10-Q 1 y67843e10vq.htm MASTERCARD INCORPORATED

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended September 30, 2004

Or

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

For the transition period from to

Commission file number: 000-50250

MasterCard Incorporated

(Exact name of registrant as specified in its charter)

Delaware *(State or other jurisdiction of incorporation or organization)*	**13-4172551** *(IRS Employer Identification Number)*
2000 Purchase Street **Purchase, NY** *(Address of principal executive offices)*	**10577** *(Zip Code)*

(914) 249-2000
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

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

Class	Outstanding at November 8, 2004
Class A redeemable common stock, par value $.01 per share	84,000,000
Class B convertible common stock, par value $.01 per share	16,000,000

MASTERCARD INCORPORATED

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CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	September 30, 2004	December 31, 2003
	(In thousands, except share data)	
ASSETS		
Cash and cash equivalents	$ 578,802	$ 374,169
Investment securities, at fair value:		
Trading	25,925	30,761
Available-for-sale	511,501	505,580
Accounts receivable	284,944	259,429
Settlement due from members	199,620	210,014
Restricted security deposits held for members	89,743	60,524
Prepaid expenses	116,965	92,189
Other current assets	64,929	77,184
Total Current Assets	1,872,429	1,609,850
Property, plant and equipment, at cost (less accumulated depreciation of $322,108 and $288,259)	232,654	258,520
Deferred income taxes	248,272	223,908
Goodwill	203,718	187,881
Other intangible assets (less accumulated amortization of $206,232 and $158,938)	313,869	327,630
Municipal bonds held-to-maturity	195,295	196,141
Other assets	110,963	96,975
Total Assets	$ 3,177,200	$ 2,900,905
LIABILITIES AND STOCKHOLDERS' EQUITY		
Bank overdraft	$ 7,642	$ —
Accounts payable	168,777	202,604
Settlement due to members	150,114	176,144
Restricted security deposits held for members	89,743	60,524
Obligations under U.S. merchant lawsuit and other legal settlements — current (Notes 11 and 13)	133,408	155,780
Accrued expenses	589,518	555,165
Other current liabilities	58,585	38,641
Total Current Liabilities	1,197,787	1,188,858
Deferred income taxes	67,271	64,125
Obligations under U.S. merchant lawsuit and other legal settlements (Notes 11 and 13)	555,353	516,686
Long-term debt	229,508	229,574
Other liabilities	196,525	198,321
Total Liabilities	2,246,444	2,197,564
Commitments and Contingencies (Notes 10 and 13)		
Minority interest	4,620	4,620
Stockholders' Equity		
Class A redeemable common stock, $.01 par value; authorized 275,000,000 shares, issued and outstanding 84,000,000 shares	840	840
Class B convertible common stock, $.01 par value; authorized 25,000,000 shares, issued and outstanding 16,000,000 shares	160	160
Additional paid-in capital	967,368	967,368
Retained earnings (accumulated deficit)	(122,474)	(359,264)
Accumulated other comprehensive income, net of tax:		
Cumulative foreign currency translation adjustments	76,301	83,210
Net unrealized gain on investment securities available-for-sale	5,216	9,476
Net unrealized loss on derivatives accounted for as hedges	(1,275)	(3,069)
Total accumulated other comprehensive income, net of tax	80,242	89,617
Total Stockholders' Equity	926,136	698,721
Total Liabilities and Stockholders' Equity	$ 3,177,200	$ 2,900,905

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

MASTERCARD INCORPORATED

CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(In thousands, except per share data)			
Revenues, net	$ 667,841	$ 594,169	$ 1,909,426	$1,663,277
Operating Expenses:				
General and administrative	284,923	255,281	846,417	813,128
Advertising and market development	190,078	183,046	586,398	530,740
U.S. merchant lawsuit and other legal settlements (Notes 11 and 13)	14,112	8,759	18,008	729,759
Depreciation	12,379	12,758	38,816	39,405
Amortization	16,798	15,425	53,303	49,160
Total operating expenses	518,290	475,269	1,542,942	2,162,192
Operating income (loss)	149,551	118,900	366,484	(498,915)
Other Income (Expense):				
Investment income, net	11,205	12,121	32,814	39,859
Interest expense	(17,792)	(18,722)	(52,205)	(42,814)
Minority interest in losses of subsidiaries	54	77	71	99
Other (expense) income, net	(2,303)	(936)	(2,494)	(2,075)
Total other (expense) income	(8,836)	(7,460)	(21,814)	(4,931)
Income (loss) before income taxes	140,715	111,440	344,670	(503,846)
Income tax expense (benefit)	43,200	37,041	107,880	(180,232)
Income (loss) before cumulative effect of accounting change	97,515	74,399	236,790	(323,614)
Cumulative effect of accounting change, net of tax	—	—	—	4,949
Net Income (Loss)	$ 97,515	$ 74,399	$ 236,790	$ (318,665)
Net Income (Loss) per Share (Basic and Diluted):				
Income (loss) before cumulative effect of accounting change	$ .98	$ .74	$ 2.37	$ (3.24)
Cumulative effect of accounting change, net of tax	—	—	—	.05
Net Income (Loss) per Share (Basic and Diluted)	$ .98	$ .74	$ 2.37	$ (3.19)

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

MASTERCARD INCORPORATED

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
	(In thousands)	
Operating Activities		
Net income (loss)	$ 236,790	$(318,665)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation	38,816	39,405
Amortization	53,303	49,160
Deferred income taxes	(3,940)	(214,833)
Other	5,550	4,350
Changes in operating assets and liabilities:		
Trading securities	4,836	(1,808)
Accounts receivable	(21,755)	(10,199)
Settlement due from members	7,598	28,976
Prepaid expenses and other current assets	(24,481)	(27,051)
Accounts payable	(33,682)	(33,074)
Settlement due to members	(23,706)	(28,943)
Legal settlement accruals, including accretion of imputed interest	16,295	738,508
Accrued expenses	33,325	(12,416)
Net change in other assets and liabilities	5,107	(23,044)
Net cash provided by operating activities	294,056	190,366
Investing Activities		
Purchases of property, plant and equipment	(13,351)	(59,025)
Capitalized software	(33,223)	(49,788)
Purchases of investment securities available-for-sale	(172,191)	(182,456)
Proceeds from sales and maturities of investment securities available-for-sale	156,943	177,942
Acquisition of businesses, net of cash acquired	(29,861)	—
Other investing activities	(4,426)	(2,943)
Net cash used in investing activities	(96,109)	(116,270)
Financing Activities		
Bank overdraft	7,642	—
Net cash provided by financing activities	7,642	—
Effect of exchange rate changes on cash and cash equivalents	(956)	4,066
Net increase in cash and cash equivalents	204,633	78,162
Cash and cash equivalents — beginning of period	374,169	336,474
Cash and cash equivalents — end of period	$ 578,802	$ 414,636

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

MASTERCARD INCORPORATED

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY (UNAUDITED)

	Total	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss), Net of Tax	Common Shares Class A	Common Shares Class B	Additional Paid-in Capital
			(In thousands)			
Balance at January 1, 2004	$698,721	$ (359,264)	$ 89,617	$ 840	$ 160	$ 967,368
Net income	236,790	236,790	—	—	—	—
Other comprehensive loss, net of tax	(9,375)	—	(9,375)	—	—	—
Balance at September 30, 2004	$926,136	$ (122,474)	$ 80,242	$ 840	$ 160	$ 967,368

MASTERCARD INCORPORATED

CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (UNAUDITED)

	Three Months Ended September 30, 2004	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
	(In thousands)			
Net Income (Loss)	$ 97,515	$ 74,399	$236,790	$(318,665)
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	3,697	3,177	(6,909)	30,469
Net unrealized gain (loss) on investment securities available-for-sale	3,757	(643)	(4,260)	(2,077)
Net unrealized gain (loss) on derivatives accounted for as hedges	239	4,170	1,794	(1,199)
Other comprehensive income (loss), net of tax	7,693	6,704	(9,375)	27,193
Comprehensive Income (Loss)	$ 105,208	$ 81,103	$227,415	$(291,472)

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

MASTERCARD INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(In thousands, except per share and percent data)

Note 1. Summary of Significant Accounting Policies

Organization — MasterCard Incorporated and its consolidated subsidiaries, including MasterCard International Incorporated ("MasterCard International") and MasterCard Europe sprl ("MasterCard Europe") (together, "MasterCard" or the "Company"), provide transaction processing and related services to customers principally in support of their credit, deposit access (debit), electronic cash and Automated Teller Machine ("ATM") payment programs, and travelers cheque programs.

Consolidation and basis of presentation — The Company follows accounting principles generally accepted in the United States of America. Certain prior period amounts have been reclassified to conform to 2004 classifications. The consolidated financial statements include the accounts of MasterCard and its majority-owned or controlled entities. Intercompany transactions are eliminated in consolidation.

The Company consolidates majority-owned or controlled entities, including variable interest entities. Minority interest is recorded for consolidated entities in which the Company owns less than 100% of the interest. Minority interest represents the equity interest not owned by the Company.

The consolidated financial statements for the three and nine months ended September 30, 2004 and 2003 and as of September 30, 2004 are unaudited, and in the opinion of management include all adjustments that are necessary to present fairly the results for interim periods. Due to seasonal fluctuations and other factors, the results of operations for the three and nine months ended September 30, 2004 are not necessarily indicative of the results to be expected for the full year.

The accompanying unaudited consolidated financial statements are presented in accordance with the requirements of Quarterly Reports on Form 10-Q and, consequently, do not include all of the disclosures required by accounting principles generally accepted in the United States of America. Reference should be made to the Company's 2003 Annual Report on Form 10-K for additional disclosures, including a summary of the Company's significant accounting policies.

Note 2. Supplemental Cash Flows

The following table includes supplemental cash flow disclosures:

	Nine Months Ended September 30,	
	2004	**2003**
Cash paid for income taxes	$ 35,522	$ 2,273
Cash paid for interest	14,063	14,117
Non-cash investing and financing activities:		
Consolidation of variable interest entity:		
Municipal bonds held-to-maturity	—	(154,000)
Long-term debt	—	149,380
Minority interest	—	4,620
Sale-leaseback transaction:		
Capital lease obligation	—	32,627
Bonds held-to-maturity	—	(32,627)

On January 1, 2003, the Company adopted the provisions of Financial Accounting Standards Board ("FASB") Interpretation Number No. 46, "Consolidation of Variable Interest Entities" ("FIN 46") and consolidated the MasterCard International O'Fallon 1999 Trust (the "Trust") on the Company's consolidated balance sheet, which resulted in recording $154,000 in municipal bonds held by the Trust, $149,380 in long-term debt and $4,620 of minority interest relating to the equity in the Trust held by a third party. The Trust financed the Company's global technology and operations facility located in O'Fallon, Missouri, named Winghaven, through a combination of a third party equity investment and the issuance of 7.36 percent Series A Senior Secured Notes (the "Secured Notes") in the amount of $149,380 due September 1, 2009. The redemption value of the minority interest approximates its carrying value. The minority interest will be redeemed by the minority interest holders upon the maturity of the Secured Notes. MasterCard

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International has guaranteed 85.15 percent of the Secured Notes outstanding, totaling $127,197 at September 30, 2004. Additionally, upon the occurrence of specific events of default, MasterCard International guarantees repayment of the total outstanding principal and interest on the Secured Notes and would own the facility.

