GOLDMAN SACHS GROUP INC/
Form 10-Q
October 04, 2006

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**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**

**FORM 10-Q**

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

**For the quarterly period ended August 25, 2006**

**or**

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

**For the transition period to**

**Commission File Number: 001-14965**
**The Goldman Sachs Group, Inc.**
**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware**<br>**(State or other jurisdiction of incorporation or organization)** | **13-4019460**<br>**(I.R.S. Employer Identification No.)** |
| **85 Broad Street, New York, NY**<br>**(Address of principal executive offices)** | **10004**<br>**(Zip Code)** |

**(212) 902-1000**
**(Registrant s telephone number, including area code)**

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer o Non-accelerated filer o

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

**APPLICABLE ONLY TO CORPORATE ISSUERS**

As of September 22, 2006 there were 425,832,104 shares of the registrant s common stock outstanding.

**THE GOLDMAN SACHS GROUP, INC.**
**QUARTERLY REPORT ON FORM 10-Q FOR THE FISCAL QUARTER ENDED AUGUST 25, 2006**
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**PART I: FINANCIAL INFORMATION**

**Item 1: Financial Statements (Unaudited)**

**THE GOLDMAN SACHS GROUP, INC. and SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS**
**(UNAUDITED)**

| | Three Months Ended August | | Nine Months Ended August | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| | (in millions, except per share amounts) | | | |
| **Revenues** | | | | |
| Investment banking | $ 1,285 | $ 998 | $ 4,276 | $ 2,667 |
| Trading and principal investments | 4,368 | 4,842 | 17,976 | 11,545 |
| Asset management and securities services | 975 | 772 | 3,545 | 2,270 |
| Interest income | 9,351 | 5,721 | 25,430 | 14,764 |
| Total revenues | 15,979 | 12,333 | 51,227 | 31,246 |
| Interest expense | 8,395 | 4,940 | 22,969 | 12,411 |
| Cost of power generation | 121 | 108 | 363 | 339 |
| Revenues, net of interest expense and cost of power generation | 7,463 | 7,285 | 27,895 | 18,496 |
| **Operating expenses** | | | | |
| Compensation and benefits | 3,510 | 3,642 | 13,897 | 9,248 |
| Brokerage, clearing and exchange fees | 454 | 271 | 1,208 | 797 |
| Market development | 117 | 92 | 338 | 268 |
| Communications and technology | 141 | 124 | 396 | 365 |
| Depreciation and amortization | 126 | 125 | 378 | 371 |
| Amortization of identifiable intangible assets | 50 | 31 | 128 | 93 |
| Occupancy | 221 | 200 | 613 | 534 |
| Professional fees | 135 | 117 | 367 | 322 |
| Other expenses | 347 | 278 | 995 | 704 |
| Total non-compensation expenses | 1,591 | 1,238 | 4,423 | 3,454 |
| Total operating expenses | 5,101 | 4,880 | 18,320 | 12,702 |
| Pre-tax earnings | 2,362 | 2,405 | 9,575 | 5,794 |
| Provision for taxes | 768 | 788 | 3,190 | 1,800 |
| Net earnings | 1,594 | 1,617 | 6,385 | 3,994 |
| Preferred stock dividends | 39 | 9 | 91 | 9 |
| Net earnings applicable to common shareholders | $ 1,555 | $ 1,608 | $ 6,294 | $ 3,985 |

| | | | | |
|---|---|---|---|---|
| **Earnings per common share** | | | | |
| Basic | $ 3.46 | $ 3.40 | $ 13.92 | $ 8.23 |
| Diluted | 3.26 | 3.25 | 13.12 | 7.89 |
| **Dividends declared and paid per common share** | $ 0.35 | $ 0.25 | $ 0.95 | $ 0.75 |
| **Average common shares outstanding** | | | | |
| Basic | 449.4 | 473.3 | 452.1 | 484.3 |
| Diluted | 477.4 | 494.2 | 479.7 | 505.2 |

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

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**THE GOLDMAN SACHS GROUP, INC. and SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**
**(UNAUDITED)**

| | As of | |
|---|---|---|
| | **August 2006** | **November 2005** |
| | (in millions, except share and per share amounts) | |
| **Assets** | | |
| Cash and cash equivalents | $ 10,063 | $ 10,261 |
| Cash and securities segregated for regulatory and other purposes | 76,309 | 51,405 |
| Receivables from brokers, dealers and clearing organizations | 13,200 | 15,150 |
| Receivables from customers and counterparties | 76,112 | 60,231 |
| Securities borrowed | 210,190 | 191,800 |
| Financial instruments purchased under agreements to resell | 82,958 | 83,619 |
| Financial instruments owned, at fair value | 269,238 | 238,043 |
| Financial instruments owned and pledged as collateral, at fair value | 39,936 | 38,983 |
| Total financial instruments owned, at fair value | 309,174 | 277,026 |
| Other assets | 20,303 | 17,312 |
| Total assets | $798,309 | $706,804 |
| **Liabilities and shareholders equity** | | |
| Secured short-term borrowings | $ 18,850 | $ 7,972 |
| Unsecured short-term borrowings | 53,814 | 47,247 |
| Total short-term borrowings, including the current portion of long-term borrowings | 72,664 | 55,219 |
| Payables to brokers, dealers and clearing organizations | 5,056 | 10,014 |
| Payables to customers and counterparties | 215,396 | 178,304 |
| Securities loaned | 26,409 | 23,331 |
| Financial instruments sold under agreements to repurchase | 128,132 | 149,026 |
| Financial instruments sold, but not yet purchased, at fair value | 156,557 | 149,071 |
| Other liabilities and accrued expenses | 31,271 | 13,830 |
| Secured long-term borrowings | 19,553 | 15,669 |
| Unsecured long-term borrowings | 109,778 | 84,338 |
| Total long-term borrowings | 129,331 | 100,007 |
| Total liabilities | 764,816 | 678,802 |
| **Commitments, contingencies and guarantees** | | |
| **Shareholders equity** | | |

| | | |
|---|---|---|
| Preferred stock, par value $0.01 per share; 150,000,000 shares authorized, 124,000 and 70,000 shares issued and outstanding as of August 2006 and November 2005, respectively, with liquidation preference of $25,000 per share | 3,100 | 1,750 |
| Common stock, par value $0.01 per share; 4,000,000,000 shares authorized, 595,168,224 and 573,970,935 shares issued as of August 2006 and November 2005, respectively, and 428,909,579 and 437,170,695 shares outstanding as of August 2006 and November 2005, respectively | 6 | 6 |
| Restricted stock units and employee stock options | 3,812 | 3,415 |
| Nonvoting common stock, par value $0.01 per share; 200,000,000 shares authorized, no shares issued and outstanding | | |
| Additional paid-in capital | 19,213 | 17,159 |
| Retained earnings | 24,927 | 19,085 |
| Accumulated other comprehensive income | 13 | |
| Common stock held in treasury, at cost, par value $0.01 per share; 166,258,645 and 136,800,240 shares as of August 2006 and November 2005, respectively | (17,578) | (13,413) |
| Total shareholders equity | 33,493 | 28,002 |
| Total liabilities and shareholders equity | $798,309 | $706,804 |

