Cash used for investing activities    | (46,164)                        | (10,910)  | 323.1 % | (112,173)                      | (10,907)   | NMF     |
| Cash provided by financing activities | 4,677                           | 2,572     | 81.8 %  | 22,032                         | 22,054     | (0.1)%  |
| Cash provided by operating activities | \$ 29,598                       | \$ 18,236 | 62.3 %  | \$ 69,027                      | \$ 29,885  | 131.0 % |
| Capital expenditures                  | (853)                           | (1,298)   | (34.3)% | (2,876)                        | (3,625)    | (20.7)% |
| Free cash flow                        | \$ 28,745                       | \$ 16,938 | 69.7 %  | \$ 66,151                      | \$ 26,260  | 151.9 % |

*NMF* — not meaningful

*pp* — percentage points

We define free cash flow as cash provided by or used for operating activities less capital expenditures. We present free cash flow solely as supplemental disclosure to help you better understand how much cash is available after we spend money to operate our business. Our management team uses free cash flow to evaluate the performance of our business. Free cash flow should not be considered an alternative to any measure of performance as promulgated under U.S. generally accepted accounting principles (GAAP) (such as cash provided by (used for) operating, investing, and financing activities), nor should this data be considered an indicator of our overall financial performance or liquidity. Also, the free cash flow definition we use may not be comparable to similarly titled measures used by other companies.

### Consolidated Revenue

In the third quarter of 2006, we generated revenue of \$81.8 million, a \$24.9 million increase over the same period in 2005. In the nine months ended September 30, 2006, we generated revenue of \$228.1 million, a \$61.7 million increase over the prior-year period. Recent acquisitions, including Ibbotson, Aspect Huntley, and the database division of InvestorForce, Inc., contributed \$11.6 million and \$22.8 million to our consolidated revenue in the third quarter and year-to-date periods, respectively. Of the revenue contributed by acquisitions in the quarter, more than 75% was contributed by Ibbotson, with the remainder primarily contributed by Aspect Huntley; in the year-to-date period, Ibbotson contributed almost 90% of the revenue generated from acquisitions.

While revenue increased in each of our three business segments, the Institutional segment was the largest contributor to revenue growth, generating over half of the revenue increase in both the third quarter and year-to-date periods. Institutional segment revenue increased \$14.5 million, or 60.3% in the third quarter, and \$34.0 million, or 49.1% in first nine months of the year. Acquisitions contributed \$8.2 million and \$15.5 million to Institutional segment revenue in the third quarter and year-to-date periods, respectively, primarily from Ibbotson. The Advisor segment accounted for approximately one-fourth of the revenue increase in both the third quarter and year-to-date periods. Advisor segment revenue increased \$5.8 million, or 31.2%, in the third quarter and \$16.6 million, or 30.8%, in the first nine months of 2006. Acquisitions contributed \$1.7 million and \$4.7 million to Advisor segment revenue in the third quarter and year-to-date periods, respectively, mainly from Ibbotson. Individual segment revenue increased \$4.9 million, or 31.6%, in the third quarter and \$12.3 million, or 26.3%, in the first nine months of 2006. Acquisitions contributed \$1.7 million and \$2.6 million of revenue to the Individual segment in the third quarter and year-to-date periods, respectively. Aspect Huntley contributed a large portion of this revenue in the third quarter and about half of the revenue in the year-to-date period, with the remainder of the increase from Ibbotson.

On a product level, over 40% of the increase in consolidated revenue growth in both the quarter and year-to-date periods was generated by the combination of Investment Consulting services and Morningstar Advisor Workstation. Approximately 50% and 40% of the growth in Investment Consulting revenue in the quarter and year-to-date periods, respectively, was driven by newly incorporated revenue from Ibbotson. The remaining increase, as seen in the past several quarters, was mainly driven by increased assets under management among existing clients for the asset allocation services we provide for funds of funds, including mutual funds and variable annuities. Growth in Advisor Workstation was mainly generated by the Enterprise Edition, which we offer to financial advisors affiliated with larger firms, reflecting growth in license agreements to both new and existing customers and an increase in the amount of functionality licensed. Total licenses for Advisor Workstation in the United States increased by nearly 20% as of September 30, 2006 compared with the prior-year period. One-time revenue of \$1.3 million for a payment received related to eliminating a redundant license

following a client merger also contributed to the increase in Advisor Workstation revenue in the third quarter and year-to-date periods.

In both the third quarter and year-to-date periods, the remaining increase in revenue excluding acquisitions was driven primarily by Morningstar.com, including Premium Membership service and Internet advertising; Licensed Data; Morningstar Equity Research; and Morningstar Direct. Newly acquired revenue from EnCorr and the Advice by Ibbotson service were also significant contributors to the increase in revenue.

Revenue from international operations increased \$4.8 million, or 63.3%, to \$12.3 million in the third quarter of 2006. Acquisitions contributed \$3.2 million of the increase, the majority of which was from Aspect Huntley. In the year-to-date period, revenue from international operations increased \$8.6 million, or 39.9%, to \$30.3 million. Acquisitions contributed \$3.9 million of this increase, including roughly equal contributions from both Aspect Huntley and Ibbotson. Foreign currency translations increased international revenue by \$0.3 million in the third quarter and \$0.4 million in the year-to-date period.

Revenue growth excluding acquisitions and foreign currency translations (organic revenue) for our consolidated operations was approximately 23% in both the quarter and year-to-date periods. Organic revenue growth for our international operations was approximately 16% and 20%, respectively, in the quarter and year-to-date periods. Organic revenue growth in our U.S. operations increased at a faster rate than our non-U.S. operations in both periods, mainly because several of our most rapidly growing products, including Investment Consulting, Advisor Workstation, and Morningstar.com, generate revenue primarily in the United States.

The table below presents a reconciliation from our consolidated revenue to revenue excluding acquisitions and the impact of foreign currency translations (organic revenue):

| (\$000)  | Three Months Ended September 30 |           |        | Nine Months Ended September 30 |            |        |
|--|---------------------------------|-----------|--------|--------------------------------|------------|--------|
|  | 2006                            | 2005      | Change | 2006                           | 2005       | Change |
| Consolidated revenue   | \$ 81,821                       | \$ 56,927 | 43.7 % | \$ 228,138                     | \$ 166,374 | 37.1 % |
| Less: acquisitions   | (11,639)                        | —         | NMF    | (22,815)                       | —          | NMF    |
| Less: impact of foreign currency                                 | (335)                           | —         | NMF    | (358)                          | —          | NMF    |
| Revenue excluding acquisitions and foreign currency translations | \$ 69,847                       | \$ 56,927 | 22.7 % | \$ 204,965                     | \$ 166,374 | 23.2 % |

The table below presents a reconciliation from our international revenue to international revenue excluding acquisitions and the impact of foreign currency:

| (\$000)  | Three Months Ended September 30 |          |        | Nine Months Ended September 30 |           |        |
|--|---------------------------------|----------|--------|--------------------------------|-----------|--------|
|  | 2006                            | 2005     | Change | 2006                           | 2005      | Change |
| International revenue  | \$ 12,304                       | \$ 7,536 | 63.3 % | \$ 30,259                      | \$ 21,635 | 39.9 % |
| Less: acquisitions   | (3,214)                         | —        | NMF    | (3,935)                        | —         | NMF    |
| Less: impact of foreign currency                                 | (335)                           | —        | NMF    | (358)                          | —         | NMF    |
| Revenue excluding acquisitions and foreign currency translations | \$ 8,755                        | \$ 7,536 | 16.2 % | \$ 25,966                      | \$ 21,635 | 20.0 % |

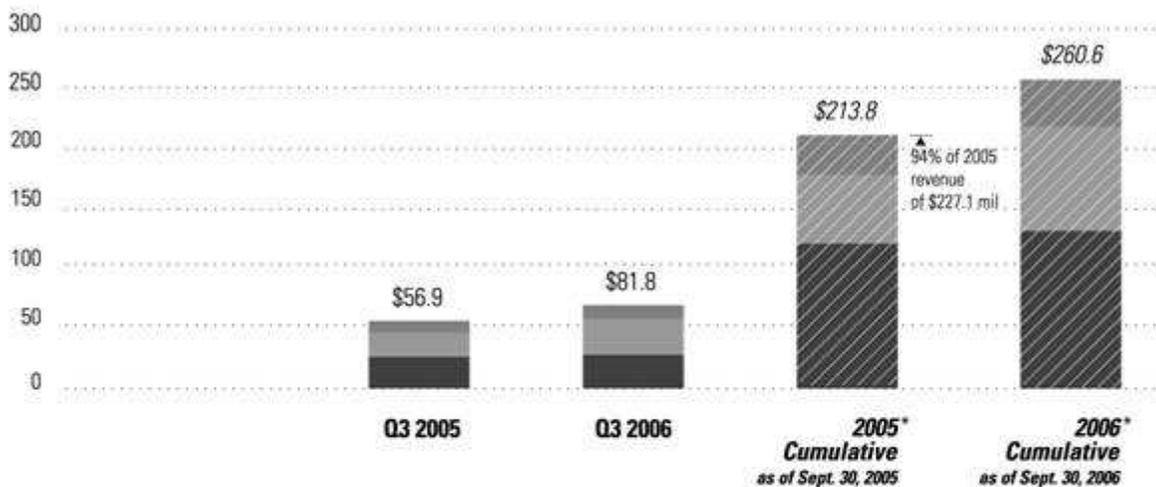
We present revenue excluding acquisitions and the impact of foreign currency translations (organic revenue) because we believe this non-GAAP measure helps investors better compare period-to-period results. Organic revenue should not be considered an alternative to any measure of performance as promulgated under GAAP.

