THE WALLACE FOUNDATION

Financial Statements

December 31, 2003 and 2002

(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, 2003 and 2002, 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 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.

As discussed in note 1 to the financial statements, 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. The financial statements are presented as if the merger had been completed January 1, 2002.

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, 2003 and 2002, 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, 2004

THE WALLACE FOUNDATION

Balance Sheets

December 31, 2003 and 2002

Assets	**2003**	**2002**
Cash equivalents and cash	$ 1,840,227	9,842,285
Investments (note 3)	1,251,706,143	1,137,579,030
Prepaid expenses and receivables	1,370,632	11,615
Fixed assets, net of accumulated depreciation of $1,539,474 in 2003 and $1,340,472 in 2002	393,611	563,284
	$ 1,255,310,613	1,147,996,214
Liabilities and Net Assets		
Liabilities:		
Accrued expenses and other payables	$ 994,081	3,849,416
Grants payable (note 4)	25,442,510	31,584,426
Deferred Federal excise tax (note 5)	1,253,930	—
Total liabilities	27,690,521	35,433,842
Net assets – unrestricted	1,227,620,092	1,112,562,372
	$ 1,255,310,613	1,147,996,214

See accompanying notes to financial statements.

THE WALLACE FOUNDATION

Statements of Activities

Years ended December 31, 2003 and 2002

	2003	2002
Revenues:		
Investment income:		
Dividends	$ 16,293,896	11,987,628
Interest	17,011,276	21,945,468
	33,305,172	33,933,096
Investment fees	(3,183,228)	(2,973,116)
Net investment income	30,121,944	30,959,980
Stock contributions received	202,218	—
Other income (note 6)	134,460	779,200
	30,458,622	31,739,180
Expenses:		
Grants and related activities	43,183,524	38,626,513
Operating expenses	8,655,430	8,224,719
Current Federal excise tax (note 5)	327,653	2,234,801
	52,166,607	49,086,033
Investment gains (losses):		
Unrealized gains (losses), net (note 5)	207,689,827	(231,685,817)
Realized (losses) gains, net (note 3)	(70,924,122)	80,571,136
Net investment gains (losses)	136,765,705	(151,114,681)
Increase (decrease) in net assets	115,057,720	(168,461,534)
Net assets:		
Beginning of year	1,112,562,372	1,281,023,906
End of year	$ 1,227,620,092	1,112,562,372

See accompanying notes to financial statements.

THE WALLACE FOUNDATION

Statements of Cash Flows

Years ended December 31, 2003 and 2002

		2003	2002
Cash flows from operating activities:			
Increase (decrease) in net assets	$	115,057,720	(168,461,534)
Adjustments to reconcile increase (decrease) in net assets to net cash (used in) provided by operating activities:			
RDA preferred stock received		(202,218)	—
Unrealized (gains) losses on investments		(208,943,757)	233,429,457
Realized losses (gains) on investments		70,924,122	(80,571,136)
Depreciation		199,002	191,824
Deferred Federal excise tax expense (benefit)		1,253,930	(1,743,640)
Change in assets and liabilities:			
(Increase) decrease in accrued investment income		(172,112)	1,710,068
(Increase) decrease in prepaid expenses and receivables		(1,359,017)	624,853
(Decrease) increase in accrued expenses and other payables		(2,855,335)	1,947,630
(Decrease) increase in grants payable		(6,141,916)	13,015,376
Net cash (used in) provided by operating activities		(32,239,581)	142,898
Cash flows from investing activities:			
Sales of investments		1,700,687,369	1,951,056,977
Purchases of investments		(1,676,420,517)	(1,950,763,828)
Capital expenditures		(29,329)	(41,580)
Net cash provided by investing activities		24,237,523	251,569
Net (decrease) increase in cash equivalents and cash		(8,002,058)	394,467
Cash equivalents and cash at beginning of year		9,842,285	9,447,818
Cash equivalents and cash at end of year	$	1,840,227	9,842,285

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 Achesan 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 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 investments is based upon quotations obtained from national securities exchanges; where securities are not listed on an exchange, quotations are obtained from other published sources. Investments in limited partnerships are reported at fair value based on information provided by the manager of the interest. The general partner determines the fair value based on quoted market prices, if available, or using 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.

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(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.

(h) Reclassifications

Certain 2002 amounts have been reclassified to conform to the 2003 presentation.

(3) Investments

At December 31, 2003 and 2002, the fair value of investments consisted of the following:

	2003	2002
Fixed income	$ 285,648,314	439,183,721
Equities	937,860,898	444,675,740
RDA – common stock	—	190,841,153
Short-term investments	32,510,323	116,283,432
Accrued investment income	2,041,967	1,869,855
Payable for investments purchased, net	(6,355,359)	(55,274,871)
	$ 1,251,706,143	1,137,579,030

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 $154 million in limited partnerships that invest in hedge funds, real estate, and private equities. At December 31, 2003 the Foundation had unfunded commitments in private equities of approximately $27 million.

The Foundation realized a net loss of approximately $90.0 million and a net gain of approximately $86.4 million in 2003 and 2002, respectively, from sales of RDA stock.

(4) Grants Payable

At December 31, 2003, grants scheduled to be paid in future years are as follows:

		Amount
Year:		
2004	$	11,097,517
2005		13,143,732
2006		245,000
2007		1,000,000
2008		250,000
		25,736,249
Less discount to present value (based on interest rates from 1.3% to 3.28%)		(293,739)
	$	25,442,510

(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, 2003 and 2002 current taxes are estimated at 1% and 2% of net investment income, respectively.

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 $1,253,930 and benefit of $1,743,640 for the years ended December 31, 2003 and 2002, respectively, on the statements of activities.

(6) Other Income

The Foundation received $134,460 and $779,200 in 2003 and 2002, respectively, 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, 2003 and 2002, the Foundation held U.S. Treasury and eurodollar futures contracts with notional amounts of approximately $86 million and $91 million, respectively. The contracts are valued daily using the mark-to-market method.

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The collateral on deposit with a third party to meet margin requirements for futures contracts and options, included in short-term investments, was approximately $352,000 and $680,000 at December 31, 2003 and 2002, respectively.

(8) Lease Commitments

The Foundation occupies office space under a lease agreement expiring in February 2006. The Foundation's total contractual lease commitment is as follows:

		Amount
Year:		
2004	$	653,000
2005		653,000
2006		109,000
	$	1,415,000

Total rent expense, including escalations, was $750,865 and $730,428 for the years ended December 31, 2003 and 2002, 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, 2003 and 2002 was $616,423 and $631,274, respectively.

(10) Merger

As discussed in note 1, the financial statements are presented as if the merger had been completed January 1, 2002. The following provides the combination of net assets and the change in net assets as previously reported in 2002 by each organization.

		DeWitt Wallace-Reader's Digest Fund, Inc.	Lila Wallace - Reader's Digest Fund, Inc.	Combined
Decrease in net assets	$	(102,428,245)	(66,033,289)	(168,461,534)
Net assets:				
Beginning of year		723,423,692	557,600,214	1,281,023,906
End of year	$	620,995,447	491,566,925	1,112,562,372