

Morningstar, Inc.
Form 10-Q
August 06, 2008
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2008

OR

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

For the transition period from to

Commission File Number: 000-51280

MORNINGSTAR, INC.

(Exact Name of Registrant as Specified in its Charter)

Illinois
(State or Other Jurisdiction of
Incorporation or Organization)

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

**225 West Wacker Drive
Chicago, Illinois
60606-6303**

(Address of Principal Executive Offices)

(312) 696-6000

(Registrant's Telephone Number, Including Area Code)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(do not check if a smaller reporting company)

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

As of August 1, 2008, there were 46,420,141 shares of the Company's common stock, no par value, outstanding.

Table of Contents

MORNINGSTAR, INC. AND SUBSIDIARIES

INDEX

PART 1 **FINANCIAL INFORMATION**

- Item 1. Unaudited Condensed Consolidated Financial Statements
- Unaudited Condensed Consolidated Statements of Income for the three and six months ended June 30, 2008 and 2007
- Unaudited Condensed Consolidated Balance Sheets as of June 30, 2008 and December 31, 2007
- Unaudited Condensed Consolidated Statements of Shareholders' Equity and Comprehensive Income for the six months ended June 30, 2008
- Unaudited Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2008 and 2007
- Notes to Unaudited Condensed Consolidated Financial Statements

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

- Item 3. Quantitative and Qualitative Disclosure about Market Risk

- Item 4. Controls and Procedures

PART 2 **OTHER INFORMATION**

- Item 1. Legal Proceedings

- Item 1A. Risk Factors

- Item 4. Submission of Matters to a Vote of Security Holders

- Item 6. Exhibits

SIGNATURE

Table of Contents**PART 1: FINANCIAL INFORMATION****Item 1: Unaudited Condensed Consolidated Financial Statements****Morningstar, Inc. and Subsidiaries****Unaudited Condensed Consolidated Statements of Income**

(in thousands except per share amounts)	Three Months Ended June 30 2008		2007		Six Months Ended June 30 2008		2007	
Revenue	\$	132,237	\$	109,685	\$	257,681	\$	205,132
Operating expense (1):								
Cost of goods sold		33,164		29,020		66,102		54,875
Development		9,801		9,134		19,916		17,189
Sales and marketing		20,866		16,471		43,090		33,200
General and administrative		20,560		21,128		39,885		37,214
Depreciation and amortization		6,276		5,486		12,433		10,181
Total operating expense		90,667		81,239		181,426		152,659
Operating income		41,570		28,446		76,255		52,473
Non-operating income (expense):								
Interest income, net		1,381		1,437		2,900		3,186
Other expense, net		(321)		(69)		(297)		(305)
Non-operating income, net		1,060		1,368		2,603		2,881
Income before income taxes and equity in net income of unconsolidated entities		42,630		29,814		78,858		55,354
Income tax expense		15,076		11,996		28,580		22,287
Equity in net income of unconsolidated entities		445		455		797		992
Net income	\$	27,999	\$	18,273	\$	51,075	\$	34,059
Net income per share:								
Basic	\$	0.61	\$	0.43	\$	1.12	\$	0.80
Diluted	\$	0.57	\$	0.38	\$	1.04	\$	0.71
Weighted average shares outstanding:								
Basic		45,921		42,852		45,572		42,632
Diluted		49,290		47,868		49,150		47,758

	Three Months Ended June 30 2008		2007		Six Months Ended June 30 2008		2007	
(1) Includes stock-based compensation expense of:								

Edgar Filing: Morningstar, Inc. - Form 10-Q

Cost of goods sold	\$	528	\$	513	\$	964	\$	851
Development		367		371		688		624
Sales and marketing		379		412		724		711
General and administrative		1,695		1,907		3,337		3,351
Total stock-based compensation expense	\$	2,969	\$	3,203	\$	5,713	\$	5,537

See notes to unaudited condensed consolidated financial statements.

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

(in thousands except share amounts)	June 30 2008	December 31 2007
Assets		
Current assets:		
Cash and cash equivalents	\$ 206,877	\$ 159,576
Investments	64,560	99,012
Accounts receivable, less allowance of \$200 and \$161, respectively	95,950	86,812
Income tax receivable	9,409	8,998
Other	14,961	13,163
Total current assets	391,757	367,561
Property, equipment, and capitalized software, net of accumulated depreciation of \$67,801 and \$57,304, respectively		
Investments in unconsolidated entities	20,041	19,855
Goodwill	158,338	128,141
Intangible assets, net	114,986	95,767
Deferred tax asset, net	11,167	15,658
Other assets	3,417	3,217
Total assets	\$ 735,657	\$ 649,307
Liabilities and shareholders equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 28,489	\$ 22,325
Accrued compensation	41,780	64,709
Deferred revenue	142,376	129,302
Deferred tax liability, net	1,051	557
Other	472	945
Total current liabilities	214,168	217,838
Accrued compensation	8,354	13,913
Other long-term liabilities	15,211	9,253
Total liabilities	237,733	241,004
Shareholders equity:		
Common stock, no par value, 200,000,000 shares authorized, of which 46,341,416 and 44,843,166 shares were outstanding as of June 30, 2008 and December 31, 2007, respectively	4	4
Treasury stock at cost, 233,332 shares at June 30, 2008 and December 31, 2007	(3,280)	(3,280)
Additional paid-in capital	367,815	332,164
Retained earnings	122,832	71,757
Accumulated other comprehensive income:		
Currency translation adjustment	10,399	7,606
Unrealized gains on available-for-sale investments	154	52
Total accumulated other comprehensive income	10,553	7,658
Total shareholders equity	497,924	408,303
Total liabilities and shareholders equity	\$ 735,657	\$ 649,307

See notes to unaudited condensed consolidated financial statements.

Table of Contents**Morningstar, Inc. and Subsidiaries****Unaudited Condensed Consolidated Statement of Shareholders' Equity and Comprehensive Income****For the Six Months Ended June 30, 2008**

(in thousands, except share amounts)	Common Stock Shares Outstanding	Par Value	Treasury Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders Equity
Balance as of December 31, 2007	44,843,166	\$ 4	\$ (3,280)	\$ 332,164	\$ 71,757	\$ 7,658	\$ 408,303
Comprehensive income:							
Net income					51,075		51,075
Unrealized gain on investments, net of income tax \$56						102	102
Foreign currency translation adjustment						2,793	2,793
Total comprehensive income					51,075	2,895	53,587
Issuance of common stock related to stock option exercises and vesting of restricted stock units, net	1,498,250			12,595			12,595
Stock-based compensation				5,713			5,713
Tax benefit derived from stock option exercises and vesting of restricted stock units				17,343			17,343
Balance as of June 30, 2008	46,341,416	\$ 4	\$ (3,280)	\$ 367,815	\$ 122,832	\$ 10,553	\$ 497,924

See notes to unaudited condensed consolidated financial statements.

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

(in thousands)	Six Months Ended June 30	
	2008	2007
Operating activities		
Net income	\$ 51,075	\$ 34,059
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	12,433	10,181
Deferred income tax expense (benefit)	2,919	(1,698)
Stock-based compensation expense	5,713	5,537
Provision for bad debt	(11)	(44)
Equity in net income of unconsolidated entities	(797)	(992)
Foreign exchange (gain) loss	(508)	120
Excess tax benefits from stock option exercises and vesting of restricted stock units	(17,343)	(7,011)
Other, net	(256)	(125)
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(3,222)	(5,456)
Other assets	(1,846)	869
Accounts payable and accrued liabilities	997	3,228
Accrued compensation	(28,890)	(12,891)
Income taxes current	13,104	7,203
Deferred revenue	6,772	13,389
Deferred rent	9,306	36
Other liabilities	(327)	(1,909)
Cash provided by operating activities	49,119	44,496
Investing activities		
Purchases of investments	(46,946)	(40,243)
Proceeds from sale of investments	82,213	42,220
Capital expenditures	(17,354)	(5,888)
Acquisitions, net of cash acquired	(51,017)	(55,063)
Other, net	(3)	(3)
Cash used for investing activities	(33,104)	(58,977)
Financing activities		
Proceeds from stock options exercises	12,595	5,686
Excess tax benefits from stock option exercises and vesting of restricted stock units	17,343	7,011
Other	(4)	
Cash provided by financing activities	29,934	12,697
Effect of exchange rate changes on cash	1,352	622
Net increase (decrease) in cash and cash equivalents	47,301	(1,162)
Cash and cash equivalents beginning of period	159,576	96,140
Cash and cash equivalents end of period	\$ 206,877	\$ 94,978
Supplemental disclosure of cash flow information:		
Cash paid for taxes	\$ 15,252	\$ 16,253
Supplemental information of non-cash investing and financing activities:		
Unrealized gain on available-for-sale investments	\$ 154	\$ 17

Edgar Filing: Morningstar, Inc. - Form 10-Q

See notes to unaudited condensed consolidated financial statements.

Table of Contents

MORNINGSTAR, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation of Interim Financial Information

The accompanying unaudited condensed consolidated financial statements of Morningstar, Inc. and subsidiaries (Morningstar, we, our, the Company) included herein have been prepared to conform to the rules and regulations of the Securities and Exchange Commission (SEC). The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amount of assets, liabilities, revenue, and expenses. Actual results could differ from those estimates. In the opinion of management, the statements reflect all adjustments, which are of a normal recurring nature, necessary to present fairly our financial position, results of operations, stockholders' equity, and cash flows. These financial statements and notes should be read in conjunction with our Consolidated Financial Statements and Notes thereto as of December 31, 2007 included in our Annual Report on Form 10-K filed with the SEC on March 7, 2008.

2. Summary of Significant Accounting Policies

Edgar Filing: Morningstar, Inc. - Form 10-Q

Our significant accounting policies are discussed in Note 2 of our Consolidated Financial Statements included in our Annual Report on Form 10-K filed with the SEC for the year ended December 31, 2007.

SFAS No. 157, Fair Value Measurements

In the first quarter of 2008, we adopted Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances and does not require any new fair value measurements.

The Statement utilizes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The following is a brief description of those three levels:

- Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that the Company has the ability to access.
- Level 2 Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.
- Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

We hold investments that are subject to valuation under SFAS No. 157. We do not have any liabilities subject to valuation under this Statement. The fair value of our marketable securities subject to fair value measurements and the necessary disclosures are as follows:

(\$000)	Fair Value Measurements as of June 30, 2008			
	Fair Value as of June 30, 2008	Using Fair Value Hierarchy		Level 3
		Level 1	Level 2	
Cash equivalents	\$ 97,186	\$ 97,186	\$	\$
Available-for-sale investments	57,449	57,449		
Trading securities	3,906	3,906		
Total	\$ 158,541	\$ 158,541	\$	\$

The fair values for available-for-sale and trading securities are based on quoted market prices from various stock and bond exchanges.

SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities

SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, permits entities the option to measure many financial instruments and certain other items at fair value with changes in fair value recognized in earnings each period. SFAS No. 159 allows the fair value option to be elected on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument.

Edgar Filing: Morningstar, Inc. - Form 10-Q

In the first quarter of 2008, we chose not to apply this fair value option to any of our eligible assets. We account for our investments in accordance with SFAS No.115, *Accounting for Certain Investments in Debt and Equity Securities*. Our available-for-sale investments are reported at fair value with net unrealized holding gains and losses excluded from earnings and reported as a separate component of shareholders equity and our held-to-maturity investments are reported at amortized cost. Our trading securities are reported at fair value and unrealized gains and losses are included in earnings. We account for our investments in unconsolidated subsidiaries using the equity method.

Table of Contents**3. Acquisitions, Goodwill, and Other Intangible Assets***Acquisition of the Hemscott data, media, and investor relations Web site businesses*

In January 2008, we acquired the Hemscott data, media, and investor relations Web site businesses from Ipreo Holdings, LLC for \$51,275,000 in cash including post-closing adjustments and transaction costs directly related to the acquisition, less acquired cash. The acquisition includes Hemscott Data, which has more than 20 years of comprehensive fundamental data on virtually all publicly listed companies in the United States, Canada, the United Kingdom, and Ireland; Hemscott India, which operates a state-of-the-art data collection center in New Delhi, India; Hemscott.com, a free investment research Web site in the United Kingdom; Hemscott Premium and Premium Plus, subscription-based investment research and data services; and Hemscott IR, a pioneer in best-practice online investor relations and corporate communications services in the United Kingdom. We began including the results of this acquisition in our Consolidated Financial Statements on January 9, 2008.

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

		(\$000)
Cash	\$	1,227
Accounts receivable		3,810
Other current assets		1,193
Fixed assets		1,367
Other non-current assets		309
Intangible assets		26,058
Goodwill		26,050
Deferred revenue		(4,571)
Accounts payable and accrued liabilities		(2,941)
Total purchase price	\$	52,502

If this acquisition had occurred as of January 1, 2007 and 2008, our results of operations would not have been significantly different from the amounts reported for the three and six months ended June 30, 2007 and 2008, respectively.

Acquisition of the mutual fund data business from Standard & Poor's

In March 2007, we acquired the mutual fund data business from Standard & Poor's for \$57,983,000 in cash including post-closing adjustments and transaction costs directly related to the acquisition, less acquired cash. Approximately 80% of this business is generated outside the United States. We began including the financial results of this acquisition in our Consolidated Financial Statements on March 16, 2007.