#### Revenue Composition

We separate our revenue into three categories: 1) new revenue, which we define as revenue from selling additional products to current customers or from selling to new customers; 2) renewal revenue, which we define as revenue from renewals of subscriptions or licenses; and 3) “walk-in” revenue, which we define as revenue we expect to recognize during the year from subscriptions and license agreements in place as of January 1 of each year, adjusted for cancellations, currency translations, and other routine adjustments during the year. As we progress through the calendar year, we expect that walk-in revenue will represent a smaller part of each quarter’s revenue as subscriptions and license agreements in place at the beginning of the year expire or come up for renewal; similarly, we expect that revenue from new contracts and renewals will represent a greater share of each quarter’s revenue.

The following table illustrates the composition of our third quarter 2005 revenue, our third quarter 2006 revenue, and the estimated composition of our 2005 and 2006 revenue from business closed through the end of the third quarter of each year. We have not incorporated revenue from 2006 acquisitions (Ibbotson, Aspect Huntley, and the database division of InvestorForce) into our revenue composition categories.

**Revenue Composition (\$mil)**



|                               | Q3 2005 | Q3 2006 | 2005* Cumulative as of Sept. 30, 2005 | 2006* Cumulative as of Sept. 30, 2006 |
|-------------------------------|---------|---------|---------------------------------------|---------------------------------------|
| New Revenue                   | \$ 10.1 | \$11.4  | \$ 33.7                               | \$ 39.7                               |
| Renewal Revenue               | 20.2    | 30.6    | 58.0                                  | 88.1                                  |
| Walk-in Revenue               | 26.6    | 28.2    | 122.1                                 | 132.8                                 |
| Revenue excluding Aquisitions | \$56.9  | \$70.2  | \$213.8                               | \$260.6                               |
| Revenue from Aquisitions      | —       | 11.6    | —                                     | —                                     |
| Consolidated Revenue          | \$56.9  | \$81.8  | \$213.8                               | \$260.6                               |

\* Each year's cumulative revenue is an estimate of revenue that will be recognized from business closed through the end of the third quarter. It includes net walk-in revenue plus the full-year impact, absent cancellations, of new and renewal business closed during the first nine months of each year. This estimate does not include any revenue from new or renewal business that will be closed during the fourth quarter of each year. Revenue from 2006 acquisitions has not been incorporated into new, renewal, or walk-in revenue.

Our third quarter 2006 revenue consisted of \$11.4 million in new revenue, or 16.2% of our total revenue excluding acquisitions, in the quarter. Renewal revenue accounted for \$30.6 million, or 43.6% of our total revenue excluding acquisitions, in the quarter. Walk-in revenue accounted for \$28.2 million, or 40.2% of our total revenue excluding acquisitions, in the quarter.

Our estimate of 2006 walk-in revenue as of January 1, 2006 was \$138.8 million. In the second quarter of 2006, we reclassified a portion of our revenue composition, reducing 2006 walk-in revenue by \$5.0 million, to more accurately reflect the cancellation terms of certain institutional contracts. Cancellations in the first nine months of 2006, the impact of currency translations, and other routine adjustments further reduced our estimate of walk-in revenue by \$1.0 million. The total impact of these adjustments reduced walk-in revenue by \$6.0 million, or approximately 4%, to \$132.8 million. Changes in our revenue composition categories have no impact on our revenue reported in our Consolidated Statements of Operations.

In the first nine months of 2006, we closed renewals and brought in new business that will contribute an estimated \$127.8 million to 2006 revenue. As a result, we expect that walk-in revenue plus the impact of new and renewal business closed during the first nine months of 2006 will be \$260.6 million in 2006. This estimate does not include the impact of revenue from business that we close or cancellations that occur in the remaining three months of 2006, nor does it include the impact of revenue from acquisitions. In addition, the 2006 total does not include variable revenue from asset-based services such as Morningstar Managed Portfolios, managed retirement accounts, and Investment Consulting.

At the end of the third quarter of 2005, the combination of walk-in revenue plus new business and renewals closed during the first nine months of 2005 totaled \$213.8 million. This represented 94% of our full year revenue of \$227.1 million. While we do not expect that this percentage will remain constant from year to year, we do believe that the trend of closing a significant portion of the year's revenue early in the year is a characteristic of our business.

After reporting full-year financial results for 2006 and walk-in revenue for 2007, we will no longer report quarterly information on new, renewal, and walk-in revenue. We are evaluating new metrics that we believe may be more useful to investors.

### Consolidated Operating Expense

| (\$000)           | Three Months Ended September 30 |           |          | Nine Months Ended September 30 |            |          |
|-------------------|---------------------------------|-----------|----------|--------------------------------|------------|----------|
|                   | 2006                            | 2005      | Change   | 2006                           | 2005       | Change   |
| Operating expense | \$ 61,284                       | \$ 44,580 | 37.5 %   | \$ 170,944                     | \$ 134,005 | 27.6 %   |
| % of revenue      | 74.9 %                          | 78.3 %    | (3.4) pp | 74.9 %                         | 80.5 %     | (5.6) pp |

In the third quarter of 2006, operating expense increased \$16.7 million, and in the first nine months of 2006, operating expense increased \$36.9 million. In both periods, two primary factors impacted all of our operating expense categories: compensation-related costs, including incentive compensation, and recent acquisitions. Bonus expense recorded in the third quarter and first nine months of 2006 increased \$5.0 million and \$11.2 million, respectively, reflecting the third-quarter impact of updated internal estimates for full-year 2006 performance versus 2005; an adjustment to bring year-to-date bonus expense in line with these estimates; and incremental bonus expense from acquisitions, primarily Ibbotson. A majority of our bonus pool is based on growth in our operating income, which may or may not recur.

Other compensation-related expense increased \$5.7 million and \$13.4 million, respectively, in the quarter and year-to-date periods mainly because of an increase in headcount, as well as annual salary increases. We had approximately 1,400 employees as of September 30, 2006, compared with about 1,120 as of September 30, 2005. About half of the increase in headcount was related to acquisitions, and a good portion of the remaining increase was from continued hiring in our development center in China. In addition to the increase in compensation-related expense, the increase in operating expense includes \$2.0 million and \$4.1 million, respectively, of amortization expense in the quarter and year-to-date periods for intangible assets acquired with Ibbotson, Aspect Huntley, and the database division of InvestorForce. We expect that amortization of these intangible assets will be an ongoing cost through the useful lives of these assets.

In the year-to-date period, lower stock-based compensation expense partially offset increases in each of our operating expense categories. Stock-based compensation expense decreased \$2.6 million in the first nine months of 2006 compared with the same period in 2005 because we are no longer required to record expense under the liability method. In the first quarter of 2005, we recorded \$2.8 million of stock-based compensation expense under this method, which did not recur in 2006.

## Cost of Goods Sold

| (\$000)            | Three Months Ended September 30 |           |         | Nine Months Ended September 30 |         |         |
|--------------------|---------------------------------|-----------|---------|--------------------------------|---------|---------|
|                    | 2006                            | 2005      | Change  | 2006                           | 2005    | Change  |
| Cost of goods sold | \$ 22,389                       | \$ 16,261 | 37.7 %  | \$ 63,114                      | 47,847  | 31.9 %  |
| % of revenue       | 27.4 %                          | 28.6 %    | (1.2)pp | 27.7 %                         | 28.8 %  | (1.1)pp |
| Gross profit       | \$ 59,432                       | \$ 40,666 | 46.1 %  | \$ 165,024                     | 118,527 | 39.2 %  |
| Gross margin       | 72.6 %                          | 71.4 %    | 1.2 pp  | 72.3 %                         | 71.2 %  | 1.1 pp  |

Cost of goods sold is our largest category of operating expense, accounting for more than 35% of the total in both the quarter and year-to-date periods. Our business relies heavily on human capital, and cost of goods sold includes the compensation expense for employees who produce the products and services we deliver to our customers. Cost of goods sold increased \$6.1 million in the third quarter of 2006 and \$15.3 million in the first nine months of 2006. The increase in expense was driven primarily by higher bonus expense and other compensation-related expense, which was mainly driven by an increase in headcount. While compensation and bonus expense increased across all three of our business segments, the increase was more pronounced in our Institutional segment mainly because a larger portion of the incremental headcount added by recent acquisitions occurred in this segment.

Acquisitions, primarily Ibbotson, also contributed to the increase in other areas of cost of goods sold. In the quarter and year-to-date periods, we recorded \$0.7 million and \$1.9 million, respectively, of outsourced product implementation expense associated with the Advice by Ibbotson service. Costs for outsourced product implementation may or may not recur, depending on client requests for development projects in a given period. Our gross margin in the third quarter of 2006 increased to 72.6%, compared with 71.4% in the third quarter of 2005, reflecting revenue growth that outpaced the increase in cost of goods sold. In the year-to-date period, gross margin improved to 72.3% compared with 71.2% in the same period last year. A \$0.3 million reduction in stock-based compensation expense contributed to the margin improvement for this period.

## Development Expense

| (\$000)             | Three Months Ended September 30 |          |        | Nine Months Ended September 30 |           |        |
|---------------------|---------------------------------|----------|--------|--------------------------------|-----------|--------|
|                     | 2006                            | 2005     | Change | 2006                           | 2005      | Change |
| Development expense | \$ 7,876                        | \$ 4,749 | 65.8 % | \$ 21,273                      | \$ 14,491 | 46.8 % |
| % of revenue        | 9.6 %                           | 8.3 %    | 1.3 pp | 9.3 %                          | 8.7 %     | 0.6 pp |

Development expense increased \$3.2 million in the third quarter of 2006 and \$6.8 million in the first nine months of 2006. The increase in both periods mainly includes additional bonuses and other compensation-related expense as well as incremental costs added by acquisitions. As a percentage of revenue, development expense increased in both the third quarter and year-to-date periods compared with the same periods last year.

