KPMG

THE WALLACE FOUNDATION

Financial Statements

December 31, 2009 and 2008

(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, 2009 and 2008, 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, 2009 and 2008, 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 4, 2010

THE WALLACE FOUNDATION

Balance Sheets

December 31, 2009 and 2008

Assets		**2009**	**2008**
Cash equivalents and cash	$	7,955,236	50,684,890
Investments (note 3)		1,266,354,544	1,057,958,591
Other assets and receivables		2,612,815	3,382,564
Fixed assets, net of accumulated depreciation of $1,314,622 in 2009 and $1,012,708 in 2008		2,910,259	3,190,006
	$	1,279,832,854	1,115,216,051
Liabilities and Net Assets			
Liabilities:			
Accrued expenses and other payables	$	1,300,927	1,803,386
Grants payable (note 4)		32,384,083	50,767,480
Deferred liabilities, net (note 5)		3,126,057	2,110,866
Total liabilities		36,811,067	54,681,732
Net assets – unrestricted		1,243,021,787	1,060,534,319
	$	1,279,832,854	1,115,216,051

See accompanying notes to financial statements.

THE WALLACE FOUNDATION

Statements of Activities

Years ended December 31, 2009 and 2008

	2009	2008
Revenues:		
Investment income:		
Dividends	$ 7,743,503	23,048,018
Interest	10,484,021	12,897,627
	18,227,524	35,945,645
Investment fees	(4,410,695)	(6,732,706)
Net investment income	13,816,829	29,212,939
Expenses:		
Grants and related activities	31,148,087	78,482,449
Operating expenses	12,149,872	11,728,388
Current federal excise tax and other taxes (note 6)	463,953	336,284
	43,761,912	90,547,121
Investment gains (losses):		
Unrealized gains (losses), net (note 6)	234,583,026	(543,664,426)
Realized (losses) gains, net	(22,150,475)	16,793,370
Net investment gains (losses)	212,432,551	(526,871,056)
Increase (decrease) in net assets	182,487,468	(588,205,238)
Net assets:		
Beginning of year	1,060,534,319	1,648,739,557
End of year	$ 1,243,021,787	1,060,534,319

See accompanying notes to financial statements.

THE WALLACE FOUNDATION

Statements of Cash Flows

Years ended December 31, 2009 and 2008

		2009	2008
Cash flows from operating activities:			
Increase (decrease) in net assets	$	182,487,468	(588,205,238)
Adjustments to reconcile increase (decrease) in net assets to net cash used in operating activities:			
Unrealized (gains) losses on investments		(235,624,974)	551,039,908
Realized losses (gains) on investments		22,150,475	(16,793,370)
Settlement proceeds in excess of fixed assets cost		—	(4,127)
Depreciation		301,914	304,979
Deferred landlord's incentive		(26,757)	(17,464)
Deferred federal excise tax expense (benefit)		1,041,948	(7,375,482)
Change in assets and liabilities:			
Accrued investment income		3,217,964	4,991,280
Other assets and receivables		769,749	(2,307,366)
Accrued expenses and other payable		(502,459)	(402,035)
Grants payable		(18,383,397)	11,989,961
Net cash used in operating activities		(44,568,069)	(46,778,954)
Cash flows from investing activities:			
Sales of investments		1,212,717,262	2,241,358,380
Purchases of investments		(1,210,856,680)	(2,168,542,274)
Purchases of fixed assets		(22,167)	(103,648)
Net cash provided by investing activities		1,838,415	72,712,458
Net (decrease) increase in cash equivalents and cash		(42,729,654)	25,933,504
Cash equivalents and cash at beginning of year		50,684,890	24,751,386
Cash equivalents and cash at end of year	$	7,955,236	50,684,890

See accompanying notes to financial statements.

