



**CENGAGE LEARNING HOLDINGS II L.P.**  
(Formerly TL Holdings II L.P.)

(As successor to Thomson Learning,  
a combination of certain assets and liabilities of The Thomson Corporation)

**First Quarter Report**  
**Three Months Ended September 30, 2007**

Unaudited Consolidated and Combined Financial Statements and  
Management's Discussion and Analysis of Financial Condition and Results of Operations

As of the end of the period covered by this quarterly report, Cengage Learning Holdings II L.P. was not subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended. Consequently, this quarterly report has not and will not be filed with the Securities and Exchange Commission (“SEC”). However, Cengage Learning Holdings II L.P. is obligated pursuant to the indentures, dated as of July 5, 2007, among Cengage Learning Acquisitions, Inc. (formerly TL Acquisitions, Inc. and a wholly owned subsidiary of Cengage Learning Holdings II L.P.), the guarantors named therein and The Bank of New York as trustee, and other agreements relating to the Company’s debt and securities, to post, on a publicly accessible page on the Company’s website and otherwise make available, financial information that Cengage Learning Holdings II L.P. would be required to file with the SEC were it subject to Sections 13 or 15(d) of the Securities Exchange Act of 1934, as amended, subject to exceptions consistent with the presentation of financial information in the Cengage Learning Acquisitions, Inc. Offering Memorandum, dated June 22, 2007, relating to the \$1,215,600,000 10.50% Senior Notes due 2015 and the \$519,000,000 13.25% Senior Subordinated Discount Notes due 2015 (the “Offering Memorandum”). This report is made available pursuant to such obligations and is presented on the basis of Cengage Learning Holdings II L.P. and its consolidated subsidiaries, as successor to Thomson Learning, which was comprised of wholly-owned indirect subsidiaries and divisions of The Thomson Corporation (“TOC”), representing the assets, liabilities, revenues and expenses directly attributed to TOC’s Domestic Higher Education and Domestic Library Reference businesses as well as certain international businesses, managed together by a single management team.

**“Safe Harbor” Statement Under the  
Private Securities Litigation Reform Act of 1995**

This quarterly report contains both historical and forward-looking statements. All statements other than statements of historical fact are, or may be deemed to be, forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are not based on historical facts, but rather reflect our current expectations concerning future results and events. These forward-looking statements generally can be identified by the use of statements that include phrases such as “believe,” “expect,” “anticipate,” “intend”, “estimate”, “plan”, “project”, “foresee”, “likely”, “will” or other words or phrases with similar meanings. Similarly, statements that describe our objectives, plans or goals are, or may be, forward-looking statements. These forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be different from any future results, performance and anticipated achievements expressed or implied by these statements. Except as required by law, we do not intend to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In addition, forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from our historical experience and present expectations or projections. These risks and uncertainties include, but are not limited to, those described in the Offering Memorandum.

**CENGAGE LEARNING HOLDINGS II L.P.**  
**(AS SUCCESSOR TO THOMSON LEARNING)**  
**Quarterly Report as of September 30, 2007 (Successor) and**  
**for the Period July 5, 2007 to September 30, 2007 (Successor),**  
**the Period July 1, 2007 to July 4, 2007 (Predecessor) and**  
**the Three Months Ended September 30, 2006 (Predecessor)**  
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**CENGAGE LEARNING HOLDINGS II L.P.**  
**(AS SUCCESSOR TO THOMSON LEARNING)**  
**Consolidated Balance Sheet at September 30, 2007 (Successor)**  
**and Combined Balance Sheet at June 30, 2007 (Predecessor)**  
**(UNAUDITED)**  
**(in thousands of U.S. dollars unless otherwise indicated)**

	<u>Successor</u> <u>September 30,</u> <u>2007</u>	<u>Predecessor</u> <u>June 30,</u> <u>2007</u>
<b>Assets</b>		
Cash and cash equivalents	\$ 115,092	\$ 18,774
Accounts receivable, net	415,866	236,693
Notes receivable from TOC (Predecessor)	-	23,820
Inventories	171,219	185,476
Deferred tax assets	-	57,461
Prepaid expenses and other current assets	56,901	40,611
Total current assets	<u>759,078</u>	<u>562,835</u>
Property, equipment and capitalized software for internal use, net	140,197	150,306
Pre-publication costs, net	215,738	233,862
Author advances, net	34,627	24,809
Identifiable intangible assets, net	3,193,635	572,325
Goodwill	4,271,706	1,387,943
Deferred tax assets	-	4,760
Deferred financing costs	87,545	-
Other non-current assets	15,046	17,817
Total assets	<u>\$ 8,717,572</u>	<u>\$ 2,954,657</u>
<b>Liabilities and Owners' Equity</b>		
Accounts payable and accrued expenses	\$ 320,979	\$ 241,186
Deferred revenue	147,592	133,694
Current portion of long-term debt	34,400	35,000
Capital lease obligation	26,013	26,022
Notes payable to TOC (Predecessor)	-	693,877
Current taxes payable	7,665	12,355
Other current liabilities	24,909	22,136
Total current liabilities	<u>561,558</u>	<u>1,164,270</u>
Long-term debt	5,575,286	14,915
Deferred tax liabilities	822,515	310,949
Other non-current liabilities	39,717	10,760
Total liabilities	<u>6,999,076</u>	<u>1,500,894</u>
Contingencies and guarantees (Note 11)		
Net investment of TOC (Predecessor)	-	1,402,513
Partners' capital (Successor)	1,757,007	-
Accumulated other comprehensive (loss) income	(38,511)	51,250
Total liabilities and owners' equity	<u>\$ 8,717,572</u>	<u>\$ 2,954,657</u>

The accompanying notes are an integral part of these Consolidated and Combined Financial Statements.

