



**THE WALLACE FOUNDATION**

Financial Statements

December 31, 2004 and 2003

(With Independent Auditors' Report Thereon)



**KPMG LLP**  
345 Park Avenue  
New York, NY 10154

## **Independent Auditors' Report**

The Board of Directors  
The Wallace Foundation:

We have audited the accompanying balance sheets of The Wallace Foundation (Foundation) as of December 31, 2004 and 2003, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the Foundation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Foundation's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of The Wallace Foundation as of December 31, 2004 and 2003, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

**KPMG LLP**

March 25, 2005

**THE WALLACE FOUNDATION**

Balance Sheets

December 31, 2004 and 2003

<b>Assets</b>	<b>2004</b>	<b>2003</b>
Cash equivalents and cash	\$ 5,372,460	1,840,227
Investments (note 3)	1,357,972,055	1,251,706,143
Prepaid expenses and receivables	981,559	1,370,632
Fixed assets, net of accumulated depreciation of \$1,733,034 in 2004 and \$1,539,474 in 2003	<u>327,962</u>	<u>393,611</u>
	<u>\$ 1,364,654,036</u>	<u>1,255,310,613</u>
<b>Liabilities and Net Assets</b>		
Liabilities:		
Accrued expenses and other payables	\$ 1,399,285	994,081
Grants payable (note 4)	29,085,768	25,442,510
Deferred Federal excise tax (note 5)	<u>3,601,751</u>	<u>1,253,930</u>
Total liabilities	34,086,804	27,690,521
Net assets -- unrestricted	<u>1,330,567,232</u>	<u>1,227,620,092</u>
	<u>\$ 1,364,654,036</u>	<u>1,255,310,613</u>

See accompanying notes to financial statements.

**THE WALLACE FOUNDATION**  
 Statements of Activities  
 Years ended December 31, 2004 and 2003

	2004	2003
Revenues:		
Investment income:		
Dividends	\$ 19,317,471	16,293,896
Interest	8,451,585	17,011,276
	27,769,056	33,305,172
Investment fees	(4,932,199)	(3,183,228)
Net investment income	22,836,857	30,121,944
Stock contributions received	—	202,218
Other income (note 6)	—	134,460
	22,836,857	30,458,622
Expenses:		
Grants and related activities	59,577,870	43,183,524
Operating expenses	9,004,347	8,655,430
Current Federal excise tax (note 5)	470,372	327,653
	69,052,589	52,166,607
Investment gains (losses):		
Unrealized gains, net (note 5)	123,650,065	207,689,827
Realized gains (losses), net	25,512,807	(70,924,122)
Net investment gains	149,162,872	136,765,705
Increase in net assets	102,947,140	115,057,720
Net assets:		
Beginning of year	1,227,620,092	1,112,562,372
End of year	\$ 1,330,567,232	1,227,620,092

See accompanying notes to financial statements.

**THE WALLACE FOUNDATION**  
 Statements of Cash Flows  
 Years ended December 31, 2004 and 2003

	2004	2003
Cash flows from operating activities:		
Increase in net assets	\$ 102,947,140	115,057,720
Adjustments to reconcile increase in net assets to net cash used in operating activities:		
RDA preferred stock received	—	(202,218)
Unrealized gains on investments	(125,997,886)	(208,943,757)
Realized (gains) losses on investments	(25,512,807)	70,924,122
Depreciation	193,560	199,002
Deferred Federal excise tax expense	2,347,821	1,253,930
Change in assets and liabilities:		
Decrease (increase) in accrued investment income	688,158	(172,112)
Decrease (increase) in prepaid expenses and receivables	389,073	(1,359,017)
Increase (decrease) in accrued expenses and other payables	405,204	(2,855,335)
Increase (decrease) in grants payable	3,643,258	(6,141,916)
Net cash used in operating activities	(40,896,479)	(32,239,581)
Cash flows from investing activities:		
Sales of investments	1,163,202,707	1,700,687,369
Purchases of investments	(1,118,646,084)	(1,676,420,517)
Capital expenditures	(127,911)	(29,329)
Net cash provided by investing activities	44,428,712	24,237,523
Net increase (decrease) in cash equivalents and cash	3,532,233	(8,002,058)
Cash equivalents and cash at beginning of year	1,840,227	9,842,285
Cash equivalents and cash at end of year	\$ 5,372,460	1,840,227

See accompanying notes to financial statements.

## THE WALLACE FOUNDATION

Notes to Financial Statements

December 31, 2004 and 2003

### (1) Nature of Operations

The Wallace Foundation is the successor to DeWitt Wallace-Reader's Digest Fund, Inc. and Lila Wallace-Reader's Digest Fund, Inc. which were created and endowed by DeWitt and Lila Acheson Wallace, co-founders of The Reader's Digest Association, Inc. (RDA). On April 18, 2003, Lila Wallace-Reader's Digest Fund, Inc. merged into DeWitt Wallace-Reader's Digest Fund, Inc. Upon completion of the merger, DeWitt Wallace-Reader's Digest Fund, Inc. was renamed The Wallace Foundation (Foundation). The financial statements for the year ended December 31, 2003 are presented as if the merger had been completed January 1, 2002.

The Foundation's resources are allocated mostly to foundation-initiated grants that further the Foundation's mission and have a national or regional impact.

### (2) Summary of Significant Accounting Policies

#### (a) Basis of Accounting

The accounts of the Foundation are maintained on the accrual basis of accounting.

#### (b) Tax-Exempt Status

The Foundation is exempt from Federal income tax under Section 501(c)(3) of the Internal Revenue Code (the Code) and is a private foundation as defined in Section 509(a) of the Code.