Edgar Filing: Morningstar, Inc. - Form 10-Q

Table of Contents

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

		(\$000)
Cash	\$	2,974
Accounts receivable		7,529
Other current assets		1,029
Fixed assets		126
Intangible assets		34,080
Goodwill		37,671
Deferred revenue		(16,450)
Accrued liabilities		(4,246)
Deferred tax liabilities		(1,626)
Other non-current liabilities		(130)
Total purchase price	\$	60,957

The allocation includes \$34,080,000 of acquired intangible assets. These assets include customer-related assets of \$13,040,000 that will be amortized over a weighted average period of 10 years; technology-based assets, including software and a database covering managed investment vehicles, including mutual funds, exchange-traded funds, hedge funds, and offshore funds, of \$20,580,000 that will be amortized over a weighted average period of nine years; and a non-compete agreement of \$460,000 that will be amortized over five years.

The deferred tax liability of \$1,626,000 results primarily because the amortization expense related to certain of these intangible assets is not deductible for income tax purposes.

Based on the purchase price allocation, we recorded \$37,671,000 of goodwill. The goodwill we recorded is not considered deductible for income tax purposes. SFAS No. 109, *Accounting for Income Taxes*, prohibits recognition of a deferred tax asset or liability for temporary differences in goodwill if goodwill is not amortizable and deductible for tax purposes.

The purchase price allocation includes a liability of \$1,685,000 for severance and lease termination costs. Substantially all of these liabilities were paid as of June 30, 2008.

If this acquisition had occurred as of January 1, 2007, our results of operations would not have been significantly different from the amounts reported for the six months ended June 30, 2007.

Goodwill

The following table shows the changes in our goodwill balances from January 1, 2007 to June 30, 2008:

Edgar Filing: Morningstar, Inc. - Form 10-Q

		(\$000)
Balance as of January 1, 2007	\$	86,680
Acquisition of the mutual fund data business acquired from Standard & Poor's		37,180
Acquisition of the minority interest in Morningstar Europe NV		1,000
Other, primarily currency translation		3,281
Balance as of December 31, 2007		128,141
Acquisition of the Hemscoff data, media, and investor relations Web site businesses		26,050
Adjustment to the goodwill of the mutual fund data business acquired from Standard & Poor's		491
Other, primarily currency translation		3,656
Balance as of June 30, 2008	\$	158,338

We did not record any impairment losses in the quarter or year-to-date periods ended June 30, 2008 or 2007, respectively.

Edgar Filing: Morningstar, Inc. - Form 10-Q

Table of Contents

The following table summarizes our intangible assets:

(\$000)	As of June 30, 2008			Weighted Average Useful Life (years)	As of December 31, 2007			Weighted Average Useful Life (years)
	Gross	Accumulated Amortization	Net		Gross	Accumulated Amortization	Net	
Intellectual property	\$ 27,703	\$ (7,248)	\$ 20,455	10	\$ 26,956	\$ (5,542)	\$ 21,414	10
Customer-related assets	59,216	(13,544)	45,672	10	58,721	(10,354)	48,367	10
Supplier relationships	240	(42)	198	20	240	(36)	204	20
Technology-based assets	30,351	(7,004)	23,347	9	30,059	(4,881)	25,178	9
Non-competition agreement	810	(291)	519	5	810	(206)	604	5
Intangible assets related to acquisition of the Hemscott businesses	26,058	(1,263)	24,795	10				
Total intangible assets	\$ 144,378	\$ (29,392)	\$ 114,986	10	\$ 116,786	\$ (21,019)	\$ 95,767	10

We amortize intangible assets using the straight-line method over their expected economic useful lives. Amortization expense was \$8,113,000 and \$5,841,000 for the six months ended June 30, 2008 and 2007, respectively.

As of June 30, 2008, we estimate that aggregate amortization expense for intangible assets will be \$16,346,000 in 2008; \$16,022,000 in 2009; \$14,493,000 in 2010; \$13,337,000 in 2011; \$12,670,000 in 2012; and \$11,829,000 in 2013. Our estimates of future amortization expense for intangible assets may be affected by changes to the preliminary purchase price allocations associated with our acquisition of the Hemscott data, media, and investor relations businesses.

4. Income per Share

The numerator for both basic and diluted income per share is net income. The denominator for basic income per share is the weighted average number of common shares outstanding during the period. For diluted income per share, the denominator includes the dilutive effect of outstanding employee stock options and restricted stock units using the treasury stock method. The following table shows how we reconcile our net income and the number of shares used in computing basic and diluted income per share:

(in thousands, except per share amounts)	Three Months Ended June 30 2008		Six Months Ended June 30 2008		2007
Basic income per share:					
Net income	\$ 27,999	\$ 18,273	\$ 51,075	\$ 34,059	
Weighted average common shares outstanding	45,921	42,852	45,572	42,632	
Basic net income per share	\$ 0.61	\$ 0.43	\$ 1.12	\$ 0.80	

Edgar Filing: Morningstar, Inc. - Form 10-Q

Diluted income per share:

Net income	\$	27,999	\$	18,273	\$	51,075	\$	34,059
Weighted average common shares outstanding		45,921		42,852		45,572		42,632
Net effect of dilutive stock options and restricted stock units		3,369		5,016		3,578		5,126
Weighted average common shares outstanding for computing diluted income per share		49,290		47,868		49,150		47,758
Diluted net income per share	\$	0.57	\$	0.38	\$	1.04	\$	0.71

5. Segment and Geographical Area Information

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

- Individual segment.** Our Individual segment focuses on products and services for individual investors. The largest product in this segment based on revenue is our U.S.-based Web site, Morningstar.com, which includes both paid Premium Membership service and sales of Internet advertising space. As a result of the Hemscott acquisition in the first quarter of 2008, this segment also includes revenue from the Hemscott Premium and Premium Plus subscription-based services and sales of Internet advertising space on Hemscott.com.

Table of Contents

Our Individual segment also includes Morningstar Equity Research, which we distribute through several channels. 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 that purchase our research for their own use or provide our research to their affiliated financial advisors or to individual investors. In addition, investors can access our equity research through our Premium Membership offering on Morningstar.com.

We also offer a variety of print publications about investing, including several newsletters and books.

- *Advisor segment.* Our Advisor segment focuses on products and services for financial advisors. Key products in this segment based on revenue are Morningstar Advisor Workstation and Morningstar Principia. Advisor Workstation is a Web-based investment planning system that provides financial advisors with a comprehensive set of tools for conducting their core business. 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; and Financial Communications, which includes investment conferences, Web sites, and magazines for financial advisors, as well as a series of presentations, charts, data, and graphs that financial advisors can license to use in published materials and demonstrate investment concepts to their clients.

- *Institutional segment.* Our Institutional segment focuses on products and services for institutions, including banks, insurance companies, mutual fund companies, brokerage firms, media firms, and retirement plan providers and sponsors. Key products and services in this segment based on revenue are Investment Consulting, which focuses on investment monitoring and asset allocation for funds of funds, including mutual funds and variable annuities; Licensed Data, a set of investment data spanning 10 core databases, available through electronic data feeds; 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; Retirement Advice, including the Morningstar Retirement Manager and Advice by Ibbotson platforms; and Licensed Tools and Content, a set of online tools and editorial content designed for institutions to use in their Web sites and software.

With the January 2008 Hemscott acquisition, our Licensed Data offerings include Hemscott Data, which has more than 20 years of comprehensive fundamental data on virtually all publicly listed companies in the United States, Canada, the United Kingdom, and Ireland. Other products that have been added to this segment include Hemscott Guru, a leading online research tool that contains financial data and directors biographies on more than 2,500 UK-quoted companies and 400,000 private companies; Hemscott Adviser Rankings Guide, a comprehensive listing of more than 1,800 leading providers of professional services to all UK- and Irish-registered companies listed on the London Stock Exchange; and Hemscott IR, a pioneer in best-practice online investor relations and corporate communications services in the United Kingdom.

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 to our Consolidated Financial Statements included in our Annual Report on Form 10-K as of December 31, 2007, except for the capitalization and amortization of internal product development costs and amortization of intangible assets. We exclude these items from our operating segment results to provide our chief operating decision maker with a better indication of each segment's ability to generate cash flow. This information is one of the criteria used by our chief operating decision maker in determining how to allocate resources to each segment. We include the capitalization and amortization of internal product development

Edgar Filing: Morningstar, Inc. - Form 10-Q

costs, the amortization of intangible assets, and the elimination of intersegment revenue and expense, in the Corporate Items and Eliminations category to arrive at the consolidated financial information. Our segment disclosures include the business segment information provided to our chief operating decision maker on a recurring basis. Therefore, we do not present balance sheet information, including goodwill or other intangibles, by segment.

Edgar Filing: Morningstar, Inc. - Form 10-Q

Table of Contents

The following tables show selected segment data for the three and six months ended June 30, 2008 and 2007:

Three months ended June 30, 2008					
(\$000)	Individual	Advisor	Institutional	Corporate Items & Eliminations	Total
Revenue:					
External customers	\$ 26,767	\$ 33,837	\$ 71,633	\$	\$ 132,237
Intersegment	1,380	25	1,209	(2,614)	
Total revenue	28,147	33,862	72,842	(2,614)	132,237
Operating expense, excluding stock-based compensation expense, depreciation, and amortization					
	18,459	21,738	43,821	(2,596)	81,422
Stock-based compensation expense					
	579	894	1,496		2,969
Depreciation and amortization					
	438	550	1,123	4,165	6,276
Operating income (loss)	\$ 8,671	\$ 10,680	\$ 26,402	\$ (4,183)	\$ 41,570
Capital expenditures					
	\$ 2,409	\$ 2,441	\$ 5,017	\$ 776	\$ 10,643
U.S. revenue					
				\$	\$ 99,534
Non-U.S. revenue					
				\$	\$ 32,703

Three months ended June 30, 2007					
(\$000)	Individual	Advisor	Institutional	Corporate Items & Eliminations	Total
Revenue:					
External customers	\$ 22,936	\$ 30,140	\$ 56,609	\$	\$ 109,685
Intersegment	1,233	69	945	(2,247)	
Total revenue	24,169	30,209	57,554	(2,247)	109,685
Operating expense, excluding stock-based compensation expense, depreciation, and amortization					
	16,635	20,722	37,346	(2,153)	72,550
Stock-based compensation expense					
	660	977	1,566		3,203
Depreciation and amortization					
	409	486	774	3,817	5,486
Operating income (loss)	\$ 6,465	\$ 8,024	\$ 17,868	\$ (3,911)	\$ 28,446
Capital expenditures					
	\$ 249	\$ 1,561	\$ 1,627	\$ 461	\$ 3,898
U.S. revenue					
				\$	\$ 86,538
Non-U.S. revenue					
				\$	\$ 23,147

Six months ended June 30, 2008					
(\$000)	Individual	Advisor	Institutional	Corporate Items & Eliminations	Total
Revenue:					
External customers	\$ 52,958	\$ 64,519	\$ 140,204	\$	\$ 257,681
Intersegment	2,548	37	2,566	(5,151)	
Total revenue	55,506	64,556	142,770	(5,151)	257,681
Capital expenditures					
	39,109	42,264	87,029	(5,122)	163,280

Edgar Filing: Morningstar, Inc. - Form 10-Q

Operating expense, excluding stock-based compensation expense, depreciation, and amortization								
Stock-based compensation expense		1,094		1,729		2,890		5,713
Depreciation and amortization		871		1,077		2,272	8,213	12,433
Operating income (loss)	\$	14,432	\$	19,486	\$	50,579	\$ (8,242)	\$ 76,255
Capital expenditures	\$	4,018	\$	4,705	\$	7,556	\$ 1,075	\$ 17,354
U.S. revenue							\$	194,697
Non-U.S. revenue							\$	62,984

								June 30, 2008
U.S. long-lived assets							\$	24,220
Non-U.S. long-lived assets							\$	11,731

Edgar Filing: Morningstar, Inc. - Form 10-Q

Table of Contents

Six months ended June 30, 2007					
(\$000)	Individual	Advisor	Institutional	Corporate Items & Eliminations	Total
Revenue:					
External customers	\$ 46,006	\$ 56,061	\$ 103,065	\$	\$ 205,132
Intersegment	2,224	125	1,841	(4,190)	
Total revenue	48,230	56,186	104,906	(4,190)	205,132
Operating expense, excluding stock-based compensation expense, depreciation, and amortization	34,505	38,659	67,883	(4,106)	136,941
Stock-based compensation expense	1,136	1,691	2,710		5,537
Depreciation and amortization	796	946	1,522	6,917	10,181
Operating income (loss)	\$ 11,793	\$ 14,890	\$ 32,791	\$ (7,001)	\$ 52,473
Capital expenditures	\$ 329	\$ 1,780	\$ 2,168	\$ 1,611	\$ 5,888
U.S. revenue				\$	166,399
Non-U.S. revenue				\$	38,733

	June 30, 2007	
U.S. long-lived assets	\$	10,235
Non-U.S. long-lived assets	\$	7,421

6. Investments

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

(\$000)	June 30 2008	December 31 2007
Available-for-sale	\$ 57,449	\$ 91,546
Held-to-maturity	3,205	3,428
Trading securities	3,906	4,038
Total	\$ 64,560	\$ 99,012

Held-to-maturity investments include a \$2,500,000 certificate of deposit held as collateral against two bank guarantees for our office space lease in Australia.

Table of Contents**7. Investments in Unconsolidated Entities**

Our investments in unconsolidated entities consist primarily of the following:

Morningstar Japan K.K. Morningstar Japan K.K. (MJKK) develops and markets products and services customized for the Japanese market. MJKK's shares are traded on the Osaka Stock Exchange, Hercules Market, using the ticker 4765. As of June 30, 2008, we owned approximately 34% of MJKK. We account for our investment in MJKK using the equity method. The book value of our investment in MJKK totaled \$17,690,000 and \$17,522,000 as of June 30, 2008 and December 31, 2007, respectively. The market value of our investment in MJKK was approximately Japanese Yen 4.9 billion (approximately U.S. \$45,835,000) as of June 30, 2008 and Japanese Yen 5.4 billion (approximately U.S. \$48,007,000) as of December 31, 2007.

