

FRANKLIN RESOURCES INC  
Form 10-Q  
August 09, 2006

---

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

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended June 30, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-09318

**FRANKLIN RESOURCES, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of incorporation  
or organization)

**One Franklin Parkway, San Mateo, CA**  
(Address of principal executive offices)

**13-2670991**  
(I.R.S. Employer Identification No.)

**94403**  
(Zip Code)

**(650) 312-3000**

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES  NO

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Outstanding: 252,579,378 shares of common stock, par value \$0.10 per share, of Franklin Resources, Inc. as of July 31, 2006.

---

## PART I FINANCIAL INFORMATION

### Item 1. Financial Statements.

#### FRANKLIN RESOURCES, INC.

#### Condensed Consolidated Statements of Income

##### Unaudited

|   | Three Months Ended |                  | Nine Months Ended |                  |
|---|--------------------|------------------|-------------------|------------------|
|   | June 30,           |                  | June 30,          |                  |
|   | 2006               | 2005             | 2006              | 2005             |
| <i>(in thousands, except per share data)</i>                            |                    |                  |                   |                  |
| <b>Operating Revenues</b>   |                    |                  |                   |                  |
| Investment management fees  | \$ 786,015         | \$ 642,034       | \$ 2,199,469      | \$ 1,801,191     |
| Underwriting and distribution fees                                      | 447,136            | 386,950          | 1,307,516         | 1,104,669        |
| Shareholder servicing fees  | 65,593             | 64,609           | 194,930           | 192,088          |
| Consolidated sponsored investment products income, net                  | 2,753              | 1,306            | 5,589             | 3,282            |
| Other, net  | 15,778             | 14,835           | 45,993            | 45,707           |
| <b>Total operating revenues</b>   | <b>1,317,275</b>   | <b>1,109,734</b> | <b>3,753,497</b>  | <b>3,146,937</b> |
| <b>Operating Expenses</b>   |                    |                  |                   |                  |
| Underwriting and distribution   | 430,727            | 359,657          | 1,224,040         | 1,018,455        |
| Compensation and benefits   | 242,686            | 232,971          | 692,348           | 662,387          |
| Information systems, technology and occupancy                           | 74,082             | 73,253           | 221,877           | 209,866          |
| Advertising and promotion   | 41,309             | 36,845           | 107,776           | 94,061           |
| Amortization of deferred sales commissions                              | 31,514             | 29,361           | 95,631            | 91,356           |
| Amortization of intangible assets                                       | 2,650              | 4,348            | 11,359            | 13,108           |
| Intangible assets impairment  |                    |                  | 68,400            |                  |
| Provision for governmental investigations, proceedings and actions, net |                    | (8,385)          |                   | 33,658           |
| Other   | 42,321             | 35,205           | 125,737           | 104,202          |
| <b>Total operating expenses</b>   | <b>865,289</b>     | <b>763,255</b>   | <b>2,547,168</b>  | <b>2,227,093</b> |
| <b>Operating income</b>   | <b>451,986</b>     | <b>346,479</b>   | <b>1,206,329</b>  | <b>919,844</b>   |
| <b>Other Income (Expenses)</b>  |                    |                  |                   |                  |
| Consolidated sponsored investment products (losses) gains, net          | (8,352)            | 4,402            | 19,454            | 19,013           |
| Investment and other income, net  | 52,271             | 21,849           | 140,025           | 87,814           |
| Interest expense  | (6,682)            | (9,017)          | (22,995)          | (25,245)         |
| <b>Other income, net</b>  | <b>37,237</b>      | <b>17,234</b>    | <b>136,484</b>    | <b>81,582</b>    |
| <b>Income before taxes on income</b>                                    | <b>489,223</b>     | <b>363,713</b>   | <b>1,342,813</b>  | <b>1,001,426</b> |

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

|                            |                   |                   |                   |                   |
|----------------------------|-------------------|-------------------|-------------------|-------------------|
| Taxes on income            | 117,809           | 101,840           | 456,914           | 278,290           |
| <b>Net Income</b>          | <b>\$ 371,414</b> | <b>\$ 261,873</b> | <b>\$ 885,899</b> | <b>\$ 723,136</b> |
| <b>Earnings per Share</b>  |                   |                   |                   |                   |
| Basic                      | \$ 1.44           | \$ 1.04           | \$ 3.46           | \$ 2.89           |
| Diluted                    | 1.41              | 1.00              | 3.37              | 2.78              |
| <b>Dividends per Share</b> | <b>\$ 0.12</b>    | <b>\$ 0.10</b>    | <b>\$ 0.36</b>    | <b>\$ 2.30</b>    |

See accompanying notes to the condensed consolidated financial statements.

## FRANKLIN RESOURCES, INC.

## Condensed Consolidated Balance Sheets

## Unaudited

| <i>(in thousands)</i>                     | June 30,<br>2006    | September 30,<br>2005 |
|---|---------------------|-----------------------|
| <b>Assets</b>                             |                     |                       |
| <b>Current Assets</b>                     |                     |                       |
| Cash and cash equivalents                 | \$ 3,203,598        | \$ 3,076,318          |
| Receivables                               | 610,404             | 549,203               |
| Investment securities, trading            | 340,234             | 254,750               |
| Investment securities, available-for-sale | 528,468             | 618,426               |
| Deferred taxes and other                  | 106,640             | 121,891               |
| <b>Total current assets</b>               | <b>4,789,344</b>    | <b>4,620,588</b>      |
| <b>Banking/Finance Assets</b>             |                     |                       |
| Cash and cash equivalents                 | 209,598             | 75,841                |
| Loans held for sale, net                  | 276,893             | 303,161               |
| Loans receivable, net                     | 240,309             | 264,275               |
| Investment securities, available-for-sale | 190,470             | 239,880               |
| Other                                     | 27,173              | 31,983                |
| <b>Total banking/finance assets</b>       | <b>944,443</b>      | <b>915,140</b>        |
| <b>Non-Current Assets</b>                 |                     |                       |
| Investments, other                        | 425,261             | 452,831               |
| Deferred sales commissions                | 285,769             | 309,858               |
| Property and equipment, net               | 487,335             | 489,366               |
| Goodwill                                  | 1,406,823           | 1,390,851             |
| Other intangible assets, net              | 577,208             | 656,593               |
| Receivable from banking/finance group     | 32,073              |                       |
| Other                                     | 26,487              | 58,700                |
| <b>Total non-current assets</b>           | <b>3,240,956</b>    | <b>3,358,199</b>      |
| <b>Total Assets</b>                       | <b>\$ 8,974,743</b> | <b>\$ 8,893,927</b>   |

[Table continued on next page]

See accompanying notes to the condensed consolidated financial statements.



## FRANKLIN RESOURCES, INC.

## Condensed Consolidated Balance Sheets

## Unaudited

[Table continued from previous page]

|  | June 30,   | September 30, |
|--|------------|---------------|
|  | 2006       | 2005          |
| <i>(in thousands, except share data)</i>   |            |               |
| <b>Liabilities and Stockholders Equity</b>   |            |               |
| <b>Current Liabilities</b>   |            |               |
| Compensation and benefits  | \$ 235,176 | \$ 252,504    |
| Commercial paper   | 167,981    | 169,389       |
| Accounts payable and accrued expenses  | 238,477    | 205,853       |
| Commissions  | 206,909    | 176,676       |
| Income taxes   | 126,058    | 25,730        |
| Other  | 22,404     | 21,745        |
| Total current liabilities  | 997,005    | 851,897       |
| <b>Banking/Finance Liabilities</b>   |            |               |
| Deposits   | 476,811    | 519,140       |
| Payable to parent  | 32,073     |               |
| Variable Funding Note  | 177,786    | 239,222       |
| Other  | 48,682     | 46,440        |
| Total banking/finance liabilities  | 735,352    | 804,802       |
| <b>Non-Current Liabilities</b>   |            |               |
| Long-term debt   | 639,354    | 1,208,390     |
| Deferred taxes   | 176,492    | 235,005       |
| Other  | 9,100      | 33,342        |
| Total non-current liabilities  | 824,946    | 1,476,737     |
| Total liabilities  | 2,557,303  | 3,133,436     |
| <b>Minority Interest</b>   | 111,110    | 76,107        |
| <b>Commitments and Contingencies (Note 11)</b>   |            |               |
| <b>Stockholders Equity</b>   |            |               |
| Preferred stock, \$1.00 par value, 1,000,000 shares authorized; none issued  |            |               |
| Common stock, \$0.10 par value, 1,000,000,000 shares authorized; 252,984,108 and 252,744,758 shares issued and outstanding, for June 30, 2006 and September 30, 2005 | 25,298     | 25,274        |
| Capital in excess of par value   | 172,384    | 374,860       |

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

|   |                     |                     |
|---|---------------------|---------------------|
| Retained earnings                                 | 5,983,101           | 5,206,485           |
| Deferred compensation                             |                     | (21,958)            |
| Accumulated other comprehensive income            | 125,547             | 99,723              |
|   | <u>          </u>   | <u>          </u>   |
| Total stockholders' equity                        | 6,306,330           | 5,684,384           |
|   | <u>          </u>   | <u>          </u>   |
| <b>Total Liabilities and Stockholders' Equity</b> | <b>\$ 8,974,743</b> | <b>\$ 8,893,927</b> |
|   | <u>          </u>   | <u>          </u>   |

See accompanying notes to the condensed consolidated financial statements.



## FRANKLIN RESOURCES, INC.

## Condensed Consolidated Statements of Cash Flows

## Unaudited

| <i>(in thousands)</i>  | Nine Months Ended |                  |
|--|-------------------|------------------|
|  | June 30,          |                  |
|  | 2006              | 2005             |
| <b>Net Income</b>  | \$ 885,899        | \$ 723,136       |
| <i>Adjustments to reconcile net income to net cash provided by operating activities:</i>       |                   |                  |
| Depreciation and amortization  | 160,844           | 146,724          |
| Equity in net income of affiliated companies   | (19,223)          | (21,278)         |
| Net gains on disposal of assets  | (12,225)          | (2,476)          |
| Intangible assets impairment   | 68,400            |                  |
| Excess tax benefit from stock-based compensation arrangements                                  | (28,295)          |                  |
| <i>Changes in operating assets and liabilities:</i>  |                   |                  |
| Increase in receivables, prepaid expenses and other  | (71,353)          | (35,012)         |
| Originations of loans held for sale, net   | (326,803)         | (354,881)        |
| Proceeds from securitization of loans held for sale  | 353,071           | 238,565          |
| Net change in trading securities   | (85,485)          | (6,639)          |
| Advances of deferred sales commissions   | (86,315)          | (106,755)        |
| (Decrease) increase in provision for governmental investigations, proceedings and actions, net | (53,361)          | 13,334           |
| Increase (decrease) in deferred income taxes and taxes payable                                 | 119,591           | (20,600)         |
| Increase in commissions payable  | 30,234            | 37,413           |
| Increase in other liabilities  | 67,241            | 149,482          |
| Stock-based compensation and increase in accrued compensation and benefits                     | 35,417            | 37,437           |
| <b>Net cash provided by operating activities</b>   | <b>1,037,637</b>  | <b>798,450</b>   |
| Purchase of investments  | (367,739)         | (921,841)        |
| Liquidation of investments   | 424,655           | 725,063          |
| Purchase of banking/finance investments  | (66,635)          | (106,692)        |
| Liquidation of banking/finance investments   | 116,832           | 117,278          |
| Net origination of loans receivable  | 24,411            | 67,279           |
| Net additions of property and equipment  | (36,549)          | (57,873)         |
| Acquisition of subsidiaries, net of cash acquired  | 3,949             | (37)             |
| <b>Net cash provided by (used in) investing activities</b>                                     | <b>98,924</b>     | <b>(176,823)</b> |
| Decrease in bank deposits  | (42,328)          | (21,759)         |
| Exercise of common stock options   | 78,297            | 95,292           |
| Dividends paid on common stock   | (87,369)          | (573,369)        |
| Purchase of common stock   | (935,091)         | (149,257)        |
| Excess tax benefits from stock-based compensation arrangements                                 | 28,295            |                  |
| Increase in debt   | 1,314             | 40,588           |
| Payments on debt   | (32,142)          | (29,055)         |

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

|   |                     |                     |
|---|---------------------|---------------------|
| Minority interest                               | 113,500             | 51,191              |
|   | <u>          </u>   | <u>          </u>   |
| Net cash used in financing activities           | (875,524)           | (586,369)           |
|   | <u>          </u>   | <u>          </u>   |
| Increase in cash and cash equivalents           | 261,037             | 35,258              |
| Cash and cash equivalents, beginning of period  | 3,152,159           | 2,917,188           |
|   | <u>          </u>   | <u>          </u>   |
| <b>Cash and Cash Equivalents, End of Period</b> | <b>\$ 3,413,196</b> | <b>\$ 2,952,446</b> |
|   | <u>          </u>   | <u>          </u>   |

[Table continued on next page]

See accompanying notes to the consolidated financial statements.

## FRANKLIN RESOURCES, INC.

## Condensed Consolidated Statements of Cash Flows

## Unaudited

[Table continued from previous page]

|   | Nine Months Ended   |                     |
|---|---------------------|---------------------|
|   | June 30,            |                     |
|   | 2006                | 2005                |
| <i>(in thousands)</i>   |                     |                     |
| <b>Components of Cash and Cash Equivalents</b>  |                     |                     |
| Cash and cash equivalents, beginning of period:   |                     |                     |
| Current assets  | \$ 3,076,318        | \$ 2,814,184        |
| Banking/finance assets  | 75,841              | 103,004             |
| <b>Total</b>  | <b>\$ 3,152,159</b> | <b>\$ 2,917,188</b> |
| Cash and cash equivalents, end of period:   |                     |                     |
| Current assets  | \$ 3,203,598        | \$ 2,811,114        |
| Banking/finance assets  | 209,598             | 141,332             |
| <b>Total</b>  | <b>\$ 3,413,196</b> | <b>\$ 2,952,446</b> |
| <b>Supplemental Disclosure of Non-Cash Information</b>  |                     |                     |
| Value of common stock issued on conversion of zero coupon convertible senior notes            | \$ 543,715          | \$                  |
| Total assets related to the net deconsolidation of certain sponsored investment products      | (182,986)           | (37,508)            |
| Total liabilities related to the net deconsolidation of certain sponsored investment products | (65,801)            | 6,659               |

See accompanying notes to the condensed consolidated financial statements.

---

**FRANKLIN RESOURCES, INC.**

**Notes to Condensed Consolidated Financial Statements**

**June 30, 2006**

**(Unaudited)**

**1. Basis of Presentation**

We have prepared these unaudited interim financial statements of Franklin Resources, Inc. (the Company) and its consolidated subsidiaries in accordance with the instructions to Form 10-Q and the rules and regulations of the U.S. Securities and Exchange Commission (the SEC). Under these rules and regulations, we have shortened or omitted some information and footnote disclosures normally included in financial statements prepared under generally accepted accounting principles. We believe that we have made all adjustments necessary for a fair statement of the financial position and the results of operations for the periods shown. All adjustments are normal and recurring. You should read these financial statements together with our audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended September 30, 2005. Certain amounts for the comparative prior fiscal year periods have been reclassified to conform to the financial presentation for and at the period ended June 30, 2006.

**2. New Accounting Standards**

In July 2006, the Financial Accounting Standards Board (the FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Tax an interpretation of FASB Statement 109 (FIN 48), which clarifies the accounting for tax positions taken or expected to be taken in a tax return. FIN 48 provides guidance on the measurement, recognition, classification and disclosure of tax positions, along with accounting for related interest and penalties. FIN 48 is effective for fiscal years beginning after December 15, 2006, with the cumulative effect of the change in accounting principle recorded as an adjustment to retained earnings. We have not determined the impact that FIN 48 will have on our Consolidated Financial Statements.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140 (SFAS 156), which provides some relief for servicers that use derivatives to economically hedge fluctuations in the fair value of their servicing rights and changes how gains and losses are computed in certain transfers or securitizations. SFAS 156 is effective for fiscal years beginning after September 15, 2006. SFAS 156 changes the way entities account for servicing assets and obligations associated with financial assets that are acquired or disposed of. The adoption of SFAS 156 is not expected to have a material impact on our Consolidated Financial Statements.

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS 155), which resolves issues addressed in Statement 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. SFAS 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133, and establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of SFAS 155 is not expected to have a material impact on our Consolidated Financial Statements.



In June 2005, the FASB ratified the consensus reached by the Emerging Issues Task Force on Issue 04-5, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or similar Entity When the Limited Partners Have Certain Rights*. Under the consensus reached, a general partner of a limited partnership is presumed to control the limited partnership, unless the limited partners have substantive termination rights or participating rights. This guidance is effective for all general partners of all newly formed limited partnerships and for existing limited partnerships for which the partnership agreements are modified after June 29, 2005. For general partners in all other limited partnerships, this consensus is effective for fiscal years beginning after December 15, 2005 and is not expected to materially impact our Consolidated Financial Statements.

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* a replacement of APB Opinion No. 20 and FASB Statement No. 3 ( SFAS 154 ), which changes the requirement for the accounting and reporting of a change in accounting principle. SFAS 154 eliminates the requirement in Accounting Principles Board Opinion No. 20, *Accounting Changes*, to include the cumulative effect of changes in accounting principle in the income statement in the period of change. Instead, to enhance the comparability of prior period financial statements, SFAS 154 requires that changes in accounting principles are retrospectively applied, unless directed otherwise by a new pronouncement. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 is not expected to have a material impact on our Consolidated Financial Statements.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* ( SFAS 123R ). SFAS 123R addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for equity instruments of the enterprise. It also addresses transactions in which an entity incurs liabilities in exchange for goods and services that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The revised statement generally requires that an entity account for those transactions using the fair-value-based method, and eliminates the intrinsic value method of accounting in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*. SFAS 123R requires an entity to recognize the grant-date fair-value of stock options and other equity-based compensation issued to employees in the income statement. The revised statement also applies to the portion of outstanding awards for which the requisite service has not yet been rendered based on the grant-date value of these awards. SFAS 123R also requires entities to disclose information about the nature of the share-based payment transactions, the method used to estimate fair value of goods and services received or the value of the equity instruments granted, and the effects of those transactions on the financial statements. On April 14, 2005, the SEC announced that SFAS 123R is to be effective for fiscal years beginning after June 15, 2005 for entities other than small business issuers, and applies to all awards granted after the required effective date and to awards modified, repurchased, or cancelled after that date. Retrospective application is permitted under SFAS 123R. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ( SAB 107 ) that interprets the interaction of SFAS 123R and certain SEC rules that must be applied on the adoption of SFAS 123R. Effective October 1, 2005, we adopted SFAS 123R and SAB 107 using the modified prospective transition method. Our adoption of SFAS 123R and SAB 107 did not materially impact our Consolidated Financial Statements (see Note 5).

In December 2004, the FASB issued Staff Position No. 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004* ( FSP FAS 109-2 ). The American Jobs Creation Act of 2004 (the *Jobs Act* ) was signed into law on October 22, 2004. Under a provision of the Jobs Act, we elected on January 26, 2006, to repatriate certain earnings of our foreign-based subsidiaries at a reduced U.S. federal tax rate in our fiscal year ending September 30, 2006. FSP FAS 109-2 provides guidance on when an enterprise should recognize in its financial statements

the effects of the one-time tax benefit of repatriation of foreign earnings under the Jobs Act, and specifies interim disclosure requirements. Under our Domestic Reinvestment Plan approved by our Chief Executive Officer and our Board of Directors, we expect to repatriate approximately \$2.0 billion of earnings from our foreign subsidiaries. Proceeds from the repatriation are expected to be received before September 30, 2006. The proceeds will be reinvested in our U.S. operations prior to October 1, 2010 consistent with the Domestic Reinvestment Plan and the intent of the Jobs Act. As a result of the repatriation, we recorded an income tax charge of \$108.5 million during the nine months ended June 30, 2006.