## Sales and Marketing Expense

| (\$000)                     | Three Months Ended September 30 |          |         | Nine Months Ended September 30 |           |         |
|-----------------------------|---------------------------------|----------|---------|--------------------------------|-----------|---------|
|                             | 2006                            | 2005     | Change  | 2006                           | 2005      | Change  |
| Sales and marketing expense | \$ 12,971                       | \$ 9,499 | 36.6 %  | \$ 36,511                      | \$ 29,129 | 25.3 %  |
| % of revenue                | 15.9 %                          | 16.7 %   | (0.8)pp | 16.0 %                         | 17.5 %    | (1.5)pp |

Sales and marketing expense increased \$3.5 million in the third quarter of 2006 and \$7.4 million in the first nine months of 2006. The increase in expense reflects higher compensation and bonus expense as a result of increased hiring for sales and marketing staff, mainly in our Advisor and Institutional segments, and in the year-to-date period, higher sales commission expense in our Advisor and Institutional segments, primarily because of increased sales volume. Incremental costs added by acquisitions also contributed a good portion of the growth in this category. As a percentage of revenue, sales and marketing expense decreased in both the quarter and year-to-date periods because revenue growth outpaced growth in this cost category.

## General and Administrative Expense

| (\$000)                            | Three Months Ended September 30 |           |         | Nine Months Ended September 30 |           |         |
|------------------------------------|---------------------------------|-----------|---------|--------------------------------|-----------|---------|
|                                    | 2006                            | 2005      | Change  | 2006                           | 2005      | Change  |
| General and administrative expense | \$ 13,781                       | \$ 11,849 | 16.3 %  | \$ 39,606                      | \$ 36,068 | 9.8 %   |
| % of revenue                       | 16.8 %                          | 20.8 %    | (4.0)pp | 17.4 %                         | 21.7 %    | (4.3)pp |

General and administrative expense increased \$2.0 million in the third quarter of 2006 and \$3.5 million in the first nine months of 2006. For both periods, the increase reflects higher compensation-related expense, including bonuses, a portion of which were added by acquisitions. In the year-to-date period, these increases were partially offset by a \$2.0 million decrease in stock-based compensation expense, primarily because we did not record any stock-based compensation expense under the liability method in the first nine months of 2006. General and administrative expense as a percentage of revenue declined because revenue growth outpaced

expense growth is this cost category; in the year-to-date period, the impact of lower stock-based compensation costs also contributed to the decline as a percentage of revenue.

#### Depreciation and Amortization Expense

| (\$000)                               | Three Months Ended September 30 |          |        | Nine Months Ended September 30 |          |        |
|---------------------------------------|---------------------------------|----------|--------|--------------------------------|----------|--------|
|                                       | 2006                            | 2005     | Change | 2006                           | 2005     | Change |
| Depreciation and amortization expense | \$ 4,267                        | \$ 2,222 | 92.0 % | \$ 10,440                      | \$ 6,470 | 61.4 % |
| % of revenue                          | 5.2 %                           | 3.9 %    | 1.3 pp | 4.6 %                          | 3.9 %    | 0.7 pp |

Depreciation and amortization expense rose \$2.1 million in the third quarter and \$3.9 million in the first nine months of 2006 compared with the comparable periods in 2005. These increases were almost entirely driven by added amortization expense from intangible assets acquired with Ibbotson, Aspect Huntley, and the database division of InvestorForce. We expect that amortization of these intangible assets will be an ongoing cost for the remaining life of the asset. The increase in amortization expense was slightly offset by a decrease in depreciation and amortization expense for certain capitalized internal product development costs and computer equipment that are now fully depreciated.

#### Stock-Based Compensation Expense

The following table summarizes our stock-based compensation expense:

| (\$000)   | Three Months Ended September 30 |          |          | Nine Months Ended September 30 |          |           |
|---|---------------------------------|----------|----------|--------------------------------|----------|-----------|
|   | 2006                            | 2005     | Change   | 2006                           | 2005     | Change    |
| Stock-based compensation expense—<br>liability method | \$ —                            | \$ —     | — %      | \$ —                           | \$ 2,810 | (100.0) % |
| Stock-based compensation expense—<br>equity method    | 2,258                           | 2,030    | 11.2 %   | 6,271                          | 6,045    | 3.7 %     |
| Total stock-based compensation expense                | \$ 2,258                        | \$ 2,030 | 11.2 %   | \$ 6,271                       | \$ 8,855 | (29.2) %  |
| % of revenue  | 2.8 %                           | 3.6 %    | (0.8) pp | 2.7 %                          | 5.3 %    | (2.6) pp  |

As a result of our initial public offering in May 2005, we are no longer required to settle stock options in cash and therefore are no longer required to record stock-based compensation expense under the liability method. Therefore, we did not record any stock-based compensation expense under the liability method in the first nine months of 2006; in contrast, we recorded \$2.8 million of expense under this method in the first nine months of 2005.

Stock-based compensation expense recorded under the equity method increased \$0.3 million in both the third quarter and first nine months of 2006. An increase in expense related to our annual equity grant in May, which consisted of restricted stock units, was substantially offset by lower expense recorded for stock options granted in previous years, as certain options became fully vested and no longer require us to record additional expense.

In 2006 we expect to record stock-based compensation expense of approximately \$8.6 million for all stock-based awards outstanding as of September 30, 2006.

#### Bonus Expense

| (\$000)       | Three Months Ended September 30 |          |        | Nine Months Ended September 30 |           |        |
|---------------|---------------------------------|----------|--------|--------------------------------|-----------|--------|
|               | 2006                            | 2005     | Change | 2006                           | 2005      | Change |
| Bonus expense | \$ 10,378                       | \$ 5,370 | 93.3 % | \$ 26,733                      | \$ 15,458 | 72.9 % |
| % of revenue  | 12.7 %                          | 9.4 %    | 3.3 pp | 11.7 %                         | 9.3 %     | 2.4 pp |

Bonus expense recorded in the third quarter and first nine months of 2006 increased \$5.0 million and \$11.2 million, respectively, reflecting the third-quarter impact of updated internal estimates for full-year performance versus 2005; an adjustment to bring year-to-date bonus expense in line with these estimates; and incremental bonus expense from acquisitions, primarily Ibbotson. A majority of our bonus pool is based on operating income growth, which may or may not recur. We include bonus expense in each of our operating expense categories.

## Consolidated Operating Income

| (\$000)          | Three Months Ended September 30 |           |        | Nine Months Ended September 30 |           |        |
|------------------|---------------------------------|-----------|--------|--------------------------------|-----------|--------|
|                  | 2006                            | 2005      | Change | 2006                           | 2005      | Change |
| Operating income | \$ 20,537                       | \$ 12,347 | 66.3 % | \$ 57,194                      | \$ 32,369 | 76.7 % |
| % of revenue     | 25.1 %                          | 21.7 %    | 3.4 pp | 25.1 %                         | 19.5 %    | 5.6 pp |

Consolidated operating income increased \$8.2 million in the third quarter of 2006 and \$24.8 million in the first nine months of 2006. Despite incremental costs added by acquisitions, such as amortization of intangible assets and increased compensation-related expense, our operating margin improved in both the quarter and year-to-date period because our revenue base expanded at a faster rate. We realized operating leverage from revenue growth in products that have had slower-growing costs, such as Investment Consulting, Advisor Workstation, Licensed Data, and Morningstar.com. In the year-to-date period, our operating margin was also positively impacted by a \$2.6 million decrease in stock-based compensation.

## Consolidated Free Cash Flow

We generated free cash flow of \$28.7 million in the third quarter of 2006, reflecting cash provided by operating activities of \$29.6 million and capital expenditures of \$0.9 million. Free cash flow increased \$11.8 million in the third quarter of 2006 compared with the third quarter of 2005, mainly reflecting a \$11.4 million increase in cash flow provided by operating activities. The increase in cash flow provided by operating activities was largely driven by increases in net income, income taxes payable, and accrued compensation. The increase in income taxes payable reflects income tax payments we expect to make in the fourth quarter because we have fully utilized the \$12.8 million in cash tax benefits we received from the Ibbotson acquisition. The increase in accrued compensation reflects the build-up of our bonus liability that will be paid in the first quarter of next year, when we typically make our annual bonus payments.

In the first nine months of 2006, we generated free cash flow of \$66.2 million, reflecting cash provided by operating activities of \$69.0 million and capital expenditures of approximately \$2.8 million. Free cash flow in the nine months ended September 30, 2006 increased \$39.9 million compared with the prior-year period, primarily reflecting a \$39.1 million increase in cash provided by operating activities. The increase in cash provided by operating activities was primarily driven by an increase in net income and income taxes payable. In the first nine months of 2006, we paid \$12.0 million less for income taxes compared with the same period last year, reflecting the cash tax benefits we received from the Ibbotson acquisition. We have fully utilized this cash tax benefit, and have increased our accrual for income taxes payable in anticipation of payments to be made in the fourth quarter.

Capital expenditures decreased approximately \$0.4 million in the third quarter and \$0.8 million in the first nine months of 2006. In the first nine months of 2006, we made capital expenditures primarily for leasehold improvements to our new office space in London, computer hardware and software, and capitalized internal product development costs. In the first nine months of 2005, capital expenditures mainly included spending for leasehold improvements in our corporate headquarters in Chicago, computer hardware, and leasehold improvements to our office space in China.