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

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**THE GOLDMAN SACHS GROUP, INC. and SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY**
**(UNAUDITED)**

| | Period Ended | |
|---|---|---|
| | **August 2006** | **November 2005** |
| | (in millions, except per share amounts) | |
| **Preferred stock** | | |
| Balance, beginning of year | $ 1,750 | $ |
| Issued | 1,350 | 1,750 |
| Balance, end of period | 3,100 | 1,750 |
| **Common stock, par value $0.01 per share** | | |
| Balance, beginning of year | 6 | 6 |
| Issued | | |
| Balance, end of period | 6 | 6 |
| **Restricted stock units and employee stock options** | | |
| Balance, beginning of year | 3,415 | 2,013 |
| Issued | 1,295 | 1,871 |
| Delivered | (776) | (423) |
| Forfeited | (121) | (37) |
| Options exercised | (1) | (9) |
| Balance, end of period | 3,812 | 3,415 |
| **Additional paid-in capital** | | |
| Balance, beginning of year | 17,159 | 15,501 |
| Issuance of common stock | 1,560 | 1,417 |
| Preferred stock issuance costs | (1) | (31) |
| Excess tax benefit related to share-based compensation | 495 | 272 |
| Balance, end of period | 19,213 | 17,159 |
| **Retained earnings** | | |
| Balance, beginning of year | 19,085 | 13,970 |
| Net earnings | 6,385 | 5,626 |
| Dividends declared on common stock | (452) | (494) |
| Dividends declared on preferred stock | (91) | (17) |
| Balance, end of period | 24,927 | 19,085 |
| **Unearned compensation** | | |

| | | |
|---|---|---|
| Balance, beginning of year | | (117) |
| Amortization of restricted stock units | | 117 |
| Balance, end of period | | |
| **Accumulated other comprehensive income** | | |
| Balance, beginning of year | | 11 |
| Currency translation adjustment, net of tax | 30 | (27) |
| Minimum pension liability adjustment, net of tax | | (11) |
| Net gains/(losses) on cash flow hedges, net of tax | (12) | 9 |
| Net unrealized gains/(losses) on available-for-sale securities, net of tax | (5) | 18 |
| Balance, end of period | 13 | |
| **Common stock held in treasury, at cost** | | |
| Balance, beginning of year | (13,413) | (6,305) |
| Repurchased | (4,165) | (7,108) |
| Balance, end of period | (17,578) | (13,413) |
| **Total shareholders equity** | $ 33,493 | $ 28,002 |

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

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**THE GOLDMAN SACHS GROUP, INC. and SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(UNAUDITED)**

| | Nine Months Ended August | |
|---|---|---|
| | **2006** | **2005** |
| | (in millions) | |
| **Cash flows from operating activities** | | |
| Net earnings | $ 6,385 | $ 3,994 |
| Non-cash items included in net earnings | | |
| Depreciation and amortization | 547 | 511 |
| Amortization of identifiable intangible assets | 182 | 127 |
| Share-based compensation | 848 | 643 |
| Changes in operating assets and liabilities | | |
| Cash and securities segregated for regulatory and other purposes | (16,364) | 1,687 |
| Net receivables from brokers, dealers and clearing organizations | (3,009) | (1,321) |
| Net payables to customers and counterparties | 22,009 | 419 |
| Securities borrowed, net of securities loaned | (15,312) | (34,851) |
| Financial instruments sold under agreements to repurchase, net of financial instruments purchased under agreements to resell | (20,233) | 36,472 |
| Financial instruments owned, at fair value | (31,535) | (40,673) |
| Financial instruments sold, but not yet purchased, at fair value | 7,136 | 17,241 |
| Other, net | 7,779 | 2,787 |
| Net cash used for operating activities | (41,567) | (12,964) |
| **Cash flows from investing activities** | | |
| Purchase of property, leasehold improvements and equipment | (1,785) | (1,025) |
| Proceeds from sales of property, leasehold improvements and equipment | 175 | 621 |
| Business acquisitions, net of cash acquired | (780) | (523) |
| Proceeds from sales of investments | 1,197 | |
| Purchase of available-for-sale securities | (6,363) | |
| Proceeds from sales of available-for-sale securities | 4,193 | |
| Net cash used for investing activities | (3,363) | (927) |
| **Cash flows from financing activities** | | |
| Short-term borrowings, net | 11,477 | 172 |
| Issuance of long-term borrowings | 47,602 | 35,669 |
| Repayment of long-term borrowings, including the current portion of long-term borrowings | (15,732) | (16,806) |
| Derivative contracts with a financing element, net | 3,195 | 823 |

| | | |
|---|---|---|
| Common stock repurchased | (4,165) | (4,646) |
| Dividends paid on common and preferred stock | (543) | (385) |
| Proceeds from issuance of common stock | 1,200 | 738 |
| Proceeds from issuance of preferred stock, net of issuance costs | 1,349 | 856 |
| Excess tax benefit related to share-based compensation | 349 | |
| Net cash provided by financing activities | 44,732 | 16,421 |
| Net (decrease)/increase in cash and cash equivalents | (198) | 2,530 |
| Cash and cash equivalents, beginning of year | 10,261 | 4,365 |
| Cash and cash equivalents, end of period | $ 10,063 | $ 6,895 |

SUPPLEMENTAL DISCLOSURES:
Cash payments for interest, net of capitalized interest, were $22.56 billion and $12.48 billion during the nine months ended August 2006 and August 2005, respectively.
Cash payments for income taxes, net of refunds, were $2.85 billion and $1.69 billion during the nine months ended August 2006 and August 2005, respectively.
*Non-cash activities:*
The firm assumed $352 million and $1.15 billion of debt in connection with business acquisitions during the nine months ended August 2006 and August 2005, respectively.

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

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**THE GOLDMAN SACHS GROUP, INC. and SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**
**(UNAUDITED)**

| | Three Months Ended August | | Nine Months Ended August | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| | (in millions) | | | |
| Net earnings | $1,594 | $1,617 | $6,385 | $3,994 |
| Currency translation adjustment, net of tax | 3 | 2 | 30 | (15) |
| Net gains/(losses) on cash flow hedges, net of tax | (10) | 3 | (12) | 7 |
| Net unrealized gains/(losses) on available-for-sale securities, net of tax | 9 | 15 | (5) | 15 |
| Comprehensive income | $1,596 | $1,637 | $6,398 | $4,001 |

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

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## THE GOLDMAN SACHS GROUP, INC. and SUBSIDIARIES
## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
## (UNAUDITED)

**Note 1. Description of Business**

The Goldman Sachs Group, Inc. (Group Inc.), a Delaware corporation, together with its consolidated subsidiaries (collectively, the firm), is a leading global investment banking, securities and investment management firm that provides a wide range of services worldwide to a substantial and diversified client base that includes corporations, financial institutions, governments and high-net-worth individuals.

The firm s activities are divided into three segments:

**Investment Banking.** The firm provides a broad range of investment banking services to a diverse group of corporations, financial institutions, governments and individuals.

**Trading and Principal Investments.** The firm facilitates client transactions with a diverse group of corporations, financial institutions, governments and individuals and takes proprietary positions through market making in, trading of and investing in fixed income and equity products, currencies, commodities and derivatives on such products. In addition, the firm engages in specialist and market-making activities on equities and options exchanges and clears client transactions on major stock, options and futures exchanges worldwide. In connection with the firm s merchant banking and other investing activities, the firm makes principal investments directly and through funds that the firm raises and manages.

**Asset Management and Securities Services.** The firm provides investment advisory and financial planning services and offers investment products across all major asset classes to a diverse group of institutions and individuals worldwide, and provides prime brokerage services, financing services and securities lending services to mutual funds, pension funds, hedge funds, foundations and high-net-worth individuals worldwide.

**Note 2. Significant Accounting Policies**

***Basis of Presentation***

These condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles that require management to make certain estimates and assumptions. The most important of these estimates and assumptions relate to fair value measurements, the accounting for goodwill and identifiable intangible assets, the determination of compensation and benefits expenses for interim periods, and the provision for potential losses that may arise from litigation and regulatory proceedings and tax audits. Although these and other estimates and assumptions are based on the best available information, actual results could be materially different from these estimates.

These condensed consolidated financial statements include the accounts of Group Inc. and all other entities in which the firm has a controlling financial interest. All material intercompany transactions and balances have been eliminated.