### 3. Comprehensive Income

The following table computes comprehensive income.

| <i>(in thousands)</i>                          | Three Months Ended |                   | Nine Months Ended |                   |
|--|--------------------|-------------------|-------------------|-------------------|
|  | June 30,           |                   | June 30,          |                   |
|  | 2006               | 2005              | 2006              | 2005              |
| Net income                                     | \$ 371,414         | \$ 261,873        | \$ 885,899        | \$ 723,136        |
| Net unrealized gain on investments, net of tax | (10,706)           | (2,851)           | 2,770             | 6,205             |
| Currency translation adjustments               | 23,517             | (10,574)          | 23,663            | 7,514             |
| Other  | (39)               |                   | (610)             |                   |
| <b>Comprehensive Income</b>                    | <b>\$ 384,186</b>  | <b>\$ 248,448</b> | <b>\$ 911,722</b> | <b>\$ 736,855</b> |

### 4. Earnings per Share

We computed earnings per share as follows:

| <i>(in thousands, except per share data)</i>  | Three Months Ended |                | Nine Months Ended |                |
|---|--------------------|----------------|-------------------|----------------|
|   | June 30,           |                | June 30,          |                |
|   | 2006               | 2005           | 2006              | 2005           |
| Net income  | \$ 371,414         | \$ 261,873     | \$ 885,899        | \$ 723,136     |
| Add: interest and discount amortization on zero coupon convertible senior notes, net of taxes | 470                | 2,227          | 3,942             | 6,647          |
| <b>Adjusted net income</b>  | <b>371,884</b>     | <b>264,100</b> | <b>889,841</b>    | <b>729,783</b> |
| Weighted-average shares outstanding basic   | 257,592            | 250,475        | 256,276           | 250,417        |
| Incremental shares from assumed conversions:  |                    |                |                   |                |
| Common stock options and nonvested stock awards and stock unit awards                         | 3,489              | 4,236          | 3,675             | 4,036          |
| Zero coupon convertible senior notes  | 1,795              | 8,154          | 4,315             | 8,154          |

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

|  |                |                |                |                |
|--|----------------|----------------|----------------|----------------|
| <b>Weighted-average shares outstanding diluted</b> | <b>262,876</b> | <b>262,865</b> | <b>264,266</b> | <b>262,607</b> |
| <b>Earnings per Share</b>                          |                |                |                |                |
| Basic  | \$ 1.44        | \$ 1.04        | \$ 3.46        | \$ 2.89        |
| Diluted  | 1.41           | 1.00           | 3.37           | 2.78           |

For both the three and nine months ended June 30, 2006, 67.8 thousands nonvested shares related to grants of stock awards and stock unit awards were excluded from the computation of diluted earnings per share because their effect would have been antidilutive. There were no potentially antidilutive nonvested stock awards, stock unit awards or options to purchase shares for the three and nine months ended June 30, 2005.



## 5. Stock-Based Compensation

Prior to October 1, 2005, we accounted for stock-based employee compensation plans according to the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Accordingly, compensation costs were not recognized for awards granted with no intrinsic value. Effective October 1, 2005, we adopted SFAS 123R, using the modified prospective transition method. Under this transition method, compensation cost recognized in the first quarter of fiscal year 2006 includes compensation cost for all share based payments granted prior to, but not yet vested as of October 1, 2005, based on the grant-date fair value estimated in accordance with the original provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS 123). Results for prior periods have not been restated. No options were granted during the nine months ended June 30, 2006.

As a result of adopting SFAS 123R, income before income taxes for the three and nine months ended June 30, 2006 include \$4.4 million and \$14.3 million of compensation costs that would not have been recognized under our previous accounting method for stock-based compensation. Net income for the three and nine months ended June 30, 2006 includes \$3.5 million and \$12.3 million of compensation costs that would not have been recognized under our previous accounting method for stock-based compensation. If we had not adopted SFAS 123R, basic net earnings per share for the three and nine months ended June 30, 2006, would have been \$0.02 higher and \$0.05 higher and diluted net earnings per share for the three and nine months ended June 30, 2006, would have been \$0.02 and \$0.05 higher.

If we had determined compensation costs for our stock option plans and our qualified, non-compensatory employee stock investment plan (the ESIP) based upon estimated fair values at the grant dates in accordance with SFAS 123, for the three and nine months ended June 30, 2005, our net income and basic and diluted earnings per share would have been reduced to the pro forma amounts indicated below. For pro forma purposes, the estimated fair value of options was calculated using the Black-Scholes option-pricing model and was amortized over the options vesting periods.

|   | Three Months Ended | Nine Months Ended |
|---|--------------------|-------------------|
|   | June 30,           | June 30,          |
|   | 2005               | 2005              |
| <i>(in thousands, except per share data)</i>  |                    |                   |
| Net income, as reported   | \$ 261,873         | \$ 723,136        |
| Less: stock-based compensation expense determined under the fair value method, net of tax | (6,314)            | (20,447)          |
| <b>Pro Forma Net Income</b>   | <b>\$ 255,559</b>  | <b>\$ 702,689</b> |
| <b>Basic Earnings per Share</b>   |                    |                   |
| As reported   | \$ 1.04            | \$ 2.89           |
| Pro forma   | 1.02               | 2.81              |
| Adjusted net income, as reported  | \$ 264,100         | \$ 729,783        |
| Less: stock-based compensation expense determined under the fair value method, net of tax | (6,314)            | (20,447)          |
| <b>Pro Forma Net Income</b>   | <b>\$ 257,786</b>  | <b>\$ 709,336</b> |
| <b>Diluted Earnings per Share</b>   |                    |                   |
| As reported   | \$ 1.00            | \$ 2.78           |
| Pro forma   | 0.98               | 2.70              |

## Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

Prior to the adoption of SFAS 123R, we presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Consolidated Statements of Cash Flows. SFAS 123R requires the cash flows resulting from tax deductions in excess of the compensation cost recognized for stock-based payments ( excess tax benefits ) to be classified as financing cash flows. The excess tax benefit of \$9.0 million and \$28.3 million for the three and nine months ended June 30, 2006, that was classified as a

financing cash inflow, would have been classified as an operating cash inflow if we had not adopted SFAS 123R.

We sponsor the 2002 Universal Stock Incentive Plan (the USIP). Under the terms of this plan, eligible employees may receive stock awards, and, in certain cases, awards settled in cash based on our performance and that of individual employees. The Compensation Committee and the Board of Directors determine the terms and conditions of stock-based compensation awards.

*Stock Options*

The following table summarizes stock option activity:

|   | Shares       | Weighted-Average<br>Exercise<br>Price | Weighted-Average                               |                                 |
|---|--------------|---------------------------------------|--|---------------------------------|
|   |              |                                       | Remaining<br>Contractual<br>Term (in<br>Years) | Aggregate<br>Intrinsic<br>Value |
| <i>(in thousands, except weighted average exercise price)</i> |              |                                       |  |                                 |
| Outstanding at September 30, 2005                             | 7,844        | \$ 37.47                              | 5.8  | \$ 293,942                      |
| Granted   |              |                                       |  |                                 |
| Exercised   | (1,041)      | 36.11                                 | 5.3  | (37,598)                        |
| Cancelled   | (7)          | 47.27                                 | 7.8  | (326)                           |
| Forfeited/expired   |              |                                       |  |                                 |
| Outstanding at December 31, 2005                              | 6,796        | \$ 37.67                              | 5.7  | \$ 256,018                      |
| Granted   |              |                                       |  |                                 |
| Exercised   | (890)        | 37.30                                 | 4.5  | (33,181)                        |
| Cancelled   | (12)         | 47.83                                 | 5.2  | (577)                           |
| Forfeited/expired   |              |                                       |  |                                 |
| Outstanding at March 31, 2006                                 | 5,894        | \$ 37.71                              | 5.5  | \$ 222,260                      |
| Granted   |              |                                       |  |                                 |
| Exercised   | (207)        | 36.49                                 | 5.0  | (7,549)                         |
| Cancelled   | (4)          | 45.83                                 | 6.5  | (176)                           |
| Forfeited/expired   |              |                                       |  |                                 |
| <b>Outstanding at June 30, 2006</b>                           | <b>5,683</b> | <b>\$ 37.75</b>                       | <b>5.3</b>                                     | <b>\$ 214,535</b>               |
| <b>Exercisable at June 30, 2006</b>                           | <b>5,077</b> | <b>\$ 36.53</b>                       | <b>5.3</b>                                     | <b>\$ 185,478</b>               |

Stock option awards outstanding under the USIP generally have been granted at prices which are either equal to or above the market value of the underlying common stock on the date of grant, generally vest over three years and expire no later than ten years after the grant date. We have not granted stock option awards under the USIP since November 2004.

## Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

Effective October 1, 2005, compensation expense related to nonvested options is recognized ratably over the remaining requisite service period. As of June 30, 2006, there was \$4.2 million of total unrecognized compensation cost related to nonvested options, which is expected to be recognized over a remaining weighted average vesting period of 0.4 years.

Our option awards are generally subject to graded vesting over a service period. We recognize compensation cost on a straight-line basis over the requisite service period for the entire award.

*Stock Awards and Stock Unit Awards*

In accordance with SFAS 123R, the fair value of stock awards and stock unit awards granted under the USIP is estimated on the date of grant based on the market price of the underlying common stock and is amortized to compensation expense on a straight-line basis over the related vesting period, which is generally three to four years. The total number of stock awards and stock unit awards expected to vest is adjusted for estimated forfeitures.

Total unrecognized compensation cost related to nonvested stock awards and stock unit awards net of estimated forfeitures was \$46.6 million at June 30, 2006. This cost is expected to be recognized over a remaining weighted-average vesting period of 1.3 years.

The following is a summary of nonvested stock award and stock unit award activity:

| <i>(shares in thousands)</i>              | Shares       | Weighted-Average Grant-Date |              |
|---|--------------|-----------------------------|--------------|
|   |              | Fair Value                  |              |
| Nonvested balance at September 30, 2005   | 597.4        | \$                          | 60.61        |
| Granted                                   | 458.8        |                             | 90.34        |
| Vested                                    | (138.5)      |                             | 64.31        |
| Forfeited                                 | (7.4)        |                             | 69.85        |
| Nonvested balance at December 31, 2005    | 910.3        | \$                          | 74.96        |
| Granted                                   | 16.7         |                             | 98.07        |
| Vested                                    | (3.4)        |                             | 100.80       |
| Forfeited                                 | (18.7)       |                             | 71.82        |
| Nonvested Balance at March 31, 2006       | 904.9        | \$                          | 75.35        |
| Granted                                   | 9.1          |                             | 84.47        |
| Vested                                    | (15.2)       |                             | 55.61        |
| Forfeited                                 | (9.8)        |                             | 73.12        |
| <b>Nonvested Balance at June 30, 2006</b> | <b>889.0</b> | <b>\$</b>                   | <b>75.81</b> |

Our stock awards generally entitle the holder to the right to sell the shares of common stock on or after the awards vest. Stock unit awards generally entitle the holder to receive the underlying shares of common stock on or after the awards vest. In addition, certain performance-based stock awards were granted to our Chief Executive Officer. The total number of shares ultimately received by the Chief Executive Officer depends on our performance against specified performance goals and is subject to vesting provisions. At June 30, 2006, the balance of nonvested shares granted to the Chief Executive Officer and subject to vesting upon the achievement of prior years' performance goals, set or determined in prior years, was 20.6 thousand and had a weighted-average grant-date fair value of \$90.08.

*Employee Stock Investment Plan*

## Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

Our ESIP allows eligible participants to buy shares of our common stock at 90% of its market value on defined dates and to receive a 50% match of the shares purchased, provided the employee, among other conditions, has held the previously purchased shares for a defined period. The Compensation Committee and the Board of Directors determine the terms and conditions of awards under the ESIP. A total of 270.5 thousand shares were issued under the ESIP during the three and nine months ended June 30, 2006. At June 30, 2006, 651.1 thousand shares were reserved for future issuance under this plan.

*All Stock-Based Plan Arrangements*

Total stock-based compensation costs of \$16.2 million and \$44.8 million were recognized in the Condensed Consolidated Statements of Income during the three and nine months ended June 30, 2006. For the three and nine months ended June 30, 2006, the income tax benefits from stock-based arrangements totaled \$11.0 million and \$36.1 million, with approximately \$8.2 million and \$28.2 million attributed to stock option exercises for the same periods. Cash received from stock option exercises for the three and nine months ended June 30, 2006 was \$7.5 million and \$78.3 million. We generally do not repurchase shares upon share option exercise or vesting of stock awards and stock unit awards. However, in order to pay taxes due in connection with the vesting of employee and executive officer stock awards and stock unit awards under the USIP and in connection with matching grants under the ESIP, we repurchase shares to pay such taxes using a net stock issuance method.

**6. Consolidated Sponsored Investment Products**

The following tables present the effect on our consolidated results of operations and financial position of the consolidation and deconsolidation activity related to sponsored investment products accounted for under FASB Statement of Financial Accounting Standards No. 94,

Consolidation of All Majority-Owned Subsidiaries, and FASB Interpretation No. 46, Consolidation of Variable Interest Entities (revised December 2003) (FIN 46-R).

|  | <b>Three Months Ended June 30, 2006</b> |                   |                     |
|--|---|-------------------|---------------------|
|  | <b>Sponsored</b>                        |                   | <b>Consolidated</b> |
|  | <b>Before</b>                           | <b>Investment</b> |                     |
| <i>(in thousands)</i>                                  | <b>Consolidation</b>                    | <b>Products</b>   | <b>Consolidated</b> |
| <b>Operating Revenues</b>                              |   |                   |                     |
| Investment management fees                             | \$ 786,799                              | \$ (784)          | \$ 786,015          |
| Underwriting and distribution fees                     | 447,315                                 | (179)             | 447,136             |
| Shareholder servicing fees                             | 65,607                                  | (14)              | 65,593              |
| Consolidated sponsored investment products income, net |   | 2,753             | 2,753               |
| Other, net   | 15,778                                  |                   | 15,778              |
| <b>Total operating revenues</b>                        | <b>1,315,499</b>                        | <b>1,776</b>      | <b>1,317,275</b>    |
| <b>Operating Expenses</b>                              | <b>865,289</b>                          |                   | <b>865,289</b>      |
| <b>Operating income</b>                                | <b>450,210</b>                          | <b>1,776</b>      | <b>451,986</b>      |
| <b>Other Income (Expenses)</b>                         |   |                   |                     |
| Consolidated sponsored investment products losses, net |   | (8,352)           | (8,352)             |
| Investment and other income (expenses), net            | 52,595                                  | (324)             | 52,271              |
| Interest expense                                       | (6,682)                                 |                   | (6,682)             |
| <b>Other income, net</b>                               | <b>45,913</b>                           | <b>(8,676)</b>    | <b>37,237</b>       |
| <b>Income before taxes on income</b>                   | <b>496,123</b>                          | <b>(6,900)</b>    | <b>489,223</b>      |
| <b>Taxes on income</b>                                 | <b>119,699</b>                          | <b>(1,890)</b>    | <b>117,809</b>      |

|                   |                   |                   |                   |
|-------------------|-------------------|-------------------|-------------------|
| <b>Net Income</b> | <u>\$ 376,424</u> | <u>\$ (5,010)</u> | <u>\$ 371,414</u> |
|-------------------|-------------------|-------------------|-------------------|



|  | Nine Months Ended June 30, 2006 |                 |                   |
|--|---------------------------------|-----------------|-------------------|
|  | Sponsored                       |                 |                   |
|  | Before                          | Investment      |                   |
| <i>(in thousands)</i>                                  | Consolidation                   | Products        | Consolidated      |
| <b>Operating Revenues</b>                              |                                 |                 |                   |
| Investment management fees                             | \$ 2,202,374                    | \$ (2,905)      | \$ 2,199,469      |
| Underwriting and distribution fees                     | 1,307,953                       | (437)           | 1,307,516         |
| Shareholder servicing fees                             | 194,960                         | (30)            | 194,930           |
| Consolidated sponsored investment products income, net |                                 | 5,589           | 5,589             |
| Other, net   | 45,993                          |                 | 45,993            |
| Total operating revenues                               | 3,751,280                       | 2,217           | 3,753,497         |
| <b>Operating Expenses</b>                              |                                 |                 |                   |
|  | 2,547,168                       |                 | 2,547,168         |
| Operating income                                       | 1,204,112                       | 2,217           | 1,206,329         |
| <b>Other Income (Expenses)</b>                         |                                 |                 |                   |
| Consolidated sponsored investment products gains, net  |                                 | 19,454          | 19,454            |
| Investment and other income (expenses), net            | 150,262                         | (10,237)        | 140,025           |
| Interest expense                                       | (22,995)                        |                 | (22,995)          |
| Other income, net                                      | 127,267                         | 9,217           | 136,484           |
| Income before taxes on income                          | 1,331,379                       | 11,434          | 1,342,813         |
| Taxes on income  | 453,918                         | 2,996           | 456,914           |
| <b>Net Income</b>                                      | <b>\$ 877,461</b>               | <b>\$ 8,438</b> | <b>\$ 885,899</b> |

|   | June 30, 2006       |                  |                     |
|---|---------------------|------------------|---------------------|
|   | Sponsored           |                  |                     |
|   | Before              | Investment       |                     |
| <i>(in thousands)</i>                       | Consolidation       | Products         | Consolidated        |
| <b>Assets</b>                               |                     |                  |                     |
| Current assets                              | \$ 4,656,485        | \$ 132,859       | \$ 4,789,344        |
| Banking/finance assets                      | 944,443             |                  | 944,443             |
| Non-current assets                          | 3,274,428           | (33,472)         | 3,240,956           |
| <b>Total Assets</b>                         | <b>\$ 8,875,356</b> | <b>\$ 99,387</b> | <b>\$ 8,974,743</b> |
| <b>Liabilities and Stockholders' Equity</b> |                     |                  |                     |
| Current liabilities                         | \$ 972,597          | \$ 24,408        | \$ 997,005          |
| Banking/finance liabilities                 | 735,352             |                  | 735,352             |
| Non-current liabilities                     | 824,946             |                  | 824,946             |
| <b>Total Liabilities</b>                    | <b>2,532,895</b>    | <b>24,408</b>    | <b>2,557,303</b>    |

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

|   |                     |                  |                     |
|---|---------------------|------------------|---------------------|
| Minority interest                                 | 39,597              | 71,513           | 111,110             |
| Total stockholders' equity                        | 6,302,864           | 3,466            | 6,306,330           |
| <b>Total Liabilities and Stockholders' Equity</b> | <b>\$ 8,875,356</b> | <b>\$ 99,387</b> | <b>\$ 8,974,743</b> |

**7. Cash and Cash Equivalents**

Cash and cash equivalents consisted of the following:

| <i>(in thousands)</i>  | <b>June 30, 2006</b> | <b>September 30, 2005</b> |
|--|----------------------|---------------------------|
| Cash and due from banks  | \$ 443,444           | \$ 373,699                |
| Federal funds sold and securities purchased under agreements to resell | 55,801               | 21,065                    |
| U.S. T-bills, time deposits, money market funds and other              | 2,913,951            | 2,757,395                 |
| <b>Total</b>   | <b>\$ 3,413,196</b>  | <b>\$ 3,152,159</b>       |

Federal Reserve Board regulations require reserve balances on deposits to be maintained with the Federal Reserve Banks by banking subsidiaries. The required reserve balances were \$0.7 million at June 30, 2006 and \$1.9 million at September 30, 2005.

## 8. Securitization of Loans Receivable

From time to time, we enter into auto loan securitization transactions with qualified special purpose entities and record these transactions as sales. The following table shows details of auto loan securitization transactions.

| <i>(in thousands)</i>                            | Three Months Ended |           | Nine Months Ended |               |
|--|--------------------|-----------|-------------------|---------------|
|  | June 30,           |           | June 30,          |               |
|  | 2006               | 2005      | 2006              | 2005          |
| Gross sale proceeds                              | \$                 | \$        | \$ 348,332        | \$ 231,570    |
| Less: net carrying amount of loans held for sale |                    |           | 348,169           | 230,581       |
| <b>Pre-Tax Gain</b>                              | <b>\$</b>          | <b>\$</b> | <b>\$ 163</b>     | <b>\$ 989</b> |

When we sell auto loans in a securitization transaction, we record an interest-only strip receivable. The interest-only strip receivable represents our contractual right to receive interest from the pool of securitized loans after the payment of required amounts to holders of the securities and certain other costs associated with the securitization. Auto loans sold in a securitization transaction in the nine months ended June 30, 2006, included loans held by a special purpose statutory Delaware trust (the Trust) that was organized in fiscal year 2005 to hold our loans held for sale and issue notes under a variable funding note warehouse facility. Directly and through the Trust, which is consolidated in our results of operations, we also enter into interest-rate swap agreements, accounted for as freestanding derivatives, to mitigate the interest risk between the fixed interest rate on the pool of automobile loans and the floating interest rate being paid under the variable funding note warehouse facility. The interest rate swap had a notional value of \$189.6 million and was reported at its fair value of \$2.1 million liability at June 30, 2006.