The table below presents a reconciliation between the increase in net income and the increase in cash flow provided by operating activities:

| (\$000)  | Three Months Ended September 30 |           |           | Nine Months Ended September 30 |           |           |
|--|---------------------------------|-----------|-----------|--------------------------------|-----------|-----------|
|  | 2006                            | 2005      | Change    | 2006                           | 2005      | Change    |
| Net income   | \$ 13,547                       | \$ 7,519  | \$ 6,028  | \$ 38,151                      | \$ 21,024 | \$ 17,127 |
| Adjustments to reconcile net income to net cash flows from operating activities: |                                 |           |           |                                |           |           |
| Non-cash items included in net income  | 1,328                           | 6,252     | (4,924)   | 3,541                          | 15,145    | (11,604)  |
| Changes in operating assets and liabilities, net of effects of acquisitions:     |                                 |           |           |                                |           |           |
| Cash paid for bonuses  | (552)                           | —         | (552)     | (22,978)                       | (18,000)  | (4,978)   |
| Cash paid for income taxes   | (1,267)                         | (4,735)   | 3,468     | (3,481)                        | (15,471)  | 11,990    |
| All other  | 16,542                          | 9,200     | 7,342     | 53,794                         | 27,187    | 26,607    |
| Cash provided by operating activities  | \$ 29,598                       | \$ 18,236 | \$ 11,362 | \$ 69,027                      | \$ 29,885 | \$ 39,142 |

In the third quarter of 2006, the increase in cash provided by operating activities of \$11.4 million exceeded the \$6.0 million increase in net income. Similarly, in the year-to-date period, the increase in cash provided by operating activities of \$39.1 million outpaced the \$17.1 million increase in net income. In both periods, a reduction in net operating assets and liabilities (working capital excluding cash) as well as an increase in net income contributed to the increase in free cash flow. The reduction in working capital excluding cash was primarily driven by an increase in income taxes payable and accrued compensation. The increase in income taxes payable reflects income tax payments we expect to make in the fourth quarter because we have fully utilized the \$12.8 million in cash tax benefits we received from the Ibbotson acquisition. The increase in accrued compensation reflects the build-up of our bonus liability that will be paid in the first quarter of 2007, when we typically make our annual bonus payments. We made \$0.6 million of bonus payments in the third quarter of 2006 to certain Ibbotson employees. Cash paid for income taxes decreased in both the quarter and year-to-date periods from the comparable periods last year because of the income tax benefits we received primarily related to the payment for the cancellation of Ibbotson's stock options. This cash income tax benefit reduces the amount of cash we pay for income taxes in 2006. In both periods, an increase in the amount of cash paid for bonuses partially offset these increases.

## Segment Results

In the first quarter of 2006, we changed our segment reporting by allocating stock-based compensation expense to each of our three business segments; before 2006, stock-based compensation expense was recorded as a corporate item. We believe this change gives our chief operating decision maker a more complete picture of the profitability of each business segment after fully allocating stock-based compensation expense. We have reclassified the 2005 financial results for each segment to reflect this change.

| Key Metrics (\$000)              | Three Months Ended September 30 |                  |         | Nine Months Ended September 30 |                   |         |
|----------------------------------|---------------------------------|------------------|---------|--------------------------------|-------------------|---------|
|                                  | 2006                            | 2005             | Change  | 2006                           | 2005              | Change  |
| <b>Revenue</b>                   |                                 |                  |         |                                |                   |         |
| Individual                       | \$ 20,389                       | \$ 15,489        | 31.6 %  | \$ 58,892                      | \$ 46,625         | 26.3 %  |
| Advisor                          | 24,397                          | 18,593           | 31.2 %  | 70,468                         | 53,868            | 30.8 %  |
| Institutional                    | 38,569                          | 24,063           | 60.3 %  | 103,437                        | 69,396            | 49.1 %  |
| Eliminations                     | (1,534)                         | (1,218)          | 25.9 %  | (4,659)                        | (3,515)           | 32.5 %  |
| Consolidated revenue             | <u>\$ 81,821</u>                | <u>\$ 56,927</u> | 43.7 %  | <u>\$ 228,138</u>              | <u>\$ 166,374</u> | 37.1 %  |
| <b>Operating income (loss)</b>   |                                 |                  |         |                                |                   |         |
| Individual                       | \$ 5,509                        | \$ 3,548         | 55.3 %  | \$ 17,293                      | \$ 10,523         | 64.3 %  |
| Advisor                          | 7,719                           | 4,114            | 87.6 %  | 20,196                         | 10,936            | 84.7 %  |
| Institutional                    | 9,661                           | 5,626            | 71.7 %  | 25,674                         | 13,647            | 88.1 %  |
| Corporate items and eliminations | (2,352)                         | (941)            | 149.9 % | (5,969)                        | (2,737)           | 118.1 % |
| Consolidated operating income    | <u>\$ 20,537</u>                | <u>\$ 12,347</u> | 66.3 %  | <u>\$ 57,194</u>               | <u>\$ 32,369</u>  | 76.7 %  |
| <b>Operating margin</b>          |                                 |                  |         |                                |                   |         |
| Individual                       | 27.0 %                          | 22.9 %           | 4.1 pp  | 29.4 %                         | 22.6 %            | 6.8 pp  |
| Advisor                          | 31.6 %                          | 22.1 %           | 9.5 pp  | 28.7 %                         | 20.3 %            | 8.4 pp  |
| Institutional                    | 25.0 %                          | 23.4 %           | 1.6 pp  | 24.8 %                         | 19.7 %            | 5.1 pp  |
| Consolidated operating margin    | 25.1 %                          | 21.7 %           | 3.4 pp  | 25.1 %                         | 19.5 %            | 5.6 pp  |

## Individual Segment

Our Individual segment focuses on products and services for individual investors. The largest product in this segment is our U.S.-based Web site, Morningstar.com, which includes both paid Premium Membership service and sales of advertising space. Our Individual segment also includes Morningstar Equity Research, which we distribute through several channels. Investors can access our equity research through our Premium Membership offering on Morningstar.com. In addition, our equity research is distributed through six major investment banks to meet the requirements for independent research under the Global Analyst Research Settlement, as well as to several other companies who provide our research to their affiliated financial advisors or to individual investors. We also offer a variety of print publications on stocks and mutual funds, including our monthly newsletters, *Morningstar FundInvestor* and *Morningstar StockInvestor*, and our twice-monthly publication, *Morningstar Mutual Funds*. We sell several annual reference guides, including the *Morningstar Funds 500*, the *Morningstar Stocks 500*, the *Morningstar ETFs 100*, and the *Stocks, Bonds, Bills, and Inflation Yearbook*. Following our acquisition of Aspect Huntley in July 2006, this segment also includes several newsletters and other publications for investors in Australia. Also, with the addition of Aspect Huntley, our Individual segment now includes revenue from both U.S. and non-U.S. operations. In the first nine months of 2006 and 2005, this segment represented, before intersegment eliminations, 25.8% and 28.0%, respectively, of our consolidated revenue.

| Key Metrics(\$000)   | Three Months Ended September 30 |           |        | Nine months ended September 30 |           |        |
|----------------------|---------------------------------|-----------|--------|--------------------------------|-----------|--------|
|                      | 2006                            | 2005      | Change | 2006                           | 2005      | Change |
| Revenue              | \$ 20,389                       | \$ 15,489 | 31.6 % | \$ 58,892                      | \$ 46,625 | 26.3 % |
| Operating income     | \$ 5,509                        | \$ 3,548  | 55.3 % | \$ 17,293                      | \$ 10,523 | 64.3 % |
| Operating margin (%) | 27.0 %                          | 22.9 %    | 4.1 pp | 29.4 %                         | 22.6 %    | 6.8 pp |

In the third quarter of 2006, revenue for the Individual segment increased \$4.9 million compared with the same period in 2005. In the first nine months of 2006, revenue for the Individual segment increased \$12.3 million compared with the prior-year period. Our acquisitions of Ibbotson and Aspect Huntley contributed \$1.7 million of revenue to the Individual segment in the third quarter of 2006 and \$2.6 million in the year-to-date period. Aspect Huntley contributed a significant portion of the revenue from acquisitions in the third quarter and accounted for about half of this revenue in the year-to-date period.

On a product level, about one-third of the increase in segment revenue in both periods was driven by growth in Morningstar.com, including Premium Membership and Internet advertising sales. The number of subscriptions for Morningstar.com Premium service continued to expand steadily, and Internet advertising sales growth remained strong. The number of subscriptions for Morningstar.com Premium service increased to 161,001 as of September 30, 2006, compared with 141,939 as of September 30, 2005.

In addition, in January 2006, we moderately increased subscription prices for Premium Membership. An increase in revenue related to Morningstar Equity Research, particularly in revenue associated with the Global Analyst Research Settlement, was another important driver behind revenue growth in this segment. In the first nine months of 2005, we provided research related to the Global Analyst Research Settlement under contracts with five investment banks. In September 2005, we entered into an agreement with a sixth investment bank to provide independent equity research under the terms of the settlement, which added incremental revenue in the first nine months of 2006 that we did not have in the same period in 2005. We're also providing analyst coverage on a larger number of stocks compared with the same period last year.

In the third quarter of 2006, operating income for the Individual segment increased \$2.0 million compared with the prior-year quarter. In the first nine months of 2006, Individual segment operating income increased \$6.8 million from the same period in 2005. The increase in operating income reflects revenue growth that flowed through to operating income because of more modest growth in operating expense. This modest growth in operating expense mainly included higher compensation-related expense, including bonuses, particularly in cost of goods sold. Hiring for our equity analyst team, whose compensation costs are included in cost of goods sold, contributed to this increase. The team expanded to 92 equity analysts as of September 30, 2006 compared with 86 as of September 30, 2005.