Morningstar Korea, Ltd. Morningstar Korea provides financial information and services for investors in South Korea. Our ownership interest and profit- and loss-sharing interest in Morningstar Korea was 40% as of June 30, 2008 and December 31, 2007. We account for this investment using the equity method. Our investment totaled \$1,450,000 and \$1,512,000 as of June 30, 2008 and December 31, 2007, respectively.

Other Investments in Unconsolidated Entities. As of June 30, 2008 and December 31, 2007, the book value of our other investments in unconsolidated entities totaled \$901,000 and \$821,000, respectively, and consist primarily of our investments in Morningstar Danmark A/S (Morningstar Denmark) and Morningstar Sweden AB (Morningstar Sweden). Morningstar Denmark and Morningstar Sweden develop and market products and services customized for their respective markets. Our ownership interest in both Morningstar Denmark and Morningstar Sweden was approximately 25% as of June 30, 2008 and December 31, 2007. We account for our investments in Morningstar Denmark and Morningstar Sweden using the equity method.

The following table shows condensed combined financial information, a portion of which is unaudited, for our investments in unconsolidated entities.

(\$000)	Three months ended June 30		Six months ended June 30			
	2008	2007	2008	2007	2008	2007
Revenue	\$ 10,042	\$ 11,121	\$ 30,784	\$ 19,403	\$ 30,784	\$ 19,403
Operating income	\$ 1,780	\$ 1,911	\$ 3,406	\$ 4,070	\$ 3,406	\$ 4,070
Net income	\$ 1,424	\$ 1,266	\$ 2,553	\$ 2,441	\$ 2,553	\$ 2,441

8. Stock-Based Compensation*Stock-Based Compensation Plans*

Edgar Filing: Morningstar, Inc. - Form 10-Q

In November 2004, we adopted the 2004 Stock Incentive Plan. The 2004 Stock Incentive Plan provides for grants of options, stock appreciation rights, restricted stock, restricted stock units, and performance shares. All of our employees are eligible for awards under the 2004 Stock Incentive Plan. Our non-employee directors are also eligible for awards under the 2004 Stock Incentive Plan. Joe Mansueto, our chairman and chief executive officer, does not participate in the 2004 Stock Incentive Plan or the Prior Plans.

Since the adoption of the 2004 Stock Incentive Plan, we have granted stock options and, beginning in 2006, restricted stock units. Stock options granted under the 2004 Stock Incentive Plan generally vest ratably over a four-year period and expire 10 years after the date of grant. Almost all of the options granted under the 2004 Stock Incentive Plan have a premium feature in which the exercise price increases over the term of the option at a rate equal to the 10-year Treasury bond yield as of the date of grant. Restricted stock units represent the right to receive a share of Morningstar common stock when that unit vests. Restricted stock units granted under the 2004 Stock Incentive Plan generally vest ratably over a four-year period. At the time of grant, employees may elect to defer receipt of the Morningstar common stock issued upon vesting of the restricted stock unit. As of June 30, 2008, we had 2,520,830 shares available for future grants under our 2004 Stock Incentive Plan compared with 2,657,982 as of December 31, 2007.

Prior to November 2004, we granted stock options under various plans, including the 1993 Stock Option Plan (the 1993 Plan), the 2000 Morningstar Stock Option Plan (the 2000 Plan), and the 2001 Morningstar Stock Option Plan (the 2001 Plan). Options granted under the 1993 Plan, the 2000 Plan and the 2001 Plan generally vested over a four-year period. As a result, all of these options related to these three plans are vested. Because the options granted under all three plans expire 10 years after the date of grant, some of these options remain outstanding. 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.

Edgar Filing: Morningstar, Inc. - Form 10-Q

Table of Contents

In February 1999, we entered into an Incentive Stock Option Agreement and a Nonqualified Stock Option Agreement under the 1999 Incentive Stock Option Plan (the 1999 Plan) with Don Phillips, an officer of Morningstar. Under these agreements, we granted Don options to purchase 1,500,000 shares of common stock at an exercise price of \$2.77 per share, equal to the fair value at the grant date. These options are fully vested and expire in February 2009. As of June 30, 2008, there were 87,576 options remaining to be exercised, compared with 217,286 as of December 31, 2007.

Accounting for Stock-Based Compensation Awards

In accordance with SFAS No. 123 (R), *Stock Based Compensation*, we estimate forfeitures of all employee stock-based awards and recognize compensation cost only for those awards expected to vest. We determine forfeiture rates based on historical experience. Estimated forfeitures are adjusted to actual forfeiture experience as needed. Because our largest annual equity grants typically have vesting dates in the second quarter, we adjusted the stock-based compensation expense to reflect those awards that ultimately vested. As a result, in the second quarter of 2008 and 2007, we recorded approximately \$210,000 and \$720,000, respectively of additional stock-based compensation expense as a result of adjusting from the estimated forfeitures to actual forfeiture experience for certain of our employee stock option and restricted stock unit grants. In addition, we reduced our estimate of the forfeiture rate that will be applied to awards not yet vested.

The following table summarizes stock-based compensation expense:

(\$000)	Three months ended June 30		Six months ended June 30	
	2008	2007	2008	2007
Stock-based compensation expense	\$ 2,969	\$ 3,203	\$ 5,713	\$ 5,537

We recorded deferred tax benefits related to this of \$1,113,000 and \$1,181,000 for the three months ended June 30, 2008 and 2007, respectively, and \$2,004,000 and \$2,020,000 for the six months ended June 30, 2008 and 2007, respectively.

Restricted Stock Units

We measure the fair value of our restricted stock units on the date of grant based on the market price of the underlying common stock as of the close of trading on the day prior to grant. We amortize that value to stock-based compensation expense, net of estimated forfeitures, ratably over the vesting period. The total grant date fair value of restricted stock units granted in the first six months of 2008 was approximately \$12,366,000. As of June 30, 2008, the total amount of unrecognized stock-based compensation expense related to restricted stock units was approximately \$24,010,000. We expect to recognize this expense over an average period of approximately 38 months.

The following table summarizes restricted stock unit activity in the first six months of 2008:

Restricted Stock Units (RSUs)	Unvested	Total
-------------------------------	----------	-------

Edgar Filing: Morningstar, Inc. - Form 10-Q

		Vested but Deferred			Weighted Average Grant Date Fair Value
Restricted Stock Units	December 31, 2007	414,282	6,621	420,903	\$ 48.41
Granted		175,805		175,805	\$ 70.34
Vested		(76,555)		(76,555)	\$ 46.84
Vested but deferred		(15,394)	15,394		\$
Forfeited		(15,653)		(15,653)	\$ 48.78
Restricted Stock Units	June 30, 2008	482,485	22,015	504,500	\$ 56.71

Edgar Filing: Morningstar, Inc. - Form 10-Q

Table of Contents

Stock Options

The following tables summarize stock option activity in the first six months of 2008 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.

Six months ended June 30, 2008			
Options Granted At an Exercise Price Below the Fair Value Per Share on the Grant Date	Underlying Shares		Weighted Average Exercise Price
Options outstanding December 31, 2007	2,068,590	\$	12.84
Canceled	(7,175)	\$	16.67
Exercised	(414,150)	\$	10.41
Options outstanding June 30, 2008	1,647,265	\$	13.62
Options exercisable June 30, 2008	1,619,515	\$	13.56

Six months ended June 30, 2008			
All Other Option Grants, Excluding Activity Shown Above	Underlying Shares		Weighted Average Exercise Price
Options outstanding December 31, 2007	4,377,089	\$	13.61
Canceled	(16,239)	\$	20.71
Exercised	(1,021,963)	\$	10.20
Options outstanding June 30, 2008	3,338,887	\$	14.73
Options exercisable June 30, 2008	3,093,235	\$	13.98

The total intrinsic value (difference between the market value of our stock on the date of exercise and the exercise price of the option) of options exercised in the six months ended June 30, 2008 and 2007 was \$82,224,000 and \$30,434,000, respectively.

The table below shows additional information for options outstanding and options exercisable as of June 30, 2008:

Range of Exercise Prices	Options Outstanding			Options Exercisable				
	Outstanding Shares	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Aggregate Intrinsic Value (\$000)	Exercisable Shares	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Aggregate Intrinsic Value (\$000)
\$2.77	165,857	0.57	\$ 2.77	\$ 11,488	165,654	0.57	\$ 2.77	\$ 11,474
\$8.57 - \$14.70	3,282,362	2.55	\$ 12.46	195,535	3,281,730	2.55	\$ 12.46	195,496
\$17.01 - \$38.57	1,537,933	6.73	\$ 19.76	80,390	1,265,366	6.67	\$ 18.95	67,170

Edgar Filing: Morningstar, Inc. - Form 10-Q

\$2.77 - \$38.57	4,986,152	3.77	\$	14.39	\$	287,413	4,712,750	3.59	\$	13.86	\$	274,140
Vested or Expected to Vest												
\$2.77 - \$38.57	4,960,561	3.76	\$	14.34	\$	286,167						

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on our closing stock price of \$72.03 on June 30, 2008, which would have been received by the option holders had all option holders exercised their options as of that date.

As of June 30, 2008, the total amount of unrecognized stock-based compensation expense related to non-vested stock options was approximately \$2,351,000. We expect to recognize this expense over a weighted average period of approximately 10 months.

Table of Contents**9. Related Party Transactions**

In 1989, under our 1989 Nonqualified Stock Option Plan (the 1989 Plan), we granted options to purchase 1,500,000 shares of common stock at an exercise price of \$0.075 per share, equal to the fair value at date of issue, to Don Phillips, an officer of Morningstar. These options were not exercised and expired in February 1999. In February 1999, in conjunction with the expiration of options granted under the 1989 Plan, we entered into a Deferred Compensation Agreement (the Agreement) with Don. Under the terms of the Agreement, on any date that Don exercises the right to purchase shares under the 1999 Plan, we shall pay to him \$2.69 per share in the form of cash or, at our election, shares of common stock. If on the date of purchase the fair value of Morningstar's stock is below \$2.77 per share, the amount paid per share will be reduced based on the terms of the Agreement. Our obligation to pay deferred compensation will not be increased by any imputed interest or earnings amount.

In May 2006, Don Phillips entered into a Rule 10b5-1 sales plan contemplating the sale of shares to be acquired through stock option exercises. Upon exercise of these stock options, we will make payments to him, as prescribed by the Agreement. In the first six months of 2008, Don exercised 129,710 options, of which 72,710 were sold under his 10b5-1 plan. As of June 30, 2008 and December 31, 2007, our Condensed Consolidated Balance Sheets include a liability of \$261,000 and \$585,000, respectively, for the Agreement. The liability is classified as Other current liabilities. The reduction in the liability since December 31, 2007 reflects amounts paid to Don in the first six months of 2008 in accordance with the Agreement.

10. Income Taxes

The following table shows our effective tax rate for the three and six months ended June 30, 2008 and 2007:

(\$000)	Three months ended June 30		Six months ended June 30	
	2008	2007	2008	2007
Income before income taxes and equity in net income of unconsolidated entities	\$ 42,630	\$ 29,814	\$ 78,858	\$ 55,354
Equity in net income of unconsolidated entities	445	455	797	992
Total	\$ 43,075	\$ 30,269	\$ 79,655	\$ 56,346
Income tax expense	\$ 15,076	\$ 11,996	\$ 28,580	\$ 22,287
Effective income tax expense rate	35.0%	39.6%	35.9%	39.6%

Our effective tax rate declined by 4.6 percentage points in the second quarter of 2008 and declined 3.7 percentage points for the six months ended June 30, 2008 compared with the prior-year periods. The 2008 effective tax rate reflects the favorable, but variable, benefit from incentive stock-option transactions. When compared against the same periods in 2007, the tax benefit of incentive stock-option transactions reduced the effective tax rate by 1.6 percentage points and 0.7 percentage points in the three and six months ended June 30, 2008 respectively. A decrease in our U.S. state tax rate following a 2007 change in state tax law and the favorable impact of lower tax rates on earnings generated outside of the United States also lowered our effective tax rate compared with the prior year periods.

We conduct business globally and as a result, we file income tax returns in U.S. Federal, state, local, and foreign jurisdictions. In the normal course of business we are subject to examination by tax authorities throughout the world. The open tax years for our U.S. Federal tax return include the years 2004 to the present. Most of our state tax returns have open tax years from 2004 to the present. In non-U.S. jurisdictions, the statute of limitations generally extends to years prior to 2003. There were no significant changes to uncertain tax positions in the first half of

Edgar Filing: Morningstar, Inc. - Form 10-Q

2008 as a result of lapses of statutes of limitation or audit activity.

We are currently under audit by various state and local tax authorities in the United States. We are also under audit by the tax authorities in certain non-U.S. jurisdictions. It is likely that the examination phase of some of these state, local, and non-U.S. audits will conclude in 2008. It is not possible to estimate the impact of current audits on previously recorded unrecognized tax benefits.

As of December 31, 2007 we had approximately \$7,195,000 of gross unrecognized tax benefits, of which \$4,741,000, if recognized, would result in a reduction of our effective income tax rate, and \$2,383,000 of tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of the deduction. In the first six months of 2008 we reduced the unrecognized tax benefit in the amount of \$2,383,000 and recorded a corresponding decrease to our deferred tax assets as a result of expected resolution concerning the timing of the deduction. Because of the impact of deferred tax accounting, other than interest and penalties, this liability did not affect our 2008 effective tax rate. Adjustments recorded to other unrecognized tax benefits in the first six months of 2008 were not material.