#### (c) Investments

Investments are stated at fair value. The valuation of marketable securities is based primarily upon quotations obtained from national securities exchanges. Investments in limited partnerships are reported at fair value based on information provided by the general partner. The general partner determines the fair value based on quoted market prices, if available, or other valuation methods, including independent appraisals. Dividend income is recorded on the ex-dividend date and interest income is recorded on the accrual basis.

#### (d) Fixed Assets

Fixed assets consist of furniture, fixtures, equipment, and leasehold improvements. All assets are depreciated on a straight-line basis over the estimated useful lives of the assets or the term of the lease, whichever is shorter.

#### (e) Grants

Grants are reported as an expense and liability of the Foundation when approved by the Foundation's Board of Directors. Payments due in more than one year are discounted to present value based on risk-free rates of return.

#### (f) Cash Equivalents

Cash equivalents represent short-term investments with maturities of three months or less at the time of purchase, except for those short-term investments managed by the Foundation's investment managers as part of their long-term investment strategies.

**THE WALLACE FOUNDATION**

Notes to Financial Statements

December 31, 2004 and 2003

**(g) Use of Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**(3) Investments**

At December 31, 2004 and 2003, the fair value of investments consisted of the following:

	2004	2003
Fixed income	\$ 172,210,165	285,648,314
Equities	1,141,226,939	937,860,898
Short-term investments	47,807,148	32,510,323
Accrued investment income	1,353,809	2,041,967
Payable for investments purchased, net	(4,626,006)	(6,355,359)
	\$ 1,357,972,055	1,251,706,143

Short-term investments include money market funds, commercial paper, and cash managed by the Foundation's investment managers as part of their long-term investment strategies. Equities include \$259 million and \$154 million in limited partnerships that invest in hedge funds, real estate, and private equities as of December 31, 2004 and 2003, respectively. At December 31, 2004, the Foundation had unfunded commitments in private equities of approximately \$41 million.

**(4) Grants Payable**

At December 31, 2004, grants scheduled to be paid in future years are as follows:

	Amount
Year:	
2005	\$ 15,618,220
2006	5,445,000
2007	4,000,000
2008	3,250,000
2009	2,000,000
	30,313,220
Less discount to present value (based on interest rates from 2.09% to 3.81%)	(1,227,452)
	\$ 29,085,768

## THE WALLACE FOUNDATION

### Notes to Financial Statements

December 31, 2004 and 2003

#### (5) Federal Excise Tax

As a private foundation, the Foundation is normally subject to a Federal excise tax equal to 2% of its net investment income for tax purposes. However, under Section 4940(e) of the Code, this tax is reduced to 1% if certain conditions are met. The Foundation's December 31, 2004 and 2003 current taxes are estimated at 1% of net investment income.

The Foundation records a liability for deferred Federal excise tax at the 2% rate on the total unrealized appreciation in the fair value of investments. The Federal excise tax will be paid as realized gains are reported for tax purposes. The unrealized gains on investments are reported net of the deferred Federal excise tax expense of \$2,347,821 and \$1,253,930 for the years ended December 31, 2004 and 2003, respectively, on the statements of activities.

#### (6) Other Income

The Foundation received \$134,460 in 2003 from claims made under the Foundation's Directors and Officers Liability insurance policy for reimbursement of legal fees paid.

#### (7) Financial Instruments

Investments are stated at fair value. The carrying amount of cash equivalents and cash, prepaid expenses and receivables, accrued expenses and other payables, and grants payable approximates fair value because of the short maturities of these financial instruments.

The Foundation permits several of its investment managers to invest, within prescribed limits, in financial futures (primarily U.S. Treasury futures) and options, and to sell securities not yet purchased for hedging purposes and for managing the asset allocation and duration of the fixed income portfolios. At December 31, 2004 and 2003, the Foundation held U.S. Treasury and eurodollar futures contracts with notional amounts of approximately \$73 million and \$86 million, respectively. The contracts are valued daily using the mark-to-market method.

The collateral on deposit with a third party to meet margin requirements for futures contracts and options, included in short-term investments, was approximately \$159,000 and \$352,000 at December 31, 2004 and 2003, respectively.



# THE WALLACE FOUNDATION

## Notes to Financial Statements

December 31, 2004 and 2003

### (8) Lease Commitments

The Foundation occupies office space under a lease agreement expiring in February 2006. During the years ended December 31, 2004 and 2003, rent expense for 2 Park Avenue, including escalations, was \$791,671 and \$750,865, respectively.

In November 2004, the Foundation signed a lease for new office space at 5 Penn Plaza. Under the terms of the lease, rent will commence in March 2006 and continue for a 15-year period.

The Foundation's anticipated total contractual lease commitments are as follows:

Year:	<u>2 Park Avenue</u>	<u>5 Penn Plaza</u>	<u>Total</u>
2005	\$ 653,000	—	653,000
2006	109,000	650,000	759,000
2007	—	780,000	780,000
2008	—	827,000	827,000
2009	—	836,000	836,000
2010 and thereafter	—	11,125,000	11,125,000
	<u>\$ 762,000</u>	<u>14,218,000</u>	<u>14,980,000</u>

### (9) Pension Plans

The Foundation provides a defined contribution, tax-deferred annuity retirement plan for all eligible employees, whereby the Foundation contributes 15% of a participant's eligible earnings on an annual basis. In addition, the Foundation provides a supplemental executive retirement plan for the benefit of certain eligible employees. Total pension expense for the years ended December 31, 2004 and 2003 was \$642,379 and \$616,423, respectively.