We generally estimate fair value based on the present value of future expected cash flows. The key assumptions used in the present value calculations of our securitization transactions at the date of securitization were as follows:

|   | Three Months Ended |      | Nine Months Ended |       |
|---|--------------------|------|-------------------|-------|
|   | June 30,           |      | June 30,          |       |
|   | 2006               | 2005 | 2006              | 2005  |
| Excess cash flow discount rate (annual rate)        |                    |      | 12.0%             | 12.0% |
| Cumulative life loss rate                           |                    |      | 3.2%              | 3.6%  |
| Pre-payment speed assumption (average monthly rate) |                    |      | 1.6%              | 1.5%  |

We determined these assumptions using data from comparable transactions, historical information and management's estimate. Interest-only strips receivable are generally restricted assets and subject to limited recourse provisions.



We generally estimate the fair value of the interest-only strips receivable at each period-end based on the present value of future expected cash flows, consistent with the methodology used at the date of securitization. The following table shows the carrying value and the sensitivity of the interest-only strips receivable to hypothetical adverse changes in the key economic assumptions used to measure fair value:

| <i>(dollar amounts in thousands)</i>                          | <u>June 30, 2006</u> | <u>September 30, 2005</u> |
|---|----------------------|---------------------------|
| Carrying amount/fair value of interest-only strips receivable | \$ 14,018            | \$ 19,126                 |
| Excess cash flow discount rate (annual rate)                  | 12.0%                | 12.0%                     |
| Impact on fair value of 10% adverse change                    | \$ (207)             | \$ (209)                  |
| Impact on fair value of 20% adverse change                    | (409)                | (413)                     |
| Cumulative life loss rate                                     | 3.4%                 | 3.5%                      |
| Impact on fair value of 10% adverse change                    | \$ (2,273)           | \$ (1,804)                |
| Impact on fair value of 20% adverse change                    | (4,546)              | (3,607)                   |
| Pre-payment speed assumption (average monthly rate)           | 1.6%                 | 1.9%                      |
| Impact on fair value of 10% adverse change                    | \$ (1,889)           | \$ (2,000)                |
| Impact on fair value of 20% adverse change                    | (3,711)              | (3,823)                   |

Actual future market conditions may differ materially. Accordingly, this sensitivity analysis should not be considered our projection of future events or losses.

We retain servicing responsibilities for auto loan securitizations and receive annual servicing fees ranging from 1% to 2% of the loans securitized for services that we provide to the securitization trusts. We do not recognize a servicing asset or liability under the provisions of FASB Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, because the benefits of servicing are just adequate to compensate us for our servicing responsibilities.

The following table is a summary of cash flows received from and paid to securitization trusts.

| <i>(in thousands)</i>                    | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>June 30,</b>           |             | <b>June 30,</b>          |             |
|  | <u>2006</u>               | <u>2005</u> | <u>2006</u>              | <u>2005</u> |
| Servicing fees received                  | \$ 3,022                  | \$ 3,589    | \$ 9,294                 | \$ 10,838   |
| Interest-only strips cash flows received | 8,763                     | 5,599       | 15,730                   | 17,312      |
| Purchase of loans from trusts            |                           |             | (23,719)                 | (12,333)    |

Amounts payable to the trustee related to loan principal and interest collected on behalf of the trusts of \$42.3 million at June 30, 2006 and \$44.7 million at September 30, 2005 are included in other banking/finance liabilities.

The following table shows details of the loans we manage that are held by securitization trusts.

| <i>(in thousands)</i> | <b>June 30, 2006</b> | <b>September 30, 2005</b> |
|-----------------------|----------------------|---------------------------|
|-----------------------|----------------------|---------------------------|

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

|  |            |            |
|--|------------|------------|
| Principal amount of loans                          | \$ 599,280 | \$ 577,696 |
| Principal amount of loans 30 days or more past due | 10,863     | 12,909     |

Net charge-offs on the securitized loan portfolio were \$1.7 million and \$7.7 million for the three and nine months ended June 30, 2006 and \$2.6 million and \$9.2 million for the three and nine months ended June 30, 2005.

## 9. Goodwill and Other Intangible Assets

Goodwill and indefinite-lived intangible assets, including those acquired before initial application of FASB Statements of Financial Accounting Standards No. 141, *Business Combinations*, and No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), are not amortized but are tested for impairment at least annually.

As of March 31, 2006, we completed our most recent annual impairment testing of goodwill and indefinite-lived intangible assets under the guidance set out in SFAS 142 and we determined that there was no impairment to these assets as of October 1, 2005.

During the three months ended March 31, 2006, Fiduciary Trust Company International (Fiduciary Trust) obtained the necessary approvals and implemented a plan of reorganization designed to emphasize its distinct high net-worth brand and to pursue further integration opportunities within the Company for its institutional business line. These changes to Fiduciary Trust's business required that the Company review the carrying value of acquired customer base intangible assets of Fiduciary Trust. As a result of these changes, we recorded a non-cash impairment charge to customer base intangible assets of \$68.4 million with respect to definite-lived intangible assets of Fiduciary Trust in the three months ended March 31, 2006. The net carrying value of Fiduciary Trust's definite-lived intangible assets remaining at March 31, 2006 after recognition of the impairment was \$82.9 million.

Intangible assets, other than goodwill were as follows:

|                                      | <b>Gross</b>      |                     | <b>Net</b>        |
|--------------------------------------|-------------------|---------------------|-------------------|
|                                      | <b>Carrying</b>   | <b>Accumulated</b>  | <b>Carrying</b>   |
| <i>(in thousands)</i>                | <b>Amount</b>     | <b>Amortization</b> | <b>Amount</b>     |
| <b>Balance at June 30, 2006</b>      |                   |                     |                   |
| Amortized intangible assets          |                   |                     |                   |
| Customer base                        | \$ 165,612        | \$ (80,428)         | \$ 85,184         |
| Other                                | 34,933            | (25,000)            | 9,933             |
|                                      | <u>200,545</u>    | <u>(105,428)</u>    | <u>95,117</u>     |
| Non-amortized intangible assets      |                   |                     |                   |
| Investment management contracts      | 482,091           |                     | 482,091           |
| <b>Total</b>                         | <b>\$ 682,636</b> | <b>\$ (105,428)</b> | <b>\$ 577,208</b> |
| <b>Balance at September 30, 2005</b> |                   |                     |                   |
| Amortized intangible assets          |                   |                     |                   |
| Customer base                        | \$ 233,737        | \$ (70,481)         | \$ 163,256        |
| Other                                | 34,933            | (23,624)            | 11,309            |
|                                      | <u>268,670</u>    | <u>(94,105)</u>     | <u>174,565</u>    |
| Non-amortized intangible assets      |                   |                     |                   |
| Investment management contracts      | 482,028           |                     | 482,028           |
| <b>Total</b>                         | <b>\$ 750,698</b> | <b>\$ (94,105)</b>  | <b>\$ 656,593</b> |



Certain of our intangible assets are denominated in currencies other than the U.S. dollar; therefore, their gross and net carrying amounts are subject to foreign currency movements.



The change in the carrying value of goodwill was as follows:

*(in thousands)*

|  |                     |
|--|---------------------|
| Balance at September 30, 2005  | \$ 1,390,851        |
| Adjustment to goodwill related to the acquisition of Fiduciary Trust | 13,824              |
| Foreign currency movements   | 2,148               |
| <b>Balance at June 30, 2006</b>                                      | <b>\$ 1,406,823</b> |

In connection with the reorganization of Fiduciary Trust, the Company determined that the related deferred tax liabilities had not been properly reflected. As a result, the Company reflected an inconsequential adjustment to the carrying value of goodwill and deferred tax liabilities totaling \$13.8 million as of March 31, 2006.

Estimated amortization expense related to non-amortized intangible assets for each of the next 5 fiscal years is as follows:

| <i>(in thousands)</i> | <b>For the Fiscal Years<br/>Ending September 30,</b> |
|-----------------------|--|
| 2006                  | \$ 14,015  |
| 2007                  | 10,595   |
| 2008                  | 10,595   |
| 2009                  | 10,595   |
| 2010                  | 10,595   |

## 10. Debt

Outstanding debt consisted of the following:

| <i>(in thousands)</i>                          | <b>June 30, 2006</b> | <b>September 30, 2005</b> |
|--|----------------------|---------------------------|
| <b>Current</b>                                 |                      |                           |
| Variable Funding Note                          | \$ 177,786           | \$ 239,222                |
| Commercial paper                               | 167,982              | 169,389                   |
|  | 345,768              | 408,611                   |
| <b>Non-Current</b>                             |                      |                           |
| Convertible Notes (including accrued interest) |                      | 540,107                   |
| Medium Term Notes                              | 420,000              | 420,000                   |
| Other  | 219,354              | 248,283                   |
|  | 639,354              | 1,208,390                 |

|                   |                   |                     |
|-------------------|-------------------|---------------------|
| <b>Total Debt</b> | <b>\$ 985,122</b> | <b>\$ 1,617,001</b> |
|-------------------|-------------------|---------------------|

As of June 30, 2006, \$177.8 million was outstanding under a one-year revolving \$250.0 million variable funding note warehouse credit facility, entered into in March 2005 and subsequently extended for an additional one-year term in March 2006, used by the banking/finance operating segment to finance our automotive lending business. The variable funding note ( Variable Funding Note ) issued under this facility is payable to certain administered conduits and is secured by cash and a pool of automobile loans that meet or will meet certain eligibility requirements. Credit enhancements for the Variable Funding Note require us to provide, as collateral, loans held for sale with a fair value in excess of the principal amount of the Variable Funding Note, as well as to hold in trust additional cash balances to cover certain shortfalls. In addition, we provide a payment provider commitment in an amount not to exceed 4.66% of the pool

balance. We also enter into interest-rate swap agreements, accounted for as freestanding derivatives, to mitigate the interest-rate risk between the fixed interest rate on the pool of automobile loans and the floating interest rate being paid on the Variable Funding Note.

In May 2001, we received approximately \$490.0 million in net proceeds from the sale of \$877.0 million principal amount at maturity of Liquid Yield Option Notes due 2031 (Zero Coupon-Senior) (the Convertible Notes). The issue price of the Convertible Notes, which were offered to qualified institutional buyers only, represented a yield to maturity of 1.875% per annum excluding any contingent interest. Each of the \$1,000 (principal amount at maturity) Convertible Notes was convertible prior to maturity into 9.3604 shares of our common stock (subject to adjustment) following the occurrence of certain specified triggering events. In particular, the Convertible Notes were convertible if, during any calendar quarter, the closing sale price of our common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of the preceding calendar quarter was more than a specified percentage (initially 120% as of the third quarter of fiscal year 2001 and declining 0.084% each quarter thereafter) of the accreted conversion price per share of our common stock on the last trading day of the preceding calendar quarter. Based on this formula, holders were able to convert their Convertible Notes during the quarter ended June 30, 2006 because the closing sale price of our common stock during the quarter ended March 31, 2006 for at least 20 trading days in the period of 30 consecutive trading days ending on the last trading day of the quarter was more than \$78.96 (118.40% of \$66.69, which was the accreted conversion price per share of our common stock on the last trading day of the quarter). In the three and nine months ended June 30, 2006, holders of the Convertible Notes converted \$346.0 million and \$870.5 million in aggregate principal amount of Convertible Notes into an aggregate of 3.2 million and 8.1 million shares of our common stock.

On May 19, 2006, we issued a notice of redemption with respect to all outstanding Convertible Notes pursuant to which we would redeem on June 5, 2006 each \$1,000 principal amount at maturity the Convertible Notes then outstanding at a price of \$627.93. Prior to the redemption date, the Convertible Notes remained convertible into our common stock at a rate of 9.3604 shares per \$1,000 principal amount at maturity of Convertible Notes surrendered for conversion until the close of business on June 1, 2006. Following our notice of redemption, \$275.5 million principal amount at maturity of the Convertible Notes were converted into an aggregate of 2.6 million shares of our common stock. On June 5, 2006, we redeemed the remaining \$0.6 million principal amount at maturity of the Convertible Notes for cash in the aggregate amount of \$0.4 million. Through June 30, 2006, holders had put to us and we had repurchased Convertible Notes with a face value of \$6.5 million principal amount at maturity, for their accreted value of \$3.9 million, in cash.

In April 2003, we completed the sale of five year senior notes due April 15, 2008 totaling \$420.0 million (the Medium Term Notes). The Medium Term Notes, which were offered to qualified institutional buyers only, carry an interest rate of 3.7% and are not redeemable prior to maturity by either the note holders or us. Interest payments are due semi-annually.

Other long-term debt primarily relates to deferred commission liabilities recognized in relation to U.S. deferred commission assets originally financed through a sale to Lightning Finance Company Limited (LFL), a company in which we hold a 49% ownership interest. Historically, Class B and certain of our Class C deferred commission assets (DCA) arising from our U.S., Canadian and European operations have been financed through sales to or other arrangements with LFL. In December 2005, LFL sold substantially all of its DCA to Lightning Asset Finance Limited (LAFL), an Irish special purpose vehicle formed in December 2005, in which we also hold a 49% ownership interest. Subsequent to the sale to LAFL, DCA originating from our Canadian and European operations are generally financed by a third party. As LFL originally entered into financing arrangements with our U.S. distribution subsidiary, we maintain a

continuing interest in the DCA transferred to LAFL by LFL until resold by LAFL. Neither we nor our U.S. distribution subsidiary retain any direct ownership interest in either the DCA sold directly to a third party or the DCA sold originally to LFL (and subsequently sold by LFL to LAFL or other third party), and therefore, the sold DCA are not available to satisfy claims of our creditors or those of our U.S. distribution subsidiary.

As of June 30, 2006, we have \$300.0 million of debt and equity securities available to be issued under a shelf registration statement filed with the SEC and \$330.0 million of additional commercial paper available for issuance. On June 10, 2005, we entered into a \$420.0 million Five Year Facility Credit Agreement with certain banks and financial institutions. In addition, at June 30, 2006, our banking/finance operating segment had \$320.0 million in available uncommitted short term bank lines under the Federal Reserve Funds system, the Federal Reserve Bank discount window, and Federal Home Loan Bank short term borrowing capacity.

## 11. Commitments and Contingencies

### *Guarantees*

Under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, we are required to recognize in our financial statements a liability for the fair value of any guarantees issued or modified after December 31, 2002 as well as make additional disclosures about existing guarantees.

In relation to the auto loan securitization transactions that we have entered into with a number of qualified special purpose entities, we are obligated to cover shortfalls in amounts due to the holders of the notes up to certain levels as specified under the related agreements. As of June 30, 2006, the maximum potential amount of future payments related to these obligations was \$30.7 million. In addition, our Condensed Consolidated Balance Sheet at June 30, 2006 included a \$0.1 million liability to reflect the fair value of certain additional obligations arising from auto securitization transactions.

At June 30, 2006, our banking/finance operating segment had issued financial standby letters of credit totaling \$2.6 million on which beneficiaries would be able to draw upon in the event of non-performance by our customers, primarily in relation to lease and lien obligations of these banking customers. These standby letters of credit, issued prior to January 1, 2003, were secured by marketable securities with a fair value of \$2.9 million as of June 30, 2006 and commercial real estate.

### *Legal Proceedings*

As previously reported, the Company and certain of its subsidiaries, and in some instances, certain of the Franklin Templeton mutual funds ( *Funds* ), current and former officers, employees, and directors have been named in multiple lawsuits in different federal courts in Nevada, California, Illinois, New York, and Florida, alleging violations of various federal securities and state laws and seeking, among other relief, monetary damages, restitution, removal of Fund trustees, directors, advisers, administrators, and distributors, rescission of management contracts and 12b-1 plans, and/or attorneys' fees and costs. Specifically, the lawsuits claim breach of duty with respect to alleged arrangements to permit market timing and/or late trading activity, or breach of duty with respect to the valuation of the portfolio securities of certain Templeton Funds managed by the Company's subsidiaries, allegedly resulting in market timing activity. The majority of these lawsuits duplicate, in whole or in part, the allegations asserted in the February 4, 2004 Massachusetts Administrative Complaint concerning one instance of market timing (the *Administrative Complaint* ) and the SEC's findings regarding market timing in its August 2, 2004 Order (the *SEC Order* ), both of which matters were previously reported. The lawsuits are styled as class actions, or derivative actions on behalf of either the named Funds or the Company.



To date, more than 400 similar lawsuits against at least 19 different mutual fund companies have been filed in federal district courts throughout the country. Because these cases involve common questions of fact, the Judicial Panel on Multidistrict Litigation (the Judicial Panel) ordered the creation of a multidistrict litigation in the United States District Court for the District of Maryland, entitled *In re Mutual Funds Investment Litigation* (the MDL). The Judicial Panel then transferred similar cases from different districts to the MDL for coordinated or consolidated pretrial proceedings.

As of August 9, 2006 the following market timing lawsuits are pending against the Company and certain of its subsidiaries (and in some instances, name certain officers, directors and/or Funds) and have been transferred to the MDL:

Kenerley v. Templeton Funds, Inc., et al., Case No. 03-770 GPM, filed on November 19, 2003 in the United States District Court for the Southern District of Illinois; Cullen v. Templeton Growth Fund, Inc., et al., Case No. 03-859 MJR, filed on December 16, 2003 in the United States District Court for the Southern District of Illinois and transferred to the United States District Court for the Southern District of Florida on March 29, 2004; Jaffe v. Franklin AGE High Income Fund, et al., Case No. CV-S-04-0146-PMP-RJJ, filed on February 6, 2004 in the United States District Court for the District of Nevada; Lum v. Franklin Resources, Inc., et al., Case No. C 04 0583 JSW, filed on February 11, 2004 in the United States District Court for the Northern District of California; Fischbein v. Franklin AGE High Income Fund, et al., Case No. C 04 0584 JSW, filed on February 11, 2004 in the United States District Court for the Northern District of California; Beer v. Franklin AGE High Income Fund, et al., Case No. 8:04-CV-249-T-26 MAP, filed on February 11, 2004 in the United States District Court for the Middle District of Florida; Bennett v. Franklin Resources, Inc., et al., Case No. CV-S-04-0154-HDM-RJJ, filed on February 12, 2004 in the United States District Court for the District of Nevada; Dukes v. Franklin AGE High Income Fund, et al., Case No. C 04 0598 MJJ, filed on February 12, 2004 in the United States District Court for the Northern District of California; McAlvey v. Franklin Resources, Inc., et al., Case No. C 04 0628 PJH, filed on February 13, 2004 in the United States District Court for the Northern District of California; Alexander v. Franklin AGE High Income Fund, et al., Case No. C 04 0639 SC, filed on February 17, 2004 in the United States District Court for the Northern District of California; Hugh Sharkey IRA/RO v. Franklin Resources, Inc., et al., Case No. 04 CV 1330, filed on February 18, 2004 in the United States District Court for the Southern District of New York; D Alliessi v. Franklin AGE High Income Fund, et al., Case No. C 04 0865 SC, filed on March 3, 2004 in the United States District Court for the Northern District of California; Marcus v. Franklin Resources, Inc., et al., Case No. C 04 0901 JL, filed on March 5, 2004 in the United States District Court for the Northern District of California; Banner v. Franklin Resources, Inc., et al., Case No. C 04 0902 JL, filed on March 5, 2004 in the United States District Court for the Northern District of California; Denenberg v. Franklin Resources, Inc., et al., Case No. C 04 0984 EMC, filed on March 10, 2004 in the United States District Court for the Northern District of California; Hertz v. Burns, et al., Case No. 04 CV 02489, filed on March 30, 2004 in the United States District Court for the Southern District of New York.

In addition, on April 12, 2005, the Attorney General of West Virginia filed a complaint in the Circuit Court of Marshall County, West Virginia (Case No. 05-C-81) against a number of companies engaged in the mutual fund industry, including the Company and its subsidiary, Franklin Advisers, Inc., and certain other parties, alleging violations of the West Virginia Consumer Credit and Protection Act and seeking, among other things, civil penalties and attorneys' fees and costs. In response to defendants' motion for transfer, on October 19, 2005, the Judicial Panel transferred the case to the MDL described above. To the extent applicable to the Company, the complaint arises from activity that occurred in 2001 and duplicates, in whole or in part, the allegations asserted in the Administrative Complaint concerning one instance of market timing and the findings regarding market timing in the SEC Order.

