Morningstar, Inc.

2005

Annual Report

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Dear Morningstar shareholders,

This is our first annual report as a public company, and I'm happy to welcome you as a new shareholder in Morningstar. I appreciate the decision you've made to become an owner of our company and the optimism in our business that it represents. We hope to build a long-term partnership with our investors and look forward to having you as a Morningstar shareholder for many years.

In this letter, I'll review our results for 2005, highlight our key priorities for 2006, and give you some insight on how we manage our company. I'll also try to be candid in my communications with you. Our attitude is to treat you as owners and deliver a realistic assessment of our business. To that end, I've written this annual letter in much the same way as I've done in the past for our employees and board of directors.

We made good progress during 2005 in all three of our key financial measures: revenue, operating income, and free cash flow. We increased our revenue 26% to $227.1 million, our operating income 162% to $46.5 million, and our free cash flow 63% to $41.0 million. Our operating margins also continued their steady improvement and reached more than 20% in 2005, after fully expensing stock options.

Our strong growth in earnings and free cash flow were largely the result of our inherent operating leverage. We're fortunate to be in a business where the marginal cost of serving a customer is low. Once we've built an investment database, for example, selling a new data feed costs relatively little. If we can get good revenue growth, our costs should grow at a slower rate. That means operating margins will improve. In 2005, for example, we increased our revenue 26% while our costs grew only 12%.

Our balance sheet also improved. We ended 2005 with $153.2 million in cash and short-term investments, up from $95.5 million in 2004. Our cash position benefited from $25.3 million in net proceeds from our initial public offering and stock option exercises, which was somewhat offset by the $8.2 million we spent on our acquisition of VARDS. In early 2006 we also bought Ibbotson Associates, which I'll discuss later, for $83 million (plus working capital). But because we're steadily generating cash, we still have plenty of financial strength and ample capacity to pursue a good opportunity should one arise.

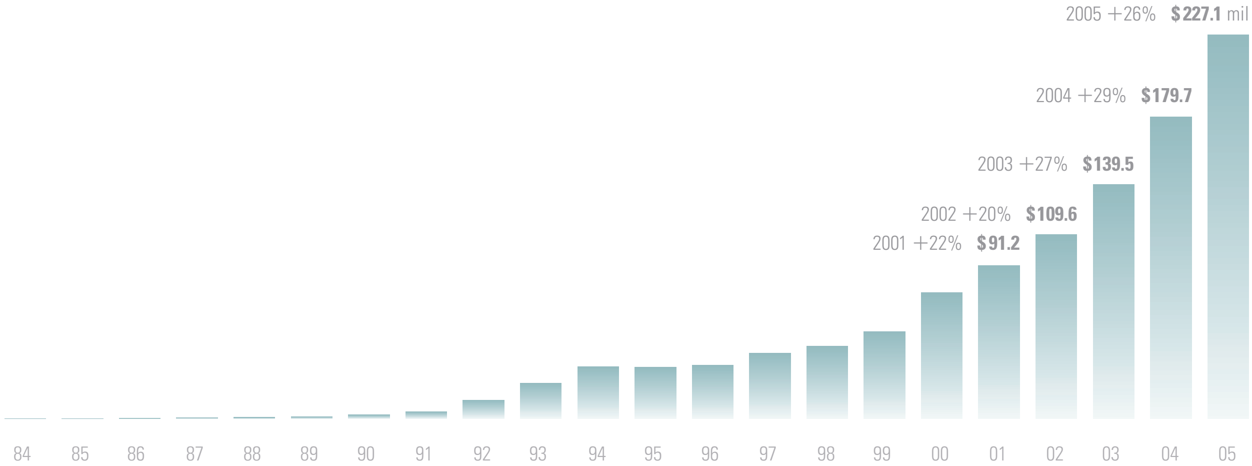
We also handily passed $200 million in sales last year. That's a big achievement for a business that took in about $100,000 in 1985, our first full year of operation. And nearly all of that growth came organically, without significant acquisitions. I've included a chart with our sales history that you might find interesting. With patience and consistent growth, compounding does create impressive results.

Business Model

In order to evaluate any business, it's important to understand its business model—how it makes money and grows. We summarize our business model in a graph we call our "leverage diagram," which you can find on page 33. At the top of the chart in the circles are all of our investment databases. Below that, in the diamonds, are our core skills of research, technology, and design—the value we add to the data. These two components represent our fixed investments.

We have high fixed costs but very low variable costs. The implication is that scale matters. Bigger is better in the information business. It's like building a power plant—expensive to do, but once you've got one it

Morningstar's revenue growth over the past 22 years.



costs little to connect an additional home. We've built our power plant and now we're focusing on building more scale by signing on new customers.

We try to increase our scale by leveraging our fixed investments as much as possible. We do that in three ways: (1) by media—creating print, desktop software, and Web-based products; (2) by audience—selling to individuals, financial advisors, and institutions; and (3) by geography—selling our products and services around the world.

The more we increase our scale, the more we can reinvest in our databases and core skills. This makes our products more valuable, which attracts more clients, which allows more reinvestment, and so on, creating a reinforcing effect. That's been our playbook for the past 20 years.

The result is competitive advantage for us and better value for our customers. If we only served the individual investor market, for example, we couldn't afford the in-depth coverage of mutual funds and stocks that we have. But by also serving advisors and institutions, we can afford to offer richer content that benefits all three audiences. One audience, in effect, helps support the other two.

Economic Moat and Growth Strategies

In addition to understanding a company's business model, it's also important to understand its "economic moat." This is a term we've borrowed from Warren Buffett to describe a company's sustainable competitive advantage—the barrier that protects the company castle. It's a helpful construct to use in analyzing any business. It's a core tenet of our stock research and it also guides our thinking in running Morningstar.

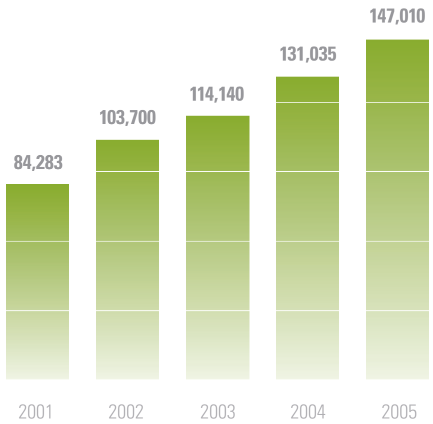
We believe we have a wide-moat business. That is, we think we have sustainable advantages that make it difficult for other companies to compete with us. The key elements of our moat are our brand and reputation, our hard-to-replicate databases, our signature investment research tools (think star ratings, style box), and our large and loyal customer base. We continue to find good opportunities to invest to widen our moat and earn attractive returns.

In our recent public offering, we described four growth strategies—building our major Internet platforms, expanding our range of services to meet additional investor needs, expanding internationally, and seeking growth through strategic acquisitions. Following our IPO, we've dropped strategic acquisitions as a core growth strategy because we expect to make acquisitions only in support of our other objectives. In what follows, I'll tell you how we widened our moat in each of the three other areas in 2005. And I'll discuss a new opportunity that we think merits equal emphasis.

1. Enhance our position in each of our three market segments by focusing on our flagship Internet-based platforms.

Our major platforms are Morningstar.com for individual investors, Morningstar Advisor Workstation for financial advisors, Morningstar Direct for institutions, and Morningstar Retirement Manager for the retirement market. Our belief is that investors want integrated solutions instead of having to link together

Growth in paid Premium Memberships on Morningstar.com—one of the largest paid financial sites on the Web.



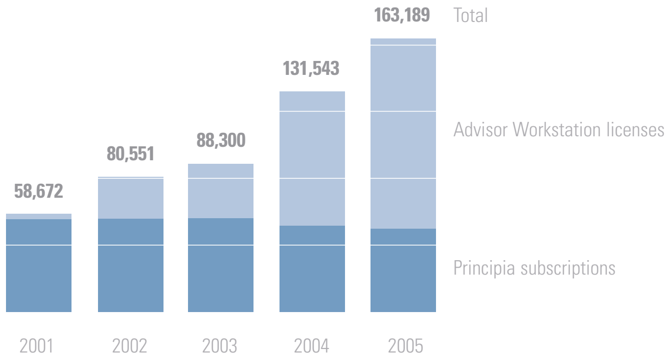
many disparate applications. So instead of launching many new products, we're concentrating our development efforts on enhancing the content and analytical tools of these major platforms.

Our paid Premium Membership service on **Morningstar.com** grew 12% to 147,010 paid subscribers by the end of 2005. Our site is one of the largest paid financial sites on the Web. To the best of my knowledge, only The Wall Street Journal Online is larger. I think gaining access to our analyst research has been the key driver behind the growth in our Premium Memberships. We offer analyst reports on 2,000 mutual funds and 1,700 stocks. We've long been known for our mutual fund analysis, but increasingly we're building a reputation for equity analysis. We now have nearly 90 stock analysts covering a broad range of stocks in every sector. We're continuing to focus on leveraging this broader research offering by drawing more equity investors to the site.

While we've made large strides in our equity analysis, I would be remiss if I didn't mention the first-rate work of our mutual fund analysts. Their perceptive and candid analyses continue to help millions of investors make better decisions. At times, their outspokenness may put us at odds with the fund industry. That doesn't bother us, as long as we're acting in the investor's interest and our reasoning is correct. Our strong reputation for independent and unbiased research has largely been the result of the high quality of our analyst research. We do all that we can to protect it.

Internet advertising revenue is becoming more significant for us. It grew by 35% during the year and now accounts for almost 30% of Morningstar.com revenue (the balance being Premium subscription revenue).

Morningstar Advisor Workstation has surpassed Principia to become the largest product in our Advisor segment.



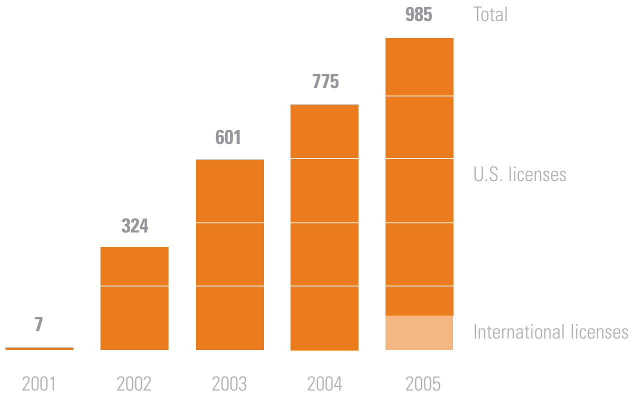
We have a high-quality and engaged investor audience on Morningstar.com. Our users typically don't come just to get a stock quote and leave. Rather they spend time—a lot of time—learning about investing and doing investment research. Our time spent per visit and page views per visit statistics were the highest among financial news and information sites on the Web in 2005, as measured by Nielsen/NetRatings. We're encouraged about the prospects for advertising revenue in 2006.

Cathy Odelbo runs our Individual business unit, which includes Morningstar.com and our fund and equity research. Cathy started as a mutual fund analyst in 1988 and is a passionate investor herself. She's been a powerful driving force behind developing Morningstar.com and expanding our research efforts.

Morningstar Advisor Workstation—our Web-based investment planning system for financial advisors—has proved to be our killer application over the past few years. Last year, its strong growth vaulted it past Principia, our CD-ROM-based research software, to become the largest product in the Advisor segment and the second-largest product at Morningstar. The number of Workstation licenses increased by about 40% to reach more than 113,000 by the end of 2005.

We've also done more work to develop the functionality and tools offered in Advisor Workstation. For example, we recently introduced a report to help advisors select the most appropriate and cost-effective share class for their clients. In 2006, we'll add portfolio accounting capabilities to our Office Edition, which we market to independent financial advisors. We hope to make this application a complete solution

We expanded the number of licenses for Morningstar Direct in 2005—including numerous accounts outside the United States.



for financial advisors, helping them with both "front office" and "back office" needs and creating a tight integration between the two.

Chris Boruff manages our Advisor business unit, which includes Advisor Workstation. He and his team have pushed hard to understand the needs of financial advisors and expand our reach in this market, with impressive results.

We have high hopes for **Morningstar Direct**, our Web-based institutional research platform. Our vision for Direct is to have all of our investment databases from around the world, all of our analytics, and all of our research in one easy-to-use application with simple pricing ($15,000 for the first user, $10,000 for the second, and $7,500 thereafter). The idea is one product, one price, sold globally. Direct offers the most complete, timely access to our data and research for institutional investors.

In 2005, we increased the number of users for Direct by about 27% and made several major improvements to the product. At the end of 2005, Morningstar Direct had 985 licenses, compared with 775 the previous year. During 2005, several of our large accounts moved to a new pricing model that has no discounting, and because of this, average revenue per license increased.

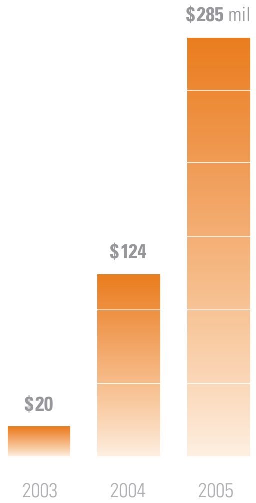
During the year, we laid the groundwork for future growth by expanding the number of institutional relationships for Morningstar Direct, including numerous new accounts outside the United States. We've also broadened the data universes we cover to allow institutions to conduct research across global markets. Morningstar Direct now includes data on locally domiciled mutual funds in 23 countries. It was also the first product at Morningstar to incorporate our data on hedge funds and hedge funds of funds. In 2006, we plan to add our stock research, ownership databases, and performance attribution analytics to Morningstar Direct.

Liz Kirscher runs our Data Services business, which produces Morningstar Direct and other data products. Liz is another long-tenured manager who brings enthusiasm and a competitive spirit to her work. Her business unit has made steady and significant progress under her leadership.

Five years ago we began offering online retirement advice through our **Morningstar Retirement Manager** platform, mainly to participants in 401(k) plans. Providing customized online advice has proved disappointing to everyone in our industry—and we've been no exception. It turns out that only a minority of retirement plan participants are willing to use an online tool to help them plan for retirement. The people who use these tools like them, but online advice doesn't meet the needs of everyone in a retirement plan. Our investment in developing these solutions has not been a good one. If it's any consolation, several competitors have spent much more than we have with what I believe are equally unimpressive results. Still, we think there is promise for this business.

The hope lies in what the industry calls managed accounts—retirement accounts where a professional manager makes the investment decisions for a fee. The idea is to help individuals who don't want to

Our asset growth in managed retirement accounts.



manage their retirement assets but instead want to outsource management to an outside firm (like us). We believe this service has broader appeal and, together with online advice, will provide a comprehensive advice solution for more retirement plan participants. We're one of the few independent providers of managed accounts in the industry. **Although our asset base in managed accounts is still relatively small, we had good growth in 2005.** We had about $285 million in assets as of year-end 2005, compared with $124 million the previous year.

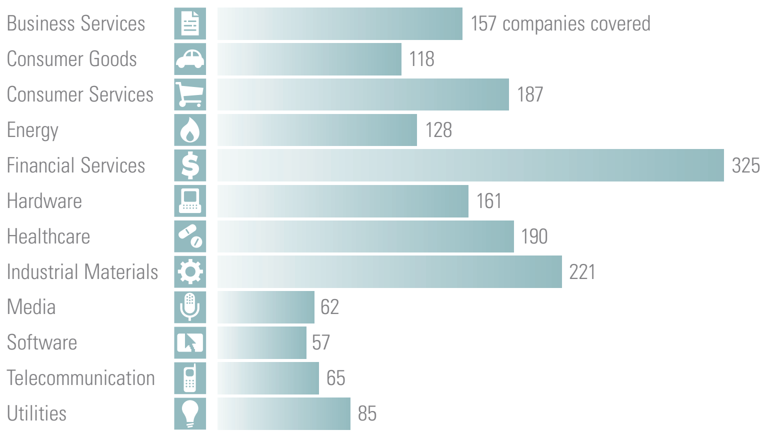
Our recent acquisition of Ibbotson Associates should boost this business in a large way. Ibbotson has done a terrific job in managed accounts and had about $4.3 billion in assets under management at the end of 2005. Now that we've completed the acquisition, Morningstar is one of the largest providers of managed retirement accounts in the industry.

Patrick Reinkemeyer manages Morningstar's Retirement Manager platform, along with our investment consulting business. Patrick is an exceptional manager who started our investment consulting business in 1998 and has created significant value for us over the years.

2. Expand the range of services we offer to investors, financial advisors, and institutional clients.

Since beginning in 1984 with a single mutual fund publication, we've grown methodically by adding offerings that meet other investor needs. Two major areas we're focusing on today are:

We now cover more than 1,700 stocks in 12 economic sectors.



Stock research

Although we've been building our equity research capabilities for a number of years, our success in winning Global Analyst Research Settlement business has catapulted the scope of our coverage into a new league. We provide **independent analyst research** to six investment banks related to the settlement. Under agreements reached with regulators, the 12 firms included in the settlement agreed to spend a total of about $450 million to provide independent research to their clients over a period of five years starting in July 2004.

As of the end of 2005, our analysts covered more than 1,700 stocks, compared with about 1,500 as of year-end 2004 and 500 at the end of 2003. Our coverage list now includes more than 99% of the stocks in the S&P 500 index based on market capitalization. We've made a major investment in our analyst staff to support these research efforts, and we now have nearly 90 stock analysts in the United States, compared with about 70 at the end of 2004. If you haven't read our equity research, I encourage you to give it a try. I'll think you'll be impressed.

We look for stocks that trade at discounts to our estimates of their intrinsic value and have the same type of economic moat we try to build for our own business. All of our analysts use the same methodology. The combination of a consistent, value-based methodology and broad coverage creates a compelling equity research offering. Now that we've made this large investment in our equity analyst staff, a key challenge for us is to leverage that investment by selling our research to new clients, both in the United States and abroad.

Hedge funds

Offering data and analysis on hedge funds is a natural extension of our work on other managed investment vehicles. Hedge funds worldwide now represent more than $1.4 trillion in investor assets. Our goal is to help investors understand this alternative asset class and help make the industry more transparent.

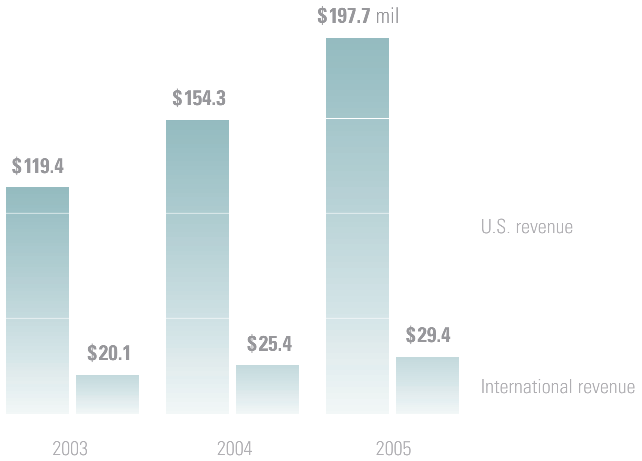
After launching our hedge fund database in early 2005, we added data on more than 1,400 hedge funds during the year. We now track data on more than 2,600 single-managed hedge funds and hedge funds of funds across 15 strategies. We currently offer Morningstar hedge fund data through Morningstar Direct and expect to offer this data through several other Morningstar products in the future.

Now that we've built our hedge fund database, our next step is to add analysis to our hedge fund reports. We've hired investment analysts who've started interviewing hedge fund managers. Their qualitative research will debut in 2006. Having a staff of knowledgeable hedge fund analysts is essential to building our capabilities in this area.

3. **Expand our international brand presence, products, and services.**

We had revenue of $29.4 million from outside the United States in 2005, compared with $25.4 million in 2004. We now have operations in 12 countries (plus minority ownership positions in another four) and reach more than 500,000 investors outside the United States. We began selling Morningstar Direct overseas in 2005. After nine months of selling we had clients in 15 of our international markets. We also expanded our consulting business internationally in 2005, with two consulting agreements in Europe

International sales made up about 13% of our total revenue in 2005.



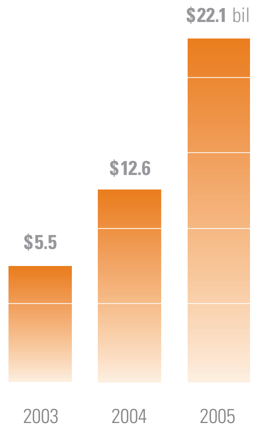
and one in Asia. In addition, we started selling our products to investors in Belgium, Luxembourg, Switzerland, and Taiwan in 2005.

International sales accounted for about 13% of our total revenue in 2005, compared with about 14% in 2004. **Our overseas business grew 16% last year** but our U.S. business grew even faster, causing the percentage of international revenue to decline slightly. Over time, we expect that the percentage of revenue from our international operations will increase.

To help drive our international growth, we're focusing more development and sales resources on global products, including Morningstar Direct, Advisor Workstation, and Investment Consulting. We're also expanding our analyst staff overseas to further develop our independent voice and provide greater help to investors in selecting securities.

Bevin Desmond runs our international business. She is skilled at developing, integrating, and expanding our overseas operations. It's not an easy assignment because we strive to operate consistently around the world—what we call our "one Morningstar" approach. That means hiring people with the same type of skill sets and entrepreneurial spirit, and having the same client experience, the same type of office space, and the same culture around the world. Bevin does a great job at it. If you ever run into her, it will probably be at an airport.

Our total assets under advisement for funds-of-funds offerings.



4. **Become a global leader in funds-of-funds investment management.**

Our new strategic goal is to become a global leader in funds-of-funds investment management, a business focused on creating portfolios of mutual funds or other types of managed investments. Given our expertise in understanding managed investment products, this is a natural business for Morningstar. The large number of managed investment products available has made assembling them into well-constructed portfolios a difficult task for many investors. There are, for example, more than 8,000 mutual funds, 50,000 variable annuity/life subaccounts, and 15,000 hedge funds. Consequently, funds-of-funds offerings have had strong growth within these industries.

We advise on approximately $22 billion in fund-of-funds offerings today. These are relationships where we either act as a portfolio construction manager or consultant to a mutual fund or variable annuity and receive a basis point fee. The Ibbotson acquisition (more on that below) added another $7 billion in assets under advisement. We see continued potential for growth in this part of our business, including in our operations outside the United States.

Another part of our funds-of-funds initiative is assets that we manage directly. In addition to managed retirement accounts, we have a Morningstar Managed Portfolios service that invests client assets in portfolios of mutual funds and exchange-traded funds. This service is distributed exclusively through financial advisors and is meant for advisors who want to outsource the portfolio management function. We had $1.4 billion in assets in Morningstar Managed Portfolios at year-end 2005, up from

We plan to incorporate Ibbotson's core products into our three global business segments.

	Individual Segment	Advisor Segment	Institutional Segment
Morningstar	Morningstar.com Morningstar Equity Research Morningstar FundInvestor Morningstar Mutual Funds Morningstar StockInvestor Books and workbooks	Morningstar Advisor Workstation Morningstar Principia Morningstar Managed Portfolios Morningstar Investment Conference	Morningstar Direct Morningstar Retirement Manager Investment Consulting Licensed Data Licensed Tools and Content Investment Profiles & Guides Morningstar Indexes
Ibbotson Associates	SBBI Yearbooks Cost of Capital Yearbook Beta Book Cost of Capital Center	Portfolio Strategist iPlan Components Presentation materials Training	Investment Consulting Advice by Ibbotson Ibbotson EnCorr

$936 million the year before. Art Lutschaunig runs this business and deserves much credit for putting us impressively on the map in this area.

Acquisitions

Ibbotson Associates

Late in 2005, we announced our acquisition of **Ibbotson Associates**. We closed this transaction on March 1, 2006. This is an important acquisition for us and our largest ever. I've known Roger Ibbotson and the management of Ibbotson Associates since the late 1980s and have long admired the company. Ibbotson is highly regarded for its asset allocation expertise and its database of long-term capital markets returns.

Roger analyzed these numbers while at the University of Chicago in the 1970s. From this, Roger created a company in 1977 to sell capital markets data and asset allocation services to institutional investors. One of the company's early publications was the annual Stocks, Bonds, Bills, and Inflation Yearbook. This publication quickly became—and still is—the industry standard reference for long-term asset class returns.

When I started in the investment business in the early 1980s, institutional investors had much larger proportions of fixed-income securities in their portfolios. Roger's research demonstrated the superiority of equity over fixed-income investments for long periods of time. His work was an important factor in institutional investors shifting their asset mix toward equities over the past two decades.

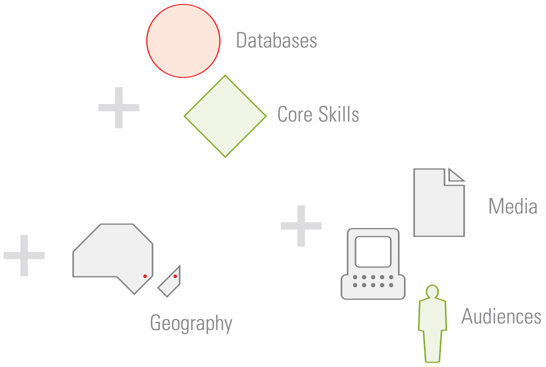
In the 1980s, we began providing our mutual fund data to Ibbotson for use in its products. At the time, we were focused on serving individuals and advisors, while Ibbotson was serving institutions. Over time, both companies began to focus on similar opportunities—especially the retirement advice business and funds-of-funds management. So last year I called Roger to see if he had an interest in selling his firm. We met in August and shook hands on a deal in November.

Roger and Mike Henkel, Ibbotson's president, are both excited about continuing their work here, and we're pleased to have them as part of Morningstar. Roger continues to teach at Yale and works part-time with our research group, doing speaking engagements, and meeting with clients. Mike will continue to run Ibbotson's core advice, investment consulting, and funds-of-funds business.

I believe we paid a fair price for Ibbotson, $83 million (plus working capital). We expect to realize about $10 million in cash tax benefits in 2006 from the transaction. The business had $37 million in sales in the year ended June 2005. It's a solid business that has a strong future.

We're excited about the combination for three key reasons: (1) Ibbotson's funds-of-funds business; (2) its managed retirement account business; and (3) its institutional software business. I've already discussed what we're doing in the first two areas, so you can see that Ibbotson will strengthen us there. But we're also excited about an Ibbotson product called EnCorr. It's a leading asset allocation software package. We plan to build that business, especially with our international operations. We'll also incorporate much of EnCorr's functionality into Morningstar Direct.

We consider acquisitions that complement our core business and fit our mission of creating great products that help investors reach their financial goals.



VARDS

We also spent $8 million early in 2005 to buy VARDS, a leading variable annuity database firm. This was a pretty easy decision. We have had a good variable annuity database for many years, but it lacked several important attributes that VARDS had built—namely policy-level data (information about the overall variable annuity policy as opposed to information about its subaccounts) and cash flow data. By combining those databases, we now have the best variable annuity database in the industry. The VARDS integration went smoothly, and the acquisition has met our expectations.

Future Acquisitions

We hope there are more acquisitions in our future. Since we know how to create investment databases and software applications, most acquisitions for us are a build-or-buy decision. If we can get where we want to go faster via an acquisition, we'll consider it. I'd much rather put our cash to work by making an attractive acquisition than by earning lower returns in a bank account.

With any acquisition, **we look for a good cultural fit, strong products, and a fair price**. We are opportunistic about acquisitions. We don't *have* to do any. But if we can find candidates that are a good fit, it can be a sensible way to expand our business. Because our business generates significant cash flow, a key factor in our future returns will be how well we deploy this capital. Adding acquisition opportunities to internal expansion opportunities increases the number of investment possibilities for this cash flow. Some areas that we're interested in for possible acquisitions include international equity data, fixed-income data, and risk analytics.

Other Operational Matters

Legal Issues

Unfortunately, we face ongoing litigation. The former head of our Australian operations is suing us, and three government agencies have made inquiries about a small part of our investment consulting business. We resolved one government inquiry in early 2006 when the SEC informed us that it was dropping its investigation of Morningstar related to a data error on the Rock Canyon mutual fund. All of these matters are detailed in the notes to our financial statements. I've also posted a detailed letter about the government inquiries on our corporate Web site. I regret that we weren't able to resolve all of the above matters in 2005.