**CENGAGE LEARNING HOLDINGS II L.P.**  
**(AS SUCCESSOR TO THOMSON LEARNING)**  
**Consolidated Statement of Operations for the Period July 5, 2007 to September 30, 2007 (Successor) and**  
**Combined Statements of Operations for the Period July 1, 2007 to July 4, 2007 (Predecessor)**  
**and the Three Months Ended September 30, 2006 (Predecessor)**  
**(UNAUDITED)**  
**(In thousands of U.S. dollars unless otherwise indicated)**

	<u>Successor</u>	<u>Predecessor</u>	
	<u>Period July 5, 2007 to September 30, 2007</u>	<u>Period July 1, 2007 to July 4, 2007</u>	<u>Three Months Ended September 30, 2006</u>
Revenues:			
Products	\$ 519,792	\$ 12,920	\$ 512,453
Services and other	111,673	5,756	105,235
Total revenues	<u>631,465</u>	<u>18,676</u>	<u>617,688</u>
Cost of revenues, excluding depreciation stated below:			
Products	205,776	6,845	204,728
Services and other	28,013	1,256	24,698
Amortization of pre-publication costs	44,111	862	46,179
Total cost of revenues, excluding depreciation stated below	<u>277,900</u>	<u>8,963</u>	<u>275,605</u>
Selling, general & administrative, excluding depreciation stated below	97,007	5,001	103,875
Allocation of management costs from TOC (Note 17)	-	821	11,580
Depreciation	13,570	641	13,589
Amortization of identifiable intangible assets	55,292	308	10,012
Total costs and expenses	<u>443,769</u>	<u>15,734</u>	<u>414,661</u>
Operating income	187,696	2,942	203,027
Interest (expense) income with TOC	-	6	(11,010)
Interest (expense) income, net	<u>(130,792)</u>	<u>3</u>	<u>(1,514)</u>
Income before taxes	56,904	2,951	190,503
Provision for income taxes	(1,599)	(1,095)	(73,940)
Equity losses of investee, net of taxes	<u>(1,372)</u>	<u>(63)</u>	<u>(1,578)</u>
Net income	<u>\$ 53,933</u>	<u>\$ 1,793</u>	<u>\$ 114,985</u>

The accompanying notes are an integral part of these Consolidated and Combined Financial Statements.

**CENGAGE LEARNING HOLDINGS II L.P.**  
**(AS SUCCESSOR TO THOMSON LEARNING)**  
**Consolidated Statement of Cash Flows for the Period July 5, 2007 to September 30, 2007 (Successor)**  
**and Combined Statements of Cash Flows for the Period July 1, 2007 to July 4, 2007 (Predecessor)**  
**and the Three Months Ended September 30, 2006 (Predecessor)**  
**(UNAUDITED)**

(In thousands of U.S. dollars unless otherwise indicated)

	<u>Successor</u>	<u>Predecessor</u>	
	<u>Period</u> <u>July 5, 2007 to</u> <u>September 30,</u> <u>2007</u>	<u>Period</u> <u>July 1, 2007</u> <u>to July 4,</u> <u>2007</u>	<u>Three Months</u> <u>Ended</u> <u>September 30,</u> <u>2006</u>
<b>Cash Flows from Operating Activities</b>			
Net income	\$ 53,933	\$ 1,793	\$ 114,985
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of pre-publication costs	44,111	862	46,179
Depreciation	13,570	641	13,589
Amortization of identifiable intangible assets	55,292	308	10,012
Amortization of debt discounts and deferred financing costs	15,298	-	-
Capitalization of interest on Senior Bridge Loan Facility	17,316	-	-
(Benefit) provision for deferred taxes	(585)	826	11,091
Equity losses of investee, net of taxes	1,372	63	1,578
Changes in working capital and other items, net of acquisitions	(25,565)	3,565	(40,080)
Increase in author advances	(9,786)	-	(8,870)
Other, net	303	(91)	(219)
Net cash provided by operating activities	<u>165,259</u>	<u>7,967</u>	<u>148,265</u>
<b>Cash Flows from Investing Activities</b>			
Acquisitions of business, less cash therein	(7,206,831)	-	(21,931)
Capital infusion into equity investee	-	-	(5,222)
Additions to pre-publication costs	(26,403)	(8)	(27,542)
Additions to property, equipment and capitalized software for internal use	(8,736)	-	(10,958)
Proceeds from disposition of property, equipment and capitalized software for internal uses	85	-	-
Other, net	(20)	-	(36)
Net cash used by investing activities	<u>(7,241,905)</u>	<u>(8)</u>	<u>(65,689)</u>
<b>Cash Flows from Financing Activities</b>			
Proceeds from issuance of debt	5,580,202	-	-
Debt issuance costs	(90,673)	-	-
Borrowings under the revolving credit facility	41,500	-	-
Repayments under the revolving credit facility	(41,500)	-	-
Repayments of capital lease obligation	(9)	-	(10)
Capital contribution	1,703,074	-	-
Change in cash overdrafts	(15,902)	(6,908)	7,934
Repayments from notes payable/receivable to TOC, net	-	(5,186)	(174,900)
Increase in net investment of TOC	-	392	88,471
Net cash provided (used) by financing activities	<u>7,176,692</u>	<u>(11,702)</u>	<u>(78,505)</u>
<b>Impact on Cash and Cash Equivalents from</b>			
<b>Change in Foreign Currency</b>	<u>15</u>	<u>-</u>	<u>608</u>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<u>100,061</u>	<u>(3,743)</u>	<u>4,679</u>
<b>Cash and Cash Equivalents</b>			
Beginning of period	15,031	18,774	24,950
End of period	<u>\$ 115,092</u>	<u>\$ 15,031</u>	<u>\$ 29,629</u>

The accompanying notes are an integral part of these Consolidated and Combined Financial Statements.

