KPMG

THE WALLACE FOUNDATION

Financial Statements

December 31, 2008 and 2007

(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, 2008 and 2007, 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, 2008 and 2007, 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

June 8, 2009

THE WALLACE FOUNDATION

Balance Sheets

December 31, 2008 and 2007

Assets	**2008**	**2007**
Cash equivalents and cash	$ 50,684,890	24,751,386
Investments (note 3)	1,057,958,591	1,670,012,515
Other assets and receivables	3,382,564	1,075,198
Fixed assets, net of accumulated depreciation of $1,012,708 in 2008 and $713,662 in 2007	3,190,006	3,387,210
	$ 1,115,216,051	1,699,226,309
Liabilities and Net Assets		
Liabilities:		
Accrued expenses and other payables	$ 1,803,386	2,205,421
Grants payable (note 4)	50,767,480	38,777,519
Deferred liabilities, net (note 5)	2,110,866	9,503,812
Total liabilities	54,681,732	50,486,752
Net assets – unrestricted	1,060,534,319	1,648,739,557
	$ 1,115,216,051	1,699,226,309

See accompanying notes to financial statements.

THE WALLACE FOUNDATION

Statements of Activities

Years ended December 31, 2008 and 2007

	2008	2007
Revenues:		
Investment income:		
Dividends	$ 23,048,018	26,001,839
Interest	12,897,627	13,618,530
	35,945,645	39,620,369
Investment fees	(6,732,706)	(8,312,028)
Net investment income	29,212,939	31,308,341
Stock contributions received	—	143,299
	29,212,939	31,451,640
Expenses:		
Grants and related activities	78,482,449	56,317,430
Operating expenses	11,728,388	10,598,801
Current federal excise tax and other taxes (note 6)	336,284	2,126,946
	90,547,121	69,043,177
Investment (losses) gains:		
Unrealized (losses) gains, net (note 6)	(543,664,426)	61,725,345
Realized gains, net	16,793,370	100,862,466
Net investment (losses) gains	(526,871,056)	162,587,811
(Decrease) increase in net assets	(588,205,238)	124,996,274
Net assets:		
Beginning of year	1,648,739,557	1,523,743,283
End of year	$ 1,060,534,319	1,648,739,557

See accompanying notes to financial statements.

THE WALLACE FOUNDATION

Statements of Cash Flows

Years ended December 31, 2008 and 2007

		2008	2007
Cash flows from operating activities:			
(Decrease) increase in net assets	$	(588,205,238)	124,996,274
Adjustments to reconcile (decrease) increase in net assets to net cash used in operating activities:			
RDA preferred stock received		—	(143,299)
Unrealized losses (gains) on investments		551,039,908	(62,985,136)
Realized gains on investments		(16,793,370)	(100,862,466)
Settlement proceeds in excess of fixed assets cost		(4,127)	—
Depreciation		304,979	277,252
Deferred landlord's incentive		(17,464)	28,997
Deferred federal excise tax expense		(7,375,482)	1,259,791
Change in assets and liabilities:			
Accrued investment income		4,991,280	(7,432,463)
Other assets and receivables		(2,307,366)	(738,882)
Accrued expenses and other payable		(402,035)	70,531
Grants payable		11,989,961	(14,106,342)
Net cash used in operating activities		(46,778,954)	(59,635,743)
Cash flows from investing activities:			
Sales of investments		2,865,849,197	1,992,753,083
Purchases of investments		(2,793,033,091)	(1,943,683,667)
Purchases of fixed assets		(103,648)	(45,633)
Net cash provided by investing activities		72,712,458	49,023,783
Net increase (decrease) in cash equivalents and cash		25,933,504	(10,611,960)
Cash equivalents and cash at beginning of year		24,751,386	35,363,346
Cash equivalents and cash at end of year	$	50,684,890	24,751,386

See accompanying notes to financial statements.

(1) Nature of Operations

The Wallace Foundation is the philanthropic legacy of DeWitt and Lila Acheson Wallace, the co-founders of Reader's Digest. The Foundation's mission is to enable institutions to expand learning and enrichment opportunities for all people by supporting and sharing effective ideas and practices. Through an integrated, team-based approach involving research and communications, in addition to grant-making, the Foundation extends its influence beyond its direct grantees. This is a recognition that significant and sustainable change requires information and insight, and the Foundation has set as its strategy to be a "knowledge center" for policy-makers and practitioners in its areas of focus.

The Foundation is currently working in three areas: strengthening education leadership to improve student achievement, improving after-school learning opportunities, and building appreciation and demand for the arts.