In two decades of operations, we've had extremely little litigation. Other than the above matters, the only other significant dispute we've had was a libel suit that was dismissed by the courts before trial in 1994. So it's unusual for us to have several legal matters ongoing.

China Office

During the past year, we've ramped up the development of our China office to handle more of our global data processing and application development. We now employ 145 people in our Shenzhen office. This allows us to manage our investment databases and create software applications more effectively. We can also expand our investment databases faster, improve their quality more quickly, and take on more software development projects. We have a talented workforce in China that interacts daily with our Chicago office and other offices around the world. We recruit from the top 20 universities in China and are pleased with the people we're attracting. I expect this office will continue to grow in size and importance to our operations in the coming years.

Office Space

We signed a 15-year lease late last year to be the anchor tenant in a new development in downtown Chicago. We're taking on more space (210,000 square feet versus our current 133,000) to accommodate our growth and our Ibbotson acquisition. With more space and higher rental rates, the new space will cost several million dollars more per year than we're currently paying. We'll build out the space to make it a stimulating place to work and reflect our strengths in financial information display and technology. We plan to move in March 2008.

Also, we expanded our London presence in early 2006. We now lease 8,700 square feet at our Oliver's Yard office versus about 1,900 square feet at our old Canon Street office. We took on more space to accommodate our European growth and house a data center that will serve our Web-based products and create additional real-time backup for our operations.

We aspire to have one standard for Morningstar offices around the world. Our space in Chicago, London, and Shenzhen, for example, is all "open plan" (without private offices) to improve communication and facilitate a collaborative working style. We also strive to have the same clean and uncluttered design in our space that you see in our products and company communications.

Morningstar's stock certificate includes an image of Walden Pond, a reference to Thoreau's *Walden*, which inspired our name.

Employee Stock Ownership

Restricted Stock Units

Starting in 2006, we will begin issuing restricted stock units for incentive compensation. A restricted stock unit is an agreement to issue shares of stock after the recipient satisfies a vesting period (in our case, four years). There are a number of advantages to restricted stock. First, we use a value-based approach to equity-based compensation, which means our goal is to deliver an equity-based award that has a specific value at the time of grant. In contrast to stock options, it's straightforward to measure the value of restricted stock.

Another benefit of restricted stock is that it retains value in all scenarios. If our share price should fall, there's still value in the restricted stock grant. With stock options, if the stock price is far below the exercise price, the options lose their incentive ability—and might even be demotivating for employees. That's why you see companies cancel underwater options and issue new ones at the current stock price (something we don't believe in and have never done).

Nearly everyone at Morningstar has an equity stake in our business—either through options or shares. This helps us to recruit and retain the best talent and provides strong incentives. Most importantly, it causes people to think like owners because they are owners.

Selling Shares

On a personal note, beginning later this year I plan to sell a small portion of my shares on a regular basis to diversify my assets. I've never sold a Morningstar share in the 22 years since I founded the company. So I have mixed emotions about this decision. I certainly don't want to signal any loss of confidence in the company. But, at the same time, I have more than 95% of my personal assets in Morningstar shares. As one of our directors points out, I'm one of a handful of people in the country to own more than 70% of a publicly held company with a market value over $1 billion. It's an extreme situation. So it's prudent to diversify—as we always tell investors.

My plan is to put in place a regular selling program (a so-called 10b5-1 plan) to sell 1% of my shares each quarter or about 4% per year. At that level of selling, if Morningstar stock appreciates in excess of 4% per year, the value of my holdings will still continue to grow. I'll review this plan each year to see if it still makes sense for me. My Morningstar investment will remain very significant and provide ample reason for me to keep my attention focused. But I want to give you advance notice of my intentions.

You probably will see other Morningstar managers sell shares on occasion. Because we've been a private firm for two decades, our employees have had few opportunities to sell stock. Consequently, many of them also have very high percentages of their net worth in our shares. So we may have some pent-up demand for diversification.

One benefit of some insider selling is that it should increase the liquidity of Morningstar shares. Our "float" (the percentage of shares that are freely traded in the market), is only about 20%. While we're not advocates of frequent trading, an increased float does make it easier to trade our stock when shareholders do wish to come or go. Additionally, during our IPO we had several large institutions tell us they would buy our shares only if they could build a meaningful position. More shares in the market help them do that.

People

You'll notice that we have a long-tenured group running the company. Our senior team works well together, and we enjoy what we do. That's a big advantage in moving quickly and staying focused on helping investors. We're choosy about hiring and strongly favor promoting from within. Not only do we get people at the top who really understand our clients, our products, and our culture, but we also build tremendous loyalty among the people who work here.

Our management style is to take good care of the people we have. We provide a stimulating, collegial office environment that supports our employees in their work. We provide superior benefits and educational support. We expect a lot from each person, but have a culture that sustains people instead of burning them out. We strive to create a company where our employees want to stay to build their careers. While it's hard to measure on our income statement, I believe our investment in people has been an important driver in our long-term success.

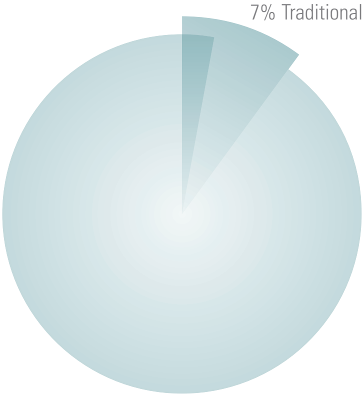
One of my top responsibilities is to ensure we have the right people in key roles at Morningstar. I've already mentioned the business unit heads who have significant operating responsibilities. A few other stars here that you should know about: Tao Huang, chief operating officer, ensures that we're running an efficient company and delivering on our product plans. Tao is integral to our operations and really involved in just about everything. Martha Dustin Boudos is our chief financial officer and heads up the finance side of our business. Don Phillips oversees our research group and spends much time speaking to investor groups. Tim Armour is a managing director who works with our sales team and large institutional clients. David Williams heads up design, a very important capability at Morningstar. John Rekenthaler spearheads our research efforts and new product development. Rich Robbins, general counsel, is the new kid on the block. We hired Rich shortly after going public, and now we wonder how we operated without him. This is an A+ group that has created much value for our company. We're extremely fortunate to have them here.

Auction IPOs

We went public last year using an auction-based method for our offering. Few companies have used this approach (the most well-known being Google). But there are numerous advantages to an auction IPO: fair and transparent pricing, lower cost, and equal access to shares for all participants. I'm happy to report that reality matched theory, and the offering came off well. In the process, we became enthusiastic supporters of the auction IPO method.

In a traditional offering, the underwriter controls the pricing decision. The underwriter, though, is in a conflicted position—balancing issuer needs with the demands of large institutional brokerage clients who are the main buyers of IPO shares. This balancing act leads to the first day "pop" in

We're enthusiastic supporters of the auction-based method for IPOs—partly because of the cost savings.



share price where key brokerage clients of the underwriting firm are rewarded by receiving allocations of slightly underpriced shares.

In an auction process, pricing is pretty simple. The underwriter constructs a demand curve by ranking all orders according to the price bid. The point where the number of buy orders matches the number of shares the company wants to sell is called the clearing price—what all successful bidders pay. Our pricing meeting took all of 10 minutes before we all headed off to dinner.

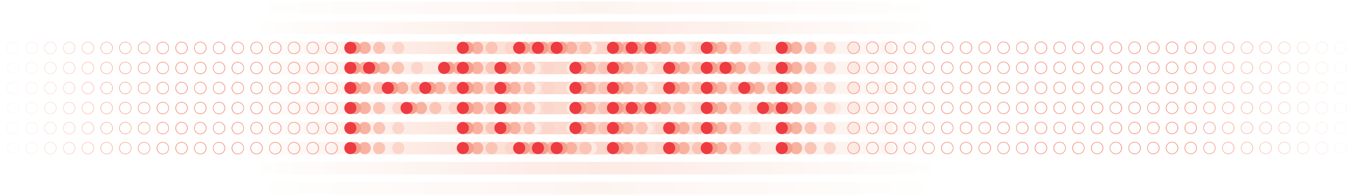
Costs are also lower. In a typical offering, the underwriter charges the issuer 7% of the offering. In our case, we paid 2%. **That's a $7 million savings on a $140 million offering.** Providing equal access to our shares to all participants was also important to us. In an auction IPO, there are no favored clients, and everyone gets an equal allocation based on the relationship between total demand and total shares offered.

WR Hambrecht + Co handled our offering and did a superior job for us. If you're thinking about going public with your firm, I'd urge you to consider an auction approach and give Bill Hambrecht a call. The world is moving in a direction that favors auctions—lower cost, transparency, and equal access. The more auctions that occur, the smoother the process will become and the more investors and issuers will benefit.

Operating as a Public Company

Before starting the IPO process, we thought hard about how we wanted to operate as a public company.

We strive to manage our company for the long term and communicate equally with all shareholders.



Above all, we wanted to preserve the qualities that made us successful as a private company. That means continuing to focus on doing the right things for investors at a product level, which in turn builds long-term value for our shareholders. We wanted to avoid the pitfalls of public company life, such as an obsession with short-term results and spending time catering to Wall Street. Setting the right expectations for shareholders is important, so we tried to communicate this non-traditional approach to potential shareholders in our "road show" presentations leading up to our public offering.

I think we're on the right track. Although it's been less than a year since Morningstar's IPO, I've enjoyed running a public company. On a daily basis, my life and work have changed little. I believe that's true of nearly everyone at Morningstar, with the exception of our CFO Martha Dustin Boudos, who now has two new significant tasks: external reporting and Sarbanes-Oxley compliance. She thanks me almost daily.

You've probably noticed we do some things that aren't the norm for public companies. We don't give earnings forecasts or guidance, and we don't hold conference calls or one-on-one meetings with investors or potential shareholders. Earnings guidance seems unnecessary because the market will simply adjust its company valuation once we report our actual results. At the same time, earnings guidance has the potential to create questionable incentives for running the business. We don't want to encourage our management team to simply "make the numbers" and possibly make decisions that don't help build shareholder value over the long haul.

With shareholder questions, it seems much more efficient for our management team to spend its time building the business rather than answering questions one-on-one. I'd rather answer a question once, put it in writing, and make the answer available to all shareholders at the same time. This approach also allows us to spend more time considering our response instead of giving an off-the-cuff answer that might not be as informative. We realize that there are potential investors out there who would like to be able to meet with our management team. But over the long term, what ultimately makes shareholders happy isn't spending time with management but seeing their shares increase in value. That's what we're focusing on.

We do, however, want to be candid in our communications with you and keep you fully informed about our business. If you have a question, we encourage you to ask it. Just send us an e-mail or a letter. We answer all questions after the market close on the first Friday of every month. We also encourage you to read our Management's Discussion and Analysis starting on page 37, which reviews our business in detail. Finally, you're welcome to attend our annual meeting on May 23 in Chicago and ask any questions in person. We'd enjoy seeing you there.

Sincerely,

Joe Mansueto, Chairman and Chief Executive Officer

Investors come first

We believe that Morningstar's strength comes largely from the faith that investors place in us. Our independence, integrity, and advocacy for investors' interests are the foundation of our company. We strive to help investors achieve better results.

Great products

We believe that Morningstar's products must exceed our customers' expectations and raise the standard over other existing products. To do this, our products must be not only innovative, but also reliable and of the highest quality. They must be marked by exemplary content, design, and usability.

Entrepreneurial spirit

We believe that companies should grow, but never grow old. The entrepreneurial spirit inspires independent thought, agile decision-making, and an acceptance of creative and unconventional solutions to business challenges.

Uncompromising ethics

We require our employees to adhere to high ethical standards, regardless of the impact on our business. We believe that high ethical standards should be pursued for their own sake, and we expect every Morningstar employee to treat our customers and their fellow employees as we would wish to be treated ourselves.

Great people

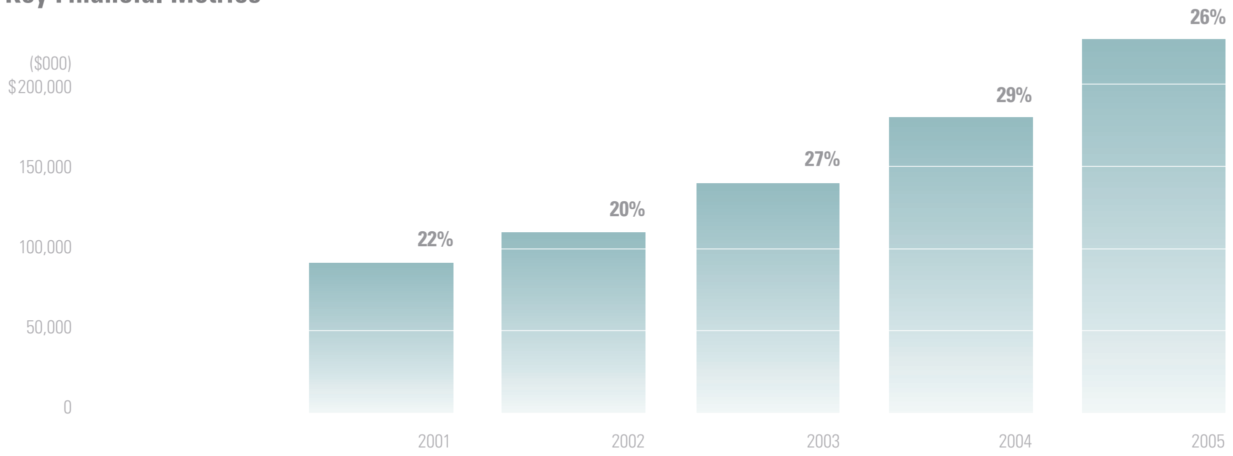
We believe that every person who works at Morningstar contributes to our success. We want to attract talented, hard-working, enthusiastic people, so we create an environment that encourages employees to learn throughout their careers, allows them to advance based on merit, and rewards them for helping Morningstar thrive.

Financial success

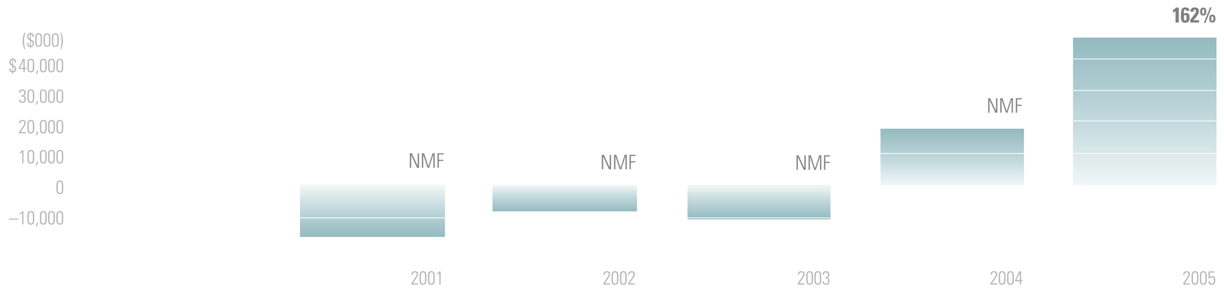
We believe that great products create value for our customers. This creates demand for our products and, in turn, generates financial success. Financial success strengthens our company and helps us continue to raise our standards and set more challenging goals.

Business Highlights

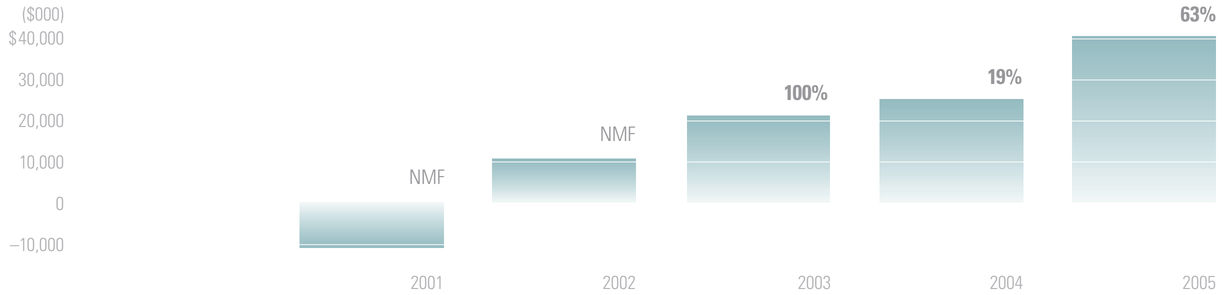
Key Financial Metrics



	2001	2002	2003	2004	2005
Revenue ($000)	**$ 91,230**	**109,619**	**139,496**	**179,658**	**227,114**
Revenue Growth	22%	20%	27%	29%	26%



	2001	2002	2003	2004	2005
Operating Income (Loss) ($000)	**$ (16,391)**	**(8,340)**	**(10,754)**	**17,735**	**46,480**
Operating Income Growth	NMF	NMF	NMF	NMF	162%



	2001	2002	2003	2004	2005
Free Cash Flow ($000)	**$ (11,115)**	**10,553**	**21,098**	**25,132**	**40,994**
Free Cash Flow Growth	NMF	NMF	100%	19%	63%

(NMF) not meaningful

Selected Financial Data

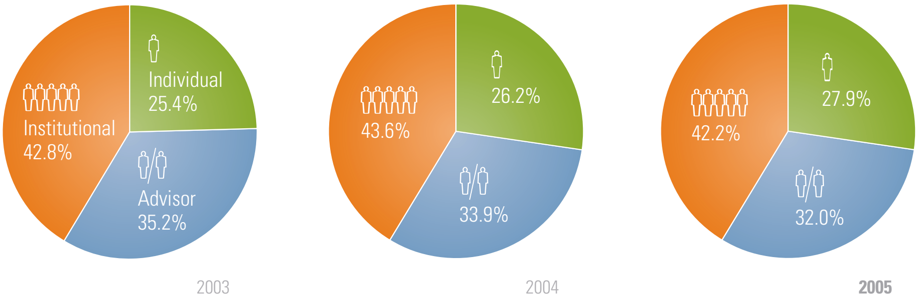
	2001	2002	2003	2004	2005
Consolidated Statements of Operations Data ($000 except per share amounts)					
Revenue	$ 91,230	$ 109,619	$ 139,496	$ 179,658	**$ 227,114**
Operating expense	107,621	117,959	150,250	161,923	**180,634**
Operating income (loss)	(16,391)	(8,340)	(10,754)	17,735	**46,480**
Non-operating income, net	676	4,463	1,110	1,805	**3,199**
Income (loss) before income taxes, equity in net income of unconsolidated entities, minority interest in net loss of consolidated entities, and extraordinary gain	(15,715)	(3,877)	(9,644)	19,540	**49,679**
Income (loss) before extraordinary gain	(9,295)	(2,638)	(11,897)	8,809	**31,117**
Extraordinary gain—acquisition	—	3,084	—	—	**—**
Net income (loss)	$ (9,295)	$ 446	$ (11,897)	$ 8,809	**$ 31,117**
Diluted income (loss) per share:					
Income (loss) before extraordinary gain	$ (0.32)	$ (0.17)	$ (0.31)	$ 0.21	**$ 0.70**
Extraordinary gain—acquisition	—	0.08	—	—	**—**
Diluted income (loss) per share	$ (0.32)	$ (0.09)	$ (0.31)	$ 0.21	**$ 0.70**
Weighted average common shares outstanding—diluted	41,364	40,361	38,382	41,858	**44,459**
Other Consolidated Financial Data ($000)					
Total stock-based compensation expense	$ 5,667	$ 7,292	$ 29,029	$ 16,723	**$ 10,895**
Operating income (loss) before stock-based compensation expense[1]	(10,724)	(1,048)	18,275	34,458	**57,375**
Cash provided by (used for) investing activities	$ 2,777	$ (6,068)	$ (29,634)	$ (22,750)	**$ (16,913)**
Cash provided by (used for) financing activities	(1,049)	(1,952)	(26)	(6,367)	**25,256**
Cash provided by (used for) operating activities	$ (5,183)	$ 16,542	$ 29,705	$ 32,862	**$ 48,445**
Capital expenditures	(5,932)	(5,989)	(8,607)	(7,730)	**(7,451)**
Free cash flow[2]	$ (11,115)	$ 10,553	$ 21,098	$ 25,132	**$ 40,994**
Consolidated Balance Sheet Data ($000 as of December 31)					
Cash, cash equivalents, and investments	$ 47,650	$ 64,796	$ 76,158	$ 95,463	**$ 153,190**
Working capital (deficit)	1,165	10,005	(5,206)	16,902	**90,374**
Total assets	128,735	152,781	180,265	213,361	**296,311**
Long-term liabilities	26,315	21,243	25,486	30,128	**6,756**
Total shareholders' equity	35,970	48,132	44,821	64,381	**173,714**

(1) Operating income (loss) before stock-based compensation expense is a measure that is not calculated in accordance with U.S. generally accepted accounting principles (U.S. GAAP). The table below reconciles operating income (loss) to operating income (loss) before stock-based compensation expense:

($000)	2001	2002	2003	2004	2005
Operating income (loss)	$ (16,391)	$ (8,340)	$ (10,754)	$ 17,735	$ 46,480
Add back: Stock-based compensation expense	5,667	7,292	29,029	16,723	10,895
Operating income (loss) before stock-based compensation expense	$ (10,724)	$ (1,048)	$ 18,275	$ 34,458	$ 57,375

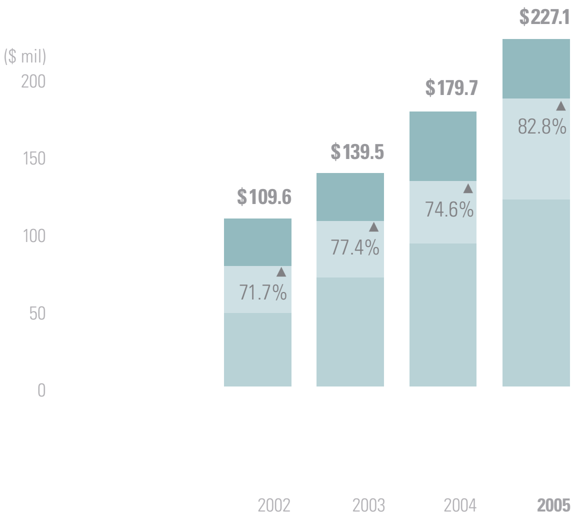
(2) We define free cash flow as cash provided by (used for) operating activities less capital expenditures. We present free cash flow solely as supplemental disclosure to help investors better understand how much cash is available after we spend money to operate our business. Our management team uses 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. 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 reported by other companies.

Revenue Composition and Free Cash Flow



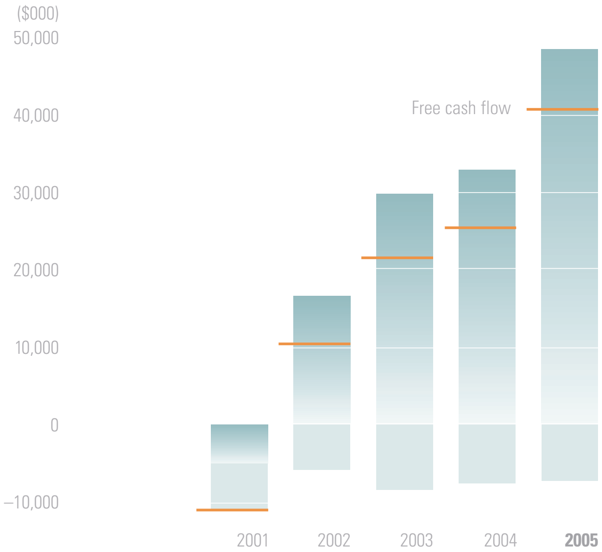
Revenue by Business Segment ($000)	2003	2004	**2005**
Individual	$ 35,406	$ 46,996	**$ 63,448**
Advisor	49,161	60,880	**72,689**
Institutional	59,745	78,402	**95,947**

Percentages total to more than 100% because of intersegment revenue.



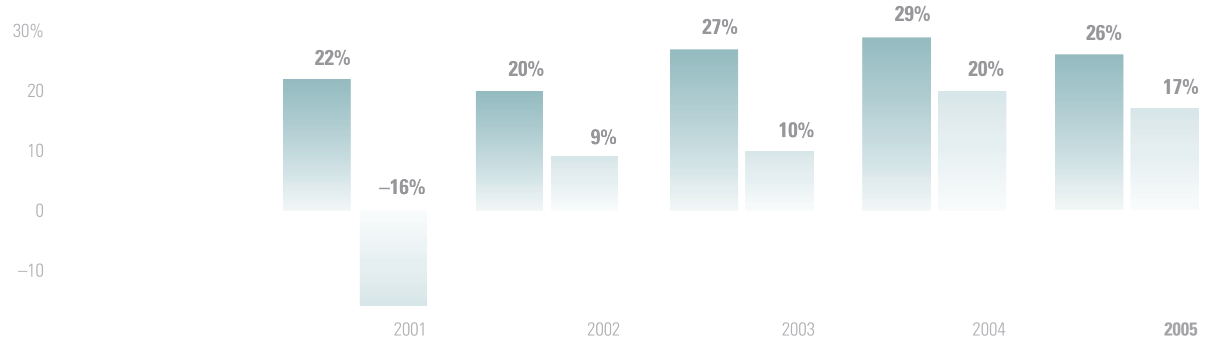
Revenue Composition ($ mil)	2002	2003	2004	**2005**
New revenue	$ 31.0	$ 31.5	$ 45.6	**$ 39.0**
Renewal revenue	30.7	36.9	40.8	**65.9**
Walk-in revenue [1]	47.9	71.1	93.3	**122.2**

(1) Net of cancellations, currency translations, and other routine adjustments. For complete definitons of new, renewal, and walk-in revenue, please refer to Recurring Revenue on page 38 of the Management's Discussion and Analysis section.



Free Cash Flow Details ($000)	2001	2002	2003	2004	**2005**
Cash provided by (used for) operating activities	$ (5,183)	$16,542	$29,705	$32,862	**$48,445**
Capital expenditures	(5,932)	(5,989)	(8,607)	(7,730)	**(7,451)**
Free cash flow	$(11,115)	$10,553	$21,098	$25,132	**$40,994**

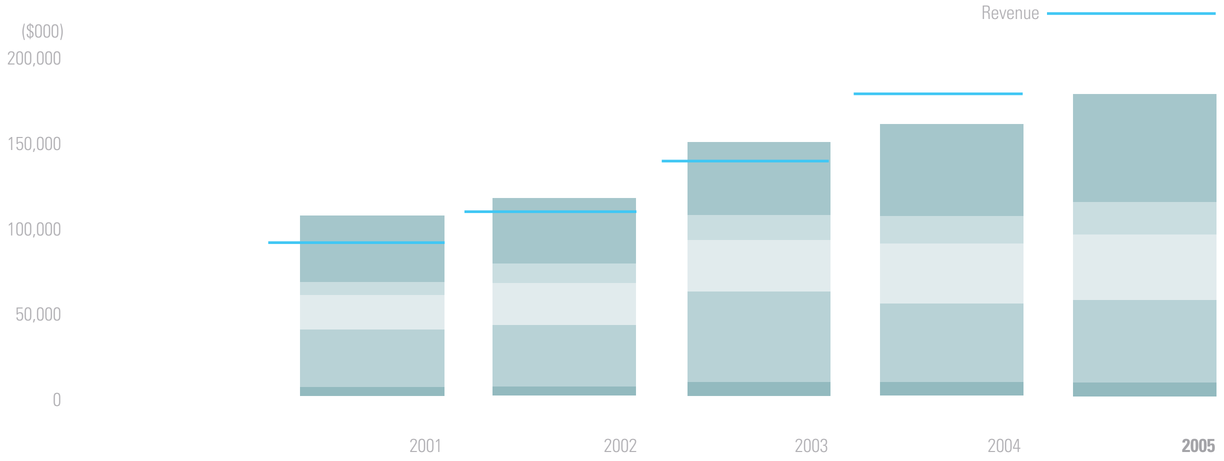
Revenue and Operating Expense



Revenue Growth vs. Expense Growth

	2001	2002	2003	2004	**2005**
Revenue	$ 91,230	$ 109,619	$ 139,496	$ 179,658	**$ 227,114**
Revenue growth	22%	20%	27%	29%	**26%**
Operating expense	$ 107,621	$ 117,959	$ 150,250	$ 161,923	**$ 180,634**
Stock-based compensation expense	5,667	7,292	29,029	16,723	**10,895**
Operating expense before stock-based comp.[1]	$ 101,954	$ 110,667	$ 121,221	$ 145,200	**$ 169,739**
Operating expense growth before stock-based compensation	–16%	9%	10%	20%	**17%**

(1) Operating expense before stock-based compensation is a measure that is not calculated in accordance with U.S. GAAP.