**CENGAGE LEARNING HOLDINGS II L.P.**  
**(AS SUCCESSOR TO THOMSON LEARNING)**  
**Combined Statement of Owners' Equity and Comprehensive Income**  
**for the Three Months Ended September 30, 2006 (Predecessor)**  
**and the Period July 1, 2007 to July 4, 2007 (Predecessor)**  
**(UNAUDITED)**  
**(In thousands of U.S. dollars unless otherwise indicated)**

	Net Investment of TOC	Accumulated Other Comprehensive Income	Total Owners' Equity	Comprehensive Income
June 30, 2006	\$ 1,433,531	\$ 34,318	\$ 1,467,849	
Increase in net investment of TOC	88,796		88,796	
Net income	114,985		114,985	\$ 114,985
Foreign currency translation adjustment		4,702	4,702	4,702
Unrealized loss on derivative instruments		(47)	(47)	(47)
Comprehensive income				<u>\$ 119,640</u>
September 30, 2006	<u>\$ 1,637,312</u>	<u>\$ 38,973</u>	<u>\$ 1,676,285</u>	
June 30, 2007	\$ 1,402,513	\$ 51,250	\$ 1,453,763	
Increase in net investment of TOC	392		392	
Net income	1,793		1,793	\$ 1,793
Foreign currency translation adjustment		2,273	2,273	2,273
Comprehensive income				<u>\$ 4,066</u>
July 4, 2007	<u>\$ 1,404,698</u>	<u>\$ 53,523</u>	<u>\$ 1,458,221</u>	

The accompanying notes are an integral part of these Consolidated and Combined Financial Statements.

**CENGAGE LEARNING HOLDINGS II L.P.**  
**(AS SUCCESSOR TO THOMSON LEARNING)**  
**Consolidated Statement of Partners' Capital and Comprehensive Income**  
**for the Period July 5, 2007 to September 30, 2007 (Successor)**  
**(UNAUDITED)**  
**(In thousands of U.S. dollars unless otherwise indicated)**

	<b>General Partner's Capital <sup>(1)</sup></b>	<b>Limited Partners' Capital <sup>(1)</sup></b>	<b>Total Partners' Capital</b>	<b>Accumulated Other Comprehensive (Loss)</b>	<b>Total Owners' Equity</b>	<b>Comprehensive Income</b>
July 5, 2007	\$ -	\$ -	\$ -	\$ -	\$ -	
Capital contribution on July 5, 2007 <sup>(1)</sup>		1,703,074	1,703,074		1,703,074	
Net income		53,933	53,933		53,933	\$ 53,933
Foreign currency translation adjustments				7,861	7,861	7,861
Unrealized loss on derivative instruments				(46,372)	(46,372)	(46,372)
Comprehensive income						<u>\$ 15,422</u>
September 30, 2007	<u>\$ -</u>	<u>\$ 1,757,007</u>	<u>\$ 1,757,007</u>	<u>\$ (38,511)</u>	<u>\$ 1,718,496</u>	

<sup>(1)</sup> The General Partner's and Limited Partners' contributions in whole U.S. dollars on July 5, 2007 were \$1.00 and \$1,703,074,189, respectively.

The accompanying notes are an integral part of these Consolidated and Combined Financial Statements.

**CENGAGE LEARNING HOLDINGS II L.P.**  
**(AS SUCCESSOR TO THOMSON LEARNING**  
**Notes to Consolidated and Combined Financial Statements**  
**(UNAUDITED)**  
**(In thousands of U.S. dollars unless otherwise indicated)**

**1. BASIS OF PRESENTATION**

Cengage Learning Holdings II L.P. and its consolidated subsidiaries (hereinafter collectively referred to as “Cengage Learning”, “Successor” or the “Company” for the period July 5, 2007 to September 30, 2007) is the successor to Thomson Learning, which was comprised of wholly-owned indirect subsidiaries and divisions of The Thomson Corporation (“TOC”) managed together by a single management team (hereinafter collectively referred to as “Thomson Learning” or “Predecessor” for the three month period ended September 30, 2006 and the period July 1, 2007 to July 4, 2007).

The accompanying unaudited combined interim financial statements of Thomson Learning reflect the assets, liabilities, revenues and expenses directly attributed to TOC’s Domestic Higher Education and Domestic Library Reference businesses as well as certain international businesses combined on the basis of common control. The unaudited consolidated interim financial statements of Cengage Learning together with the combined interim financial statements of Thomson Learning are hereinafter collectively referred to as the “Financial Statements”.

The Financial Statements are prepared in accordance with the accounting policies described in the Transition Report for the Six Months Ended June 30, 2007 and Annual Report for the Years Ended December 31, 2006, 2005 and 2004 (the “Transition Report”). Certain information and note disclosures included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America (“GAAP”) have been condensed or omitted. The Financial Statements should be read in conjunction with the Transition Report.