Plaintiffs in the MDL filed consolidated amended complaints on September 29, 2004. On February 25, 2005, defendants filed motions to dismiss. The Company's and its subsidiaries' motions are currently under submission with the court.

As previously reported, various subsidiaries of the Company, as well as certain Templeton Fund registrants, have also been named in several class action lawsuits originally filed in state courts in Illinois, alleging breach of duty with respect to the valuation of the portfolio securities of certain Templeton Funds managed by such subsidiaries, and seeking, among other relief, monetary damages and attorneys' fees and costs, as follows:

Bradfish v. Templeton Funds, Inc., et al., Case No. 2003 L 001361, filed on October 3, 2003 in the Circuit Court of the Third Judicial Circuit, Madison County, Illinois; Woodbury v. Templeton Global Smaller Companies Fund, Inc., et al., Case No. 2003 L 001362, filed on October 3, 2003 in the Circuit Court of the Third Judicial Circuit, Madison County, Illinois; Kwiatkowski v. Templeton Growth Fund, Inc., et al., Case No. 03 L 785, filed on December 17, 2003 in the Circuit Court of the Twentieth Judicial Circuit, St. Clair County, Illinois; Parise v. Templeton Funds, Inc., et al., Case No. 2003 L 002049, filed on December 22, 2003 in the Circuit Court of the Third Judicial Circuit, Madison County, Illinois.

In April 2005, defendants removed these lawsuits to the United States District Court for the Southern District of Illinois. On July 12, 2005, the court dismissed with prejudice one of these lawsuits, Bradfish v. Templeton Funds, Inc., et al., and dismissed the remaining three lawsuits on August 25, 2005. Plaintiffs appealed the dismissals to the United States Court of Appeals for the Seventh Circuit (Bradfish v. Templeton Funds, Inc., et al., Case No. 05-3390, Woodbury v. Templeton Global Smaller Companies Fund, Inc., et al., Case No. 05-3559, Kwiatkowski v. Templeton Growth Fund, Inc., et al., Case No. 05-3558, Parise v. Templeton Funds, Inc., et al., Case No. 05-3586). On May 19, 2006, the Seventh Circuit affirmed the dismissals. Plaintiffs' subsequent requests to the Seventh Circuit for reconsideration were also denied.

In addition, Franklin Templeton Investments Corp., a subsidiary of the Company and the investment manager of Franklin Templeton's Canadian mutual funds, has been named in four class action market timing lawsuits in Canada, seeking, among other relief, monetary damages, an order barring any increase in management fees for a period of two years following judgment, and/or attorneys' fees and costs, as follows: Huneault v. AGF Funds, Inc., et al., Case No. 500-06-000256-046, filed on October 25, 2004 in the Superior Court for the Province of Quebec, District of Montreal; Heinrichs, et al. v. CI Mutual Funds, Inc., et al., Case No. 04-CV-29700, filed on December 17, 2004 in the Ontario Superior Court of Justice; Fischer, et al. v. IG Investment Management Ltd., et al. Case No. 06-CV-307599CP, filed on March 9, 2006 in the Ontario Superior Court of Justice; and Richardson v. Franklin Templeton Investments Corp., Case No. 05-CV-303069, filed on December 23, 2005 in the Ontario Superior Court of Justice and served on Franklin Templeton Investments Corp. on June 21, 2006.

As also previously reported, the Company and certain of its subsidiaries, and in some instances, certain current and former officers, employees, and directors, have been named in multiple lawsuits alleging violations of various securities laws and pending state law claims relating to marketing support payments and/or payment of allegedly excessive commissions, and/or advisory or distribution fees, and seeking, among other relief, monetary damages, restitution, an accounting of all fees, commissions and soft dollar payments, declaratory relief, injunctive relief, and/or attorneys' fees and costs. These lawsuits are styled as class actions and/or derivative actions brought on behalf of certain Funds, and are as follows:

Stephen Alexander IRA v. Franklin Resources, Inc., et al., Case No. 04-982 JLL, filed on March 2, 2004 in the United States District Court for the District of New Jersey; Strigliabotti v. Franklin Resources, Inc., et al., Case No. C 04 0883 SI, filed on March 4, 2004 in the United States District Court for the Northern District of California; Tricarico v. Franklin Resources, Inc., et al., Case No. CV-04-1052 JAP, filed on

March 4, 2004 in the United States District Court for the District of New Jersey; Wilcox v. Franklin Resources, Inc., et al., Case No. 04-2258 WHW, filed on May 12, 2004 in the United States District Court for the District of New Jersey; Bahe, Custodian CGM Roth Conversion IRA v. Franklin/Templeton Distributors, Inc., et al., Case No. 04-11195 PBS, filed on June 3, 2004 in the United States District Court for the District of Massachusetts.

The United States District Court for the District of New Jersey consolidated for pretrial purposes three of the above lawsuits (Stephen Alexander IRA, Tricarico, and Wilcox) into a single action entitled *In re Franklin Mutual Funds Fee Litigation* (Case No. 04-cv-982 (WJM)(RJH)). Following a September 9, 2005 order of dismissal with leave to amend certain claims, on March 10, 2006, plaintiffs in those three lawsuits filed a second amended derivative consolidated complaint (the *Complaint*). Thereafter, on June 9, 2006, defendants moved to dismiss the *Complaint*.

In addition, the parties to the Bahe lawsuit referenced above recently reached a settlement in principle. A hearing on the matter is scheduled for September 7, 2006.

Management strongly believes that the claims made in each of the lawsuits identified above are without merit and intends to defend against them vigorously. The Company cannot predict with certainty, however, the eventual outcome of these lawsuits, nor whether they will have a material negative impact on the Company.

The Company is from time to time involved in litigation relating to claims arising in the normal course of business. Management is of the opinion that the ultimate resolution of such claims will not materially affect the Company's business or financial position.

In management's opinion, an adequate accrual has been made as of June 30, 2006 to provide for any probable losses that may arise from these matters for which we could reasonably estimate an amount.

#### *Other Commitments and Contingencies*

We have reviewed our interest in LFL and LAFL for consolidation under FIN 46-R. Based on our analysis, we determined that we hold a significant interest in both LFL and LAFL but we are not the primary beneficiary of either company because we do not hold a majority of the risks and rewards of ownership. As of June 30, 2006, LFL had approximately \$12.9 million in total assets and our exposure to loss related to LFL was limited to the carrying value of our investment, and interest and fees receivable totaling approximately \$0.9 million. As of June 30, 2006, LAFL had approximately \$448.8 million in total assets and our exposure to loss related to LAFL totaled approximately \$220.6 million, representing our maximum exposure under the joint venture agreement. During the three and nine months ended June 30, 2006, we recognized pre-tax income of approximately \$0.5 million and \$1.2 million for our share of their net income over these periods. Due to our significant interest in both LFL and LAFL, we continue to carry on our balance sheet the DCA originally sold to LFL by our U.S. subsidiary. Neither we nor our U.S. distribution subsidiary retain any direct ownership interest in either the DCA sold directly to a third party or the DCA sold originally to LFL (and subsequently sold by LFL to LAFL or other third party), and therefore, the sold DCA are not available to satisfy claims of our creditors or those of our U.S. distribution subsidiary.

At June 30, 2006, the total assets of sponsored investment products in which we held a significant interest under FIN 46-R were approximately \$602.6 million and our exposure to loss as a result of our interest in these products was \$144.8 million. These amounts represent our maximum exposure to loss and do not reflect our estimate of the actual losses that could result from adverse changes.





In July 2003, we renegotiated an agreement to outsource management of our data center and distributed server operations, originally signed in February 2001. We may terminate the amended agreement any time after July 1, 2006 by incurring a termination charge. The maximum termination charge payable will depend on the termination date of the amended agreement, the service levels before our termination of the agreement, costs incurred by our service provider to wind-down the services and costs associated with assuming equipment leases. As of June 30, 2006, we estimated that the termination fee payable in July 2006, not including costs associated with assuming equipment leases, would approximate \$14.4 million and would decrease each month for the subsequent two years, reaching a payment of approximately \$2.2 million in July 2008.

At June 30, 2006, our banking/finance operating segment had commitments to extend credit aggregating \$217.0 million, primarily under credit card lines.

We lease office space and equipment under long-term operating leases. As of June 30, 2006, there were no material changes in leasing arrangements that would have a significant effect on future minimum lease payments reported in our Annual Report on Form 10-K for the fiscal year ended September 30, 2005.

## **12. Common Stock Repurchases**

During the three months ended June 30, 2006, we repurchased 9.8 million shares of our common stock at a cost of \$850.7 million. During the nine months ended June 30, 2006, we repurchased 10.7 million shares of our common stock at a cost of \$935.1 million. At June 30, 2006, approximately 22.1 thousand shares remained available for repurchase under our Board of Directors authorization. During the three and nine months ended June 30, 2005, we repurchased 0.4 million and 2.2 million shares of our common stock at a cost of \$23.1 million and \$149.3 million, respectively. In July 2006, our Board of Directors authorized the Company to purchase from time to time, up to an aggregate of 10.0 million shares of our common stock in addition to any remaining shares then available pursuant to the prior existing authorization of our Board of Directors. This stock repurchase authorization was announced by the Company in a press release issued on July 10, 2006. Our stock repurchase program is not subject to an expiration date.

## **13. Segment Information**

We based our operating segment selection process primarily on services offered. We derive the majority of our operating revenue and net income from providing investment management, fund administration, shareholder services, transfer agency, underwriting, distribution, custodial, trustee and other fiduciary services (collectively investment management and related services ) to the Franklin, Templeton, Mutual Series, Bissett, Fiduciary Trust and Darby Overseas sponsored investment products. This is our primary business activity and operating segment. Our secondary business and operating segment is banking/finance. The banking/finance operating segment offers selected retail-banking services to high net-worth individuals, foundations and institutions, and consumer lending services. Our consumer lending activities include automotive lending related to the purchase, securitization, and servicing of retail installment sales contracts originated by independent automobile dealerships, consumer credit and debit cards, real estate equity lines, and home equity/mortgage lending.

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

Financial information for our two operating segments is presented in the table below. Operating revenues of the banking/finance operating segment are reported net of interest expense and the provision for probable loan losses.

| <i>(in thousands)</i>                      | Three Months Ended  |                     | Nine Months Ended   |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | June 30,            |                     | June 30,            |                     |
|  | 2006                | 2005                | 2006                | 2005                |
| <b>Operating Revenues</b>                  |                     |                     |                     |                     |
| Investment management and related services | \$ 1,304,256        | \$ 1,097,717        | \$ 3,715,664        | \$ 3,109,932        |
| Banking/finance                            | 13,019              | 12,017              | 37,833              | 37,005              |
| <b>Total</b>                               | <b>\$ 1,317,275</b> | <b>\$ 1,109,734</b> | <b>\$ 3,753,497</b> | <b>\$ 3,146,937</b> |
| <b>Income Before Taxes on Income</b>       |                     |                     |                     |                     |
| Investment management and related services | \$ 485,039          | \$ 358,762          | \$ 1,328,221        | \$ 983,689          |
| Banking/finance                            | 4,184               | 4,951               | 14,592              | 17,737              |
| <b>Total</b>                               | <b>\$ 489,223</b>   | <b>\$ 363,713</b>   | <b>\$ 1,342,813</b> | <b>\$ 1,001,426</b> |

Operating segment assets were as follows:

| <i>(in thousands)</i>                      | June 30, 2006       | September 30, 2005  |
|--|---------------------|---------------------|
| Investment management and related services | \$ 8,030,300        | \$ 7,978,787        |
| Banking/finance                            | 944,443             | 915,140             |
| <b>Total</b>                               | <b>\$ 8,974,743</b> | <b>\$ 8,893,927</b> |

All of our goodwill and intangible assets, including those arising from the purchase of Fiduciary Trust in April 2001, relate to our investment management and related services operating segment.

Operating revenues of the banking/finance operating segment included above were as follows:

| <i>(in thousands)</i>                           | Three Months Ended |          | Nine Months Ended |          |
|---|--------------------|----------|-------------------|----------|
|   | June 30,           |          | June 30,          |          |
|   | 2006               | 2005     | 2006              | 2005     |
| Interest and fees on loans                      | \$10,635           | \$ 8,275 | \$28,884          | \$20,619 |
| Interest and dividends on investment securities | 4,717              | 2,961    | 12,793            | 7,687    |

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

|                                    |                 |                 |                 |                 |
|------------------------------------|-----------------|-----------------|-----------------|-----------------|
| Total interest income              | 15,352          | 11,236          | 41,677          | 28,306          |
| Interest on deposits               | (3,885)         | (2,043)         | (10,400)        | (5,165)         |
| Interest on short-term debt        | (2,910)         | (1,938)         | (7,020)         | (2,107)         |
| Interest expense inter-segment     | (72)            |                 | (292)           | (409)           |
| Total interest expense             | (6,867)         | (3,981)         | (17,712)        | (7,681)         |
| Net interest income                | 8,485           | 7,255           | 23,965          | 20,625          |
| Other income                       | 4,559           | 5,003           | 15,704          | 17,185          |
| Provision for probable loan losses | (25)            | (241)           | (1,836)         | (805)           |
| <b>Total Operating Revenues</b>    | <b>\$13,019</b> | <b>\$12,017</b> | <b>\$37,833</b> | <b>\$37,005</b> |

Inter-segment interest payments from the banking/finance operating segment to the investment management and related services operating segment are based on market rates prevailing at the inception of each loan. Inter-segment interest income and expense are not eliminated in our Condensed Consolidated Statements of Income.

**14. Banking Regulatory Ratios**

We are a bank holding company and a financial holding company subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can result in certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material adverse effect on our financial statements. We must meet specific capital adequacy guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require us to maintain a minimum Tier 1 capital and Tier 1 leverage ratio (as defined in the regulations), as well as minimum Tier 1 and Total risk-based capital ratios (as defined in the regulations). Based on our calculations, at June 30, 2006, and September 30, 2005, we exceeded the capital adequacy requirements applicable to us as listed below.

|                                      | <b>June 30,</b> | <b>September 30,</b> | <b>Capital</b>  |
|--------------------------------------|-----------------|----------------------|-----------------|
|                                      | <b>2006</b>     | <b>2005</b>          | <b>Adequacy</b> |
| <i>(dollar amounts in thousands)</i> | <b>2006</b>     | <b>2005</b>          | <b>Minimum</b>  |
| Tier 1 capital                       | \$ 4,359,037    | \$ 3,700,203         | N/A             |
| Total risk-based capital             | 4,361,757       | 3,703,109            | N/A             |
| Tier 1 leverage ratio                | 61%             | 54%                  | 4%              |
| Tier 1 risk-based capital ratio      | 104%            | 85%                  | 4%              |
| Total risk-based capital ratio       | 105%            | 85%                  | 8%              |

---

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

This Quarterly Report on Form 10-Q includes trademarks and registered trademarks of Franklin Resources, Inc. (the Company) and its direct and indirect subsidiaries.

**FORWARD-LOOKING STATEMENTS**

In this section, we discuss and analyze our results of operations and our financial condition. In addition to historical information, we also make statements relating to the future, called forward-looking statements, which are provided under the safe harbor protection of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are generally written in the future tense and/or are preceded by words such as will, may, should, could, expect, believe, anticipate, intend, plan, or other similar words. These forward-looking statements involve a number of known and unknown risks, uncertainties and other important factors that could cause the actual results and outcomes to differ materially from any future results or outcomes expressed or implied by such forward-looking statements. You should carefully review the Risk Factors section set forth below and in our recent filings with the U. S. Securities and Exchange Commission (the SEC), which describes these risks, uncertainties and other important factors in more detail. We undertake no obligation to update any forward-looking statements in order to reflect events or circumstances that may arise after the date of this Quarterly Report on Form 10-Q.

**OVERVIEW**

Many of our key performance measures, including assets under management, net income and earnings per share, continued to trend higher in the three and nine months ended June 30, 2006, as compared to the three and nine months ended June 30, 2005. This trend was in spite of an income tax charge of \$108.5 million related to repatriated earnings of our foreign subsidiaries under the American Jobs Creation Act of 2004 (the Jobs Act) in the nine months ended June 30, 2006 and a non-cash impairment charge of \$68.4 million in our operating expenses with respect to certain intangible assets of Fiduciary Trust Company International (Fiduciary Trust), a subsidiary of the Company, in relation to the reorganization of that business in the quarter ended March 31, 2006. In part, we attribute this continued growth to our ongoing focus on diversifying our client base and product offerings. This diversification, along with the overall increases in many foreign equity markets and to a lesser extent the U. S. markets, has led to a year over year increase in our assets under management driven from both market appreciation and generally positive net flows into our sponsored investment products. We continually evaluate our business from the standpoint of profitability, product performance and client service, among other things, in light of our long-term strategies. Our strategies of expanding our assets under management and related operations internationally, continually seeking positive investment performance, protecting and furthering our brand recognition, developing and maintaining broker/dealer and client loyalties, providing a high level of customer service and closely monitoring costs, while also developing our human capital base and our systems and technology, and growing our investment management services all continue as objectives in the context of uncertain global market conditions.

**GENERAL**

We derive the majority of our operating revenues, operating expenses and net income from providing investment management, fund administration, shareholder services, transfer agency, underwriting, distribution, custodial, trustee and other fiduciary services (collectively investment management and related services) to retail mutual funds, institutional accounts, high net-worth clients, private accounts and other investment products. This is our primary business activity and operating segment. The mutual funds

and other products that we serve, collectively called our sponsored investment products, are distributed to the public globally under six distinct names:

Franklin

Templeton

Mutual Series

Bissett

Fiduciary Trust

Darby Overseas

Our sponsored investment products include a broad range of global/international equity, domestic (U. S.) equity, hybrid, fixed-income and money market mutual funds, and other investment products that meet a wide variety of specific investment needs of individuals and institutions.

The level of our revenues depends largely on the level and relative mix of assets under management. To a lesser degree, our revenues also depend on the level of mutual fund sales and the number of mutual fund shareholder accounts. The fees charged for our services are based on contracts with our sponsored investment products or our clients. These arrangements could change in the future.

Our secondary business and operating segment is banking/finance. Our banking/finance group offers selected retail-banking services to high net-worth individuals, foundations and institutions, and consumer lending services. Our consumer lending activities include automotive lending related to the purchase, securitization, and servicing of retail installment sales contracts originated by independent automobile dealerships, consumer credit and debit cards, real estate equity lines, and home equity/mortgage lending.

## RESULTS OF OPERATIONS

|  | Three Months Ended |            |                   | Nine Months Ended |            |                   |
|--|--------------------|------------|-------------------|-------------------|------------|-------------------|
|  | June 30,           |            | Percent<br>Change | June 30,          |            | Percent<br>Change |
|  | 2006               | 2005       |                   | 2006              | 2005       |                   |
| <i>(dollar amounts in millions, except per share data)</i> |                    |            |                   |                   |            |                   |
| <b>Net Income</b>  | \$ 371.4           | \$ 261.9   | 42%               | \$ 885.9          | \$ 723.1   | 23%               |
| <b>Earnings Per Common Share</b>                           |                    |            |                   |                   |            |                   |
| Basic  | \$ 1.44            | \$ 1.04    | 38%               | \$ 3.46           | \$ 2.89    | 20%               |
| Diluted  | 1.41               | 1.00       | 41%               | 3.37              | 2.78       | 21%               |
| <b>Operating Margin<sup>1</sup></b>                        | <b>34%</b>         | <b>31%</b> |                   | <b>32%</b>        | <b>29%</b> |                   |

---

<sup>1</sup> Defined as operating income divided by total operating revenues.

Net income increased by 42% and diluted earnings per share increased by 41% for the three months ended June 30, 2006, as compared to the same period last year. The increase is primarily due to higher fees for providing investment management and fund administration services ( investment management fees ), higher underwriting and distribution fees and an increase in other income, net, partly offset by higher operating expenses, primarily underwriting and distribution and compensation and benefits expenses.

Net income increased by 23% and diluted earnings per share increased by 21% for the nine months ended June 30, 2006, as compared to the same period last year due primarily to higher investment management fees and underwriting and distribution fees. The resulting increase in net income was partially offset by higher operating expenses, primarily underwriting and distribution costs, compensation and benefits costs and the \$68.4 million non-cash impairment charge to intangible assets recognized in the quarter ended



March 31, 2006, as well as a \$108.5 million income tax charge related to repatriated earnings under the Jobs Act recognized during the quarters ended March 31, 2006 and June 30, 2006.