The firm determines whether it has a controlling financial interest in an entity by first evaluating whether the entity is a voting interest entity, a variable interest entity (VIE) or a qualifying special-purpose entity (QSPE) under generally accepted accounting principles.

**Voting Interest Entities.** Voting interest entities are entities in which (i) the total equity investment at risk is sufficient to enable the entity to finance its activities independently and (ii) the equity holders have the obligation to absorb losses, the right to receive residual returns and the right to make decisions about the entity s activities. Voting interest entities

## THE GOLDMAN SACHS GROUP, INC. and SUBSIDIARIES
## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
## (UNAUDITED)

are consolidated in accordance with Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements, as amended. ARB No. 51 states that the usual condition for a controlling financial interest in an entity is ownership of a majority voting interest. Accordingly, the firm consolidates voting interest entities in which it has a majority voting interest.

**Variable Interest Entities.** VIEs are entities that lack one or more of the characteristics of a voting interest entity. A controlling financial interest in a VIE is present when an enterprise has a variable interest, or a combination of variable interests, that will absorb a majority of the VIE s expected losses, receive a majority of the VIE s expected residual returns, or both. The enterprise with a controlling financial interest, known as the primary beneficiary, consolidates the VIE. In accordance with Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 46-R, Consolidation of Variable Interest Entities, the firm consolidates VIEs of which it is the primary beneficiary.

The firm determines whether it is the primary beneficiary of a VIE by first performing a qualitative analysis of the VIE that includes a review of, among other factors, its capital structure, contractual terms, which interests create or absorb variability, related party relationships and the design of the VIE. Where qualitative analysis is not conclusive, the firm performs a quantitative analysis. For purposes of allocating a VIE s expected losses and expected residual returns to its variable interest holders, the firm utilizes the top down method. Under that method, the firm calculates its share of the VIE s expected losses and expected residual returns using the specific cash flows that would be allocated to it, based on contractual arrangements and/or the firm s position in the capital structure of the VIE, under various probability-weighted scenarios.

**QSPEs.** QSPEs are passive entities that are commonly used in mortgage and other securitization transactions. Statement of Financial Accounting Standards (SFAS) No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, sets forth the criteria an entity must satisfy to be a QSPE. These criteria include the types of assets a QSPE may hold, limits on asset sales, the use of derivatives and financial guarantees, and the level of discretion a servicer may exercise in attempting to collect receivables. These criteria may require management to make judgments about complex matters, including whether a derivative is considered passive and the degree of discretion a servicer may exercise. In accordance with SFAS No. 140 and FIN No. 46-R, the firm does not consolidate QSPEs.

**Equity-Method Investments.** When the firm does not have a controlling financial interest in an entity but exerts significant influence over the entity s operating and financial policies (generally defined as owning a voting interest of 20% to 50%) and has an investment in common stock or in-substance common stock, the firm accounts for its investment in accordance with the equity method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock.

**Other.** If the firm does not consolidate an entity or apply the equity method of accounting, the firm accounts for its investment at fair value. The firm also has formed numerous nonconsolidated investment funds with third-party investors that are typically organized as limited partnerships. The firm acts as general partner for these funds and does not hold a majority of the economic interests in any fund. For funds established on or before June 29, 2005 in which the firm holds more than a minor interest and for funds established or modified after June 29, 2005, the firm has provided the third-party investors with rights to remove the

**THE GOLDMAN SACHS GROUP, INC. and SUBSIDIARIES**
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**
**(UNAUDITED)**

firm as the general partner or to terminate the funds (see Recent Accounting Developments below for a discussion of the impact of Emerging Issues Task Force (EITF) Issue No. 04-5). These fund investments are included in Financial instruments owned, at fair value in the condensed consolidated statements of financial condition.

These condensed consolidated financial statements are unaudited and should be read in conjunction with the audited consolidated financial statements incorporated by reference in the firm s Annual Report on Form 10-K for the fiscal year ended November 25, 2005. The condensed consolidated financial information as of November 25, 2005 has been derived from audited consolidated financial statements not included herein.

These unaudited condensed consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. These adjustments are of a normal, recurring nature. Interim period operating results may not be indicative of the operating results for a full year.

Unless specifically stated otherwise, all references to August 2006 and August 2005 refer to the firm s fiscal periods ended, or the dates, as the context requires, August 25, 2006 and August 26, 2005, respectively. All references to November 2005, unless specifically stated otherwise, refer to the firm s fiscal year ended, or the date, as the context requires, November 25, 2005. All references to 2006, unless specifically stated otherwise, refer to the firm s fiscal year ending, or the date, as the context requires, November 24, 2006. Certain reclassifications have been made to previously reported amounts to conform to the current presentation.

***Revenue Recognition***

**Investment Banking.** Underwriting revenues and fees from mergers and acquisitions and other financial advisory assignments are recognized in the condensed consolidated statements of earnings when the services related to the underlying transaction are completed under the terms of the engagement. Expenses associated with such transactions are deferred until the related revenue is recognized or the engagement is otherwise concluded. Underwriting revenues are presented net of related expenses. Expenses associated with financial advisory transactions are recorded as non-compensation expenses, net of client reimbursements.

**Financial Instruments.** Total financial instruments owned, at fair value and Financial instruments sold, but not yet purchased, at fair value are reflected in the condensed consolidated statements of financial condition on a trade-date basis and consist of financial instruments carried at fair value or amounts that approximate fair value, with related unrealized gains or losses generally recognized in the condensed consolidated statements of earnings. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

In determining fair value, the firm separates its financial instruments into three categories cash (i.e., nonderivative) trading instruments, derivative contracts and principal investments.

**Cash Trading Instruments.** Fair values of the firm s cash trading instruments are generally obtained from quoted market prices in active markets, broker or dealer price quotations, or alternative pricing sources with reasonable levels of price transparency. The types of instruments valued in this manner include U.S. government and agency securities, other sovereign government obligations, liquid mortgage products, investment-grade and high-yield

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**THE GOLDMAN SACHS GROUP, INC. and SUBSIDIARIES**
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**
**(UNAUDITED)**

corporate bonds, listed equities, money market securities, state, municipal and provincial obligations, and physical commodities.

Certain cash trading instruments trade infrequently and have little or no price transparency. Such instruments may include certain corporate bank loans, mortgage whole loans and distressed debt. The firm values these instruments initially at cost and generally does not adjust valuations unless there is substantive evidence supporting a change in the value of the underlying instrument or valuation assumptions (such as similar market transactions, changes in financial ratios or changes in the credit ratings of the underlying companies). Where there is evidence supporting a change in the value, the firm uses valuation methodologies such as the present value of known or estimated cash flows.

Cash trading instruments owned by the firm (long positions) are marked to bid prices, and instruments sold but not yet purchased (short positions) are marked to offer prices. If liquidating a position is expected to affect its prevailing market price, the valuation is adjusted generally based on market evidence or predetermined policies. In certain circumstances, such as for highly illiquid positions, management s estimates are used to determine this adjustment.

**Derivative Contracts.** Fair values of the firm s derivative contracts consist of exchange-traded and over-the-counter (OTC) derivatives and are reflected net of cash that the firm has paid and received (for example, option premiums or cash paid or received pursuant to credit support agreements). Fair values of the firm s exchange-traded derivatives are generally determined from quoted market prices. OTC derivatives are valued using valuation models. The firm uses a variety of valuation models including the present value of known or estimated cash flows and option-pricing models. The valuation models used to derive the fair values of the firm s OTC derivatives require inputs including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates and correlations of such inputs. The selection of a model to value an OTC derivative depends upon the contractual terms of, and specific risks inherent in, the instrument as well as the availability of pricing information in the market. The firm generally uses similar models to value similar instruments. Where possible, the firm verifies the values produced by its pricing models to market transactions. For OTC derivatives that trade in liquid markets, such as generic forwards, swaps and options, model selection does not involve significant judgment because market prices are readily available. For OTC derivatives that trade in less liquid markets, model selection requires more judgment because such instruments tend to be more complex and pricing information is less available in these markets. Price transparency is inherently more limited for more complex structures because they often combine one or more product types, requiring additional inputs such as correlations and volatilities. As markets continue to develop and more pricing information becomes available, the firm continues to review and refine the models it uses.