In the opinion of management, the Financial Statements include all adjustments (consisting of normal recurring adjustments) considered necessary by management to fairly state the results of operations, financial position and cash flows.

On July 5, 2007, Cengage Learning Holdings II L.P. (i) acquired the stock of certain companies and certain assets, and (ii) assumed certain liabilities, of Thomson Learning from TOC in exchange for cash consideration of \$7,108.9 million, subject to working capital purchase price adjustments (the “Acquisition”). In accordance with Cengage Learning’s accounting policy, the Company has performed a preliminary allocation related to the purchase price of the Acquisition, and the fair value of the net assets acquired of Thomson Learning. The remaining excess cost of the Acquisition over the fair values attributed to underlying net tangible assets and identifiable intangible assets has been assigned to goodwill. As discussed in Note 2, “Acquisition of Thomson Learning”, this preliminary allocation reflects management’s estimates and may be subject to change.

On October 18, 2007, Cengage Learning Holdings II L.P. changed its fiscal year end from December 31 to June 30.

As described in Note 17, “Related Party Transactions”, prior to the Acquisition, Thomson Learning and other subsidiaries of TOC engaged in extensive intercompany transactions, and Thomson Learning relied on TOC for some of its administrative support for which it was allocated costs using methodologies that management believes were reasonable. The amounts recorded for these transactions and allocations were not necessarily representative of the amounts that would have been reflected in the Financial Statements had Thomson Learning been an entity operated independently of TOC. In addition, a variety of transactions occurred between Thomson Learning, TOC and other subsidiaries of TOC. Other than those transactions reflected as notes payable to or receivable from TOC, these transactions are presented in the Predecessor Financial Statements as related party transactions, the net effect of which is presented within "Net investment of TOC" on the Combined Balance Sheet. All transactions recorded through the "Net investment of TOC" are reflected as financing activities in the accompanying Combined Statements of Cash Flows.

Costs incurred by Thomson Learning during the four day period ended July 4, 2007 for employee retention bonuses and professional services fees in connection with the Acquisition amounted to approximately \$500 and have been recorded in “Selling, general & administrative, excluding depreciation stated below”.

**CENGAGE LEARNING HOLDINGS II L.P.**  
**(AS SUCCESSOR TO THOMSON LEARNING**  
**Notes to Consolidated and Combined Financial Statements**  
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**(In thousands of U.S. dollars unless otherwise indicated)**

**Notes Receivable and Notes Payable with TOC**

Prior to the Acquisition, Thomson Learning periodically lent to, or borrowed money from, various subsidiaries of TOC as part of TOC's overall cash management and capitalization program. These arrangements were subject to written loan agreements specifying repayment terms and interest payments. These notes are reflected separately in the Combined Balance Sheet based on their legal form. As the balances pursuant to these notes fluctuated on a frequent basis, Thomson Learning classified both the "Notes receivable from TOC" and "Notes payable to TOC" as a current asset and a current liability, respectively. As these notes were part of TOC's overall capitalization of Thomson Learning, changes in the notes' balances have been reflected as financing activities in the Combined Statements of Cash Flows. Cengage Learning did not acquire these notes receivable or assume these notes payable as part of the Acquisition. (See Note 2, "Acquisition of Thomson Learning".)

**2. ACQUISITION OF THOMSON LEARNING**

On July 5, 2007, Cengage Learning Holdings II L.P. (i) acquired the stock of certain companies and certain assets, and (ii) assumed certain liabilities, of Thomson Learning from TOC in exchange for cash consideration of \$7,108.9 million, subject to working capital purchase price adjustments (the "Acquisition").

The Acquisition was financed through (i) a common equity capital contribution of \$1,703.1 million (the "Equity Contribution") and (ii) \$5,580.2 million in aggregate gross proceeds of debt financing, less \$90.7 million associated with financing fees, (the "Financing Transactions") as follows:

- \$3,440.0 million of borrowings under \$3,740.0 million of senior secured credit facilities, consisting of a \$3,440.0 million term loan facility with a seven-year maturity and a \$300.0 million revolving credit facility with a six-year maturity;
- \$1,215.6 million aggregate principal amount (\$1,200.1 million gross proceeds) of 10.50% senior notes due 2015;
- \$519.0 million aggregate principal amount at maturity (\$400.1 million gross proceeds) of 13.25% senior subordinated discount notes due 2015, for which no cash interest will accrue between the date of original issuance and July 15, 2009; and
- \$540.0 million of borrowings under a senior bridge loan credit facility.

The Financing Transactions, together with the Acquisition and Equity Contribution, are hereinafter referred to as the "Transactions". See Note 8, "Debt" for additional descriptions of the Financing Transactions.

**Preliminary Allocation of the Purchase Price**

A preliminary allocation of the purchase price was performed using information currently available and is based on preliminary estimates of the fair value of assets acquired and liabilities assumed in connection with the Transactions. The final purchase price allocation is dependent upon, among other things, the finalization of asset and liability valuations. A final determination of these fair values will reflect management's consideration of a final valuation prepared by third-party appraisers and will be based on the actual net tangible and identifiable intangible assets that existed as of July 5, 2007. Any final adjustment will change the allocations of purchase price, which could affect the fair values assigned to the assets and liabilities, including a change to goodwill.