(1) Nature of Operations

The Wallace Foundation (the Foundation) is the philanthropic legacy of DeWitt and Lila Acheson Wallace, the co-founders of Reader's Digest. The Foundation's mission is to improve learning and enrichment opportunities for children 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) Income Taxes

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. As required by the Code, the Foundation distributes annually 5% of the average of the fair market value of its assets no later than the twelve month period following the end of its fiscal year.

In 2009, the Foundation adopted Accounting Standards Update (ASU) 2009-06, *Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*, in conjunction with its adoption of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (now included in Accounting Standards Codification (ASC) Subtopic 740-10, *Income Taxes – Overall*). FASB Interpretation No. 48 addresses the accounting for uncertainties in income taxes recognized in an organization's financial statements and prescribes a threshold of more-likely than-not for recognition and de-recognition of tax positions taken or expected to be taken in a tax return. FASB Interpretation No. 48 also provides related guidance on measurement, classification, interest and penalties, and disclosures. There was no significant impact to the Foundation's financial statements as a result of the adoption of FASB Interpretation No. 48 or ASU 2009-06.

(c) 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. The fair value hierarchy maximizes the use of observable inputs and minimizes the use of unobservable inputs when measuring fair value. The Foundation uses three levels of inputs 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.

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 instrument, 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) Investments

Investments in equity securities with readily determinable fair values are reported at fair value based on quoted market prices. Investments in debt securities are measured using quoted market prices where available. If quoted market prices for debt securities are not available, the fair value is determined using an income approach valuation technique that considers, among other things, rates currently observed in publicly traded markets for debt of similar terms to companies with comparable credit risk, the issuer's credit spread, and illiquidity by sector and maturity.

In 2009, the Foundation adopted the provisions of Accounting Standards Update No. 2009-12, *Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)* (ASU 2009-12), with regard to investments in funds that do not have readily determinable fair values, including private investments, hedge funds, real estate, and other funds. ASU 2009-12 allows for the estimation of the fair value of investments in investment companies for which the investment does not have a readily determinable fair value using net asset value per share or its equivalent. Those estimated fair values may differ significantly from the values that would have been used had a ready market for these securities existed.

Most investments classified in Levels 2 and 3 consist of shares or units in investment funds as opposed to direct interests in the funds' underlying holdings, which may be marketable. Because the net asset value reported by each fund is used as a practical expedient to estimate fair value of the Foundation's interest therein, its classification in Level 2 or 3 is based on the Foundation's ability to redeem its interest at or near December 31. If the interest can be redeemed in the near term, the investment is classified as Level 2. The classification of investments in the fair value hierarchy is not necessarily an indication of the risks, liquidity, or degree of difficulty in estimating the fair value of each investment's underlying assets and liabilities.

In 2009, the Foundation adopted FASB Staff Position FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Has Significantly Decreased and Identifying Transactions That Are Not Orderly*, included in ASC Subtopic 820-10, *Fair Value Measurements and Disclosures*. FAS 157-4 requires additional disclosures including the inputs and valuation techniques used to measure fair value and a change from disclosing securities by major category to disclosing securities by major security type based upon the nature and risk of the security.

(e) 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, office equipment is depreciated over five years, and furniture and fixtures are depreciated over fifteen years. Leasehold improvements are depreciated over the life of the lease or the estimated life of the leasehold improvement, whichever is shorter.

(f) Grants

Grants are reported as an expense and liability of the Foundation when approved by the Foundation's board of directors and communicated to the grantee. Payments due in more than one year are discounted to present value.

(g) 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.

(h) 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.

(i) Reclassifications

Certain reclassifications of 2008 amounts have been made to conform to the 2009 presentation.