At the inception of an OTC derivative contract (day one), the firm values the contract at the model value if the firm can verify all of the significant model inputs to observable market data and verify the model to market transactions. When appropriate, valuations are adjusted to reflect various factors such as liquidity, bid/offer spreads and credit considerations. These adjustments are generally based on market evidence or predetermined policies. In certain circumstances, such as for highly illiquid positions, management s estimates are used to determine these adjustments.

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**THE GOLDMAN SACHS GROUP, INC. and SUBSIDIARIES**
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**
**(UNAUDITED)**

Where the firm cannot verify all of the significant model inputs to observable market data and verify the model to market transactions, the firm values the contract at the transaction price at inception and, consequently, records no day one gain or loss in accordance with EITF Issue No. 02-3, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities (see Recent Accounting Developments below for a discussion of the impact of SFAS No. 157 on EITF Issue No. 02-3).

Following day one, the firm adjusts the inputs to its valuation models only to the extent that changes in these inputs can be verified by similar market transactions, third-party pricing services and/or broker quotes, or can be derived from other substantive evidence such as empirical market data. In circumstances where the firm cannot verify the model to market transactions, it is possible that a different valuation model could produce a materially different estimate of fair value.

**Principal Investments.** In valuing corporate and real estate principal investments, the firm s portfolio is separated into investments in private companies (including the firm s investment in the ordinary shares of Industrial and Commercial Bank of China Limited (ICBC)), investments in public companies (excluding the firm s investment in the convertible preferred stock of Sumitomo Mitsui Financial Group, Inc. (SMFG)) and the firm s investment in SMFG.

The firm s private principal investments, by their nature, have little or no price transparency. Such investments (including the firm s investment in ICBC) are initially carried at cost as an approximation of fair value. Adjustments to carrying value are made if there are third-party transactions evidencing a change in value. Downward adjustments are also made, in the absence of third-party transactions, if it is determined that the expected realizable value of the investment is less than the carrying value. In reaching that determination, many factors are considered including, but not limited to, the operating cash flows and financial performance of the companies or properties relative to budgets or projections, trends within sectors and/or regions, underlying business models, expected exit timing and strategy, and any specific rights or terms associated with the investment, such as conversion features and liquidation preferences.

The firm s public principal investments, which tend to be large, concentrated holdings that result from initial public offerings or other corporate transactions, are valued using quoted market prices discounted based on predetermined written policies for nontransferability and illiquidity.

The firm s investment in the convertible preferred stock of SMFG is carried at fair value, which is derived from a model that incorporates SMFG s common stock price and credit spreads, the impact of nontransferability and illiquidity, and the downside protection on the conversion strike price. The firm s investment in the convertible preferred stock of SMFG is generally nontransferable, but is freely convertible into SMFG common stock. Restrictions on the firm s ability to hedge or sell two-thirds of the common stock underlying its investment in SMFG lapsed in equal installments on February 7, 2005 and March 9, 2006. As of the date of this filing, the firm has fully hedged the first one-third installment of the unrestricted shares and has hedged a majority of the second one-third installment of the unrestricted shares. Restrictions on the firm s ability to hedge or sell the remaining one-third installment lapse on February 7, 2007. As of the date of this filing, the conversion price of the firm s SMFG preferred stock into shares of SMFG common stock was ¥319,700. This price is subject to

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downward adjustment if the price of SMFG common stock at the time of conversion is less than the conversion price (subject to a floor of ¥105,400).

In general, transfers of financial assets are accounted for as sales under SFAS No. 140 when the firm has relinquished control over the transferred assets. For transfers accounted for as sales, any related gains or losses are recognized in net revenues. Transfers that are not accounted for as sales are accounted for as collateralized financing arrangements and secured borrowings, with the related interest expense recognized in net revenues over the lives of the transactions.

**Collateralized Financing Arrangements.** Collateralized financing arrangements consist of resale and repurchase agreements, securities borrowed and loaned, and secured short and long-term borrowings. Interest income or expense on collateralized financing arrangements is recognized in net revenues over the life of the transaction.

**Resale and Repurchase Agreements.** Financial instruments purchased under agreements to resell and financial instruments sold under agreements to repurchase, principally U.S. government, federal agency and investment-grade foreign sovereign obligations, represent short-term collateralized financing transactions and are carried in the condensed consolidated statements of financial condition at their contractual amounts plus accrued interest. These amounts are presented on a net-by-counterparty basis when the requirements of FIN No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements, or FIN No. 39, Offsetting of Amounts Related to Certain Contracts, are satisfied. The firm receives financial instruments purchased under agreements to resell, makes delivery of financial instruments sold under agreements to repurchase, monitors the market value of these financial instruments on a daily basis and delivers or obtains additional collateral as appropriate.

**Securities Borrowed and Loaned.** Securities borrowed and loaned are recorded based on the amount of cash collateral advanced or received. These transactions are generally collateralized by cash, securities or letters of credit. The firm receives securities borrowed, makes delivery of securities loaned, monitors the market value of securities borrowed and loaned, and delivers or obtains additional collateral as appropriate.

**Secured Short and Long-Term Borrowings.** The firm also obtains financing through the use of secured short and long-term borrowings. The firm pledges financial instruments and other assets as collateral for such borrowings. See Notes 3, 4 and 5 for further information regarding the firm s secured short and long-term borrowings.

**Power Generation.** Power generation revenues associated with the firm s consolidated power generation facilities are included in Trading and principal investments in the condensed consolidated statements of earnings when power is delivered. Cost of power generation in the condensed consolidated statements of earnings includes all of the direct costs of these facilities (e.g., fuel, operations and maintenance), as well as the depreciation and amortization associated with the facilities and related contractual assets.

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The following table sets forth the power generation revenues and costs directly associated with the firm s consolidated power generation facilities:

| | Three Months Ended August | | Nine Months Ended August | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| | | (in millions) | | |
| Revenues [1] | $146 | $132 | $436 | $377 |
| Cost of power generation | 121 | 108 | 363 | 339 |

(1) Excludes revenues from nonconsolidated power generation facilities, accounted for in accordance with the equity method of accounting, as well as revenues associated with the firm s power trading activities.

**Commissions.** Commission revenues from executing and clearing client transactions on stock, options and futures markets worldwide are recognized in Trading and principal investments in the condensed consolidated statements of earnings on a trade-date basis.

**Insurance Contracts.** Revenues from variable annuity and variable life insurance contracts, and from providing reinsurance of such contracts, generally consist of fees assessed on contract holder account balances for mortality charges, policy administration and surrender charges. These fees are recognized in the condensed consolidated statements of earnings in the period that services are provided. Premiums earned for providing catastrophe reinsurance are recognized in revenues over the coverage period, net of premiums ceded for the cost of reinsurance. Insurance revenues are included in Trading and principal investments in the condensed consolidated statements of earnings.

**Merchant Banking Overrides.** The firm is entitled to receive merchant banking overrides (i.e., an increased share of a fund s income and gains) when the return on the funds investments exceeds certain threshold returns. Overrides are based on investment performance over the life of each merchant banking fund, and future investment underperformance may require amounts of override previously distributed to the firm to be returned to the funds. Accordingly, overrides are recognized in the condensed consolidated statements of earnings only when all material contingencies have been resolved. Overrides are included in Trading and principal investments in the condensed consolidated statements of earnings.