Operating Expense as a % of Revenue

	2001	2002	2003	2004	**2005**
Cost of goods sold	43.3%	35.6%	31.2%	30.5%	**28.4%**
Development	8.4%	10.8%	10.5%	9.0%	**8.7%**
Sales and marketing	22.6%	22.8%	22.1%	20.1%	**17.2%**
General and administrative	37.5%	33.3%	38.8%	26.0%	**21.7%**
Depreciation and amortization	6.1%	5.1%	5.1%	4.6%	**3.6%**
Total operating expense[1]	118.0%	107.6%	107.7%	90.1%	**79.5%**

(1) Sum of percentages may not match total because of rounding.

Key Initiatives in 2005 and Business Model (Leverage Diagram)

Fixed Investments:

Databases

- Added 1,400 funds to hedge fund database
- Expanded variable annuity coverage by completing VARDs acquisition
- Created pension and life database in the United Kingdom
- Introduced new F class database in Canada to provide information on these lower-fee funds
- Completed comprehensive data quality audit and began implementing Six Sigma tools

Core Skills

- Announced agreement to acquire Ibbotson Associates, expanding our asset allocation research and services
- Created new Morningstar Rating for load-waived A shares
- Expanded analyst coverage on individual stocks to 1,700 from 1,500
- Launched Stewardship Grade for Stocks on Morningstar.com
- Introduced new discounted cash-flow model for valuing real estate investment trusts
- Expanded analyst coverage on exchange-traded funds to 100 from about 35
- Continued to invest in China offshore center for database and development work

Leveraged by:

Media

- Launched next generation of Morningstar Direct, which includes global databases and hedge fund data
- Introduced new Principia module for defined contribution plans
- Introduced new series of Advisor Compliance Tools
- Launched three new newsletters for individual investors

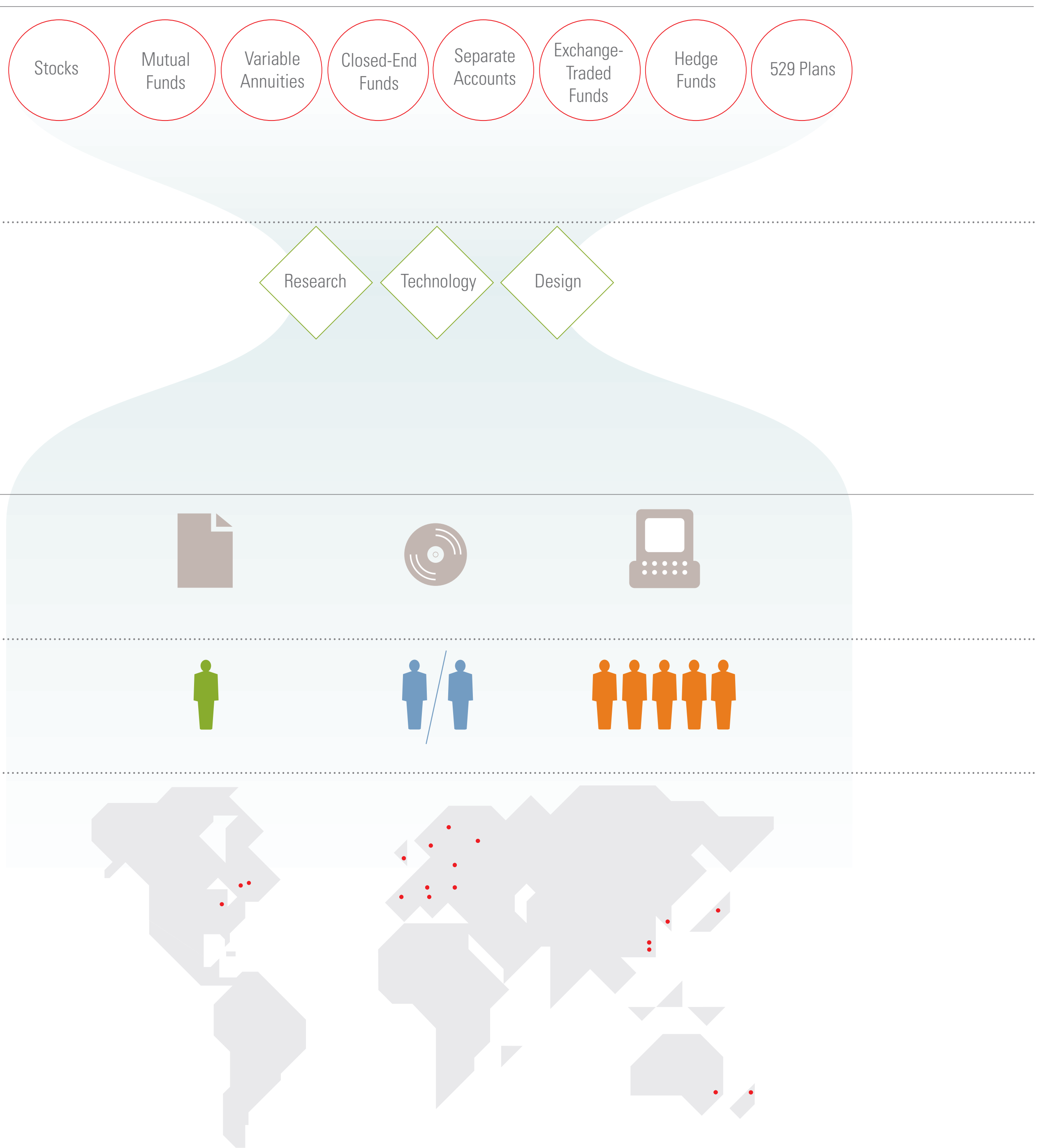
Audience

- Expanded audience to reach more than:
  4.9 million individual investors
  185,000 financial advisors
  750 institutions

Geography

- Began providing services to investors in Belgium, Luxembourg, Switzerland, and Taiwan
- Expanded licensing of our Morningstar Direct institutional research platform to reach numerous international clients
- Expanded investment consulting business with new agreements in France, Italy, and China
- Expanded equity research to provide services to clients outside the United States
- Introduced new China Index Series tracking stock market in China

Business Model (opposite): We leverage our eight core investment databases by selling a wide variety of products via multiple media to three key investor segments around the world.


Stocks
Mutual Funds
Variable Annuities
Closed-End Funds
Separate Accounts
Exchange-Traded Funds
Hedge Funds
529 Plans
Research
Technology
Design

Major Products and Services*

Major Products and Services*	Segment	Format	Markets	Databases
Morningstar.com Destination site for independent analysis and timely data				S, MF, CE, ETF, 529
Morningstar Equity Research Independent research and ratings on more than 1,700 stocks				S
Morningstar FundInvestor Monthly fund-selection newsletter				MF, ETF
Morningstar Mutual Funds Reference guide with one-page reports on 1,500 funds				MF
Morningstar StockInvestor Monthly newsletter with stock portfolios and watchlists				S
Morningstar Advisor Workstation Web-based investment planning system for advisors				S, MF, VA, CE, SA, ETF, 529
Morningstar Principia Research and planning software for advisors				S, MF, VA, CE, SA
Morningstar Managed Portfolios Fee-based discretionary asset management service				MF, ETF
Morningstar Direct Web-based institutional research platform				S, MF, VA, CE, SA, ETF, HF, 529
Morningstar Retirement Manager Advice and management services for retirement plan participants				S, MF, VA, SA
Investment Consulting Customized consulting and advisory solutions				MF, VA, CE, SA
Licensed Data Data feeds including access to proprietary data and stats				S, MF, VA, CE, SA, ETF, 529
Licensed Tools and Content Online tools and editorial for use in Web sites and software				S, MF, VA, CE, SA, ETF, 529
Investment Profiles & Guides Publications for institutional investor communications				S, MF, VA, CE, SA, ETF, 529
Morningstar Indexes Series of indexes based on market capitalization and style				S, MF, ETF

*As of December 31, 2005. One of our five largest products based on revenue in 2005. One of our four major Internet platforms.

Management's Discussion and Analysis of Financial Condition and Results of Operations

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Understanding Our Company

The discussion included in this section, as well as other sections of this document, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. 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 Item 1A—Risk Factors of our Annual Report on Form 10-K. 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 document or our Annual Report on Form 10-K 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.

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 to 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.

We manage Morningstar to maximize our long-term results, while staying focused on our mission of helping investors and adhering to our company values. We invest significantly in new product development and in enhancements to our current offerings. It typically takes many years to recoup these investments, but we believe they are critical to building long-term value for our shareholders.

We emphasize a decentralized approach to running our business to empower our managers and to create a culture of responsibility and accountability. Our decentralized business structure includes three global business segments: Individual, Advisor, and Institutional. Early in our history, our product lineup emphasized products for individual investors. As a result, the Individual segment contributed a majority of our revenue. In the early 1990s, our Advisor segment became a more important part of our business. More recently, we've begun serving more investors through our Institutional segment, which was the largest of our three segments in terms of revenue in 2005, 2004, and 2003. In all three of these segments, we believe our work helps individual investors make better investment decisions.

In March 2006, we acquired Ibbotson Associates, a privately held firm that specializes in asset allocation research and services, for approximately $83 million in cash, subject to adjustments for working capital and other items. This acquisition fits several of our growth strategies and broadens our reach in the areas of investment consulting, managed retirement accounts, and institutional and advisor software.

Key Business Characteristics

We believe our business has the following characteristics:

Recurring Revenue

We have historically generated recurring revenue because many of our products are sold through subscriptions or license agreements. These subscriptions and licenses generally come up for renewal after one- to three-year terms. Many of the license agreements in our Advisor and Institutional segments span multiple years. Because of this recurring revenue, we generally have subscriptions and license agreements in place for a meaningful percentage of our total annual revenue at the beginning of each year. We think of this as our "walk-in" revenue.

We separate our annual revenue into three categories, defined as follows:

▹ *New revenue.*
We define new revenue as revenue from selling additional products to current customers or from selling to new customers;

▹ *Renewal revenue.*
We define renewal revenue as revenue from renewals of subscriptions or licenses; and

▹ *"Walk-in" revenue.*
We define "walk-in" revenue 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. For example, as of January 1, 2005, we had agreements in place that were expected to generate $124.9 million of revenue in 2005. During 2005, cancellations and other routine adjustments subsequently reduced this revenue by approximately 2%. 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 sequential quarter's revenue.

In addition to looking at the mix of walk-in, renewal, and new revenue for each period, we calculate a retention rate to evaluate how successful we've been in maintaining existing business for products and services that have renewable revenue. We use two different methods for calculating retention. For subscription-based products (including our print newsletters, Morningstar.com Premium Membership service, and Principia), we track the number of subscriptions retained during the year. For products sold through contracts and licenses, we use the contract value method, which is based on tracking the dollar value of renewals compared with the total dollar value of contracts up for renewal during the period. We include changes in the contract value in the renewal amount, unless the change specifically results from adding a new product that we can identify. The retention rate excludes setup and customization fees, migrations to other Morningstar products, and contract renewals that were still pending as of January 31, 2006.

Significant Operating Leverage

Our business requires significant investments to create and maintain proprietary databases and content. We strive to leverage these costs by selling a wide variety of products and services to multiple investor segments, through multiple media, and in many geographic markets. 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. Historically, we have made investments in building our databases and content that have adversely affected our short-term operating results for certain periods. In the past several years, our profitability has improved because we've been able to increase revenue without increasing our cost base at the same rate. We look for this operating leverage to be evident in our operations over the long term.

Deferred Revenue

We frequently collect cash in advance of providing services or fulfilling subscriptions for our customers. As a result, we can use some of this cash to fund our operations and invest in new product development. Although we may need to issue refunds for the unused portion of the subscription if a customer cancels, we generally have used cash collected in advance of providing services or fulfilling subscriptions to fund many of our other activities. The deferred revenue shown on our balance sheet totaled $71.2 million and $63.4 million as of December 31, 2005 and 2004, respectively.

How We Evaluate Our Business

When our analysts evaluate a stock, they focus on assessing the company's estimated intrinsic value—the value of the company's future cash flows, discounted to their worth in today's dollars. Our approach to evaluating our own business works the same way. Our goal is to increase the intrinsic value of our business over time, which we believe is the best way to create value for our shareholders.

We do not make public financial forecasts for our business because they are, by their nature, subjective and could have an effect on our company's stock price. We want to avoid creating any incentive within our company to alter behavior to "make the numbers."

We provide three specific measures that can help investors generate their own assessment of how our intrinsic value has changed over time:

- *Revenue;*
- *Operating income (loss); and*
- *Free cash flow.*

We define free cash flow as cash provided by operating activities less capital expenditures. We present free cash flow solely as supplemental disclosure to help investors 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 (U.S. 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 reported by other companies.

How Our Business Works

Revenue

We earn revenue by selling a variety of investment-related products and services. Many of our offerings, such as our newsletters, Principia software, and Premium service on Morningstar.com, are sold via subscriptions. These subscriptions are mainly offered for a one-year term, although we also offer terms over other periods ranging from one month to three years. We also sell advertising on our Web sites in the United States and internationally. Several of our other products are sold through license agreements, including Morningstar Advisor Workstation, Morningstar Equity Research, Morningstar Direct, Morningstar Retirement Manager, and Licensed Data. Our license agreements typically range from one to three years. For some of our other institutional services, mainly Investment Consulting, our fees are generally based on the scope of work and the level of service we provide. Finally, we collect fees relating to Morningstar Managed Portfolios, managed retirement account services, and Investment Consulting that are calculated as a percentage of total assets under management.

Operating Expense

We classify our expenses into separate categories for cost of goods sold, development, sales and marketing, general and administrative, and depreciation and amortization, as described below. We include stock-based compensation expense, as appropriate, in each of these categories.

- *Cost of goods sold.*

This category includes the compensation expense for employees who produce the products we deliver to our customers. For example, this category covers the cost of production teams and analysts who write investment research reports. Cost of goods sold also includes other expenses such as postage, printing, and CD-ROM replication, as well as shareholder servicing fees for Morningstar Managed Portfolios.

- *Development.*

This category mainly includes compensation expense for programmers, designers, and other employees who develop new products and make enhancements to existing products. In some cases, we capitalize the compensation costs associated with certain development projects. This reduces the expense that we would otherwise report in this category. We amortize these capitalized costs over the estimated economic life of the software, which is generally three years.

- *Sales and marketing.*

This category includes compensation expense for our sales teams, product managers, and other marketing professionals. We also include the cost of advertising, direct mail campaigns, and other marketing programs to promote our products.

▹ *General and administrative.*
This category consists mainly of compensation expense for each segment's management team, as well as human resources, finance, and support employees for each segment. The category also includes compensation expense for senior management and corporate expenses, including corporate systems, accounting, legal, and facilities expense.

▹ *Depreciation and amortization.*
Our capital expenditures consist mainly of computers, leasehold improvements, and capitalized product development costs related to certain software development projects. We recognize depreciation and amortization costs for these items over their estimated useful lives, generally ranging from three to seven years. We also include amortization related to intangible assets in this category.

International Operations
We consolidate the results of our majority-owned international operations. We account for our investments in Japan, Korea, Denmark, and Sweden using the equity method.

Industry Overview

We monitor developments in the economic and financial information industry on an ongoing basis and use these insights to help inform our company strategy, product development plans, and marketing initiatives.

Investment Landscape and Database Areas
Performance in the U.S. equity markets fell behind the double-digit gains shown in 2003 and 2004, but stocks continued to generate positive returns in 2005. Morningstar's U.S. Market Index, a broad equity market benchmark, posted total returns of 6.5% for the year. With the investment climate generally favorable and all domestic equity-fund categories posting positive total returns for the year, mutual funds based in the United States enjoyed positive cash flows for the year, although cash flows into equity and hybrid funds were lower than in 2004. Net cash flows into taxable bond, municipal bond, and money market funds all increased over 2004 levels. Although the number of mutual funds declined slightly during 2005, total fund assets increased by about 9.4% to $8.9 trillion as of year-end. The Investment Company Institute estimates that approximately 53.7 million households in the United States, or 47.5% of all households, own mutual funds, which is down slightly from the peak level in 2001. We believe that continued asset growth and widespread usage of mutual funds is significant because a large portion of Morningstar's business has historically focused on this area. We estimate that information and analysis related to mutual funds account for approximately two thirds of our total revenue, although this amount has been declining as we expand into equity research and other areas.

We continued to see debate about pricing models for securities research during 2005, which we think is significant because it has long-term implications for all independent equity research providers. During 2005, Fidelity announced a pilot program to unbundle its research and trade execution costs with Lehman Brothers and will pay for them separately going forward. Fidelity also announced an agreement with Deutsche Bank Securities to pay separately for its proprietary research instead of including it in trading costs. This follows a similar move by MFS Investment Management, which discontinued its use of soft dollar research payments in 2004. During 2005, the SEC issued more specific guidance on soft dollar research payments. We believe these developments will help enhance pricing transparency for mutual fund shareholders and others, as well as encouraging debate about the value of independent research.

We continued to see strong interest in alternative asset classes during 2005. Hedge funds, in particular, continued to enjoy strong growth. Based on the latest Hedge Fund Manager/Advent survey of hedge fund administrators, total hedge fund assets worldwide increased to $2.2 trillion as of November 2005, a 49% increase from $1.5 trillion in November 2004. Single-managed hedge funds now claim $1.4 trillion in total assets, while assets in hedge funds of funds total about $700 billion. The number of hedge funds and funds of funds continued to balloon, with more than 15,000 funds in existence as of November 2005, compared with about 12,000 as of November 2004. We continue to invest in developing our hedge fund database and plan to continue expanding our efforts in this area to meet investors' need for information on this asset class.

Asset growth in separately managed accounts was also relatively strong in 2005. Based on data from the Money Management Institute, assets in separate accounts increased by about 21% to reach $646 billion as of September 30, 2005. The average account balance and number of separate accounts have also continued to expand. Until now, however, separate account performance and operations information has largely only been available from advisors or investment consultants. To help enhance investor understanding of separately managed accounts, we recently partnered with *Barron's* to create a new Separate Accounts Quarterly Review. The new section, which will appear in *Barron's* print and online editions on a regular basis, will include articles about the separate account industry accompanied by a series of data tables. We are providing several statistics such as total returns, fee information, and Morningstar Ratings for our entire database, which includes approximately 5,000 separate account strategies (including retail and institutional accounts) from about 1,000 money managers.

Assets in exchange-traded funds increased 30.8% to reach about $296 billion as of December 2005, compared with $226 billion as of December 2004, based on data from the Investment Company Institute. Exchange-traded funds continued to gain 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 increased our analyst coverage in this area and recently introduced the *Morningstar ETFs 100*, an annual softcover reference guide. In March 2006, we introduced a new rating system for exchange-traded funds.

Individual Investor Market

With market conditions generally positive, the environment for advertising sales has been relatively healthy. A recent report from Credit Suisse First Boston increased previous estimates for online advertising in the fourth quarter of 2005, as well as projected spending for 2006. Based on a survey of online advertisers, the report forecasts total spending on online advertising to reach $16.6 billion in 2006, compared with a previous estimate of $14.9 billion, reflecting a shift from traditional print, radio, and television placements to online. Because of favorable conditions for Internet advertising, we plan to increase our prices for online advertising in 2006.

Based on research from Nielsen NetRatings, Yahoo! Finance maintained a dominant share of total page views and user visits compared with other retail investment Web sites in 2005. Page views to Morningstar.com remained lower than those of supersites such as Yahoo! Finance, AOL Money & Finance, and MSN Money during 2005, but average monthly page views were about 30% higher in the second half of the year relative to the first half.

We continue to define Morningstar.com as a targeted site that appeals to experienced and engaged investors. Although total page views to our site are lower than those of larger supersites, the average number of pages per visit and length of time per visit is significantly higher. We believe this indicates that investors view our site as a place that is worth spending time with and that they find value in the information we provide. We also appeal to a highly qualified audience based on income levels and investable assets.

Financial Advisor Market

The aging of the American population and the corresponding need for more information and advice on retirement income planning has been an important trend in the advisor segment. Morningstar has been actively developing retirement income software to meet this emerging need, and we expect to launch these applications during 2006. Ibbotson Associates, which we acquired in March 2006, also offers several research tools and applications to help meet the growing need for information on retirement income management.

Many advisors have also sought to streamline and simplify their operations; to meet this need, some advisors have been outsourcing investment management so they can spend more time on planning-related issues and client management. We've also seen a continuing consolidation trend among broker-dealers and other firms in the advisor segment. We believe that this ongoing acquisition trend is being driven by the desire to offer comprehensive financial solutions and maximize cost efficiencies. Some studies suggest that smaller advisory firms are continuing to struggle amid higher costs and lower revenue growth. Independent financial advisors have continued to gain market share among high-net-worth investors, but larger institutions are benefiting from their lower cost structures and economies of scale. As the financial advisory landscape continues to evolve, we believe advisors will continue to demand comprehensive research platforms and integrated portfolio tools.

Institutional Market

Insurance companies and mutual fund companies continued to struggle to find unique ways to attract and serve the needs of aging baby boomers during 2005. We believe many companies are focusing resources on this growing trend, including creating tailored investment products and developing planning tools tailored to meet the needs of this market segment. The increased need for retirement income planning has also been an area of focus for brokers, investment advisors, and insurance companies.

The trend toward packaged/wrapped investment products, including mutual fund wrap programs, lifestyle funds, target maturity funds, and managed accounts, is another key trend in the institutional segment. Many of these programs match investors to an asset allocation and investment portfolio that automatically rebalances over time. These products simplify the investment process and help investors outsource the investment decision-making process.

A report published in July 2005 by Financial Research Corporation noted that the variable annuity industry has continued to increase its usage of funds of funds to address regulatory concerns that asset allocation programs offered through variable annuities constitute investment advice and therefore need to be offered by a registered investment advisor.

In the retirement market, the House and Senate passed two key pension reform bills, HR 2830 and S 1783, toward the end of 2005. While both bills primarily address pension issues, they also contain provisions related to defined contribution plans. Among other things, the House bill would allow large retirement plan administrators to offer their own investment advice to plan participants, including possible recommendations of proprietary funds being offered on their platforms. The Senate bill includes a provision granting employers and other retirement plan fiduciaries a safe harbor from liability arising from providing independent, third-party investment advice to plan participants. The two bills also include measures that would encourage companies to automatically enroll employees in 401(k) plans. We expect lawmakers to meet in 2006 to address the differences between the two bills.

International Markets

Overall, mutual funds outside of the United States continued to grow at a moderate pace during the year, with total worldwide fund assets increasing about 19.4% over the prior-year period to $17.3 trillion as of September 30, 2005 based on data from the Investment Company Institute. We continued to see a trend toward structured investment products, such as funds of funds and other packaged products, in major asset management markets worldwide during 2005.

Europe remained the largest fund market outside of the United States, with nearly $6 trillion in assets as of September 30, 2005. Mutual funds based in Luxembourg, which has emerged as a center of funds management in Europe, continued to enjoy strong net sales in 2005, as did funds in France, the second-largest fund market in Europe. Prominent U.S.-based asset managers such as Fidelity and Franklin Templeton continued to gain market share in Europe versus local-market asset managers. In the United Kingdom, the Pensions Act of 2004 is slated to go into effect in April 2006 and represents a far-reaching reform of tax laws that govern pension contributions and benefits. We expect that this law will increase employee contributions into private pension funds. Also in the United Kingdom, regulators continue to demand more transparency from funds.

In Asia, funds based in Japan had strong net sales in each of the first three quarters, although performance in other Asian markets was mixed. Wrap account assets in Japan have also continued to increase following the government's decision in 2004 to allow securities firms to offer them to high-end investors.

Funds based in Canada continued to enjoy strong net cash flows through September 2005. Fund companies in Canada have also been making a transition to new regulations introduced in 2005 that increased disclosure requirements for mutual funds, including publishing the top 25 holdings every quarter, including a narrative management report on fund performance, publishing a trading expense ratio in the annual report, and issuing disclosure documents within a shorter time after the end of the reporting period. We've also continued to see continued growth in funds of funds in Canada as financial advisors have been turning to these products to simplify their roles to focus more on client management.

Performance Summary

The list below summarizes the key accomplishments and disappointments that our management team has highlighted related to our 2005 performance:

Key Accomplishments

▹ We successfully completed our auction-based initial public offering in May 2005.

▹ We announced an agreement to acquire Ibbotson Associates, a Chicago-based firm that specializes in asset allocation research and services. We believe Ibbotson complements our growth strategies in several key areas, including investment consulting, managed retirement accounts, and institutional and advisor software. It also complements our international growth strategy. Ibbotson had $37.2 million in revenue for its fiscal year ending June 30, 2005. We completed the acquisition on March 1, 2006.

▹ We retained all five contracts for independent equity research associated with the Global Analyst Research Settlement for the second year of the five-year period covered under the settlement, and we entered into an agreement with a sixth investment bank to provide equity research. We now provide analyst coverage on more than 1,700 stocks.

▹ We launched the next generation of Morningstar Direct, expanding the range of data universes to allow institutions to conduct research across global markets and adding the full range of Morningstar's available data on stocks, hedge funds, and Section 529 College Savings Plans.

▹ We expanded our variable annuity data and strengthened our investment database with the January 2005 acquisition of Variable Annuity Research and Data Service (VARDS).

▹ We began to build our investment consulting business outside the United States and entered into our first consulting agreements in France, Italy, and China.

▹ We continued to invest in our development center in China and now employ approximately 130 programmers and data analysts there.

Disappointments

▹ Even though we think online investment advice for retirement plan participants is a valuable service, it is less popular than we—and the industry—expected. As a result, revenue for the online advice service we offer through the Morningstar Retirement Manager platform has declined slightly. The most exciting part of this business is our managed retirement account service, which is growing, but from a small base. We expect our acquisition of Ibbotson Associates to provide greater opportunities in this market.

▹ All of our international operations experienced growth, but at a slower rate than we expected. To increase our international growth rate, we're focusing more development and sales resources on global products, including Morningstar Direct, Advisor Workstation, and Investment Consulting, and adding more securities analysts overseas to further build our brand.

▹ While we announced in February 2006 that the Securities and Exchange Commission has decided not to proceed against Morningstar in its investigation related to incorrect total return data for the Rock Canyon Top Flight Fund, investigations into our Morningstar Associates subsidiary by the New York Attorney General's office, the Securities and Exchange Commission, and the Department of Labor have not been resolved.

2005 vs. 2004

Consolidated Results

($000)	2005	2004	Change
Revenue	**$ 227,114**	$ 179,658	26.4%
Operating income (loss)	**46,480**	17,735	162.1%
Operating margin (%)	**20.5%**	9.9%	10.6pp
Stock-based compensation expense	**10,895**	16,723	(34.9)%
Cash used for investing activities	**(16,913)**	(22,750)	(25.7)%
Cash provided by (used for) financing activities	**25,256**	(6,367)	NMF
Cash provided by operating activities	**$ 48,445**	$ 32,862	47.4%
Capital expenditures	**(7,451)**	(7,730)	(3.6)%
Free cash flow	**$ 40,994**	$ 25,132	63.1%

(NMF) not meaningful; (pp) percentage point(s)

We define free cash flow as cash provided by operating activities less capital expenditures. We present free cash flow solely as supplemental disclosure to help investors 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. 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 reported by other companies.