**CENGAGE LEARNING HOLDINGS II L.P.**  
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The estimated values of assets and liabilities have been based on a preliminary purchase price which was calculated as follows:

	<u>(in millions)</u>
Acquisition consideration	\$ 7,108.9
Transaction costs (a)	57.7
Retirement of U.K. pension obligation (b)	40.2
Total preliminary allocable purchase price	\$ 7,206.8
<b>Estimated Allocation of Purchase Price<sup>(1)</sup></b>	
	<u>(in millions)</u>
Company net assets	\$ 1,458.2
Assets and liabilities retained by TOC, net (c)	732.2
Deferred tax adjustments (d)	101.4
Historical net investment of TOC as adjusted for assets and liabilities not acquired	2,291.8
Purchase accounting adjustments:	
Reverse historical intangibles and goodwill (e)	(1,962.0)
Deferred taxes relating to purchase accounting (f)	(674.6)
Deferred revenue	34.4
Other, net	4.1
	(306.3)
Identifiable intangible assets (g)	3,249.0
Goodwill (h)	4,264.1
	\$ 7,206.8

<sup>(1)</sup> As of July 5, 2007.

- (a) Includes \$36.4 million of fees paid to certain affiliates of Apax Partners L.P. (hereinafter, collectively referred to as “Apax”) in connection with the Acquisition. See Note 17, “Related Party Transactions”.
- (b) Represents £20 million put into escrow to fund The Thomson Corporation PLC pension plan pursuant to Sections 75 and 75A of the U.K. Pensions Act of 1995 and the Occupations Pension Schemes (Employer Debt) Regulations 2005.
- (c) Pursuant to the Acquisition Agreement, Cengage Learning did not acquire notes receivable from TOC, notes payable to TOC, current and long-term portions of long-term debt, current taxes payable and certain other indebtedness related to management retention plans.
- (d) Historical deferred taxes and liabilities of one of the Thomson Learning entities are eliminated upon the consummation of the Acquisition because the acquisition of the entity is accounted for as an asset purchase for income tax purposes.
- (e) Historical intangibles and goodwill are eliminated upon the consummation of the Acquisition.
- (f) Represents recognition of deferred income taxes relating to the Acquisition at the corporate level.

**CENGAGE LEARNING HOLDINGS II L.P.**  
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**Notes to Consolidated and Combined Financial Statements**  
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- (g) Based on management's estimate including management's consideration of preliminary external valuation of identifiable intangible assets consisting primarily of content and customer relationships with a weighted average life of 19 years.
- (h) Represents the excess purchase price over the estimated fair value of net identifiable assets acquired. Goodwill is attributable to Cengage Learning's three segments. Approximately \$1,394 million of goodwill is deductible for tax purposes.

**Transition Services Agreements with TOC**

Concurrent with the consummation of the Acquisition, Cengage Learning entered into a Transition Services Agreement with a subsidiary of TOC. Under the Transition Services Agreement, the TOC subsidiary will provide to Cengage Learning various services, including services relating to financial consolidation and reporting, payroll, technology infrastructure, real estate, treasury and cash management, telecommunications and information technology. Under the Transition Services Agreement, the cost of each transition service generally will be based on a flat fee.

Unless specifically indicated below, all services to be provided under the Transition Services Agreement will be provided for a specified period of time, and Cengage Learning can terminate those services in advance upon 30 days written notice without penalty and in certain circumstances, the TOC subsidiary can terminate some services.

Costs incurred under the Transition Services Agreement for the period July 5, 2007 to September 30, 2007 amounted to approximately \$200.

Concurrent with the consummation of the Acquisition, Cengage Learning also entered into a Human Resources Services Agreement with the same TOC subsidiary. Under the Human Resources Services Agreement, the TOC subsidiary will provide to Cengage Learning certain employee benefit plan, payroll, administration and other human resources services. Under the terms of the agreement, Cengage Learning is required to establish and maintain certain employee benefit plans pursuant to an administrative service contract, insurance or other arrangement entered into between the Company and a vendor approved by the TOC subsidiary and the third-party service provider to be used by the TOC subsidiary in providing the services under the agreement.

The cost of each service provided under the Human Resources Services Agreement is based on either a flat fee or an allocation (based on size or usage) of the cost incurred by TOC in providing the service. All services to be provided under the Human Resources Services Agreement will be provided for a specified period of time, generally two years from the date of the Acquisition, and Cengage Learning does not have the ability to terminate those services or the Human Resources Services Agreement in advance. The TOC subsidiary can generally terminate the services upon six months prior notice.

Costs incurred under the Human Resources Services Agreement for the period July 5, 2007 to September 30, 2007 amounted to \$676.

**Benefit Plans**

Concurrent with the consummation of the Acquisition, all employees of Thomson Learning ceased to be active participants in all TOC sponsored employee benefit and stock-based compensation plans described in Note 13, "Benefit Plans" and Note 14, "Stock-Based Compensation". Post Acquisition, the Company did not retain any obligations under, or liabilities with respect to, these plans.

**Pro Forma Financial Information**

The pro forma results below include the effects of the Acquisition as if it had been consummated as of July 1, 2007 and July 1, 2006 for the 3 months ended September 30, 2007 and September 30, 2006, respectively. The pro-forma results include; (i) the amortization associated with the estimated value of acquired identifiable intangible assets; (ii) interest expense associated with the debt used to fund the Acquisition; and (iii) advisory fees payable to Apax and OMERS Capital Partners ("OMERS") (see Note 17, "Related Party Transactions"). The pro forma results do not include any anticipated benefits from

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cost savings or adjustments to exclude the Allocation of management costs from TOC. Accordingly, the pro forma financial information below is not necessarily indicative of either future results of operations or results that might have been achieved had the Acquisition been consummated as of these dates.