Table of Contents

Our effective income tax rate reflects the fact that we are not recording an income tax benefit related to losses recorded by certain of our non-U.S. operations. The net operating losses (NOLs) may become deductible in certain non-U.S. tax jurisdictions to the extent these non-U.S. operations become profitable. In the year certain non-U.S. entities record 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 NOLs 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. Upon determining that it is more likely than not that the NOLs will be realized, we reduce the tax valuation allowances related to these NOLs, which results in a reduction to our income tax expense and our effective tax rate in the period. In the first half of 2008 and 2007, we recorded a net reduction of the valuation allowances related to the NOLs for certain of our non-U.S. operations, reducing our effective tax rate in each of these years.

11. Contingencies

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

Securities and Exchange Commission

In February 2005, Morningstar Associates, LLC, a wholly owned subsidiary of Morningstar, Inc., received a request from the SEC for the voluntary production of documents relating to the investment consulting services the company offers to retirement plan providers, including fund lineup recommendations for retirement plan sponsors. In July 2005, the SEC issued a subpoena to Morningstar Associates that was virtually identical to its February 2005 request.

Subsequently, the SEC focused on disclosure relating to an optional service offered to retirement plan sponsors (employers) that select 401(k) plan services from ING, one of Morningstar Associates' clients. In response to the SEC investigation, ING and Morningstar Associates revised certain documents for plan sponsors to further clarify the roles of ING and Morningstar Associates in providing that service. The revisions also help reinforce that Morningstar Associates makes its selections only from funds available within ING's various retirement products.

In January 2007, the SEC notified Morningstar Associates that it ended its investigation, with no enforcement action, fines, or penalties.

New York Attorney General's Office

In December 2004, Morningstar Associates received a subpoena from the New York Attorney General's office seeking information and documents related to an investigation the New York Attorney General's office is conducting. The request is similar in scope to the SEC subpoena described above. Morningstar Associates has provided the requested information and documents.

Edgar Filing: Morningstar, Inc. - Form 10-Q

In January 2007, Morningstar Associates received a Notice of Proposed Litigation from the New York Attorney General's office. The Notice centers on the same issues that became the focus of the SEC investigation described above. The Notice gave Morningstar Associates the opportunity to explain why the New York Attorney General's office should not institute proceedings. Morningstar Associates promptly submitted its explanation and has cooperated fully with the New York Attorney General's office.

We cannot predict the scope, timing, or outcome of this matter, 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, this matter may have on our business, operating results, or financial condition.

United States Department of Labor

In May 2005, Morningstar Associates received a subpoena from the United States Department of Labor, seeking information and documents related to an investigation the Department of Labor is conducting. The Department of Labor subpoena is substantially similar in scope to the SEC and New York Attorney General subpoenas.

In January 2007, the Department of Labor issued a request for additional documents pursuant to the May 2005 subpoena, including documents and information regarding Morningstar Associates' retirement advice products for plan participants. Morningstar Associates continues to cooperate fully with the Department of Labor.

Table of Contents

We cannot predict the scope, timing, or outcome of this matter, which may include the institution of administrative, civil, injunctive, or criminal proceedings, the imposition of fines and penalties, and other remedies and sanctions, any of which could lead to an adverse impact on our stock price, the inability to attract or retain key employees, and the loss of customers. We also cannot predict what impact, if any, these matters may have on our business, operating results, or financial condition.

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

12. Recently Issued Accounting Pronouncements

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of SFAS No. 133*. The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. To date, we have not engaged in currency or other hedging activities, and we do not currently have any positions in derivative instruments. Therefore, we do not expect the adoption of SFAS No. 161 will have any impact on our Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations*. SFAS No. 141(R) modifies the financial accounting and reporting of business combinations. SFAS No. 141(R) requires the acquirer to recognize and measure the fair value of the acquired operation as a whole, and the assets acquired and liabilities assumed at their full fair values as of the date control is obtained, regardless of the percentage ownership in the acquired operation or how the acquisition was achieved. SFAS No. 141(R) is effective for business combination transactions with acquisition dates on or after the first annual reporting period beginning on or after December 15, 2008. SFAS No. 141(R) is required to be adopted concurrently with SFAS No. 160, *Accounting and Reporting of Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*. SFAS No. 141(R) requires prospective application and prohibits earlier application. We are in the process of determining the effect the adoption of SFAS No. 141 (R) will have on our Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 160, *Accounting and Reporting of Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*. SFAS No. 160 amends the financial accounting and reporting of noncontrolling (or minority) interests in consolidated financial statements. SFAS No. 160 is required to be adopted concurrently with SFAS No. 141(R) and is effective for the first annual reporting period beginning on or after December 15, 2008. Earlier application is prohibited. We are in the process of determining the effect the adoption of SFAS No. 160 will have on our Consolidated Financial Statements.

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The discussion included in this section, as well as other sections of this Quarterly Report on Form 10-Q, contains forward-looking statements as that term is used in the Private Securities Litigation Reform Act of 1995. These statements are based on our current expectations about future events or future financial performance. Forward-looking statements by their nature address matters that are, to different degrees, uncertain, and often contain words such as may, could, expect, intend, plan, seek, anticipate, believe, estimate, predict, potential, or continue. These statements involve known and unknown risks and uncertainties that may cause the events we discussed not to occur or to differ significantly from what we expected. For us, these risks and uncertainties include, among others, general industry conditions and competition; damage to our reputation resulting from claims made about possible conflicts of interest; liability for any losses that result from an actual or claimed breach of our fiduciary duties; legal, regulatory, or political issues related to our data center in China; the potential impact of market volatility on revenue from asset-based fees; a prolonged outage of our database and network facilities; challenges faced by our non-U.S. operations; and the availability of free or low-cost investment information.

A more complete description of these risks and uncertainties can be found in our other filings with the SEC, including our Annual Report on Form 10-K for the year ended December 31, 2007. If any of these risks and uncertainties materialize, our actual future results may vary significantly from what we expected. We do not undertake to update our forward-looking statements as a result of new information or future events.

Understanding our Company

Our Business

Our mission is to create great products that help investors reach their financial goals. We offer an extensive line of Internet, software, and print-based products for individual investors, financial advisors, and institutional clients. We also offer asset management services for advisors, institutions, and retirement plan participants. Many of our products are sold through subscriptions or license agreements. As a result, we typically generate recurring revenue.

We emphasize a decentralized approach to running our business to empower our managers and to create a culture of responsibility and accountability. We operate our decentralized business structure in three global business segments: Individual, Advisor, and Institutional. In all three of these segments, we believe our work helps individual investors make better investment decisions.

Historically, we have focused primarily on organic growth by introducing new products and services and expanding our marketing efforts for existing products. However, we have made and expect to continue to make selective acquisitions that support our four key growth strategies, which are:

Edgar Filing: Morningstar, Inc. - Form 10-Q

- Enhance our position in each of our three operating segments by focusing on our three major Internet-based platforms;
- Become a global leader in funds-of-funds investment management;
- Expand the range of services we offer investors, financial advisors, and institutional clients; and
- Expand our international brand presence, products, and services.

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.

In the second quarter of 2008, the U.S. equity markets began on a more stable note, but investors remained uncertain about the impact of the credit crisis, rising energy prices, and possible inflation. Morningstar's U.S. Market Index, a broad market benchmark, was down 1.5% for the quarter, following a 9.5% loss in the first quarter of 2008. For the six months ending June 30, 2008 the U.S. Market Index was down 10.8%. Many global markets also experienced losses during the quarter, and bond markets also suffered because of widening credit spreads as well as fears of inflation and possible interest-rate increases.

Net inflows to mutual funds were relatively stable during the quarter. Total U.S. mutual fund assets were \$11.7 trillion as of June 30, 2008, about the same as the total as of March 31, 2008, based on data from the Investment Company Institute (ICI).

Asset flows to alternative asset classes remained lower than 2007 levels. Based on data from Hedge Fund Research, hedge funds had \$12.5 billion in net inflows during the second quarter of 2008, which was down significantly from the same period in 2007. Assets in exchange-traded funds (ETFs) increased to \$578 billion as of June 30, 2008, compared with \$571 billion as of March 31, 2008, based on data from the ICI.

Table of Contents

Despite weakness in some areas of the financial sector, online advertising generally remained strong as advertisers have continued to shift spending from traditional media to the Internet. Industry publication eMarketer projects that total online ad spending will reach \$25.9 billion in 2008, a 23% increase from 2007. Based on data from Nielsen/Net Ratings, aggregate page views and unique users to financial and investment sites both increased by about 20% in the second quarter of 2008 compared with the same period in 2007, although the number of pages viewed per visit declined by about 9%. We believe this indicates that while some investors may be disengaged because of the market downturn, many people are still interested in investment-related content.

Overall, we believe the disruption in the financial markets has caused fairly widespread investor uncertainty, and the market downturn has also created some spending cutbacks among asset management firms and other financial services companies. We remain cautious because of the tough market environment, but we are continuing to invest in our business.

Three and Six Months Ended June 30, 2008 vs. Three and Six Months Ended June 30, 2007**Consolidated Results**

Key Metrics (\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
Revenue	\$ 132,237	\$ 109,685	20.6%	\$ 257,681	\$ 205,132	25.6%
Operating income	41,570	28,446	46.1%	76,255	52,473	45.3%
Operating margin	31.4%	25.9%	5.5pp	29.6%	25.6%	4.0pp
Cash provided by (used for) investing activities	4,859	(10,938)	NMF	(33,104)	(58,977)	(43.9)%
Cash provided by financing activities	18,217	8,991	102.6%	29,934	12,697	135.8%
Cash provided by operating activities	\$ 47,742	\$ 36,112	32.2%	\$ 49,119	\$ 44,496	10.4%
Capital expenditures	(10,643)	(3,898)	173.0%	(17,354)	(5,888)	194.7%
Free cash flow	\$ 37,099	\$ 32,214	15.2%	\$ 31,765	\$ 38,608	(17.7)%

NMF not meaningful

pp percentage points

We define free cash flow as cash provided by or used for operating activities less capital expenditures. We present free cash flow solely as supplemental disclosure to help you better understand how much cash is available after we spend money to operate our business. Our management team uses free cash flow to evaluate the performance of our business. Free cash flow is not a measure of performance set forth under U.S. generally accepted accounting principles (GAAP). Also, the free cash flow definition we use may not be comparable to similarly titled measures used by other companies.

Second-Quarter Highlights

- Revenue increased 20.6% compared with the same period in 2007. Because of the difficult market environment, our organic revenue growth (which we define as consolidated revenue excluding acquisitions and the impact of foreign currency translations) was slower compared with past levels, but still relatively strong given market conditions.
- Our second-quarter financial results include the Hemscott data, media, and investor relations Web site businesses, which we acquired on January 9, 2008. Revenue from acquisitions contributed 4.4 percentage points to second-quarter revenue growth.
- Licensed Data and Morningstar Advisor Workstation were the two largest contributors to organic revenue growth during the quarter, reflecting demand from new and existing customers.
- International revenue grew about 40% compared with the second quarter of 2007, and the percentage of revenue from outside the United States was on par with first-quarter levels. Acquisitions accounted for about one-third of the growth in international revenue. Favorable changes in exchange rates added about 13 percentage points of the growth.

Table of Contents

- Operating margin increased by 5.5 percentage points relative to the prior-year period, partly because of lower bonus, legal, and general and administrative expense.
- Free cash flow increased by approximately \$4.9 million compared with the prior-year period, reflecting an \$11.6 million increase in cash flow from operations and a \$6.7 million increase in capital expenditures.

Consolidated Revenue

Because we have made several acquisitions in recent years, comparing our financial results from year to year is complex. To make it easier for investors to compare our results in different periods, we provide information on both organic revenue, which reflects our underlying business excluding acquisitions, and revenue from acquisitions. We include an acquired operation as part of our revenue from acquisitions for 12 months after we complete the acquisition. After that, we include it as part of our organic revenue.

The table below shows the period in which we included each acquired operation in revenue from acquisitions:

Acquisition	Revenue from Acquisitions	
	Three Months Ended June 30, 2008	Six Months Ended June 30, 2008
Mutual fund data business acquired from Standard & Poor's		January 1, 2008 through March 15, 2008
Hemscott data, media, and investor relations Web site businesses	April 1, 2008 through June 30, 2008	January 9, 2008 through June 30, 2008

In the second quarter of 2008, our consolidated revenue increased 20.6% to \$132.2 million. Revenue for the first half of the year increased 25.6% to \$257.7 million. Acquisitions contributed \$4.9 million to our consolidated revenue in the second quarter of 2008 and \$16.0 million in the six months ended June 30, 2008. Foreign currency translations also had a positive impact on revenue, particularly in the second quarter. Because of continued market weakness and economic uncertainty, organic revenue increased at a lower rate than in the past, although it was still relatively strong for both the second quarter and first six months of 2008.

Consolidated revenue excluding acquisitions and the impact of foreign currency translations (organic revenue) is considered a non-GAAP financial measure. The definition of organic revenue we use may not be the same as similarly titled measures used by other companies. Organic revenue should not be considered an alternative to any measure of performance as promulgated under GAAP.

The table below reconciles consolidated revenue with revenue excluding acquisitions and the impact of foreign currency translations (organic revenue):

Edgar Filing: Morningstar, Inc. - Form 10-Q

(\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
Consolidated revenue	\$ 132,237	\$ 109,685	20.6%	\$ 257,681	\$ 205,132	25.6%
Less: acquisitions	(4,876)		NMF	(15,974)		NMF
Less: impact of foreign currency translations	(3,085)		NMF	(5,366)		NMF
Consolidated revenue excluding acquisitions and foreign currency translations	\$ 124,276	\$ 109,685	13.3%	\$ 236,341	\$ 205,132	15.2%

The Institutional segment was the largest contributor to revenue growth, generating about two-thirds of the increase in revenue for both the second quarter and six-month periods. Institutional segment revenue increased \$15.3 million, or 26.6%, in the second quarter of 2008, and \$37.9 million, or 36.1%, in first six months of 2008. Acquisitions contributed approximately \$4.3 million to Institutional segment revenue in the second quarter and \$13.7 million in the first six months. Advisor segment revenue increased \$3.7 million, or 12.1%, in the second quarter and \$8.4 million, or 14.9%, in the first six months of 2008. All of the second-quarter Advisor segment revenue was organic; for the year-to-date period, acquisitions contributed \$1.1 million to this segment. Individual segment revenue increased \$4.0 million, or 16.5%, in the second quarter and \$7.3 million, or 15.1%, in the first six months of the year. Acquisitions contributed \$0.6 million and \$1.1 million of revenue to the Individual segment in the second quarter and year-to-date periods, respectively.