**Asset Management.** Management fees are recognized over the period that the related service is provided based upon average net asset values. In certain circumstances, the firm is also entitled to receive asset management incentive fees based on a percentage of a fund s return or when the return on assets under management exceeds specified benchmark returns or other performance targets. Incentive fees are generally based on investment performance over a 12-month period and are subject to adjustment prior to the end of the measurement period. Accordingly, incentive fees are recognized in the condensed consolidated statements of earnings when the measurement period ends. Asset management fees and incentive fees are included in Asset management and securities services in the condensed consolidated statements of earnings.

***Share-Based Compensation***

In the first quarter of fiscal 2006, the firm adopted SFAS No. 123-R, Share-Based Payment, which is a revision to SFAS No. 123, Accounting for Stock-Based Compensation. SFAS No. 123-R focuses primarily on accounting for transactions in which an entity obtains employee services in exchange for share-based payments. Under SFAS No. 123-R, share-based awards that do not require future service (i.e., vested awards) are expensed immediately. Share-based employee

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awards that require future service are amortized over the relevant service period. The firm adopted SFAS No. 123-R under the modified prospective adoption method. Under that method of adoption, the provisions of SFAS No. 123-R are generally applied only to share-based awards granted subsequent to adoption. The accounting treatment of share-based awards granted to retirement-eligible employees prior to the firm s adoption of SFAS No. 123-R has not changed and financial statements for periods prior to adoption are not restated for the effects of adopting SFAS No. 123-R.

Two key differences between SFAS No. 123-R and SFAS No. 123 are:

First, SFAS No. 123-R requires expected forfeitures to be included in determining share-based employee compensation expense. Prior to the adoption of SFAS No. 123-R, forfeiture benefits were recorded as a reduction to compensation expense when an employee left the firm and forfeited the award. In the first quarter of fiscal 2006, the firm recorded a benefit for expected forfeitures on all outstanding share-based awards. The transition impact of adopting SFAS No. 123-R as of the first day of the firm s 2006 fiscal year, including the effect of accruing for expected forfeitures on outstanding share-based awards, was not material to the firm s results of operations for that quarter.

Second, SFAS No. 123-R requires the immediate expensing of share-based awards granted to retirement-eligible employees, including awards subject to non-compete agreements. Share-based awards granted to retirement-eligible employees prior to the adoption of SFAS No. 123-R must continue to be amortized over the stated service period of the award (and accelerated if the employee actually retires). Consequently, the firm s compensation and benefits expenses in fiscal 2006 (and, to a lesser extent, in fiscal 2007 and fiscal 2008) will include both the amortization (and acceleration) of awards granted to retirement-eligible employees prior to the adoption of SFAS No. 123-R as well as the full grant-date fair value of new awards granted to such employees under SFAS No. 123-R. The estimated annual non-cash expense in fiscal 2006 associated with the continued amortization of share-based awards granted to retirement-eligible employees prior to the adoption of SFAS No. 123-R is approximately $650 million, of which $133 million and $508 million were recognized in the three and nine months ended August 2006, respectively.

The firm began to account for share-based awards in accordance with the fair value method prescribed by SFAS No. 123,  Accounting for Stock-Based Compensation,  as amended by SFAS No. 148,  Accounting for Stock-Based Compensation  Transition and Disclosure,  in 2003. Share-based employee awards granted for the year ended November 29, 2002 and prior years were accounted for under the intrinsic-value-based method prescribed by APB Opinion No. 25,  Accounting for Stock Issued to Employees,  as permitted by SFAS No. 123. Therefore, no compensation expense was recognized for unmodified stock options issued for years prior to fiscal 2003 that had no intrinsic value on the date of grant.

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If the firm were to recognize compensation expense over the relevant service period, generally three years, under the fair value method per SFAS No. 123 with respect to stock options granted for the year ended November 29, 2002 and prior years, net earnings would have decreased for the three and nine months ended August 2005, resulting in pro forma net earnings and earnings per common share (EPS) as set forth below:

| | Three Months Ended August 2005 | Nine Months Ended August 2005 |
|---|---|---|
| | (in millions, except per share amounts) | |
| Net earnings applicable to common shareholders, as reported | $1,608 | $3,985 |
| Add: Share-based compensation expense, net of related tax effects, included in reported net earnings | 144 | 415 |
| Deduct: Share-based compensation expense, net of related tax effects, determined under the fair value method for all awards | (156) | (451) |
| Pro forma net earnings applicable to common shareholders | $1,596 | $3,949 |
| Earnings per common share, as reported | | |
| Basic | $ 3.40 | $ 8.23 |
| Diluted | 3.25 | 7.89 |
| Pro forma earnings per common share | | |
| Basic | $ 3.37 | $ 8.15 |
| Diluted | 3.23 | 7.82 |

The firm pays cash dividend equivalents on outstanding restricted stock units. Dividend equivalents paid on restricted stock units accounted for under SFAS No. 123 and SFAS No. 123-R are charged to retained earnings when paid. SFAS No. 123-R requires dividend equivalents paid on restricted stock units expected to be forfeited to be included in compensation expense. Prior to the adoption of SFAS No. 123-R, dividend equivalents paid on restricted stock units that were later forfeited by employees were reclassified to compensation expense from retained earnings. Dividend equivalents paid on restricted stock units granted prior to 2003 were accounted for under APB Opinion No. 25 and charged to compensation expense.

Prior to the adoption of SFAS No. 123-R, the firm presented all tax benefits resulting from share-based compensation as cash flows from operating activities in the condensed consolidated statements of cash flows. SFAS No. 123-R requires cash flows resulting from tax deductions in excess of the grant-date fair value of share-based awards to be included in cash flows from financing activities.

***Goodwill***

Goodwill is the cost of acquired companies in excess of the fair value of identifiable net assets at acquisition date. In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, goodwill is tested at least annually for impairment. An impairment loss is triggered if the estimated fair value of an operating segment is less than its estimated net book value. Such loss is calculated as the difference between the estimated fair value of goodwill and its carrying value.

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***Identifiable Intangible Assets***

Identifiable intangible assets, which consist primarily of customer lists, above-market power contracts, specialist rights and the value of business acquired (VOBA) and deferred acquisition costs (DAC) in the firm s insurance subsidiaries, are amortized over their estimated useful lives. Identifiable intangible assets are tested for potential impairment whenever events or changes in circumstances suggest that an asset s or asset group s carrying value may not be fully recoverable in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. An impairment loss, calculated as the difference between the estimated fair value and the carrying value of an asset or asset group, is recognized if the sum of the estimated undiscounted cash flows relating to the asset or asset group is less than the corresponding carrying value.

***Property, Leasehold Improvements and Equipment***

Property, leasehold improvements and equipment, net of accumulated depreciation and amortization, are included in Other assets in the condensed consolidated statements of financial condition.

Property and equipment placed in service prior to December 1, 2001 are depreciated under the accelerated cost recovery method. Property and equipment placed in service on or after December 1, 2001 are depreciated on a straight-line basis over the useful life of the asset. Leasehold improvements for which the useful life of the improvement is shorter than the term of the lease are amortized under the accelerated cost recovery method if placed in service prior to December 1, 2001. All other leasehold improvements are amortized on a straight-line basis over the useful life of the improvement or the term of the lease, whichever is shorter. Certain costs of software developed or obtained for internal use are capitalized and amortized on a straight-line basis over the useful life of the software.

Property, leasehold improvements and equipment are tested for potential impairment whenever events or changes in circumstances suggest that an asset s or asset group s carrying value may not be fully recoverable in accordance with SFAS No. 144. An impairment loss, calculated as the difference between the estimated fair value and the carrying value of an asset or asset group, is recognized if the sum of the expected undiscounted cash flows relating to the asset or asset group is less than the corresponding carrying value.