	<b>Three Months Ended September 30, 2007</b>	<b>Three Months Ended September 30, 2006</b>
Revenue	\$ 650,141	\$ 599,392
Operating income	188,374	145,420
Net income	48,617	5,570

### 3. SEASONALITY AND COMPARABILITY

Typically, a greater portion of Cengage Learning's revenue, operating profit and operating cash flow is derived in the first half of the fiscal year because customer buying patterns are concentrated during this period, while costs are incurred more evenly throughout the year. As a result, operating margins generally decrease as the fiscal year progresses. For these reasons, the performance of Cengage Learning's businesses may not be comparable quarter to consecutive quarter and should be considered on the basis of results for the whole year or by comparing results in a quarter with results in the same quarter for the previous year. In addition, as a result of the Acquisition, assets and liabilities have been adjusted to their fair values and accordingly, historical valuation reserves have been eliminated.

Effective January 1, 2007, Thomson Learning adopted the provisions of the Financial Accounting Standards Board ("FASB") Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"). As a result of this change in accounting policy, the Company recorded a non-cash charge of \$2,125 to its opening retained earnings as of January 1, 2007 with an offsetting increase to "Net investment of TOC". Pursuant to the terms of the Acquisition, TOC agreed to indemnify Cengage Learning against certain taxes and associated expenses, including those related to unrecognized tax benefits, imposed on or payable by the Company for any taxable period that ends on or before July 5, 2007 or is allocable to the period ending on the same date.

### 4. CRITICAL ACCOUNTING POLICIES

#### Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in these Financial Statements and accompanying notes. Although these estimates are based on management's best knowledge of current events and actions that Cengage Learning may undertake in the future, actual results could differ from those estimates. These estimates include, but are not limited to, reserve for sales returns, inventory obsolescence reserve, allowance for doubtful accounts, realization of deferred tax assets, the allocation of certain expenses to Thomson Learning (for periods prior to July 5, 2007) and the determination of fair values related to purchase accounting and used in the assessment of the realizability of long-lived assets, goodwill and identifiable intangible assets.

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**Summary of Critical Accounting Policies**

**Revenue Recognition:** Cengage Learning delivers learning solutions for universities, students, professors, libraries, professionals and corporations around the world. These solutions are delivered through specialized content, applications and services. Although printed materials continue to be the most widely-sold learning resource, the Company is increasingly providing customers with electronic resources. Services and other revenues include revenues from the delivery of content in electronic format and administrative services (e.g., distribution, warehousing and payroll). Cengage Learning recognizes revenue when the following four criteria are met:

- persuasive evidence of an arrangement exists;
- delivery has occurred;
- the fee is fixed or determinable; and
- collectibility is probable.

*Print products.* Revenue from the sale of print products, less estimated returns, is recognized when the product is shipped and title passes to the customer. Amounts billed to customers for shipping and handling are classified as revenue.

*Subscription-based products.* Revenues from sales of subscription-based products are recognized ratably over the term of the subscription. Subscription revenue received or receivable in advance of the delivery of services or publications is included in deferred revenue. Incremental costs that are directly related to the subscription revenue are deferred and amortized over the subscription period.

*Multiple element arrangements.* When a sales arrangement requires the delivery of more than one product or service, the individual deliverables are accounted for separately, if applicable criteria are met. Specifically, the revenue is allocated to each deliverable if reliable and objective evidence of fair value for each deliverable is available. The amount allocated to each unit is then recognized when each unit is delivered, provided that all other relevant revenue recognition criteria are met with respect to that unit. If, however, evidence of fair value is only available for undelivered elements, the revenue is allocated first to the undelivered items, with the remainder of the revenue being allocated to the delivered items, according to a calculation known as the residual method. Amounts allocated to delivered items are deferred if there are further obligations with respect to the delivered items. If evidence of fair value is only available for the delivered items, but not the undelivered items, the arrangement is considered a single element arrangement and revenue is recognized as the relevant recognition criteria are met.

**Allowance for Doubtful Accounts and Reserve for Sales Returns:** Most of Cengage Learning's accounts receivable are due from universities, bookstores, students, libraries, professionals and corporations. Trade accounts receivable are recorded at the invoiced amount and do not bear interest. Accounts receivable are reflected net of an allowance for doubtful accounts and sales returns of \$181,966 and \$118,028 at September 30, 2007 and June 30, 2007 respectively. The Company periodically assesses the allowance for doubtful accounts and estimates the amount of future returns by evaluating general factors such as the length of time individual receivables are past due, historical collections and sales returns experience and the economic and competitive environment.

**Inventories:** Inventories, which are principally comprised of books, other print products and electronic media, are stated at lower of cost or market value, with cost determined generally using the weighted average method. Allowances are established to reduce the cost of excess and obsolete inventories to their estimated net realizable value.

**Pre-publication Costs:** Pre-publication costs are costs to create a book or other media, and include costs for the associated delivery method when such media is electronic. Pre-publication costs are amortized upon publication of the title over estimated economic lives of one to six years, being the estimated expected operating life cycle of the title, with a higher proportion of the amortization taken in the earlier years. The amortization method and periods chosen best reflect the expected sales generated from individual titles or programs. See "—Impairment of Long-lived Assets" below.