Edgar Filing: Morningstar, Inc. - Form 10-Q

Table of Contents

The table below presents our consolidated revenue by segment for the three and six months ended June 30, 2008 and 2007:

Revenue by Segment (\$000)	Three Months Ended June 30			Six Months Ended June 30			2007					
	2008	Amount	% of total	2007	Amount	% of total	2008	Amount	% of total			
Individual	\$	28,147	21.3%	\$	24,169	22.0%	\$	55,506	21.5%	\$	48,230	23.5%
Advisor		33,862	25.6		30,209	27.5		64,556	25.1		56,186	27.4
Institutional		72,842	55.1		57,554	52.5		142,770	55.4		104,906	51.1
Elimination of intersegment revenue		(2,614)	(2.0)		(2,247)	(2.0)		(5,151)	(2.0)		(4,190)	(2.0)
Consolidated revenue	\$	132,237	100.0%	\$	109,685	100.0%	\$	257,681	100.0%	\$	205,132	100.0%

On a product level, Licensed Data and Morningstar Advisor Workstation were the two largest contributors to organic revenue growth in the second quarter, and were also major contributors to revenue growth for the six-month period. Licensed Data was a major contributor to growth in the quarter, reflecting demand from new and existing customers. Total licenses for Morningstar Advisor Workstation in the United States were up 15.2% as of June 30, 2008 compared with the same period in 2007. Growth in Advisor Workstation reflects additional users and functionality for existing clients as well as new client contracts. The year-over-year comparisons also reflect the ongoing positive impact of renewal deals signed in 2007 for expanded functionality and additional users.

Investment Consulting was the third-largest contributor to organic revenue growth in the second quarter and the second largest driver behind organic revenue growth for the six-month period, although growth was more moderate than in the past. Much of our Investment Consulting business focuses on asset allocation services that we provide for funds of funds, where we typically act as a portfolio consultant or portfolio construction manager. While assets under advisement increased more than 20% year over year for both periods, asset levels only rose modestly compared with the first quarter of 2008. Changes in the value of assets under advisement can come from two primary sources: gains or losses related to overall trends in market performance, and net inflows or outflows caused when investors add to or redeem shares from these portfolios. Most of the funds of funds on which we provide advisory services continued to show net inflows, but these inflows were partially offset by negative market performance.

During the quarter, an Investment Consulting client informed us that it does not plan to renew its contract in October 2008. This contract represented about \$11.3 million, or 2%, of our consolidated revenue for the 12-month period ending June 30, 2008. We expect to continue providing other services to this client and will seek to replace this work with new business.

The remaining increase in organic revenue on a product level was driven primarily by Morningstar Direct, and, to a lesser extent, Morningstar.com, which includes Premium Membership service and Internet advertising sales.

Revenue from international operations increased as a percentage of total revenue for both periods, although more so for the year-to-date period. The fund data business acquired from Standard & Poor's and the Hemscott data business both have extensive operations outside the United States. Revenue from international operations grew \$9.6 million, or 41.3%, to \$32.7 million in the second quarter of 2008, with acquisitions contributing \$3.5 million of the increase. In the year-to-date period, revenue from international operations increased \$24.3 million, or 62.6%, to \$63.0 million, with acquisitions contributing \$12.4 million to the increase.

Edgar Filing: Morningstar, Inc. - Form 10-Q

Foreign currency translations also had a favorable impact on international revenue, particularly in the second-quarter period. Foreign currency translations contributed \$3.1 million to international revenue during the quarter. Excluding the impact of acquisitions and foreign currency translations, revenue growth in our non-U.S. operations was approximately 12.9% and 16.7%, respectively, in the quarter and year-to-date periods. As in the United States, international organic growth for the current quarter was lower than past levels, reflecting the impact of slower growth rates in the operations we acquired from Standard & Poor s.

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

(\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
International revenue	\$ 32,703	\$ 23,147	41.3%	\$ 62,984	\$ 38,733	62.6%
Less: acquisitions	(3,495)		NMF	(12,399)		NMF
Less: impact of foreign currency translations	(3,085)		NMF	(5,366)		NMF
International revenue excluding acquisitions and foreign currency translations	\$ 26,123	\$ 23,147	12.9%	\$ 45,219	\$ 38,733	16.7%

Table of Contents

We present international organic revenue because we believe this non-GAAP financial measure helps investors better compare period-to-period results. International organic revenue should not be considered an alternative to any measure of performance as promulgated under GAAP.

Consolidated Operating Expense

(\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
Operating expense	\$ 90,667	\$ 81,239	11.6%	\$ 181,426	\$ 152,659	18.8%
% of revenue	68.6%	74.1%	(5.5)pp	70.4%	74.4%	(4.0)pp

In the second quarter of 2008, our consolidated operating expense rose moderately, increasing \$9.4 million, or 11.6%, compared with the same period in 2007. For the first six months of 2008, operating expense was up \$28.8 million, or 18.8%.

Compensation-related expense, excluding bonuses, accounted for the majority of the increase in both periods, mainly because of growth in headcount and higher sales commission expense. We had approximately 2,060 employees worldwide as of June 30, 2008, compared with approximately 1,620 as of June 30, 2007. With our acquisition of Hemscott, we added approximately 200 employees in New Delhi, India plus 60 in Europe. Over the past year, we have also continued hiring in China and the United States. Shortly after the end of the second quarter, we hired 50 employees as part of the Morningstar Development Program, a two-year rotational program for entry-level college graduates.

Bonus expense recorded in the second quarter of 2008 declined by \$0.9 million compared with the same period in 2007, and increased \$1.6 million in the year-to-date period. Changes in the size of our bonus pool are based on full-year operating income growth relative to the previous year. The size of the bonus pool varies each year and is reviewed and updated quarterly.

Other factors contributing to the increase in operating expense in the quarter include higher lease expense for our new headquarters and offices outside the United States. We also had higher marketing expense in Europe in the second quarter as well as additional amortization expense. These expense increases were partially offset by lower legal fees and general and administrative costs. In addition, we had about \$1.6 million in product implementation expense for Advice by Ibbotson in the first half of 2007 that did not recur in the first six months of 2008.

As a percentage of revenue, operating expense declined by 5.5 percentage points in the second quarter of 2008 compared with the same quarter in 2007. In the first half of 2008, operating expense as a percentage of revenue declined by 4.0 percentage points compared with the same period in 2007. In both the second quarter and first half of 2008, operating margin increased partly because of lower bonus expense, legal expense, and other general and administrative expense as a percentage of revenue, as well as the decline in product implementation expense associated with the Advice by Ibbotson service.

Cost of Goods Sold

Edgar Filing: Morningstar, Inc. - Form 10-Q

(\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
Cost of goods sold	\$ 33,164	\$ 29,020	14.3%	\$ 66,102	\$ 54,875	20.5%
% of revenue	25.1%	26.5%	(1.4)pp	25.7%	26.8%	(1.1)pp
Gross profit	\$ 99,073	\$ 80,665	22.8%	\$ 191,579	\$ 150,257	27.5%
Gross margin	74.9%	73.5%	1.4pp	74.3%	73.2%	1.1pp

Cost of goods sold is our largest category of operating expense, accounting for more than one-third of our total operating expense in both 2008 and 2007. Our business relies heavily on human capital, and cost of goods sold includes the compensation expense for employees who produce our products and services.

Cost of goods sold increased \$4.1 million in the second quarter of 2008 and \$11.2 million in the first six months of 2008. About three-fourths of the increase was driven by higher compensation expense. However, this was partly offset by a reduction in product implementation expense. In 2007, we recorded outsourced product implementation expense associated with the Advice by Ibbotson service of \$0.3 million in the second quarter and \$1.6 million in the year-to-date period, which did not recur in 2008.

Edgar Filing: Morningstar, Inc. - Form 10-Q

Table of Contents

Because cost of goods sold increased at a lower rate than revenue, gross margin in the second quarter of 2008 rose to 74.9%, compared with 73.5% in the second quarter of 2007. The year-to-date gross margin improved to 74.3%, compared with 73.2% in the same period last year.

Development Expense

(\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
Development expense	\$ 9,801	\$ 9,134	7.3%	\$ 19,916	\$ 17,189	15.9%
% of revenue	7.4%	8.3%	(0.9)pp	7.7%	8.4%	(0.7)pp

Development expense increased \$0.7 million in the second quarter of 2008 and \$2.7 million in the first six months of 2008. This increase was mainly driven by higher compensation expense for both periods. Because development costs increased at a lower rate than revenue, this category declined as a percentage of revenue for both periods compared with the same periods in 2007.

Sales and Marketing Expense

(\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
Sales and marketing expense	\$ 20,866	\$ 16,471	26.7%	\$ 43,090	\$ 33,200	29.8%
% of revenue	15.8%	15.0%	0.8pp	16.7%	16.2%	0.5pp

Sales and marketing expense increased \$4.4 million in the second quarter of 2008 and \$9.9 million in the first six months of the year compared with the same periods in 2007. Higher compensation expense and sales commission expense were the two main contributors to the increase in both periods. Marketing expense also rose because of marketing campaigns for certain products, primarily the Morningstar Investment Conference held in Europe during the second quarter.

As a percentage of revenue, sales and marketing expense increased slightly in both the second quarter and year-to-date periods.

General and Administrative Expense

(\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
General and administrative expense	\$ 20,560	\$ 21,128	(2.7)%	\$ 39,885	\$ 37,214	7.2%
% of revenue	15.5%	19.3%	(3.8)pp	15.5%	18.1%	(2.6)pp

Edgar Filing: Morningstar, Inc. - Form 10-Q

General and administrative expense decreased \$0.6 million in the second quarter of 2008, but increased \$2.7 million in the first six months of 2008. Lower bonus expense was the main contributor to the decline in general and administrative expense in the quarter, as it outweighed the increase in other compensation-related expenses. For the six-month period, compensation expense increased, reflecting continued hiring in China and the United States, partially offset by the favorable impact of lower bonus expense in this cost category. In the second quarter and first six months of 2008, lease costs increased compared with the same periods in 2007 because in addition to lease costs for our current headquarters, we are now recording expense for the new headquarters we expect to move into later this year. However, the increase in office lease expense was offset by lower spending on legal fees in both the quarter and the year-to-date periods.

As a percentage of revenue, general and administrative expense dropped by about 3.8 percentage points in the second quarter and 2.6 percentage points in the six-month period compared with the same periods in 2007. The drop in both periods reflects the reduction in compensation expense, including bonus, and legal fees as a percentage of revenue.

Depreciation and Amortization Expense

(\$000)	Three Months Ended June 30			Six Months Ended June 30			Change
	2008	2007	Change	2008	2007	Change	
Depreciation expense	\$ 2,185	\$ 2,185		\$ 4,320	\$ 4,340	(0.5)%	
Amortization expense	4,091	3,301	23.9%	8,113	5,841	38.9%	
Total depreciation and amortization expense	\$ 6,276	\$ 5,486	14.4%	\$ 12,433	\$ 10,181	22.1%	
% of revenue	4.7%	5.0%	(0.3)pp	4.8%	5.0%	(0.2)pp	

Table of Contents

Depreciation and amortization expense increased \$0.8 million in the second quarter and \$2.3 million in the first six months of 2008 compared with the same periods last year. Amortization of intangible assets related to acquisitions increased substantially, particularly for the six-month period primarily because of the Hemscott acquisition, which was completed on January 9, 2008.

We expect that amortization of intangible assets will be an ongoing cost for the remaining life of the assets. As of June 30, 2008, we estimate that aggregate amortization expense for intangible assets will be \$16.3 million in 2008. Our estimates of future amortization expense for intangible assets may be affected by changes to the preliminary purchase price allocations associated with the Hemscott acquisition.

Stock-Based Compensation Expense

(\$000)	Three Months Ended June 30			Six Months Ended June 30			Change
	2008	2007	Change	2008	2007	Change	
Stock-based compensation expense	\$ 2,969	\$ 3,203	(7.3)%	\$ 5,713	\$ 5,537	3.2%	
% of revenue	2.2%	2.9%	(0.7)pp	2.2%	2.7%	(0.5)	

Stock-based compensation expense decreased \$0.2 million in the second quarter, but increased \$0.2 million in the first six months of 2008.

Under Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), *Share Based Payment*, we record stock-based compensation cost only for those awards that ultimately vest. As a result, our stock-based compensation expense reflects an estimate of the expected forfeiture rate. We usually adjust our estimate of the forfeiture rate in the second quarter, which is when most of our larger equity grants typically vest. The adjustment recorded in the second quarter of 2008 was expense of \$0.2 million, lower than the adjustment of \$0.7 million of expense recorded in the second quarter of 2007.

Based on grants made through June 30, 2008, we anticipate that stock-based compensation expense will be \$11.2 million for the full year 2008. This amount is subject to change based on additional equity grants or any change in our estimated forfeiture rate.