Consolidated Revenue

In 2005, our consolidated revenue increased by 26.4% over 2004. We finished the year with $227.1 million in consolidated revenue. Consistent with the patterns we've reported in the past, we generated almost all of our revenue increases through organic growth in 2005. Our growth was also diversified by segment in 2005, with all three segments generating significant revenue growth for the year. We acquired VARDS from Finetre Corporation for $8.2 million in cash in January 2005. This acquisition contributed revenue of $2.4 million in 2005.

While all three segments contributed to our growth in 2005, the Institutional segment, which accounted for 42.2% (before intersegment eliminations) of our consolidated revenue, was the largest contributor to revenue growth, with segment revenue increasing $17.5 million, or 22.4%, for the year. Individual segment revenue increased by about $16.4 million, or 35.0%, over the previous year, which was mainly driven by newly generated business associated with the Global Analyst Research Settlement. We began recognizing revenue for our equity research related to the settlement in July 2004, which led to a favorable year-over-year comparison in 2005. The Advisor segment, which accounts for almost a third of total revenue, had revenue growth of $11.8 million, or 19.4%, for the year.

On a product level, revenue from Morningstar Advisor Workstation was the largest driver of the revenue increase in 2005. Growth in this product was mainly driven by the Enterprise Edition, which we offer to financial advisors affiliated with larger firms, but the Office Edition for independent financial advisors also experienced revenue growth for the year. During 2005, revenue from Advisor Workstation surpassed revenue from our Principia software, which has historically been our largest product. Total licenses for Advisor Workstation in the United States increased by about 40% during the year.

The second largest driver of consolidated revenue growth was our independent equity research, primarily associated with the Global Analyst Research Settlement. In July 2004, we began providing independent equity research under agreements with five major investment banks. We continued to provide this research to these five firms throughout 2005. In September 2005, we entered into an equity research agreement with a sixth investment bank involved in the settlement and began recognizing this new revenue in the fourth quarter of 2005. Our revenue in this area also benefited because we increased the number of stocks under coverage in 2005, leading to higher contract values for some of the equity research contracts related to the settlement.

Our Investment Consulting area was another key contributor to consolidated revenue growth in 2005, primarily reflecting expanded relationships and increased assets under management with existing clients for the asset allocation services we provide to funds of funds and variable annuities. Licensed Data and Morningstar.com were the fourth and fifth largest drivers of revenue growth in 2005. Principia was the only one of our top five products that didn't generate a revenue increase in 2005 because many of our customers have been adopting Advisor Workstation, our newer Web-based investment planning system. Principia revenue declined approximately 2% compared with 2004.

Revenue from international operations increased $4.0 million, or 15.9%, to $29.4 million in 2005. International revenue made up about 13% of consolidated revenue in 2005, compared with about 14% in 2004. While expanding our international presence remains an important growth strategy, our U.S. revenue grew at a faster pace than non-U.S. revenue in 2005, partly because of the new revenue related to the Global Analyst Research Settlement and growth in our Investment Consulting business in the United States. Foreign currency translations contributed $0.7 million of the increase in international revenue for the year. Excluding the impact of foreign currency translations, our international revenue increased approximately 13% in 2005.

Without the impact of foreign currency translations and the VARDS acquisition, our consolidated revenue increased approximately 25% in 2005. Similar to 2004, acquisitions and foreign currency translations continued to have a minimal impact on our consolidated revenue growth in 2005. Because of our recent acquisition of Ibbotson Associates, we expect acquisitions to have a more significant impact on revenue growth in 2006.

Our top five products—Licensed Data, Morningstar Advisor Workstation, Principia, Morningstar.com, and Investment Consulting—represented 60.7% of our revenue base in 2005, compared with 61.5% in 2004. While the percentage of our revenue base made up by our top five products remained relatively consistent, the mix of the top five products changed compared with 2004. Principia, historically our largest product, was surpassed by Licensed Data and Advisor Workstation, which reported more revenue in 2005.

($000)	Revenue	% Revenue
2005 Top Five Products (Segment)		
Licensed Data (Institutional)	**$ 32,435**	**14.3%**
Advisor Workstation (Advisor)	**29,280**	**12.9**
Principia (Advisor)	**28,788**	**12.7**
Morningstar.com (Individual)	**25,502**	**11.2**
Investment Consulting (Institutional)	**21,904**	**9.6**
2004 Top Five Products (Segment)		
Principia (Advisor)	$ 29,231	16.3%
Licensed Data (Institutional)	27,203	15.1
Morningstar.com (Individual)	20,670	11.5
Advisor Workstation (Advisor)	19,464	10.8
Investment Consulting (Institutional)	13,853	7.7

Revenue Composition

As discussed in the Recurring Revenue section of Key Business Characteristics, to help investors evaluate our ongoing business results, we separate our revenue into three categories: new revenue, renewal revenue, and "walk-in" revenue. The following table illustrates the composition of our 2005, 2004, and 2003 revenue.

($mil)	2005	2004	2003
New revenue	**$ 39.0**	$ 45.6	$ 31.5
Renewal revenue	**65.9**	40.8	36.9
Net walk-in revenue	**122.2**	93.3	71.1
Total	**$ 227.1**	$ 179.7	$ 139.5
% of revenue from walk-in and renewal combined	**82.8%**	74.6%	77.4%

Our 2005 revenue consisted of $39.0 million in new revenue, or 17.2%, of our total revenue for the year. Renewal revenue accounted for $65.9 million, or 29.0%, of our total revenue for the year. Walk-in revenue accounted for $122.2 million, or 53.8%, of our total revenue for the year. In 2004, new revenue made up a greater percentage of our total annual revenue partly because of the equity research we began providing in July 2004 related to the Global Analyst Research Settlement.

As of January 1, 2006, our estimate of 2006 walk-in revenue is $138.8 million. This estimate is subject to change based on cancellations during the year, the impact of currency translations, and other routine adjustments. In comparison, our walk-in revenue as of January 1, 2005, was $124.9 million. In 2005, walk-in revenue benefited from newly generated equity research revenue associated with the Global Analyst Research Settlement. In addition, the walk-in revenue figure does not include variable revenue from asset-related services such as Morningstar Managed Portfolios, managed retirement account services, and Investment Consulting that are calculated as a percentage of total assets under management. These areas of our business have been increasing over the past several years.

In 2005, we estimate that our retention rate for subscription-based products such as Principia, Premium Membership service, and print and online newsletters averaged between 60% to 65%. For contract-based products and services, we estimate that our weighted average renewal rate generally ranged from 100% to 105% in 2005. The figure for contract-based products exceeds 100% because it includes the impact of price changes and changes to the contract value upon renewal. While we're satisfied with the retention and renewal rates we achieved in 2005, we constantly strive to improve these measures because the cost of maintaining existing customers is lower than the cost of acquiring new customers to replace business that doesn't renew.

Consolidated Operating Expense

($000)	**2005**	2004	Change
Total operating expense	**$ 180,634**	$ 161,923	11.6%
% of revenue	**79.5%**	90.1%	(10.6)pp

Our consolidated operating expense increased $18.7 million in 2005. Approximately half of this increase was from higher cost of goods sold; the remaining portion of the increase occurred across other operating expense categories, including development, sales and marketing, and general and administrative expense. The increase in consolidated operating expense was largely driven by a $15.6 million increase in compensation-related costs, including salaries, bonus, benefits, and sales commissions, stemming from higher headcount. We record these costs in the various operating expense categories as appropriate. We had approximately 1,130 employees worldwide as of December 31, 2005, compared with approximately 1,000 as of December 31, 2004. Approximately 60% of the increase in headcount was driven by technical staffing in our development center in China. Most of the remaining increase in headcount consists of additional stock analysts in our U.S. operations and increased staffing in our corporate departments to meet the requirements of being a public company. An increase in spending for corporate initiatives and legal fees and a decline in capitalized internal product development costs also contributed to the increase in operating expense. A decline in stock-based compensation of $5.8 million in 2005 partially offset the increase in compensation costs and other operating expenses.

Because our consolidated operating expense grew at a slower rate than our revenue, our consolidated operating expense as a percentage of revenue declined by more than 10 percentage points in 2005. This decline was primarily driven by the timing of revenue and expense associated with the Global Analyst Research Settlement and the decrease in stock-based compensation expense mentioned above, as well as the operating leverage inherent in our business. 2005 was the first full year of revenue from equity research related to the settlement; as a result, revenue in this area grew faster than expenses during the year. Similarly, as revenue from Institutional products such as Investment Consulting and Licensed Data rose during the year, our cost base for producing these products increased at a lower rate. Because consolidated operating expense declined as a percentage of revenue, operating margin showed a corresponding increase.

Cost of Goods Sold

($000)	**2005**	2004	Change
Cost of goods sold	**$ 64,408**	$ 54,709	17.7%
% of revenue	**28.4%**	30.5%	(2.1)pp
Gross profit	**$ 162,706**	$ 124,949	30.2%
Gross margin	**71.6%**	69.5%	2.1 pp

Cost of goods sold has generally been our largest category of operating expense, and that pattern continued in 2005. 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 $9.7 million in 2005. Compensation expense increased in all three segments, but mainly reflects additional costs for newly hired stock analysts in our Individual segment. Shareholder servicing fees related to Morningstar Managed Portfolios, which increased because of higher assets under management, contributed $1.5 million to the increase in cost of goods sold.

As a percentage of revenue, cost of goods sold declined by about 2 percentage points in 2005. This partly reflects the timing of hiring expenses for our independent equity research. We began incurring incremental compensation costs at the beginning of 2004 as we increased staffing in preparation for the ramp-up of our equity research efforts. We continued to increase staffing in 2005, but had already completed the majority of the staffing increase in 2004. As a result, cost of goods sold increased less dramatically in 2005.

Because cost of goods sold declined as a percentage of revenue in 2005, gross margin showed a corresponding increase. Gross margin has been steadily increasing over the past several years, from 68.8% in 2003 to 71.6% in 2005.

Development Expense

($000)	**2005**	2004	Change
Development expense	**$ 19,654**	$ 16,167	21.6%
% of revenue	**8.7%**	9.0%	(0.3)pp

Development expense increased $3.5 million in 2005 because of increased hiring for programming and development staff primarily in our Advisor and Institutional segments and a reduction in the amount of expense capitalized related to development projects. We capitalize compensation costs associated with certain development projects, which reduces the costs included in development expense. Many of the projects for which we capitalized product development costs in 2004 have now been placed into service, and the ongoing costs are no longer capitalized. Instead, we now expense these costs as incurred. During 2005 we capitalized $0.4 million of development costs, compared with $2.8 million in 2004. As a percentage of revenue, development expense was slightly lower in 2005 compared with 2004.

Sales and Marketing Expense

($000)	**2005**	2004	Change
Sales and marketing expense	**$ 39,071**	$ 36,034	8.4%
% of revenue	**17.2%**	20.1%	(2.9)pp

Sales and marketing expense increased $3.1 million because of higher commission costs, salaries, and benefits expense. We incurred additional commission costs because of both increased sales volume, primarily in our Advisor and Institutional segments, and changes to the incentive structure for certain products in the Advisor segment, including Principia and Advisor Workstation Office Edition. Salaries and benefits included in this expense category also increased, mainly because of an increase in headcount for the sales and marketing team in our Advisor segment. Because our revenue base increased at a faster pace than our sales and marketing expense, sales and marketing expense as a percentage of revenue declined by about 3 percentage points in 2005.

General and Administrative Expense

($000)	**2005**	2004	Change
General and administrative expense	**$ 49,235**	$ 46,788	5.2%
% of revenue	**21.7%**	26.0%	(4.3)pp

General and administrative expense has generally been our second largest category of operating expense following cost of goods sold, and that pattern continued in 2005. The $2.4 million increase in general and administrative expense mainly includes higher compensation costs, which increased primarily because we added staff in our corporate departments to meet the requirements of being a public company. Higher incentive compensation also contributed to the increase in this category in 2005. We also incurred $2.0 million more for spending on corporate initiatives and legal fees related to regulatory investigations in 2005 than in 2004. In addition, we increased our offer to settle various claims related to Morningstar Research Pty Limited (Morningstar Australia). Refer to Note 17 of the Notes to our Consolidated Financial Statements for more information regarding this litigation. Stock-based compensation expense included in general and administrative expense decreased $4.3 million during 2005, which largely offset the increases in other areas. The decrease in stock-based compensation expense was driven by a decline in expense for options accounted for under the liability method, as described below. Because our general and administrative expense increased at a slower pace compared with our revenue growth, general and administrative expense as a percentage of revenue declined by about 4 percentage points in 2005.

Depreciation and Amortization Expense

($000)	**2005**	2004	Change
Depreciation and amortization expense	**$ 8,266**	$ 8,225	0.5%
% of revenue	**3.6%**	4.6%	(1.0)pp

Depreciation and amortization expense increased slightly in 2005 primarily because of amortization of the intangible assets related to the VARDS acquisition. This increase was offset by a decrease in depreciation and amortization expense for capitalized software, computer equipment, and internal product development costs, as many of the assets in these categories are now fully depreciated.

Stock-Based Compensation Expense

We have historically used two different methods of accounting for stock-based compensation expense: the liability method, which involves recording a liability for vested options equal to the difference between the option exercise price and the fair value per share of the common stock, and the equity method, which is based on the Black-Scholes value of the option at the time of the grant and recorded over the vesting period of the option. Following 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.

The following table summarizes our stock-based compensation expense:

($000)	2005	2004	Change
Stock-based compensation expense —liability method	**$ 2,810**	$ 8,963	(68.6)%
Stock-based compensation expense —equity method	**8,085**	7,760	4.2%
Total stock-based compensation expense	**$ 10,895**	$ 16,723	(34.9)%
% of revenue	**4.8%**	9.3%	(4.5)pp

Total stock-based compensation expense declined $5.8 million in 2005.

Stock-based compensation expense recorded under the liability method declined $6.2 million in 2005. The expense recorded under the liability method in 2005 reflects the expense recorded through the first quarter, when we adjusted the liability to reflect our initial public offering price of $18.50 per share compared with a fair value of $17.50 per share as of December 31, 2004. The expense recorded under the liability method in 2004 reflects a $2.80 increase in the fair value per share of our common stock to $17.50 per share as of December 31, 2004 from $14.70 per share as of December 31, 2003.

Stock-based compensation expense recorded under the equity method increased $0.3 million in 2005. This increase mainly reflects the impact of approximately 1.1 million options granted in 2005, as well as ongoing expense associated with options granted in 2004 and prior years. This increase was partially offset by lower expense for options granted in previous years, which are now fully vested and no longer require recording additional expense.

In 2006, we expect to record approximately $7.0 million of stock-based compensation expense for all options outstanding as of December 31, 2005.

Bonus Expense

($000)	2005	2004	Change
Bonus expense	**$ 22,511**	$ 21,037	7.0%
% of revenue	**9.9%**	11.7%	(1.8)pp

Bonus expense increased $1.5 million in 2005. This category of expense increased primarily because our financial performance in 2005 exceeded our financial performance in 2004. The impact of this increase was partially offset because our bonus expense in 2004 included a special bonus for our analyst team that did not recur in 2005. Bonus expense is included in each of the operating expense categories.

Operating Income

($000)	2005	2004	Change
Operating income	**$ 46,480**	$ 17,735	162.1%
% of revenue	**20.5%**	9.9%	10.6pp

Because our consolidated revenue grew at a faster rate than our operating expense, our operating margin increased by more than 10 percentage points in 2005. This increase was primarily driven by the timing of revenue and expense associated with the Global Analyst Research Settlement and the $5.8 million decrease in stock-based compensation expense, as well as the operating leverage inherent in our business. 2005 was the first full year of revenue from equity research associated with the Global Analyst Research Settlement. During 2005, we were able to increase costs associated with this revenue at a lower rate because much of the cost increases occurred in 2004 as we built our staff in anticipation of this revenue. In addition, revenue growth for many of our Institutional products, such as Investment Consulting and Licensed Data, increased during the year. We were able to increase costs in most of the related expense categories at a lower rate than this revenue growth.

The table below provides a reconciliation from operating income to operating income before stock-based compensation expense:

($000)	2005	2004	Change
Operating income	**$ 46,480**	$ 17,735	162.1%
Stock-based compensation expense	**10,895**	16,723	(34.9)%
Operating income before stock-based compensation expense	**$ 57,375**	$ 34,458	66.5%

The table below provides a reconciliation of operating margin to operating margin before stock-based compensation expense:

(percentage of revenue)	2005	2004
Operating margin	**20.5%**	9.9%
Stock-based compensation expense	**4.8**	9.3
Operating margin before stock-based compensation expense	**25.3%**	19.2%

Stock-based compensation expense had a larger impact on our operating margin in 2004 because of the expense recorded under the liability method, as discussed in the Stock-Based Compensation Expense section above.

We expect stock-based compensation expense to be a recurring cost. We have presented operating income before stock-based compensation expense and operating margin before stock-based compensation expense solely as supplemental disclosures to help investors better understand the performance of our business, to enhance comparison of our performance from period to period, and to allow better comparison of our performance with that of our competitors. We use operating income before stock-based compensation expense and operating margin before stock-based compensation expense to evaluate the performance of our business. Operating income before stock-based compensation expense and operating margin before stock-based compensation expense should not be considered alternatives to any measure of performance as promulgated under U.S. GAAP (such as operating income or operating margin), nor should this data be considered an indicator of our overall financial performance or liquidity. Also, the calculations of operating income before stock-based compensation expense and operating margin before stock-based compensation expense used by us may not be comparable to similarly titled measures reported by other companies.

Consolidated Free Cash Flow

We generated free cash flow of $41.0 million in 2005, reflecting cash provided by operating activities of $48.4 million and capital expenditures of $7.4 million. Free cash flow increased by $15.9 million in 2005, reflecting a $15.6 million increase in cash provided by operating activities, which was driven by an increase in net income, as well as approximately a $0.3 million reduction in capital expenditures. As a percentage of revenue, free cash flow was 18.0% of revenue in 2005, compared with 14.0% in 2004.

The decrease in capital expenditures in 2005 primarily reflects lower capitalized internal product development costs. Because several products for which costs were previously capitalized have now been put into service, we expense the ongoing costs as we incur them.

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

($000)	2005	2004	Change
Net income	**$ 31,117**	$ 8,809	$ 22,308
Adjustments to reconcile net income to net cash flows from operating activities:			
Non-cash items included in net income	**20,647**	23,899	(3,252)
Changes in operating assets and liabilities, net of effects of acquisitions:			
Cash paid for bonuses	**(18,000)**	(12,252)	(5,748)
Cash paid for income taxes	**(19,527)**	(6,613)	(12,914)
Other	**34,208**	19,019	15,189
Cash provided by operating activities	**$ 48,445**	$ 32,862	$15,583

In 2005, the increase in cash provided by operating activities of $15.6 million lagged the $22.3 million increase in net income. There were several items that contributed to lower relative growth in cash provided by operating activities in 2005. Payments made for both income taxes and bonuses had the largest impact on the gap between cash provided by operating activities and net income. Income tax payments in 2005 increased $12.9 million compared with the previous year. In 2004, we used the majority of our U.S. net operating losses, reducing the amount of taxes paid. Bonus payments in 2005 increased $5.7 million compared with 2004, reflecting strong business performance during 2004, as well as the last installment of a special bonus established for our analyst team in 2004. In addition, non-cash items included in net income decreased primarily because of lower deferred income tax expense. While income tax payments, bonus payments, and non-cash items included in net income lowered our cash flow provided by operating activities, they were largely offset by a greater cash flow benefit in 2005 arising from changes in operating assets and liabilities. Over half of this benefit reflects increases in accounts payable and accrued expenses; the remaining increase was driven by accrued income taxes and accrued compensation, excluding the payments discussed above.

Segment Results

($000)	**2005**	2004	Change
Revenue			
Individual	**$ 63,448**	$ 46,996	35.0%
Advisor	**72,689**	60,880	19.4%
Institutional	**95,947**	78,402	22.4%
Eliminations	**(4,970)**	(6,620)	(24.9)%
Consolidated revenue	**$ 227,114**	$ 179,658	26.4%
Operating income			
Individual	**18,373**	7,825	134.8%
Advisor	**17,892**	13,966	28.1%
Institutional	**24,796**	13,667	81.4%
Corporate items and eliminations	**(14,581)**	(17,723)	(17.7)%
Consolidated operating income	**$ 46,480**	$ 17,735	162.1%
Operating margin			
Individual	**29.0%**	16.7%	12.3pp
Advisor	**24.6%**	22.9%	1.7pp
Institutional	**25.8%**	17.4%	8.4pp
Consolidated operating margin	**20.5%**	9.9%	10.6pp

Individual Segment

Our Individual segment provides 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 currently generate all of the revenue from our Individual segment in the United States. In 2005 and 2004, this segment represented, before intersegment eliminations, 27.9% and 26.2%, respectively, of our consolidated revenue.

($000)	**2005**	2004	Change
Revenue	**$ 63,448**	$ 46,996	35.0%
Operating income	**$ 18,373**	$ 7,825	134.8%
Operating margin (%)	**29.0%**	16.7%	12.3pp

In 2005, revenue for the Individual segment increased $16.4 million compared with 2004. The increase primarily reflects revenue from the independent equity research we are providing under the Global Analyst Research Settlement. In the third quarter of 2004, we entered into agreements with five major investment banks to provide independent equity research to meet the terms of the settlement. These agreements are structured as annual contracts that include both renewal and cancellation options. Because we did not begin recognizing revenue under these contracts until the end of July 2004, the full year of revenue recognized in 2005 compared favorably with the partial year of revenue recognized in 2004. We retained these five contracts for the second year of the five-year period under the settlement. In September 2005, we entered into an agreement with a sixth investment bank to provide independent equity research as part of the terms of the settlement. Revenue also increased because we're providing coverage on a larger number of stocks compared with the prior year. Growth in Morningstar.com Premium membership and Internet advertising sales accounted for the majority of the remaining increase in revenue. Subscriptions for Morningstar.com Premium Membership service increased to 147,010 as of December 31, 2005, compared with 131,035 as of December 31, 2004.

In 2005, operating income for the Individual segment increased $10.6 million compared with 2004. The significant increase in operating income reflects the impact of revenue growth against more moderate growth in operating expenses. Operating expense in 2005 increased $5.9 million, or 15.1%, compared with the prior year. This increase was driven primarily by increased compensation expense from hiring additional equity analysts. Our equity analyst team consisted of 87 analysts as of December 31, 2005, compared with 73 as of December 31, 2004. The improvement in operating income was also impacted by a difference in the timing between revenue and expense associated with the Global Analyst Research Settlement. Beginning in 2004, we invested heavily in the hiring of our analyst team in anticipation of the revenue associated with the Global Analyst Research Settlement. We began recognizing revenue from the Global Analyst Research Settlement at the end of July 2004. This resulted in higher compensation-related costs with no corresponding increase in revenue for the first seven months of 2004. In 2005, however, we had a full year of revenue to cover costs. As a result, operating margin significantly improved in 2005 compared with 2004.

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 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. In 2005 and 2004, this segment represented, before intersegment eliminations, 32.0% and 33.9%, respectively, of our consolidated revenue.

($000)	**2005**	2004	Change
Revenue	**$ 72,689**	$ 60,880	19.4%
Operating income	**$ 17,892**	$ 13,966	28.1%
Operating margin (%)	**24.6%**	22.9%	1.7pp

In 2005, revenue for the Advisor segment increased $11.8 million compared with 2004. The increase was primarily driven by Morningstar Advisor Workstation. We continue to see strong growth in licenses of the Enterprise Edition of Morningstar Advisor Workstation, and we entered into numerous new agreements in 2005. In addition, we also experienced strong renewals for the product during 2005, and several contracts that were scheduled to expire during 2005 renewed at significantly higher price points, reflecting both higher user counts and an increase in the amount of functionality licensed. During 2005, revenue from Advisor Workstation surpassed revenue from Principia, which has historically been our largest product. The number of U.S. licenses for Morningstar Advisor Workstation increased to 113,461 as of December 31, 2005, compared with 80,235 as of December 31, 2004. Morningstar Managed Portfolios also contributed to revenue growth in the segment, but to a lesser degree. Assets under management for Morningstar Managed Portfolios increased to $1.4 billion as of December 31, 2005, compared with $936.0 million as of December 31, 2004. Principia revenue declined slightly during 2005. The number of subscriptions for Principia declined to 49,728 as of December 31, 2005 compared with 51,308 as of December 31, 2004. While the number of subscriptions declined slightly, average revenue per subscription increased primarily because of previous price increases and reductions in certain discount programs. The VARDS acquisition contributed $0.4 million to revenue in this segment during 2005.

In 2005, we refined the way we count Principia subscriptions. We now count subscriptions to each of the six modules in the Principia suite as separate subscriptions. We also refined the way we count U.S. licenses for Advisor Workstation to more consistently include only financial advisors licensed to use the product and to exclude support staff. If the license agreement allows access by users not employed by the licensing enterprise, we only include actual users within the past 12 months. We believe these changes provide better information regarding our market penetration within the financial advisor market. The table below shows historical quarterly data adjusted to reflect these changes.

Principia Subscriptions and Advisor Workstation Licenses (Revised)

	Dec 31 2003	Mar 31 2004	Jun 30 2004	Sept 30 2004	Dec 31 2004	Mar 31 2005	Jun 30 2005	Sept 30 2005
Number of U.S. Advisor Workstation Licenses	32,408	57,166	75,810	72,190	80,235	90,323	101,318	102,606
Number of Principia Subscriptions	55,892	55,493	54,824	52,366	51,308	53,048	50,797	50,484

In 2005, operating income for the Advisor segment increased $3.9 million compared with 2004, reflecting an increase in revenue partially offset by higher operating expense in all categories. Operating expense increased $7.9 million, or 16.8%, compared with the prior year. A little over one-third of the increase in expense was driven by an increase in cost of goods sold because of increased compensation costs related to additional headcount and shareholder servicing fees related to higher levels of assets under management for Morningstar Managed Portfolios. An increase in general and administrative expense, driven by higher corporate overhead expense, also contributed approximately one-third of the increase in operating expense for this segment. The remaining increase in operating expense primarily reflects increased sales and marketing expense, which was driven by higher compensation-related expense and commissions for sales of Advisor Workstation and Principia. The higher sales commissions reflect increased sales volume in Advisor Workstation and changes to the incentive structure for both products. Operating margin improved slightly in 2005, reflecting the impact of higher revenue against the operating cost structure.

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 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 Data, a set of investment data spanning eight core databases, available through electronic data feeds; Investment Consulting, which focuses on investment monitoring and asset allocation for funds of funds, including mutual funds and variable annuities; Investment Profiles & Guides, which are designed for institutions to use in communicating investment information to individual investors; and Morningstar Retirement Manager, a suite of advice and guidance services for retirement plan participants. In 2005 and 2004, this segment represented, before intersegment eliminations, 42.2% and 43.6%, 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.

($000)	2005	2004	Change
Revenue	**$ 95,947**	$ 78,402	22.4%
Operating income	**$ 24,796**	$ 13,667	81.4%
Operating margin (%)	**25.8%**	17.4%	8.4pp

In 2005, revenue for the Institutional segment increased $17.5 million compared with 2004. More than 40% of the increase was driven by increased revenue for Investment Consulting services. During 2005, we expanded existing relationships and our scope of responsibilities with two major clients. Revenue also increased because we receive asset-based fees for our services, and assets under advisement in this area significantly increased compared with the prior year. Morningstar provided advisory services on approximately $22.1 billion in assets as of December 31, 2005, compared with approximately $12.6 billion as of December 31, 2004. These totals include consulting relationships as well as agreements where we act as a portfolio construction manager for a mutual fund or variable annuity and receive a basis point fee. Licensed Data, and to a lesser extent, Morningstar Direct, also contributed to revenue growth during 2005. The VARDS acquisition contributed $2.0 million to revenue in this segment during 2005. The number of licenses for Morningstar Direct was 985 as of December 31, 2005, compared with 775 as of December 31, 2004. Beginning in the second quarter of 2005, we began selling Morningstar Direct licenses in international markets. The number of licenses as of December 31, 2005 includes both U.S. and non-U.S. users. The number of global licenses as of June 30, 2005 and September 30, 2005 was 843 and 931, respectively. Revenue growth in Morningstar Direct exceeded growth in the number of licenses because of the impact of a new pricing model implemented during 2004. Several key contracts whose terms ended during 2005 renewed for a smaller number of licenses, but at a greater price per license.