Note 3. Net Income (Loss) Per Share

The following table sets forth the computation of net income (loss) per share (basic and diluted):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Numerator for net income (loss) per share (basic and diluted):				
Income (loss) before cumulative effect of accounting change	$ 97,515	$ 74,399	$236,790	$(323,614)
Cumulative effect of accounting change, net of tax	—	—	—	4,949
Net income (loss)	$ 97,515	$ 74,399	$236,790	$(318,665)
Denominator for net income (loss) per share (basic and diluted):				
Weighted average shares outstanding	100,000	100,000	100,000	100,000
Income (loss) per share before cumulative effect of accounting change	$ .98	$ .74	$ 2.37	$ (3.24)
Cumulative effect of accounting change per share, net of tax	—	—	—	.05
Net income (loss) per share (basic and diluted)	$ .98	$ .74	$ 2.37	$ (3.19)

Note 4. Acquisition of Europay International ("EPI")

On June 28, 2002, MasterCard Incorporated issued 23,760 shares of its common stock to the shareholders of EPI and MasterCard Europay U.K. Limited ("MEPUK"), in return for directly and indirectly acquiring 100% of the shares of EPI not previously owned by MasterCard International. However, of the 23,760 shares issued, only 17,610 were considered to be issued unconditionally. The purchase price for EPI was based on the estimated value of the unconditional shares only, and this estimated value was determined on the basis of an independent valuation. Considering this valuation and the 17,610 unconditional shares issued, the purchase price of EPI was $267,856, excluding estimated acquisition costs of $10,486 that were incurred by the Company.

In calculating the purchase price of EPI, the Company considered only the unconditional shares issued to the former shareholders of EPI and MEPUK because the agreement relating to the EPI acquisition provides that the number of shares allocated to these shareholders will potentially increase or decrease at the end of a three-year transition period as a result of the application of a global proxy formula for the third year of the transition period. Of the 23,760 shares attributable to the exchange of EPI and MEPUK shares, 6,150 shares are conditional shares subject to reallocation at the end of the transition period. EPI and MEPUK shareholders therefore received 17,610 unconditional shares at closing.

Since former EPI and MEPUK shareholders would retain or receive additional shares of MasterCard Incorporated at the end of the transition period without remitting any additional consideration, any shares retained or received by them that are above their minimum allocation at that time would constitute a part of the purchase price. Any such additional shares will be valued at that time based upon the fair value of the stock of MasterCard Incorporated. Any such reallocation of shares to former EPI and MEPUK shareholders will increase the purchase price for EPI and, accordingly, the amount of goodwill and additional paid-in capital recorded.

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Included in the liabilities assumed in the acquisition was a liability for exit costs relating to the integration of the Company and EPI (now MasterCard Europe). The changes in the liability for exit costs are summarized as follows:

	Europay Brand/Logo Elimination	Redundant Computer Systems/Technology Elimination	Workforce Reduction	Total
Balance as of December 31, 2003	$ 10,452	$ 9,810	$ 1,042	$ 21,304
Utilization	(9,459)	(4,999)	(21)	(14,479)
Change in estimate	—	—	(248)	(248)
Change due to currency translation	(219)	(109)	(77)	(405)
Balance as of September 30, 2004	$ 774	$ 4,702	$ 696	$ 6,172

Note 5. Goodwill

The changes in the carrying amount of goodwill since December 31, 2003 are as follows:

Balance as of December 31, 2003	$187,881
Acquisition of businesses	20,225
Impairment loss	(1,676)
Foreign currency translation	(2,548)
Other	(164)
Balance as of September 30, 2004	$203,718

In February 2004, the Company acquired a research and advisory firm focused exclusively on the global financial services industry. In May 2004, the Company acquired a consulting firm specializing in the optimization of customer relationships. During the three months ended September 30, 2004, the Company identified and recorded impairment losses of $2,011 for one of the acquisitions above (goodwill of $1,676 and other intangible assets of $335), which is reflected within General and Administrative expenses in the Consolidated Statements of Operations.

Note 6. Other Intangible Assets

The following table sets forth gross and net intangible assets, other than goodwill:

	September 30, 2004			December 31, 2003		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Amortizable intangible assets:						
Capitalized software	$309,607	$ (188,995)	$120,612	$283,217	$ (148,408)	$134,809
Trademarks and tradenames	22,664	(14,707)	7,957	20,204	(9,802)	10,402
Other	7,941	(2,530)	5,411	728	(728)	—
Total amortizable intangible assets	340,212	(206,232)	133,980	304,149	(158,938)	145,211
Unamortizable intangible assets:						
Customer relationships	179,889	—	179,889	182,419	—	182,419
Total	$520,101	$ (206,232)	$313,869	$486,568	$ (158,938)	$327,630

Additions to capitalized software primarily relate to internal projects associated with system enhancements or infrastructure improvements adjusted for the translation of capitalized software denominated in foreign currency. As discussed in Note 5 herein, MasterCard's acquisitions during the nine months ended September 30, 2004 resulted in an increase in trademarks and tradenames in the amount of $2,650 and an increase in other amortizable intangible assets, including covenants not to compete, customer lists and a research library, in the amount of $7,213.

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Amortizable trademarks and tradenames and unamortizable customer relationships include assets which are denominated in foreign currency. As such, a component of the net change in these intangible assets is attributable to foreign currency translation. In particular, for the nine months ended September 30, 2004, customer relationships and trademarks assumed in the acquisition of EPI on June 28, 2002 decreased by $2,530 and $190, respectively.

Amortization and impairment expense on the assets above amounted to the following:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	2003	2004	2003
Amortization	$ 16,798	$ 15,425	$ 53,303	$ 49,160
Impairment	425	1,062	892	2,562

The following table sets forth the estimated future amortization expense on amortizable intangible assets:

For the three months ending December 31, 2004	$19,251
For the year ending December 31, 2005	55,339
For the year ending December 31, 2006	36,829
For the year ending December 31, 2007	17,313
For the year ending December 31, 2008	2,629
For the year ending December 31, 2009 and thereafter	2,619

Note 7. Pension Plans

The Company maintains a noncontributory defined benefit pension plan with a cash balance feature covering substantially all of its U.S. employees. Additionally, the Company has an unfunded nonqualified supplemental executive retirement plan that provides certain key employees with supplemental retirement benefits in excess of limits imposed on qualified plans by U.S. tax laws.

Net periodic pension cost is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Service cost	$ 4,038	$ 4,214	$ 12,114	$ 12,642
Interest cost	2,449	2,119	7,347	6,357
Expected return on plan assets	(2,580)	(2,165)	(7,740)	(6,495)
Amortization of prior service credit	(79)	(79)	(237)	(237)
Recognized actuarial loss	318	890	954	2,670
Net periodic pension cost	$ 4,146	$ 4,979	$ 12,438	$ 14,937

The funded status of the qualified plan exceeds minimum funding requirements. In the fourth quarter of 2004, the Company expects to make a contribution to its defined benefit pension plan. The amount of the contribution may be up to $40,000 depending on market conditions.

Note 8. Postretirement Health and Life Insurance Benefits

The Company maintains a postretirement plan providing health coverage and life insurance benefits for substantially all of its U.S. employees and retirees.

In May 2004, the FASB issued FASB Staff Position No. 106-2, “Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003” (“FSP 106-2”). FSP 106-2 requires (a) that the effects of the federal subsidy be considered an actuarial gain and recognized in the same manner as other actuarial gains and losses and (b) certain

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(In thousands, except per share and percent data)

disclosures for employers that sponsor postretirement benefit plans that provide prescription drug benefits. The Company has determined that the enactment of the Medicare Modernization Act was not a significant event with respect to its plans, and accordingly, as required by FSP 106-2, the effects of the Act will be incorporated into the Company's December 31, 2004 measurement of the plan's benefit obligations.

Net periodic postretirement benefit cost is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Service cost	$ 774	$ 644	$ 2,322	$ 1,932
Interest cost	741	557	2,223	1,671
Amortization of prior service cost	17	17	51	51
Amortization of transition obligation	145	145	435	435
Recognized actuarial gain	—	(38)	—	(114)
Net periodic postretirement benefit cost	$ 1,677	$ 1,325	$ 5,031	$ 3,975

The Company funds its postretirement benefits as payments are required through cash flows from operations.

Note 9. Credit Facility

On June 18, 2004, the Company entered into a committed unsecured $1,950,000 revolving credit facility (the "Credit Facility") with certain financial institutions, which expires on June 17, 2005. Borrowings under the facility are available to provide liquidity in the event of one or more settlement failures by MasterCard International members and, subject to a limit of $300,000, for general corporate purposes. The Credit Facility replaced MasterCard Incorporated's prior $1,200,000 credit facility which expired on June 18, 2004. Interest on borrowings under the Credit Facility is charged at the London Interbank Offered Rate plus 28 basis points. An additional 10 basis points would be applied if the aggregate borrowings under the Credit Facility were to exceed 33% of the commitments. MasterCard agreed to pay a facility fee which varies based on MasterCard's credit rating and is currently equal to 7 basis points on the total commitment. MasterCard was in compliance with the Credit Facility covenants as of September 30, 2004. There were no borrowings under the Credit Facility at September 30, 2004. The majority of Credit Facility lenders are members or affiliates of members of MasterCard International.

In July 2004, MasterCard Europe and European Payment System Services sprl, subsidiaries of MasterCard, reduced a multi-purpose uncommitted credit facility with a bank from 35,000 euros to a 1,000 euro overdraft facility for MasterCard Europe and European Payment System Services sprl and a 1,000 euro guarantee facility for MasterCard Europe. Additionally, MasterCard Europe has canceled an uncommitted credit agreement totaling 30,000 euros as of June 30, 2004.

Note 10. Commitments and Contingent Liabilities

The future minimum payments under non-cancelable operating or capital leases for office buildings and equipment, sponsorships and licensing and other agreements at September 30, 2004 are as follows:

	Total	Capital Leases	Operating Leases	Sponsorships, Licensing & Other
The remainder of 2004	$ 98,377	$ 2,967	$ 10,467	$ 84,943
2005	226,050	6,965	31,705	187,380
2006	189,184	4,267	27,134	157,783
2007	94,981	3,319	23,007	68,655
2008	62,845	2,284	16,585	43,976
Thereafter	80,877	43,962	12,107	24,808
Total	$752,314	$63,764	$ 121,005	$ 567,545

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(In thousands, except per share and percent data)

Included in the table above are capital leases with imputed interest expense of $17,094 and a net present value of minimum lease payments of $46,670. In addition, at September 30, 2004, $24,275 of the future minimum payments in the table above for operating leases, sponsorships and licensing and other agreements was accrued.

Consolidated rental expense for the Company's office space was approximately $7,537 and $7,434 for the three months ended September 30, 2004 and 2003, respectively, and $23,454 and $21,755 for the nine months ended September 30, 2004 and 2003, respectively. Consolidated lease expense for automobiles, computer equipment and office equipment was $2,150 and $2,146 for the three months ended September 30, 2004 and 2003, respectively, and $7,416 and $6,751 for the nine months ended September 30, 2004 and 2003, respectively.

MasterCard licenses certain software to its customers. The license agreements contain guarantees under which the Company indemnifies licensees from any adverse judgments arising from claims of intellectual property infringement by third parties. The terms of the guarantees are equal to the terms of the license to which they relate. The amount of the guarantees are limited to damages, losses, costs, expenses or other liabilities incurred by the licensee as a result of any intellectual property rights claims. The Company does not generate significant revenues from software licensing. The fair value of the guarantees is estimated to be negligible.