The firm s operating leases include space held in excess of current requirements. Rent expense relating to space held for growth is included in Occupancy in the condensed consolidated statements of earnings. In accordance with SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, the firm records a liability, based on the remaining lease rentals reduced by any potential or existing sublease rentals, for leases where the firm has ceased using the space and management has concluded that the firm will not derive any future economic benefits. Costs to terminate a lease before the end of its term are recognized and measured at fair value upon termination.

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***Foreign Currency Translation***

Assets and liabilities denominated in non-U.S. currencies are translated at rates of exchange prevailing on the date of the condensed consolidated statement of financial condition, and revenues and expenses are translated at average rates of exchange for the fiscal period. Gains or losses on translation of the financial statements of a non-U.S. operation, when the functional currency is other than the U.S. dollar, are included, net of hedges and taxes, on the condensed consolidated statements of comprehensive income. The firm seeks to reduce its net investment exposure to fluctuations in foreign exchange rates through the use of foreign currency forward contracts and foreign currency-denominated debt. For foreign currency forward contracts, hedge effectiveness is assessed based on changes in forward exchange rates; accordingly, forward points are reflected as a component of the currency translation adjustment in the condensed consolidated statements of comprehensive income. For foreign currency-denominated debt, hedge effectiveness is assessed based on changes in spot rates. Foreign currency remeasurement gains or losses on transactions in nonfunctional currencies are included in the condensed consolidated statements of earnings.

***Income Taxes***

Deferred tax assets and liabilities are recognized for temporary differences between the financial reporting and tax bases of the firm s assets and liabilities. Valuation allowances are established to reduce deferred tax assets to the amount that more likely than not will be realized. The firm s tax assets and liabilities are presented as a component of Other assets and Other liabilities and accrued expenses, respectively, in the condensed consolidated statements of financial condition. Tax provisions are computed in accordance with SFAS No. 109, Accounting for Income Taxes. Contingent liabilities related to income taxes are recorded when the criteria for loss recognition under SFAS No. 5, Accounting for Contingencies, as amended, have been met (see Recent Accounting Developments below for a discussion of the impact of FIN No. 48 on SFAS No. 109).

***Earnings Per Common Share***

Basic EPS is calculated by dividing net earnings applicable to common shareholders by the weighted average number of common shares outstanding. Common shares outstanding includes common stock and restricted stock units for which no future service is required as a condition to the delivery of the underlying common stock. Diluted EPS includes the determinants of basic EPS and, in addition, reflects the dilutive effect of the common stock deliverable pursuant to stock options and to restricted stock units for which future service is required as a condition to the delivery of the underlying common stock.

***Cash and Cash Equivalents***

The firm defines cash equivalents as highly liquid overnight deposits held in the ordinary course of business.

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***Recent Accounting Developments***

In June 2005, the EITF reached consensus on Issue No. 04-5, Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights, which requires general partners (or managing members in the case of limited liability companies) to consolidate their partnerships or to provide limited partners with rights to remove the general partner or to terminate the partnership. The firm, as the general partner of numerous merchant banking and asset management partnerships, is required to adopt the provisions of EITF Issue No. 04-5 (i) immediately for partnerships formed or modified after June 29, 2005 and (ii) in the first quarter of fiscal 2007 for partnerships formed on or before June 29, 2005 that have not been modified. The firm generally expects to provide limited partners in these funds with rights to remove the firm as the general partner or to terminate the partnerships and, therefore, does not expect that EITF Issue No. 04-5 will have a material effect on the firm s financial condition, results of operations or cash flows.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140. SFAS No. 155 permits an entity to measure at fair value any financial instrument that contains an embedded derivative that otherwise would require bifurcation. As permitted, the firm early adopted SFAS No. 155 in the first quarter of fiscal 2006. Adoption did not have a material effect on the firm s financial condition, results of operations or cash flows.

Effective for the first quarter of fiscal 2006, the firm adopted SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140, which permits entities to elect to measure servicing assets and servicing liabilities at fair value and report changes in fair value in earnings. The firm acquires residential mortgage servicing rights in connection with its mortgage securitization activities and has elected under SFAS No. 156 to account for these servicing rights at fair value. Adoption did not have a material effect on the firm s financial condition, results of operations or cash flows.

In April 2006, the FASB issued FASB Staff Position (FSP) FIN No. 46-R-6, Determining the Variability to Be Considered in Applying FASB Interpretation No. 46-R. This FSP addresses how a reporting enterprise should determine the variability to be considered in applying FIN No. 46-R by requiring an analysis of the purpose for which an entity was created and the variability that the entity was designed to create. This FSP must be applied prospectively to all entities with which a reporting enterprise first becomes involved and to all entities previously required to be analyzed under FIN No. 46-R when a reconsideration event has occurred. As permitted, the firm early adopted FSP FIN No. 46-R-6 in the third quarter of fiscal 2006. Adoption did not have a material effect on the firm s financial condition, results of operations or cash flows.

In June 2006, the FASB issued FIN No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109. FIN No. 48 requires that the firm determine whether a tax position is more likely than not to be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. Once it is determined that a position meets this recognition threshold, the position is measured to determine the amount of benefit to be recognized in the financial statements. The firm expects to adopt the provisions of FIN No. 48 beginning in the first quarter of fiscal 2008. The firm is currently evaluating the impact of adopting FIN No. 48 on its financial condition, results of operations and cash flows.

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In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 clarifies that fair value is the amount that would be exchanged to sell an asset or transfer a liability, in an orderly transaction between market participants. SFAS No. 157 nullifies the consensus reached in EITF Issue No. 02-3 prohibiting the recognition of day one gain or loss on derivative contracts (and hybrid instruments measured at fair value under SFAS No. 133 as modified by SFAS No. 155) where the firm cannot verify all of the significant model inputs to observable market data and verify the model to market transactions. However, SFAS No. 157 requires that a fair value measurement technique include an adjustment for risks inherent in a particular valuation technique (such as a pricing model) and/or the risks inherent in the inputs to the model, if market participants would also include such an adjustment. In addition, SFAS No. 157 prohibits the recognition of block discounts for large holdings of unrestricted financial instruments where quoted prices are readily and regularly available in an active market. The provisions of SFAS No. 157 are to be applied prospectively, except for changes in fair value measurements that result from the initial application of SFAS No. 157 to existing derivative financial instruments measured under EITF Issue No. 02-3, existing hybrid instruments measured at fair value, and block discounts, which are to be recorded as an adjustment to opening retained earnings in the year of adoption. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The firm is evaluating whether it will early adopt SFAS No. 157 as of the first quarter of fiscal 2007 as permitted, and is currently evaluating the impact adoption may have on its financial condition, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132-R. SFAS No. 158 requires an entity to recognize in its statement of financial condition the funded status of its defined benefit postretirement plans, measured as the difference between the fair value of the plan assets and the benefit obligation. SFAS No. 158 also requires an entity to recognize changes in the funded status of a defined benefit postretirement plan within accumulated other comprehensive income, net of tax, to the extent such changes are not recognized in earnings as components of periodic net benefit cost. SFAS No. 158 is effective as of the end of the fiscal year ending after December 15, 2006. The firm will adopt SFAS No. 158 as of the end of fiscal 2007. The firm does not expect that the adoption of SFAS No. 158 will have a material effect on the firm s financial condition, results of operations or cash flows.