As mentioned in the Key Accomplishments and Disappointments section included in the Performance Summary above, revenue for the online advice service we offer through the Morningstar Retirement Manager platform declined slightly in 2005. We continue to enhance our online advice services and have been transitioning clients to our new user interface, which is more streamlined and simpler to use. Based on industry research, however, we believe online retirement advice appeals to a relatively small segment of self-directed investors within the large population of 401(k) plan participants. We see greater growth potential in managed retirement accounts, which may appeal to a broader segment of retirement plan participants. We had $285.0 million in assets under management in the managed retirement accounts offered through Morningstar Retirement Manager as of December 31, 2005, compared with $123.9 million as of December 31, 2004. As of December 31, 2005, more than 9 million retirement plan participants had access to Morningstar Retirement Manager through approximately 69,000 plan sponsors and 30 plan providers. The number of plan participants decreased from prior periods because we received revised participant counts from certain plan providers.

In 2005, operating income for the Institutional segment increased $11.1 million compared with 2004. The increase in operating income was primarily driven by revenue growth in our Investment Consulting and Licensed Data services. Contract values in both areas and asset-based fees in Investment Consulting have increased, while the cost base for these services has remained relatively stable. Operating expense in 2005 increased $6.4 million, or 9.9%, compared with 2004. More than half of the growth in operating expense was driven by an increase in cost of goods sold, reflecting higher compensation expense, including bonus expense and costs relating to the VARDS acquisition. The remaining increase in operating expense was driven by growth in sales and marketing expense, reflecting higher compensation and sales commission expense, and an increase in general and administrative expense, reflecting higher corporate overhead. Operating margin significantly improved compared with 2004, reflecting the impact of revenue growth that exceeded the increase in operating expense.

Corporate and Eliminations

Corporate items and eliminations primarily include stock-based compensation expense, capitalized internal product development costs and related amortization, and amortization related to intangible assets. The following table shows the components of corporate and eliminations expense (income) that impacted our consolidated operating income:

($000)	**2005**	2004	Change
Stock-based compensation expense	**$ 10,895**	$ 16,723	(34.9)%
Capitalized internal product development costs	**(375)**	(2,802)	(86.6)%
Depreciation and amortization	**3,576**	3,342	7.0%
Other	**485**	460	5.4%
Corporate items and eliminations	**$ 14,581**	$ 17,723	(17.7)%

In 2005, corporate items and eliminations decreased $3.1 million, primarily reflecting a decline of $5.8 million in stock-based compensation expense. This decrease was partially offset by a decrease of $2.4 million in capitalized internal product development costs and a $0.3 million increase in depreciation and amortization.

2004 vs. 2003

Consolidated Results

($000)	2004	2003	Change
Revenue	$ 179,658	$ 139,496	28.8%
Operating income (loss)	17,735	(10,754)	NMF
Operating margin (%)	9.9%	NMF	NMF
Stock-based compensation expense	16,723	29,029	(42.4)%
Cash used for investing activities	(22,750)	(29,634)	(23.2)%
Cash used for financing activities	(6,367)	(26)	NMF
Cash provided by operating activities	$ 32,862	$ 29,705	10.6%
Capital expenditures	(7,730)	(8,607)	(10.2)%
Free cash flow	$ 25,132	$ 21,098	19.1%

(NMF) not meaningful

Consolidated Revenue

In 2004, our revenue increased $40.2 million, or 28.8%, to $179.7 million from $139.5 million in 2003, reflecting strong demand for the products and services in each of our business segments. Price adjustments had minimal impact on revenue growth. Revenue in our Individual segment increased $11.6 million; revenue in our Advisor segment increased $11.7 million; and revenue in our Institutional segment increased $18.7 million. The consolidated revenue increase was driven mainly by our independent equity research associated with the Global Analyst Research Settlement; Morningstar.com Premium service; Internet advertising sales; Morningstar Advisor Workstation; Morningstar Managed Portfolios; Morningstar Retirement Manager (primarily resulting from the acquisition of mPower.com, Inc.); Licensed Data; Morningstar Direct; and Investment Consulting. The revenue increase in these products and services was partially offset by lower revenue from some of our more mature products such as Reprints, *Morningstar Mutual Funds*, and *Morningstar FundInvestor*.

Revenue from international operations increased $5.3 million, or 26.3%, to $25.4 million in 2004 compared with $20.1 million in 2003. Currency translations contributed $1.9 million; excluding the impact of currency translations, our international revenue increased approximately 17%. Revenue from mPower.com, Inc. (mPower), which we acquired in July 2003, was $4.6 million in 2004, or approximately $2.5 million more than the revenue we recognized from this business during the six months following the acquisition in 2003. Excluding the impact of currency translations and the mPower revenue in the first six months of 2004, our revenue increased approximately 26% in 2004.

The following table summarizes our top five revenue-generating products:

($000)	Revenue	% Revenue
2004 Top Five Products (Segment)		
Principia (Advisor)	$ 29,231	16.3%
Licensed Data (Institutional)	27,203	15.1
Morningstar.com (Individual)	20,670	11.5
Advisor Workstation (Advisor)	19,464	10.8
Investment Consulting (Institutional)	13,853	7.7
2003 Top Five Products (Segment)		
Principia (Advisor)	$ 28,856	20.7%
Licensed Data (Institutional)	22,453	16.1
Morningstar.com (Individual)	16,312	11.7
Advisor Workstation (Advisor)	10,799	7.7
Licensed Tools and Content (Institutional)	9,222	6.6

Consolidated Operating Expense

($000)	2004	2003	Change
Total operating expense	$ 161,923	$ 150,250	7.8%
% of revenue	90.1%	107.7%	(17.6)pp

(pp) percentage point(s)

Consolidated operating expense increased $11.6 million, or 7.8%, to $161.9 million in 2004 from $150.3 million in 2003. The increase primarily reflects an $11.2 million increase in cost of goods sold and a $5.2 million increase in sales and marketing expense. These increases were partially offset by a $7.3 million reduction in general and administrative expense, mainly because of a reduction in stock-based compensation expense.

Cost of Goods Sold

($000)	2004	2003	Change
Cost of goods sold	$ 54,709	$ 43,521	25.7%
% of revenue	30.5%	31.2%	(0.7)pp
Gross profit	$ 124,949	$ 95,975	30.2%
Gross margin	69.5%	68.8%	0.7pp

Cost of goods sold increased $11.2 million, or 25.7%, to $54.7 million in 2004 from $43.5 million in 2003. The increase in cost of goods sold mainly reflects higher compensation costs relating to expanded staffing across all of our business segments, higher incentive compensation driven by financial performance that exceeded internal estimates, and incentive compensation for our analyst team. These increases were partially offset by a reduction in stock-based compensation expense.

Development Expense

($000)	2004	2003	Change
Development expense	$ 16,167	$ 14,663	10.3%
% of revenue	9.0%	10.5%	(1.5)pp

Development expense increased $1.5 million, or 10.3%, to $16.2 million in 2004 from $14.7 million in 2003. The increase mainly stems from higher compensation expense (including incentive compensation) and a reduction in capitalized internal product development costs, partially offset by lower stock-based compensation expense. Capitalized internal product development costs in 2004 primarily relates to ongoing development of products such as Morningstar Direct, Morningstar Retirement Manager, and Morningstar Advisor Workstation.

Sales and Marketing Expense

($000)	2004	2003	Change
Sales and marketing expense	$ 36,034	$ 30,798	17.0%
% of revenue	20.1%	22.1%	(2.0)pp

Sales and marketing expense increased $5.2 million, or 17.0%, to $36.0 million in 2004 from $30.8 million in 2003, largely because of higher compensation expense (including sales commissions and incentive compensation) primarily for our Advisor and Institutional businesses and increased marketing expense for our Individual business. These increases were partially offset by a reduction in stock-based compensation expense.

General and Administrative Expense

($000)	2004	2003	Change
General and administrative expense	$ 46,788	$ 54,145	(13.6)%
% of revenue	26.0%	38.8%	(12.8)pp

General and administrative expense decreased $7.3 million, or 13.6%, to $46.8 million in 2004 from $54.1 million in 2003. A $9.3 million reduction in stock-based compensation expense and lower sales tax expense in 2004 were partially offset by an increase in incentive compensation expense and corporate overhead.

Depreciation and Amortization Expense

($000)	2004	2003	Change
Depreciation and amortization expense	$ 8,225	$ 7,123	15.5%
% of revenue	4.6%	5.1%	(0.5)pp

Depreciation and amortization expense increased $1.1 million, or 15.5%, to $8.2 million in 2004 from $7.1 million in 2003. This increase was mainly driven by depreciation and amortization expense for computer equipment, leasehold improvements, and capitalized internal product development costs.

Stock-Based Compensation Expense

The following table summarizes stock-based compensation expense recorded under the liability and the equity methods:

($000)	2004	2003	Change
Stock-based compensation expense —liability method	$ 8,963	$ 17,796	(49.6)%
Stock-based compensation expense —equity method	7,760	11,233	(30.9)%
Total stock-based compensation expense	$ 16,723	$ 29,029	(42.4)%
% of revenue	9.3%	20.8%	(11.5)pp

Stock-based compensation expense decreased $12.3 million, or 42.4%, to $16.7 million in 2004 from $29.0 million in 2003. The decrease reflects the fact that certain stock options granted in previous years were fully vested and as a result no longer required recording additional expense. In addition, for options accounted for under the liability method, the $2.80 per share increase in the fair value of our common stock in 2004 was lower than the $6.13 per share increase in the fair value of our common stock in 2003.

Bonus Expense

($000)	2004	2003	Change
Bonus expense	$ 21,037	$ 12,620	66.7%
% of revenue	11.7%	9.0%	2.7pp

Bonus expense increased $8.4 million, or 66.7%, to $21.0 million in 2004 from $12.6 million in 2003, primarily because of financial performance that exceeded internal estimates. The increase in 2004 also reflects accruals for a special bonus established for our analyst team. Bonus expense is reflected in each of the appropriate operating expense categories.

Consolidated Operating Income

($000)	2004	2003	Change
Operating income (loss)	$ 17,735	$ (10,754)	NMF
% of revenue	9.9%	NMF	NMF

Operating income increased $28.5 million to $17.7 million in 2004 from an operating loss of $10.8 million in 2003, reflecting the impact of our operating leverage (the relatively low level of variable cost of adding new customers) and lower stock-based compensation expense impacting all expense categories. The revenue increase of $40.2 million was partially offset by operating expense growth of approximately $11.7 million.

The table below provides a reconciliation from operating income to operating income before stock-based compensation expense:

($000)	2004	2003	Change
Operating income (loss)	$ 17,735	$ (10,754)	NMF
Stock-based compensation expense	16,723	29,029	(42.4)%
Operating income before stock-based compensation expense	$ 34,458	$ 18,275	88.6%

The table below provides a reconciliation of operating margin to operating margin before stock-based compensation expense:

(percentage of revenue)	2004	2003
Operating margin	9.9%	NMF
Stock-based compensation expense	9.3	20.8
Operating margin before stock-based compensation expense	19.2%	13.1%

Consolidated Free Cash Flow

We generated approximately $25.2 million in free cash flow in 2004, reflecting cash provided by operating activities of $32.9 million and capital expenditures of $7.7 million. Free cash flow increased by approximately $4.1 million from $21.1 million in 2003, due to a $3.2 million improvement in cash provided by operating activities and a $0.9 million reduction in capital expenditures.

The increase in cash provided by operations in 2004 reflects an improvement in our net income adjusted for non-cash items, partially offset by higher working capital. The working capital increase primarily reflects a $10.9 million increase in receivables from clients as a result of additional billings, offset by a $7.0 million increase in deferred revenue and a $3.8 million increase in income taxes payable.

Segment Results

($000)	2004	2003	Change
Revenue			
Individual	$ 46,996	$ 35,406	32.7%
Advisor	60,880	49,161	23.8%
Institutional	78,402	59,745	31.2%
Eliminations	(6,620)	(4,816)	37.5%
Consolidated revenue	$ 179,658	$ 139,496	28.8%
Operating income (loss)			
Individual	7,825	7,391	5.9%
Advisor	13,966	9,521	46.7%
Institutional	13,667	4,160	228.5%
Corporate items and eliminations	(17,723)	(31,826)	(44.3)%
Consolidated operating income (loss)	$ 17,735	$ (10,754)	NMF
Operating margin			
Individual	16.7%	20.9%	(4.2)pp
Advisor	22.9%	19.4%	3.5pp
Institutional	17.4%	7.0%	10.4pp
Consolidated operating margin	9.9%	NMF	NMF

Individual Segment

($000)	2004	2003	Change
Revenue	$ 46,996	$ 35,406	32.7%
Operating income	$ 7,825	$ 7,391	5.9%
Operating margin (%)	16.7%	20.9%	(4.2)pp

Revenue for the Individual segment increased $11.6 million in 2004 compared with 2003. The main contributors to revenue growth were revenue relating to the Global Analyst Research Settlement and Morningstar.com, partially offset by lower revenue from some of our more mature products such as Reprints, Morningstar Mutual Funds, and Morningstar FundInvestor. Subscriptions for Morningstar.com Premium service increased to 131,035 as of December 31, 2004, compared with 114,140 as of December 31, 2003.

Operating income for the Individual segment increased $0.4 million, or 5.9%, in 2004 compared with 2003. The revenue increase of $11.6 million exceeded the increase in operating expense of $11.2 million. Expense related to the expansion of our stock research capabilities, including the hiring of additional stock analysts, preceded revenue from the services we are providing under the Global Analyst Research Settlement. Cost of goods sold accounted for most of the expense increase and was driven by higher compensation costs, including special incentive compensation for our analyst team. Sales and marketing expense increased primarily as a result of marketing efforts for Morningstar.com Premium service. General and administrative expense increased due to higher corporate overhead. Depreciation and amortization expense increased slightly, reflecting refurbishment costs and network equipment additions.

Advisor Segment

($000)	2004	2003	Change
Revenue	$ 60,880	$ 49,161	23.8%
Operating income	$ 13,966	$ 9,521	46.7%
Operating margin (%)	22.9%	19.4%	3.5pp

Advisor Workstation and Morningstar Managed Portfolios made the largest contribution to the Advisor segment's revenue growth of $11.7 million in 2004. Principia revenue was relatively unchanged compared with 2003. The increase in Advisor Workstation revenue is mainly from sales of the Enterprise Edition. The number of licenses and subscriptions for Advisor Workstation and Principia combined increased to 131,543 as of December 31, 2004, compared with 88,300 as of December 31, 2003. The increase in revenue for Morningstar Managed Portfolios was driven by an increase in the amount of assets under management compared with 2003.

Operating income increased $4.5 million to $14.0 million in 2004, compared with $9.5 million in 2003. The $11.7 million increase in revenue was partially offset by approximately a $7.2 million increase in operating expense. Cost of goods sold increased primarily as a result of higher compensation-related expense, including higher incentive compensation expense associated with favorable segment performance. Development expense increased primarily due to higher incentive compensation expense. Sales and marketing expense increased primarily due to higher sales commissions expense for products such as Advisor Workstation. General and administrative expense increased primarily because of higher corporate overhead.

Institutional Segment

($000)	2004	2003	Change
Revenue	$ 78,402	$ 59,745	31.2%
Operating income	$ 13,667	$ 4,160	228.5%
Operating margin (%)	17.4%	7.0%	10.4pp

Revenue increased $18.7 million in 2004 compared with 2003, driven primarily by Investment Consulting, Licensed Data, Morningstar Direct, Licensed Tools and Content, and Morningstar Retirement Manager. The number of licenses and subscriptions for Morningstar Direct increased to 775 as of December 31, 2004, compared with 601 as of December 31, 2003. In 2004, we recognized a full year of revenue from the acquisition of mPower, compared with six months in 2003. We acquired mPower in July 2003.

Operating income increased $9.5 million in 2004 compared with 2003. The increase was primarily due to revenue growth of $18.7 million. Operating expense increased approximately $9.2 million, or 16.5%, primarily reflecting increases in cost of goods sold, sales and marketing expense, and general and administrative expense. The increase in these categories was mainly driven by compensation-related expense, including incentive compensation and sales commissions, increased operating expense in our international operations, primarily in Europe, and our acquisition of mPower.

Corporate and Eliminations

Corporate items and eliminations include stock-based compensation expense, capitalized internal product development costs and related amortization, and amortization related to intangible assets. The following table shows the components of corporate and eliminations expense (income) that impacted our consolidated operating income:

($000)	2004	2003	Change
Stock-based compensation expense	$ 16,723	$ 29,029	(42.4)%
Capitalized internal product development costs	(2,802)	(3,662)	(23.5)%
Depreciation and amortization	3,342	2,250	48.5%
Sales tax expense	—	3,079	(100.0)%
Other	460	1,130	(59.3)%
Corporate items and eliminations	$ 17,723	$ 31,826	(44.3)%

2004 vs. 2003

In 2004, corporate items and eliminations decreased $14.1 million reflecting a decline of $12.3 million in stock-based compensation expense. In addition, in 2003, we participated in voluntary disclosure or similar programs related to state sales tax. Through these programs we identified sales tax amounts due for prior years and have negotiated or are in discussions with local tax authorities to settle these amounts. We estimated our total liability for these taxes to be approximately $9.0 million, of which $5.9 million was recorded in years prior to 2003, and $3.1 million was recorded in 2003.

Non-Operating Income and Income Tax Expense

Non-Operating Income

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

($000)	2005	2004	2003
Gain on sale of investment in unconsolidated entity	$ —	$ 19	$ 510
Interest income, net	3,078	1,211	279
Other income, net	121	575	321
Non-operating income	$ 3,199	$ 1,805	$ 1,110

Net interest income primarily reflects interest from our investment portfolio. Net interest income increased $1.9 million and $0.9 million during 2005 and 2004, respectively, because of increases in cash, cash equivalents, and investments, as well as higher returns on invested cash balances. During 2006, we expect interest income to decline because our cash and investment balances declined to fund the March 2006 purchase of Ibbotson Associates.

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

In March 2000, we entered into a stock purchase agreement with Techfi Corporation (Techfi), a provider of portfolio management and accounting software, training, and support to investment advisors and financial planners. On June 7, 2002, Techfi Corporation and Advent Software, Inc. entered into an Agreement and Plan of Merger, whereby all of the issued and outstanding shares of Techfi common stock and vested options were converted into the right to receive cash. Our share of the total proceeds was $4.8 million, resulting in a gain of $3.4 million in 2002. In 2004 and 2003, less than $0.1 million and $0.5 million, respectively, were released from escrow and recorded as additional gains. The gains recorded in 2004 and 2003 are included as "Gain on sale of investment in unconsolidated entity." There were no gains recorded in 2005.

Income Tax Expense

The following table summarizes the components of our effective income tax expense rate:

($000)	2005	2004	2003
Income (loss) before income taxes and equity in net income of unconsolidated entities	$ 49,679	$ 19,540	$ (9,644)
Equity in net income of unconsolidated entities	1,662	843	697
Total	$ 51,341	$ 20,383	$ (8,947)
Income tax expense	$ 20,224	$ 11,574	$ 2,950
Effective income tax expense rate	39.4%	56.8%	33.0%

For a reconciliation of the U.S. federal tax rate to our effective tax rate, refer to Note 16 in the Notes to our Consolidated Financial Statements. Our effective income tax rate is influenced by three primary factors: incentive stock options; the reported income or loss of our non-U.S. entities and our evaluation of the realizability of our net operating losses; and the impact of specific tax planning strategies.

In 2005, our effective income tax expense rate decreased compared with prior years, primarily due to a reduction in the tax impact related to incentive stock options. For incentive stock options, we record stock-based compensation expense but we do not record a corresponding tax benefit. This has the impact of increasing our effective income tax rate above the U.S. Federal rate of 35%. The amount of incentive stock option expense recorded in 2005 was lower than the amounts recorded in 2004 and 2003, reflecting the fact that, subsequent to our initial public offering, incentive stock options are no longer accounted for under the liability method, and because they are fully vested, no stock-based compensation expense was recorded for these options during the last nine months of the 2005. Our 2005 effective tax rate also reflects an increase in the number of disqualifying dispositions related to 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.

Our effective income tax expense rate also reflects the fact that we are not recording an income tax benefit related to losses recorded by certain of our non-U.S. operations. The foreign net operating losses may become deductible in certain international tax jurisdictions to the extent these international operations become profitable. In the year the non-U.S. entity records a loss, we do not record a corresponding tax benefit, thus increasing our effective tax rate. For each of our entities, 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. In 2004, based on the evidence related to one of our non-U.S. entities, we concluded it was more likely than not that we would be able to use the accumulated net operating losses. We therefore reduced the valuation reserve and recorded a tax benefit of $0.6 million in 2004.

In the second quarter of 2005, we recorded a deferred income tax benefit of $0.7 million related to research and development expenses due to a change in U.S. income tax regulations, which resulted in a one-time reduction of our effective income tax expense rate. In the fourth quarter of 2005, we formalized cost-sharing agreements among our operations to more accurately reflect the economic sharing arrangements that benefit our subsidiaries. This also had the effect of lowering our taxes in certain jurisdictions.

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 December 31, 2005, we had cash and cash equivalents of $92.4 million, an increase of $56.5 million compared with December 31, 2004. The increase primarily reflects $48.4 million in cash provided by operating activities and $25.3 million in cash provided by financing activities, partially offset by $16.9 million in cash used for investing activities. In addition to the $92.4 million of cash and cash equivalents as of December 31, 2005, we had $60.8 million of investments, consisting primarily of fixed-income securities, an increase of $1.2 million from December 31, 2004. In February 2006, we paid $22.4 million of annual bonuses to our employees, and in March 2006, we acquired Ibbotson Associates for approximately $83 million in cash, subject to adjustments for working capital and certain other items.

In March 2005, the SEC issued guidance concerning the financial statement presentation of auction-rate securities. Auction-rate securities are long-term variable rate bonds tied to short-term interest rates that are reset through an auction process that occurs approximately every seven to 35 days. Holders of auction-rate securities may liquidate their holdings to prospective buyers by participating in the auctions. Because of their long-term maturity dates and because there is no guarantee that holders of auction-rate securities will be able to liquidate their holdings through the auction process, the SEC stated that auction-rate securities do not qualify as cash equivalents. Accordingly, in 2005, we reclassified our investments in auction-rate securities from cash and cash equivalents to investments in our Consolidated Balance Sheets. The amount of auction-rate securities reclassified from cash and cash equivalents to investments as of December 31, 2004, December 31, 2003, and December 31, 2002 was $23.6 million, $21.7 million, and $12.5 million, respectively. We also made related adjustments to the Consolidated Statements of Cash Flows to reflect the gross purchases and sales of these securities as investing activities. The change in classification had no effect on the amount of total current assets, total assets, net income, income per share, or cash flow from operations as previously reported.

Cash Provided by Operating Activities

Our main source of capital is cash generated from operating activities. In 2005, cash provided by operating activities increased approximately $15.6 million, or 47.4%, to $48.4 million compared with $32.9 million in 2004. The increase in operating cash flows during 2005 primarily reflects an increase in net income and a decrease in net operating assets and liabilities, excluding income tax and bonus payments. In 2005, we made income tax payments of $19.5 million. In 2004, we made only $6.6 million of income tax payments because of the U.S. net operating loss carryforwards available from prior years. In 2005 and 2004, we paid bonuses of approximately $18.0 million and $12.3 million, respectively. The higher bonuses paid in 2005 were the result of strong 2004 operating performance and the last installment of a special bonus paid to our analyst team in connection with the ramp-up of our independent equity research business. Excluding the impact of income tax and bonus payments, our net operating assets and liabilities decreased primarily because of increases in accounts payable and accrued liabilities, accrued bonuses related to the current year's performance, and accrued income taxes. The increase in accounts receivable, resulting primarily from higher client billings, was partially offset by the related increase in deferred revenue.

In 2004, cash provided by operating activities increased $3.2 million, or 10.6%, to $32.9 million compared with $29.7 million in 2003. The increase in cash provided by operations reflects an improvement in our net income adjusted for non-cash items, partially offset by an increase in working capital. The change in working capital primarily reflects a $10.9 million increase in receivables from clients as a result of increased billings, offset by a $7.0 million increase in deferred revenue and a $3.8 million increase in income tax payable.

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 Consolidated Balance Sheets. As of December 31, 2005 and December 31, 2004, our deferred revenue was $71.2 million and $63.4 million, respectively.

In 2003, we began participating in voluntary disclosure or similar programs related to state sales tax. We estimated our total liability for these taxes to be approximately $9.0 million. Beginning in 2003 through the end of 2005, we made total cash payments of $6.7 million in conjunction with these voluntary disclosure programs. Additionally, we decreased our liability by $0.3 million in 2005 due to changes in the estimated liabilities. The remaining $2.0 million expected to be due in connection with these voluntary disclosure programs is recorded as an accrued liability in our Consolidated Balance Sheet as of December 31, 2005. We anticipate that the majority of this amount will be paid in 2006.

In February 2006, we paid annual cash bonuses of $22.4 million related to prior years' performance. These payments will reduce our cash provided by operating activities during the first quarter of 2006.

Cash Used for Investing Activities

Cash used for investing activities consists primarily of purchases of investments, net of proceeds from the sale of investments; capital expenditures; and cash used for acquisitions. In 2005, cash used for investing activities decreased $5.9 million from 2004 primarily reflecting a decrease in purchases of investments, net of proceeds from the sale of investments. This decrease in cash used was partially offset by cash outflows related to the January 2005 acquisition of VARDS. In 2004, cash used for investing activities decreased $6.8 million from 2003, primarily reflecting lower levels of cash used for acquisitions and cash used for capital expenditures, partially offset by an increase in cash transferred to our investment portfolio.

Purchases of investments, net of proceeds from the sale of investments, were $1.3 million, $14.9 million, and $10.8 million in 2005, 2004, and 2003, respectively. As of December 31, 2005 and 2004, we had investments, consisting primarily of fixed-income securities, of $60.8 million and $59.6 million, respectively. As of December 31, 2005, our investments represented approximately 40% of our total cash, cash equivalents, and investments compared with approximately 62% as of December 31, 2004. The change in mix from investments to cash and cash equivalents reflected the need for cash to fund our acquisition of Ibbotson Associates and annual bonus payments in the first quarter of 2006.

Capital expenditures were $7.5 million, $7.7 million, and $8.6 million in 2005, 2004, and 2003, respectively. Capital expenditures are primarily for leasehold improvements, computer hardware, and capitalized internal product development costs. In 2006, we expect that our capital expenditures will be approximately $5.3 million. This amount is less than the capital expenditures made in 2005 because in 2005 we substantially completed the capital spending for new office space in London, as well as additional buildouts for our development center in China.

Cash used for acquisitions was $8.2 million in 2005, related to our January 2005 acquisition of VARDS. In 2004, cash used for acquisitions was $0.2 million, related to our February 2004 purchase of the remaining 51% of Morningstar Norge AS (Morningstar Norway) that we did not previously own. In 2003, cash used for acquisitions, net of cash acquired, was $10.8 million, related to our acquisitions of Morningstar Research Inc. (Morningstar Canada) and mPower.

Cash Provided by (Used for) Financing Activities

In 2005, cash provided by financing activities increased $31.7 million, reflecting net proceeds of $18.1 million from our initial public offering in May 2005. These proceeds resulted from the underwriters' exercise of their 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. We also received proceeds of $7.2 million from stock option exercises in 2005, compared with only $0.2 million in 2004. Stock option exercises increased in 2005 following our initial public offering.

In March 2004, we repaid a $6.5 million promissory note payable to Joe Mansueto, our chairman, chief executive officer, and controlling shareholder. The obligation and related interest were paid in full. See Note 13 of the Notes to our Consolidated Financial Statements.