Note 11. U.S. Merchant Lawsuit and Other Legal Settlements

During 2003, MasterCard settled the U.S. merchant lawsuit described in Note 13 herein and contract disputes with certain customers. MasterCard International signed a Memorandum of Understanding ("MOU") with plaintiffs in the U.S. merchant lawsuit on April 30, 2003. On June 4, 2003, MasterCard International and plaintiffs signed a settlement agreement (the "Settlement Agreement") embodying the terms originally set forth in the MOU. The Settlement Agreement required the Company to pay $125,000 in 2003 and requires it to pay $100,000 annually in December from 2004 through 2012. In addition, the Company adopted rules which permit U.S. merchants to elect not to accept MasterCard branded debit (or credit) cards, implemented programs to allow merchants to identify debit cards, provided signage to merchants and established a separate debit interchange rate for a required period. For a description of interchange, see the text under the heading "Global Interchange Proceedings" in Note 13 herein.

In connection with the signing of the MOU, MasterCard recorded a pre-tax charge of $721,000 ($469,000 after-tax) in the three months ended March 31, 2003, consisting of (i) the monetary amount of the U.S. merchant lawsuit settlement (discounted at 8 percent over the payment term), (ii) certain additional costs in connection with, and in order to comply with, other requirements of the U.S. merchant lawsuit settlement, and (iii) costs to address the merchants who opted not to participate in the plaintiff class in the U.S. merchant lawsuit. As noted above and described further in Note 13 herein, several lawsuits have been commenced by merchants who have opted not to participate in the plaintiff class in the U.S. merchant lawsuit. The "opt out" merchant lawsuits are not covered by the terms of the Settlement Agreement. The $721,000 pre-tax charge amount was an estimate, which was subsequently revised based on the approval of the Settlement Agreement by the court, and other factors. If necessary, future refinements will also be made.

During 2004, total liabilities for the U.S. merchant lawsuit and other legal settlements changed as follows:

Balance as of December 31, 2003	$672,466
Other legal settlements and revisions of merchant opt-out estimate	18,008
Interest accretion	38,029
Payments	(39,742)
Balance as of September 30, 2004	$688,761

Interest accretion of $12,933 and $14,161 for the three months ended September 30, 2004 and 2003, respectively, and $38,029 and $28,240 for the nine months ended September 30, 2004 and 2003, respectively, are included in interest expense.

Note 12. Income Tax

The effective tax rate for the three and nine months ended September 30, 2004 was 30.7% and 31.3%, respectively, compared to 33.2% and 35.8% for the three and nine months ended September 30, 2003, respectively. The decrease in the rate in 2004 is primarily attributable to discrete items that occurred in the second and third quarters of 2004. The primary discrete item in the third quarter was an increase in the Company's deferred state tax assets as a result of a change in the taxation of our state and local income. The primary discrete items in the second quarter that, together with the third quarter discrete items resulted in the decrease in the nine-month effective tax rate were the favorable settlement and reassessment of various tax controversies and the filing and recognition of refund claims, partially offset by an increase in the valuation allowance for the future realization of a benefit from a capital loss carryover. Absent the discrete items the Company's effective tax rate for the three and nine month periods ended September 30, 2004 would have been 36.8% and 36.3%, respectively, compared to 33.2% and 33.1% for the three and nine month periods ended September 30, 2003, respectively. The increase in the 2004 rates before discrete items is primarily attributable to a decrease in the percentage of tax exempt interest income and other favorable permanent tax items as a percent of pretax income, as well as a change in the geographic distribution of pretax income from taxable jurisdictions with lower rates to those with higher rates.

Note 13. Legal Proceedings

MasterCard is a party to legal proceedings with respect to a variety of matters in the ordinary course of business. Except as described below, MasterCard does not believe that any legal proceedings to which it is a party would have a material impact on its results of operations, financial position, or cash flows.

Department of Justice Antitrust Litigation and Related Private Litigation

In October 1998, the United States Department of Justice ("DOJ") filed suit against MasterCard International, Visa U.S.A., Inc. and Visa International Corp. in the U.S. District Court for the Southern District of New York alleging that both MasterCard's and Visa's governance structure and policies violated U.S. federal antitrust laws. First, the DOJ claimed that "dual governance" — the situation where a financial institution has a representative on the board of directors of MasterCard or Visa while a portion of its card portfolio is issued under the brand of the other association — was anti-competitive and acted to limit innovation within the payment card industry. At the same time, the DOJ conceded that "dual issuance" — a term describing the structure of the bank card industry in the United States in which a single financial institution can issue both MasterCard and Visa-branded cards — was pro-competitive. Second, the DOJ challenged MasterCard's Competitive Programs Policy ("CPP") and a Visa bylaw provision that prohibit financial institutions participating in the respective associations from issuing competing proprietary payment cards (such as American Express or Discover). The DOJ alleged that MasterCard's CPP and Visa's bylaw provision acted to restrain competition.

A bench trial concerning the DOJ's allegations was concluded on August 22, 2000. On October 9, 2001, the District Court judge issued an opinion upholding the legality and pro-competitive nature of dual governance. In so doing, the judge specifically found that MasterCard and Visa have competed vigorously over the years, that prices to consumers have dropped dramatically, and that MasterCard has fostered rapid innovations in systems, product offerings and services.

However, the judge also held that MasterCard's CPP and the Visa bylaw constitute unlawful restraints of trade under the federal antitrust laws. The judge found that the CPP and Visa bylaw weakened competition and harmed consumers by preventing competing proprietary payment card networks such as American Express and Discover from entering into agreements with banks to issue cards on their networks. In reaching this decision, the judge found that two distinct markets — a credit and charge card issuing market and a network services market — existed in the United States, and that both MasterCard and Visa had market power in the network market. MasterCard strongly disputes these findings and believes that the DOJ failed, among other things, to demonstrate that U.S. consumers have been harmed by the CPP.

On November 26, 2001, the judge issued a final judgment that orders MasterCard to repeal the CPP insofar as it applies to issuers and enjoins MasterCard from enacting or enforcing any bylaw, rule, policy or practice that prohibits its issuers from issuing general purpose credit or debit cards in the United States on any other general purpose card network. The judge also concluded that during the period in which the CPP was in effect, MasterCard was able to "lock up" certain members by entering into long-term agreements with them pursuant to which the members committed to maintain a certain percentage of their general purpose card volume, new card issuance or total number of cards in force in the United States on MasterCard's network. Accordingly, the final judgment provides that there will be a period (commencing on the effective date of the judgment and ending on the later of two years from that date or two years from the resolution of any final appeal) during which MasterCard will be required to permit any issuer with which it entered into such an agreement prior to the effective date of the final judgment to terminate that agreement without penalty, provided that the reason for the termination is to permit the issuer to enter into an agreement with American Express or Discover. MasterCard would be free to apply to the District Court to recover funds paid but not yet earned under any terminated agreement. The final judgment imposes parallel requirements on Visa. The judge explicitly provided that MasterCard and Visa would be free to enter into new partnership or member business agreements in the future.

MasterCard appealed the judge's ruling with respect to the CPP and on February 6, 2002, the judge issued an order granting MasterCard's and Visa's motion to stay the final judgment pending appeal. On September 17, 2003 a three-judge panel of the Second Circuit issued its decision upholding the District Court's decision. On May 10, 2004, MasterCard filed a petition for certiorari with the Supreme Court. On October 4, 2004, the Supreme Court denied MasterCard's petition for certiorari, thereby exhausting all avenues for further appeal in this case. The Second Circuit issued its mandate on October 15, 2004. MasterCard will treat the final judgment as effective as of October 15, 2004.

In addition, on September 18, 2003, MasterCard filed a motion before the District Court judge in this case seeking to enjoin Visa, pending completion of the appellate process, from enforcing a newly-enacted bylaw requiring Visa's 100 largest issuers of debit cards in the United States to pay a so-called "settlement service" fee if they reduce their Visa debit volume by more than 10%. This bylaw was later modified to clarify that the settlement service fee would only be imposed if an issuer shifted its portfolio of debit cards to MasterCard. Visa implemented this bylaw provision following the settlement of the U.S. merchant lawsuit described under the heading "U.S. Merchant Opt Out and Consumer Litigations" below. MasterCard believes that this bylaw is punitive and inconsistent with the final judgment in the DOJ litigation. On December 8, 2003, the District Court judge ruled that the District Court lacked jurisdiction to issue an injunction, but held that the court would have the authority to rescind contracts entered into by issuers with Visa during the time that the settlement service fee was in effect if the court's final judgment is upheld on appeal and the court finds that the settlement service fee violates the final judgment. In light of the Supreme Court's denial of certiorari, MasterCard may now renew its challenge to the bylaw in the District Court. At this time it is not possible to determine the ultimate resolution of this matter.

On October 4, 2004, Discover Financial Services, Inc., filed a complaint against MasterCard, Visa U.S.A., Inc. and Visa International Incorporated. The complaint was filed in the Southern District of New York and was designated as a related case to the DOJ litigation, and preliminarily assigned to the same judge. The complaint alleges that the implementation and enforcement of MasterCard's CPP and Visa's bylaw provision violated Sections 1 and 2 of the Sherman Act as well as California's Unfair Competition Act. In the complaint, Discover requests that the District Court apply collateral estoppel with respect to its final judgment in the DOJ litigation and enter an order that the CPP and Visa's bylaw provision have injured competition and Discover. Discover seeks treble damages in an amount to be proved at trial, along with attorneys' fees and costs. MasterCard's time in which to respond to the complaint is currently running. At this time it is not possible to determine the ultimate resolution of this matter. At the time of this report, American Express has not initiated a similar private lawsuit against MasterCard although its executives have made public comments that they are currently considering such an action. No provision for losses has been provided in connection with the Discover litigation.

Currency Conversion Litigations

MasterCard International, together with Visa U.S.A., Inc. and Visa International Corp., are defendants in a state court lawsuit in California. The lawsuit alleges that MasterCard and Visa wrongfully imposed an asserted one percent currency conversion "fee" on every credit card transaction by U.S. MasterCard and Visa cardholders involving the purchase of goods or services in a foreign country, and that such alleged "fee" is unlawful. This action, titled Schwartz v. Visa Int'l Corp., et al., was brought in the Superior Court of California in February 2000, purportedly on behalf of the general public. Trial of the Schwartz matter commenced on May 20, 2002 and concluded on November 27, 2002. The Schwartz action claims that the alleged "fee" grossly exceeds any costs the defendants might incur in connection with currency conversions relating to credit card purchase transactions made in foreign countries and is not properly disclosed to cardholders. Plaintiffs seek to prevent defendants from continuing to engage in, use or employ the alleged practice of charging and collecting the asserted one percent currency conversion "fee" and from charging any type of purported currency conversion "fee" without providing a clear, obvious and comprehensive notice that a fee will be charged. Plaintiffs also request an order (1) requiring defendants to fund a corrective advertising campaign; and (2) awarding restitution of the monies allegedly wrongfully acquired by imposing the purported currency conversion "fee". MasterCard denies these allegations.