(Continued)

(3) Investments

(a) Fair Value Hierarchy

The following tables present the Foundation's fair value hierarchy for investments, the only financial instruments measured at fair value as of December 31, 2009 and 2008:

	2009			
	Level 1	Level 2	Level 3	Total fair value
Stocks:				
Direct ownership – United States	$ 172,755,302	—	—	172,755,302
Mutual funds – international	59,582,106	—	—	59,582,106
Commingled funds:				
United States	—	62,879,885	—	62,879,885
International	—	144,621,677	—	144,621,677
Subtotal	—	207,501,562	—	207,501,562
Total	232,337,408	207,501,562	—	439,838,970
Fixed income:				
Direct ownership:				
United States government/ agency	—	75,835,346	—	75,835,346
United States corporate and other	—	56,928,690	1,181,717	58,110,407
Subtotal	—	132,764,036	1,181,717	133,945,753
Mutual funds:				
United States government/ agency	60,838,575	—	—	60,838,575
United States corporate and other	56,687,272	—	—	56,687,272
International	11,586,710	—	—	11,586,710
Subtotal	129,112,557	—	—	129,112,557
Commingled funds:				
United States corporate and other	—	—	3,944,190	3,944,190
Total	129,112,557	132,764,036	5,125,907	267,002,500
Hedge funds:				
Multistrategy	—	92,572,589	59,575,678	152,148,267
Credit – redeemable	—	13,285,762	34,324,346	47,610,108
Credit – nonredeemable	—	—	36,518,978	36,518,978
Total	—	105,858,351	130,419,002	236,277,353
Inflation hedges:				
Direct ownership – natural resources stocks	24,361,528	—	—	24,361,528
Public energy funds	—	32,566,355	—	32,566,355
Public real estate funds	—	34,580,802	23,897,951	58,478,753
Private energy funds	—	—	22,568,307	22,568,307
Private real estate funds	—	—	18,783,278	18,783,278
Total	24,361,528	67,147,157	65,249,536	156,758,221
Private equity funds	—	—	107,135,374	107,135,374
Short-term investments	7,999,161	37,011,106	—	45,010,267
Accrued investment income	1,628,295	—	—	1,628,295
Receivable for investments sold, net	12,703,564	—	—	12,703,564
Total	$ 408,142,513	550,282,212	307,929,819	1,266,354,544

	2008			
	Level 1	**Level 2**	**Level 3**	**Total fair value**
Stocks:				
Direct ownership – United States	$ 139,603,276	—	—	139,603,276
Mutual funds – international	55,885,571	—	—	55,885,571
Commingled funds:				
United States	—	53,181,718	—	53,181,718
International	—	147,822,874	—	147,822,874
Subtotal	—	201,004,592	—	201,004,592
Total	195,488,847	201,004,592	—	396,493,439
Fixed income:				
Direct ownership:				
United States government/ agency	—	20,452,716	—	20,452,716
United States corporate and other	—	50,514,205	13,294,294	63,808,499
Subtotal	—	70,966,921	13,294,294	84,261,215
Mutual funds:				
United States government/ agency	43,778,330	—	—	43,778,330
United States corporate and other	43,299,400	—	—	43,299,400
International	10,900,603	—	—	10,900,603
Subtotal	97,978,333	—	—	97,978,333
Commingled funds:				
United States corporate and other	—	—	4,477,957	4,477,957
Total	97,978,333	70,966,921	17,772,251	186,717,505
Hedge funds:				
Multistrategy	—	133,398,842	36,247,953	169,646,795
Credit – redeemable	—	—	17,074,595	17,074,595
Credit – nonredeemable	—	—	23,428,156	23,428,156
Total	—	133,398,842	76,750,704	210,149,546
Inflation hedges:				
Public energy funds	—	59,890,846	—	59,890,846
Public real estate funds	—	35,817,997	14,522,712	50,340,709
Private energy funds	—	—	17,964,680	17,964,680
Private real estate funds	—	—	24,826,242	24,826,242
Total	—	95,708,843	57,313,634	153,022,477
Private equity funds	—	—	86,027,482	86,027,482
Short-term investments	7,494,342	13,954,791	—	21,449,133
Accrued investment income	4,846,259	—	—	4,846,259
Payable for investments purchased, net	(747,250)	—	—	(747,250)
Total	$ 305,060,531	515,033,989	237,864,071	1,057,958,591

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.