Under the 1993 Morningstar Stock Option Plan, subject to certain conditions, holders of vested options were permitted, prior to completion of our initial public offering, to exercise their options and immediately resell to us the shares of common stock obtained from the exercise at a price equal to the fair value of the shares, as determined by our board of directors. We have the right to pay this balance in equal installments over a period of five years, with the deferred balance accruing interest at a floating rate based on the U.S. Treasury bill. As of December 31, 2005, we had less than $0.1 million of deferred obligations relating to such repurchases, which are included in Other Liabilities in our Consolidated Balance Sheets. We expect to satisfy these obligations in the first quarter of 2006.

Acquisitions

Variable Annuity Research and Data Service (VARDS)

In January 2005, we acquired the VARDS unit from Finetre Corporation for $8.2 million in cash. VARDS provides research and data on variable annuities and is used by many firms that offer variable annuities. The service is also used by many brokerage firms for research, due diligence, and suitability determination. We believe this acquisition strengthens our investment database and will enhance our efforts to provide investors with the information they need to make well-informed decisions when investing in variable annuities. The acquisition contributed approximately $2.4 million of revenue in 2005.

Morningstar Norway

In February 2004, we purchased the remaining 51% of Morningstar Norway that we did not previously own. The purchase price consisted of $0.2 million in cash and approximately $0.1 million of other consideration. Prior to this transaction, we accounted for our investment in Morningstar Norway using the equity method.

mPower

In July 2003, we acquired all of the outstanding stock of mPower for $4.9 million. mPower contributed $2.1 million to our revenue in 2003. This transaction is accounted for as a "bargain purchase" because the purchase price was less than the total fair value of the assets acquired. Therefore, certain long-term assets were assigned values that were lower than their fair value at the date of acquisition.

Morningstar Canada

In January 2003, we purchased the remaining half of Morningstar Canada that we did not previously own for $6.3 million. We have always consolidated the results of Morningstar Canada for all periods presented in the financial statements because we have always controlled its day-to-day operations.

Initial Public Offering

In May 2005, we completed our initial public offering of 7,612,500 shares of our common stock. These shares commenced trading on May 3, 2005 on the Nasdaq National Market under the symbol "MORN." All of these shares were sold by affiliates of SOFTBANK Finance Corporation, a wholly owned subsidiary of SOFTBANK Corp. We did not receive any proceeds from the sale of these shares.

We granted the underwriters the right to purchase up to an additional 1,141,875 shares at the initial public offering price to cover over-allotments. In May 2005, the underwriters exercised their over-allotment option in full. The net proceeds to us from the exercise of the underwriters' over-allotment option were $18.1 million, based on our initial public offering price of $18.50 per share, after deducting the underwriting discounts and commissions and $2.6 million of offering expenses.

Reclassification of Stock Options Accounted for as Liabilities to Additional Paid-in Capital

As a result of our initial public offering in May 2005, we are no longer required to settle any options in cash. As a result, current liabilities of $16.7 million and long-term liabilities of $24.9 million associated with these options were reclassified to additional paid-in capital in the second quarter of 2005.

Subsequent Event

On March 1, 2006, we acquired Ibbotson Associates, a privately held firm that specializes in asset allocation research and services for approximately $83 million in cash, subject to adjustments for working capital and other items. 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. Related to this acquisition, we anticipate realizing approximately $10 million in cash tax benefits in 2006 related to payment for the cancellation of Ibbotson's stock options.

Application of Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based on our Consolidated Financial Statements, which have been prepared in accordance with U.S. GAAP. Our significant accounting policies are discussed in Note 2 of the Notes to our Consolidated Financial Statements. The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expense, and related disclosures included in our Consolidated Financial Statements.

We evaluate our estimates on an ongoing basis. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. The results of these assumptions are the basis for judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could vary from the estimates and assumptions used in the preparation of our Consolidated Financial Statements. If actual amounts are ultimately different from previous estimates, the revisions are included in our results of operations for the period in which the actual amounts become known.

We believe the following critical accounting policies reflect the significant judgments and estimates used in the preparation of our Consolidated Financial Statements:

Revenue Recognition

Much of our revenue comes from the sale of subscriptions or licenses for print publications, software, and Internet-based products and services. We recognize this revenue in equal amounts over the term of the subscription or license, which generally ranges from one to three years. We also provide analysis, consulting, retirement advice, and other services. We recognize this revenue when the service is provided or during the service obligation period defined in the contract. Deferred revenue is the amount invoiced or collected in advance for subscriptions, licenses, or services that has not yet been recognized as revenue. At December 31, 2005 our deferred revenue was $71.2 million. We expect to recognize this deferred revenue in future periods as we fulfill our service obligations. The amount of deferred revenue may increase or decrease primarily based on the mix of contracted products and services and the volume of new and renewal subscriptions. The timing of future revenue recognition may change depending on the terms of the license agreements and timing of fulfilling of our service obligations. We believe that the estimate related to revenue recognition is a critical accounting estimate, and to the extent that there are material differences between our determination of deferred revenue and actual results, our financial condition or results of operations may be affected.

Purchase Price Allocation
Over the past several years, we have acquired companies that complement our business operations. In 2005, we acquired VARDS for $8.2 million in cash. In 2004, we acquired the remaining 51% of Morningstar Norway that we did not previously own for $0.2 million in cash and $0.1 million in other consideration. In 2003, we acquired mPower for $4.9 million in cash and the remaining 50% of Morningstar Canada that we did not previously own for $6.3 million. For each of these acquisitions, the purchase price was allocated to the assets acquired, liabilities assumed, and goodwill, in accordance with SFAS No. 141, *Business Combinations*. We recognized the assets and liabilities acquired related to these acquisitions at their estimated fair values including $8.4 million of value assigned to intangible assets such as customer lists, intellectual property, supplier lists, and technology. For these intangible assets, the estimated useful lives range from 3 to 20 years. We also recorded $11.8 million in goodwill related to these acquisitions.

Management judgment is required in allocating the purchase price to the acquired assets and liabilities. We use judgment to:

- *identify the acquired assets,*
- *estimate the fair value of these assets,*
- *estimate the useful life of the assets; and*
- *assess the appropriate method for recognizing depreciation or amortization expense over the asset's useful life.*

We believe that the accounting estimates related to purchase price allocations are critical accounting estimates because the assumptions impact the amounts and classifications of assets and liabilities presented in our Consolidated Balance Sheets, the amount of amortization and depreciation expense, if any, recorded in our Consolidated Statements of Operations, and the impairment testing performed in subsequent periods.

Goodwill
Goodwill recorded on our Consolidated Balance Sheets was $17.5 million as of December 31, 2005. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, we do not amortize goodwill. Instead, it is subject to at least an annual test for impairment, or whenever indicators of impairment exist, based on a discounted cash flow model. An impairment would occur if the carrying amount of a reporting unit, including goodwill, exceeded the fair value of that reporting unit.

The process of evaluating the potential impairment of goodwill is subjective and requires significant judgment. In estimating the fair value of the reporting units, we make estimates and judgments about the future cash flows of the reporting unit. These estimates include assumptions about future market growth and trends, forecasted revenue and costs, capital investments, appropriate discount rates, and other variables that can significantly affect the value of the reporting unit.

Although our cash flow forecasts are based on assumptions that are consistent with plans and estimates we use to manage the underlying business, there is significant judgment in determining the cash flows attributable to these businesses over a long-term horizon. We update these assumptions and cash flow estimates annually, at a minimum.

We believe that the accounting estimate related to goodwill impairment is a critical accounting estimate because the assumptions used are highly susceptible to changes in the operating results and cash flows of the reporting units included in our segments. If actual results differ from our estimates, future tests may indicate an impairment of goodwill. This would result in a non-cash charge, adversely affecting our results of operations.

Impairment of Long-Lived Assets
Our Consolidated Balance Sheet includes property, equipment, and capitalized software of $17.4 million and $7.3 million of intangible assets at December 31, 2005. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we review our property, equipment, capitalized software, and intangible assets for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Such events or changes may include a deterioration in the business climate for a specific product or service. If the total of projected future undiscounted cash flows is less than the

carrying amount of an asset, we may need to record an impairment loss based on the excess of the carrying amount over the fair value of the assets.

Estimates of future cash flows and the estimated useful lives associated with these assets are critical to the assessment of recoverability and fair values. They are susceptible to change from period to period due to the requirement to make assumptions about future cash flows generated over extended periods of time. Changes in these estimates could result in a determination of asset impairment, which would result in a reduction to the carrying value and could adversely affect our operating results in the related period.

Stock-Based Compensation

We account for stock option grants made to employees and non-employee directors in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation*. Following our initial public offering in May 2005, we use the equity method to account for all outstanding stock options. In 2005, stock-based compensation expense recorded under the equity method was $8.1 million, representing 4.5% of our 2005 operating expense. We calculate this expense based on the fair value of the option at the time of the grant. We determine the fair value using a Black-Scholes option pricing model.

Determining the fair value of our options requires that we make several estimates, including the volatility of our stock price, the expected life of the option, and the expected strike price at the time of exercise. As a new public company, we estimate stock-price volatility with reference to a peer group of companies. Determining the companies to include in this peer group involves judgment. Our current estimate of volatility used in the Black-Scholes model is 50%. In making our estimates, we have used historical data as well as management judgment to arrive at the data inputs. A 1% change in the Black-Scholes value would have resulted in a corresponding change of approximately $0.1 million in stock-based compensation expense in 2005 for options accounted for using the equity method.

We believe that the estimates related to stock-based compensation expense are critical accounting estimates because the assumptions used could significantly impact the amount of stock-based compensation expense recorded in our Consolidated Statement of Operations.

Income Taxes

Our annual effective income tax expense rate is based on the mix of income and losses in our U.S. and non-U.S. entities which are part of our Consolidated Financial Statements, statutory tax rates, and tax planning opportunities available to us in the various jurisdictions in which we operate. Significant judgment is required in evaluating our tax positions.

Tax law requires items to be included in the tax return at different times than when these items are reflected in our Consolidated Financial Statements. As a result, the effective tax rate reflected in our consolidated financial statements is different from the tax rate reported on our tax return (our cash tax rate). Some of these differences are permanent, such as expenses that are not deductible in our tax return, and some differences reverse over time, such as depreciation expense. These timing differences create deferred tax assets and liabilities. Deferred tax assets and liabilities are determined based on temporary differences between the financial reporting and the tax basis of assets and liabilities.

As of December 31, 2005, we had $0.8 million of net current deferred tax liabilities and $29.7 million of net long-term deferred tax assets. In addition, we have net operating loss (NOL) carryforwards of $26.3 million related to our non-U.S. operations. Of these NOLs, $6.5 million will begin to expire in 2008 through 2020 and $19.8 million have no expiration. Due to the historical operating losses of certain of the non-U.S. operations that generated these NOLs, we have recorded a valuation allowance against all but $0.4 million of the NOLs, reflecting the likelihood that the benefit of the NOLs will not be realized. In assessing the realizability of our deferred tax assets and NOLs, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. In assessing the need for a valuation allowance, we consider both positive and negative evidence, including tax-planning strategies, projected future taxable income, and recent financial performance. If after future assessments of the realizability of the deferred tax assets we determine a lesser allowance is required, we would record a reduction to the income tax expense and to the valuation allowance in the period this determination was made. This would cause our income tax expense, effective tax rate, and net income to fluctuate.

In addition, we establish reserves at the time that we determine that it is more likely than not that we will need to pay additional taxes related to certain matters. We adjust these reserves, including any impact of the related interest and penalties, in light of changing facts and circumstances such as the progress of a tax audit. A number of years may elapse before a particular matter for which we have established a reserve is audited and finally resolved. The number of years with open tax audits varies depending on the tax jurisdiction. While it is often difficult to predict the final outcome or the timing of resolution of any particular tax matter, we record a reserve when we determine the likelihood of loss is more likely than not. Such liabilities are recorded as income taxes payable in our Consolidated Balance Sheets. Settlement of any particular issue would usually require the use of cash. Favorable resolutions of tax matters for which we have previously established reserves are recognized as a reduction to our income tax expense when the amounts involved become known.

Assessing the future tax consequences of events that have been recognized in our financial statements or tax returns requires judgment. Variations in the actual outcome of these future tax consequences could materially impact our financial position, results of operations, or cash flows.

Contingencies

We are subject to various claims and contingencies related to legal proceedings and investigations. Refer to Note 17 of the Notes to our Consolidated Financial Statements. Due to their nature, such legal proceedings involve inherent uncertainties including, but not limited, to court rulings, negotiations between affected parties, and government actions. Judgment is required as we assess the probability of loss for such contingencies and either accrue a liability or disclose the relevant circumstances, as appropriate. If actual results differ from our assessments, our financial position, results of operations, or cash flows would be impacted.

Recently Issued Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123 (R)), which requires all companies to measure compensation cost for all share-based payments (including employee stock options) at fair value. In April 2005, the SEC announced the adoption of a rule that defers the required effective date of SFAS No. 123 (R) until the beginning of the first fiscal year beginning after June 15, 2005, instead of at the beginning of the first quarter after June 15, 2005 (as prescribed originally by SFAS 123 (R)). Therefore, we will adopt the provisions of SFAS No. 123 (R) in the first quarter of 2006; we will adopt SFAS 123 (R) prospectively.

We currently measure and record compensation expense related to stock option grants in accordance with the provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*. We use a Black-Scholes model to estimate the fair value of stock options granted to employees and expect to continue to use this acceptable option valuation model upon the adoption of SFAS No. 123 (R). We currently account for forfeitures of stock options as they occur. SFAS 123 (R) eliminates this alternative and 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 will record a cumulative effect of accounting change, net of tax, of approximately $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. Other than this cumulative effect of accounting change, we do not anticipate that adoption of SFAS 123 (R) will have a material impact on our Consolidated Statements of Operations or our Consolidated Balance Sheets. Concerning our Consolidated Statements of Cash Flows, SFAS 123 (R) requires that the benefits of tax deductions in excess of recognized compensation expense be reported as a financing cash flow, rather than as an operating cash flow. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. While we cannot estimate what those amounts will be in the future because they depend on employee stock option exercises and other factors, the amount of operating cash flows recognized in 2005 for such excess tax deductions was $2.5 million.

In March 2005, the FASB issued FASB Interpretation (FIN) No. 47, *Accounting for Conditional Asset Retirement Obligations, an Interpretation of FASB Statement No. 143*. A conditional asset retirement obligation refers to a legal obligation to retire assets where the timing and/or method of settlement are conditioned on future events. FIN No. 47 requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. FIN No. 47 is effective for companies no later than the end of the first fiscal year ending after December 15, 2005. The adoption of FIN No. 47 did not have a material impact on our results of operations, financial position, or cash flows.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections—replacement of APB Opinion No. 20 and FASB Statement No. 3 (SFAS No. 154)*. SFAS No. 154 changes the accounting for and reporting of a change in accounting principle by requiring retrospective application to prior periods' financial statements of changes in accounting principle unless impracticable. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Companies are permitted to adopt the standard earlier than the required date for accounting changes and corrections of errors made in fiscal years beginning after the date that SFAS No. 154 was issued. We do not expect the adoption of SFAS No. 154 to have a material impact on our results of operations, financial position, or cash flows.

Contractual Obligations

The table below presents our known contractual obligations as of December 31, 2005 and the expected timing of cash payments related to these contractual obligations.

In addition, we have an obligation to pay up to approximately $2.3 million under a deferred compensation agreement with an executive officer, discussed in Note 13 of the Notes to our Consolidated Financial Statements. As of December 31, 2005, $2.1 million is classified as current and $0.2 million is classified as long-term. We are required to make these payments as the officer exercises certain stock options granted to him under the 1999 Stock Option Plan. Because the timing of these payments is uncertain, we have not included this obligation in the table below.

There are no purchase commitments as of December 31, 2005 that we believe would have a significant impact on our Consolidated Balance Sheet or Consolidated Statement of Cash Flows.

Contractual Obligations

($000)	2006	2007	2008	2009	2010	Thereafter	Total
Minimum commitments on non-cancelable operating lease obligations[1]	$ 2,511	$ 1,978	$ 3,019	$ 4,314	$ 4,806	$ 68,144	$ 84,772
Asset retirement obligation[2]	—	—	98	—	—	—	98
Obligations related to stock options[3]	45	—	—	—	—	—	45
Total	$ 2,556	$ 1,978	$ 3,117	$ 4,314	$ 4,806	$ 68,144	$ 84,915

(1) The non-cancelable lease obligations relate primarily to lease commitments on office space. In December 2005, we signed an agreement with the Mills Corporation to lease approximately 210,000 square feet of new office space for our corporate headquarters in Chicago, Illinois. The lease begins in March 2008 and has a term of 15 years. The minimum future lease payments are included in the table presented above.

(2) The asset retirement obligation relates to costs that will be incurred to return office space modified by leasehold improvements to its original condition in accordance with the lease agreement.

(3) These obligations relate to stock option exercises. See Note 13 of the Notes to our Consolidated Financial Statements.

Selected Quarterly Financial Data

				2004				2005
(in thousands except per share amounts)	Q1	Q2	Q3	Q4	**Q1**	**Q2**	**Q3**	**Q4**
Revenue	$ 41,127	$ 43,244	$ 46,573	$ 48,714	**$ 53,204**	**$ 56,243**	**$ 56,927**	**$ 60,740**
Operating expense[1]:								
Cost of goods sold	12,266	14,908	13,858	13,677	**15,912**	**15,674**	**16,261**	**16,561**
Development	3,361	3,664	4,057	5,085	**5,149**	**4,593**	**4,749**	**5,163**
Sales and marketing	8,365	8,284	9,367	10,018	**9,785**	**9,845**	**9,499**	**9,942**
General and administrative	8,688	11,176	10,930	15,994	**13,084**	**11,135**	**11,849**	**13,167**
Depreciation and amortization	1,811	1,788	1,755	2,871	**2,396**	**1,852**	**2,222**	**1,796**
Total operating expense	34,491	39,820	39,967	47,645	**46,326**	**43,099**	**44,580**	**46,629**
Operating income	6,636	3,424	6,606	1,069	**6,878**	**13,144**	**12,347**	**14,111**
Non-operating income (expense):								
Gain on sale of investment in unconsolidated entity	—	—	—	19	**—**	**—**	**—**	**—**
Interest income, net	224	210	260	517	**449**	**605**	**892**	**1,132**
Other income (expense), net	38	58	250	229	**260**	**(200)**	**(46)**	**107**
Non-operating income, net	262	268	510	765	**709**	**405**	**846**	**1,239**
Income before income taxes and equity in net income of unconsolidated entities	6,898	3,692	7,116	1,834	**7,587**	**13,549**	**13,193**	**15,350**
Income tax expense	2,674	2,440	3,235	3,225	**4,060**	**4,600**	**5,857**	**5,707**
Equity in net income of unconsolidated entities	282	97	212	252	**480**	**549**	**183**	**450**
Net income (loss)	$ 4,506	$ 1,349	$ 4,093	$ (1,139)	**$ 4,007**	**$ 9,498**	**$ 7,519**	**$ 10,093**
Basic income (loss) per share	$ 0.12	$ 0.04	$ 0.11	$ (0.03)	**$ 0.10**	**$ 0.24**	**$ 0.19**	**$ 0.25**
Weighted average common shares outstanding —basic	38,395	38,397	38,438	38,442	**38,448**	**39,064**	**39,922**	**40,109**
Diluted income (loss) per share	$ 0.09	$ 0.03	$ 0.10	$ (0.03)	**$ 0.09**	**$ 0.22**	**$ 0.17**	**$ 0.22**
Weighted average common shares outstanding —diluted	41,546	41,528	41,819	38,442	**42,944**	**43,742**	**45,354**	**45,730**

(1) Includes stock-based compensation expense of:

Cost of goods sold	$ 258	$ 526	$ 336	$ 1,023	**$ 664**	**$ 264**	**$ 274**	**$ 271**
Development	147	267	157	449	**275**	**105**	**112**	**111**
Sales and marketing	156	306	180	542	**325**	**128**	**129**	**128**
General and administrative	1,522	3,017	1,897	5,940	**3,623**	**1,441**	**1,515**	**1,530**
Total stock-based compensation expense	$ 2,083	$ 4,116	$ 2,570	$ 7,954	**$ 4,887**	**$ 1,938**	**$ 2,030**	**$ 2,040**
Stock-based compensation expense (income) under the liability method	$ (424)	$ 2,381	$ 1,142	$ 5,864	**$ 2,810**	**$ —**	**$ —**	**$ —**
Stock-based compensation expense under the equity method	2,507	1,735	1,428	2,090	**2,077**	**1,938**	**2,030**	**2,040**
Total stock-based compensation expense	$ 2,083	$ 4,116	$ 2,570	$ 7,954	**$ 4,887**	**$ 1,938**	**$ 2,030**	**$ 2,040**

Quantitative and Qualitative Disclosures about Market Risk

We may be subject to risk from fluctuating interest rates. Our investment portfolio is actively managed and may suffer losses due to fluctuating interest rates, market prices, or adverse security selection. At December 31, 2005, we held $60.8 million of investments, consisting primarily of fixed-income securities. 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 $0.3 million.

As our non-U.S. revenue increases, fluctuation in foreign currencies is an increasing 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.

Information on Change in Independent Registered Public Accounting Firm

During 2005 the Audit Committee of our Board of Directors solicited proposals from several audit firms to serve as our independent registered public accounting firm. The Audit Committee conducted this review in keeping with its responsibilities to evaluate and select our audit firm and because it believes that it should conduct periodic reviews as a matter of good corporate governance. On November 23, 2005, the Audit Committee decided to engage Ernst & Young as our independent registered public accounting firm beginning with the audit for the fiscal year ended December 31, 2006.

Deloitte & Touche LLP (Deloitte) was engaged to audit our consolidated financial statements for the fiscal year ended December 31, 2005 and was dismissed as our independent registered public accounting firm upon completion of these services when we filed our Annual Report on Form 10-K for 2005. During our fiscal years ended December 31, 2005 and 2004 and through the date we filed our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, we had no disagreements with Deloitte on any matter of accounting principle or practice, financial statement disclosure, or auditing scope or procedure which, if not resolved to Deloitte's satisfaction, would have caused it to make reference to the matter in conjunction with its report on our consolidated financial statements for the relevant year; and there were no reportable events as defined in Item 304(a)(1)(v) of SEC Regulation S-K.

Deloitte's audit reports on our consolidated financial statements for the fiscal years ended December 31, 2005 and 2004 did not contain an adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope, or accounting principles.

During our fiscal years ended December 31, 2005 and 2004 and through the date we filed our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, neither we, nor anyone on our behalf, consulted with Ernst & Young with respect to either (i) the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on our consolidated financial statements, and no written report or oral advice was provided by Ernst & Young to us that Ernst & Young concluded was an important factor considered by us in reaching a decision as to the accounting, auditing, or financial reporting issue or (ii) any matter that was the subject of either a disagreement (as defined in Item 304(a)(1)(iv) of SEC Regulation S-K) or a reportable event (as described in Item 304(a)(1)(v) of SEC Regulation S-K).

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Morningstar, Inc.
Chicago, Illinois

We have audited the accompanying consolidated balance sheets of Morningstar, Inc. and subsidiaries (the Company) as of December 31, 2005 and 2004, and the related consolidated statements of operations, shareholders' equity and comprehensive income (loss), and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP
Chicago, Illinois, March 3, 2006

Consolidated Statements of Operations

Year ended December 31 (in thousands except per share amounts)	**2005**	2004	2003
Revenue	**$ 227,114**	$ 179,658	$ 139,496
Operating expenses[1]:			
Cost of goods sold	**64,408**	54,709	43,521
Development	**19,654**	16,167	14,663
Sales and marketing	**39,071**	36,034	30,798
General and administrative	**49,235**	46,788	54,145
Depreciation and amortization	**8,266**	8,225	7,123
Total operating expense	**180,634**	161,923	150,250
Operating income (loss)	**46,480**	17,735	(10,754)
Non-operating income:			
Gain on sale of investment in unconsolidated entity	**—**	19	510
Interest income, net	**3,078**	1,211	279
Other income, net	**121**	575	321
Non-operating income, net	**3,199**	1,805	1,110
Income (loss) before income taxes and equity in net income of unconsolidated entities	**49,679**	19,540	(9,644)
Income tax expense	**20,224**	11,574	2,950
Equity in net income of unconsolidated entities	**1,662**	843	697
Net income (loss)	**$ 31,117**	$ 8,809	$ (11,897)
Basic income (loss) per share	**$ 0.79**	$ 0.23	$ (0.31)
Diluted income (loss) per share	**$ 0.70**	$ 0.21	$ (0.31)
Weighted average shares outstanding:			
Basic	**39,392**	38,418	38,382
Diluted	**44,459**	41,858	38,382

(1) Includes stock-based compensation expense of:

Cost of goods sold	**$ 1,473**	$ 2,143	$ 3,091
Development	**603**	1,020	2,090
Sales and marketing	**710**	1,184	2,107
General and administrative	**8,109**	12,376	21,741
Total stock-based compensation expense	**$ 10,895**	$ 16,723	$ 29,029

See Notes to Consolidated Financial Statements

Consolidated Balance Sheets

As of December 31 (in thousands except share amounts)	2005	2004
Assets		
Current assets:		
Cash and cash equivalents	**$ 92,367**	$ 35,907
Investments	**60,823**	59,556
Accounts receivable, less allowance of $418 and $256, respectively	**47,530**	33,668
Deferred tax asset, net	—	2,373
Other	**5,495**	4,250
Total current assets	**206,215**	135,754
Property, equipment, and capitalized software, net	**17,355**	17,521
Investments in unconsolidated entities	**16,355**	14,704
Goodwill	**17,500**	14,408
Intangible assets, net	**7,251**	1,573
Deferred tax asset, net	**29,729**	27,105
Other assets	**1,906**	2,296
Total assets	**$ 296,311**	$ 213,361
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable and accrued liabilities	**$ 13,664**	$ 12,085
Accrued compensation	**26,463**	20,204
Income tax payable	**1,259**	3,763
Deferred revenue	**71,155**	63,363
Deferred tax liability, net	**833**	—
Accrued stock-based compensation	—	15,874
Long-term debt—current portion	—	18
Other	**2,467**	3,545
Total current liabilities	**115,841**	118,852
Accrued compensation	**4,458**	3,567
Accrued stock-based compensation	—	23,943
Other long-term liabilities	**2,298**	2,618
Total liabilities	**122,597**	148,980
Shareholders' equity:		
Common stock, no par value, 200,000,000 shares authorized, of which 40,284,513 and 38,446,614 shares were outstanding as of December 31, 2005 and 2004, respectively	**4**	4
Treasury stock at cost, 233,332 shares as of December 31, 2005 and 2004	**(3,280)**	(3,280)
Additional paid-in capital	**226,593**	148,144
Accumulated deficit	**(50,608)**	(81,725)
Accumulated other comprehensive income (loss):		
Currency translation adjustment	**1,130**	1,340
Unrealized losses on available for sale securities	**(125)**	(102)
Total accumulated other comprehensive income	**1,005**	1,238
Total shareholders' equity	**173,714**	64,381
Total liabilities and shareholders' equity	**$ 296,311**	$ 213,361

See Notes to Consolidated Financial Statements

Consolidated Statements of Shareholders' Equity and Comprehensive Income (Loss)