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**Identifiable Intangible Assets and Goodwill:** Upon acquisition, identifiable intangible assets are recorded at fair value. Identifiable intangible assets with finite lives are amortized over their estimated useful lives. The carrying values of these identifiable intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. The initial test for impairment compares the carrying amounts with the sum of undiscounted cash flows related to the identifiable intangible asset. If the carrying value is greater than the undiscounted cash flows of the asset, the identifiable intangible asset is written down to its estimated fair value.

Goodwill represents the excess of the cost of acquired businesses over fair values attributed to underlying net tangible assets and identifiable intangible assets. The carrying value of goodwill is tested at least annually for impairment on a “reporting unit” level, using a two-step approach. In the first step, the fair value of each reporting unit is determined. If the fair value of a reporting unit is less than its carrying value, this is an indicator that the goodwill assigned to that reporting unit may be impaired. In this case, the second step is to allocate the fair value of the reporting unit to the assets and liabilities of the reporting unit as if it had just been acquired in a business combination, and as if the purchase price was equivalent to the fair value of the reporting unit. The excess of the fair value of the reporting unit over the amounts assigned to its assets and liabilities is referred to as the implied fair value of goodwill. The implied fair value of the reporting unit’s goodwill is then compared to the actual carrying value of goodwill. If the implied fair value is less than the carrying value, an impairment loss is recognized for that excess.

**Impairment of Long-lived Assets:** Management evaluates the impairment of long-lived assets whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. The initial test for impairment compares the carrying amounts with the sum of undiscounted cash flows related to the asset. If the carrying value is greater than the undiscounted cash flows of the asset, the asset is written down to its estimated fair value.

**Income Taxes:** Cengage Learning accounts for income taxes in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 109, *Accounting for Income Taxes* applied to Cengage Learning Holdings II L.P. and each of its consolidated subsidiaries, which are liable for tax in various jurisdictions. No provision for income taxes is recorded for the limited partnership, Cengage Learning Holdings II L.P., as any liabilities or benefits for income taxes flow to the partners and are their obligations or benefits.

In accordance with FASB Interpretation Number 18, *Accounting for Income Taxes in Interim Periods* (“FIN 18”), the Company excluded from the consolidated worldwide effective tax rate computations, certain jurisdictions where no tax benefit of losses, either year-to-date or anticipated for the fiscal year, would be recognized. Accordingly, the tax rate for the first quarter of 2008 excludes the benefit of losses in the United States of America as well as selected foreign jurisdictions in which the Company anticipates providing a full valuation allowance against the loss carry-forward. The effective tax rate is dependent upon the geographic distribution of worldwide earnings or losses, tax regulations in each geographic region, the availability of tax credits and carry-forwards, and the effectiveness of our tax planning strategies. Assumptions used in estimating our annual effective tax rate are regularly monitored and adjusted. If actual results differ from those estimates, future income tax expense could be materially affected.

Deferred income taxes are determined based on the temporary differences between the financial reporting and tax bases of assets and liabilities using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse. A valuation allowance is recorded against deferred income tax assets if management determines that it is more likely than not that such deferred income tax assets will not be realized. The income tax provision for the period shown is the taxes payable or receivable for the period and the change during the period in deferred income tax assets and liabilities.

Cengage Learning recognizes interest and penalties related to income tax matters as a component of income tax expense.

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**5. RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This guidance defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements, to be applied under other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 is effective the first fiscal year beginning after November 15, 2007. Cengage Learning is currently evaluating the impact of this standard on its Financial Statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of SFAS 115*. This guidance provides the option to measure and report certain assets and liabilities at their fair value. SFAS No. 159 is effective as of the beginning of the first fiscal year after November 15, 2007. Cengage Learning is currently evaluating the impact of this standard on its Financial Statements.

**6. INVENTORIES**

Inventories consist of the following:

	<b>Successor</b> <b>September 30,</b> <b>2007</b>	<b>Predecessor</b> <b>June 30,</b> <b>2007</b>
Raw materials	\$ 5,747	\$ 7,955
Work-in-progress	4,003	4,534
Finished goods	170,241	236,662
	179,991	249,151
Obsolescence reserve	(8,772)	(63,675)
Inventories, net	<u>\$ 171,219</u>	<u>\$ 185,476</u>

**7. IDENTIFIABLE INTANGIBLE ASSETS**

A preliminary allocation of the acquisition purchase price (see Note 2, “Acquisition of Thomson Learning”) was performed using information currently available, including preliminary estimates of the fair value of intangible assets. A final determination of these fair values will reflect management’s consideration of a final valuation prepared by third-party appraisers as of the closing date of the Acquisition. Any final adjustment may change the determination and allocation of identifiable intangible assets.

At the date of the Acquisition, management’s estimate of identifiable intangible assets, which included the consideration of a preliminary external valuation, was \$3,249 million consisting primarily of content and customer relationships with a weighted average life of 19 years. Amortization of \$55,292 was recorded during the period July 5, 2007 to September 30, 2007.