**ASSETS UNDER MANAGEMENT**

| <i>(in billions)</i>   | <b>June 30, 2006</b> | <b>June 30, 2005</b> |
|--|----------------------|----------------------|
| <b>Equity</b>  |                      |                      |
| Global/international   | \$ 209.7             | \$ 168.0             |
| Domestic (U. S.)   | 82.1                 | 74.5                 |
| <b>Total equity</b>  | <b>291.8</b>         | <b>242.5</b>         |
| <b>Hybrid</b>  | <b>84.6</b>          | <b>73.3</b>          |
| <b>Fixed-Income</b>  |                      |                      |
| Tax-free   | 54.1                 | 53.5                 |
| Taxable  |                      |                      |
| Domestic (U. S.)   | 31.3                 | 32.8                 |
| Global/international   | 22.4                 | 17.6                 |
| <b>Total fixed-income</b>  | <b>107.8</b>         | <b>103.9</b>         |
| <b>Money Market</b>  | <b>5.9</b>           | <b>5.7</b>           |
| <b>Total</b>   | <b>\$ 490.1</b>      | <b>\$ 425.4</b>      |
| <b>Simple Monthly Average for the Three-Month Period<sup>2</sup></b> | <b>\$ 494.6</b>      | <b>\$ 416.0</b>      |
| <b>Simple Monthly Average for the Nine-Month Period<sup>2</sup></b>  | <b>\$ 476.0</b>      | <b>\$ 400.3</b>      |

<sup>2</sup> Investment management fees from approximately 54% of our assets under management at June 30, 2006 were calculated using daily average assets under management.

Our assets under management at June 30, 2006 were \$490.1 billion, 15% higher than they were at this time last year, due to excess sales over redemptions of \$17.9 billion and market appreciation of \$50.1 billion during the twelve-months ended June 30, 2006. Simple monthly average assets under management, which are generally more indicative of trends in revenue for providing investment management and fund administration services ( investment management services ) than the year over year change in ending assets under management, were 19% higher for the nine months ended June 30, 2006 than for the nine months ended June 30, 2005.

The simple monthly average mix of assets under management is shown below.

| <b>Nine Months Ended</b> |             |
|--------------------------|-------------|
| <b>June 30,</b>          |             |
| <b>2006</b>              | <b>2005</b> |

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

|              |             |             |
|--------------|-------------|-------------|
| Equity       | 59%         | 56%         |
| Hybrid       | 17%         | 17%         |
| Fixed-income | 22%         | 25%         |
| Money market | 2%          | 2%          |
| <b>Total</b> | <b>100%</b> | <b>100%</b> |

For the nine months ended June 30, 2006, our effective investment management fee rate (investment management fees divided by simple monthly average assets under management) increased to 0.616% from 0.600% in the same period last year. The change in the mix of assets under management, resulting from higher relative excess sales over redemptions and greater appreciation of equity products as compared to

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

fixed-income products, and an increase in performance fees, contributed to an increase in our effective investment management fee rate. Generally, management fees earned on equity products are higher than fees earned on fixed-income products.

Assets under management by region of sale were as follows:

| <i>(dollar amounts in billions)</i> | June 30,        |             | June 30,        |             |
|-------------------------------------|-----------------|-------------|-----------------|-------------|
|                                     | 2006            | % of Total  | 2005            | % of Total  |
| United States                       | \$ 344.6        | 70%         | \$ 305.4        | 72%         |
| Europe                              | 54.6            | 11%         | 42.2            | 10%         |
| Canada                              | 36.2            | 8%          | 30.5            | 7%          |
| Asia/Pacific and other <sup>3</sup> | 54.7            | 11%         | 47.3            | 11%         |
| <b>Total</b>                        | <b>\$ 490.1</b> | <b>100%</b> | <b>\$ 425.4</b> | <b>100%</b> |

<sup>3</sup> Includes multi-jurisdictional assets under management.

Components of the change in our assets under management were as follows:

| <i>(dollar amounts in billions)</i>   | Three Months Ended |                 |                   | Nine Months Ended |                 |                   |
|---------------------------------------|--------------------|-----------------|-------------------|-------------------|-----------------|-------------------|
|                                       | June 30,           |                 | Percent<br>Change | June 30,          |                 | Percent<br>Change |
|                                       | 2006               | 2005            |                   | 2006              | 2005            |                   |
| Beginning assets under management     | \$ 491.6           | \$ 412.1        | 19%               | \$ 453.1          | \$ 361.9        | 25%               |
| Sales                                 | 35.4               | 29.7            | 19%               | 98.3              | 91.0            | 8%                |
| Reinvested distributions              | 2.9                | 1.9             | 53%               | 12.6              | 7.3             | 73%               |
| Redemptions                           | (34.0)             | (22.0)          | 55%               | (88.5)            | (63.0)          | 40%               |
| Distributions                         | (3.5)              | (2.4)           | 46%               | (15.5)            | (9.3)           | 67%               |
| Acquisitions                          | 0.2                |                 | N/A               | 0.2               | 0.1             | 100%              |
| (Depreciation) appreciation           | (2.5)              | 6.1             | N/A               | 29.9              | 37.4            | (20%)             |
| <b>Ending Assets Under Management</b> | <b>\$ 490.1</b>    | <b>\$ 425.4</b> | <b>15%</b>        | <b>\$ 490.1</b>   | <b>\$ 425.4</b> | <b>15%</b>        |

For the three and nine months ended June 30, 2006, excess sales over redemptions were \$1.4 billion and \$9.8 billion as compared to \$7.7 billion and \$28.0 billion for the same periods last year. Our products experienced (depreciation) appreciation of \$(2.5) billion and \$29.9 billion for the three and nine months ended June 30, 2006, related primarily to our equity products, as compared to market appreciation of \$6.1 billion and \$37.4 billion for the same periods last year. On April 3, 2006, we acquired a 0.2% ownership interest in Bradesco Templeton Asset Management Ltda. ( BTAM ), a Brazilian joint venture, in addition to the 49.9% ownership interest that we already held, resulting in the addition of \$0.2 billion in assets under management as of the acquisition date.

OPERATING REVENUES

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

| <i>(dollar amounts in millions)</i>                    | Three Months Ended |                   |            | Nine Months Ended |                   |            |
|--|--------------------|-------------------|------------|-------------------|-------------------|------------|
|  | June 30,           |                   | Percent    | June 30,          |                   | Percent    |
|  | 2006               | 2005              | Change     | 2006              | 2005              | Change     |
| Investment management fees                             | \$ 786.0           | \$ 642.0          | 22%        | \$ 2,199.5        | \$ 1,801.2        | 22%        |
| Underwriting and distribution fees                     | 447.1              | 387.0             | 16%        | 1,307.5           | 1,104.7           | 18%        |
| Shareholder servicing fees                             | 65.6               | 64.6              | 2%         | 194.9             | 192.1             | 1%         |
| Consolidated sponsored investment products income, net | 2.8                | 1.3               | 115%       | 5.6               | 3.2               | 75%        |
| Other, net   | 15.8               | 14.8              | 7%         | 46.0              | 45.7              | 1%         |
| <b>Total Operating Revenues</b>                        | <b>\$ 1,317.3</b>  | <b>\$ 1,109.7</b> | <b>19%</b> | <b>\$ 3,753.5</b> | <b>\$ 3,146.9</b> | <b>19%</b> |

### **Investment Management Fees**

Investment management fees, accounting for 60% and 59% of our operating revenues for the three and nine months ended June 30, 2006, as compared to 58% and 57% for the same periods last year, consist of fees earned from providing investment management services. These fees are generally calculated under contractual arrangements with our sponsored investment products as a percentage of the market value of assets under management. Annual rates vary by investment objective and type of services provided.

Investment management fees increased 22% for the three and nine months ended June 30, 2006, as compared to the same periods last year, consistent with a 19% increase in simple monthly average assets under management for the three and nine months ended June 30, 2006 and an increase in our effective investment management fee rate resulting from a shift in average asset mix toward equity products, which generally carry higher management fees than fixed-income products, and an increase in performance fees.

### **Underwriting and Distribution Fees**

Many of our sponsored investment products pay distribution fees in return for sales, marketing and distribution efforts on their behalf. We earn underwriting fees from the sale of certain classes of sponsored investment products on which investors pay a sales commission at the time of purchase. Sales commissions are reduced or eliminated on some share classes and for sales to shareholders or intermediaries that exceed specified minimum amounts. In addition, in the United States, distribution fees include 12b-1 fees which are subject to maximum payout levels based on a percentage of the assets in each fund and other regulatory limitations. Therefore, underwriting fees will change with the overall level of gross sales, the size of individual transactions, and the relative mix of sales between different share classes.

We pay a significant portion of underwriting and distribution fees to the financial advisers and other intermediaries who sell our sponsored investment products to the public on our behalf. See the description of underwriting and distribution expenses below.

In total, underwriting and distribution fees increased 16% and 18% for the three and nine months ended June 30, 2006, as compared to the same periods last year. Underwriting fees increased 4% and 12% consistent with a 19% and 8% increase in gross sales for the three and nine months ended June 30, 2006 over the same periods last year, as well as a change in product and class sales mix that partly reflected a shift in sales regions. Distribution fees increased 24% and 23% consistent with a 19% increase in simple monthly average assets under management.

### **Shareholder Servicing Fees**

Shareholder servicing fees are generally fixed charges per shareholder account that vary with the particular type of fund and the service being rendered. In some instances, sponsored investment products are charged these fees based on the level of assets under management. We receive fees as compensation for providing transfer agency services, including providing customer statements, transaction processing, customer service and tax reporting. In the United States, transfer agency service agreements provide that accounts closed in a calendar year generally remain billable at a reduced rate through the second quarter of the following calendar year. In Canada, such agreements provide that accounts closed in the calendar year remain billable for four months after the end of the calendar year. Accordingly, the level of fees will vary with the growth in new accounts and the level of closed accounts that remain billable. We anticipate that approximately 1,615,000 accounts closed in the U.S. during calendar year 2005 will no longer be billable effective July 1, 2006.

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

Shareholder servicing fees increased 2% and 1% for the three and nine months ended June 30, 2006, as compared to the same periods last year. The increase reflects a 7% increase in simple monthly average

billable shareholder accounts for the three and nine months ended June 30, 2006; however, the majority of the increase in shareholder accounts related to shareholder accounts billable at a lower rate, in particular accounts originated in Asia.

### Consolidated Sponsored Investment Products Income, Net

Consolidated sponsored investment products income, net reflects the net investment income, including dividends received, of sponsored investment products consolidated under Financial Accounting Standards Board (the FASB ) Interpretation No. 46, Consolidation of Variable Interest Entities (revised December 2003) ( FIN 46-R ) and FASB Statement of Financial Accounting Standards No. 94, Consolidation of All Majority-Owned Subsidiaries .

The increases of 115% and 75% for the three and nine months ended June 30, 2006, as compared to the same periods last year, reflect the fluctuation in timing and amounts of income earned by the sponsored investment products.

### Other, Net

Other, net consists primarily of revenues from the banking/finance operating segment as well as income from custody services. Revenues from the banking/finance operating segment include interest income on loans, servicing income, and investment income on banking/finance investment securities, and are reduced by interest expense and the provision for probable loan losses.

Other, net increased 7% and 1% for the three and nine months ended June 30, 2006, as compared to the same periods last year primarily due to higher interest income from banking/finance investments and auto loans, partly offset by higher interest expense on deposits and to finance the automotive lending business.

### OPERATING EXPENSES

|   | Three Months Ended |          |                   | Nine Months Ended |            |                   |
|---|--------------------|----------|-------------------|-------------------|------------|-------------------|
|   | June 30,           |          | Percent<br>Change | June 30,          |            | Percent<br>Change |
|   | 2006               | 2005     |                   | 2006              | 2005       |                   |
| <i>(dollar amounts in millions)</i>                                     |                    |          |                   |                   |            |                   |
| Underwriting and distribution   | \$ 430.7           | \$ 359.7 | 20%               | \$ 1,224.0        | \$ 1,018.5 | 20%               |
| Compensation and benefits   | 242.7              | 233.0    | 4%                | 692.4             | 662.4      | 5%                |
| Information systems, technology and occupancy                           | 74.1               | 73.3     | 1%                | 221.9             | 209.9      | 6%                |
| Advertising and promotion   | 41.3               | 36.8     | 12%               | 107.8             | 94.0       | 15%               |
| Amortization of deferred sales commissions                              | 31.5               | 29.4     | 7%                | 95.6              | 91.4       | 5%                |
| Amortization of intangible assets                                       | 2.7                | 4.3      | (37)%             | 11.4              | 13.1       | (13)%             |
| Intangible assets impairment  |                    |          |                   | 68.4              |            | N/A               |
| Provision for governmental investigations, proceedings and actions, net |                    | (8.4)    | (100)%            |                   | 33.6       | (100)%            |
| Other   | 42.3               | 35.2     | 20%               | 125.7             | 104.2      | 21%               |

|                                 |                 |                 |            |                   |                   |            |
|---------------------------------|-----------------|-----------------|------------|-------------------|-------------------|------------|
| <b>Total Operating Expenses</b> | <u>\$ 865.3</u> | <u>\$ 763.3</u> | <u>13%</u> | <u>\$ 2,547.2</u> | <u>\$ 2,227.1</u> | <u>14%</u> |
|---------------------------------|-----------------|-----------------|------------|-------------------|-------------------|------------|

**Underwriting and Distribution**

Underwriting and distribution includes expenses payable to financial advisers and other third parties for selling, distributing and providing ongoing services to investors in our sponsored investment products.



Underwriting and distribution expense increased 20% for the three and nine months ended June 30, 2006 over the same periods last year consistent with similar trends in underwriting and distribution revenue and a shift to sales regions outside of the United States where we are subject to higher cost structures.

### Compensation and Benefits

Compensation and benefits expense increased 4% and 5% for the three and nine months ended June 30, 2006, as compared to the same periods last year as we experienced increases related to annual merit salary adjustments effective December 1, 2005 in the quarter ended December 31, 2005 and December 1, 2004 in same period last year, and higher staffing levels. In addition, we recorded stock option expense and additional expense related to our 1998 Employee Stock Investment Plan resulting from our adoption of FASB Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment ( SFAS 123R ) in fiscal year 2006. The increase was partially offset by a decline in bonus expense under the Amended and Restated Annual Incentive Compensation Plan, pursuant to which bonus awards have been made, based, in part, on our performance. We employed approximately 7,800 people at June 30, 2006, as compared to about 7,000 at June 30, 2005. A significant portion of the new employees we added during the quarter ended June 30, 2006 were in our India operations, reflective of our long-term approach of moving more of our human capital to lower cost centers.

### Information Systems, Technology and Occupancy

Information systems, technology and occupancy costs increased 1% for the three months ended June 30, 2006, as compared to the same period last year primarily due to higher occupancy costs related to global expansion and an increase in external data services costs, partly offset by a decrease in non-capitalized technology consulting costs.

Information systems, technology and occupancy costs increased 6% during the nine months ended June 30, 2006, as compared to the same period last year primarily due to higher occupancy costs related to global expansion, an increase in technology consulting costs that are not subject to capitalization and increased external data services costs. This increase was partially offset by a decline in depreciation levels for capitalized information systems and technology costs related to a decline in the number and scope of technology projects that have been completed and are therefore subject to amortization.

Details of capitalized information systems and technology costs, which exclude occupancy costs, were as follows:

|   | Three Months Ended |                | Nine Months Ended |                |
|---|--------------------|----------------|-------------------|----------------|
|   | June 30,           |                | June 30,          |                |
|   | 2006               | 2005           | 2006              | 2005           |
| <i>(in millions)</i>  |                    |                |                   |                |
| Net carrying amount at beginning of period                      | \$ 40.6            | \$ 44.3        | \$ 42.7           | \$ 51.3        |
| Additions during period, net of disposals and other adjustments | 7.0                | 5.1            | 17.1              | 13.7           |
| Amortization during period                                      | (5.8)              | (7.5)          | (18.0)            | (23.1)         |
| <b>Net Carrying Amount at End of Period</b>                     | <b>\$ 41.8</b>     | <b>\$ 41.9</b> | <b>\$ 41.8</b>    | <b>\$ 41.9</b> |

**Advertising and Promotion**

Advertising and promotion expense increased 12% and 15% for the three and nine months ended June 30, 2006, as compared to the same periods last year due to an increase in marketing and support payments made to our U. S. distributors and an increase in media advertising. We are committed to investing in advertising and promotion in response to changing business conditions, and in order to advance our products where we see continued or potential new growth opportunities, which means that the level of advertising and promotion expenditures may increase more rapidly or decrease more slowly than our revenues. In addition

to potential changes in our strategic marketing campaigns, advertising and promotion may also be impacted by changes in levels of sales and assets under management that affect marketing support payments made to the distributors of our sponsored investment products.

#### **Amortization of Deferred Sales Commissions**

Certain fund share classes globally, including Class B shares in the United States, are sold without a front-end sales charge to shareholders, although our distribution subsidiaries pay a commission on the sale. Furthermore, in the United States, Class A shares are sold without a front-end sales charge to shareholders when minimum investment criteria are met and Class C shares are sold without a front-end sales charge. However, our U.S. distribution subsidiary pays a commission on these sales. We defer and amortize all up-front commissions paid by our distribution subsidiaries and amortize them over 12 months to 8 years depending on share class or financing arrangements. The U.S. funds that had offered Class B shares ceased offering Class B shares to new investors and existing shareholders effective during the three months ended March 31, 2005. Existing Class B shareholders may continue to exchange shares into Class B shares of different funds. Existing Class B shareholders may also continue to reinvest dividends in additional Class B shares.

Historically, Class B and certain of our Class C deferred commission assets ( DCA ) arising from our U.S., Canadian and European operations have been financed through sales to or other arrangements with Lightning Finance Company Limited ( LFL ), a company in which we hold a 49% ownership interest. In December 2005, LFL sold substantially all of its DCA to Lightning Asset Finance Limited ( LAFL ), an Irish special purpose vehicle formed in December 2005, in which we also hold a 49% ownership interest. Subsequent to the sale to LAFL, DCA originating from our Canadian and European operations are generally financed by a third party. As LFL originally entered into financing arrangements with our U.S. distribution subsidiary, we maintain a continuing interest in the DCA transferred to LAFL by LFL until resold by LAFL. As a result, we retain DCA originally sold to LFL under the U.S. agreement in our financial statements and amortize them over an 8-year period, or until sold by LAFL to third parties. Neither we nor our U.S. distribution subsidiary retain any direct ownership interest in either the DCA sold directly to a third party or the DCA sold originally to LFL (and subsequently sold by LFL to LAFL or other third party), and therefore, the sold DCA are not available to satisfy claims of our creditors or those of our U.S. distribution subsidiary. In contrast to the U.S. arrangement, LFL, in most cases, entered into direct agreements with our Canadian and European sponsored investment products, and, as a result, we did not record DCA from these sources in our financial statements.

Amortization of deferred sales commissions increased 7% and 5% for the three and nine months ended June 30, 2006, as compared to the same periods last year principally reflecting an increase in gross product sales for Class A and Class C product sales, as the decline in DCA on Class B shares has been offset by an increase in DCA on Class A shares and Class C shares in the United States.

#### **Amortization of Intangible Assets and Intangible Assets Impairment**

Amortization of intangible assets decreased 37% and 13% for the three and nine months ended June 30, 2006, as compared to the same periods last year, reflecting the lower net carrying value of definite-lived intangible assets following a \$68.4 million non-cash impairment charge to Fiduciary Trust intangible assets recorded in the quarter ended March 31, 2006.

As of March 31, 2006, we completed our most recent annual impairment testing of goodwill and indefinite-lived intangible assets under the guidance set out in FASB Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets ( SFAS 142 ), and we determined that there was no impairment to these assets as of October 1, 2005.

During the three months ended March 31, 2006, Fiduciary Trust obtained the necessary approvals and implemented a plan of reorganization designed to emphasize its distinct high net-worth brand and to pursue further integration opportunities within the Company for its institutional business line. These changes to Fiduciary Trust's business required that the Company review the carrying value of acquired customer base intangible assets of Fiduciary Trust. As a result of these changes, we recorded a non-cash impairment charge of \$68.4 million with respect to definite-lived intangible assets of Fiduciary Trust in the three months ended March 31, 2006. See also Note 9 to the Condensed Consolidated Financial Statements.

