THE WALLACE FOUNDATION

Financial Statements

December 31, 2007 and 2006

(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, 2007 and 2006, 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, 2007 and 2006, 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 3, 2008

THE WALLACE FOUNDATION

Balance Sheets

December 31, 2007 and 2006

Assets	**2007**	**2006**
Cash equivalents and cash	$ 24,751,386	35,363,346
Investments (note 3)	1,670,012,515	1,547,658,567
Other assets and receivables	1,075,198	336,316
Fixed assets, net of accumulated depreciation of $713,662 in 2007 and $436,410 in 2006	3,387,210	3,618,829
	$ 1,699,226,309	1,586,977,058
Liabilities and Net Assets		
Liabilities:		
Accrued expenses and other payables	$ 2,205,421	2,134,890
Grants payable (note 4)	38,777,519	52,883,861
Deferred liabilities, net (note 5)	9,503,812	8,215,024
Total liabilities	50,486,752	63,233,775
Net assets – unrestricted	1,648,739,557	1,523,743,283
	$ 1,699,226,309	1,586,977,058

See accompanying notes to financial statements.

THE WALLACE FOUNDATION

Statements of Activities

Years ended December 31, 2007 and 2006

	2007	2006
Revenues:		
Investment income:		
Dividends	$ 26,001,839	29,841,119
Interest	13,618,530	12,751,232
	39,620,369	42,592,351
Investment fees	(8,312,028)	(8,641,500)
Net investment income	31,308,341	33,950,851
Stock contributions received	143,299	194,499
	31,451,640	34,145,350
Expenses:		
Grants and related activities	56,317,430	78,238,732
Operating expenses	10,598,801	9,771,018
Current federal excise tax (note 6)	2,126,946	2,179,567
	69,043,177	90,189,317
Investment gains:		
Unrealized gains, net (note 6)	61,725,345	97,126,406
Realized gains, net	100,862,466	83,343,954
Net investment gains	162,587,811	180,470,360
Increase in net assets	124,996,274	124,426,393
Net assets:		
Beginning of year	1,523,743,283	1,399,316,890
End of year	$ 1,648,739,557	1,523,743,283

See accompanying notes to financial statements.

THE WALLACE FOUNDATION

Statements of Cash Flows

Years ended December 31, 2007 and 2006

		2007	2006
Cash flows from operating activities:			
Increase in net assets	$	124,996,274	124,426,393
Adjustments to reconcile increase in net assets to net cash used in operating activities:			
RDA preferred stock received		(143,299)	(194,499)
Unrealized gains on investments		(62,985,136)	(99,108,576)
Realized gains on investments		(100,862,466)	(83,343,954)
Depreciation		277,252	285,532
Deferred landlord's incentive		28,997	159,091
Deferred federal excise tax expense		1,259,791	1,982,170
Change in assets and liabilities:			
Increase in accrued investment income		(7,432,463)	(1,394,129)
Increase in other assets and receivables		(738,882)	(162,693)
Increase in accrued expenses and other payables		70,531	61,026
(Decrease) increase in grants payable		(14,106,342)	13,048,717
Net cash used in operating activities		(59,635,743)	(44,240,922)
Cash flows from investing activities:			
Sales of investments		1,992,753,083	1,411,324,452
Purchases of investments		(1,943,683,667)	(1,340,143,125)
Purchases of fixed assets		(45,633)	(86,133)
Net cash provided by investing activities		49,023,783	71,095,194
Net (decrease) increase in cash equivalents and cash		(10,611,960)	26,854,272
Cash equivalents and cash at beginning of year		35,363,346	8,509,074
Cash equivalents and cash at end of year	$	24,751,386	35,363,346

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 an 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.

(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 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.

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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, 2007 and 2006, the fair value of investments consisted of the following:

	2007	2006
Fixed income	$ 186,388,324	167,985,673
Equities	1,433,253,763	1,321,342,995
Short-term investments	60,815,435	57,229,215
Accrued investment income	9,837,539	2,405,076
Payable for investments purchased, net	(20,282,546)	(1,304,392)
	$ 1,670,012,515	1,547,658,567

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 $493 million and $382 million in limited partnerships that invest in hedge funds, real estate, and private equities as of December 31, 2007 and 2006, respectively. At December 31, 2007 and 2006, the Foundation had unfunded commitments in private equities of approximately $120 million and $154 million, respectively.

(4) Grants Payable

At December 31, 2007, grants scheduled to be paid in future years are as follows:

	Amount
Year:	
2008	$ 27,985,460
2009	9,734,150
2010	2,305,000
2011	200,000
2012	50,000
	40,274,610
Less discount to present value (based on interest rates from 2.86% to 4.94%)	(1,497,091)
	$ 38,777,519

(5) Deferred Liabilities

At December 31, 2007 and 2006, deferred liabilities consisted of the following:

		2007	2006
Federal excise tax (note 6)	$	7,375,482	6,115,691
5 Penn Plaza landlord incentives		2,128,330	2,099,333
	$	9,503,812	8,215,024

(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, 2007 and 2006 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 $1,259,791 and $1,982,170 for the years ended December 31, 2007 and 2006, 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, 2007 and 2006, the Foundation held U.S. Treasury and eurodollar futures contracts with notional amounts of approximately $39 million and $35 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 $353,000 and $235,000 at December 31, 2007 and 2006, 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:		
2008	$	827,000
2009		836,000
2010		883,000
2011		893,000
2012		939,000
2013 and thereafter		8,409,000
	$	12,787,000

During the years ended 2007 and 2006, rent expense, including escalations, was $840,184 and $796,545, 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, 2007 and 2006 was $833,119 and $667,178, respectively.