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**Note 3. Financial Instruments**

***Fair Value of Financial Instruments***

The following table sets forth the firm s financial instruments owned, at fair value, including those pledged as collateral, and financial instruments sold, but not yet purchased, at fair value:

| | As of | | | |
|---|---|---|---|---|
| | August 2006 | | November 2005 | |
| | Assets | Liabilities | Assets | Liabilities |
| | (in millions) | | | |
| Commercial paper, certificates of deposit, time deposits and other money market instruments | $ 10,641 (1) | $ | $ 14,609 (1) | $ |
| U.S. government, federal agency and sovereign obligations | 67,436 | 57,720 | 68,688 | 51,458 |
| Corporate and other debt obligations | | | | |
| Mortgage whole loans and collateralized debt obligations | 36,507 | 507 | 31,459 | 223 |
| Investment-grade corporate bonds | 17,515 | 4,326 | 12,415 | 4,232 |
| Bank loans | 27,254 | 722 | 13,843 | 288 |
| High-yield securities | 8,318 | 2,125 | 8,822 | 2,072 |
| Preferred stock | 7,631 | 395 | 7,315 | 71 |
| Other | 1,187 | 356 | 877 | 278 |
| | 98,412 | 8,431 | 74,731 | 7,164 |
| Equities and convertible debentures | 66,826 | 32,457 | 56,656 | 32,565 |
| State, municipal and provincial obligations | 3,550 | | 2,524 | |
| Derivative contracts | 60,181 (2) | 57,196 (3) | 58,532 (2) | 57,829 (3) |
| Physical commodities | 2,128 | 753 | 1,286 | 55 |
| Total | $309,174 (4) | $156,557 | $277,026 | $149,071 |

(1) Includes $7.28 billion and $6.12 billion, as of August 2006 and November 2005, respectively, of money market instruments held by William Street Funding Corporation to support the William Street credit extension

program.

(2) Net of cash received pursuant to credit support agreements of $22.24 billion and $22.61 billion as of August 2006 and November 2005, respectively.

(3) Net of cash paid pursuant to credit support agreements of $17.27 billion and $16.10 billion as of August 2006 and November 2005, respectively.

(4) Includes securities held by the firm s bank and insurance subsidiaries, which are accounted for as available-for-sale (AFS) under SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. The following table sets forth the types of AFS securities and their maturity profile:

| | Under One Year | 1-5 Years | 6-10 Years | Over 10 Years | Total |
|---|---|---|---|---|---|
| | | | (in millions) | | |
| Mortgage-backed and other federal agency securities | $826 | $ 794 | $146 | $ 7 | $1,773 |
| Investment-grade corporate bonds | 50 | 564 | 66 | 52 | 732 |
| Collateralized debt obligations | 7 | 645 | 20 | | 672 |
| Other investment-grade debt securities | 42 | 8 | 58 | 111 | 219 |
| Total | $925 | $2,011 | $290 | $170 | $3,396 |

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***Derivative Activities***

Derivative contracts are instruments, such as futures, forwards, swaps or option contracts that derive their value from underlying assets, indices, reference rates or a combination of these factors. Derivative instruments may be privately negotiated contracts, which are often referred to as OTC derivatives, or they may be listed and traded on an exchange. Derivatives may involve future commitments to purchase or sell financial instruments or commodities, or to exchange currency or interest payment streams. The amounts exchanged are based on the specific terms of the contract with reference to specified rates, securities, commodities, currencies or indices.

Certain cash instruments, such as mortgage-backed securities, interest-only and principal-only obligations, and indexed debt instruments, are not considered derivatives even though their values or contractually required cash flows are derived from the price of some other security or index. However, certain commodity-related contracts are included in the firm s derivatives disclosure, as these contracts may be settled in cash or are readily convertible into cash.

The firm enters into derivative transactions to facilitate client transactions, to take proprietary positions and as a means of risk management. Risk exposures are managed through diversification, by controlling position sizes and by entering into offsetting positions. For example, the firm may manage the risk related to a portfolio of common stock by entering into an offsetting position in a related equity-index futures contract.

The firm applies hedge accounting under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, to certain derivative contracts. The firm uses these derivatives to manage certain interest rate and currency exposures, including the firm s net investment in non-U.S. operations. The firm designates certain interest rate swap contracts as fair value hedges. These interest rate swap contracts hedge changes in the relevant benchmark interest rate (e.g., London Interbank Offered Rate (LIBOR)), effectively converting a substantial portion of the firm s long-term and certain short-term borrowings into floating rate obligations. In addition, the firm applies cash flow hedge accounting to a limited number of foreign currency forward contracts that hedge currency exposure on certain forecasted transactions in its consolidated power generation facilities. See Note 2 for information regarding the firm s policy on foreign currency forward contracts used to hedge its net investment in non-U.S. operations.

The firm applies a long-haul method to substantially all of its hedge accounting relationships to perform an ongoing assessment of the effectiveness of these relationships in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged. The firm utilizes a dollar-offset method, which compares the change in the fair value of the hedging instrument to the change in the fair value of the hedged item, excluding the effect of the passage of time, to prospectively and retrospectively assess hedge effectiveness. The firm s prospective dollar-offset assessment utilizes scenario analyses to test hedge effectiveness via simulations of numerous parallel and slope shifts of the relevant yield curve. Parallel shifts change the interest rate of all maturities by identical amounts. Slope shifts change the curvature of the yield curve. A hedging relationship is deemed to be effective if the fair values of the hedging instrument and the hedged item change inversely within a range of 80 to 125% in response to each of the simulated yield curve shifts.

For fair value hedges, gains or losses on derivative transactions as well as the hedged item are recognized in Interest expense in the condensed consolidated statements of earnings. For cash flow hedges, the effective portion of gains or losses on derivative transactions is reported as a component of Other comprehensive income. Gains or losses related to hedge ineffectiveness for

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all hedges are generally included in Interest expense. These gains or losses and the component of gains or losses on derivative transactions excluded from the assessment of hedge effectiveness (e.g., the effect of the passage of time on fair value hedges of the firm s borrowings) were not material to the firm s results of operations for the three and nine months ended August 2006. Gains and losses on derivatives used for trading purposes are generally included in Trading and principal investments in the condensed consolidated statements of earnings.

Fair values of the firm s derivative contracts are reflected net of cash paid or received pursuant to credit support agreements and are reported on a net-by-counterparty basis in the firm s condensed consolidated statements of financial condition when management believes a legal right of setoff exists under an enforceable netting agreement. The fair value of derivative financial instruments, computed in accordance with the firm s netting policy, is set forth below:

| | As of | | | |
|---|---|---|---|---|
| | August 2006 | | November 2005 | |
| | Assets | Liabilities | Assets | Liabilities |
| | (in millions) | | | |
| Forward settlement contracts | $10,779 | $11,373 | $13,921 | $15,345 |
| Swap agreements | 25,652 | 20,902 | 25,865 | 22,001 |
| Option contracts | 23,750 | 24,921 | 18,746 | 20,483 |
| Total | $60,181 | $57,196 | $58,532 | $57,829 |

The fair values of derivatives accounted for as qualifying hedges under SFAS No. 133 consisted of $1.69 billion and $2.10 billion in assets as of August 2006 and November 2005, respectively, and $991 million and $443 million in liabilities as of August 2006 and November 2005, respectively.

The firm also has embedded derivatives that have been bifurcated from related borrowings under SFAS No. 133. Such derivatives, which are classified in short-term and long-term borrowings, had a carrying value of $1.18 billion and $607 million (excluding the debt host contract) as of August 2006 and November 2005, respectively. See Notes 4 and 5 for further information regarding the firm s borrowings.

***Securitization Activities***

The firm securitizes commercial and residential mortgages, home equity and auto loans, government and corporate bonds and other types of financial assets. The firm acts as underwriter of the beneficial interests that are sold to investors. The firm derecognizes financial assets transferred in securitizations provided it has relinquished control over such assets. Transferred assets are accounted for at fair value prior to securitization. Net revenues related to these underwriting activities are recognized in connection with the sales of the underlying beneficial interests to investors.

The firm may retain interests in securitized financial assets, primarily in the form of senior or subordinated securities, including residual interests. Retained interests are accounted for at fair value and included in Total financial instruments owned, at fair value in the condensed consolidated statements of financial condition.