On April 8, 2003, the trial court judge issued a final decision in the Schwartz matter. In his decision, the trial judge found that MasterCard's currency conversion process does not violate the Truth in Lending Act or regulations, nor is it unconscionably priced under California law. However, the judge found that the practice is deceptive under California law, and ordered that MasterCard mandate that members disclose the currency conversion process to cardholders in cardholder agreements, applications, solicitations and monthly billing statements. As to MasterCard, the judge also ordered restitution to California cardholders. The judge issued a decision on restitution on September 19, 2003, which requires a traditional notice and claims process in which consumers have approximately six months to submit their claims. The court issued its final judgment on October 31, 2003. On December 29, 2003, MasterCard appealed the judgment. The final judgment and restitution process have been stayed pending MasterCard's appeal. On August 6, 2004 the court awarded plaintiff's attorneys' fees in the amount of $28,224 to be paid equally by MasterCard and Visa. Accordingly, during the three months ended September 30, 2004, MasterCard accrued amounts totaling $14,112 which are included in U.S. Merchant Lawsuit and Other Legal Settlements in the Consolidated Statements of Operations (see Note 11). MasterCard subsequently filed a notice of appeal on the attorneys' fee award on October 1, 2004. With respect to restitution, MasterCard believes that it is likely to prevail on appeal.

In addition, MasterCard has been served with complaints in state courts in New York, Arizona, Texas, Florida, Arkansas, Kentucky, Illinois, Tennessee, Michigan, Pennsylvania, Ohio, Minnesota and Missouri seeking to, in effect, extend the judge's decision in the Schwartz matter to MasterCard cardholders outside of California. Some of these cases have been transferred to the U.S. District Court for the Southern District of New York and combined with the federal complaints in MDL No. 1409 discussed below. In other state court cases, MasterCard has moved to dismiss the claims. On December 12, 2003, the action in Kentucky was dismissed. On July 28, 2004, a New York state action was dismissed without prejudice. MasterCard has also been served with complaints in state courts in California and Texas alleging it wrongfully imposed an asserted one percent currency conversion "fee" in every debit card transaction by U.S. MasterCard cardholders involving the purchase of goods or services in a foreign country and that such alleged "fee" is unlawful. Visa USA, Inc. and Visa International Corp. have been named as co-defendants in the California cases. One such Texas case was dismissed voluntarily by plaintiffs, however a new complaint is expected to be filed. At this time, it is not possible to determine the ultimate resolution of these matters.

MasterCard International, Visa U.S.A., Inc., Visa International Corp., several member banks including Citibank (South Dakota), N.A., Citibank (Nevada), N.A., Chase Manhattan Bank USA, N.A., Bank of America, N.A. (USA), MBNA, and Diners Club are also defendants in a number of federal putative class actions that allege, among other things, violations of federal antitrust laws based on the asserted one percent currency conversion "fee". Pursuant to an order of the Judicial Panel on Multidistrict Litigation, the federal complaints have been consolidated in MDL No. 1409 before Judge William H. Pauley III in the U.S. District Court for the Southern District of New York. In January 2002, the federal plaintiffs filed a Consolidated Amended Complaint ("MDL Complaint") adding MBNA Corporation and MBNA America Bank, N.A. as defendants. This pleading asserts two theories of antitrust conspiracy under Section 1 of the Sherman Act: (i) an alleged "inter-association" conspiracy among MasterCard (together with its members), Visa (together with its members) and Diners Club to fix currency conversion "fees" allegedly charged to cardholders of "no less than 1% of the transaction amount and frequently more;" and (ii) two alleged "intra-association" conspiracies, whereby each of Visa and MasterCard is claimed separately to have conspired with its members to fix currency conversion "fees" allegedly charged to cardholders of "no less than 1% of the transaction amount" and "to facilitate and encourage institution — and collection — of second tier currency conversion surcharges." The MDL Complaint also asserts that the alleged currency conversion "fees" have not been disclosed as required by the Truth in Lending Act and Regulation Z.

Defendants have moved to dismiss the MDL Complaint. On July 3, 2003, Judge Pauley issued a decision granting MasterCard's motion to dismiss in part. Judge Pauley dismissed the Truth in Lending claims in their entirety as against MasterCard, Visa and several of the member bank defendants. Judge Pauley did not dismiss the antitrust claims. Discovery in this matter is expected to close on November 19, 2004. On November 12, 2003 plaintiffs filed a motion for class certification, which was granted on October 15, 2004. A trial date has been set for October 10, 2005. At this time, it is not possible to determine the ultimate resolution of this matter.

For the reasons set forth above, except as discussed above, no provision for losses has been provided in connection with these currency conversion litigations.

Merchant Chargeback-Related Litigations

On May 12, 2003, a complaint alleging violations of federal and state antitrust laws, breach of contract, fraud and other theories was filed in the U.S. District Court for the Central District of California (Los Angeles) against MasterCard by a merchant aggregator whose customers include businesses selling adult entertainment content over the Internet. The complaint's allegations focus on MasterCard's past and potential future assessments on the plaintiff's merchant bank (acquirer) for exceeding excessive chargeback standards in connection with the plaintiff's transaction activity as well as the effect of MasterCard's chargeback rules and other practices on "card-not-present" merchants. Chargebacks refer to a situation where a transaction is returned, or charged back, to an acquirer by an issuer at the request of cardholders or for other reasons. Prior to MasterCard filing any motion or responsive pleading, the plaintiff filed a voluntary notice of dismissal without prejudice on December 5, 2003. On the same date, the plaintiff filed a complaint in the U.S. District Court for the Eastern District of New York making similar allegations to those made in its initial California complaint. MasterCard moved to dismiss all of the claims in the complaint for failure to state a cause of action. The Court has yet to schedule oral argument on the motion.

In addition, on June 6, 2003, an action titled California Law Institute v. Visa U.S.A, et al. was initiated against MasterCard and Visa U.S.A., Inc. in the Superior Court of California, purportedly on behalf of the general public. Plaintiffs seek disgorgement, restitution and injunctive relief for unlawful and unfair business practices in violation of California Unfair Trade Practices Act Section 17200, et. seq. Plaintiffs purportedly allege that MasterCard's (and Visa's) chargeback fees are unfair and punitive in nature. Plaintiffs seek injunctive relief preventing MasterCard from continuing to engage in its chargeback practices and requiring MasterCard to provide restitution and/or disgorgement for monies improperly obtained by virtue of them. On August 13, 2003, MasterCard made motions seeking to dismiss the complaint in its entirety or, in the alternative, to narrow the scope of the proceeding and add necessary parties. Oral argument on the motions was held on October 27, 2003. The Court denied the motions. Initial, but limited, discovery is now proceeding in this matter.

On September 20, 2004, MasterCard was served with a complaint titled PSW Inc. v. Visa U.S.A, Inc, MasterCard International Incorporated, et. al., No. 04-347, in the District Court of Rhode Island. The plaintiff, as alleged in the complaint, provided credit card billing services primarily for adult content web sites. The plaintiff alleges defendants' excessive chargeback standards, exclusionary rules, merchant registration programs, cross-border acquiring rules and interchange pricing to internet merchants violate federal and state antitrust laws as well as state contract and tort law. The plaintiff seeks $60,000 in compensatory damages as well as $180,000 in punitive damages. MasterCard's time in which to respond to the complaint is currently running.

At this time it is not possible to determine the outcome of the merchant chargeback-related litigations. For reasons set forth above, no provision for losses has been provided in connection with these litigations.

U.S. Merchant Opt Out and Consumer Litigations

Commencing in October 1996, several class action suits were brought by a number of U.S. merchants against MasterCard International and Visa U.S.A., Inc. challenging certain aspects of the payment card industry under U.S. federal antitrust law. Those suits were later consolidated in the U.S. District Court for the Eastern District of New York. The plaintiffs challenged MasterCard's "Honor All Cards" rule (and a similar Visa rule), which required merchants who accept MasterCard cards to accept for payment every validly presented MasterCard card. Plaintiffs claimed that MasterCard and Visa unlawfully tied acceptance of debit cards to acceptance of credit cards. In essence, the merchants desired the ability to reject off-line, signature-based debit transactions (for example, MasterCard card transactions) in favor of other payment forms including on-line, PIN-based debit transactions (for example, Maestro or regional ATM network transactions) which generally impose lower transaction costs for merchants. The plaintiffs also claimed that MasterCard and Visa conspired to monopolize what they characterized as the point-of-sale debit card market, thereby suppressing the growth of regional networks such as ATM payment systems. Plaintiffs alleged that the plaintiff class had been forced to pay unlawfully high prices for debit and credit card transactions as a result of the alleged tying arrangement and monopolization practices. On June 4, 2003, MasterCard International signed the Settlement Agreement to settle the claims brought by the plaintiffs in this matter, which the Court approved on December 19, 2003. A number of class members have appealed the district court's approval of the settlement to the Second Circuit Court of Appeals. These appeals are largely focused on the court's attorneys' fees award as well on the court's ruling on the scope of the release. The Second Circuit heard oral arguments on these appeals on August 25, 2004 and a decision is currently pending. For a further description of the U.S. merchant lawsuit settlement, see Note 11.

Several lawsuits have been commenced by merchants who have opted not to participate in the plaintiff class in the U.S. merchant lawsuit, including Best Buy Stores, CVS, Giant Eagle, Home Depot, Toys "R" Us and Darden Restaurants. The majority of these cases were filed in the U.S. District Court for the Eastern District of New York and we expect that all of these cases will be tried in that Court for, at minimum, pretrial issues. On March 19, 2004, the opt out merchants amended their complaints to include allegations, among other things: (i) that MasterCard's (and Visa's) interchange fees contravene the Sherman Act and (ii) that the opt out merchants were harmed by MasterCard's CPP. MasterCard filed its response to the amended complaints on April 21, 2004. MasterCard has entered into separate settlement agreements with CVS, Home Depot and Darden Restaurants resolving those opt out merchants' claims against MasterCard. The District Court has entered orders dismissing with prejudice the respective merchants' complaints against MasterCard. MasterCard continues to be involved in court-ordered mediation with the remaining opt out merchant plaintiffs while discovery continues to proceed.

In addition, individual or multiple complaints have been brought in 19 different states and the District of Columbia under state unfair competition statutes against MasterCard International (and Visa) on behalf of putative classes of consumers. The claims in these actions mirror the allegations made in the U.S. merchant lawsuit and assert that merchants, faced with excessive merchant discount fees, have passed these overcharges to consumers in the form of higher prices on goods and services sold. While these actions are in their early stages, MasterCard has filed motions to dismiss the complaints in a number of state courts for failure to state a cause of action. Courts in New York, Michigan, Minnesota, Nebraska, Maine, North Dakota, Kansas, North Carolina and South Dakota have granted MasterCard's motions and dismissed the complaints with prejudice. The plaintiffs in the New York, Maine and Michigan cases have filed a notice of appeal and the time in which the plaintiffs in the other states may appeal is currently running. The plaintiffs in Minnesota have filed a revised complaint on behalf of a purported class of Minnesota consumers who made purchases with debit cards rather than on behalf of all consumers, MasterCard's time in which to respond to this complaint is currently running. In addition, the courts in Tennessee and California have granted MasterCard's motion to dismiss the respective state unfair competition claims but have denied MasterCard's motions with respect to unjust enrichment claims in Tennessee and Section 17200 claims for unlawful, unfair, and/or fraudulent business practices in California. MasterCard has appealed the court's decision in Tennessee on the unjust enrichment claims and plaintiffs have filed a motion for reconsideration of the court's dismissal of their antitrust claims. The time in which MasterCard and plaintiff may appeal the California ruling is currently running. MasterCard is awaiting decisions on its motions to dismiss in the other state courts. At this time, it is not possible to determine the outcome of these consumer cases. Neither the consumer class actions nor the "opt out" merchant litigations are covered by the terms of the Settlement Agreement in the U.S. merchant lawsuit.