#### **Provision for Governmental Investigations, Proceedings and Actions, Net**

In the three months ended June 30, 2005, we received \$8.4 million from our insurance provider for certain legal costs we incurred associated with previously disclosed governmental investigations, proceedings and actions. In the quarter ended March 31, 2005, we recognized charges to income aggregating to \$42.0 million (\$26.5 million, net of taxes) related to governmental investigations, proceedings and actions.

#### **Other Operating Expenses**

Other operating expenses consist primarily of professional fees, investment management and shareholder servicing fees payable to external parties, corporate travel and entertainment, and other miscellaneous expenses.

Other operating expenses increased 20% for the three months ended June 30, 2006, as compared to the same period last year due primarily to an increase in corporate travel and entertainment and higher investment management fees payable to external parties consistent with an increase in simple monthly average assets under management.

Other operating expenses increased 21% for the nine months ended June 30, 2006, as compared to the same period last year due primarily to an increase in investment management fees payable to external parties consistent with an increase in simple monthly average assets under management, higher costs associated with the resolution of nominal transaction or operational claims, an increase in corporate travel and entertainment and higher consulting and professional fees.

#### **OTHER INCOME (EXPENSES)**

Other income (expenses) includes net realized and unrealized investment gains (losses) of consolidated sponsored investment products, investment and other income, net and interest expense. Investment and other income, net is comprised primarily of income related to our investments, including dividends, interest income, realized gains and losses and income from investments accounted for using the equity method of accounting, as well as minority interest in less than wholly-owned subsidiaries and investments and foreign currency exchange gains and losses.

Other income (expenses) increased 116% for the three months ended June 30, 2006, as compared to the same period last year primarily due to higher dividend income and an increase in interest income, realized gains and equity method income from our investments, including equity income from BTAM earned prior to its consolidation in the Company's results of operations. These increases were partially offset by realized and unrealized net losses from our consolidated sponsored investment products, net of minority interest in the three months ended June 30, 2006 as compared to net gains in the same period last year, higher minority interest expense in consolidated subsidiaries and net realized and unrealized

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

foreign exchange losses in the quarter ended June 30, 2006. Minority interest expense from consolidated subsidiaries includes the minority interest holders' interest in performance fees earned by an investment management services subsidiary specializing in alternative investments.

Other income (expenses) increased 67% for the nine months ended June 30, 2006, as compared to the same period last year primarily due to higher dividend income, interest income and realized gains from our investments. These increases were partially offset by higher minority interest expense in consolidated subsidiaries, higher realized and unrealized foreign exchange losses, an other-than-temporary decline in certain of our long-term investments recognized in the nine months ended June 30, 2006 and a gain on disposition of fixed assets in the prior fiscal year. We anticipate that other income (expenses) may increase or decrease in the future as a result of market factors and changes in our sponsored investment products.

## Taxes on Income

As a multi-national corporation, we provide investment management services to a wide range of international sponsored investment products, often managed from locations outside the United States. Some of these jurisdictions have lower tax rates than the United States. The mix of pre-tax income (primarily from our investment management business) subject to these lower rates, when aggregated with income originating in the United States, produces a lower overall effective tax rate than existing U.S. federal and state tax rates.

Our effective income tax rate for the nine months ended June 30, 2006 was 34.03% and has increased from 27.79% for the comparative period in the prior fiscal year primarily due to an income tax charge of \$108.5 million related to repatriated earnings of our foreign subsidiaries under the Jobs Act recognized in fiscal year 2006. At June 30, 2006, we estimated that the effective tax rate for the fiscal year ending 2006 will be between 26.0% and 26.5% and will continue to reflect the relative contributions of foreign earnings that are subject to reduced tax rates and that are not currently included in U.S. taxable income, as well as other factors, including a reduction in our state tax liabilities due to the favorable state tax ruling obtained in fiscal year 2005 and previously reported in our Annual Report on Form 10-K for the fiscal year ended September 30, 2005, which is in effect through fiscal year 2007.

## LIQUIDITY AND CAPITAL RESOURCES

The following table summarizes certain key financial data relating to our liquidity, and sources and uses of capital.

| <i>(in millions)</i>      | <u>June 30, 2006</u> | <u>September 30, 2005</u> |
|---------------------------|----------------------|---------------------------|
| <b>Balance Sheet Data</b> |                      |                           |
| <b>Assets</b>             |                      |                           |
| Liquid assets             | \$ 5,082.8           | \$ 4,814.4                |
| Cash and cash equivalents | 3,413.2              | 3,152.2                   |
| <b>Liabilities</b>        |                      |                           |
| <b>Debt</b>               |                      |                           |
| Variable Funding Note     | \$ 177.8             | \$ 239.2                  |
| Commercial paper          | 167.9                | 169.4                     |
| Convertible Notes         |                      | 540.1                     |
| Medium Term Notes         | 420.0                | 420.0                     |
| Other long-term debt      | 219.4                | 248.3                     |
| <b>Total Debt</b>         | <b>\$ 985.1</b>      | <b>\$ 1,617.0</b>         |

Nine Months Ended June 30,

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

*(in millions)*

|                       | <u>2006</u> | <u>2005</u> |
|-----------------------|-------------|-------------|
| <b>Cash Flow Data</b> |             |             |
| Operating cash flows  | \$ 1,037.6  | \$ 798.5    |
| Investing cash flows  | 98.9        | (176.8)     |
| Financing cash flows  | (875.5)     | (586.4)     |

Liquid assets, which consist of cash and cash equivalents, investments (trading and available-for-sale) and current receivables, increased from September 30, 2005, primarily due to cash provided by operating activities. Cash and cash equivalents include cash, debt instruments with maturities of three months or less at the purchase date and other highly liquid investments that are readily convertible into cash, including money market funds. Cash and cash equivalents increased from September 30, 2005 as we invested operating cash flows in debt instruments, including term deposits, U.S. T-bills and other interest-bearing deposits, with maturities of three months or less from the purchase date.

The decrease in total debt outstanding from September 30, 2005 relates primarily to the conversion of \$870.5 million principal amount out of a total of \$877.0 million principal amount at maturity of Liquid Yield Option Notes due 2031 (Zero-Coupon Senior) (the Convertible Notes) that we originally sold in May 2001. These notes converted into approximately 8.1 million shares of our common stock during the nine months ended June 30, 2006, as further described below. The decline was also related to repayments made under a one-year revolving \$250.0 million variable funding note warehouse credit facility, subsequent to the completion of an auto loan securitization transaction in December 2005.

We experienced higher operating cash flows for the nine months ended June 30, 2006, as compared to the same period last year, primarily due to an increase in net income and higher deferred income taxes and taxes payable, including income taxes of \$108.5 million related to repatriated foreign earnings under the Jobs Act, partially offset by a decline in other liabilities and an increase in trading securities. Our investing activities provided net cash flows in the nine months ended June 30, 2006 due to lower net purchases of investments as compared to the same period last year. The increase in cash used in financing activities included an increase in purchases of our common stock, partially offset by a decline in dividends paid on our common stock. During the three months ended June 30, 2006, we repurchased 9.8 million shares of our common stock at a cost of \$850.7 million. During the nine months ended June 30, 2006, we repurchased 10.7 million shares of our common stock at a cost of \$935.1 million. At June 30, 2006, approximately 22.1 thousand shares remained available for repurchase under our Board of Directors authorization. During the three and nine months ended June 30, 2005, we repurchased 0.4 million and 2.2 million shares of our common stock at a cost of \$23.1 million and \$149.3 million, respectively. In July 2006, our Board of Directors authorized the Company to purchase from time to time, up to an aggregate of 10.0 million shares of our common stock in addition to any remaining shares then available pursuant to the prior existing authorization of our Board of Directors. This stock repurchase authorization was announced by the Company in a press release issued on July 10, 2006. Our stock repurchase program is not subject to an expiration date.

Prior to October 1, 2005, we accounted for stock-based employee compensation plans according to the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Accordingly, no related compensation costs were recognized for awards granted with no intrinsic value. Effective October 1, 2005, we adopted SFAS 123R, using the modified prospective transition method. Our adoption of SFAS 123R did not materially impact our Consolidated Financial Statements (see Note 5 to our Condensed Consolidated Financial Statements). Prior to the adoption of SFAS 123R, we presented all tax benefits resulting from the exercise of stock options as operating cash flows in our Consolidated Statements of Cash Flows. SFAS 123R requires excess tax benefits be reported as financing cash inflows rather than as a reduction of taxes paid.

#### *Capital Resources*

We believe that we can meet our present and reasonably foreseeable operating cash needs and future commitments through existing liquid assets, continuing cash flows from operations, borrowing capacity under current credit facilities, the ability to issue debt or equity securities, and mutual fund sales



commission financing arrangements. In particular, we expect to finance future investment in our banking/finance activities through operating cash flows, debt, increased deposit base, and through the securitization of a portion of the receivables from consumer lending activities.

As of June 30, 2006, we had \$300.0 million of debt and equity securities available to be issued under a shelf registration statement filed with the SEC and \$330.0 million of additional commercial paper available for issuance. On June 10, 2005, we entered into a \$420.0 million Five Year Facility Credit Agreement with certain banks and financial institutions. The Five Year Facility Credit Agreement replaced our \$210.0 million 364-day revolving credit facility, which matured by its terms on June 2, 2005, and our \$210.0 million five-year revolving credit facility, which was terminated on June 10, 2005, prior to its scheduled expiration date of June 6, 2007. There were no amounts outstanding under either the former 364-day or the former five-year credit facilities on the respective dates of termination and no early termination penalties were incurred by us. At June 30, 2006, the Five Year Facility Credit Agreement was undrawn and available. In addition, at June 30, 2006, our banking/finance operating segment had \$320.0 million in available uncommitted short-term bank lines under the Federal Reserve Funds system, the Federal Reserve Bank discount window, and Federal Home Loan Bank short-term borrowing capacity. Our ability to access the capital markets in a timely manner depends on a number of factors including our credit rating, the condition of the global economy, investors' willingness to purchase our securities, interest rates, credit spreads and the valuation levels of equity markets. In extreme circumstances, we might not be able to access this liquidity readily.

Our investment management and related services operating segment has historically financed Class B and certain Class C DCA arising from our U.S., Canadian and European operations through sales to or other arrangements with LFL, a company in which we hold a 49% ownership interest. As noted above, LFL sold substantially all of its DCA to LAFL, an Irish special purpose vehicle formed in December 2005, in which we also hold a 49% ownership interest. Subsequent to the sale to LAFL, DCA originating from our Canadian and European operations are generally financed by a third party. Class B and C share sales commissions that we have financed globally through a sale to LFL during the nine months ended June 30, 2006 were approximately \$17.7 million and were related to our first fiscal quarter, as compared to \$20.3 million and \$98.0 million during the three and nine months ended June 30, 2005. Our ability to access credit facilities, as well as LAFL's ability to access the securitization market in the future, will directly affect our existing financing arrangements.

Our banking/finance operating segment finances its automotive lending activities through operational cash flows, the issuance of notes under a one-year revolving \$250.0 million variable funding note warehouse credit facility, inter-segment loans and by selling its auto loans in securitization transactions with qualified special purpose entities, which then issue asset-backed securities to private investors. Gross sale proceeds from auto loan securitization transactions were \$348.3 million for the nine months ended June 30, 2006 and \$231.6 million for the nine months ended June 30, 2005. There were no securitization transactions in the three months ended June 30, 2006 and 2005.

The variable funding note ( Variable Funding Note ) balance issued and outstanding under the variable funding note warehouse credit facility, which was entered into in March 2005 and subsequently extended for an additional one-year term in March 2006, was \$177.8 million at June 30, 2006. The Variable Funding Note is payable to certain administered conduits and is secured by cash and a pool of automobile loans that meet or will meet certain eligibility requirements. Credit enhancements for the Variable Funding Note require us to provide, as collateral, loans held for sale with a fair value in excess of the principal amount of the Variable Funding Note, as well as to hold in trust additional cash balances to cover certain shortfalls. In addition, we provide a payment provider commitment in an amount not to exceed 4.66% of the pool

balance. We also enter into interest-rate swap agreements to mitigate the interest-rate risk, accounted for as freestanding derivatives, between the fixed interest rate on the pool of automobile loans and the floating interest rate being paid on the Variable Funding Note. Our ability to access the securitization and capital markets will directly affect our plans to finance the auto loan portfolio in the future.

#### *Uses of Capital*

We expect that the main uses of cash will be to expand our core business, make strategic acquisitions, acquire shares of our common stock, fund property and equipment purchases, pay operating expenses of the business, enhance technology infrastructure and business processes, pay stockholder dividends and repay and service debt.

On June 20, 2006, our Board of Directors declared a regular quarterly cash dividend of \$0.12 per share payable on July 14, 2006 to stockholders of record on July 5, 2006.

In May 2001, we received approximately \$490.0 million in net proceeds from the sale of \$877.0 million principal amount at maturity of the Convertible Notes. The issue price of the Convertible Notes, which were offered to qualified institutional buyers only, represented a yield to maturity of 1.875% per annum excluding any contingent interest. Each of the \$1,000 (principal amount at maturity) Convertible Notes was convertible prior to maturity into 9.3604 shares of our common stock (subject to adjustment) following the occurrence of certain specified triggering events. In particular, the Convertible Notes were convertible if, during any calendar quarter, the closing sale price of our common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of the preceding calendar quarter was more than a specified percentage (initially 120% as of the third quarter of fiscal year 2001 and declining 0.084% each quarter thereafter) of the accreted conversion price per share of our common stock on the last trading day of the preceding calendar quarter. Based on this formula, holders were able to convert their Convertible Notes during the quarter ended June 30, 2006 because the closing sale price of our common stock during the quarter ended March 31, 2006 for at least 20 trading days in the period of 30 consecutive trading days ending on the last trading day of the quarter was more than \$78.96 (118.40% of \$66.69, which was the accreted conversion price per share of our common stock on the last trading day of the quarter). In the three and nine months ended June 30, 2006, holders of the Convertible Notes converted \$346.0 million and \$870.5 million in aggregate principal amount of Convertible Notes into an aggregate of 3.2 million and 8.1 million shares of our common stock.

On May 19, 2006, we issued a notice of redemption with respect to all outstanding Convertible Notes pursuant to which we would redeem on June 5, 2006 each \$1,000 principal amount at maturity of the Convertible Notes then outstanding at a price of \$627.93. Prior to the redemption date, the Convertible Notes remained convertible into our common stock at a rate of 9.3604 shares per \$1,000 principal amount at maturity of Convertible Notes surrendered for conversion until the close of business on June 1, 2006. Following our notice of redemption, \$275.5 million principal amount at maturity of the Convertible Notes were converted into an aggregate of 2.6 million shares of our common stock. On June 5, 2006, we redeemed the remaining \$0.6 million principal amount at maturity of the Convertible Notes for cash in the aggregate amount of \$0.4 million. Through June 30, 2006, holders had put to us and we had repurchased Convertible Notes with a face value of \$6.5 million principal amount at maturity, for their accreted value of \$3.9 million, in cash.

In December 2004, the FASB issued Staff Position No. 109-2, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004 ( FSP FAS 109-2 ). The Jobs Act was signed into law on October 22, 2004. Under a provision of the Jobs Act, we may elect to repatriate certain earnings of our foreign-based subsidiaries at a reduced U.S. federal tax rate in

either of our fiscal years ended September 30, 2005 or ending September 30, 2006. FSP FAS 109-2 provides guidance on when an enterprise should recognize in its financial statements the effects of the one-time tax benefit of repatriation of foreign earnings under the Jobs Act, and specifies interim disclosure requirements. On January 26, 2006, we completed our evaluation of the repatriation provisions, and a plan to repatriate approximately \$2.0 billion of earnings from foreign subsidiaries was approved. Proceeds from the repatriation are expected to be received before September 30, 2006. The proceeds will be reinvested in our U. S. operations prior to October 1, 2010, consistent with the Domestic Reinvestment Plan approved by our Chief Executive Officer and our Board of Directors and the intent of the Jobs Act. As a result of the repatriation, we recorded an income tax charge of \$108.5 million during the nine months ended June 30, 2006.

## **CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS**

Our contractual obligations are summarized in our Annual Report on Form 10-K for the fiscal year ended September 30, 2005. As of June 30, 2006, there had been no material changes outside the ordinary course in our contractual obligations from September 30, 2005.

In relation to the auto loan securitization transactions that we have entered into with a number of qualified special purpose entities, we are obligated to cover shortfalls in amounts due to the holders of the notes up to certain levels as specified under the related agreements. As of June 30, 2006, the maximum potential amount of future payments related to these obligations was \$30.7 million. In addition, our Condensed Consolidated Balance Sheet at June 30, 2006 included a \$0.1 million liability to reflect the fair value of certain additional obligations arising from auto securitization transactions.

At June 30, 2006, the banking/finance operating segment had commitments to extend credit aggregating \$217.0 million, primarily under its credit card lines, and had issued financial standby letters of credit totaling \$2.6 million on which beneficiaries would be able to draw upon in the event of non-performance by our customers, primarily in relation to lease and lien obligations of these banking customers. These standby letters of credit, issued prior to January 1, 2003, were secured by marketable securities with a fair value of \$2.9 million as of June 30, 2006 and commercial real estate.

## **OFF-BALANCE SHEET ARRANGEMENTS**

As discussed above, we hold a 49% ownership interest in LAFL, an entity formed in December 2005 to hold substantially all of the remaining unamortized Class B and C DCA balances that had been financed through sales to or other arrangements with its predecessor, LFL, in which we also hold a 49% ownership interest. We account for the ownership interest in these companies using the equity method of accounting. As of June 30, 2006, LFL had approximately \$12.9 million in total assets and our exposure to loss related to LFL was limited to the carrying value of our investment, and interest and fees receivable totaling approximately \$0.9 million. As of June 30, 2006, LAFL had approximately \$448.8 million in total assets and our exposure to loss related to LAFL totaled approximately \$220.6 million, representing our maximum exposure under the joint venture agreement. During the three and nine months ended June 30, 2006, we recognized pre-tax income of approximately \$0.5 million and \$1.2 million for our share of their net income over these periods. Due to our significant interest in both LFL and LAFL, we continue to carry on our balance sheet the DCA originally sold to LFL by our U.S. subsidiary. Neither we nor our U.S. distribution subsidiary retain any direct ownership interest in either the DCA sold directly to a third party or the DCA sold originally to LFL (and subsequently sold by LFL to LAFL or other third party), and therefore, the sold DCA are not available to satisfy claims of our creditors or those of our U.S. distribution subsidiary.

As discussed above, our banking/finance operating segment periodically enters into auto loan securitization transactions with qualified special purpose entities, which then issue asset-backed securities to private



investors. Our main objective in entering into securitization transactions is to obtain financing for auto loan activities. Securitized loans held by the securitization trusts totaled \$599.3 million at June 30, 2006 and \$577.7 million at September 30, 2005.

## **CRITICAL ACCOUNTING POLICIES**

Our financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles in the United States. The preparation of these financial statements requires us to make estimates and assumptions that impact our financial position and results of operations. These estimates and assumptions are affected by our application of accounting policies. Below we describe certain critical accounting policies that we believe are important to understanding our results of operations and financial position. For additional information about our accounting policies, please refer to Note 1 to the financial statements contained in our Annual Report on Form 10-K for the fiscal year ended September 30, 2005.

### *Stock-Based Compensation*

We account for stock-based compensation in accordance with SFAS 123R. Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. Determining the fair value of share-based awards at the grant date requires judgment, including estimating expected dividends. In addition, judgment is also required in estimating the amount of share-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be materially impacted.

### *Goodwill and Other Intangible Assets*

We make significant estimates and assumptions when valuing goodwill and other intangible assets in connection with the initial purchase price allocation of an acquired entity, as well as when evaluating impairment of intangibles on an ongoing basis.

Under SFAS 142, we are required to test the fair value of goodwill and indefinite-lived intangibles when there is an indication of impairment, or at least once a year. Goodwill impairment is indicated when the carrying amount of a reporting unit exceeds its implied fair value, calculated based on anticipated discounted cash flows. In estimating the fair value of the reporting unit, we use valuation techniques based on discounted cash flows similar to models employed in analyzing the purchase price of an acquisition target.

Intangible assets subject to amortization are reviewed for impairment on the basis of the expected future undiscounted operating cash flows, without interest charges, to be derived from these assets. We review definite-lived intangible assets for impairment when there is an indication of impairment, or at least once a year.