Bonus Expense

(\$000)	Three Months Ended June 30			Six Months Ended June 30			Change
	2008	2007	Change	2008	2007	Change	
Bonus expense	\$ 12,182	\$ 13,076	(6.8)%	\$ 24,719	\$ 23,082	7.1%	
% of revenue	9.2%	11.9%	(2.7)pp	9.6%	11.3%	(1.7)pp	

Although we had incremental bonus expense from additional headcount in 2008 relative to the same periods in 2007, the amount of bonus expense is not a fixed cost. Instead, changes in the size of our bonus pool are based on full-year operating income growth relative to the previous year, and the size of the bonus pool varies each year. We review and update growth estimates and the bonus pool size quarterly. In the second quarter, bonus expense declined about \$0.9 million compared with the same period in 2007. As a result, bonus expense declined to 9.2% of

Edgar Filing: Morningstar, Inc. - Form 10-Q

revenue in the second quarter of 2008, compared with 11.9% in the same period in 2007. For the first six months of 2008, bonus expense as a percentage of revenue was 9.6%, about 1.7 percentage points lower than the same period in 2007. We include bonus expense in each of our operating expense categories.

Consolidated Operating Income

(\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
Operating income	\$ 41,570	\$ 28,446	46.1%	\$ 76,255	\$ 52,473	45.3%
% of revenue	31.4%	25.9%	5.5pp	29.6%	25.6%	4.0pp

Consolidated operating income increased \$13.1 million in the second quarter of 2008 and \$23.8 million in the first six months of 2008. The margin improvement reflects the impact of lower bonus expense as a percentage of revenue, as well as cost efficiencies as a percentage of revenue in most other expense categories. In addition, we had about \$1.6 million in product implementation costs related to the Advice by Ibbotson service in the first half of 2007, but these costs did not recur in the first half of 2008. Lower legal fees, professional fees, and other general and administrative related spending as a percentage of revenue also contributed to the higher operating margin.

Table of Contents**Consolidated Free Cash Flow**

We generated positive free cash flow in both the second quarter of 2008 and year-to-date periods. Our free cash flow of \$37.1 million in the second quarter of 2008 reflects cash provided by operating activities of \$47.7 million and capital expenditures of \$10.6 million. Free cash flow of \$31.8 million in the first six months of 2008 reflects cash provided by operating activities of \$49.1 million offset by capital expenditures of \$17.4 million. Free cash flow generated in the second quarter made up the majority of the \$31.8 million in free cash flow generated in the first six months of 2008. Our cash flow from operations is typically stronger in the second quarter compared with the first quarter because we pay annual bonuses early in the year.

Free cash flow increased \$4.9 million in the second quarter of 2008 compared with the same quarter in 2007, reflecting an \$11.6 million increase in cash flow provided by operating activities, which was offset by a \$6.7 million increase in capital expenditures. Free cash flow declined \$6.8 million in the first six months of 2008 compared with the first six months of 2007, reflecting a \$4.6 million increase in cash flow provided by operating activities, which was more than offset by an \$11.5 million increase in capital expenditures.

Cash flow provided by operating activities increased \$11.6 million in the second quarter of 2008 but only \$4.6 million for the first half of the year. Cash flow from operations in both periods benefited from the positive impact of our net income (adjusted for non-cash items) and additional deferred rent related to tenant improvement allowances for our new corporate headquarters. The changes in most operating assets moved in a similar direction on a quarter and year-to-date basis, with the notable exception being cash paid for bonuses. The year-to-date period includes the impact of our annual bonus payments, which typically occur in the first quarter. Bonus payments in the first six months of 2008 increased \$14.0 million compared with the first half of 2007, and resulted in stronger cash provided by operating activities in the second quarter than in the year-to-date period.

In the second quarter and the first six months of 2008, capital expenditures were \$10.6 million and \$17.4 million respectively, an increase of \$6.7 million and \$11.5 million from comparable prior-year periods. The increase was almost entirely driven by capital expenditures for our new headquarters in Chicago. In the comparable prior-year periods we made capital expenditures for computer hardware to keep our operations up and running in the event of a disaster, as well as for design work related to our new headquarters in Chicago.

Higher deferred rent contributed to the positive cash from operations in both periods. We had additional deferred rent of \$5.9 million in the second quarter and \$9.3 million in the first six months. Both amounts include the tenant improvement allowance received in connection with the build-out of our new headquarters in Chicago. We will amortize this allowance over the lease term as a reduction in office lease expense.

To provide investors with additional insight into our financial results, we provide a comparison between the change in net income and the change in cash from operations in the table below:

(\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
Net income	\$ 27,999	\$ 18,273	\$ 9,726	\$ 51,075	\$ 34,059	\$ 17,016
Adjustments to reconcile net income to net cash flows from operating activities:						

Edgar Filing: Morningstar, Inc. - Form 10-Q

Excess tax benefits in accordance with SFAS No. 123(R)	(11,376)	(4,879)	(6,497)	(17,343)	(7,011)	(10,332)
Depreciation and amortization expense	6,276	5,486	790	12,433	10,181	2,252
Stock-based compensation expense	2,969	3,203	(234)	5,713	5,537	176
All other non-cash items included in net income	(1,422)	(1,535)	113	1,347	(2,739)	4,086
Changes in operating assets and liabilities, net of effects of acquisitions:						
Cash paid for bonuses				(49,253)	(35,269)	(13,984)
Cash paid for income taxes	(13,195)	(14,110)	915	(15,252)	(16,253)	1,001
Accounts receivable	2,484	2,126	358	(3,222)	(5,456)	2,234
Deferred revenue	(2,449)	2,368	(4,817)	6,772	13,389	(6,617)
Income taxes current	19,197	12,856	6,341	28,356	23,456	4,900
Accrued compensation	13,040	13,402	(362)	20,363	22,378	(2,015)
Deferred rent	5,923	81	5,878	9,306	36	9,270
Other assets	121	(374)	495	(1,846)	869	(2,715)
Accounts payable and accrued liabilities	(1,773)	966	(2,739)	997	3,228	(2,231)
All other	(52)	(1,751)	1,663	(327)	(1,909)	1,582
Cash provided by operating activities	\$ 47,742	\$ 36,112	\$ 11,630	\$ 49,119	\$ 44,496	\$ 4,623

Table of Contents**Segment Results**

Key Metrics (\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
Revenue						
Individual	\$ 28,147	\$ 24,169	16.5%	\$ 55,506	\$ 48,230	15.1%
Advisor	33,862	30,209	12.1%	64,556	56,186	14.9%
Institutional	72,842	57,554	26.6%	142,770	104,906	36.1%
Eliminations	(2,614)	(2,247)	16.3%	(5,151)	(4,190)	22.9%
Consolidated revenue	\$ 132,237	\$ 109,685	20.6%	\$ 257,681	\$ 205,132	25.6%
Operating income (loss)						
Individual	\$ 8,671	\$ 6,465	34.1%	\$ 14,432	\$ 11,793	22.4%
Advisor	10,680	8,024	33.1%	19,486	14,890	30.9%
Institutional	26,402	17,868	47.8%	50,579	32,791	54.2%
Corporate items and eliminations	(4,183)	(3,911)	7.0%	(8,242)	(7,001)	17.7%
Consolidated operating income	\$ 41,570	\$ 28,446	46.1%	\$ 76,255	\$ 52,473	45.3%
Operating margin						
Individual	30.8%	26.7%	4.1pp	26.0%	24.5%	1.5pp
Advisor	31.5%	26.6%	4.9pp	30.2%	26.5%	3.7pp
Institutional	36.2%	31.0%	5.2pp	35.4%	31.3%	4.1pp
Consolidated operating margin	31.4%	25.9%	5.5pp	29.6%	25.6%	4.0pp

Individual Segment

Our Individual segment focuses on products and services for individual investors. The largest product in this segment based on revenue is our U.S.-based Web site, Morningstar.com, which includes both paid Premium Membership service and sales of Internet advertising space. As a result of the Hemscott acquisition in the first quarter of 2008, this segment also includes revenue from the Hemscott Premium and Premium Plus subscription-based services and sales of Internet advertising space on Hemscott.com.

Our Individual segment also includes Morningstar Equity Research, which we distribute through several channels. 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 that purchase our research for their own use or provide our research to their affiliated financial advisors or to individual investors. In addition, investors can access our equity research through our Premium Membership offering on Morningstar.com.

We also offer a variety of print publications about investing, including several newsletters and books.

In the first six months of 2008 and 2007, this segment represented, before intersegment eliminations, 21.5% and 23.5%, respectively, of our consolidated revenue.

Edgar Filing: Morningstar, Inc. - Form 10-Q

Key Metrics (\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
Revenue	\$ 28,147	\$ 24,169	16.5%	\$ 55,506	\$ 48,230	15.1%
Operating income	\$ 8,671	\$ 6,465	34.1%	\$ 14,432	\$ 11,793	22.4%
Operating margin (%)	30.8%	26.7%	4.1pp	26.0%	24.5%	1.5pp

Edgar Filing: Morningstar, Inc. - Form 10-Q

Table of Contents

In the second quarter of 2008, revenue for the Individual segment increased \$4.0 million compared with the same period in 2007. In the first half of 2008, revenue for the Individual segment increased \$7.3 million compared with the first half of 2007. Acquisitions contributed \$0.6 million of revenue in the second quarter and \$1.1 million of revenue in the first six months of 2007, with 3 and 2 percentage points of growth, respectively, coming from acquisitions.

Morningstar.com Premium Membership and Internet advertising sales drove about half of the segment's organic revenue growth in both periods. Subscriptions for Morningstar.com Premium service increased to 179,827 as of June 30, 2008, compared with 173,974 as of June 30, 2007. In addition, in January 2008, we moderately increased subscription prices for Premium service. As a result, revenue growth outpaced growth in the number of subscriptions. However, in the second quarter and first six months of 2008 subscribers declined 1,951 and 539, respectively, compared with new subscriber additions of approximately 2,265 and 8,017 in the comparable 2007 periods, as general market weakness affected subscriber growth. Although advertising sales remained strong and Premium subscriptions grew year over year, trial memberships have been slow this year, resulting in a modest decline in Premium subscriptions in the second quarter.

Morningstar Equity Research, which primarily includes revenue related to the Global Analyst Research Settlement, was the second-largest contributor to organic revenue growth for this segment in both periods of 2008. Revenue for Morningstar Equity Research increased because the number of companies under coverage rose, leading to higher contract values for some of the agreements related to the settlement. Revenue related to the Global Analyst Research Settlement accounted for approximately 4% of our consolidated revenue for the last 12 months. The period covered by the Global Analyst Research Settlement will expire in July 2009. After the settlement period expires, the investment banks covered by it will no longer be required to provide independent research to their clients. For further discussion, see Item 1A Risk Factors in our Report on Form 10-K for the year ended December 31, 2007.

Newsletters also contributed to the organic growth in the segment revenue in the second quarter and first six months of 2008.

In the second quarter of 2008, operating income for the Individual segment increased approximately \$2.2 million. Operating income for the first six months of 2008 increased by \$2.6 million as overall operating expense, including additional expense from the Hemscott acquisition, grew more slowly than revenue.

Operating expense increased \$1.8 million, or 10.0%, in the second quarter compared with the second quarter of 2007, and in the year-to-date period, operating expense increased \$4.6 million, or 12.7%, compared with the same period in 2007. Compensation-related expense generated most of the increase in operating expense in both periods. Our equity analyst team, whose compensation costs are included in cost of goods sold, grew to 132 as of June 30, 2008, compared with 113 as of June 30, 2007.

The segment's margin expanded by 4.1 percentage point in the second quarter of 2008 and 1.5 percentage points in the first six months of 2008 as the revenue growth rate outpaced the operating expense growth rate, mainly because of lower general and administrative and bonus expenses as a percent of revenue.

Advisor Segment

Edgar Filing: Morningstar, Inc. - Form 10-Q

Our Advisor segment focuses on products and services for financial advisors. Key products in this segment based on revenue are Morningstar Advisor Workstation and Morningstar Principia. Advisor Workstation is a Web-based investment planning system that provides financial advisors with a comprehensive set of tools for conducting their core business. 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; and Financial Communications, which includes investment conferences, Web sites, and magazines for financial advisors, as well as a series of presentations, charts, data, and graphs that financial advisors can license to use in published materials and demonstrate investment concepts to their clients.

In the first six months of 2008 and 2007, this segment represented, before intersegment eliminations, 25.1% and 27.4%, respectively, of our consolidated revenue.

Key Metrics (\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
Revenue	\$ 33,862	\$ 30,209	12.1%	\$ 64,556	\$ 56,186	14.9%
Operating income	\$ 10,680	\$ 8,024	33.1%	\$ 19,486	\$ 14,890	30.9%
Operating margin (%)	31.5%	26.6%	4.9pp	30.2%	26.5%	3.7pp

Table of Contents

In the second quarter and first six months of 2008, revenue for the Advisor segment increased \$3.7 million and \$8.4 million, respectively, compared with the same periods in 2007. All revenue growth in the second quarter was organic. Acquisitions contributed \$1.1 million to revenue growth in the first six months of 2008. Excluding acquisitions, the majority of the increase in revenue in the quarter was driven by Morningstar Advisor Workstation. The number of U.S. licenses for Morningstar Advisor Workstation increased to 188,792 as of June 30, 2008, compared with 163,813 as of June 30, 2007. The revenue growth reflects new client contracts as well as additional users and functionality for existing clients. The year-over-year comparisons also reflect the ongoing positive impact of renewal deals signed in 2007 for expanded functionality and additional users.

Morningstar Managed Portfolios and Financial Communications, including the annual Morningstar Investment Conference held in June that generated \$2.3 million of revenue, also contributed to revenue growth in the segment, but to a lesser degree. Assets under management for Morningstar Managed Portfolios were \$2.1 billion as of June 30, 2008, on par with the year-ago asset level. Because of the market turnaround, however, assets decreased by approximately \$100 million compared with December 31, 2007.