The following table presents a reconciliation for all Level 3 assets measured at fair value at December 31:

		2009	2008
Beginning balance	$	237,864,071	206,335,820
Total net realized and unrealized gains (losses)		35,197,203	(81,288,473)
Purchases and settlements, net		40,422,887	89,070,784
Transfers (out) in		(5,554,342)	23,745,940
Ending balance	$	307,929,819	237,864,071

(b) Portfolio Liquidity

The Foundation reviews the liquidity of its investments to ensure that it is able to meet its cash needs for grants, operating expenses, and capital calls. As of December 31, 2009, the Foundation had investments of $607.3 million that could be sold on a daily basis under normal market conditions. This included $368.1 million in direct ownership investments held in separate accounts with the Foundation's custodial trustee, $196.6 million in mutual fund investments, $32.6 million in a public energy fund, which is part of the Foundation's inflation hedge portfolio, and $10.0 million in an international commingled stock fund.

The Foundation's investments in commingled bond and stock funds, hedge funds, inflation hedge funds and private equity funds, including the $32.6 million public energy fund and the $10.0 million international commingled stock fund noted above, totaled $687.3 million as of December 31, 2009. The liquidity of these investments is determined by the redemption period for each fund, which differs among investments and is detailed in note 3(c).

(c) Strategies of Commingled, Hedge, Inflation Hedge and Private Equity Funds

The following table lists the investment strategies, redemption terms, and assets for commingled, hedge, inflation hedges and private equity funds measured at fair value as of December 31, 2009:

	Total fair value	Unfunded commitments	Redemption dates per year	Redemption notice period
Commingled bond fund	$ 3,944,190	—	None	N/A
Commingled stock funds:				
United States	62,879,885	—	12	6 – 10 days
International	144,621,677	—	Daily/12	3 – 30 days
Total	207,501,562	—		
Hedge funds:				
Multistrategy	152,148,267	—	1/2/4	45 – 180 days
Credit – redeemable	47,610,108	—	1	60/90 days
Credit – nonredeemable	36,518,978	—	None	N/A
Total	236,277,353	—		
Inflation hedge funds:				
Public energy	32,566,355	—	Daily	1 day
Public real estate	58,478,753	—	1/4	1/45 days
Private energy	22,568,307	15,597,656	None	N/A
Private real estate	18,783,278	11,100,000	None	N/A
Total	132,396,693	26,697,656		
Private equity funds	107,135,374	112,266,255	None	N/A
Total	$ 687,255,172	138,963,911		

The following provides details for the investment strategies listed above:

Commingled Bond Fund

This consists of $3.9 million invested in a fund that invests in co-op mortgage loans that are not traded on public markets. This fund is not redeemable but makes distributions to investors at the manager's discretion. The fund is expected to fully distribute its assets over the next two years.

Commingled Stock Funds

This includes $207.5 million invested in five funds that invest in publicly traded common stock and one fund that invests in a portfolio of publicly traded closed-end mutual funds. These closed-end mutual funds primarily invest in publicly traded common stock.

Multi-Strategy Hedge Funds

This consists of $152.1 million invested in four hedge funds that are fully redeemable with the exception of $7.4 million that is subject to a lock-up restriction that expires on June 30, 2010, and $33.4 million that is subject to a lock-up restriction that expires on December 31, 2010, and $18.7 million in private investments that are expected to be liquidated by the manager over the next two to four years. These hedge funds invest in equity, fixed income and derivative investments and vary their investment strategies in response to changing market opportunities. As of December 31, 2009, the Foundation's combined investments in these funds included 42% equity strategies, 36% credit strategies, 15% private investments and 7% cash.

