THE WALLACE FOUNDATION

Financial Statements

December 31, 2006 and 2005

(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, 2006 and 2005, 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, 2006 and 2005, 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 31, 2007

THE WALLACE FOUNDATION

Balance Sheets

December 31, 2006 and 2005

Assets		**2006**	**2005**
Cash equivalents and cash	$	35,363,346	8,509,074
Investments (note 3)		1,547,658,567	1,434,798,736
Prepaid expenses and receivables		336,316	173,623
Fixed assets, net of accumulated depreciation of $436,410 in 2006 and $327,155 in 2005		3,618,829	3,818,228
	$	1,586,977,058	1,447,299,661
Liabilities and Net Assets			
Liabilities:			
Accrued expenses and other payables	$	2,134,890	2,073,864
Grants payable (note 4)		52,883,861	39,835,144
Deferred liabilities, net (note 5)		8,215,024	6,073,763
Total liabilities		63,233,775	47,982,771
Net assets – unrestricted		1,523,743,283	1,399,316,890
	$	1,586,977,058	1,447,299,661

See accompanying notes to financial statements.

THE WALLACE FOUNDATION

Statements of Activities

Years ended December 31, 2006 and 2005

	2006	2005
Revenues:		
Investment income:		
Dividends	$ 29,841,119	21,326,045
Interest	12,751,232	10,156,120
	42,592,351	31,482,165
Investment fees	(8,641,500)	(7,083,400)
Net investment income	33,950,851	24,398,765
Stock contributions received	194,499	148,759
	34,145,350	24,547,524
Expenses:		
Grants and related activities	78,238,732	68,285,241
Operating expenses	9,771,018	9,829,469
Current federal excise tax (note 6)	2,179,567	1,663,279
	90,189,317	79,777,989
Investment gains:		
Unrealized gains, net (note 6)	97,126,406	26,996,681
Realized gains, net	83,343,954	96,983,442
Net investment gains	180,470,360	123,980,123
Increase in net assets	124,426,393	68,749,658
Net assets:		
Beginning of year	1,399,316,890	1,330,567,232
End of year	$ 1,523,743,283	1,399,316,890

See accompanying notes to financial statements.

THE WALLACE FOUNDATION

Statements of Cash Flows

Years ended December 31, 2006 and 2005

	2006	2005
Cash flows from operating activities:		
Increase in net assets	$ 124,426,393	68,749,658
Adjustments to reconcile increase in net assets to net cash used in operating activities:		
RDA preferred stock received	(194,499)	(148,759)
Unrealized gains on investments	(99,108,576)	(27,528,451)
Realized gains on investments	(83,343,954)	(96,983,442)
Loss on disposal of fixed assets	—	98,050
Depreciation	285,532	227,349
Deferred landlord’s incentive	159,091	1,940,242
Deferred federal excise tax expense	1,982,170	531,770
Change in assets and liabilities:		
(Increase) decrease in accrued investment income	(1,394,129)	342,862
(Increase) decrease in prepaid expenses and receivables	(162,693)	807,936
Increase in accrued expenses and other payables	61,026	674,579
Increase in grants payable	13,048,717	10,749,376
Net cash used in operating activities	(44,240,922)	(40,538,830)
Cash flows from investing activities:		
Sales of investments	1,411,324,452	1,474,612,370
Purchases of investments	(1,340,143,125)	(1,427,121,261)
Proceeds from disposal of fixed assets	—	7,400
Purchases of fixed assets	(86,133)	(2,220,137)
Leasehold improvements from landlord’s incentive	—	(1,602,928)
Net cash provided by investing activities	71,095,194	43,675,444
Net increase in cash equivalents and cash	26,854,272	3,136,614
Cash equivalents and cash at beginning of year	8,509,074	5,372,460
Cash equivalents and cash at end of year	$ 35,363,346	8,509,074

See accompanying notes to financial statements.

(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.

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(g) Use of Estimates

The preparation of financial statements in conformity with U.S. 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, 2006 and 2005, the fair value of investments consisted of the following:

	2006	2005
Fixed income	$ 167,985,673	170,967,801
Equities	1,321,342,995	1,227,343,723
Short-term investments	57,229,215	48,081,507
Accrued investment income	2,405,076	1,010,947
Payable for investments purchased, net	(1,304,392)	(12,605,242)
	$ 1,547,658,567	1,434,798,736

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 $382 million and $344 million in limited partnerships that invest in hedge funds, real estate, and private equities as of December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, the Foundation had unfunded commitments in private equities of approximately $154 million and $81 million, respectively.

(4) Grants Payable

At December 31, 2006, grants scheduled to be paid in future years are as follows:

	Amount
Year:	
2007	$ 30,555,560
2008	19,800,000
2009	3,999,150
2010	585,000
	54,939,710
Less discount to present value (based on interest rates from 2.33% to 5.02%)	(2,055,849)
	$ 52,883,861

(5) Deferred Liabilities

At December 31, 2006 and 2005, deferred liabilities consisted of the following:

		2006	2005
Federal excise tax (note 6)	$	6,115,691	4,133,521
5 Penn Plaza landlord incentives		2,099,333	1,940,242
	$	8,215,024	6,073,763

(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, 2006 and 2005 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 $1,982,170 and $531,770 for the years ended December 31, 2006 and 2005, 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, 2006 and 2005, the Foundation held U.S. Treasury and eurodollar futures contracts with notional amounts of approximately $35 million and $40 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 $235,000 and $123,000 at December 31, 2006 and 2005, respectively.

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(8) Lease Commitments

The Foundation occupies office space under a lease agreement expiring in 2021.

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

		5 Penn Plaza
Year:		
2007	$	780,000
2008		827,000
2009		836,000
2010		883,000
2011		893,000
2012 and thereafter		9,348,000
	$	13,567,000

During the years ended 2006 and 2005, rent expense, including escalations, was $899,407 and $747,738, 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, 2006 and 2005 was $667,178 and $599,150, respectively.