(in thousands except share amounts)	Common Stock Shares Outstanding	Common Stock Par Value	Treasury Stock	Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance January 1, 2003	38,366,415	$ 4	$ (3,280)	$ 127,790	$ (78,637)	$ 2,255	$ 48,132
Comprehensive loss:							
Net loss		—	—	—	(11,897)	—	(11,897)
Reclassification adjustment for realized gains included in net loss		—	—	—	—	88	88
Unrealized gain on investments, net of tax of $16		—	—	—	—	96	96
Foreign currency translation adjustment		—	—	—	—	(2,969)	(2,969)
Total comprehensive loss		—	—	—	(11,897)	(2,785)	(14,682)
Issuance of common stock related to stock option exercises, net	29,065	—	—	127	—	—	127
Stock-based compensation		—	—	11,244	—	—	11,244
Balance, December 31, 2003	38,395,480	4	(3,280)	139,161	(90,534)	(530)	44,821
Comprehensive income:							
Net income		—	—	—	8,809	—	8,809
Reclassification adjustment for realized gains included in net income		—	—	—	—	(8)	(8)
Unrealized loss on investments, net of tax of $69		—	—	—	—	(97)	(97)
Foreign currency translation adjustment		—	—	—	—	1,873	1,873
Total comprehensive income		—	—	—	8,809	1,768	10,577
Issuance of common stock related to stock option exercises, net	51,134	—	—	692	—	—	692
Reclassification related to conversion of Morningstar Europe options to Morningstar, Inc. options		—	—	531	—	—	531
Stock-based compensation		—	—	7,760	—	—	7,760
Balance December 31, 2004	38,446,614	4	(3,280)	148,144	(81,725)	1,238	64,381
Comprehensive income:							
Net income		—	—	—	**31,117**	—	**31,117**
Reclassification adjustment for realized gains included in net income		—	—	—	—	**(3)**	**(3)**
Unrealized loss on investments, net of tax of $16		—	—	—	—	**(20)**	**(20)**
Foreign currency translation adjustment		—	—	—	—	**(210)**	**(210)**
Total comprehensive income		—	—	—	**31,117**	**(233)**	**30,884**
Issuance of common stock related to initial public offering, net of related costs	**1,141,875**	—	—	**18,108**	—	—	**18,108**
Issuance of common stock related to stock option exercises, net	**696,024**	—	—	**8,221**	—	—	**8,221**
Reclassification of stock-based compensation liabilities		—	—	**41,589**	—	—	**41,589**
Stock-based compensation		—	—	**8,085**	—	—	**8,085**
Tax benefit derived from stock option exercises		—	—	**2,446**	—	—	**2,446**
Balance December 31, 2005	**40,284,513**	**$ 4**	**$ (3,280)**	**$ 226,593**	**$ (50,608)**	**$ 1,005**	**$ 173,714**

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows

Year ended December 31 (in thousands except per share amounts)	2005	2004	2003
Operating activities			
Net income (loss)	**$ 31,117**	$ 8,809	$ (11,897)
Adjustments to reconcile net income (loss) to net cash flows from operating activities:			
Depreciation and amortization	**8,266**	8,225	7,123
Deferred income taxes	**583**	830	2,457
Stock-based compensation	**10,895**	16,723	29,029
Provision for (recovery of) bad debt	**223**	(55)	855
Gain on sale of investment in unconsolidated entity	—	(19)	(510)
Equity in net income of unconsolidated entities	**(1,662)**	(843)	(697)
Foreign exchange (gain) loss	**146**	(333)	—
(Gain) loss on sale of fixed assets	**19**	(73)	—
Stock option income tax benefits	**2,446**	—	—
Other, net	**(269)**	(556)	(325)
Changes in operating assets and liabilities, net of effect of acquisitions			
Accounts receivable	**(14,989)**	(10,866)	(2,218)
Other assets	**(1,076)**	(2,358)	36
Accounts payable and accrued liabilities	**2,167**	2,489	3,696
Accrued compensation	**6,997**	—	—
Deferred revenue	**7,364**	7,038	4,435
Accrued stock-based compensation	—	(303)	(320)
Income taxes payable	**(2,438)**	3,763	—
Other liabilities	**(1,344)**	391	(1,959)
Cash provided by operating activities	**48,445**	32,862	29,705
Investing activities			
Purchases of investments	**(78,798)**	(79,126)	(47,200)
Proceeds from sale of investments	**77,510**	64,180	36,427
Proceeds from sale of investments in unconsolidated entity	—	19	510
Proceeds from sale of fixed assets	**3**	73	—
Capital expenditures	**(7,451)**	(7,730)	(8,607)
Acquisitions, net of cash acquired	**(8,192)**	(210)	(10,801)
Other, net	**15**	44	37
Cash used for investing activities	**(16,913)**	(22,750)	(29,634)
Financing activities			
Payments of long-term debt and capital lease obligations	**(18)**	(6,561)	(153)
Proceeds from sale of common stock, primarily stock option exercises	**7,166**	194	127
Proceeds from initial public offering, net	**18,108**	—	—
Cash provided by (used for) financing activities	**25,256**	(6,367)	(26)
Effect of exchange rate changes on cash and cash equivalents	**(328)**	317	(26)
Net increase in cash and cash equivalents	**56,460**	4,062	19
Cash and cash equivalents — Beginning of year	**35,907**	31,845	31,826
Cash and cash equivalents — End of year	**$ 92,367**	$35,907	$ 31,845
Supplemental disclosures of cash flow information			
Cash paid for interest	**$ 29**	$ 90	$ 293
Cash paid for income taxes	**$ 19,527**	$ 6,613	$ 802
Supplemental information of non-cash investing and financing activities			
Unrealized gain (loss) on available for sale investments	**$ (36)**	$ (166)	$ 112
Non-cash consideration related to acquisition	**$ —**	$ 69	$ —

See Notes to Consolidated Financial Statements

Notes to Consolidated Financial Statements

1. Description of Business

Morningstar, Inc. and its subsidiaries (Morningstar, we, our), is a provider of independent investment research in the United States and in major international markets. We offer an extensive line of Internet, software, and print-based products for individual investors, financial advisors, and institutional clients and provide data on investment offerings worldwide. We also offer asset management services to advisors and institutional clients.

2. Summary of Significant Accounting Policies

Principles of Consolidation
The accompanying consolidated financial statements include the accounts of Morningstar, Inc. and our wholly and majority-owned subsidiaries. The assets, liabilities, and results of operations of subsidiaries in which we have a controlling interest have been consolidated. We account for investments in entities in which we exercise significant influence, but do not control, using the equity method. All significant intercompany accounts and transactions have been eliminated.

Use of Estimates
The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses during the reporting period. Actual results may differ from these estimates.

Reclassifications
In March 2005, the SEC issued guidance concerning the financial statement presentation of auction-rate securities. Auction-rate securities are long-term variable rate bonds tied to short-term interest rates that are reset through an auction process that occurs approximately every seven to 35 days. Holders of auction-rate securities may liquidate their holdings to prospective buyers by participating in the auctions. Because of their long-term maturity dates and because there is no guarantee that holders of auction-rate securities will be able to liquidate their holdings through the auction process, the SEC stated that auction-rate securities do not qualify as cash equivalents. Accordingly, during 2005, we reclassified our investments in auction-rate securities from cash and cash equivalents to investments in our Consolidated Balance Sheets. The amount of auction-rate securities reclassified from cash and cash equivalents to investments as of December 31, 2004, December 31, 2003, and December 31, 2002 was $23,586,000, $21,664,000, and $12,511,000, respectively. We also made related adjustments to the Consolidated Statements of Cash Flows to reflect the gross purchases and sales of these securities as investing activities. The change in classification had no effect on the amount of total current assets, total assets, net income, income per share, or cash flow from operations as previously reported.

Certain other amounts reported in 2004 and 2003 have been reclassified to conform to the 2005 presentation.

Cash and Cash Equivalents
Cash and cash equivalents consist of cash and money market funds with original maturities of three months or less. We state them at cost, which approximates fair market value.

Investments
We classify certain investments, consisting of certificates of deposit, as held-to-maturity securities, based on our intent and ability to hold these securities to maturity. We record held-to-maturity investments at amortized cost on the Consolidated Balance Sheets. We classify certain other investments, consisting primarily of equity securities, as trading securities, based on our intent to hold the securities for a short period of time and generate profits on short-term differences in price, as well as the requirements of one of our wholly owned subsidiaries, which is a registered broker-dealer. We include realized and unrealized gains and losses associated with these investments in "Other income (expense), net" in the Consolidated Statements of Operations. We classify investments not classified as held-to-maturity or trading securities, which primarily consist of fixed-income securities, as available-for-sale securities. We report unrealized gains and losses for available-for-sale securities as other comprehensive income (loss), net of related income taxes. We record both trading and available-for-sale securities at their fair value on the Consolidated Balance Sheets.

Concentration of Credit Risk

No single customer is large enough to pose a significant credit risk to our operations or financial condition. For the years ended December 31, 2005, 2004, and 2003, no single customer represented 10% or more of our consolidated revenue. If receivables from our customers become delinquent, we begin a collections process. We maintain an allowance for doubtful accounts based on our estimate of the probable losses in accounts receivable.

Property, Equipment, and Depreciation

We state property and equipment at historical cost, net of accumulated depreciation. We depreciate property and equipment primarily using the straight-line method based on the useful life of the asset which ranges from three to seven years. We amortize leasehold improvements over the remaining lease term or their useful lives, whichever is shorter.

Computer Software and Internal Product Development Costs

We capitalize certain costs in accordance with American Institute of Certified Public Accountants Statement of Position No. 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, and Statement of Financial Accounting Standards (SFAS) No. 86, Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed, and Emerging Issues Task Force (EITF) 00-2, Accounting for Web Site Development Costs. Internal product development costs mainly consist of personnel costs relating to the development of new Web-based products and certain major enhancements of existing products. We amortize these costs on a straight-line basis over the estimated economic life, which is generally three years.

Goodwill

During the years ended December 31, 2005, 2004, and 2003, changes in the carrying amount of our recorded goodwill were primarily the result of business acquisitions. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is not amortized; instead, goodwill is subject to at least an annual test for impairment, or whenever indicators of impairment exist. An impairment would occur if the carrying amount of a reporting unit exceeded the fair value of that reporting unit. Our reporting units are components of our reportable segments. We performed annual impairment reviews as of December 31, 2005, 2004, and 2003 and did not record any impairment losses in these years.

Intangible Assets

We amortize intangible assets using the straight-line method over their economic useful lives, which range from three to 20 years. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we review intangible assets for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. If the value of future undiscounted cash flows is less than the carrying amount of an asset, we record an impairment loss based on the excess of the carrying amount over the fair value of the asset. No impairment losses were recorded in 2005, 2004, or 2003.

Revenue Recognition

We recognize revenue from subscription sales, including print publications, CD-ROM software, and other subscription products, in equal installments over the term of the subscription, generally one year. Deferred revenue represents the portion of subscriptions billed or collected in advance which we expect to recognize in future periods. We recognize revenue from consulting, retirement advice, and other non-subscription products and services when the product or service is delivered or, when applicable, over the service obligation period defined by the terms of the contract.

Advertising Costs

Advertising costs include expenses incurred for various print and Internet ads, search engine fees, and direct mail campaigns. We expense advertising costs as incurred. Advertising expense for the years ended December 31, 2005, 2004, and 2003 totaled $5,862,000, $6,180,000, and $5,639,000, respectively.

Stock-Based Compensation Expense

We measure and record compensation expense related to stock option grants in accordance with the provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*.

Income (Loss) per Share

We compute and present income (loss) per share in accordance with SFAS No. 128, *Earnings per Share*. The difference between weighted average shares outstanding and diluted shares outstanding reflects the dilutive effect of stock options in all periods presented.

Income Taxes

We record deferred income taxes for the temporary differences between the carrying amount of assets and liabilities for financial statement purposes and the amounts used for income tax purposes in accordance with SFAS No. 109, *Accounting for Income Taxes*.

Foreign Currency

We translate the financial statements of non-U.S. subsidiaries to U.S. dollars using the period-end exchange rate for assets and liabilities and an average exchange rate for revenue and expenses. We use the local currency as the functional currency for all of our non-U.S. subsidiaries. We record translation adjustments for non-U.S. subsidiaries as a component of "Accumulated other comprehensive income (loss)" in the Consolidated Statements of Shareholders' Equity and Comprehensive Income (Loss). We include exchange gains and losses arising from transactions denominated in currencies other than the functional currency in "Other income (expense), net" in the Consolidated Statements of Operations.

3. Initial Public Offering

In May 2005, we completed our initial public offering of 7,612,500 shares of our common stock. These shares commenced trading on May 3, 2005 on the Nasdaq National Market under the symbol "MORN." All of these shares were sold by affiliates of SOFTBANK Finance Corporation, a wholly owned subsidiary of SOFTBANK Corp. We did not receive any proceeds from the sale of these shares. In addition, we granted the underwriters the right to purchase up to an additional 1,141,875 shares at the initial public offering price to cover over-allotments. In May 2005, the underwriters exercised their over-allotment option in full. We received net proceeds of $18,108,000 based on our initial public offering price of $18.50 per share, after deducting the underwriting discounts and commissions and $2,594,000 of offering expenses.

4. Income (Loss) Per Share

We compute basic income (loss) per share by dividing net income (loss) by the applicable number of weighted average common shares outstanding during the year. Diluted income (loss) per share includes the assumed impact, using the treasury stock method, of converting stock options with an exercise price below the average fair value of our common stock, if the impact of this calculation is more dilutive.

The computation of weighted average common shares outstanding for the year ended December 31, 2003 excluded 5,163,000 incremental shares related to employee stock options. These shares were not included in the computation of the loss per share due to their anti-dilutive effect.

The following table reconciles our net income (loss) and the number of shares used in computing basic and diluted income (loss) per share:

(in thousands, except per share amounts)	2005	2004	2003
Basic income (loss) per share:			
Net income (loss)	**$ 31,117**	$ 8,809	$ (11,897)
Weighted average common shares outstanding	**39,392**	38,418	38,382
Basic income per share	**$ 0.79**	$ 0.23	$ (0.31)
Diluted income (loss) per share:			
Net income (loss)	**$ 31,117**	$ 8,809	$ (11,897)
Weighted average common shares outstanding	**39,392**	38,418	38,382
Net effect of dilutive stock options based on the treasury stock method	**5,067**	3,440	—
Weighted average common shares outstanding for computing diluted income (loss) per share	**44,459**	41,858	38,382
Diluted income (loss) per share	**$ 0.70**	$ 0.21	$ (0.31)

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 provides 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*.

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.

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 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 Data, a set of investment data spanning eight core databases, available through electronic data feeds; Investment Consulting, which focuses on investment monitoring and asset allocation for funds of funds, including mutual funds and variable annuities; Investment Profiles and Guides, which are designed for institutions to use in communicating investment information to individual investors; and Morningstar Retirement Manager, a suite of advice and guidance services for retirement plan participants.

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."

Our segment accounting policies are the same as those described in Note 2, except for the capitalization and amortization of internal product development costs, stock-based compensation expense, 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, stock-based compensation expense, and amortization of intangible assets, as well as 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 years ended December 31, 2005, 2004, and 2003.

($000)	Individual	Advisor	Institutional	Corporate Items & Eliminations	Total
2005 Segment Data					
Revenue:					
External customers	**$ 60,643**	**$ 72,683**	**$ 93,788**	**$ —**	**$ 227,114**
Intersegment	**2,805**	**6**	**2,159**	**(4,970)**	**—**
Total revenue	**63,448**	**72,689**	**95,947**	**(4,970)**	**227,114**
Operating expense, excluding depreciation and amortization	**43,903**	**53,290**	**69,140**	**6,035**	**172,368**
Depreciation and amortization	**1,172**	**1,507**	**2,011**	**3,576**	**8,266**
Operating income (loss)	**$ 18,373**	**$ 17,892**	**$ 24,796**	**$ (14,581)**	**$ 46,480**
Capital expenditures	**$ 305**	**$ 709**	**$ 1,939**	**$ 4,498**	**$ 7,451**
U.S. revenue					**$ 197,672**
Non-U.S. revenue					**$ 29,442**
U.S. long-lived assets (as of Dec. 31)					**$ 13,894**
Non-U.S. long-lived assets (as of Dec. 31)					**$ 3,461**
2004 Segment Data					
Revenue:					
External customers	$ 44,478	$ 59,326	$ 75,854	$ —	$ 179,658
Intersegment	2,518	1,554	2,548	(6,620)	—
Total revenue	46,996	60,880	78,402	(6,620)	179,658
Operating expense, excluding depreciation and amortization	38,130	45,311	62,496	7,761	153,698
Depreciation and amortization	1,041	1,603	2,239	3,342	8,225
Operating income (loss)	$ 7,825	$ 13,966	$ 13,667	$ (17,723)	$ 17,735
Capital expenditures	$ 100	$ 622	$ 772	$ 6,286	$ 7,730
U.S. revenue					$ 154,248
Non-U.S. revenue					$ 25,410
U.S. long-lived assets (as of Dec. 31)					$ 16,016
Non-U.S. long-lived assets (as of Dec. 31)					$ 1,505
2003 Segment Data					
Revenue:					
External customers	$ 33,259	$ 48,281	$ 57,956	$ —	$ 139,496
Intersegment	2,147	880	1,789	(4,816)	—
Total revenue	35,406	49,161	59,745	(4,816)	139,496
Operating expense, excluding depreciation and amortization	27,127	37,964	53,276	24,760	143,127
Depreciation and amortization	888	1,676	2,309	2,250	7,123
Operating income (loss)	$ 7,391	$ 9,521	$ 4,160	$ (31,826)	$ (10,754)
Capital expenditures	$ 216	$ 274	$ 638	$ 7,479	$8,607
U.S. revenue					$ 119,378
Non-U.S. revenue					$ 20,118
U.S. long-lived assets (as of Dec. 31)					$ 15,856
Non-U.S. long-lived assets (as of Dec. 31)					$ 1,744

6. Investments

We classify our investment portfolio, which is primarily invested in fixed-income securities, as follows:

($000)	Dec. 31 2005	Dec. 31 2004
Available-for-sale	**$ 58,761**	$ 55,536
Held-to-maturity	**420**	2,850
Trading securities	**1,642**	1,170
Total	**$ 60,823**	$ 59,556

The following table shows the cost, unrealized gains (losses), and fair values related to investments classified as available for sale and held to maturity:

($000)	Cost	Unrealized Gain	Unrealized Loss	Fair Value
Dec. 31, 2005				
Available-for-sale:				
Auction-rate securities	**$ 16,298**	**$ —**	**$ —**	**$ 16,298**
Corporate bonds	**18,420**	**2**	**(57)**	**18,365**
Government obligations	**24,245**	**—**	**(147)**	**24,098**
Total	**$ 58,963**	**$ 2**	**$ (204)**	**$ 58,761**
Held-to-maturity:				
Certificate of deposit	**$ 420**	**$ —**	**$ —**	**$ 420**
Dec. 31, 2004				
Available-for-sale:				
Auction-rate securities	$ 23,586	$ —	$ —	$ 23,586
Corporate bonds	20,483	2	(102)	20,383
Government obligations	11,636	1	(70)	11,567
Total	$ 55,705	$ 3	$ (172)	$ 55,536
Held-to-maturity:				
Certificate of deposit	$ 2,850	$ —	$ —	$ 2,850

As of December 31, 2005 and 2004, investments with unrealized losses for greater than a 12-month period were not material to the Consolidated Balance Sheets and were not deemed to have other than temporary declines in value.

The following table shows the cost and estimated fair value of debt and marketable equity securities classified as available-for-sale and held-to-maturity based on their contractual maturities. The expected maturities of certain fixed-income securities may differ from their contractual maturities because some of these holdings have call features that allow the issuers the right to prepay obligations without penalties.

($000)	Cost	Fair Value
Dec. 31, 2005		
Available-for-sale:		
Due in one year or less	**$ 25,820**	**$ 25,740**
Due in one to three years	**16,845**	**16,723**
Due in greater than ten years	**16,298**	**16,298**
Total	**$ 58,963**	**$ 58,761**
Held-to-maturity:		
Due in one year or less	**$ 420**	**$ 420**
Dec. 31, 2004		
Available-for-sale:		
Due in one year or less	$ 12,134	$ 12,076
Due in one to three years	19,985	19,874
Due in greater than ten years	23,586	23,586
Total	$ 55,705	$ 55,536
Held-to-maturity:		
Due in one year or less	$ 2,850	$ 2,850

Securities with contractual maturities of greater than 10 years consist of auction-rate securities. Auction-rate securities are long-term variable rate bonds tied to short-term interest rates that are reset through an auction process that occurs approximately every seven to 35 days. While the contractual maturities are long-term, holders of auction-rate securities may liquidate their holdings to prospective buyers by participating in the auctions.

Net unrealized gains on trading securities included in our Consolidated Statements of Operations were $18,000, $71,000, and $57,000 in 2005, 2004, and 2003, respectively.

The following table shows the net realized gains (losses) arising from sales of our investments recorded in our Consolidated Statements of Operations:

($000)	Dec. 31 2005	Dec. 31 2004	Dec. 31 2003
Realized gains	**$ 36**	$ 33	$ 95
Realized losses	**(4)**	(2)	(7)
Realized gains (losses), net	**$ 32**	$ 31	$ 88

7. Acquisitions, Goodwill, and Other Intangible Assets

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 Consolidated Financial Statements beginning in January 2005. VARDS provides research and data on variable annuities and is used by many firms that offer variable annuities. The service is also used by many brokerage firms for research, due diligence, and suitability determination. This acquisition strengthens our investment database and furthers our efforts to provide investors with the information they need to make well-informed decisions when investing in variable annuities.

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	$ 8,192

The acquired intangible assets include $5,700,000 of customer-related assets, consisting primarily of acquired customer contracts; $430,000 of 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.

If the acquisition of VARDS had occurred as of January 1, 2003, revenue, operating income, net income, and basic and diluted income per share would not have been significantly different from the amounts reported in 2004 and 2003.

Morningstar Norway

In February 2004, we purchased the remaining 51% of Morningstar Norway that we did not previously own. The purchase price consisted of $210,000 in cash and $69,000 of other consideration. Prior to this transaction, we accounted for our investment in Morningstar Norway using the equity method.

mPower.com, Inc.

In July 2003, we acquired 100% ownership of mPower.com, Inc. (mPower), an investment advisory firm that specialized in serving the large plan sponsor retirement market. The aggregate purchase price was $4,864,000. The results of mPower's operations have been included in the Consolidated Financial Statements since that date. The acquisition was strategic in nature and gave us immediate entry into the large plan sponsor market.
The purchase price was less than the total fair value of the assets acquired; as a result, certain long-term assets were allocated values that were lower than their fair values at the date of acquisition. We allocated the aggregate purchase price to the acquired assets and liabilities based on estimated fair market values as of the date of acquisition.

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)

Cash	$ 397
Other current assets	451
Property, equipment, and capitalized software	161
Deferred tax assets	4,663
Intangible assets	2,003
Liabilities, primarily deferred revenue	(2,811)
Total purchase price	$ 4,864

Of the $2,003,000 of acquired intangible assets, $871,000 was assigned to a customer list and $1,132,000 was assigned to intellectual property.

The following table shows pro forma consolidated financial information combining our 2003 financial results with mPower's financial results for the year ended December 31, 2003:

($000)	Year Ended Dec. 31, 2003 (Unaudited Pro forma)
Revenue	$ 142,222
Operating loss	(13,280)
Net loss	(14,484)
Basic loss per share	(0.38)
Diluted loss per share	(0.38)

Morningstar Canada

In January 2003, we purchased the remaining 50% of Morningstar Research Inc. (Morningstar Canada) that we did not previously own for $6,334,000 in cash. The purchase price has been allocated to the acquired assets and liabilities based on their estimated fair values as of the date of acquisition, with the remainder allocated to goodwill.

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)	
Current assets	$ 674
Property, equipment, and capitalized software	223
Other assets	376
Goodwill	8,484
Liabilities	(3,423)
Total purchase price	$ 6,334

Goodwill

The following table shows the changes in our goodwill balances from January 1, 2004 to December 31, 2005:

($000)	
Balance as of January 1, 2004	$ 14,075
Goodwill acquired related to Morningstar Norway	248
Other, primarily currency translation adjustment	85
Balance as of December 31, 2004	$ 14,408
Goodwill acquired related to VARDS	**3,084**
Other, primarily currency translation adjustment	**8**
Balance as of December 31, 2005	**$ 17,500**

We did not record any goodwill impairment losses in 2005, 2004, or 2003, respectively.

Other Intangible Assets

The following table summarizes our intangible assets:

($000)	Gross	Accumulated Amortization	Net	Weighted Average Useful Life (years)
Dec. 31, 2005				
Intellectual property	**$ 1,132**	**$ (405)**	**$ 727**	**7**
Customer-related assets	**6,571**	**(597)**	**5,974**	**18**
Supplier relationships	**240**	**(12)**	**228**	**20**
Technology-based assets	**430**	**(108)**	**322**	**4**
Total intangible assets	**$ 8,373**	**$ (1,122)**	**$ 7,251**	**16**
Dec. 31, 2004				
Intellectual property	$ 1,132	$ (243)	$ 889	7
Customer-related assets	871	(187)	684	7
Supplier relationships	—	—	—	—
Technology-based assets	—	—	—	—
Total intangible assets	$ 2,003	$ (430)	$ 1,573	7

We amortize intangible assets using the straight-line method over their expected economic useful lives. Amortization expense for the years ended December 31, 2005, 2004, and 2003 was $692,000, $287,000, and $143,000, respectively.

We estimate that aggregate amortization expense for intangible assets will be $692,000 in each of the years ending December 31, 2006 and 2007; $635,000 in each of the years ending December 31, 2008 and 2009; and $440,000 in the year ending December 31, 2010.

8. Investments in Unconsolidated Entities

Our investments in unconsolidated entities consist primarily of the following:

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 December 31, 2005 and 2004, we owned approximately 35% of MJKK. We account for our investment in MJKK using the equity method. Our investment in MJKK totaled $14,884,000 and $13,852,000 as of December 31, 2005 and 2004, respectively. MJKK's market value was approximately Japanese Yen 27.8 billion (approximately U.S. $235,625,000) and Japanese Yen 10.7 billion (approximately U.S. $103,400,000) as of December 31, 2005 and 2004, respectively.

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 named 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 investments in South Korea. Our ownership interest and profit and loss sharing interest in Morningstar Korea was 40% as of December 31, 2005 and 2004. We account for this investment using the equity method. Our investment totaled $1,129,000 and $767,000 as of December 31, 2005 and 2004, respectively.

Other Investments in Unconsolidated Entities

As of December 31, 2005 and 2004, the book value of our other investments in unconsolidated entities totaled $342,000 and $85,000, 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 and established 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 Stadsporten Citygate AB and established 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 December 31, 2005 and 2004.

The following table shows condensed combined financial information, a portion of which is unaudited, for our investments in unconsolidated entities, and has been updated to reflect consolidated data for MJKK in 2004 and 2003.

($000)	**2005**	2004	2003
Revenue	**$ 15,069**	$ 9,648	$ 8,819
Operating income (loss)	**2,940**	1,143	392
Net income (loss)	**3,178**	656	2

($000)	**Dec. 31 2005**	Dec. 31 2004	Dec. 31 2003
Current assets	**$ 49,538**	$ 50,133	$ 45,041
Total assets	**55,235**	55,294	52,635
Current liabilities	**2,792**	1,536	1,219
Total liabilities	**3,071**	1,536	1,222

9. Property, Equipment, and Capitalized Software

The following table shows our property, equipment, and capitalized software summarized by major category:

($000)	**Dec. 31 2005**	Dec. 31 2004
Computer equipment	**$ 19,794**	$ 18,505
Capitalized software	**20,400**	19,259
Furniture and fixtures	**2,710**	3,479
Leasehold improvements	**13,565**	8,725
Telephone equipment	**1,277**	1,268
Other	**296**	296
Property, equipment, and capitalized software, at cost	**58,042**	51,532
Less accumulated depreciation	**(40,687)**	(34,011)
Property, equipment, and capitalized software, net	**$ 17,355**	$ 17,521

Depreciation and leasehold amortization expense totaled $7,574,000, $7,938,000, and $6,980,000, in 2005, 2004, and 2003, respectively.

10. Long-Term Debt

As of December 31, 2004, we had $18,000 of short-term capital lease obligations recorded on our Consolidated Balance Sheets. The related assets consisted primarily of computer equipment with a remaining net book value of $13,000 at December 31, 2004. As of December 31, 2005, all capital lease obligations have been satisfied.