Global Interchange Proceedings

Interchange fees represent a sharing of payment system costs among the financial institutions participating in a four-party payment card system such as MasterCard's. Generally, interchange fees are paid by the merchant bank (the "acquirer") to the cardholder bank (the "issuer") in connection with transactions initiated with the payment system's cards. These fees reimburse the issuer for a portion of the costs incurred by it in providing services which are of benefit to all participants in the system, including acquirers and merchants. MasterCard establishes a multilateral interchange fee ("MIF") in certain circumstances as a default fee that applies when there is no other interchange fee arrangement between the issuer and the acquirer. MasterCard establishes a variety of MIF rates depending on such considerations as the location and the type of transaction, and collects the MIF on behalf of the institutions entitled to receive it. As described more fully below, MIFs are subject to regulatory or legal review and/or challenges in a number of jurisdictions.

European Union. In September 2000, the European Commission issued a "Statement of Objections" challenging Visa International's cross-border MIF under European Community competition rules. On July 24, 2002, the European Commission announced its decision to exempt the Visa MIF from these rules based on certain changes proposed by Visa to its MIF. Among other things, in connection with the exemption order, Visa agreed to adopt a cost-based methodology for calculating its MIF similar to the methodology employed by MasterCard, which considers the costs of certain specified services provided by issuers, and to reduce its MIF rates for debit and credit transactions to amounts at or below certain specified levels.

On September 25, 2003, the European Commission issued a Statement of Objections challenging MasterCard Europe's cross-border MIF. MasterCard Europe filed its response to this Statement of Objections on January 5, 2004. MasterCard Europe is engaged in discussions with the European Commission in order to determine under what conditions, if any, the European Commission would issue a favorable ruling regarding MasterCard Europe's MIF. If MasterCard is unsuccessful in obtaining a favorable ruling, the European Commission could issue a prohibition decision ordering MasterCard to change the manner in which it calculates its cross-border MIF. MasterCard could appeal such a decision to the European Court of Justice. Because the cross-border MIF constitutes an essential element of MasterCard Europe's operations, changes to it could significantly impact MasterCard International's European members and the MasterCard business in Europe. At this time, it is not possible to determine the ultimate resolution of this matter.

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United Kingdom Office of Fair Trading. On September 25, 2001, the Office of Fair Trading of the United Kingdom ("OFT") issued a Rule 14 Notice under the U.K. Competition Act 1998 challenging the MasterCard MIF, the fee paid by acquirers to issuers in connection with point of sale transactions, and multilateral service fee ("MSF"), the fee paid by issuers to acquirers when a customer uses a MasterCard-branded card in the United Kingdom either at an ATM or over the counter to obtain a cash advance. The MIF and MSF are established by MasterCard U.K. Members Forum Limited (formerly MEPUK) ("MMF") for domestic credit card transactions in the United Kingdom. The notice contained preliminary conclusions to the effect that the MasterCard U.K. MIF and MSF may infringe U.K. competition law and do not qualify for an exemption in their present forms. In January 2002, MasterCard, MEPUK and several MasterCard U.K. members responded to the notice. On February 11, 2003, the OFT issued a supplemental Rule 14 Notice, which also contained preliminary conclusions challenging MasterCard's U.K. MIF under the Competition Act. On May 2, 2003, MasterCard and MMF responded to the supplemental notice. The OFT has given written notice that it will issue a Statement of Objection in November 2004.

If MasterCard and MMF are unsuccessful in obtaining a favorable ruling, the OFT could issue a prohibition decision ordering MasterCard to change the manner in which it calculates its U.K. MIF. Because the MIF constitutes an essential element of MasterCard's U.K. operations, a negative decision by the OFT could have a significant adverse impact on MasterCard's U.K. members and on MasterCard's competitive position and overall business in the U.K. In the event of a negative decision by the OFT, MasterCard intends to appeal to the Competition Appeals Tribunal and to seek interim relief. At this time, it is not possible to determine the ultimate resolution of this matter.

United States. In July 2002, a purported class action lawsuit was filed by a group of merchants in the U.S. District Court for the Northern District of California against MasterCard International, Visa U.S.A., Inc., Visa International Corp. and several member banks in California alleging, among other things, that MasterCard's and Visa's interchange fees contravene the Sherman Act. The suit seeks treble damages in an unspecified amount, attorney's fees and injunctive relief, including the divestiture of bank ownership of MasterCard and Visa, and the elimination of MasterCard and Visa marketing activities. On March 4, 2004, the court dismissed the lawsuit with prejudice in reliance upon the approval of the Settlement Agreement in the U.S. merchant lawsuit by the U.S. District Court for the Eastern District of New York, which held that the settlement and release in that case extinguished the claims brought by the merchant group in the present case. The plaintiffs have appealed the U.S. District Court for the Eastern District of New York's approval of the U.S. merchant settlement and release to the Second Circuit Court of Appeals and have also appealed the U.S. District Court for the Northern District of California's dismissal of the present lawsuit to the Ninth Circuit Court of Appeals. Oral argument was held in the Second Circuit Court of Appeals on August 25, 2004, and a decision is currently pending. At this time it is not possible to determine the outcome of this proceeding.

On October 8, 2004, a new purported class action lawsuit was filed by a group of merchants in the U.S. District Court for the Northern District of California against MasterCard International, Visa U.S.A., Inc., Visa International Corp. and several member banks in California alleging, among other things, that MasterCard's and Visa's interchange fees contravene the Sherman Act. The complaint appears to contain substantively similar claims to those brought in the interchange case described in the preceding paragraph, and plaintiffs have designated it as a related case. MasterCard's time in which to respond is currently running.

Other Jurisdictions. MasterCard is aware that regulatory authorities in certain other jurisdictions, including Poland, Spain, New Zealand, Portugal, Mexico, Colombia and Switzerland are reviewing MasterCard's and/or its members' interchange fees and/or related practices and may seek to regulate the establishment of such fees and/or such practices. At this time it is not possible to determine the outcome of these proceedings.

Note 14. Settlement and Travelers Cheque Risk Management

Settlement risk is the legal exposure due to the difference in timing between the payment transaction date and subsequent final settlement. Settlement risk is estimated using the average daily card charges during the quarter multiplied by the estimated number of days to settle. The Company has global risk management policies and procedures, which include risk standards, to provide a framework for managing the Company's settlement exposure. MasterCard International's rules generally guarantee the payment of MasterCard transactions and certain Cirrus and Maestro transactions between principal members. The term and amount of the guarantee are unlimited. Member-reported transaction data and the transaction clearing data underlying the settlement risk exposure calculation may be revised in subsequent reporting periods.

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In the event that MasterCard International effects a payment on behalf of a failed member, MasterCard International may seek an assignment of the underlying receivables. Subject to approval by the Board of Directors, members may be assessed for the amount of any settlement loss.

MasterCard requires certain members that are not in compliance with the Company's risk standards to post collateral, typically in the form of letters of credit and bank guarantees. This requirement is based on management review of the individual risk circumstances for each member that is out of compliance. In addition to these amounts, MasterCard holds collateral to cover: variability and future growth in member programs; the possibility that it may choose to pay merchants to protect brand integrity in the event of merchant bank (acquirer) failure, although it is not contractually obligated to do so; and Cirrus and Maestro related risk. MasterCard monitors its credit risk portfolio on a regular basis to estimate potential concentration risks and the adequacy of collateral on hand.

Estimated settlement exposure, and the portion of the Company's uncollateralized settlement exposure for MasterCard-branded transactions that relates to members that are deemed not to be in compliance with, or that are under review in connection with, the Company's risk management standards, at September 30, 2004 and December 31, 2003 were as follows:

	September 30, 2004	December 31, 2003
MasterCard-branded transactions:		
Gross legal settlement exposure	$ 12,691,503	$ 11,880,152
Collateral held for legal settlement exposure	(1,423,032)	(1,344,621)
Net uncollateralized settlement exposure	$ 11,268,471	$ 10,535,531
Uncollateralized settlement exposure attributable to non-compliant members	$ 265,721	$ 250,984
Cirrus and Maestro transactions:		
Gross legal settlement exposure	$ 889,666	$ 591,317

Although MasterCard holds collateral at the member level, the Cirrus and Maestro estimated settlement exposures are calculated at the regional level. Therefore, these settlement exposures are reported on a gross basis, rather than net of collateral.

MasterCard's estimated settlement exposure under the MasterCard brand, net of collateral, had concentrations of 57% and 58% in North America and 22% and 22% in Europe at September 30, 2004 and December 31, 2003, respectively.

A significant portion of the uncollateralized settlement exposure attributable to non-compliant members is concentrated in three members ($127,425 and $157,955 for September 30, 2004 and December 31, 2003, respectively).

MasterCard guarantees the payment of MasterCard-branded travelers cheques in the event of issuer default. The guarantee estimate is based on all outstanding MasterCard-branded travelers cheques, reduced by an actuarial determination of cheques that are not anticipated to be presented for payment. The term and amount of the guarantee are unlimited. MasterCard calculated its MasterCard-branded travelers cheques exposure under this guarantee as $1,185,500 and $1,205,921 at September 30, 2004 and December 31, 2003, respectively.

A significant portion of the Company's credit risk is concentrated in one MasterCard travelers cheque issuer. MasterCard has obtained an unlimited guarantee estimated at $984,934 and $996,927 at September 30, 2004 and December 31, 2003, respectively, from a financial institution that is a member, to cover all of the exposure of outstanding travelers cheques with respect to that issuer. In addition, MasterCard has obtained guarantees estimated at $28,833 and $32,101 at September 30, 2004 and December 31, 2003, respectively, from financial institutions that are members in order to cover the exposure of outstanding travelers cheques with respect to another issuer. These guarantee amounts have also been reduced by an actuarial determination of cheques that are not anticipated to be presented for payment.

Based on the Company's ability to assess its members for settlement and travelers cheque losses, the effectiveness of the Company's global risk management policies and procedures, and the historically low level of losses that the Company has experienced, management believes the probability of future payments for settlement and travelers cheque losses in excess of existing reserves is negligible. However, if circumstances in the future change, the Company may need to reassess whether it would be necessary to record an obligation for the fair value of some or all of its settlement and travelers cheque guarantees.

(In thousands, except per share and percent data)

Note 15. Foreign Exchange Risk Management

The Company enters into foreign exchange contracts to minimize risk associated with anticipated receipts and disbursements denominated in foreign currencies. The Company also enters into contracts to offset possible changes in value due to foreign exchange fluctuations of assets and liabilities denominated in foreign currencies. MasterCard's forward contracts are classified by functional currency as summarized below:

U.S. Dollar Functional Currency

	September 30, 2004		December 31, 2003	
Forward Contracts	Notional	Estimated Fair Value	Notional	Estimated Fair Value
Commitments to purchase foreign currency	$38,348	$ (241)	$64,147	$ 595
Commitments to sell foreign currency	18,920	(355)	60,162	(46)

Euro Functional Currency

	September 30, 2004		December 31, 2003	
Forward Contracts	Notional	Estimated Fair Value	Notional	Estimated Fair Value
Commitments to purchase foreign currency	$55,708	$ (1,445)	$178,030	$ (5,112)

The currencies underlying the foreign currency forward contracts consist primarily of euro, Japanese yen and U.K. pounds sterling. The fair value of the foreign currency forward contracts generally reflects the estimated amounts that the Company would receive or (pay) to terminate the contracts at the reporting date based on broker quotes for the same or similar instruments. The terms of the foreign currency forward contracts are generally less than 18 months. The Company has deferred $1,275 and $3,069 of net losses in accumulated other comprehensive income as of September 30, 2004 and December 31, 2003, respectively, all of which are expected to be reclassified to earnings within the next three months to provide an economic offset to the earnings impact of the anticipated cash flows hedged.