In the year-to-date period, stock-based compensation expense allocated to the Individual segment decreased \$1.1 million, which partially offset the increase in compensation costs. Despite operating expense increasing in most categories, operating margin improved by 4.1 percentage points in the third quarter and 6.8 percentage points in the year-to-date period, reflecting the impact of higher revenue against the operating expense structure and, in the year-to-date period, a reduction in stock-based compensation expense.

### Advisor Segment

Our Advisor segment focuses on products and services for financial advisors. Key products in this segment are Morningstar Advisor Workstation and Morningstar Principia. Advisor Workstation is a Web-based investment planning system that provides financial advisors with a comprehensive set of tools for conducting their core business including investment research, planning, and presentations. Advisor Workstation is available in two editions: the Office Edition for independent financial advisors and the Enterprise Edition for financial advisors affiliated with larger firms. Principia is our CD-ROM-based investment research and planning software for financial advisors. In addition, we offer Morningstar Managed Portfolios, a fee-based discretionary asset management service that includes a series of mutual fund and exchange-traded fund portfolios tailored to meet a range of investment time horizons and risk levels that financial advisors can use for their clients' taxable and tax-deferred accounts.

Following our acquisition of Ibbotson, we offer a series of NASD-reviewed Financial Communications materials that advisors can use to educate clients about asset allocation and demonstrate other key investment concepts, as well as data and graphs that financial advisors can license to use in published materials. Following our acquisition of Aspect Huntley, this segment also includes software that we sell to financial planners and other market participants in Australia as well as investment conferences. In the first nine months of 2006 and 2005, this segment represented, before intersegment eliminations, 30.9% and 32.4%, respectively, of our consolidated revenue.

| Key Metrics(\$000)   | Three Months Ended September 30 |           |        | Nine Months Ended September 30 |           |        |
|----------------------|---------------------------------|-----------|--------|--------------------------------|-----------|--------|
|                      | 2006                            | 2005      | Change | 2006                           | 2005      | Change |
| Revenue              | \$ 24,397                       | \$ 18,593 | 31.2%  | \$ 70,468                      | \$ 53,868 | 30.8%  |
| Operating income     | \$ 7,719                        | \$ 4,114  | 87.6%  | \$ 20,196                      | \$ 10,936 | 84.7%  |
| Operating margin (%) | 31.6%                           | 22.1%     | 9.5 pp | 28.7%                          | 20.3%     | 8.4 pp |

In the third quarter of 2006, revenue for the Advisor segment increased \$5.8 million compared with the third quarter of 2005, and revenue in the first nine months of 2006 increased \$16.6 million from the prior-year period. Morningstar Advisor Workstation drove the majority of the revenue increase in both periods. We continued to see growth in the Enterprise Edition of Morningstar Advisor Workstation and have continued to benefit from new and renewal contracts that were initiated in the past several quarters. Many contracts that were scheduled to expire during 2005 and 2006 renewed at higher contract values, reflecting both higher user counts and an increase in the amount of functionality licensed. We also recognized \$1.3 million of one-time revenue during the third quarter of 2006 associated with eliminating a redundant license agreement following a client merger, which added to the increase in Advisor Workstation revenue. The number of U.S. licenses for Morningstar Advisor Workstation increased to 121,179 as of September 30, 2006, compared with 102,606 as of September 30, 2005. Most of the license growth came from institutions that license a portion of Advisor Workstation, instead of the entire platform. Although the number of licenses increased compared with the same period last year, it declined slightly from the second quarter of 2006 because of the elimination of the redundant license, an annual reset based on usage, and a reduction in base users for one client renewal.

Acquisitions contributed \$1.7 million and \$4.7 million of revenue to the Advisor segment in the third quarter and year-to-date periods, respectively. In the third quarter, revenue contributed by acquisitions mainly included sales of certain Ibbotson software tools. In the year-to-date period, revenue contributed by acquisitions primarily reflects sales generated from Financial Communications materials

used by financial advisors because a majority of the sales for this product typically occur in the first quarter of each year; Ibbotson software tools also contributed to revenue from acquisitions in the year-to-date period. Morningstar Managed Portfolios also contributed to revenue growth in the segment in both periods, but to a lesser degree. Assets under management for Morningstar Managed Portfolios rose to \$1.6 billion as of September 30, 2006, compared with \$1.3 billion as of September 30, 2005. Principia revenue was essentially unchanged in both the third quarter and year-to-date periods. The number of subscriptions for Principia declined to 48,944 as of September 30, 2006, compared with 50,484 as of September 30, 2005. While the number of subscriptions declined, average revenue per subscription grew primarily because of an increase in the number of higher-priced advanced modules sold and previous price increases.

In the third quarter of 2006, operating income for the Advisor segment increased \$3.6 million compared with the prior-year quarter, and increased \$9.3 million in the first nine months of 2006 compared with the same period last year. The increase in operating income in both periods reflects growth in Advisor segment revenue that outpaced growth in operating expense. Operating expense in the third quarter of 2006 increased approximately \$2.2 million, or 15.2%, compared with the third quarter of 2005, and increased \$7.4 million, or 17.1%, in the first nine months of 2006 compared with the first nine months of 2005. In both the quarter and year-to-date period, costs of goods sold and sales and marketing expense contributed a good majority of the increase in operating expense, primarily reflecting incremental compensation costs related to additional headcount and increased bonus expense. In the year-to-date period, stock-based compensation expense decreased \$0.8 million, partially offsetting expense increases in other areas. Operating margin in the third quarter and year-to-date periods improved by 9.5 percentage points and 8.4 percentage points, respectively, over the same periods in 2005 reflecting the impact of higher revenue against the operating cost structure. Our operating margin in the year-to-date period also benefited from the positive impact of lower stock-based compensation expense.

### Institutional Segment

Our Institutional segment focuses on products and services for institutions, including banks, insurance companies, mutual fund companies, brokerage firms, media outlets, and retirement plan providers and sponsors. Key products and services in this segment are Investment Consulting, which focuses on investment monitoring and asset allocation for funds of funds, including mutual funds and variable annuities; Licensed Data, a set of investment data spanning eight core databases, available through electronic data feeds; Retirement Advice, including the Morningstar Retirement Manager and Advice by Ibbotson platforms; Morningstar Direct, a Web-based institutional research platform that provides advanced research and tools on the complete range of securities in Morningstar's global database; Licensed Tools and Content, a set of online tools and editorial content designed for institutions to use in their Web sites and software; Investment Profiles & Guides, which are designed for institutions to use in communicating investment information to individual investors; the Morningstar Research Annuity Center (formerly VARDS Online); and EnCorr, an asset allocation software package. Following our acquisition of Aspect Huntley, this segment now includes financial information as well as other data feeds on Australian stocks which we sell to stock brokers, information providers, and financial Web sites. The Institutional segment also includes the hedge fund and separate account database division we acquired from InvestorForce in August. In the first nine months of 2006 and 2005, this segment represented, before intersegment eliminations, 45.3% and 41.7%, respectively, of our consolidated revenue. We expect that the Institutional segment will continue to account for the largest portion of our consolidated revenue for the foreseeable future.

| Key Metrics(\$000)   | Three Months Ended September 30 |           |        | Nine Months Ended September 30 |           |        |
|----------------------|---------------------------------|-----------|--------|--------------------------------|-----------|--------|
|                      | 2006                            | 2005      | Change | 2006                           | 2005      | Change |
| Revenue              | \$ 38,569                       | \$ 24,063 | 60.3 % | \$ 103,437                     | \$ 69,396 | 49.1 % |
| Operating income     | \$ 9,661                        | \$ 5,626  | 71.7 % | \$ 25,674                      | \$ 13,647 | 88.1 % |
| Operating margin (%) | 25.0 %                          | 23.4 %    | 1.6 pp | 24.8 %                         | 19.7 %    | 5.1 pp |

In the third quarter of 2006, revenue for the Institutional segment increased \$14.5 million compared with the third quarter of 2005, and year-to-date revenue increased \$34.0 million from the same period in 2005. Acquisitions contributed \$8.2 million and \$15.5 million of revenue to this segment in the third quarter and year-to-date periods, respectively, mainly from Investment Consulting services and EnCorr. For the segment overall, revenue growth was primarily driven by Investment Consulting services, including asset allocation and investment selection for funds of funds. Revenue increased partly because we receive asset-based fees for our services, and assets under management in these client portfolios significantly increased. Incremental revenue added by Ibbotson contributed about half of the increase in Investment Consulting revenue in the quarter, and about 40% of the increase in the year-to-date period. We provided advisory services on approximately \$47.6 billion in assets (including \$35.0 billion from Morningstar Associates and \$12.6 billion from Ibbotson Associates) as of September 30, 2006, compared with approximately \$19.4 billion as of September 30, 2005 (Morningstar Associates only). In addition, we also provide Investment Consulting services for some assets under management for which we receive a flat fee.

Excluding acquisitions, Licensed Data and Morningstar Direct were the next largest contributors to revenue growth in both the quarter and year-to-date periods. Both products benefited from expanded sales efforts in Europe and other international markets, as well as continued strength in the United States. The number of licenses for Morningstar Direct increased to 1,212 worldwide as of September 30, 2006 compared with 931 as of September 30, 2005.