Principia revenue declined in the second quarter and remained relatively flat during the first six months compared with prior-year periods. The number of subscriptions for Principia was 45,219 as of June 30, 2008, a 9% decrease from 49,486 as of June 30, 2007. The decline in the number of subscriptions was partially the result of two large clients migrating from Principia to Advisor Workstation.

In the second quarter of 2008, operating income for the Advisor segment was \$10.7 million, an increase of \$2.7 million compared with the prior-year period. In the first six months of 2008, Advisor segment operating income was \$19.5 million, an increase of \$4.6 million compared with the first six months of 2007. Operating expense in the second quarter and first six months of 2008 increased by approximately 4.5% and 9.1%, respectively, compared with the same periods in 2007. Compensation-related expense, including incentive compensation and commissions, accounted for about one half of the increase in operating expense in the second quarter and in the first six months.

Operating margin in the second quarter and first six months increased by 4.9 and 3.7 percentage points, respectively, compared with prior-year periods. The increase in operating margin reflects growth in the Advisor segment revenue, offset by a lower rate of growth in overall operating expense. As a percentage of revenue, nearly every category of operating expenses declined in the second quarter and in the first six months, with lower bonus and general and administrative expense as a percentage of revenue contributing the most improvement.

Institutional Segment

Our Institutional segment focuses on products and services for institutions, including banks, insurance companies, mutual fund companies, brokerage firms, media firms, and retirement plan providers and sponsors. Key products and services in this segment based on revenue are Investment Consulting, which focuses on investment monitoring and asset allocation for funds of funds, including mutual funds and variable annuities; Licensed Data, a set of investment data spanning 10 core databases, available through electronic data feeds; 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; Retirement Advice, including the Morningstar Retirement Manager and Advice by Ibbotson platforms; and Licensed Tools and Content, a set of online tools and editorial content designed for institutions to use in their Web sites and software.

Edgar Filing: Morningstar, Inc. - Form 10-Q

With the January 2008 Hemscott acquisition, our Licensed Data offerings include Hemscott Data, which has more than 20 years of comprehensive fundamental data on virtually all publicly listed companies in the United States, Canada, the United Kingdom, and Ireland. Other products that have been added to this segment include Hemscott Guru, a leading online research tool that contains financial data and directors biographies on more than 2,500 UK-quoted companies and 400,000 private companies; Hemscott Adviser Rankings Guide, a comprehensive listing of more than 1,800 leading providers of professional services to all UK- and Irish-registered companies listed on the London Stock Exchange; and Hemscott IR, a pioneer in best-practice online investor relations and corporate communications services in the United Kingdom.

In the first six months of 2008 and 2007, this segment represented, before intersegment eliminations, 55.4% and 51.1%, respectively, of our consolidated revenue. We expect that the Institutional segment will continue to account for the largest portion of our consolidated revenue for the foreseeable future.

Key Metrics (\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
Revenue	\$ 72,842	\$ 57,554	26.6%	\$ 142,770	\$ 104,906	36.1%
Operating income	\$ 26,402	\$ 17,868	47.8%	\$ 50,579	\$ 32,791	54.2%
Operating margin (%)	36.2%	31.0%	5.2pp	35.4%	31.3%	4.1pp

Edgar Filing: Morningstar, Inc. - Form 10-Q

Table of Contents

In the second quarter and first six months of 2008, revenue for the Institutional segment increased \$15.3 million and \$37.9 million, respectively, compared with the same periods in 2007. Acquisitions contributed approximately \$4.3 million of revenue to this segment during the quarter and \$13.7 million during the first six months, representing approximately 7.4 and 13.1 percentage points of the revenue growth rate, respectively.

On a product level, the increase in this segment's organic revenue was primarily driven by Licensed Data and Morningstar Direct, which combined to contribute more than half of the segment's organic revenue growth in both the second quarter and first six months. Growth in the Licensed Data business reflects strong renewal rates and new business. The number of licenses for Morningstar Direct totaled 2,683 worldwide as of June 30, 2008, compared with 1,684 worldwide as of June 30, 2007. Investment Consulting and Licensed Tools and Content were the next largest contributors to revenue growth in the second quarter of 2008.

We provided advisory services on approximately \$99.1 billion in assets as of June 30, 2008, compared with approximately \$81.5 billion in assets as of June 30, 2007. 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. In addition, we also provide Investment Consulting services for some assets under management for which we receive a flat fee.

Assets under advisement for Investment Consulting (\$ billions)	As of June 30		2007
	2008		
Ibbotson Associates	\$ 45.0	\$	31.7
Morningstar Associates	54.1		49.8
Total	\$ 99.1	\$	81.5

While we saw significant growth in assets under advisement year over year, asset levels have been relatively flat since the fourth quarter of 2007. Changes in the value of assets under advisement can come from two primary sources: gains or losses related to overall trends in market performance, and net inflows or outflows caused when investors add to or redeem shares from these portfolios. Most of the funds of funds on which we provide advisory services continued to show net inflows, but these inflows were partially offset by negative market performance. During the quarter, one of our Investment Consulting clients informed us that it does not plan to renew its contract in October 2008. This contract represented about \$11.3 million, or 2%, of our revenue for the 12 months ending June 30, 2008. We expect to continue providing other services to this client and will seek to replace this work with new business.

Retirement Advice did not make a significant contribution to the segment's revenue growth in the second quarter or first six months of 2008, however, it remains one of the larger products in the segment based on revenue. The table below shows assets under management in our managed retirement accounts.

Assets under management in managed retirement accounts (\$ billions)	As of June 30		2007
	2008		
Advice by Ibbotson	\$ 13.4	\$	10.7
Morningstar Retirement Manager	1.2		0.9
Total	\$ 14.6	\$	11.6

The tables below show the breakdown of retirement plan participants who had access to the services offered through Morningstar Retirement Manager and Advice by Ibbotson, as well as the number of plan sponsors and plan providers that provide these services.

Edgar Filing: Morningstar, Inc. - Form 10-Q

	As of June 30	
	2008	2007
Plan Participants (millions)		
Advice by Ibbotson	7.0	6.0
Morningstar Retirement Manager	8.6	8.9
Total	15.6	14.9

Plan Sponsors (approximate)		
Advice by Ibbotson	63,000	59,000
Morningstar Retirement Manager	73,000	71,000
Total	136,000	130,000

Plan Providers		
Advice by Ibbotson	8	9
Morningstar Retirement Manager	21	23
Total	29	32

Edgar Filing: Morningstar, Inc. - Form 10-Q

Table of Contents

In the second quarter and first six months of 2008, operating income for the Institutional segment increased \$8.5 million, or 47.8%, and \$17.9 million or 54.2%, respectively, compared with the prior-year periods. The increase in operating income was primarily driven by revenue growth in Licensed Data, Morningstar Direct, and Investment Consulting partially offset by an increase in operating expense.

Operating expense rose approximately \$6.8 million, or 17.0%, in the second quarter of 2008 and rose \$20.1 million, or 27.8%, in the first six months of 2008 compared with the same periods in 2007. Operating costs associated with the Hemscott acquisition contributed a significant portion of the increase. This additional expense is included in all expense categories, but had the largest impact on compensation expense. Excluding incremental costs from acquired businesses, compensation-related expense was the largest driver of the increase in operating expense in both periods. This expense increase was offset by lower bonus and general and administrative expense in the quarter. In the second quarter and in the first six months, comparisons to prior year periods also benefited from reduced product implementation fees related to our Advice by Ibbotson service of \$0.3 million and \$1.6 million, respectively.

The segment's operating margin improved by 5.2 percentage points over the prior-year quarter, and 4.1 percentage points over the prior six month period, reflecting the impact of revenue growth that exceeded the increase in operating expense. Lower bonus and general and administrative expense as a percentage of revenue helped improve the margin in both periods. Lower product implementation fees related to our Advice by Ibbotson service also contributed to the margin improvement, primarily in the year-to-date period. The Hemscott acquisition partially offset the margin improvement.

Corporate and Eliminations

This category primarily includes amortization expense related to intangible assets recorded when we allocate the purchase price of acquisitions. The following table shows the components of corporate and eliminations expense that impacted our consolidated operating income:

Key Metrics (\$000)	Three Months Ended June 30			Six Months Ended June 30		
	2008	2007	Change	2008	2007	Change
Depreciation and amortization	\$ 4,165	\$ 3,817	9.1%	\$ 8,213	\$ 6,917	18.7%
Other	18	94	NMF	29	84	NMF
Corporate items and eliminations	\$ 4,183	\$ 3,911	6.9%	\$ 8,242	\$ 7,001	17.7%

In the second quarter and first six months of 2008, corporate items and eliminations increased almost entirely because of additional amortization expense related to intangible assets from acquisitions. Amortization of intangible assets increased \$0.3 million in the second quarter of 2008 and \$1.3 million in the first six months. These increases primarily relate to intangible assets associated with the Hemscott acquisition and, to a lesser extent, the fund data business acquired from Standard & Poor's. Some of the purchase price allocations are preliminary, and the values assigned to intangible assets and the associated amortization expense may change in future periods.

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

Equity in Net Income of Unconsolidated Entities

Edgar Filing: Morningstar, Inc. - Form 10-Q

(\$000)	Three Months Ended June 30		Six Months Ended June 30		2007			
	2008		2007	2008				
Equity in net income of unconsolidated entities	\$	445	\$	455	\$	797	\$	992

Equity in net income of unconsolidated entities includes our portion of the net income (loss) of Morningstar Japan K.K. (MJKK), Morningstar Korea, Ltd., Morningstar Danmark A/S, and Morningstar Sweden AB.

Non-Operating Income

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

(\$000)	Three Months Ended June 30		Six Months Ended June 30		2007			
	2008		2007	2008				
Interest income, net	\$	1,381	\$	1,437	\$	2,900	\$	3,186
Other expense, net		(321)		(69)		(297)		(305)
Non-operating income, net	\$	1,060	\$	1,368	\$	2,603	\$	2,881

Table of Contents

Net interest income mainly reflects interest from our investment portfolio. Net interest income decreased \$0.1 million in the second quarter and \$0.3 million in first six months of 2008 compared with the prior-year periods as a result of slightly lower returns on our invested balances in 2008. In response to the volatility in the credit markets in the first half of 2008, we invested a larger portion of our excess cash in cash equivalents instead of investments.

Other income (expense) primarily represents foreign currency exchange gains and losses arising from the ordinary course of business related to our non-U.S. operations, the minority interest in earnings of our consolidated entities, unrealized and realized gains and losses from our investment portfolio.

Income Tax Expense

The following table summarizes our effective tax rate:

(\$000)	Three Months Ended June 30		Six Months Ended June 30	
	2008	2007	2008	2007
Income before income taxes and equity in net income of unconsolidated entities	\$ 42,630	\$ 29,814	\$ 78,858	\$ 55,354
Equity in net income of unconsolidated entities	445	455	797	992
Total	\$ 43,075	\$ 30,269	\$ 79,655	\$ 56,346
Income tax expense	\$ 15,076	\$ 11,996	\$ 28,580	\$ 22,287
Effective income tax expense rate	35.0%	39.6%	35.9%	39.6%

Our effective tax rate declined by 4.6 percentage points in the second quarter of 2008 and declined by 3.7 percentage points in the first six months of 2008 compared with the prior-year periods. The 2008 effective tax rate reflects the favorable, but variable, benefit from incentive stock-option transactions. When compared against the same periods in 2007, the tax benefit of incentive stock-option transactions reduced our effective tax rate by 1.6 percentage points and 0.7 percentage points in the three and six months ended June 30, 2008, respectively. A decrease in our U.S. state tax rate following a 2007 change in state tax law and the favorable impact of lower tax rates on earnings generated outside of the United States also lowered our effective tax rate compared with the prior periods.

As of December 31, 2007, we had approximately \$7.2 million of gross unrecognized tax benefits, including approximately \$4.8 million of unrecognized tax benefits which, if recognized, would result in a reduction of our effective income tax rate and \$2.4 million of tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of the deduction. In the first quarter of 2008 we reduced the unrecognized tax benefit by \$2.4 million because of expected resolution concerning the timing of the deduction. Because of the impact of deferred tax accounting, other than interest and penalties, the reduction of this liability did not affect our 2008 effective tax rate.

Liquidity and Capital Resources

Edgar Filing: Morningstar, Inc. - Form 10-Q

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 maintain a conservative investment policy for our investments and invest a portion of these assets in municipal securities with high-quality stand-alone credit ratings. Investments in our portfolio have a maximum maturity of two years; the weighted average maturity is approximately one year. 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 June 30, 2008, we had cash and cash equivalents of \$206.9 million, an increase of \$47.3 million compared with December 31, 2007. This increase mainly reflects cash provided by operations, net of \$49.3 million of annual bonus payments in the first quarter of 2008, cash flows from stock option exercises and the related excess tax benefits, the movement of a portion of investments into cash and cash equivalents, less cash paid for the Hemscott businesses and for capital expenditures primarily related to our new corporate headquarters in Chicago.

Cash Provided by Operating Activities

Our main source of capital is cash generated from operating activities. We typically pay bonuses in the first quarter of the year. As a result, cash flow from operations in the first quarter tends to be lower compared with subsequent quarters.

Table of Contents

In the first six months of 2008, cash provided by operating activities was \$49.1 million, an increase of \$4.6 million compared with \$44.5 million in the first six months of 2007. The increase in cash flow from operations reflects the positive impact of our net income (adjusted for non-cash items), and higher deferred rent of \$9.3 million. Included in our deferred rent is the tenant improvement allowance recorded in connection with the build-out of our new corporate headquarters in Chicago. While this results in a cash flow benefit in the 2008 year-to-date period, the benefit will begin to reverse as we amortize this allowance over the lease term as a reduction in rent expense.