During the quarter ended March 31, 2006, we completed our annual impairment testing of goodwill and indefinite-lived intangible assets under the guidance set out in SFAS 142 and we determined that there was no impairment in the value of these assets as of October 1, 2005. During the quarter ended March 31, 2006, we also performed an impairment test on the definite-lived assets of Fiduciary Trust, pursuant to our reorganization of its business, and recorded an impairment charge of \$68.4 million.

Edgar Filing: FRANKLIN RESOURCES INC - Form 10-Q

In performing our analyses, we used certain assumptions and estimates, including those related to discount rates and the expected future period of cash flows to be derived from the assets, based on, among other

factors, historical trends and the characteristics of the assets. While we believe that our testing was appropriate, if these estimates and assumptions change in the future, we may be required to record impairment charges or otherwise increase amortization expense.

#### *Income Taxes*

As a multinational corporation, we operate in various locations outside the United States and generate earnings from our foreign subsidiaries. Aside from the repatriation pursuant to the Jobs Act noted below, it is our intention to continue to indefinitely reinvest the undistributed earnings of foreign subsidiaries. This policy was in effect as of December 31, 2005 based on tax laws then in effect. On January 26, 2006, a plan to repatriate approximately \$2.0 billion of these undistributed earnings under the Jobs Act was approved by our Chief Executive Officer and our Board of Directors. Accordingly, as a result of the repatriation, we recorded an income tax charge of \$108.5 million during the nine months ended June 30, 2006. However, we have not made a provision for U.S. taxes and have not recorded a deferred tax liability on the remaining \$1,470.3 million of cumulative undistributed earnings recorded by foreign subsidiaries as of June 30, 2006. Changes to our policy of reinvesting foreign earnings may have a significant effect on our financial condition and results of operations.

#### *Valuation of Investments*

We record substantially all investments in our financial statements at fair value or amounts that approximate fair value. Where available, we use prices from independent sources such as listed market prices or broker or dealer price quotations. For investments in illiquid and privately held securities that do not have readily determinable fair values, we estimate the value of the securities based upon available information. However, even where the value of a security is derived from an independent market price or broker or dealer quote, some assumptions may be required to determine the fair value. For example, we generally assume that the size of positions in securities that we hold would not be large enough to affect the quoted price of the securities when sold, and that any such sale would happen in an orderly manner. However, these assumptions may be incorrect and the actual value realized on sale could differ from the current carrying value.

We evaluate our investments for other-than-temporary decline in value on a periodic basis. This may exist when the fair value of an investment security has been below the carrying value for an extended period of time. As most of our investments are carried at fair value, if an other-than-temporary decline in value is determined to exist, the unrealized investment loss recorded net of tax in accumulated other comprehensive income is realized as a charge to net income, in the period in which the other-than-temporary decline in value is determined. We classify securities as trading when it is management's intent at the time of purchase to sell the security within a short period of time. Accordingly, we record unrealized gains and losses on these securities in our consolidated income.

The process of evaluating our investments for other-than-temporary decline in value involves the use of estimates. Different assumptions could result in changes to the recorded amounts in our financial statements.

#### *Loss Contingencies*

We are involved in various lawsuits and claims encountered in the normal course of business. When such a matter arises and periodically thereafter, we consult with our legal counsel and evaluate the merits of the claim based on the facts available at that time. In management's opinion, an adequate accrual has been made as of June 30, 2006 to provide for any probable losses that may arise from these matters for which we could reasonably estimate an amount. See also Note 11 to our Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 of this report.





### *Variable Interest Entities*

Under FIN 46-R, a variable interest entity ( VIE ) is an entity in which the equity investment holders have not contributed sufficient capital to finance its activities or the equity investment holders do not have defined rights and obligations normally associated with an equity investment. FIN 46-R requires consolidation of a VIE by the enterprise that has the majority of the risks and rewards of ownership, referred to as the primary beneficiary.

Evaluating whether related entities are VIEs, and determining if we qualify as the primary beneficiary of these VIEs, is highly complex and involves the use of estimates and assumptions. To determine our interest in the expected losses or residual returns of each VIE, we performed an expected cash flow analysis using certain discount rate and volatility assumptions based on available historical information and management's estimates. Based on our analysis, we consolidated two VIEs into our financial statements during the nine months ended June 30, 2006. While we believe that our testing and approach were appropriate, future changes in estimates and assumptions may affect our decision to consolidate or deconsolidate VIEs in our financial statements.

### **RISK FACTORS**

*Our ability to repatriate foreign earnings at the amount currently anticipated is based on current interpretations of the Jobs Act, timely completion of the planned repatriation and relatively stable foreign exchange rates.* Our ability to repatriate undistributed earnings of our non-U.S. subsidiaries, including under our planned repatriation, is subject to current interpretations and compliance with the Jobs Act (including Internal Revenue Code Section 965), as well as the rules and regulations promulgated by, among others, the Internal Revenue Service and the United States Treasury Department. Moreover, changes in the interpretation of these rules and regulations may have an effect on our ability to repatriate foreign earnings. Our inability to timely complete or satisfy the requirements of our planned repatriation could also have a negative impact on our planned repatriation. Regulators in non-U.S. jurisdictions could also place local restrictions on or otherwise impede our ability to repatriate distributable earnings. The amount of distributable dividends available for repatriation is also subject to foreign exchange risk and currency fluctuations that could negatively impact the amount available for repatriation.

*We are subject to extensive and often complex, overlapping and frequently changing regulation domestically and abroad.* Our investment management and related services business and our banking/finance business are subject to extensive and often complex, overlapping and frequently changing regulation in the United States and abroad, including, among others, securities, banking, accounting and tax laws and regulations. Moreover, financial reporting requirements, and the processes, controls and procedures that have been put in place to address them, are often comprehensive and complex. While management has focused attention and resources on our compliance policies, procedures and practices, non-compliance with applicable laws or rules or regulations, either in the United States or abroad, or our inability to keep up with, or adapt to, an often ever changing, complex regulatory environment could result in sanctions against us, including fines and censures, injunctive relief, suspension or expulsion from a certain jurisdiction or market or the revocation of licenses, any of which could also adversely affect our reputation, prospects, revenues, and earnings. We are subject to federal securities laws, state laws regarding securities fraud, other federal and state laws and rules and regulations of certain regulatory and self regulatory organizations, including those rules and regulations promulgated by, among others, the SEC, NASD, NYSE and the NYSE Arca, and to the extent operations or trading in our securities take place outside the United States, by foreign regulations and regulators, such as the U.K. Listing Authority. Certain of our subsidiaries are registered with the SEC under the Investment Advisers Act of 1940, as amended, and many of our funds are registered with the SEC under the Investment Company Act of 1940, as amended, both of which impose numerous obligations, as well as detailed operational requirements, on our subsidiaries which are investment advisers

to registered investment companies. Our subsidiaries, both in the United States and abroad, must comply with a myriad of complex and often changing U.S. and/or foreign regulations, some of which may conflict, including complex U.S. and non-U.S. tax regimes. Additionally, as we expand our operations, sometimes rapidly, into non-U.S. jurisdictions, the rules and regulations of these non-U.S. jurisdictions become applicable, sometimes with short compliance deadlines, and add further regulatory complexity to our ongoing compliance operations. In addition, we are a bank holding company and a financial holding company subject to the supervision and regulation of the Federal Reserve Board, or FRB, and are subject to the restrictions, limitations, or prohibitions of the Bank Holding Company Act of 1956 and the Gramm-Leach-Bliley Act. The FRB may impose additional limitations or restrictions on our activities, including if the FRB believes that we do not have the appropriate financial and managerial resources to commence or conduct an activity or make an acquisition. Further, our subsidiary, Fiduciary Trust, is subject to extensive regulation, supervision and examination by the FDIC and New York State Banking Department, while another of our subsidiaries is subject to oversight by the Office of Thrift Supervision. The laws and regulations of these regulators generally impose restrictions and requirements in connection with a variety of technical, specialized and recently expanding matters and concerns. For example, compliance with anti-money laundering requirements, both domestically and internationally, and the Bank Secrecy Act has taken on heightened importance with regulators as a result of efforts to, among other things, limit terrorism. As we continue to address these requirements or focus on meeting new or expanded ones, we may expend a substantial amount of time and resources, even though our banking/finance business does not constitute our dominant business sector. Moreover, any inability to meet these requirements, within the timeframes set by regulators, may subject us to sanctions or other restrictions by the regulators that impact our broader business.

*Regulatory and legislative actions and reforms, particularly those specifically focused on the mutual fund industry, are making the regulatory environment in which we operate more costly and future actions and reforms could adversely impact our assets under management, increase costs and negatively impact our profitability and future financial results.* Since 2001, the federal securities laws have been augmented substantially and made significantly more complex by, among other measures, the Sarbanes-Oxley Act of 2002 and the USA Patriot Act of 2001. Moreover, changes in the interpretation or enforcement of existing laws or regulations have directly affected our business. With new laws and changes in interpretation and enforcement of existing requirements, the associated time we must dedicate to, and related costs we must incur in, meeting the regulatory complexities of our business have increased and these outlays have also increased as we expand our business into various non-U.S. jurisdictions. For example, in the past few years following the enactment of the Sarbanes-Oxley Act of 2002, new rules of the SEC, NYSE, NYSE Arca and NASD were promulgated and other rules revised. Among other things, these new requirements have necessitated us to make changes to our corporate governance and public disclosure policies, procedures and practices and our registered investment companies and investment advisers have been required to make similar changes. Compliance activities to meet these new requirements have required us to expend additional time and resources, including without limitation substantial efforts to conduct evaluations required to ensure compliance with the management certification and attestation requirements under the Sarbanes-Oxley Act of 2002, and, consequently, we are incurring increased costs of doing business, which potentially negatively impacts our profitability and future financial results. Moreover, current and pending regulatory and legislative actions and reforms affecting the mutual fund industry, including compliance initiatives, may negatively impact revenues by increasing our costs of accessing or dealing in the financial markets.

*Any significant limitation or failure of our software applications and other technology systems that are critical to our operations could constrain our operations.* We are highly dependent upon the use of various proprietary and third-party software applications and other technology systems to operate our business. We use our technology to, among other things, obtain securities pricing information, process client transactions

and provide reports and other customer services to the clients of the funds we manage. Any inaccuracies, delays or systems failures in these and other processes could subject us to client dissatisfaction and losses. Although we take protective measures, our technology systems may be vulnerable to unauthorized access, computer viruses or other events that have a security impact, such as an authorized employee or vendor inadvertently causing us to release confidential information, which could materially damage our operations or cause the disclosure or modification of sensitive or confidential information. Moreover, loss of confidential customer identification information could harm our reputation. Most of the software applications that we use in our business are licensed from, and supported, upgraded and maintained by, third-party vendors. A suspension or termination of certain of these licenses or the related support, upgrades and maintenance could cause temporary system delays or interruption. In addition, we have outsourced to a single vendor management of our data center and distributed server operations, and this vendor also is responsible for our disaster recovery systems. A failure by this vendor to continue to manage our data center or support our servers and our disaster recovery systems adequately in the future could have a material adverse impact on our business. Moreover, although we have in place certain disaster recovery plans, we may experience system delays and interruptions as a result of natural disasters, power failures, acts of war, and third party failures. Potential system failures or breaches and the cost necessary to correct them could result in material financial loss, regulatory actions, breach of client contracts, reputational harm or legal claims and liability, which in turn could negatively impact our revenues and income.

*We face risks, and corresponding potential costs and expenses, associated with conducting operations and growing our business in numerous foreign countries.* We sell mutual funds and offer investment management and related services in many different regulatory jurisdictions around the world, and intend to continue to expand our operations internationally. As we do so, we will continue to face various ongoing challenges to ensure that we have sufficient resources, procedures and controls in place to address and ensure that our operations abroad operate consistently and effectively. Local regulatory environments may vary widely, as may the adequacy and sophistication of each. Similarly, local distributors, and their policies and practices as well as financial viability, may be inconsistent or less developed or mature. Notwithstanding potential long-term cost savings by increasing certain operations, such as transfer agent and other back-office operations, in countries or regions of the world with lower operating costs, growth of our international operations may involve near-term increases in expenses as well as additional capital costs, such as information, systems and technology costs and costs related to compliance with particular regulatory or other local requirements or needs. Local requirements or needs may also place additional demands on sales and compliance personnel and resources, such as meeting local language requirements while also integrating personnel into an organization with a single operating language. Finding and hiring additional, well-qualified personnel and crafting and adopting policies, procedures and controls to address local or regional requirements remain a challenge as we expand our operations internationally. Moreover, regulators in non-U.S. jurisdictions could also change their policies or laws in a manner that might restrict or otherwise impede our ability to distribute or register investment products in their respective markets. Any of these local requirements, activities or needs could increase the costs and expenses we incur in a specific jurisdiction without any corresponding increase in revenues and income from operating in the jurisdiction.

*We depend on key personnel and our financial performance could be negatively affected by the loss of their services.* The success of our business will continue to depend upon our key personnel, including our portfolio and fund managers, investment analysts, investment advisers, sales and management personnel and other professionals as well as our executive officers and business unit heads. In a tightening labor market, competition for qualified, motivated and highly skilled executives, professionals and other key personnel in the asset management and banking/finance industries remains significant. Our success depends to a substantial degree upon our ability to attract, retain and motivate qualified individuals, including through competitive compensation packages, and upon the continued contributions of these people. As our business grows, we are likely to need to increase correspondingly the overall number of individuals that we

employ. Moreover, in order to retain certain key personnel, we may be required to increase compensation to such individuals, resulting in additional expense without a corresponding increase in potential revenue. We cannot assure you that we will be successful in attracting and retaining qualified individuals, and the departure of key investment personnel, in particular, if not replaced, could cause us to lose clients, which could have a material adverse effect on our financial condition, results of operations and business prospects. Moreover, our employees may voluntarily terminate their employment with us at any time. The loss of the services of key personnel or our failure to attract replacement or additional qualified personnel could negatively affect our financial performance.

*Strong competition from numerous and sometimes larger companies with competing offerings and products could limit or reduce sales of our products, potentially resulting in a decline in our market share, revenues and net income.* We compete with numerous asset management companies, mutual fund, stock brokerage and investment banking firms, insurance companies, banks, savings and loan associations and other financial institutions. Our investment products also compete with products offered by these competitors as well as real estate investment trusts, hedge funds and others. Over the past decade, a significant number of new asset management firms and mutual funds have been established, increasing competition. At the same time, consolidation in the financial services industry has created stronger competitors with greater financial resources and broader distribution channels than our own. Competition is based on various factors, including, among others, business reputation, investment performance, product offerings, service quality, distribution relationships, and fees charged. Additionally, competing securities broker/dealers whom we rely upon to distribute and sell our mutual funds also sell their own proprietary funds and investment products, which could limit the distribution of our investment products. To the extent that existing or potential customers, including securities broker/dealers, decide to invest in or distribute the products of our competitors, the sales of our products as well as our market share, revenues and net income could decline. Our ability to attract and retain assets under our management is also dependent on the relative investment performance of our funds and other managed investment portfolios and our ability to maintain our investment management services fees at competitive levels.

*Changes in the distribution channels on which we depend could reduce our revenues and hinder our growth.* We derive nearly all of our fund sales through broker/dealers and other similar investment advisers. Increasing competition for these distribution channels and recent regulatory initiatives have caused our distribution costs to rise and could cause further increases in the future or could otherwise negatively impact the distribution of our products. Higher distribution costs lower our net revenues and earnings. Additionally, if one or more of the major financial advisers who distribute our products were to cease operations or limit or otherwise end the distribution of our products, it could have a significant adverse impact on our revenues and earnings. There is no assurance we will continue to have access to the third-party broker/dealers and similar investment advisers that currently distribute our products, or continue to have the opportunity to offer all or some of our existing products through them. A failure to maintain strong business relationships with the major investment advisers who currently distribute our products may also impair our distribution and sales operations. Because we use broker/dealers and other similar investment advisers to sell our products, we do not control the ultimate investment recommendations given to clients. Any inability to access and successfully sell our products to clients through third-party distribution channels could have a negative effect on our level of assets under management, related revenues and overall business and financial condition.

*The amount or mix of our assets under management are subject to significant fluctuations and could negatively impact our revenues and income.* We have become subject to an increased risk of asset volatility from changes in the domestic and global financial and equity markets. Individual financial and equity markets may be adversely affected by political, financial or other instabilities that are particular to the country or regions in which a market is located, including without limitation local acts of terrorism,

economic crises or other business, social or political crises. Declines in these markets have caused in the past, and would cause in the future, a decline in our revenues and income. Global economic conditions, exacerbated by war or terrorism or financial crises, changes in the equity market place, currency exchange rates, interest rates, inflation rates, the yield curve and other factors that are difficult to predict affect the mix, market values and levels of our assets under management. Our investment management services revenues are derived primarily from fees based on a percentage of the value of assets under management and vary with the nature of the account or product managed. A decline in the price of stocks or bonds, or in particular market segments, or in the securities market generally, could cause the value and returns on our assets under management to decline, resulting in a decline in our revenues and income. Moreover, changing market conditions may cause a shift in our asset mix between international and U.S. assets, potentially resulting in a decline in our revenue and income depending upon the nature of our assets under management and the level of management fees we earn based on them. Additionally, changing market conditions may cause a shift in our asset mix towards fixed-income products and a related decline in our revenue and income, as we generally derive higher fee revenues and income from equity assets than from fixed-income products we manage. On the other hand, increases in interest rates, in particular if rapid, or high interest rates, as well as any uncertainty in the future direction of interest rates, may impact negatively on our fixed-income products as rising interest rates or interest rate uncertainty typically decrease the total return on many bond investments due to lower market valuations of existing bonds. Any decrease in the level of assets under management resulting from price declines, interest rate volatility or uncertainty or other factors could negatively impact our revenues and income.

*Our increasing focus on international markets as a source of investments and sales of investment products subject us to increased exchange rate and other risks in connection with earnings and income generated overseas.* While we operate primarily in the United States, we also provide services and earn revenues in Canada, the Bahamas, Europe, Asia, South America, Africa, Australia and Mexico. As a result, we are subject to foreign exchange risk through our foreign operations. While we have taken steps to reduce our exposure to foreign exchange risk, for example, by denominating a significant amount of our transactions in U.S. dollars, the situation may change in the future as our business continues to grow outside the United States. Stabilization or appreciation of the U.S. dollar could moderate revenues from sales of investment products internationally. Separately, management fees that we earn tend to be higher in connection with international assets under management than with U.S. assets under management. Consequently, a downturn in international markets could have a significant effect on our revenues and income. Moreover, as our business grows in non-U.S. markets, any business, social and political unrest affecting these markets, in addition to any direct consequences such as unrest may have on our personnel and facilities located in the affected area, may also have a more lasting impact on the long-term investment climate in these and other areas and, as a result, our assets under management and the corresponding revenues and income that we generate from them may be negatively affected.

*Poor investment performance of our products could affect our sales or reduce the level of assets under management, potentially negatively impacting our revenues and income.* Our investment performance, along with achieving and maintaining superior distribution and client services, is critical to the success of our investment management and related services business. Strong investment performance often stimulates sales of our investment products. Poor investment performance as compared to third-party benchmarks or competitive products could lead to a decrease in sales of investment products we manage and stimulate redemptions from existing products, generally lowering the overall level of assets under management and reducing the management fees we earn. We cannot assure you that past or present investment performance in the investment products we manage will be indicative of future performance. Any poor future performance may negatively impact our revenues and income.

*We could suffer losses in earnings or revenue if our reputation is harmed.* Our reputation is important to the success of our business. The Franklin Templeton Investments brand has been, and continues to be, extremely well received both in our industry and with our clients, reflecting the fact that our brand, like our business, is based in part on trust and confidence. If our reputation is harmed, existing clients may reduce amounts held in, or withdraw entirely from, funds that we advise or funds may terminate their management agreements with us, which could reduce the amount of assets under management and cause us to suffer a corresponding loss in earnings or revenue. Moreover, reputational harm may cause us to lose current employees and we may be unable to continue to attract new ones with similar qualifications, motivations or skills. If we fail to address, or appear to fail to address, successfully and promptly the underlying causes of any reputational harm, we may be unsuccessful in repairing any existing harm to our reputation and our future business prospects would likely be affected.

*Our future results are dependent upon maintaining an appropriate level of expenses, which are subject to fluctuation.* The level of our expenses are subject to fluctuation and may increase for the following or other reasons: changes in the level and scope of our advertising expenses in response to market conditions; variations in the level of total compensation expense due to, among other things, bonuses, changes in our employee count and mix, and competitive factors; changes in expenses and capital costs, including costs incurred to maintain and enhance our administrative and operating services infrastructure; and an increase in insurance expenses including through the assumption of higher deductibles and/or co-insurance liability.