Credit Hedge Funds – Redeemable

This includes $47.6 million invested in two hedge funds that invest primarily in publicly traded debt securities purchased at discounts to par value, including publicly traded bonds, bank debt, residential and commercial mortgage-backed securities, and other asset-backed securities.

Credit Hedge Fund – Nonredeemable

This consists of $36.5 million invested in a hedge fund that makes distributions to investors at the manager's discretion and is expected to fully distribute its assets over the next five years. The fund invests in publicly traded and private debt securities purchased at discounts to par value.

Public Energy Fund

This includes $32.6 million invested in a fund that invests on a global basis in the publicly traded common stock of energy companies.

Public Real Estate Funds

This consists of $58.5 million invested in two funds that invest primarily in publicly traded equity and debt securities issued by Real Estate Investment Trusts (REITs) and other companies with significant real estate holdings.

Private Energy Funds

This consists of $22.6 million in four funds that make distributions to investors at the managers' discretion and are expected to fully distribute their assets over the next ten years. As of December 31, 2009, the Foundation's combined investments in these funds included 83% private energy funds of funds that invest in diversified portfolios of direct private energy funds and 17% in a direct private energy fund that invests in companies that acquire or develop natural resource reserves, power generation facilities and energy infrastructure assets.

Private Real Estate Funds

This includes $18.8 million invested in three funds that make distributions to investors at the managers' discretion and are expected to fully distribute their assets over the next ten years. These funds invest directly in real estate properties that are not traded on public markets. As of

December 31, 2009, the Foundation's combined investments in these funds included 63% value add and 37% opportunistic investments.

Private Equity Funds

This includes $107.1 million invested in 17 funds that make distributions to investors at the managers' discretion and are expected to fully distribute their assets over the next ten years. As of December 31, 2009, the Foundation's combined investments in these funds included 40% primary funds of funds that invest in a diversified portfolio of buyout and venture capital funds, 38% secondary funds of funds that purchase interests in buyout and venture capital funds on a secondary basis at discounts to net asset value, 15% buyout funds that invest directly in media and financial companies, and 7% venture capital funds that invest directly in technology and media companies.

(4) Grants Payable

At December 31, 2009 and 2008, grants scheduled to be paid in future years are as follows:

		2009	2008
Year:			
2009	$	—	36,124,760
2010		21,474,450	12,455,000
2011		8,102,000	3,237,000
2012		3,100,000	100,000
2013		175,000	50,000
		32,851,450	51,966,760
Less discount to present value (based on interest rates from 0.35% to 4.89% for 2009 and 1.58% to 4.94% for 2008)		(467,367)	(1,199,280)
	$	32,384,083	50,767,480

(5) Deferred Liabilities

At December 31, 2009 and 2008, deferred liabilities consisted of the following:

		2009	2008
Federal excise tax (note 6)	$	1,041,948	—
5 Penn Plaza landlord incentives		2,084,109	2,110,866
	$	3,126,057	2,110,866

(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, 2009 and 2008 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 expense of $1,041,948 and tax benefit of $7,375,482 for the years ended December 31, 2009 and 2008, respectively, on the statements of activities.

(7) Fair Value Disclosures

The carrying amount of cash equivalents and cash, other assets 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, 2009 and 2008, the Foundation held no futures contracts.

(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:		
2010	$	883,000
2011		893,000
2012		939,000
2013		947,000
2014		948,000
2015 and thereafter		6,514,000
	$	11,124,000

During the years ended 2009 and 2008, rent expense, including escalations, was $863,490 and $844,082, 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, 2009 and 2008 was $1,001,928 and $933,323, respectively.

(Continued)

(10) Subsequent Events

In connection with the preparation of the financial statements and in accordance with ASC Subtopic 855-10, *Subsequent Events*, which was adopted in 2009, the Foundation evaluated subsequent events after the balance sheet date of December 31, 2009 through June 4, 2010, which was the date the financial statements were available to be issued and determined that there were no matters that are required to be disclosed.