EnCorr and Advice by Ibbotson were also significant contributors to revenue growth in the quarter and year-to-date periods. The Ibbotson acquisition significantly expanded our asset base in managed retirement

accounts, and we are now among the largest providers in this area. We had \$7.2 billion in combined assets under management in the managed retirement accounts offered through Advice by Ibbotson (\$6.7 billion) and Morningstar Retirement Manager (\$513.7 million) as of September 30, 2006, compared with \$225.9 million as of September 30, 2005.

In the third quarter of 2006, operating income for the Institutional segment increased \$4.1 million compared with the prior-year quarter. In the year-to-date period, Institutional segment operating income increased \$12.1 million. The increase in operating income in both periods was driven by higher segment revenue, driven by Investment Consulting. Operating expense increased \$10.5 million, or 56.8%, in the third quarter compared with the prior-year quarter, and in the year-to-date period, operating expense increased \$22.1 million, or 39.5%, compared with the same period in 2005. About 40% of the increase in operating expense was driven by higher cost of goods sold. Cost of goods sold increased mainly because of two factors. First, acquisitions contributed incremental costs, including \$0.7 million and \$1.9 million, respectively, of product implementation fees for Advice by Ibbotson incurred in the third quarter and year-to-date periods. Second, compensation-related expense, including bonuses, also increased. A significant portion of incremental headcount added by recent acquisitions occurred in this segment, which contributed to higher compensation expense.

Operating expense also increased across the other expense categories in both the quarter and year-to-date periods, reflecting higher compensation and bonus expense and incremental operating expense from acquisitions. In the year-to-date period, stock-based compensation expense decreased \$0.8 million, which partially offset higher expense in other areas. Operating margin in the third quarter increased by 1.6 percentage points over the prior-year quarter. In the year-to-date period, operating margin improved 5.1 percentage points. The increase in margin for the quarter reflects revenue growth that moderately outpaced growth in operating expense. Lower stock-based compensation expense also had a positive impact on operating margin for the year-to-date period.

### Corporate and Eliminations

Corporate items and eliminations primarily include capitalized internal product development costs and related amortization expense as well as amortization expense related to intangible assets, mainly recorded as part of acquisition-related purchase price allocations. The following table shows the components of corporate and eliminations expense (income) that impacted our consolidated operating income:

| Key Metrics(\$000)                             | Three Months Ended September 30 |               |          | Nine Months Ended September 30 |                 |         |
|--|---------------------------------|---------------|----------|--------------------------------|-----------------|---------|
|  | 2006                            | 2005          | Change   | 2006                           | 2005            | Change  |
| Capitalized internal product development costs | \$ —                            | \$ (164)      | (100.0)% | \$ (176)                       | \$ (367)        | (52.0)% |
| Depreciation and amortization                  | 2,868                           | 976           | 193.9%   | 6,667                          | 2,968           | 124.6%  |
| Other  | (516)                           | 129           | NMF      | (522)                          | 136             | NMF     |
| Corporate items and eliminations               | <u>\$ 2,352</u>                 | <u>\$ 941</u> | 149.9%   | <u>\$ 5,969</u>                | <u>\$ 2,737</u> | 118.1%  |

In both the third quarter and first nine months of 2006, corporate items and eliminations increased primarily because of amortization expense of \$2.0 million and \$4.1 million, respectively, related to intangible assets acquired with Ibbotson, Aspect Huntley, and the database division of InvestorForce. The increase in amortization expense was offset to a small extent in both periods by a decrease in amortization related to certain capitalized internal development costs that are now fully amortized. Other items in both the third quarter and year-to-date periods of 2006 primarily include a refund of sales taxes previously paid as part of our voluntary disclosure programs.

### Equity in Net Income of Unconsolidated Entities, Non-Operating Income, and Income Tax Expense

#### Equity in Net Income of Unconsolidated Entities

| (\$000)   | Three Months Ended September 30 |        | Nine Months Ended September 30 |          |
|---|---------------------------------|--------|--------------------------------|----------|
|   | 2006                            | 2005   | 2006                           | 2005     |
| Equity in net income of unconsolidated entities | \$ 1,100                        | \$ 183 | \$ 2,405                       | \$ 1,212 |

Equity in net income of unconsolidated entities includes our portion of the net income (loss) of Morningstar Japan K.K. (MJKK), Morningstar Korea, Ltd (Morningstar Korea), Morningstar Danmark A/S (Morningstar Denmark) and Morningstar Sweden AB (Morningstar Sweden). In the third quarter and first nine months of 2006, equity in net income of unconsolidated entities increased \$0.9 million and \$1.2 million, respectively. The increase in both periods primarily reflects an increase in equity income from MJKK. In the third quarter of 2006, MJKK recorded a gain related to the sale of shares in a subsidiary's initial public offering. Our share of the pre-tax gain was approximately \$1.0 million. For more information about our investments in unconsolidated entities, refer to Note 7 of the Notes to our Consolidated Financial Statements.

## Non-Operating Income

The following table presents the components of net non-operating income:

| (\$000)                   | Three Months Ended September 30 |               | Nine Months Ended September 30 |                 |
|---------------------------|---------------------------------|---------------|--------------------------------|-----------------|
|                           | 2006                            | 2005          | 2006                           | 2005            |
| Interest income, net      | \$ 1,169                        | \$ 892        | \$ 3,086                       | \$ 1,946        |
| Other income (loss), net  | (31)                            | (46)          | (343)                          | 14              |
| Non-operating income, net | <u>\$ 1,138</u>                 | <u>\$ 846</u> | <u>\$ 2,743</u>                | <u>\$ 1,960</u> |

Net interest income primarily reflects interest from our investment portfolio. Net interest income increased \$0.3 million and \$1.2 million in the third quarter and first nine months of 2006, respectively, compared with the same periods in the prior year. The increase in net interest income primarily reflects higher levels of cash, cash equivalents, and investments in the first nine months of 2006 compared with the first nine months of 2005.

Net other income (loss) primarily represents foreign currency exchange gains and losses arising from the ordinary course of business related to our international operations, royalty income from Morningstar Japan K.K., and realized gains and losses from our investment portfolio.

## Income Tax Expense

The following table presents our effective income tax expense rate:

| (\$000)   | Three Months Ended September 30 |           | Nine Months Ended September 30 |           |
|---|---------------------------------|-----------|--------------------------------|-----------|
|   | 2006                            | 2005      | 2006                           | 2005      |
| Income before income taxes, equity in net income of unconsolidated entities, and cumulative effect of accounting change | \$ 21,675                       | \$ 13,193 | \$ 59,937                      | \$ 34,329 |
| Equity in net income of unconsolidated entities   | 1,100                           | 183       | 2,405                          | 1,212     |
| Total   | \$ 22,775                       | \$ 13,376 | \$ 62,342                      | \$ 35,541 |
| Income tax expense  | \$ 9,228                        | \$ 5,857  | \$ 24,450                      | \$ 14,517 |
| Effective income tax expense rate   | 40.5 %                          | 43.8 %    | 39.2 %                         | 40.8 %    |

Our effective income tax expense rate in the third quarter of 2006 decreased 3.3 percentage points compared with the same period in 2005. In the first nine months of 2006, our effective income tax expense rate decreased 1.6 percentage points compared with the prior-year period. Our effective tax rate in both the third quarter and year-to-date periods reflects an increase in the benefits we received related to disqualifying dispositions for incentive stock options. A disqualifying disposition occurs when the option holder sells shares within one year of exercising an incentive stock option. We receive a tax benefit in the period that the disqualifying disposition occurs. Additional income tax expense related to certain operations outside of the United States recorded in the second quarter of 2006 partially offset the tax benefit of the disqualifying dispositions.

The effective tax rate in the first nine months of 2005 reflects the fact that in the first quarter of 2005, we recorded stock-based compensation expense related to incentive stock options but we did not record a corresponding tax benefit. This had the impact of increasing our effective income tax rate above the U.S. Federal rate of 35%. Because the incentive stock options were fully vested by March 31, 2005 and because we no longer account for options under the liability method subsequent to our initial public offering, we did not record any stock-based compensation expense related to incentive stock options in the first nine months of 2006. The impact of incentive stock options was partially offset by a deferred income tax benefit of \$0.7 million we recorded in the second quarter of 2005 related to research and development expenses due to a change in U.S. tax regulations, resulting in a one-time reduction of our effective income tax expense rate in 2005.

In 2006 and 2005, our effective income tax expense rate reflects the fact that we are not recording an income tax benefit related to losses recorded by certain of our non-U.S. operations. In the year these non-U.S. entities record a loss, we do not record a corresponding tax benefit, thus increasing our effective tax rate. The foreign net operating losses may become deductible in certain non-U.S. tax jurisdictions to the extent these non-U.S. operations become profitable. For each of our operations, we evaluate whether it is more likely than not that the tax benefits related to net operating losses will be realized. As part of this evaluation, we consider evidence such as tax planning strategies, historical operating results, forecasted taxable income, and recent financial performance.

## Liquidity and Capital Resources

We believe that our available cash balances and investments, along with cash generated from operations, will be sufficient to meet our operating and cash needs for the foreseeable future. We invest our cash reserves in cash equivalents and investments, consisting primarily of fixed-income securities. We intend to use our cash, cash equivalents, and investments for general corporate purposes, including working capital and for funding future growth.

### Cash and Cash Equivalents

As of September 30, 2006, we had cash, cash equivalents, and investments of \$124.3 million, a decrease of \$28.9 million compared with \$153.2 million as of December 31, 2005. The decrease primarily reflects \$86.4 million used to acquire Ibbotson in March 2006; \$20.5 million used to acquire Aspect Huntley in July 2006; \$10.0 million used to acquire the database division of InvestorForce in August 2006; and \$22.4 million of annual bonus payments that were made in the first quarter of 2006. These decreases in cash, cash equivalents, and investments were partially offset by \$69.0 million of cash flow provided by operating activities and \$22.0 million of cash provided by financing activities in the first nine months of 2006.