During the nine months ended August 2006 and August 2005, the firm securitized $78.77 billion and $65.10 billion, respectively, of financial assets, including $55.20 billion and $45.39 billion, respectively, of residential mortgage loans and securities. Cash flows received on

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retained interests were approximately $613 million and $655 million for the nine months ended August 2006 and August 2005, respectively.

As of August 2006 and November 2005, the firm held $8.28 billion and $6.07 billion of retained interests, respectively, including $6.26 billion and $5.62 billion, respectively, held in QSPEs. The fair value of retained interests valued using quoted market prices in active markets was $1.27 billion and $1.34 billion as of August 2006 and November 2005, respectively.

The following table sets forth the weighted average key economic assumptions used in measuring retained interests for which fair value is based on alternative pricing sources with reasonable, little or no price transparency and the sensitivity of those fair values to immediate adverse changes of 10% and 20% in those assumptions:

| | As of August 2006 | | | As of November 2005 | | |
|---|---|---|---|---|---|---|
| | Type of Retained Interests | | | Type of Retained Interests | | |
| | Mortgage-Backed | CDOs | Corporate Debt [3] | Mortgage-Backed | CDOs | Corporate Debt [3] |
| | ($ in millions) | | | | | |
| Fair value of retained interests | $3,841 | $2,101 | $1,071 | $2,928 | $ 516 | $1,283 |
| Weighted average life (years) | 6.6 | 5.2 | 2.4 | 5.7 | 4.9 | 2.2 |
| Constant prepayment rate | 19.1% | 24.7% | N/A% | 18.6% | 21.5% | N/A% |
| Impact of 10% adverse change | $ (90) | $ (4) | $ | $ (44) | $ (2) | $ |
| Impact of 20% adverse change | (162) | (7) | | (73) | (4) | |
| Anticipated credit losses [1] | 3.7% | 2.1% | N/A% | 5.0% | 2.5% | N/A% |
| Impact of 10% adverse change [2] | $ (92) | $ (3) | $ | $ (25) | $ (4) | $ |
| Impact of 20% adverse change [2] | (172) | (5) | | (48) | (9) | |
| Discount rate | 8.8% | 5.8% | 2.3% | 7.4% | 6.1% | 3.7% |
| Impact of 10% adverse change | $ (137) | $ (40) | $ (9) | $ (70) | $ (3) | $ (10) |
| Impact of 20% adverse change | (263) | (80) | (18) | (136) | (8) | (21) |

(1) Anticipated credit losses are computed only on positions in which expected credit loss is a key assumption in the determination of fair values.

(2) The impacts of adverse change take into account credit mitigants incorporated in the retained interests, including over- collateralization and subordination provisions.

(3) Includes retained interests in bonds and other types of financial assets that are not subject to prepayment risk.

The preceding table does not give effect to the offsetting benefit of other financial instruments that are held to mitigate risks inherent in these retained interests. Changes in fair value based on an adverse variation in assumptions generally cannot be extrapolated because the relationship of the change in assumptions to the change in fair value is not usually linear. In addition, the impact of a change in a particular assumption is calculated independently of changes in any other assumption. In practice, simultaneous changes in assumptions might magnify or counteract the sensitivities disclosed above.

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In addition to the retained interests described above, the firm also held interests in residential mortgage QSPEs purchased in connection with secondary market-making activities. These purchased interests approximated \$7 billion and \$5 billion as of August 2006 and November 2005, respectively.

***Variable Interest Entities (VIEs)***

The firm, in the ordinary course of business, retains interests in VIEs in connection with its securitization activities. The firm also purchases and sells variable interests in VIEs, which primarily issue mortgage-backed and other asset-backed securities and collateralized debt obligations (CDOs), in connection with its market-making activities and makes investments in and loans to VIEs that hold performing and nonperforming debt, equity, real estate, power-related and other assets. In addition, the firm utilizes VIEs to provide investors with credit-linked and asset-repackaged notes designed to meet their objectives.

VIEs generally purchase assets by issuing debt and equity instruments. In certain instances, the firm provides guarantees to VIEs or holders of variable interests in VIEs. In such cases, the maximum exposure to loss included in the tables set forth below is the notional amount of such guarantees. Such amounts do not represent anticipated losses in connection with these guarantees.

The firm s variable interests in VIEs include senior and subordinated debt; limited and general partnership interests; preferred and common stock; interest rate, foreign currency, equity, commodity and credit derivatives; guarantees; and residual interests in mortgage-backed and asset-backed securitization vehicles and CDOs. The firm s exposure to the obligations of VIEs is generally limited to its interests in these entities.

The following table sets forth the firm s total assets and maximum exposure to loss associated with its significant variable interests in consolidated VIEs where the firm does not hold a majority voting interest. The firm has aggregated consolidated VIEs based on principal business activity, as reflected in the first column.

| | As of August 2006 | | As of November 2005 | |
|---|---|---|---|---|
| | VIE Assets (1) | Maximum Exposure to Loss | VIE Assets (1) | Maximum Exposure to Loss |
| | (in millions) | | | |
| Investments in loans and real estate | \$1,788 | \$ 637 | \$2,081 | \$ 717 |
| Municipal bonds | 2,568 | 2,568 | 1,587 | 1,587 |
| Mortgage-backed and other asset-backed | 457 | 117 | 522 | 55 |
| Asset repackagings and credit-linked notes | 1,246 | 929 | 1,266 | 880 |
| Investments in preferred stock | 425 | 244 | 416 | 221 |
| Foreign exchange and commodities | 554 | 412 | 600 | 205 |
| Other | 150 | 286 | 152 | 279 |
| Total | \$7,188 | \$5,193 | \$6,624 | \$3,944 |

(1) Consolidated VIE assets include assets financed by nonrecourse short-term and long-term debt. Nonrecourse debt is debt that only the issuing subsidiary or, if applicable, a subsidiary guaranteeing the debt is obligated to repay.

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The following tables set forth total assets in nonconsolidated VIEs in which the firm holds significant variable interests and the firm s maximum exposure to loss associated with these interests. The firm has aggregated nonconsolidated VIEs based on principal business activity, as reflected in the first column. The nature of the firm s variable interests can take different forms, as described in the columns under maximum exposure to loss.

| | As of August 2006 | | | | | |
|---|---|---|---|---|---|---|
| | | Maximum Exposure to Loss in Nonconsolidated VIEs | | | | |
| | VIE Assets | Purchased and Retained Interests | Commitments and Guarantees | Derivatives (1) | Loans and Investments | Total |
| | (in millions) | | | | | |
| Collateralized debt obligations | $40,916 | $2,170 | $ | $ 9,439 | $ | $11,609 |
| Asset repackagings and credit-linked notes | 4,778 | | | 3,237 | | 3,237 |
| Power-related | 3,398 | 2 | 73 | | 618 | 693 |
| Investments in loans and real estate | 14,086 | | 34 | 15 | 1,658 | 1,707 |
| Mortgage-backed and other asset-backed | 4,714 | 62 | 1,256 | 63 | 260 | 1,641 |
| Total | $67,892 | $2,234 | $1,363 | $12,754 | $2,536 | $18,887 |

| | As of November 2005 | | | | | |
|---|---|---|---|---|---|---|
| | | Maximum Exposure to Loss in Nonconsolidated VIEs | | | | |
| | VIE Assets | Purchased and Retained Interests | Commitments and Guarantees | Derivatives (1) | Loans and Investments | Total |
| | (in millions) | | | | | |
| Collateralized debt obligations | $24,295 | $ 780 | $ | $ 4,536 | $ | $ 5,316 |
| Asset repackagings and credit-linked | 2,568 | | | 1,527 | | 1,527 |

| | | |
|---|---|---|
| notes | | |
| Power-related | 6,667 | 2 |