Cash paid in the first quarter of 2008 for annual bonuses of \$49.3 million was \$14.0 million higher than the amount paid in 2007 because of improved financial performance in 2007 versus the prior year and incremental bonuses from acquisitions. Deferred revenue also provided a lower cash flow benefit in the first half of 2008.

Cash Used for Investing Activities

Cash used for investing activities consists primarily of cash used for acquisitions; purchases of investments, net of proceeds from the sale of investments; and capital expenditures. The level of investing activities can vary from period to period depending on the level of activity in these categories.

In the first six months of 2008, cash used for investing activities was \$33.1 million, compared with \$59.0 million in the same period in 2007.

Cash used for acquisitions, net of cash acquired, was \$51.0 million in the first six months of 2008 and \$55.1 million in the first six months of 2007. In January 2008, we acquired the Hemscott data, media, and investor relations Web site businesses. In March 2007, we acquired the mutual fund data business from Standard & Poor's. Cash used for acquisitions also includes transaction costs directly related to the acquisitions.

In the first six months of 2008 and 2007, proceeds from sales of investments exceeded purchases of investments by \$35.3 million and \$2.0 million, respectively. In response to the volatility in the credit markets experienced in the first half of 2008, we invested a larger portion of our excess cash in cash equivalents instead of investments. As of June 30, 2008 and December 31, 2007, we had investments, consisting mainly of fixed-income securities, of \$64.6 million and \$99.0 million, respectively. Investments represented 24% of our total cash, cash equivalents, and investments at June 30, 2008, compared with 38% at December 31, 2007.

Capital expenditures were \$17.4 million in the first six months of 2008, compared with \$5.9 million in the same period in 2007. The increase was almost entirely driven by capital expenditures for our new corporate headquarters in Chicago. In the first six months of 2007, capital expenditures primarily consisted of computer hardware to keep our operations up and running in the event of a disaster, design and architectural fees related to the planned office space for our corporate headquarters and U.S. operations, and leasehold improvements for our new office space in Canada, Europe, and Australia.

We anticipate that our capital expenditures in 2008 will be significantly higher than in previous years primarily because of the build-out of our new corporate headquarters in Chicago. We expect to make capital expenditures of approximately \$55 million in 2008, including approximately \$40 million for the build-out of the new office space. A portion of the capital expenditures will be offset by tenant improvement allowances

which will reduce the total amount of cash we will need to pay for the build-out.

Cash Provided by Financing Activities

Cash provided by financing activities consists primarily of proceeds from stock option exercises and excess tax benefits related to stock option exercises and vesting of restricted stock units. Excess tax benefits occur when a stock option is exercised and the intrinsic value of the option (the difference between the market value of our stock on the date of exercise and the exercise price of the option) is greater than the fair value of the option at the time of grant. Similarly, excess tax benefits are generated upon vesting of restricted stock units when the market value of our common stock on the vesting date exceeds the grant price of the restricted stock units. These excess tax benefits reduce the cash we pay for income taxes in the year they are recognized. It is not possible to predict the timing of stock option exercises, nor the values that will be achieved at the time options are exercised or upon vesting of restricted stock units. As a result, we expect our cash flow from financing activities to vary over time. Note 8 in the Notes to our Condensed Consolidated Financial Statements includes additional information concerning stock options and restricted stock units outstanding as of June 30, 2008.

Cash provided by financing activities was \$29.9 million in the first six months of 2008 compared with \$12.7 million in the prior-year period. We received proceeds of \$12.6 million from stock option exercises, an increase of \$6.9 million compared with the first six months of 2007. We also recorded \$17.3 million for excess tax benefits related to stock option exercises and vesting of restricted stock units, which was \$10.3 million greater than the \$7.0 million recorded in the prior-year period.

The increase in the proceeds from stock option exercises reflects a larger number of stock options exercised. In the first six months of 2008, employees exercised 1.4 million stock options, compared with 0.7 million options in the first six months of 2007.

Table of Contents

The increase in the excess tax benefits reflects the larger number of stock options exercised and a higher stock price on the date of these exercises. The intrinsic value of stock options exercised during the first six months of 2008 and 2007 was \$82.2 million and \$30.4 million, respectively. In addition, the excess tax benefit related to restricted stock units vested in the first six months of 2008 was \$1.9 million, compared with \$0.1 million in the same period in 2007. This reflects the increase in our stock price as well as the larger number restricted stock units that vested in the first half of 2008 compared with 2007.

Acquisitions

Hemscott data, media, and investor relations Web site businesses

In January 2008, we acquired the Hemscott data, media, and investor relations Web site businesses from Ipreo Holdings, LLC for \$51.3 million in cash including post-closing adjustments and transaction costs directly related to the acquisition, less cash acquired. The acquisition included Hemscott Data, which has more than 20 years of comprehensive fundamental data on virtually all publicly listed companies in the United States, Canada, the United Kingdom, and Ireland; Hemscott Guru, a leading online research tool that contains financial data and directors' biographies on more than 2,500 UK-quoted companies and 400,000 private companies; Hemscott Adviser Rankings Guide, a comprehensive listing of more than 1,800 leading providers of professional services to all UK- and Irish-registered companies listed on the London Stock Exchange; Hemscott India, which operates a state-of-the-art data collection center in New Delhi; Hemscott.com, a free investment research Web site in the United Kingdom; Hemscott Premium and Premium Plus, subscription-based investment research and data; and Hemscott IR, a pioneer in best-practice online investor relations and corporate communications services in the United Kingdom. We began including the results of this acquisition in our Consolidated Financial Statements on January 9, 2008.

Standard & Poor's mutual fund data business

In March 2007, we acquired the mutual fund data business from Standard & Poor's for \$58.0 million in cash including post-closing adjustments and transaction costs directly related to the acquisition, less cash acquired. This business consists of data and products covering approximately 135,000 managed investment vehicles, including mutual funds, ETFs, hedge funds, and offshore funds. Approximately 80% of the mutual fund data business acquired from Standard & Poor's is outside the United States. We began including the results of this acquisition in our Consolidated Financial Statements on March 16, 2007.

Application of Critical Accounting Policies and Estimates

Our critical accounting policies and estimates are discussed in the Management's Discussion and Analysis section of our Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) for the year ended December 31, 2007.

In the first quarter of 2008, we adopted SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances and does not

Edgar Filing: Morningstar, Inc. - Form 10-Q

require any new fair value measurements.

The Statement utilizes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The following is a brief description of those three levels:

- Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that the Company has the ability to access.
- Level 2 Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.
- Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

We hold cash equivalents and investments that are subject to valuation under SFAS No. 157. We do not have any liabilities subject to valuation under this Statement. The table below shows the fair value of our cash equivalents and investments subject to fair value measurements:

(\$000)	Fair Value as of June 30, 2008	Fair Value Measurements as of June 30, 2008 Using Fair Value Hierarchy		
		Level 1	Level 2	Level 3
Cash equivalents	\$ 97,186	\$ 97,186	\$	\$
Available-for-sale investments	57,449	57,449		
Trading securities	3,906	3,906		
Total	\$ 158,541	\$ 158,541	\$	\$

Table of Contents

SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, permits entities the option to measure many financial instruments and certain other items at fair value with changes in fair value recognized in earnings each period. SFAS No. 159 allows the fair value option to be elected on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument.

In the first quarter of 2008, we chose not to apply this fair value option to any of our eligible assets. We account for our investments in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Our available-for-sale investments are reported at fair value with net unrealized holding gains and losses excluded from earnings and reported as a separate component of shareholders equity. Our held-to-maturity investments are reported at amortized cost. Our trading securities are reported at fair value and, unrealized gains and losses are included in earnings. We account for our investments in unconsolidated entities using the equity method.

Recently Issued Accounting Pronouncements

In March 2008, the Financial Accounting Standards Board (FASB) issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of SFAS No. 133*. The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. To date, we have not engaged in currency or other hedging activities, and we do not currently have any positions in derivative instruments. Therefore, do not expect the adoption of SFAS No. 161 will have any impact on our Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations*. SFAS No. 141(R) modifies the financial accounting and reporting of business combinations. SFAS No. 141(R) requires the acquirer to recognize and measure the fair value of the acquired operation as a whole, and the assets acquired and liabilities assumed at their full fair values as of the date control is obtained, regardless of the percentage ownership in the acquired operation or how the acquisition was achieved. SFAS No. 141(R) is effective for business combination transactions with acquisition dates on or after the first annual reporting period beginning on or after December 15, 2008. SFAS No. 141 (R) is required to be adopted concurrently with SFAS No. 160, *Accounting and Reporting of Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*. SFAS No. 141(R) requires prospective application and prohibits earlier application. We are in the process of determining the effect the adoption of SFAS No. 141(R) will have on our Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 160, *Accounting and Reporting of Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*. SFAS No. 160 amends the financial accounting and reporting of noncontrolling (or minority) interests in consolidated financial statements. SFAS No. 160 is required to be adopted concurrently with SFAS No. 141(R) and is effective for the first annual reporting period beginning on or after December 15, 2008. Earlier application is prohibited. We are in the process of determining the effect the adoption of SFAS No. 160 will have on our Consolidated Financial Statements.

Table of Contents**Rule 10b5-1 Sales Plans**

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

The following table, which we are providing on a voluntary basis, shows the Rule 10b5-1 sales plans entered into by our directors and executive officers that were in effect as of August 1, 2008:

Name and Position	Date of Plan	Plan Termination Date	Number of Shares to be Sold under the Plan	Timing of Sales under the Plan	Number of Shares Sold under the Plan through August 1, 2008	Projected Beneficial Ownership (1)
Joe Mansueto Chairman and Chief Executive Officer	09/12/07	12/31/08	1,120,000	Shares to be sold ratably over the course of the plan	582,996	26,942,550
Chris Boruff President, Advisor Business	05/12/08	11/15/08	10,000	Shares to be sold under the plan if the stock reaches specified prices		146,739
Tao Huang Chief Operating Officer	02/26/08	12/31/08	300,000	Weekly increments of up to 10,000 shares	72,500	1,072,803
	05/08/08	09/19/08	300,000	Weekly increments of up to 20,000 shares	60,000	832,803
Elizabeth Kirscher President, Data Services Business	05/22/08	06/30/09	100,000	Shares to be sold under the plan if the stock reaches specified prices		81,123
Jack Noonan Director	08/22/06	12/31/08	72,000	Monthly increments of up to 1,000 shares	67,000	74,390
Don Phillips Managing Director	05/09/06	11/30/08	1,382,310	Weekly increments of up to 17,500 shares	1,016,600	558,079
Patrick Reinkemeyer President, Morningstar Associates	5/21/08	09/30/08	9,000	Weekly increments of up to 1,000 shares	6,000	295,276
Paul Sturm Director	03/12/08	04/30/09	120,000	Monthly increments of up to 20,000 shares	66,000	107,871
David Williams Managing Director, Design	03/31/08	11/30/08	10,000	Monthly increments of up to 2,000 shares	6,000	100,934

Edgar Filing: Morningstar, Inc. - Form 10-Q

(1) This column reflects an estimate of the number of shares each identified director and executive officer will beneficially own following the sale of all shares under the Rule 10b5-1 sales plans identified above. This information reflects the beneficial ownership of our common stock on June 30, 2008, and includes shares of our common stock subject to options that were then exercisable or that will have become exercisable by August 29, 2008 and restricted stock units that will vest by August 29, 2008. The estimates do not reflect any changes to beneficial ownership that may have occurred since June 30, 2008. Each director and executive officer identified in the table may amend or terminate his or her Rule 10b5-1 sales plan and may adopt additional Rule 10b5-1 plans in the future.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Our investment portfolio is actively managed and may suffer losses from fluctuating interest rates, market prices, or adverse security selection. Our investment portfolio is mainly invested in high-quality fixed-income securities. We do not have any direct exposure to subprime mortgages. As of June 30, 2008, our cash, cash equivalents, and investments balance was \$271.4 million. Based on our estimates, a 100 basis-point change in interest rates would have increased or decreased the fair value of our investment portfolio by approximately \$0.4 million.

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

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation and Disclosure Controls and Procedures

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

We carried out an evaluation, under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 12a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as of June 30, 2008. Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized, and reported as and when required.

(b) Changes in Internal Controls Over Financial Reporting

There were no changes in our internal controls over financial reporting during the quarter ended June 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART 2 OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2007.

Item 4. Submission of Matters to a Vote of Security Holders

Morningstar held its Annual Shareholders Meeting on May 20, 2008, for the purpose of electing directors and ratifying the appointment of Ernst & Young LLP (Ernst & Young) as Morningstar's independent registered public accounting firm for 2008. Each of the nominees for director, as listed in the proxy statement, was elected with the number of votes set forth below.

Name	Votes For	Votes Withheld
Joe Mansueto	43,504,016	245,156
Don Phillips	43,534,959	214,213
Cheryl Francis	43,536,294	212,877
Steve Kaplan	43,529,518	219,654
Bill Lyons	43,525,741	223,430
Jack Noonan	43,514,915	234,256
Frank Ptak	43,470,416	278,755
Paul Sturm	43,298,958	450,214

The appointment of Ernst & Young as Morningstar's independent registered public accounting firm for 2008 was ratified. Of the total votes cast, 43,503,183 were cast for the proposal, 218,662 votes were cast against the proposal, and there were 27,326 abstentions and no broker non-votes.

Table of Contents

Item 6. Exhibits

(a) Exhibits

Exhibit No	Description of Exhibit
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Table of Contents

SIGNATURE

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

MORNINGSTAR, INC.

Date: August 6, 2008

By: /s/ Scott Cooley
Scott Cooley
Chief Financial Officer