### Cash Provided by Operating Activities

Our main source of capital is cash generated from operating activities. In the first nine months of 2006, cash provided by operating activities was \$69.0 million, compared with \$29.9 million in the first nine months of 2005. The increase of \$39.1 million in operating cash flows mainly reflects an increase in net income and an increase in income taxes payable. In the first nine months of 2006, we made \$3.5 million of income tax payments, compared with \$15.5 million in the first nine months of 2005. As part of the Ibbotson

purchase price allocation, we recorded a reduction to income taxes payable of \$12.8 million. This income tax benefit, primarily related to the payments for the cancellation of Ibbotson's stock options, was fully used during the first half of 2006, reducing the amount we paid for income taxes. This cash income tax benefit did not impact our income tax expense or net income in the first nine months of 2006. We will not receive additional cash tax benefits from the Ibbotson acquisition, and therefore, we have increased our income taxes payable in anticipation of fourth quarter income tax payments.

An increase in accrued bonuses related to the current year's performance and an increase in deferred revenue also contributed to the growth in cash flow provided by operating activities during the first nine months of 2006. Because we frequently invoice our customers and collect cash in advance of providing services or fulfilling subscriptions, we often have significant deferred revenue, which is shown as a liability on our balance sheet. As of September 30, 2006 and December 31, 2005, our deferred revenue was \$92.8 million and \$71.2 million, respectively. An increase in bonus payments made in the first nine months of 2006 partially offset these increases. In the first nine months of 2006, we made annual bonus payments of approximately \$23.0 million, compared with \$18.0 million of bonus payments made in the same period in 2005. The higher bonuses in 2006 were the result of strong 2005 operating performance. We made \$0.6 million of bonus payments in the third quarter of 2006 to certain Ibbotson employees.

We have an obligation to pay up to approximately \$2.2 million under a Deferred Compensation Agreement (the Agreement) with Don Phillips, an executive officer, as discussed in Note 9 of the Notes to our Unaudited Condensed Consolidated Financial Statements. Under the terms of the Agreement, on any date that Don exercises the right to purchase shares under the 1999 Plan, we will pay him \$2.69 per share in the form of cash or, at our election, shares of common stock. If on the date of purchase the fair value of Morningstar's stock is below \$2.77 per share, the amount paid per share will be reduced based on the terms of the Agreement. As detailed below in the Rule 10b5-1 Plans section, in May 2006, Don entered into a Rule 10b5-1 plan contemplating the sale of up to 450,000 shares to be acquired through stock option exercises in 2006 and 2007. As these stock options are exercised, we will make payments to him as prescribed by the Agreement, which, if all 450,000 stock options are exercised, would total approximately \$1.2 million. Don sold 80,000 shares during the first nine months of 2006, and we made corresponding payments to him in accordance with the Agreement.

### **Cash Used for Investing Activities**

In the first nine months of 2006, cash used for investing activities was \$112.2 million, compared with \$10.9 million in the first nine months of 2005. The increase was largely driven by cash used for acquisitions. Cash used for acquisitions, net of cash acquired, was \$116.9 million in the first nine months of 2006 and \$8.2 million in the first nine months of 2005. In March 2006, we acquired Ibbotson; in July 2006, we acquired Aspect Huntley; and in August 2006, we acquired the database division of InvestorForce. In January 2005, we acquired VARDS from Finetre Corporation. We anticipate making additional purchase price payments related to Aspect Huntley of approximately \$2.1 million, the majority of which will be paid in the third quarter of 2007.

In the first nine months of 2006, proceeds from sales of investments exceeded purchases of investments by \$7.9 million, resulting in a reallocation from investments to cash and cash equivalents. In the first nine months of 2005, proceeds from the sale of investments exceeded purchases of investments by \$0.9 million. As of September 30, 2006 and December 31, 2005, our investments, consisting primarily of fixed-income securities, were \$53.1 million and \$60.8 million, respectively.

Capital expenditures were \$2.9 million in the first nine months of 2006, compared with \$3.6 million in the prior-year period. Our capital expenditures primarily consisted of leasehold improvements, computer hardware, and capitalized internal product development costs. We anticipate that our capital expenditures in 2006 will be approximately \$6.0 million.

### **Cash Provided by Financing Activities**

Cash provided by financing activities was \$22.0 million in the first nine months of 2006, primarily reflecting proceeds received from stock option exercises. In the first nine months of 2006, we received proceeds of \$13.2 million from stock option exercises. We also recognized \$8.8 million of excess tax benefits from stock option exercises in the first nine months of 2006. We adopted SFAS No. 123(R), *Shared-Based Payment*, on January 1, 2006; the new standard requires that we record excess tax benefits from stock option exercises as a financing activity, instead of as an operating activity. Excess tax benefits occur at the time a stock option is exercised when the intrinsic value of the option (the difference between the exercise price of the option and the fair value of our stock on the date of exercise) is greater than the fair value of the option at the time of grant.

In the first nine months of 2005, cash provided by financing activities was \$22.1 million, primarily reflecting proceeds received from our initial public offering. In the second quarter of 2005, we recorded \$18.1 million of net proceeds from our initial public offering. These proceeds resulted from the underwriter's exercise of its over-allotment option based on our initial public offering price of \$18.50 per share, after deducting the underwriting discounts and commissions and approximately \$2.6 million of offering expenses. In addition, in the first nine months of 2005, we received proceeds of \$4.0 million from stock option exercises.

## Acquisitions

### *Institutional Hedge Fund and Separate Account Database Division of InvestorForce, Inc.*

In August 2006, we acquired the institutional hedge fund and separate account database division of InvestorForce, Inc., a financial software and data integration company based in Wayne, Pennsylvania, for \$10.0 million in cash, including transaction costs. This acquisition includes both the Altvest database, one of the first and largest databases covering hedge funds, managers, and data, along with InvestorForce's extensive institutional separate account database. It also includes several online software applications for manager search, research, and reporting. We began including the results of the database division of InvestorForce's operations in our Condensed Consolidated Financial Statements on August 1, 2006. We believe that this acquisition will strengthen our proprietary investment data and allow us to continue offering one of the largest, most comprehensive databases.

### *Aspect Huntley Pty Limited*

In July 2006, we acquired Aspect Huntley Pty Limited, a leading provider of equity information, research, and financial trade publishing in Australia, for Australian \$30.0 million in cash, of which Australian \$2.0 million will be paid in 2007 subject to post-closing and working capital adjustments. In the third quarter of 2006, the cash paid for Aspect Huntley, including transaction costs, was U.S. \$20.5 million (net of \$0.9 million of cash acquired). We began including the results of Aspect Huntley's operations in our Condensed Consolidated Financial Statements on July 25, 2006. This acquisition fits with our growth strategy to expand our products and services internationally. The key benefit of this acquisition is the combination of Morningstar's expertise in fund research and information with Aspect Huntley's equity research, information, and financial media expertise in Australia. We believe this acquisition will significantly expand the breadth and quality of services we can deliver to individuals, advisors, and institutions and will offer Australian investors one place to obtain their investment information and research.

### *Ibbotson Associates, Inc.*

In March 2006, we acquired Ibbotson Associates, Inc., a privately held firm specializing in asset allocation research and services, for \$83.0 million in cash, plus an additional \$3.4 million for working capital and other items, net of cash acquired. We began including the results of Ibbotson's operations in our Condensed Consolidated Financial Statements on March 1, 2006. This acquisition fits several of Morningstar's growth strategies and broadens our reach in the areas of investment consulting, managed retirement accounts, and institutional and advisor software.

### *Variable Annuity Research and Data Service (VARDS)*

In January 2005, we acquired the VARDS unit, which provides research and data on variable annuities, from Finetre Corporation for \$8.2 million in cash. We believe this acquisition strengthened our investment database and enhanced our efforts to provide investors with the information they need to make well-informed decisions when investing in variable annuities.

## **Application of Critical Accounting Policies and Estimates**

We discuss our critical accounting policies and estimates in the Management's Discussion and Analysis section of our Annual Report on Form 10-K filed with the SEC for the year ended December 31, 2005.

Effective January 1, 2006, we adopted SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123(R)), using the modified prospective transition method. Under this method, the provisions of SFAS No. 123(R) apply to all awards granted after the date of adoption and to any unrecognized expense of awards unvested at the date of adoption based on the fair value as of the date of grant. Prior to this date, we accounted for our stock option plans in accordance with the fair value provisions of SFAS No. 123, *Stock-Based Compensation* (SFAS No. 123). Under SFAS No. 123, we accounted for forfeitures of stock options as they occurred. SFAS No.

123(R) requires us to estimate expected forfeitures at the grant date and recognize compensation cost only for those awards expected to vest. Accordingly, in the first quarter of 2006, we recorded a cumulative effect of accounting change, net of tax, of \$0.3 million to reverse the impact of stock-based compensation expense recorded in prior years related to outstanding stock options that we estimate will not vest. Aside from recording this cumulative effect of accounting change, the adoption of SFAS No. 123(R) did not have a significant impact on our financial position or results of operations because we previously recognized stock-based compensation expense in accordance with SFAS No. 123.