The Company's derivative financial instruments are subject to both credit and market risk. Credit risk is the risk of loss due to failure of a counterparty to perform its obligations in accordance with contractual terms. Market risk is the potential change in an investment's value caused by fluctuations in interest and currency exchange rates, credit spreads or other variables. Credit and market risk related to derivative instruments were not material at September 30, 2004 and December 31, 2003.

Generally, the Company does not obtain collateral related to forward contracts because of the high credit ratings of the counter-parties that are members. The amount of accounting loss the Company would incur if the counterparties failed to perform according to the terms of the contracts is not considered material.

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

The following discussion should be read in conjunction with the consolidated financial statements and notes of MasterCard Incorporated and its consolidated subsidiaries, including MasterCard International Incorporated ("MasterCard International") and MasterCard Europe sprl ("MasterCard Europe")(together, "MasterCard" or the "Company") included elsewhere in this report. References to "we", "our" and similar terms in the following discussion are references to the Company.

Forward-Looking Statements

This Report on Form 10-Q contains forward-looking statements pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. When used in this Report, the words "believe," "expect," "could," "may," "will" and similar words are intended to identify forward-looking statements. These statements relate to our future prospects, developments and business strategies. Many factors and uncertainties relating to our operations and business environment, all of which are difficult to predict and many of which are outside of our control, influence whether any forward-looking statements can or will be achieved. Any one of those factors could cause our actual results to differ materially from those expressed or implied in writing in any forward-looking statements made by MasterCard or on its behalf. We believe there are certain risk factors that are important to our business, and these could cause actual results to differ from our expectations. Please see a complete discussion of these risk factors under the caption "Risk Factors" in Item 1 — Business of the Annual Report on Form 10-K of MasterCard for the year ended December 31, 2003.

Overview

We achieved double-digit revenue growth of 12% in the three months ended September 30, 2004 and 15% in the nine months ended September 30, 2004 from the comparable periods in 2003. Of these increases, 2% in each period was due to the weakening of the U.S. dollar against the euro in 2004 versus the comparable period in 2003, which created a favorable foreign currency translation. Increased usage of MasterCard products spurred by economic recovery in many of the countries in which we do business resulted in higher gross dollar volume and more transactions processed by MasterCard. In addition, the conflict in Iraq, threat of terrorism, and SARS negatively impacted cross-border travel in the beginning of 2003. As international travel returned to more normal levels in 2004, our cross-border transactions and related revenue have increased significantly.

Our cost control initiatives have taken effect. Excluding the impact of the U.S. merchant lawsuit and other legal settlements, our operating expenses as a percentage of total revenues declined to 76% from 79% for the three months ended September 30, 2004, and to 80% from 86% for the nine months ended September 30, 2004, in each case from the comparable period in 2003. Excluding the impact of the U.S. merchant lawsuit and other legal settlements, our operating expenses increased 8% in the three months ended September 30, 2004 and 6% for the nine months ended September 30, 2004, in each case from the comparable period in 2003. In each of the periods 1% of the increase was due to the weakening of the U.S. dollar against the euro, creating an unfavorable currency translation.

As the payments industry continues to evolve, we face increased competition, consolidation and globalization. We are, and will continue to be, significantly dependent on our relationships with our issuers and acquirers and their further relationships with cardholders and merchants to support our programs and services. Most of our relationships with our customers are not exclusive and may be terminated at the convenience of our customers. The consolidation or merger of one or more of our customers with financial institutions aligned with our competitors could have a material adverse impact on our revenues.

In recent years, our corporate strategy has been to focus on our key customers to drive our business growth; to strengthen our brands, technology and acceptance network; and to differentiate MasterCard from our competition by developing innovative payment solutions and customized consulting services. In 2004, we remain committed to this strategic direction and have begun to implement initiatives to expand our customer-focused approach to a broader group of customers, as well as to further develop relationships with merchants that accept our cards. In addition, we will continue to focus resources on proactively addressing the legal and regulatory risks that impact our business, as described more fully below.

Legal and Regulatory Impact on our Business

Our financial results have been and will continue to be significantly influenced by the legal and regulatory environment in which we operate our business. MasterCard is a party to several legal and regulatory proceedings, as discussed in Note 13 to the Consolidated Financial Statements included herein, which could have a material adverse impact on our business. In particular, any of the following outcomes to our legal and regulatory proceedings could adversely affect our results of operations and liquidity:

- if regulatory challenges to interchange fees, which we set for our customers under certain circumstances, are successful, our customers could reduce their use of payment programs carrying our brands, thereby negatively impacting our future revenues;

- if we are unsuccessful in private lawsuits, such as the one initiated by Discover, that attempt to use the U.S. Department of Justice litigation as a basis for claiming that they were damaged by our Competitive Programs Policy, we could be required to pay damages, which could adversely affect our results of operations;

- if we are unsuccessful in our state and federal lawsuits regarding our currency conversion practices, we could be required to change these practices, pay damages or provide other equitable relief, which could have an adverse impact on our results of operations;

- if we do not prevail in the lawsuits brought by merchants who have opted not to participate in the plaintiff class in the U.S. merchant lawsuit or in the related consumer cases, then we could be subject to damages, which could adversely impact our results of operations; and

- if we are unsuccessful in our litigations related to our chargeback rules, we could be forced to change our chargeback rules and pay damages, which could adversely affect our results of operations.

See Note 13 to the Consolidated Financial Statements included herein for a discussion of these and other legal and regulatory proceedings to which we are a party.

We earn a portion of our revenues in connection with MasterCard-branded offline debit cards issued in the United States. Following the settlement of the U.S. merchant lawsuit in 2003, Visa U.S.A., Inc. implemented a bylaw requiring Visa's 100 largest issuers of debit cards in the United States to pay a fee if they reduce their debit volume by more than 10%. If Visa is permitted to enforce this bylaw, it would penalize Visa members seeking to do debit business with MasterCard and effectively prevent them from converting their debit cards to the MasterCard brand. MasterCard has challenged the validity of this bylaw provision. In addition, under the Settlement Agreement in the U.S. merchant lawsuit, merchants have the right to reject MasterCard-branded debit cards in the United States, while still accepting other MasterCard-branded cards and vice versa. These scenarios may be detrimental to MasterCard's ability to maintain and grow its debit card business in the United States.

As a result of the U.S. Supreme Court's denial of our petition for certiorari with respect to the U.S. Department of Justice litigation described in Note 13 to the Consolidated Financial Statements included herein. MasterCard will be required to repeal its Competitive Programs Policy, which prohibited its members from issuing credit cards on competing proprietary networks (such as American Express and Discover). Furthermore, for a period of two years from the entry of the final judgment, members will be permitted to terminate without penalty, agreements that they entered into with MasterCard prior to the effective date of the final judgment, whereby the member agreed to long-term commitments to the MasterCard brand, provided that the reason for such termination is to permit the member to enter into an agreement with American Express or Discover. Repeal of the Competitive Programs Policy and/or termination of certain member business agreements could cause members to reduce, or reduce the growth of, their MasterCard-branded card volumes, which could have an adverse impact on our business. On January 29, 2004, MBNA Corporation announced its intention to offer American Express credit cards to its customers.

Results of Operations

Key selected financial and operating data for the three and nine months ended September 30, 2004 and 2003 is included in the table below:

	Three Months Ended September 30, 2004	Three Months Ended September 30, 2003	Percent Increase (Decrease) 2004 vs. 2003	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003	Percent Increase (Decrease) 2004 vs. 2003
	(in millions, except per share amounts and percentages)					
Operations fees	$ 419	$ 373	12%	$ 1,188	$ 1,041	14%
Assessments	249	221	13%	722	622	16%
Revenue	668	594	12%	1,910	1,663	15%
General and administrative	285	255	12%	846	813	4%
Advertising and market development	190	183	4%	587	530	11%
U.S. merchant lawsuit and other legal settlements	14	9	56%	18	730	(98%)
Depreciation and amortization	29	28	4%	92	89	3%
Total operating expenses	518	475	9%	1,543	2,162	(29%)
Operating income (loss)	150	119	26%	367	(499)	174%
Total other income (expense)	(9)	(8)	13%	(22)	(5)	340%
Income (loss) before income tax expense (benefit) and cumulative effect of accounting change	141	111	27%	345	(504)	168%
Income tax expense (benefit)	43	37	16%	108	(180)	160%
Cumulative effect of accounting change, net of tax	—	—	—	—	5	(100%)
Net income (loss)	$ 98	$ 74	32%	$ 237	$ (319)	174%
Net income (loss) per share (basic and diluted)	$ .98	$ .74	32%	$ 2.37	$ (3.19)	174%
Weighted average shares outstanding (basic and diluted)	100	100	—	100	100	—
Effective tax rate	30.7%	33.2%	—	31.3%	35.8%	—
Gross dollar volume ("GDV") on a U.S. dollar converted basis (in billions).	$ 366	$ 324	13%	$ 1,049	$ 926	13%
Processed transactions	2,833	2,528	12%	7,991	7,130	12%

Our functional currency is primarily the U.S. dollar except for MasterCard Europe, whose functional currency is the euro. Accordingly, our results of operations have been impacted by movements of the euro against the U.S. dollar. As the euro strengthened against the U.S. dollar during the three and nine months ended September 30, 2004 compared to the same periods in 2003, MasterCard Europe's revenue and expenses increased as a result of translation into U.S. dollar amounts. In addition, we assess our members for foreign currency denominated transactions based on the equivalent U.S. dollar volume of their card programs. Since the U.S. dollar devalued against most major currencies, our revenues increased accordingly.

Revenues

Our revenues are generated from the fees that we charge our customers for providing transaction processing and other payment services, and from assessments calculated on the dollar volume of activity on cards carrying our brands. We establish standards and procedures for the acceptance and settlement of our customers' transactions on a global basis. We do not issue cards, set fees, or determine the interest rates consumers will be charged on MasterCard-branded cards. Our issuing customers have the responsibility for determining these and most other competitive card features. Our revenues are based upon transactional information accumulated by our systems and/or reported by our customers. Certain revenues are estimated based upon aggregate transaction information and historical and projected customer performance.

MasterCard has business agreements with certain customers that provide for fee rebates when the customers meet certain performance based criteria. Such rebates are calculated on a monthly basis based upon estimated performance and the contracted discount rates for the services provided. In addition, MasterCard enters into agreements with certain customers and merchants to provide GDV-based and support incentives. Rebates and incentives are recorded as a reduction of revenue in the same periods as the revenue is earned.