*Our ability to successfully integrate widely varied business lines can be impeded by systems and other technological limitations.* Our continued success in effectively managing and growing our business, both domestically and abroad, depends on our ability to integrate the varied accounting, financial, information and operational systems of our various businesses on a global basis. Moreover, adapting or developing our existing technology systems to meet our internal needs, as well as client needs, industry demands and new regulatory requirements, is also critical for our business. The constant introduction of new technologies presents new challenges to us. We have an ongoing need to continually upgrade and improve our various technology systems, including our data processing, financial, accounting and trading systems. This need could present operational issues or require, from time to time, significant capital spending. It also may require us to reevaluate the current value and/or expected useful lives of our technology systems, which could negatively impact our results of operations.

*Our inability to successfully recover should we experience a disaster or other business continuity problem could cause material financial loss, loss of human capital, regulatory actions, reputational harm or legal liability.* Should we experience a local or regional disaster or other business continuity problem, our continued success will depend, in part, on the availability of our personnel, our office facilities and the proper functioning of our computer, telecommunication and other related systems and operations. While our operational size, the diversity of locations from which we operate, and our redundant back-up systems provide us with a strong advantage should we experience a local or regional disaster or other business continuity event, we could still experience near-term operational challenges, in particular depending upon how a local or regional event may affect our human capital across our operations or with regard to particular segments of our operations, such as key executive officers or personnel in our technology group. Past disaster recovery efforts, such as in response to the effects of Hurricane Wilma on our Fort Lauderdale, Florida operations, have demonstrated that even seemingly localized events may require broader disaster recovery efforts throughout our operations and, consequently, we are constantly assessing and taking steps to improve upon our existing business continuity plans and key management succession. However, a disaster on a significant scale or affecting certain of our key operating areas across regions, or our inability to successfully recover should we experience a disaster or other business continuity problem, could materially interrupt our business operations and cause material financial loss, loss of human capital, regulatory actions, reputational harm or legal liability.

*Certain of the portfolios we manage, including our emerging market portfolios, are vulnerable to market-specific political, economic or other risks, any of which may negatively impact our revenues and income.* Our emerging market portfolios and revenues derived from managing these portfolios are subject to significant risks of loss from political, economic, and diplomatic developments, currency fluctuations, social instability, changes in governmental policies, expropriation, nationalization, asset confiscation and changes in legislation related to foreign ownership. Foreign trading markets, particularly in some emerging market countries, are often smaller, less liquid, less regulated and significantly more volatile than the U.S. and other established markets.

*Our revenues, earnings and income could be adversely affected if the terms of our management agreements are significantly altered or these agreements are terminated by the funds we advise.* Our revenues are dependent on fees earned under investment management and related services agreements that we have with the funds we advise. These revenues could be adversely affected if these agreements are altered significantly or terminated. The decline in revenue that might result from alteration or termination of our investment management or selected administration agreements could have a material adverse impact on our earnings or income.

*Diverse and strong competition limits the interest rates that we can charge on consumer loans.* We compete with many types of institutions for consumer loans, which can provide loans at significantly below-market interest rates or in some cases zero interest rates in connection with automobile sales. Our inability to compete effectively against these companies or to maintain our relationships with the various automobile dealers through whom we offer consumer loans could limit the growth of our consumer loan business. Economic and credit market downturns could reduce the ability of our customers to repay loans, which could cause losses to our consumer loan portfolio.

*Future sales of our common stock in the public market could adversely affect our stock price.* We cannot predict the effect, if any, that future sales of shares of our common stock or the availability for future sales of shares of our common stock or securities convertible into or exercisable for our common stock will have on the market price of our common stock prevailing from time to time. For example, we have on file with the SEC a shelf registration statement on Form S-3 that provides for the issuance of up to approximately \$300 million in aggregate amount of our common stock or debt securities, including without limitation debt securities that may be convertible into, or otherwise exchangeable for, our common stock. Sale, or the availability for sale, of substantial amounts of common stock by us, through the issuance of shares of common stock upon the exercise of stock options or the conversion of convertible securities, or the perception that such sales or issuances could occur, could adversely affect prevailing market prices for our common stock.

*Civil litigation arising out of or relating to previously settled governmental investigations or other matters, governmental or regulatory investigations and/or examinations and the legal risks associated with our business could adversely impact our assets under management, increase costs and negatively impact our profitability and/or our future financial results.* We have been named in shareholder class action, derivative, and other lawsuits, many of which arise out of or relate to previously settled governmental investigations. While management believes that the claims made in these lawsuits are without merit, and intends to vigorously defend against them, litigation typically is an expensive process. Risks associated with legal liability often are difficult to assess or quantify and their existence and magnitude can remain unknown for significant periods of time. Moreover, settlements or judgments against us have the potential of being substantial if we are unsuccessful in settling or otherwise resolving matters early in the process and/or on favorable terms. It is also possible that we may be named in additional civil or governmental actions similar to those already instituted. From time to time we may receive requests for documents or other information from governmental authorities or regulatory bodies or we also may become the subject of governmental or

regulatory investigations and/or examinations. Moreover, governmental or regulatory investigations or examinations that have been inactive could become active. We may be obligated, and under our standard form of indemnification agreement with certain officers and directors in some instances we are obligated, or we may choose, to indemnify directors, officers or employees against liabilities and expenses they may incur in connection with such matters to the extent permitted under applicable law. Eventual exposures from and expenses incurred relating to current and future litigation, investigations, examinations and settlements could adversely impact our assets under management, increase costs and negatively impact our profitability and/or our future financial results. Judgments or findings of wrongdoing by regulatory or governmental authorities or in civil litigation against us could affect our reputation, increase our costs of doing business and/or negatively impact our revenues, any of which could have a material negative impact on our financial results.

*Our ability to meet cash needs depends upon certain factors, including our asset value, credit worthiness and the market value of our stock.* Our ability to meet anticipated cash needs depends upon factors including our asset value, our creditworthiness as perceived by lenders and the market value of our stock. Similarly, our ability to securitize and hedge future loan portfolios and credit card receivables, and to obtain continued financing for certain Class C shares, is also subject to the market's perception of those assets, finance rates offered by competitors, and the general market for private debt. If we are unable to obtain these funds and financing, we may be forced to incur unanticipated costs or revise our business plans.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

In the normal course of business, our financial position is subject to market risk: the potential loss due to changes in the value of financial instruments including those resulting from adverse changes in interest rates, foreign exchange and equity and commodity prices. Financial instruments include, but are not limited to, trade accounts receivable, investment securities, deposits and other debt obligations. Management is responsible for managing market risk. Our Enterprise Risk Management Committee is responsible for providing a framework to assist management to identify, assess and manage market and other risks.

Our banking/finance operating segment is exposed to interest rate fluctuations on its loans receivable, debt securities held, and deposit liabilities. In our banking/finance operating segment, we monitor the net interest rate margin and the average maturity of interest earning assets, as well as funding sources.

Our investment management and related services operating segment is exposed to changes in interest rates, primarily through its investment in debt securities and its outstanding debt. We minimize the impact of interest rate fluctuations related to our investments in debt securities by managing the maturities of these securities, and through diversification. In addition, we seek to minimize the impact of interest rate changes on our outstanding debt by entering into financing transactions that ensure an appropriate mix of debt at fixed and variable interest rates.

At June 30, 2006, we have considered the potential impact of a 2% movement in market interest rates in relation to the banking/finance segment interest earning assets, net of interest-bearing liabilities, total debt outstanding and our portfolio of debt securities, individually and in the aggregate. Based on our analysis, we do not expect that this change would have a material impact on our operating revenues or results of operations.

We are subject to foreign exchange risk through our foreign operations. We operate primarily in the United States, but also provide services and earn revenues in Canada, the Bahamas, Europe, Asia, South America, Africa, Australia and Mexico. Our exposure to foreign exchange risk is minimized since a significant portion of these revenues and associated expenses are denominated in U.S. dollars. This situation may change in the future as our business continues to grow outside the United States.





We are exposed to equity price fluctuations through securities we hold that are carried at fair value and through investments held by majority-owned sponsored investment products that we consolidate which are also carried at fair value. To mitigate this risk, we maintain a diversified investment portfolio. Our exposure to equity price fluctuations is also minimized as we sponsor a broad range of investment products in various global jurisdictions. The following is a summary of the effect of a 10% increase or decrease in equity prices on our financial instruments subject to equity price fluctuations at June 30, 2006.

| <i>(in thousands)</i>                     | <b>Carrying Value</b> | <b>Carrying Value<br/>Assuming a 10%<br/>Increase</b> | <b>Carrying Value<br/>Assuming a 10%<br/>Decrease</b> |
|---|-----------------------|---|---|
| <b>Current</b>                            |                       |   |   |
| Investment securities, trading            | \$ 340,235            | \$ 374,258  | \$ 306,211  |
| Investment securities, available-for-sale | 528,468               | 581,315   | 475,621   |
| <b>Total Current</b>                      | <b>\$ 868,703</b>     | <b>\$ 955,573</b>                                     | <b>\$ 781,832</b>                                     |
| <b>Banking/Finance</b>                    |                       |   |   |
| Investment securities, available-for-sale | \$ 190,471            | \$ 209,518  | \$ 171,424  |
| <b>Non-Current</b>                        |                       |   |   |
| Investment in equity-method investees     | \$ 212,558            | \$ 233,814  | \$ 191,302  |
| Equities and other                        | 212,703               | 233,973   | 191,433   |
| <b>Total Non-Current</b>                  | <b>\$ 425,261</b>     | <b>\$ 467,787</b>                                     | <b>\$ 382,735</b>                                     |

**Item 4. Controls and Procedures.**

The Company's management evaluated, with the participation of the Company's principal executive and principal financial officers, the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of June 30, 2006. Based on their evaluation, the Company's principal executive and principal financial officers concluded that the Company's disclosure controls and procedures as of June 30, 2006 were designed and are functioning effectively to provide reasonable assurance that the information required to be disclosed by the Company in reports filed under the Exchange Act is (i) recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and (ii) accumulated and communicated to management, including the principal executive and principal financial officers, as appropriate, to allow timely decisions regarding disclosure.

There has been no change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the Company's quarter ended June 30, 2006, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

---

## PART II OTHER INFORMATION

### Item 1. Legal Proceedings.

As previously reported, various subsidiaries of Franklin Resources, Inc. (the Company), as well as certain Templeton mutual fund (Fund) registrants, have been named in several class action lawsuits originally filed in state courts in Illinois alleging breach of duty with respect to the valuation of the portfolio securities of certain Templeton Funds managed by such subsidiaries, and seeking, among other relief, monetary damages and attorneys' fees and costs, as follows:

Bradfish v. Templeton Funds, Inc., et al., Case No. 2003 L 001361, filed on October 3, 2003 in the Circuit Court of the Third Judicial Circuit, Madison County, Illinois; Woodbury v. Templeton Global Smaller Companies Fund, Inc., et al., Case No. 2003 L 001362, filed on October 3, 2003 in the Circuit Court of the Third Judicial Circuit, Madison County, Illinois; Kwiatkowski v. Templeton Growth Fund, Inc., et al., Case No. 03 L 785, filed on December 17, 2003 in the Circuit Court of the Twentieth Judicial Circuit, St. Clair County, Illinois; Parise v. Templeton Funds, Inc., et al., Case no 2003 L 002049, filed on December 22, 2003 in the Circuit Court of the Third Judicial Circuit, Madison County, Illinois.

In April 2005, defendants removed these lawsuits to the United States District Court for the Southern District of Illinois. On July 12, 2005, the court dismissed with prejudice one of these lawsuits, Bradfish v. Templeton Funds, Inc., et al., and dismissed the remaining three lawsuits on August 25, 2005. Plaintiffs appealed the dismissals to the United States Court of Appeals for the Seventh Circuit (Bradfish v. Templeton Funds, Inc., et al., Case No. 05-3390, Woodbury v. Templeton Global Smaller Companies Fund, Inc., et al., Case No. 05-3559, Kwiatkowski v. Templeton Growth Fund, Inc., et al., Case No. 05-3558, Parise v. Templeton Funds, Inc., et al., Case No. 05-3586). On May 19, 2006, the Seventh Circuit affirmed the dismissals. Plaintiffs' subsequent requests to the Seventh Circuit for reconsideration were also denied.

In addition, Franklin Templeton Investments Corp., a subsidiary of the Company and the investment manager of Franklin Templeton's Canadian mutual funds, has been named in a fourth class action market timing lawsuit in Canada, seeking, among other relief, monetary damages, an order barring any increase in management fees for a period of two years following judgment, and/or attorneys' fees and costs, as follows: Richardson v. Franklin Templeton Investments Corp., Case No. 05-CV-303069, filed on December 23, 2005 in the Ontario Superior Court of Justice and served on Franklin Templeton Investments Corp. on June 21, 2006.

Management strongly believes that the claims made in the lawsuit identified above are without merit and intends to defend against them vigorously. The Company cannot predict with certainty, however, the eventual outcome of the lawsuit, nor whether it will have a material negative impact on the Company.

The Company is from time to time involved in litigation relating to claims arising in the normal course of business. Management is of the opinion that the ultimate resolution of such claims will not materially affect the Company's business or financial position.

Other than as noted above and as updated in Part II, Item 1 Legal Proceedings in the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, there have been no other material changes to the matters discussed in Part I, Item 3 Legal Proceedings in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2005.

**Item 1A. Risk Factors.**

Our Annual Report on Form 10-K for the fiscal year ended September 30, 2005 includes a detailed discussion of our risk factors and our Quarterly Reports on Form 10-Q for the quarters ended December 31, 2005 and March 31, 2006 include an addition to, and certain material amendments and updates to some of, the risk factors set out in our Annual Report on Form 10-K. The information presented below sets out material amendments and certain updates to our prior risk factors included in our previously filed reports, and should be read in conjunction with the risk factors and information disclosed in our Annual Report on Form 10-K and prior Quarterly Reports on Form 10-Q.

*Future sales of our common stock in the public market could adversely affect our stock price.* We cannot predict the effect, if any, that future sales of shares of our common stock or the availability for future sales of shares of our common stock or securities convertible into or exercisable for our common stock will have on the market price of our common stock prevailing from time to time. For example, we have on file with the SEC a shelf registration statement on Form S-3 that provides for the issuance of up to approximately \$300 million in aggregate amount of our common stock or debt securities, including without limitation debt securities that may be convertible into, or otherwise exchangeable for, our common stock. Sale, or the availability for sale, of substantial amounts of common stock by us, through the issuance of shares of common stock upon the exercise of stock options or the conversion of convertible securities, or the perception that such sales or issuances could occur, could adversely affect prevailing market prices for our common stock.

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

The following table provides information with respect to the shares of common stock we repurchased during the three months ended June 30, 2006.

| Period                               | Total                            |                                    | Total Number<br>of Shares<br>Purchased as Part<br>of Publicly<br>Announced Plans<br>or Programs | Maximum<br>Number of<br>Shares that<br>May Yet Be<br>Purchased<br>Under the Plans<br>or Programs |
|--------------------------------------|----------------------------------|------------------------------------|---|--|
|                                      | Number of<br>Shares<br>Purchased | Average Price<br>Paid per<br>Share |   |  |
| April 1, 2006 through April 30, 2006 |                                  | \$                                 |   | 9,821,139  |
| May 1, 2006 through May 31, 2006     | 3,235,900                        | 88.26                              | 3,235,900   | 6,585,239  |
| June 1, 2006 through June 30, 2006   | 6,563,110                        | 86.10                              | 6,563,110   | 22,129   |
| <b>Total</b>                         | <b>9,799,010</b>                 | <b>\$ 86.81</b>                    | <b>9,799,010</b>  | <b>22,129</b>  |

Under our stock repurchase program, we can repurchase shares of our common stock from time to time in the open market and in private transactions in accordance with applicable laws and regulations, including without limitation applicable federal securities laws. From time to time we have announced the existence of the Company's continuing policy of purchasing shares of its common stock, including announcements made in March 2000, August 2002, May 2003, August 2003 and July 2006. From fiscal year 2002 through June 30, 2006, our Board of Directors had authorized and approved the repurchase of up to 30.0 million shares under our stock repurchase program, of which 22,129 shares remained available for repurchase at June 30, 2006. In July 2006, our Board of Directors authorized the Company to purchase, from time to time, up to an aggregate of 10.0 million shares of our common stock in addition to any remaining shares then available pursuant to the prior existing authorization of our Board of Directors. This stock repurchase authorization was announced by the Company in a press release issued on July 10, 2006. Our stock repurchase program is not subject to an expiration date.



**Item 6. Exhibits.**

| <u>Exhibit No.</u> | <u>Description</u>  |
|--------------------|---|
| Exhibit 3(i)(a)    | Registrant's Certificate of Incorporation, as filed November 28, 1969, incorporated by reference to Exhibit (3)(i) to the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 1994 (File No. 001-09318) (the 1994 Annual Report).      |
| Exhibit 3(i)(b)    | Registrant's Certificate of Amendment of Certificate of Incorporation, as filed March 1, 1985, incorporated by reference to Exhibit (3)(ii) to the 1994 Annual Report.  |
| Exhibit 3(i)(c)    | Registrant's Certificate of Amendment of Certificate of Incorporation, as filed April 1, 1987, incorporated by reference to Exhibit (3)(iii) to the 1994 Annual Report.   |
| Exhibit 3(i)(d)    | Registrant's Certificate of Amendment of Certificate of Incorporation, as filed February 2, 1994, incorporated by reference to Exhibit (3)(iv) to the 1994 Annual Report.   |
| Exhibit 3(i)(e)    | Registrant's Certificate of Amendment of Certificate of Incorporation, as filed on February 4, 2005, incorporated by reference to Exhibit (3)(i)(e) to the Company's Quarterly Report on Form 10-Q for the period ended December 31, 2004 (File No. 001-09318). |
| Exhibit 3(ii)      | Registrant's Amended and Restated By-laws of Franklin Resources, Inc. adopted October 11, 2005, incorporated by reference to Exhibit 3.1 to the Company's Form 8-K filed with the SEC on October 14, 2005 (File No. 001-09318).                                 |
| Exhibit 31.1       | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).  |
| Exhibit 31.2       | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).  |
| Exhibit 32.1       | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).   |
| Exhibit 32.2       | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).   |

**SIGNATURES**

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.

**FRANKLIN RESOURCES, INC.**

(Registrant)

Date: August 9, 2006

/s/ JAMES R. BAIO

By: \_\_\_\_\_

**James R. Baio**

**Executive Vice President,**

**Chief Financial Officer and Treasurer**

**(Duly Authorized Officer and  
Principal Financial Officer)**

**EXHIBIT INDEX**

| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
| Exhibit 3(i)(a)    | Registrant's Certificate of Incorporation, as filed November 28, 1969, incorporated by reference to Exhibit (3)(i) to the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 1994 (File No. 001-09318) (the 1994 Annual Report).      |
| Exhibit 3(i)(b)    | Registrant's Certificate of Amendment of Certificate of Incorporation, as filed March 1, 1985, incorporated by reference to Exhibit (3)(ii) to the 1994 Annual Report.  |
| Exhibit 3(i)(c)    | Registrant's Certificate of Amendment of Certificate of Incorporation, as filed April 1, 1987, incorporated by reference to Exhibit (3)(iii) to the 1994 Annual Report.   |
| Exhibit 3(i)(d)    | Registrant's Certificate of Amendment of Certificate of Incorporation, as filed February 2, 1994, incorporated by reference to Exhibit (3)(iv) to the 1994 Annual Report.   |
| Exhibit 3(i)(e)    | Registrant's Certificate of Amendment of Certificate of Incorporation, as filed on February 4, 2005, incorporated by reference to Exhibit (3)(i)(e) to the Company's Quarterly Report on Form 10-Q for the period ended December 31, 2004 (File No. 001-09318). |
| Exhibit 3(ii)      | Registrant's Amended and Restated By-laws of Franklin Resources, Inc. adopted October 11, 2005, incorporated by reference to Exhibit 3.1 to the Company's Form 8-K filed with the SEC on October 14, 2005 (File No. 001-09318).                                 |
| Exhibit 31.1       | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).  |
| Exhibit 31.2       | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).  |
| Exhibit 32.1       | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).   |
| Exhibit 32.2       | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).   |