Prior to our adoption of SFAS 123(R), we classified tax benefits arising from the exercise of stock options as operating cash flows. SFAS No. 123(R) requires that we classify the cash flows resulting from the tax benefit that arises when the tax deductions exceed the compensation cost recognized for those options (excess tax benefits) as financing cash flows. The excess tax benefits were \$8.8 million in the first nine months of 2006, and \$1.1 million in the first nine months of 2005. Refer to Note 8 of the Notes to our Unaudited Condensed Consolidated Financial Statements for more information regarding our adoption of SFAS No. 123(R) and our accounting for stock options.

## **Recently Issued Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 157, *Fair Value Measurements* (SFAS No. 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years; therefore, we will adopt SFAS No. 157 in the first quarter of 2008. We are in the process of determining the effect the adoption of SFAS No. 157 will have on our financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 addresses quantifying the financial statement effects of misstatements, specifically, how the effects of prior year uncorrected errors must be considered in quantifying misstatements in the current year financial statements. SAB 108 is effective for fiscal years ending after November 15, 2006; therefore, we will adopt SAB 108 in the fourth quarter of 2006. We do not anticipate that SAB 108 will have an impact on our financial statements.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48), which prescribes the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, and disclosure for uncertain tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006; therefore, we will adopt FIN 48 in the first quarter of 2007. We are in the process of determining the effect, if any, the adoption of FIN 48 will have on our financial statements.

In June 2006, the Emerging Issues Task Force (EITF) ratified EITF Issue No. 06-2, *Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, "Accounting for Compensation Absence"* (EITF No. 06-2), which requires that a liability for employees' sabbatical benefits be accrued over the period required for employees to earn the right to sabbatical leave. EITF No. 06-2 is effective for fiscal years beginning after December 15, 2006; therefore, we will adopt EITF No. 06-2 in the first quarter of 2007. We are in the process of determining the effect the adoption of EITF No. 06-2 will have on our financial statements.

In June 2006, the EITF ratified EITF Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement* (EITF No. 06-3), which concludes that companies have the option to report taxes that are externally imposed on a revenue producing transaction between a seller and a customer either gross within revenue or net. This is, it may include charges to customers for taxes within revenues and the charge for taxes from the taxing authority within cost of sales, or alternatively, it may net the charge to the customer and the charge from the taxing authority. In addition, if these taxes are significant, disclosure of the accounting policy used is required. EITF No. 06-3 is effective for fiscal years beginning after December 15, 2006; therefore, we will adopt EITF No. 06-3 in the first quarter of 2007. We do not anticipate that EITF No. 06-3 will have an impact on our financial statements.

## **Rule 10b5-1 Plans**

Our directors and executive officers may exercise stock options or purchase or sell shares of our common stock in the market from time to time. We encourage them to make these transactions through plans that comply with Exchange Act Rule 10b5-1(c). Morningstar will not receive any proceeds, other than proceeds from the exercise of stock options, related to these transactions.

The following table, which we are providing on a voluntary basis, shows the Rule 10b5-1 plans entered into by our directors and executive officers that were in effect on November 1, 2006:

| <b><u>Name and Position</u></b>                         | <b><u>Date of Plan</u></b> | <b><u>Plan Termination Date</u></b> | <b><u>Number of Shares to be Sold under the Plan</u></b> | <b><u>Timing of Sales under the Plan</u></b>   | <b><u>Number of Shares Sold under the Plan through November 1, 2006</u></b> | <b><u>Projected Beneficial Ownership(1)</u></b> |
|---|----------------------------|-------------------------------------|--|--|---|---|
| Joe Mansueto(2)<br>Chairman and Chief Executive Officer | 05/09/06                   | 12/29/06                            | 700,000  | Up to 100,000 shares to be sold during June 2006, and up to 300,000 shares to be sold during each of the fiscal quarters ending September 30, 2006 and December 31, 2006 | 400,000   | 29,297,000                                      |
| Bevin Desmond<br>President, International Business      | 06/28/06                   | 12/31/06                            | 123,750  | Up to 123,750 shares to be sold  | —   | 62,036  |
| Cheryl Francis<br>Director                              | 05/09/06                   | 12/31/06                            | 20,000   | Daily increments of up to 500 shares, or all remaining shares under the plan if the stock reaches a specified price  | 14,000  | 64,000  |
| Tao Huang<br>Chief Operating Officer                    | 05/15/06                   | 02/28/07                            | 70,000   | Monthly increments of up to 10,000 shares  | —   | 1,432,803                                       |
| Steve Kaplan<br>Director                                | 05/10/06                   | 12/09/06                            | 44,000   | Monthly increments of up to 7,000 shares, except for the last month which will be 9,000 shares   | 35,000  | 88,000  |
| Jack Noonan<br>Director                                 | 08/22/06                   | 12/10/07                            | 60,000   | Monthly increments of up to 4,000 shares   | 4,000   | 72,000  |
| Don Phillips<br>Managing Director                       | 05/09/06                   | 08/26/07                            | 450,000  | Semimonthly increments of up to 15,000 shares  | 100,000   | 1,377,484                                       |

(1) This column reflects an estimate of the number of shares each identified director and executive officer will beneficially own following the sale of all shares under his or her Rule 10b5-1 plan identified above. This information reflects the beneficial ownership of our common stock on September 30, 2006, and includes shares of our common stock subject to options that were then exercisable or that will have become exercisable by November 29, 2006. The estimates do not reflect any changes to beneficial ownership that may have occurred since September 30, 2006. Directors and executive officers identified in the table may amend or terminate their Rule 10b5-1 plans and may adopt additional Rule 10b5-1 plans in the future.

(2) On April 7, 2006, we announced that Joe Mansueto, our chairman and chief executive officer, would establish a Rule 10b5-1 plan and that he intends to sell up to 1.2 million shares, or 4% of his total shares, during a 12-month period beginning in June 2006. The 700,000 shares subject to his Rule 10b5-1 plan reflect the portion of the shares to be sold by December 29, 2006.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

Our investment portfolio is actively managed and may suffer losses from fluctuating interest rates, market prices, or adverse security selection. As of September 30, 2006, our investments, consisting primarily of fixed-income securities, were \$53.1 million. Based on our estimates, a 100 basis point change in interest rates would have increased or decreased the fair value of our investment portfolio by approximately \$0.1 million.

As our non-U.S. revenue increases as a percentage of revenue over the long term, fluctuations in foreign currencies present a greater potential risk. To date, we have not engaged in currency hedging, and we do not currently have any positions in derivative instruments to hedge our currency risk. Our results could suffer if certain foreign currencies decline relative to the U.S. dollar. In addition, because we use the local currency of our subsidiaries as the functional currency, we are affected by the translation of foreign currencies into U.S. dollars.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### **(a) Evaluation and Disclosure Controls and Procedures**

Disclosure controls and procedures are designed to reasonably assure that information required to be disclosed in the reports filed or submitted under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to reasonably assure that information required to be disclosed in the reports filed under the Exchange Act is accumulated and communicated to management, including the chief executive officer and the chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Morningstar carried out an evaluation, under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2006. Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized, and reported as and when required.

#### **(b) Changes in Internal Controls Over Financial Reporting**

There were no changes in Morningstar's internal controls over financial reporting during the period covered by this Quarterly Report on Form 10-Q that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

**PART 2 OTHER INFORMATION**

**Item 1. Legal Proceedings**

We incorporate by reference the information regarding legal proceedings set forth in Note 11, "Contingencies," of the Notes to our Unaudited Condensed Consolidated Financial Statements contained in Part 1., Item 1. of this Quarterly Report on Form 10-Q.

**Item 1A. Risk Factors**

There have been no material changes to the risk factors disclosed in Item 1A — Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005.

**Item 6. Exhibits**

(a) Exhibits

| <b>Exhibit No</b> | <b>Description of Exhibit</b>  |
|-------------------|--|
| 31.1              | Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934 |
| 31.2              | Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934 |
| 32.1              | Certification of Chief Executive Officer Pursuant to 18 U.S.C. 1350  |
| 32.2              | Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350  |

**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.

MORNINGSTAR, INC.

Date: November 9, 2006

By: /s/ Martha Dustin Boudos

Martha Dustin Boudos  
Chief Financial Officer

## CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, Joe Mansueto, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Morningstar, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a. designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. (paragraph omitted pursuant to SEC Release Nos. 33-8392 and 34-49313);
  - c. evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 9, 2006

/s/ Joe Mansueto  
Joe Mansueto  
Chairman of the Board and Chief Executive Officer

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## CERTIFICATION OF CHIEF FINANCIAL OFFICER

I, Martha Dustin Boudos, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Morningstar, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a. designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. (paragraph omitted pursuant to SEC Release Nos. 33-8392 and 34-49313);
  - c. evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 9, 2006

/s/ Martha Dustin Boudos  
Martha Dustin Boudos  
Chief Financial Officer

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CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO SECTION 906 OF  
THE SARBANES-OXLEY ACT OF 2002

Joe Mansueto, as Chairman of the Board and Chief Executive Officer of Morningstar, Inc. (the "Company"), certifies, pursuant to 18 U.S.C. 1350, as adopted pursuant to 906 of the Sarbanes-Oxley Act of 2002, that:

1. the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934; and
2. the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Joe Mansueto

Joe Mansueto  
Chairman of the Board and Chief Executive Officer

November 9, 2006

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CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO SECTION 906 OF  
THE SARBANES-OXLEY ACT OF 2002

Martha Dustin Boudos, as Chief Financial Officer of Morningstar, Inc. (the "Company"), certifies, pursuant to 18 U.S.C. 1350, as adopted pursuant to 906 of the Sarbanes-Oxley Act of 2002, that:

1. the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934; and
2. the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Martha Dustin Boudos

Martha Dustin Boudos  
Chief Financial Officer

November 9, 2006

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