The U.S. remains our largest geographic market based on revenues. However, international revenues grew at a faster rate than U.S. revenues for the three and nine months ended September 30, 2004, particularly in the European region. U.S. revenues have been negatively impacted by the increasing demand from our customers to receive better pricing and greater incentives than in the past. Accordingly, revenue generated in the U.S. was approximately 58% and 61% of total revenues for the three months ended September 30, 2004 and 2003, respectively, and 58% and 63% of total revenues for the nine months ended September 30, 2004 and 2003, respectively. The growth in the European region is primarily due to new assessment revenue streams and increased transactions. The European region generated revenues of approximately 20% and 18% of total revenues for the three months ended September 30, 2004 and 2003, respectively, and 20% and 16% of total revenues for the nine months ended September 30, 2004 and 2003, respectively. No individual country, other than the U.S., generated more than 10% of total revenues in either period.

Operations Fees

Operations fees primarily represent user fees for authorization, settlement and other payment services that facilitate transaction and information management among our customers on a global basis. Operations fees increased $46 million or 12% and $147 million or 14% in the three and nine months ended September 30, 2004, respectively, compared to the same periods in 2003. The significant changes in operations fees were as follows:

	Change in Revenue Increase (Decrease) (in millions) Three Months Ended September 30, 2004 vs. 2003	Nine Months Ended September 30, 2004 vs. 2003
Authorization, settlement and switch	$ 27	$ 96
Currency conversion	12	37
Warning bulletins	(1)	(5)
Rebates	(13)	(24)
Excessive chargeback fees	2	(7)
Consulting	5	11
Other operations fees	14	39
	$ 46	$ 147

- Authorization, settlement and switch revenues increased primarily due to increased transactions processed through our systems of 12% in each of the three and nine months ended September 30, 2004 as a result of economic recovery in various regions in which we do business. In 2004, a portion of the increase in transactions processed by MasterCard is attributable to the conversion of two debit brands to Maestro in 2003, one in the U.K. and the other in Latin America. In addition, volatility of exchange rates in 2004 contributed to increased trading settlement revenue for the nine months ended September 30, 2004 versus the comparable prior period in 2003.

- Currency conversion revenues increased as a result of greater cross border transactions in 2004 by cardholders in all regions. These revenues fluctuate with cross border travel. The conflict in Iraq, the threat of terrorism and SARS negatively impacted cross border travel in the beginning of 2003, which returned to normal levels in 2004.

- Fees for warning bulletins, which are listings of restricted cards, decreased primarily due to issuers of MasterCard-branded cards shifting from a paper-based version of restricted card listings to lower priced electronic versions.

- Our pricing structure rewards our customers with lower prices in exchange for certain volume, share and other commitments. We offer tiered pricing for our services. Therefore, as our customers grow and merge, they move into lower relative pricing for the same level of services. In addition to tiered pricing, rebates to certain customers continued to increase and are recorded as a reduction of revenue. Rebates are primarily based on transactions and volumes and, accordingly, increase as these variables increase.

- Excessive chargeback fees are charged to acquiring banks that acquire transactions from merchants that experience a high level of disputed claims from their customers. The decrease in excessive chargeback fees in the nine months ended September 30, 2004 was the result of the imposition of such fees on one large acquiring bank in the second quarter 2003 in connection with its merchant activity, in accordance with the MasterCard rules.

- Consulting fees are generated by our advisory services group. During 2004, the incremental consulting revenue is primarily the result of the acquisition of two consulting firms. See Note 5 to the Consolidated Financial Statements included herein.

- Other operations fees represent various revenue streams that relate to our transaction processing services. These revenues increased due to an overall increase in the demand for our programs and services. However, the change in any individual revenue line was not considered material. Examples of these revenues are fees to promote acceptance of our brands and the purchase of holograms by our customers for their cards.

Assessments

Assessments are based primarily on our customers' GDV of MasterCard transactions. GDV represents gross usage (purchase and cash disbursements) on MasterCard-branded cards for goods and services including balance transfers and convenience checks. In the three and nine months ended September 30, 2004, assessments revenue grew $28 million or 13% and $100 million or 16% respectively, over the same periods in 2003. GDV growth was 10% and 9% when measured in local currency terms in the three and nine months ended September 30, 2004 respectively, over the same periods in 2003 and 13% in each period when measured on a U.S. dollar converted basis.

In addition to the increase in GDV, assessments growth in 2004 was due to the following factors:

- In certain countries in Europe and Latin America, our customers are charged a marketing assessment fee based on volume. These fees are used by MasterCard to expand new and existing market development programs to promote the MasterCard brand in these countries. These fees were extended to additional countries in 2003 and, accordingly, increased $7 million or 35% for the three months ended September 30, 2004 and $25 million or 48% for the nine months ended September 30, 2004, in each case over the comparable periods in 2003.

- The assessment rates vary based on the nature of the transactions that generate the GDV. In 2004, there was stronger growth in international volumes and purchase volumes, which are assessed at higher rates than domestic volumes and cash volumes, respectively.

Rebates and incentives provided to customers and merchants reduce revenue and moderate assessments growth. These rebates and incentives generally are based on card generated volume as well as a fixed component for the issuance of new cards or launch of new programs. In the three and nine months ended September 30, 2004, these rebates and incentives increased $15 million and $38 million, respectively, compared to the same periods in 2003. Rebates and incentives as a percentage of assessments increased to 39% from 37% for the three months ended September 30, 2004 and to 36% from 35% for the nine months ended

September 30, 2004, in each case, from the comparable periods in 2003. During 2004, MasterCard increased the incentives offered to certain customers and merchants to promote usage and acceptance of our brands.

Operating Expenses

Our operating expenses are comprised of general and administrative, advertising and market development, the U.S. merchant lawsuit and other legal settlements, and depreciation and amortization expenses. In the three months ended September 30, 2004, there was an increase in operating expenses of $43 million or 9% over the same period in 2003. In the nine months ended September 30, 2004, there was a decrease in operating expenses of $619 million or 29% over the same period in 2003, or an increase of $93 million or 6% excluding the charges to earnings related to the U.S. merchant lawsuit and other legal settlements. Approximately $10 million and $18 million of these increases in the three and nine months ended September 30, 2004, respectively, related to the acquisition of the two consulting firms described in Note 5 to the Consolidated Financial Statements included herein.

General and Administrative

General and administrative expenses consist primarily of personnel, professional fees, data processing, telecommunications and travel. These activities accounted for approximately 43% of total revenues in each of the three months ended September 30, 2004 and 2003, respectively, and 44% and 49% of total revenues in the nine months ended September 30, 2004 and 2003, respectively. General and administrative expenses increased $30 million or 12% and $33 million or 4% in the three and nine months ended September 30, 2004, respectively, over the same periods in 2003 due to the following:

- Personnel expense increased $19 million and $24 million in the three and nine months ended September 30, 2004, respectively, compared to the same periods in 2003, respectively, due to merit increases.

- Professional fees increased $11 million and $17 million in the three and nine months ended September 30, 2004, respectively, over the same periods in 2003 primarily due to consulting services utilized in developing our strategic initiatives and services related to compliance with the Sarbanes-Oxley Act.

- Telecommunications expense decreased $2 million and $12 million in the three and nine months ended September 30, 2004, respectively, over the same periods in 2003 due to our ongoing evaluation of telecommunication needs, including the renegotiation of certain contracts with service providers.

Advertising and Market Development

Advertising and market development consists of expenses associated with advertising, marketing, promotions and sponsorships, which promote our brands and assist our customers to achieve their goals by raising consumer awareness and usage of cards carrying our brands. These activities accounted for approximately 28% and 31% of total revenues in the three months ended September 30, 2004 and 2003, respectively, and 31% and 32% of total revenues in the nine months ended September 30, 2004 and 2003, respectively. Advertising and market development expenses increased $7 million or 4% and $57 million or 11% in the three and nine months ended September 30, 2004, respectively, over the same periods in 2003. These increases are primarily due to additional media advertising in our European region. Our Priceless campaign continues to be successful in 96 countries and 48 languages, and we plan to continue to invest significantly in this campaign.

MasterCard implemented a four-year plan in 2002 to accelerate our growth and to enhance the global position of MasterCard and its customers by significantly expanding its spending in advertising and market development. For the three months ended September 30, 2004 and 2003, we spent $30 million and $42 million, respectively, and in the nine months ended September 30, 2004 and 2003, we spent $108 million, in each case, on advertising and marketing relating to this plan. The primary focus of these initiatives is to build brand recognition, promote brand acceptance, and enhance the development of our programs and services in certain markets. We will continue to evaluate the extent of these initiatives in light of changing market conditions.

The MasterCard family of brands, principally MasterCard, is a valuable strategic asset which conveys a symbol that can be readily identified by our customers, as well as our cardholders, creating value for our business. Our advertising and marketing efforts are focused on ensuring that our services are identified, communicated and marketed in a clear, efficient and consistent manner, not only on a local level, but also on a global scale. We are committed to maintaining and enhancing our MasterCard brand reputation, image and ultimate value.

Merchant Lawsuit and Other Legal Settlements

In the first quarter of 2003, we recorded a pre-tax charge of $721 million for settlement of the U.S. merchant lawsuit. The primary components of this charge were (i) the monetary amount of the U.S. merchant settlement (discounted at 8 percent over the payment term), (ii) certain additional costs in connection with, and in order to comply with, other requirements of the U.S. merchant lawsuit settlement, and (iii) costs to address certain merchants who opted not to participate in the U.S. merchant lawsuit. This amount was an estimate, which was revised in subsequent periods based on approval of the Settlement Agreement by the court, and other factors. If necessary, future refinements will also be made. Relating to these settlements, payments of $29 million and $40 million were made during the three and nine months ended September 30, 2004, respectively. The Company recorded additional charges of $14 million and $18 million in the three and nine months ended September 30, 2004, respectively, principally related to the awarding of legal costs under an unrelated currency conversion case. See Note 13 to the Consolidated Financial Statements included herein.

Depreciation and Amortization

Depreciation and amortization increased $1 million and $3 million in the three and nine months ended September 30, 2004, respectively, over the same periods in 2003. Our business is dependent on the technology that we use to process transactions, which is continuously updated and improved. Therefore, our investments in capitalized software and related amortization also continue to increase.

Other Income and Expense

Other income (expense) is comprised primarily of investment income and interest expense. Investment income decreased $1 million and $7 million in the three and nine months ended September 30, 2004, respectively, over the same periods in 2003 resulting from a decline in the market value of the trading securities portfolio, which had significant appreciation in the comparable periods in 2003. Interest expense decreased $1 million and increased $9 million in the three and nine months ended September 30, 2004, respectively, primarily due to the imputed interest on the U.S. merchant lawsuit settlement obligation.

Income Taxes

The effective tax rate for the three and nine months ended September 30, 2004 was 30.7% and 31.3%, respectively, compared to 33.2% and 35.8% for the three and nine months ended September 30, 2003, respectively. The decrease in the rate in 2004 is primarily attributable to discrete items that occurred in the second and third quarters of 2004. The primary discrete item in the third quarter was an increase in our deferred state tax assets as a result of a change in the taxation of our state and local income. The primary discrete items in the second quarter that, together with the third quarter discrete items resulted in the decrease in the nine-month effective tax rate were the favorable settlement and reassessment of various tax controversies and the filing and recognition of refund claims, partially offset by an increase in the valuation allowance for the future realization of a benefit from a capital loss carryover. Absent the discrete items our effective tax rate for the three and nine months ended September 30, 2004 would have been 36.8% and 36.3%, respectively, compared to 33.2% and 33.1% for the three and nine months ended September 30, 2003, respectively. The increase in the 2004 rates before discrete items is primarily attributable to a decrease in the percentage of tax exempt interest income and other favorable permanent tax items as a percent of pretax income, as well as a change in the geographic distribution of pretax income from taxable jurisdictions with lower rates to those with higher rates.

