THE WALLACE FOUNDATION

Financial Statements

December 31, 2005 and 2004

(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, 2005 and 2004, 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of The Wallace Foundation as of December 31, 2005 and 2004, and the changes in its net assets and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

KPMG LLP

May 10, 2006

THE WALLACE FOUNDATION

Balance Sheets

December 31, 2005 and 2004

Assets	2005	2004
Cash equivalents and cash	$ 8,509,074	5,372,460
Investments (note 3)	1,434,798,736	1,357,972,055
Prepaid expenses and receivables	173,623	981,559
Fixed assets, net of accumulated depreciation of $327,155 in 2005 and $1,733,034 in 2004	3,818,228	327,962
	$ 1,447,299,661	1,364,654,036
Liabilities and Net Assets		
Liabilities:		
Accrued expenses and other payables	$ 2,073,864	1,399,285
Grants payable (note 4)	39,835,144	29,085,768
Deferred liabilities, net (note 5)	6,073,763	3,601,751
Total liabilities	47,982,771	34,086,804
Net assets – unrestricted	1,399,316,890	1,330,567,232
	$ 1,447,299,661	1,364,654,036

See accompanying notes to financial statements.

THE WALLACE FOUNDATION

Statements of Activities

Years ended December 31, 2005 and 2004

	2005	2004
Revenues:		
Investment income:		
Dividends	$ 21,326,045	19,317,471
Interest	10,156,120	8,451,585
	31,482,165	27,769,056
Investment fees	(7,083,400)	(4,932,199)
Net investment income	24,398,765	22,836,857
Stock contributions received	148,759	—
	24,547,524	22,836,857
Expenses:		
Grants and related activities	68,285,241	59,577,870
Operating expenses	9,829,469	9,004,347
Current federal excise tax (note 6)	1,663,279	470,372
	79,777,989	69,052,589
Investment gains:		
Unrealized gains, net (note 6)	26,996,681	123,650,065
Realized gains, net	96,983,442	25,512,807
Net investment gains	123,980,123	149,162,872
Increase in net assets	68,749,658	102,947,140
Net assets:		
Beginning of year	1,330,567,232	1,227,620,092
End of year	$ 1,399,316,890	1,330,567,232

See accompanying notes to financial statements.

THE WALLACE FOUNDATION

Statements of Cash Flows

Years ended December 31, 2005 and 2004

		2005	2004
Cash flows from operating activities:			
Increase in net assets	$	68,749,658	102,947,140
Adjustments to reconcile increase in net assets to net cash used in operating activities:			
RDA preferred stock received		(148,759)	—
Unrealized gains on investments		(27,528,451)	(125,997,886)
Realized gains on investments		(96,983,442)	(25,512,807)
Loss on disposal of fixed assets		98,050	—
Depreciation		227,349	193,560
Deferred landlord's incentive		1,940,242	—
Deferred federal excise tax expense		531,770	2,347,821
Change in assets and liabilities:			
Decrease in accrued investment income		342,862	688,158
Decrease in prepaid expenses and receivables		807,936	389,073
Increase in accrued expenses and other payables		674,579	405,204
Increase in grants payable		10,749,376	3,643,258
Net cash used in operating activities		(40,538,830)	(40,896,479)
Cash flows from investing activities:			
Sales of investments		1,474,612,370	1,163,202,707
Purchases of investments		(1,427,121,261)	(1,118,646,084)
Proceeds from disposal of fixed assets		7,400	—
Purchases of fixed assets		(2,220,137)	(127,911)
Leasehold improvements from landlord's incentive		(1,602,928)	—
Net cash provided by investing activities		43,675,444	44,428,712
Net increase in cash equivalents and cash		3,136,614	3,532,233
Cash equivalents and cash at beginning of year		5,372,460	1,840,227
Cash equivalents and cash at end of year	$	8,509,074	5,372,460

See accompanying notes to financial statements.

THE WALLACE FOUNDATION

Notes to Financial Statements

December 31, 2005 and 2004

(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 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. Computers and office equipment is depreciated over three years. Furniture and leasehold improvements are depreciated over the life of the lease.

(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.

(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, 2005 and 2004, the fair value of investments consisted of the following:

	2005	2004
Fixed income	$ 170,967,801	172,210,165
Equities	1,227,343,723	1,141,226,939
Short-term investments	48,081,507	47,807,148
Accrued investment income	1,010,947	1,353,809
Payable for investments purchased, net	(12,605,242)	(4,626,006)
	$ 1,434,798,736	1,357,972,055

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 $344 million and $259 million in limited partnerships that invest in hedge funds, real estate, and private equities as of December 31, 2005 and 2004, respectively. At December 31, 2005 and 2004, the Foundation had unfunded commitments in private equities of approximately $81 million and $41 million, respectively.

(4) Grants Payable

At December 31, 2005, grants scheduled to be paid in future years are as follows:

	Amount
Year:	
2006	$ 25,109,500
2007	8,680,000
2008	5,250,000
2009	2,000,000
	41,039,500
Less discount to present value (based on interest rates from 2.33% to 4.47%)	(1,204,356)
	$ 39,835,144

(5) Deferred Liabilities

At December 31, 2005 and 2004, deferred liabilities consisted of the following:

		2005	2004
Federal excise tax (note 6)	$	4,133,521	3,601,751
5 Penn Plaza landlord incentives		1,940,242	—
	$	6,073,763	3,601,751

(6) 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, 2005 and 2004 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 $531,770 and $2,347,821 for the years ended December 31, 2005 and 2004, respectively, on the statements of activities.

(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, 2005 and 2004, the Foundation held U.S. Treasury and eurodollar futures contracts with notional amounts of approximately $40 million and $73 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 $123,000 and $159,000 at December 31, 2005 and 2004, respectively.

(8) Lease Commitments

On November 21, 2005, the Foundation ended its office rental lease at 2 Park Avenue. Under the Foundation's new lease for office space at 5 Penn Plaza, rent will commence in March 2006 and continue for a 15-year period.

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

	5 Penn Plaza
Year:	
2006	$ 650,000
2007	780,000
2008	827,000
2009	836,000
2010	883,000
2011 and thereafter	10,242,000
	$ 14,218,000

During the years ended 2005 and 2004, rent expense for 2 Park Avenue, including escalations, was $747,738 and $791,671, respectively.

(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, 2005 and 2004 was $599,150 and $642,379, respectively.