11. Operating Leases

The following table shows our minimum future rental commitments due in each of the next five years and thereafter for all non-cancelable operating leases, consisting primarily of leases for office space:

($000)	
2006	$ 2,511
2007	1,978
2008	3,019
2009	4,314
2010	4,806
Thereafter	68,144
Total	$ 84,772

In December 2005, we signed an agreement with the Mills Corporation to lease approximately 210,000 square feet of new office space for our corporate headquarters and U.S. operations in Chicago, Illinois. The lease begins in March 2008 and has a term of 15 years. The minimum future lease payments are included in the table above.

Rent expense for 2005, 2004, and 2003 was $5,234,000, $4,155,000, and $3,521,000, respectively, including taxes, insurance, and other operating costs.

Deferred rent in the amount of $808,000 and $848,000 at December 31, 2005 and 2004, respectively, relates to build-out and rent abatement allowances received, which are being amortized on a straight-line basis over the remaining portion of the original term of the lease. Deferred rent is included in Other Current Liabilities and Other Long-Term Liabilities on our Consolidated Balance Sheets, as appropriate.

In 2005, we recorded an asset retirement obligation of $98,000 for costs that will be incurred in 2008 to return office space modified by leasehold improvements to its original condition in accordance with the lease agreement. The asset retirement obligation is recorded in Other Long-Term Liabilities on our Consolidated Balance Sheets.

12. Stock-Based Compensation

Stock Option Plans

Prior to November 2004, we granted 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. Options granted under the 2004 Stock Incentive Plan vest ratably over a four-year period and expire 10 years after the date of grant. All of the options granted under the 2004 Stock Incentive Plan, excluding those options granted as a result of the exchange of Morningstar Europe options for Morningstar, Inc. options, as discussed below, have a premium feature in which the exercise price increases over the term of the options at a rate equal to the 10-year Treasury bond yield as of the date of grant. The number of shares available for future stock option grants as of December 31, 2005 and 2004 was 2,989,322 and 4,006,304, 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 an officer of Morningstar. Under these agreements, we granted 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, to the officer. 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 shares became and continue to become exercisable each year from 1999 through 2008. As of December 31, 2005 and 2004, there were 869,174 options remaining to be exercised.

Conversion of Morningstar Europe Options

Prior to 2004, Morningstar Europe, a majority-owned subsidiary of Morningstar, granted approximately 1,500,000 options to acquire common stock of Morningstar Europe to certain of its employees. The options vested over a four-year period and none had been exercised as of December 31, 2004. We accounted for these options as equity instruments in accordance with the provisions of SFAS No. 123. In December 2004, the Board of Directors authorized the cancellation of the Morningstar Europe option plan and the exchange of all options outstanding under the Morningstar Europe option plan for 81,189 options granted under the 2004 Stock Incentive Plan. The conversion was accounted for in accordance with SFAS No. 123 and did not result in any incremental stock-based compensation expense.

Accounting for Stock Options

We account for our stock option plans in accordance with SFAS No. 123, *Stock-Based Compensation*. Subsequent to our initial public offering in May 2005, we account for all outstanding options using the equity method of SFAS No. 123.

Prior to our initial public offering in May 2005, we accounted for options granted under the 1993 Plan and the 1999 Plan using the liability method in accordance with SFAS No. 123, reflecting the terms of the respective stock option plans. Under the terms of the 1993 Plan, at the option holder's election, the option could be settled in cash, subject to certain conditions, based on the difference in exercise price and the fair value at the date of exercise, or the option could be exercised resulting in issuance of common stock to the employee. In the event that an employee exercised an option and elected net cash settlement, Morningstar had the right to make payment to the employee over a period of time, generally five years. Interest accrued on any unpaid balance due to the employee at a floating rate equal to the yield on the 13-week U.S. Treasury Bill, adjusted on January 1 and July 1 of each year. Under the terms of our 1999 Plan, an officer periodically exercised options that were net settled in cash based on the difference between the exercise price and the fair value of our common stock on the date of exercise.

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 the Consolidated Statements of Operations. As of December 31, 2004, we recorded the liability using a fair value of $17.50 per share; our Consolidated Balance Sheet reflected $15,874,000 of current liabilities and $23,943,000 of long-term liabilities related to stock options accounted for under the liability method.

As a result of our initial public offering, we are no longer required to settle options under the 1993 Plan and 1999 Plan in cash. Upon our initial public offering, we valued the liability using a fair value of $18.50 per share, 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 are fully vested, no additional expense will be recorded for these options in future periods.

Stock-Based Compensation Expense

The following table summarizes our stock-based compensation expense:

($000)	**2005**	2004	2003
Stock-based compensation expense under the liability method	**$ 2,810**	$ 8,963	$ 17,796
Stock-based compensation expense under the equity method	**8,085**	7,760	11,233
Total stock-based compensation expense	**$ 10,895**	$ 16,723	$ 29,029

Stock Option Fair Value

The weighted average fair value of the options granted in 2005, 2004, and 2003, calculated using a Black-Scholes option-pricing model, was $9.62 per share, $9.39 per share, and $4.08 per share, respectively. We estimated the fair value of these options on the date of grant using the following weighted average assumptions:

	2005	2004	2003
Expected life (years)	**7.0**	7.0	5.0
Expected volatility (%)	**50%**	50%	50%
Dividend yield (%)	**—**	—	—
Interest rate (%)	**4.04%**	4.24%	4.19%
Expected exercise price	**$ 26.20**	$ 19.67	$ 8.57

Options granted in 2005 have initial exercise prices that will increase over the term of the options at a rate equal to the 10-year Treasury bond yield as of the date of grant. Options granted in 2004, excluding the options granted as a result of the exchange of Morningstar Europe options for Morningstar, Inc. options, also have exercise prices that will increase over the term of the options at a rate equal to the 10-year Treasury bond yield as of the date of grant. We calculated the expected exercise price included in the option pricing models for these options using an estimated life of seven years and the applicable 10-year Treasury bond rate.

For options granted in 2003, the exercise price of $8.57 remains constant for the life of the options.

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. The weighted average exercise prices reflect the exercise price at the date of grant adjusted for the impact of the premium feature, if any.

Stock Option Activity	2005		2004		2003	
	Underlying Shares	**Weighted Average Exercise Price**	Underlying Shares	Weighted Average Exercise Price	Underlying Shares	Weighted Average Exercise Price
Options Granted At an Exercise Price Below the Fair Value Per Share on the Grant Date						
Options outstanding—beginning of year	**3,557,683**	**$ 10.39**	1,936,624	$ 6.78	1,937,174	$ 6.80
Granted	**—**	**—**	1,622,539	14.70	14,750	8.57
Canceled	**(42,658)**	**14.84**	(1,455)	8.57	(15,300)	10.93
Exercised	**(176,066)**	**13.03**	(25)	8.57	—	—
Options outstanding—end of year	**3,338,959**	**10.50**	3,557,683	10.39	1,936,624	6.78
Options exercisable	**2,102,247**	**8.31**	1,760,893	7.07	1,487,329	6.69
All Other Option Grants, Excluding Activity Shown Above						
Options outstanding—beginning of year	**7,394,248**	**$ 10.67**	7,556,364	$ 10.62	6,949,790	$ 10.85
Granted	**1,077,084**	**19.64**	—	—	834,988	8.57
Canceled	**(98,451)**	**13.79**	(80,705)	11.69	(168,810)	13.20
Exercised	**(577,033)**	**10.24**	(81,411)	5.45	(59,604)	1.72
Options outstanding—end of year	**7,795,848**	**11.96**	7,394,248	10.67	7,556,364	10.62
Options exercisable	**6,193,670**	**10.79**	6,011,684	10.61	4,648,302	9.84

Stock Options Outstanding and Exercisable

The table below shows additional information for options outstanding and options exercisable as of December 31, 2005, and December 31, 2004:

	Options Outstanding			Options Exercisable	
Dec. 31, 2005	Outstanding Shares	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Exercisable Shares	Weighted Average Exercise Price
Range of Exercise Prices					
$2.00–$2.77	**2,353,317**	**2.62**	**$ 2.51**	**2,244,682**	**$ 2.50**
$8.57–$14.70	**6,255,811**	**5.07**	**12.55**	**5,706,290**	**12.86**
$15.38–$32.25	**2,525,679**	**9.11**	**17.36**	**344,945**	**15.38**
$2.00–$32.25	**11,134,807**	**5.47**	**11.52**	**8,295,917**	**10.16**
Dec. 31, 2004					
Range of Exercise Prices					
$1.72–$2.77	2,493,506	3.53	$ 2.49	2,343,420	$ 2.48
$8.57–$14.70	8,458,425	6.84	12.95	5,429,157	12.97
$1.72–$14.70	10,951,931	6.09	10.57	7,772,577	9.81

13. Related Party Transactions

Under the 1993 Plan, and prior to our initial public offering in May 2005, employees were able to exercise options and elect net cash settlement based on the difference between the exercise price and the fair value of our common stock. If an employee exercised an option and elected net cash settlement, we had the right to make payments over a period of five years. Interest accrued on any unpaid balance due to the employee at a floating rate equal to the yield on the 13-week U.S. Treasury bill, adjusted on January 1 and July 1 of each year. The liability remaining for these transactions as of December 31, 2005 will be paid in the first quarter of 2006.

In years prior to 2004, certain employees, including an officer of Morningstar, sold common stock back to Morningstar. We had the right to make payments to employees for the purchase price of these shares over a five-year period. All of the remaining payments related to these common stock repurchases were completed during 2005.

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 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 this officer. Under the terms of the Agreement, on any date that the officer exercises the right to purchase shares under the 1999 Plan, we shall pay to the officer $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.

The following table shows the liabilities recorded for stock options exercised, common stock repurchases, and the Agreement:

($000)	**Dec. 31 2005**	Dec. 31 2004
Liability for stock options exercised	**$ 45**	$ 1,048
Liability for common stock repurchases	**—**	394
Liability for the Agreement	**2,340**	2,340
Total	**$ 2,385**	$ 3,782

We have included the liabilities for stock options exercised, common stock repurchases, and the Agreement in our Consolidated Balance Sheets as follows:

($000)	Dec. 31 2005	Dec. 31 2004
Other current liabilities	**$ 2,190**	$ 3,337
Other non-current liabilities	**195**	445
Total	**$ 2,385**	$ 3,782

Interest expense incurred on the liabilities for stock options exercised and common stock repurchases was $14,000, $27,000, and $36,000 for the years ended December 31, 2005, 2004, and 2003, respectively.

Between December 1995 and December 2003, a corporation wholly owned by Joe Mansueto, our chairman and chief executive officer, provided sales and other services for us. We agreed to pay an amount equal to the total costs incurred by the corporation in providing these services, consisting solely of compensation-related expenses for the corporation's employees (which did not include Joe Mansueto), plus 5% of such costs. In 2003, we recorded expense for these services of $2,915,000, of which $139,000 represented the amount paid in excess of the corporation's actual costs. This arrangement was discontinued on December 31, 2003 at which time all employees of the corporation were transferred to Morningstar. As of December 31, 2005 and 2004, no liabilities remain related to this arrangement.

In March 2004, we repaid a note payable of $6,500,000 related to borrowings from Joe Mansueto, our chairman and chief executive officer. The repayment is included in our Consolidated Statement of Cash Flows for the year ended December 31, 2004.

14. Defined Contribution Profit-Sharing Plan

We sponsor a defined contribution 401(k) plan, which allows our U.S.-based employees to voluntarily contribute pre-tax dollars up to a maximum amount allowable by the U.S. Internal Revenue Service. We contribute an amount equal to the employee's contributions, up to 7% of the employee's salary. Our matching contributions were $3,717,000, $3,221,000, and $2,324,000, respectively, for the years ended December 31, 2005, 2004, and 2003, respectively.

15. Non-Operating Income

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

($000)	2005	2004	2003
Gain on sale of investment in unconsolidated entity	**$ —**	$ 19	$ 510
Interest income, net	**3,078**	1,211	279
Other income (expense), net	**121**	575	321
Non-operating income, net	**$ 3,199**	$ 1,805	$ 1,110

Interest income, net primarily reflects interest from our investment portfolio. Other income (expense), net primarily represents royalty income from Morningstar Japan K.K. and Morningstar Denmark, unrealized and realized gains and losses from our investment portfolio, and foreign currency exchange gains and losses arising in the ordinary course of business related to our international operations.

In March 2000, we entered into a stock purchase agreement with Techfi Corporation (Techfi), a provider of portfolio management and accounting software, training, and support to investment advisors and financial planners. In June 2002, Techfi Corporation and Advent Software, Inc. entered into an Agreement and Plan of Merger, whereby all of the issued and outstanding shares of Techfi common stock and vested options were converted into the right to receive cash. Our share of the total proceeds was $4,838,000, resulting in a gain of $3,398,000 in 2002. In 2004 and 2003, $19,000 and $510,000, respectively, was released from escrow and recorded as an additional gain. The gains recorded in 2004 and 2003 are included as "Gain on sale of investment in unconsolidated entity," in the Consolidated Statements of Operations.

16. Income Taxes

The following table shows our effective income tax expense rate:

($000)	2005	2004	2003
Income (loss) before income taxes and equity in net income of unconsolidated entities	**$ 49,679**	$ 19,540	$ (9,644)
Equity in net income of unconsolidated entities	**1,662**	843	697
Total	**$ 51,341**	$ 20,383	$ (8,947)
Income tax expense	**$ 20,224**	$ 11,574	$ 2,950
Effective income tax expense rate	**39.4%**	56.8%	33.0%

The following table provides our income (loss) before income taxes and equity in net income of unconsolidated entities generated by our U.S. and non-U.S. operations:

($000)	2005	2004	2003
U.S.	**$ 48,580**	$ 22,178	$ (5,311)
Non-U.S.	**1,099**	(2,638)	(4,333)
Income (loss) before income taxes and equity in net income of unconsolidated entities	**$ 49,679**	$ 19,540	$ (9,644)

The table below reconciles our income tax expense (benefit) at the U.S. federal income tax rate of 35% to income tax expense (benefit) as recorded.

Our effective income tax rate is influenced by three primary factors: incentive stock options; the reported income or loss of our non-U.S. entities and our evaluation of the realizability of their net operating losses; and the impact of specific tax planning strategies.

In 2005, our effective income tax expense rate decreased compared with prior years, primarily due to a reduction in the tax impact related to incentive stock options. For incentive stock options, we record stock-based compensation expense but we do not record a corresponding tax benefit. This has the impact of increasing our effective income tax rate above the U.S. federal rate of 35%. The amount of incentive stock option expense recorded in 2005 was lower than the amounts recorded in 2004 and 2003, reflecting the fact that, subsequent to our initial public offering, incentive stock options are no longer accounted for under the liability method, and because they are fully vested, no stock-based compensation expense was recorded for these options in the last nine months of 2005. Our 2005 effective tax rate also reflects an increase in the number of disqualifying dispositions related to 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.

Our effective income tax expense rate also reflects the fact that we are not recording an income tax benefit related to losses recorded by certain of our non-U.S. operations. The foreign net operating losses may become deductible in certain international tax jurisdictions to the extent these international operations become profitable. In the year the non-U.S. entity records a loss, we do not record a corresponding tax benefit, thus increasing our effective tax rate. 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,

Income Tax Expense (Benefit) Reconciliation

	2005		2004		2003	
($000, except percentages)	**$000**	**%**	$000	%	$000	%
Income tax expense (benefit) at U.S. federal rate	**$ 17,969**	**35.0%**	$ 7,134	35.0%	$ (3,132)	(35.0)%
State income taxes—net of federal income tax effect	**2,419**	**4.7**	1,670	8.2	342	3.8
Impact of equity in net (income) losses of unconsolidated entities	**(494)**	**(0.9)**	(295)	(1.4)	(244)	(2.7)
Stock option activity	**1,716**	**3.3**	2,351	11.5	4,507	50.3
Disqualifying dispositions on incentive stock options	**(441)**	**(0.9)**	(78)	(0.4)	(102)	(1.1)
Difference between U.S. federal statutory and foreign tax rates	**115**	**0.2**	366	1.8	1,520	16.9
Research and development deduction	**(588)**	**(1.1)**	—	—	—	—
Other—net	**(472)**	**(0.9)**	426	2.1	59	0.8
Total income tax expense	**$ 20,224**	**39.4%**	$ 11,574	56.8%	$ 2,950	33.0%

we consider evidence such as tax planning strategies, historical operating results, forecasted taxable income, and recent financial performance.

In the second quarter of 2005, we recorded a deferred income tax benefit of $668,000 related to research and development expenses due to a change in U.S. income tax regulations, which resulted in a one-time reduction of our effective income tax expense rate.

Income tax expense consists of the following:

($000)	**2005**	2004	2003
Federal—deferred	**$ 411**	$ 1,043	$ 2,047
Federal—current	**15,625**	8,652	353
State—deferred	**92**	352	410
State—current	**3,515**	2,084	137
Non-U.S.—deferred	**80**	(565)	—
Non-U.S.—current	**501**	8	3
Income tax expense	**$ 20,224**	$ 11,574	$ 2,950

We recognize deferred income taxes for the temporary differences between the carrying amount of assets and liabilities for financial statement purposes and their tax bases. The tax effects of the temporary differences that give rise to the deferred income tax assets and liabilities are shown in the table below.

A portion of the net operating losses (NOLs) generated by mPower in the years prior to July 1, 2003 (the date of acquisition) is available to Morningstar. On July 1, 2003, mPower had $121,430,000 of NOLs. Because of limitations on the use of the NOLs imposed by the U.S. Internal Revenue Code, our use of the NOLs is limited to approximately $224,000 per year. On the date of acquisition, we recorded a valuation allowance of $116,932,000 representing a portion of these NOLs to reflect the likelihood that the benefit of the NOLs will not be realized. In 2003, we used $112,000 of these NOLs and in 2004 and 2005 we used $224,000 of these NOLs in each year. The remaining U.S. NOL carryforward as of December 31, 2005 of $3,938,000, net of the valuation allowance, will expire in 2022.

In addition, we have NOL carryforwards of $26,319,000 related to our non-U.S. operations. Of these NOLs, $6,512,000 will begin to expire in 2008 through 2020 and $19,807,000 have no expiration date. Due to the historical operating losses of the non-U.S. operations that generated these NOLs, we have recorded a valuation allowance against all but $396,000 of these NOLs, reflecting the likelihood that the benefit of the NOLs will not be realized.

We establish reserves at the time that we determine that it is more likely than not that we will need to pay additional taxes related to certain matters. We adjust these reserves, including any impact of the related interest and penalties, in light of changing

Defered Tax Assets and Liabilities

				Dec. 31, 2005				Dec. 31, 2004
	Current Asset	**Current Liability**	**Non-current Asset**	**Non-current Liability**	Current Asset	Current Liability	Non-current Asset	Non-current Liability
Net operating loss carryforwards–U.S.	**$ —**	**$ —**	**$ 1,614**	**$—**	$ —	$ —	$ 1,676	$ —
Net operating loss carryforwards–non-U.S., net of valuation reserve	**143**	**—**	**—**	**—**	448	—	—	—
Stock-based compensation	**—**	**—**	**23,633**	**—**	—	—	22,617	—
Deferred revenue	**—**	**(847)**	**—**	**—**	—	—	—	—
Property, equipment, and capitalized software	**—**	**—**	**1,050**	**—**	—	—	575	—
Deferred rent	**—**	**—**	**190**	**—**	—	—	331	—
Allowance for doubtful accounts	**167**	**—**	**—**	**—**	92	—	—	—
Prepaid expenses	**—**	**(1,133)**	**—**	**—**	—	(1,349)	—	—
Deferred royalty revenue	**—**	**—**	**586**	**—**	—	—	609	—
Accrued liabilities	**891**	**—**	**1,700**	**—**	3,225	—	1,457	—
Foreign exchange gains	**—**	**—**	**—**	**(6)**	—	—	—	(160)
Alternative Minimum Tax Credit	**—**	**—**	**294**	**—**	—	—	—	—
Research and development credit	**—**	**—**	**668**	**—**	—	—	—	—
Unrealized loss on available-for-sale securities	**—**	**(54)**	**—**	**—**	—	(43)	—	—
	$ 1,201	**$ (2,034)**	**$ 29,735**	**$ (6)**	$ 3,765	$ (1,392)	$ 27,265	$ (160)

facts and circumstances such as the progress of a tax audit. A number of years may elapse before a particular matter for which we have established a reserve is audited and finally resolved. The number of years with open tax audits varies depending on the tax jurisdiction. While it is often difficult to predict the final outcome or the timing of resolution of any particular tax matter, we record a reserve when we determine the likelihood of loss is more likely than not. These liabilities are recorded as income taxes payable in our Consolidated Balance Sheets and are not material to our Consolidated Balance Sheets. Settlement of any particular issue would usually require the use of cash. Favorable resolutions of tax matters for which we have previously established reserves are recognized as a reduction to our income tax expense when the amounts involved become known.

17. 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 also was 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 noted above 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 shareholders agreement of Morningstar Australia). 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 will be entitled to be paid costs 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 must 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 must also be paid to Morningstar.

In July 2005, Mr. Rich provided the indemnity and he and his companies paid Morningstar the costs in respect of the 2001 injunction proceedings in the amount of approximately Australian $116,000. Mr. Rich and his companies have satisfied the obligation to provide the court with security for Morningstar's potential costs by arranging for two bank guarantees, one, as of July 12, 2005, in the amount of Australian $350,000, and a second, as of January 31, 2006, in the amount of Australian $300,000. Security for approximately Australian $275,000 is due to the court on June 30, 2006.

On September 20, 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, we increased our offer to settle all claims to approximately Australian $2,500,000, which approximates U.S. $1,800,000, and, in accordance with SFAS No. 5, have a reserve recorded for this amount. While Morningstar is vigorously contesting the claims against it, we cannot predict the outcome of the proceeding.

Securities and Exchange Commission "Wells Notice"

The staff of the Securities and Exchange Commission (SEC) conducted an investigation related to incorrect total return data that Morningstar published with respect to a single mutual fund, the Rock Canyon Top Flight Fund, that overstated the fund's returns. In May 2004, Morningstar received a "Wells Notice" from the staff of the Division of Enforcement of the SEC indicating that it intended to recommend that the SEC take legal action against Morningstar alleging that it violated Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10(b)-5 promulgated thereunder. On February 7, 2006, the SEC's Division of Enforcement informed Morningstar that it had decided not to proceed with an action against Morningstar.

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. On December 16, 2004, shortly after the New York Attorney General's office issued the subpoena, 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.

18. Subsequent Event

In March 2006, we acquired Ibbotson Associates, a privately held firm that specializes in asset allocation research and services, for $83 million in cash, subject to adjustments for working capital and other items. 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. Related to this acquisition, we anticipate realizing approximately $10 million in cash tax benefits during 2006 related to payment for the cancellation of Ibbotson's stock options.

19. Recently Issued Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123 (R)), which requires all companies to measure compensation cost for all share-based payments (including employee stock options) at fair value. In April 2005, the SEC announced the adoption of a rule that defers the required effective date of SFAS No. 123 (R) until the beginning of the first fiscal year beginning after June 15, 2005, instead of at the beginning of the first quarter after June 15, 2005 (as prescribed originally by SFAS No. 123 (R). Therefore, we will adopt the provisions of SFAS No. 123 (R) in the first quarter of 2006; we will adopt SFAS No. 123 (R) prospectively.

We currently measure and record compensation expense related to stock option grants in accordance with the provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*. We use a Black-Scholes model to estimate the fair value of stock options granted to employees and expect to continue to use this acceptable option valuation model upon the adoption of SFAS No. 123 (R). We currently account for forfeitures of stock options as they occur. SFAS No. 123 (R) eliminates this alternative and 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 will record a cumulative effect of accounting change, net of tax, of approximately $260,000 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 this cumulative effect of accounting change, we do not anticipate that adoption of SFAS No. 123 (R) will have a material impact on our Consolidated Statements of Operations or our Consolidated Balance Sheets. Concerning our Consolidated Statements of Cash Flows, SFAS No. 123 (R) requires that the benefits of tax deductions in excess of recognized compensation expense be reported as a financing cash flow, rather than as an operating cash flow.

This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. While we cannot estimate what those amounts will be in the future because they depend on employee stock option exercises and other factors, the amount of operating cash flows recognized in 2005 for these excess tax deductions was $2,451,000.

In March 2005, the FASB issued FASB Interpretation (FIN) No. 47, *Accounting for Conditional Asset Retirement Obligations, an Interpretation of FASB Statement No. 143*. A conditional asset retirement obligation refers to a legal obligation to retire assets where the timing and/or method of settlement are conditioned on future events. FIN No. 47 requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. FIN No. 47 is effective for companies no later than the end of the first fiscal year ending after December 15, 2005. The adoption of FIN No. 47 did not have a material impact on our results of operations, financial position, or cash flows.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections—replacement of APB Opinion No. 20 and FASB Statement No. 3*. SFAS No. 154 changes the accounting for and reporting of a change in accounting principle by requiring retrospective application to prior periods' financial statements of changes in accounting principle unless impracticable. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Companies are permitted to adopt the standard earlier than the required date for accounting changes and corrections of errors made in fiscal years beginning after the date that SFAS No. 154 was issued. We do not expect the adoption of SFAS No. 154 will have a material impact on our results of operations, financial position, or cash flows.

Shareholder Information

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Morningstar 2005 Annual Report
This report is a summary and does not provide complete information. We encourage investors to read our Annual Report on Form 10-K for the year ended December 31, 2005. This 10-K report is available without charge on Morningstar's corporate Web site at http://corporate.morningstar.com.

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2 North LaSalle Street
Chicago, IL 60602
+1 866 303-0659 (toll free)

Ethics Hotline
Morningstar has established a confidential Ethics Hotline that anyone may use to report complaints or concerns about ethics violations, including accounting irregularities, financial misstatements, problems with internal accounting controls, or non-compliance with external rules and regulations.

The Morningstar Ethics Hotline is operated by MySafeWorkplace, an independent company that is not affiliated with Morningstar. The hotline is available 24 hours a day, seven days a week.

Anyone may make a confidential, anonymous report by calling the hotline toll free at:
+1 800 461-9330 (in the United States)
+00 800 1777 9999 (outside the United States)

Price Range of Common Stock
Our common stock is listed on the Nasdaq National Market under the symbol MORN.

The following table shows the high and low price per share for our common stock as quoted on the Nasdaq National Market following our initial public offering in May 2005. Our stock was first publicly traded on May 3, 2005.

Year Ended December 31, 2005	High	Low
Second Quarter	$ 29.59	$ 18.51
Third Quarter	$ 34.10	$ 26.01
Fourth Quarter	$ 37.43	$ 24.83

Shareholders of Record
As of March 2, 2006, there were approximately 70 shareholders of record of our common stock.

Investor Questions
We encourage all interested parties—including securities analysts, potential shareholders, and others—to submit questions to us in writing. We publish responses to these questions on the first Friday of every month on our Web site and in Form 8-Ks furnished to the SEC. If you have a question about our business, please send it to investors@morningstar.com.

Board of Directors

Cheryl Francis
Vice Chairman,
Corporate Leadership Center

Steve Kaplan
Neubauer Family Professor of Entrepreneurship and Finance,
University of Chicago
Graduate School of Business

Joe Mansueto
Chairman and Chief Executive Officer,
Morningstar, Inc.

Jack Noonan
President and Chief Executive Officer,
SPSS Inc.

Don Phillips
Managing Director,
Morningstar, Inc.

Paul Sturm
Contributing Editor,
SmartMoney Magazine

Senior Management

Tim Armour
Managing Director, Strategic Relationships and Business Development

Chris Boruff
President, Advisor Business

Bevin Desmond
President, International Business

Martha Dustin Boudos
Chief Financial Officer

Catherine Gillis Odelbo
President, Individual Business

Mike Henkel
President, Ibbotson Associates

Tao Huang
Chief Operating Officer

Elizabeth Kirscher
President, Data Services Business

Art Lutschaunig
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Morningstar Investment Services, Inc.

Joe Mansueto
Chairman and Chief Executive Officer

Don Phillips
Managing Director, Corporate Strategy,
Research, and Communications

Patrick Reinkemeyer
President, Morningstar Associates, LLC

John Rekenthaler
Vice President, Research and
New Product Development

Richard E. Robbins
General Counsel and Corporate Secretary

David W. Williams
Managing Director, Design

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