(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. Private foundations are required by the Code to distribute annually 5% of the average of the fair market value of their assets no later than the twelve month period following the end of their fiscal year.

(c) Fair Value Hierarchy and Adoption of Statement of Financial Accounting Standards (SFAS 157), Fair Value Measurements

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Effective January 1, 2008, the Foundation adopted Statement of Financial Accounting Standards 157 (SFAS No. 157), *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This pronouncement does not require any new fair value measurements. SFAS No. 157 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities that are traded in an active exchange market.

Level 2: Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted market prices that are traded less frequently than exchange-traded instruments.

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Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the asset or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

Fair value estimates are made at a specific point in time, based on available market information and judgments about the financial asset, including estimates of timing, amount of expected future cash flows and the credit standing of the issuer. In some cases, the fair value estimates cannot be substantiated by comparison to independent markets. In addition, the disclosed fair value may not be realized in the immediate settlement of the financial asset. The disclosed fair values do not reflect any premium or discount that could result from offering for sale at one time an entire holding of a particular financial asset.

Potential taxes and other expenses that would be incurred in an actual sale or settlement are not reflected in amounts disclosed.

(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 are depreciated over three years and office equipment is depreciated over five 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 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.

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(3) Investments

The following table presents the Foundation's fair value hierarchy based on the definition provided in SFAS No. 157 for those assets and liabilities measured at fair value as of December 31, 2008 compared with the total fair value for December 31, 2007.

	2008				2007
	Level 1	Level 2	Level 3	Total fair value	Total fair value
Investments:					
Stocks	$ 195,488,847	—	—	195,488,847	391,321,961
Fixed income	97,978,333	58,782,234	29,956,938	186,717,505	186,388,323
Commingled stock funds	—	260,895,438	—	260,895,438	549,142,764
Hedge funds	—	—	245,967,543	245,967,543	339,849,831
Private equity	—	—	86,027,482	86,027,482	72,358,452
Private real estate	—	—	39,348,954	39,348,954	66,558,739
Private energy	—	—	17,964,680	17,964,680	14,022,017
Short-term investments	7,494,342	13,954,791	—	21,449,133	60,815,435
Accrued investment income	4,846,259	—	—	4,846,259	9,837,539
Payable for purchased, net	(747,250)	—	—	(747,250)	(20,282,546)
Total	$ 305,060,531	333,632,463	419,265,597	1,057,958,591	1,670,012,515

The following table presents a reconciliation for all Level 3 assets measured at fair value for the period January 1, 2008 to December 31, 2008.

	Level 3 investments
Beginning balance, January 1, 2008	
Total net realized and unrealized losses	$ 466,176,272
Purchases and settlements, net	(148,042,659)
Ending balance, December 31, 2008	101,131,984
	$ 419,265,597

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.

At December 31, 2008 and 2007, the Foundation had unfunded commitments in private equities of approximately $168 million and $120 million, respectively.

(4) Grants Payable

At December 31, 2008, grants scheduled to be paid in future years are as follows:

		Amount
Year:		
2009	$	36,124,760
2010		12,455,000
2011		3,237,000
2012		100,000
2013		50,000
		51,966,760
Less discount to present value (based on interest rates from 1.58% to 4.94%)		(1,199,280)
	$	50,767,480

(5) Deferred Liabilities

At December 31, 2008 and 2007, deferred liabilities consisted of the following:

		2008	2007
Federal excise tax (note 6)	$	—	7,375,482
5 Penn Plaza landlord incentives		2,110,866	2,128,330
	$	2,110,866	9,503,812

(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, 2008 and 2007 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 (losses) on investments are reported net of the deferred federal excise tax benefits of $7,375,482 and expenses of $1,259,791 for the years ended December 31, 2008 and 2007, 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.

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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, 2008, the Foundation held no futures contracts. The Foundation held U.S. Treasury and eurodollar futures contracts with notional amounts of approximately $39 million at December 31, 2007. The contracts were valued daily using the mark-to-market method. At December 31, 2007, the collateral on deposit with a third party to meet margin requirements for futures contracts and options, included in short-term investments, was approximately $353,000.

(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:		
2009	$	836,000
2010		883,000
2011		893,000
2012		939,000
2013		947,000
2014 and thereafter		7,462,000
	$	11,960,000

During the years ended 2008 and 2007, rent expense, including escalations, was $844,082 and $840,184, respectively.

(9) Pension Plans

The Foundation provides a defined contribution 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, 2008 and 2007 was $933,323 and $833,119, respectively.