Liquidity

We believe our ability to generate cash from our operations to reinvest in our business is one of our fundamental financial strengths. We need capital resources and liquidity to fund our global development, to provide for settlement risk, to finance capital expenditures and any future acquisitions and to service the payments of principal and interest on our outstanding debt and the settlement of the U.S. merchant lawsuit. At September 30, 2004, we had $1.1 billion of liquid investments with which to manage operations, compared to $880 million at December 31, 2003. We expect that cash and cash equivalents, cash generated from operations and our borrowing capacity will be sufficient to meet our operating, working capital and capital needs in 2004 and beyond. In addition, we believe that our resources are sufficient to fund our initiatives to accelerate our profitable growth and to enhance the global position of MasterCard in 2004 and 2005.

	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003	Percent Change 2004 vs. 2003
	(in millions, except percentages)		
Cash flow data:			
Net cash provided by operating activities	$ 294	$ 190	55%
Net cash used in investing activities	(96)	(116)	17%
Net cash provided in financing activities	8	—	100%

	September 30, 2004	December 31, 2003
	(in millions, except ratios)	
Balance sheet data:		
Current assets	$ 1,872	$ 1,610
Current liabilities	1,198	1,189
Long-term liabilities	1,049	1,009
Stockholders' equity	926	699
Working capital ratio	1.56	1.35

Net cash provided by operating activities in 2004 was generated principally by current period earnings exclusive of non-cash charges for depreciation and amortization and an increase in accrued expenses. These increases were offset by the payment of accounts payable that had increased at December 31, 2003 due to heavy fourth quarter 2003 advertising and market development activity.

The utilization of cash by investing activities in 2004 was primarily due to the purchase of, or cost of internally developed, capitalized software and the acquisition of certain businesses as described in Note 5 to the Consolidated Financial Statements included herein. Our capitalized software is essential to providing payment card transaction processing to our customers through our proprietary global computer and telecommunications system. Our investing activities in 2003 included funding for a back-up center in Kansas City, Missouri, and associated equipment.

In addition to our liquid investments, we provide for liquidity through a committed $1.95 billion revolving credit facility (the "Credit Facility") with certain financial institutions which expires on June 17, 2005. The Credit Facility replaced MasterCard Incorporated's prior $1.2 billion credit facility which expired on June 18, 2004. Borrowings under the facility are available to provide liquidity in the event of one or more settlement failures by MasterCard International members and, subject to a limit of $300 million, for general corporate purposes. Interest on borrowings under the Credit Facility is charged at the London Interbank Offered Rate ("LIBOR") plus 28 basis points. An additional 10 basis points would be applied if the aggregate borrowings under the Credit Facility exceed 33% of the commitments. MasterCard agreed to pay a facility fee which varies based on MasterCard's credit rating and is currently equal to 7 basis points on the total commitment. MasterCard was in compliance with the Credit Facility covenants as of September 30, 2004. There were no borrowings under the Credit Facility at September 30, 2004. The majority of Credit Facility lenders are members or affiliates of members of MasterCard International.

Future Obligations

The following table summarizes our obligations as of September 30, 2004 that are expected to impact liquidity and cash flows in future periods. We believe that we will be able to fund these obligations through cash generated from operations and our existing cash balances.

	Payments Due by Period				
	Total	1 Year or Less	2-3 Years	4-5 Years	More Than 5 Years
			(in millions)		
Capital leases[a]	$ 64	$ 3	$ 11	$ 6	$ 44
Operating leases[b]	121	10	59	40	12
Sponsorship, licensing & other[c]	568	85	345	113	25
U.S. merchant lawsuit and other legal settlements[d]	933	133	200	200	400
Debt[e]	250	5	11	234	—
Total	$1,936	$ 236	$ 626	$ 593	$ 481

(a) Most capital leases relate to certain property, plant and equipment used in our business. Our largest capital lease relates to our Kansas City, Missouri co-processing facility.

(b) We enter into operating leases in the normal course of business, including the lease on our facility in St. Louis. Substantially all lease agreements have fixed payment terms based on the passage of time. Some lease agreements provide us with the option to renew the lease or purchase the leased property. Our future operating lease obligations would change if we exercised these renewal options and if we entered into additional lease agreements.

(c) Amounts primarily relate to sponsorships with certain organizations to promote the MasterCard brand. The amounts included are fixed and non-cancelable. In addition, these amounts include purchase obligations.

(d) Amounts due in accordance with legal settlements entered into during 2003 and refined in 2004, including the Settlement Agreement in the U.S. merchant lawsuit.

(e) Debt primarily represents principal and interest owed on our subordinated notes due June 2008 and the principal owed on our Secured Notes due September 2009. We also have various credit facilities for which there were no outstanding balances at September 30, 2004 that, among other things, would provide liquidity in the event of settlement failures by our members. Our debt obligations would change if one or more of our members failed and we needed these credit facilities to settle on our members' behalf or if we borrowed under these facilities for other reasons.

Recent Accounting Pronouncements

In May 2004, the FASB issued FASB Staff Position No. FAS 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003" ("FSP 106-2"). FSP 106-2 requires (a) that the effects of the federal subsidy be considered an actuarial gain and recognized in the same manner as other actuarial gains and losses and (b) certain disclosures for employers that sponsor postretirement benefit plans that provide prescription drug benefits. The Company has determined that the enactment of the Medicare Modernization Act was not a significant event with respect to its plans, and accordingly, as required by FSP 106-2, the effects of the Act will be incorporated into our December 31, 2004 measurement of the plan's benefit obligations.

In March 2004, the Emerging Issues Task Force ("EITF") reached a consensus on EITF Issue No. 03-01, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," ("EITF 03-01"). EITF 03-01 addresses determining the meaning of other-than-temporary impairment and its application to investments classified as either available-for-sale or held-to-maturity under Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Investments" ("SFAS 115") and investments accounted for under the cost method or the equity method. The EITF reached a consensus on a model for determining whether an investment within the scope of EITF 03-01 is other-than-temporarily impaired and reached a consensus that investors should provide certain disclosures related to investments that are within the scope of EITF 03-01. The consensus for evaluating whether an investment is other-than-temporarily impaired should be applied to evaluations made in reporting periods beginning after June 15, 2004. The consensus on additional disclosures for cost method investments is effective for fiscal years ending after June 15, 2004. The adoption of EITF 03-01 is not expected to have an impact on our financial position or results of operations.

In January 2003, the FASB issued Interpretation No. 46, “Consolidation of Variable Interest Entities” (“FIN 46”). FIN 46 clarifies that companies may need to consolidate certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 applied immediately to variable interest entities created or in which an enterprise obtained an interest after January 31, 2003. The Company adopted FIN 46 on January 1, 2003 and therefore consolidated its variable interest entity as described in Note 1 and 2 to the Consolidated Financial Statements included herein. In December 2003, FIN 46 was revised. The adoption of the revisions to FIN 46 did not have an impact on our financial position or results of operations.

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

Market risk is the potential for economic losses to be incurred on market risk sensitive instruments arising from adverse changes in market factors such as interest rates, foreign currency exchange rates, and equity price risk. We have limited exposure to market risk from changes in interest rates, foreign exchange rates and equity price risk. Management establishes and oversees the implementation of policies, which have been approved by the Board of Directors, governing our funding, investments, and use of derivative financial instruments. We monitor aggregate risk exposures on an ongoing basis. There have been no material changes in our market risk exposures at September 30, 2004 as compared to December 31, 2003.

Item 4. *Controls and Procedures*

MasterCard Incorporated’s management, including the President and Chief Executive Officer and Chief Financial Officer, carried out an evaluation of the Company’s disclosure controls and procedures (as defined in Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this Report. Based on that evaluation, the Company’s President and Chief Executive Officer and Chief Financial Officer concluded that MasterCard Incorporated had effective controls and procedures for (i) recording, processing, summarizing and reporting information that is required to be disclosed in its reports under the Securities Exchange Act of 1934, as amended, within the time periods specified in the Securities and Exchange Commission’s rules and forms and (ii) ensuring that information required to be disclosed in such reports is accumulated and communicated to MasterCard Incorporated’s management, including its President and Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure.

[PRICEWATERHOUSECOOPERS LETTERHEAD]

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
Of MasterCard Incorporated:

We have reviewed the accompanying consolidated balance sheet of MasterCard Incorporated and its subsidiaries as of September 30, 2004, and the related consolidated statements of operations and consolidated condensed statements of comprehensive income (loss) for each of the three- and nine-month periods ended September 30, 2004 and 2003 and the consolidated statement of cash flows for the nine-month period ended September 30, 2004 and 2003 and the consolidated statement of changes in stockholders' equity for the nine-month period ended September 30, 2004. These interim financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2003, and the related consolidated statements of operations, comprehensive income (loss), changes in stockholders'/members' equity, and cash flows for the year then ended (not presented herein), and in our report dated March 4, 2004 we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet information as of December 31, 2003, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

PricewaterhouseCoopers LLP
New York, NY
November 9, 2004

MASTERCARD INCORPORATED

FORM 10-Q

PART II — OTHER INFORMATION

Item 1. ***Legal Proceedings***

Refer to Notes 11 and 13 to the Consolidated Financial Statements included herein.

Item 6. ***Exhibits***

Refer to the Exhibit Index herein.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: November 9, 2004		MASTERCARD INCORPORATED *(Registrant)*
Date: November 9, 2004	By:	/s/ ROBERT W. SELANDER Robert W. Selander *President and Chief Executive Officer* *(Principal Executive Officer)*
Date: November 9, 2004	By:	/s/ CHRIS A. MCWILTON Chris A. McWilton *Chief Financial Officer* *(Principal Financial Officer)*
Date: November 9, 2004	By:	/s/ LISA WAGNER Lisa Wagner *Senior Vice President and Controller* *(Principal Accounting Officer)*

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EXHIBIT INDEX

Exhibit Number	Exhibit Description
3.1(a)	Amended and Restated Certificate of Incorporation of MasterCard Incorporated (incorporated by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K dated June 28, 2002 and filed July 12, 2002 (No. 333-67544)).
3.1(b)	Amended and Restated Bylaws of MasterCard Incorporated (incorporated by reference to Exhibit 3.1(b) to the Company's Annual Report on Form 10-K filed March 7, 2003 (No. 333-67544)).
3.2(a)	Amended and Restated Certificate of Incorporation of MasterCard International Incorporated (incorporated by reference to Exhibit 3.2(a) to the Company's Quarterly Report on Form 10-Q filed August 14, 2002 (No. 333-67544)).
3.2(b)	Amended and Restated Bylaws of MasterCard International Incorporated (incorporated by reference to Exhibit 3.2(b) to the Company's Quarterly Report on Form 10-Q filed August 14, 2002 (No. 333-67544)).
4.1	Amendment to MasterCard International Incorporated Note Purchase Agreement, dated August 4, 2004, regarding $80,000,000 of 6.67% Subordinated Notes due June 30, 2008.
31.1	Certification of Robert W. Selander, President and Chief Executive Officer, pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chris A. McWilton, Chief Financial Officer, pursuant to Rule 13a-14(a)/ 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Robert W. Selander, President and Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chris A. McWilton, Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.