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**8. DEBT**

Short-term borrowings consist of the following:

	<u>Successor</u> <u>September 30,</u> <u>2007</u>	<u>Predecessor</u> <u>June 30,</u> <u>2007</u>
Current portion of notes payable, due 2008		\$ 35,000
Current portion of senior secured credit facilities:		
Term loan facility	\$ 34,400	
Capital lease obligation	26,013	26,022
Notes payable to TOC		693,877
	<u>\$ 60,413</u>	<u>\$ 754,899</u>

Long-term debt consists of the following:

	<u>Successor</u> <u>September 30,</u> <u>2007</u>	<u>Predecessor</u> <u>June 30,</u> <u>2007</u>
Senior secured credit facilities:		
Term loan facility	\$ 3,440,000	
Fixed rate notes:		
10.50% Senior Notes due 2015	1,215,600	
Unamortized discount on 10.50% Notes due 2015	(15,022)	
13.25% Senior Subordinated Discount Notes due 2015	519,000	
Unamortized discount on 13.25% Notes due 2015	(107,208)	
Senior Bridge Loan Credit Facility	557,316	
Notes payable, due 2008		\$ 50,000
Unamortized discount on notes payable due 2008		(85)
Total long-term debt	<u>5,609,686</u>	<u>49,915</u>
Less: current portion	<u>(34,400)</u>	<u>(35,000)</u>
	<u>\$ 5,575,286</u>	<u>\$ 14,915</u>

Scheduled payments due on long-term debt as of September 30, 2007, including the capital lease obligation, for the next five years and thereafter are as follows:

<u>Fiscal Year Ending June 30,</u>						
<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>Thereafter</u>	<u>Total</u>
\$ 51,813	\$ 34,400	\$ 34,400	\$ 34,400	\$ 34,400	\$ 5,568,516	\$ 5,757,929

**Notes Payable, Due 2008**

The notes payable bore interest at a rate of 3.5% per year, subject to increase in certain circumstances. Cengage Learning did not assume this liability as part of the Acquisition. (See Note 2, "Acquisition of Thomson Learning").

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### **Senior Secured Credit Facilities**

The senior secured credit facilities provide the Company with variable rate financing of \$3,740.0 million, consisting of a seven year \$3,440.0 million term loan facility and a six year \$300.0 million revolving credit facility (together, the “Senior Credit Facilities”). Concurrent with the Acquisition, the Company borrowed \$3,440.0 million under the term loan facility and incurred \$58.7 million of related financing costs. Such costs are included in “Deferred financing costs” on the Consolidated Balance Sheet and are being amortized over the term of the Senior Credit Facilities. The Senior Credit Facilities also provide the Company with the option to raise, subject to certain limitations, additional incremental term loan facilities, or increase the amount available under its revolving credit facility in an aggregate amount of up to \$750.0 million, which amount may be increased by the amount of any voluntary repayments of the term loans under the Senior Credit Facilities and additional amounts to the extent the Company maintains certain leverage ratios.

Under the Senior Credit Facilities, the Company can elect the tenor of each drawdown and loan rollover, as well as which benchmark interest rate would apply, plus a predefined margin based on the Company’s leverage ratio. The \$3,440 million borrowed under the term loan facility for the period July 5, 2007 to September 30, 2007 bore interest at an average annual rate of 8.08%. In addition, during the quarter the Company borrowed and repaid \$35 million of term loans under the revolver at an average annual rate of 8.07%. The interest rate for term loan borrowings under the term loan facility and the revolving credit facility were the applicable LIBOR rate plus a margin of 2.75% during the quarter. The Company also borrowed and repaid \$6.5 million of swing line loans under the revolver at an average annual rate of 9.86%. The interest rate for swing line loans under the revolving credit facility were the applicable base rate (prime) plus a margin of 1.75% during the quarter. Under the revolver, up to \$150 million is available for the issuance of letters of credit, of which \$35 million was outstanding as at September 30, 2007 at a cost of 2.75% per annum during the quarter.

In addition, there is a commitment fee of 0.50% per annum on unutilized borrowings under the revolving credit facility. The commitment fee, letter of credit fee and margin for borrowings under both the term loan facility and the revolving credit facility may be reduced in the future subject to the Company attaining certain leverage ratios.

Commencing on December 31, 2007, the Company is required to pay quarterly installments of \$8.6 million on the term loans with the remaining amount payable on July 3, 2014. Principal amounts not previously repaid under the revolving credit facility are payable on July 5, 2013.

All obligations under the Senior Credit Facilities are guaranteed by Cengage Learning Holdings II L.P. and substantially all of its material wholly-owned domestic subsidiaries, and are secured by substantially all of the assets of Cengage Learning Holdings II L.P. and such Guarantors, subject to certain customary exceptions.

The Senior Credit Facilities require, among other things, that the Company maintain an agreed upon senior secured leverage ratio. As of September 30, 2007, the Company was in compliance with the applicable senior secured leverage ratio.

Subject to certain exceptions, the credit agreement limits the amount the Company can repay under the senior subordinated discount notes and the loans under the Senior Bridge Facility as well as the Company’s ability to enter into amendments to the senior subordinated discount notes or the Senior Bridge Facility that are materially adverse to the lenders under the Senior Credit Facilities. The Senior Credit Facilities include provisions whereby a portion of excess cash flow, all of the proceeds from any non-permitted debt issuance and a portion of the proceeds from non-ordinary course asset dispositions, subject to certain exceptions and reinvestment rights, would have to be used to partially prepay the term loan. The Senior Credit Facilities also contain certain other customary restrictions, affirmative covenants, negative covenants and events of default.

### **Senior Notes and Senior Subordinated Discount Notes**

The Company issued \$1,215.6 million aggregate principal amount at maturity of senior notes due 2015 (the “Senior Notes”) and \$519.0 million aggregate principal amount at maturity (\$400.1 million in aggregate gross proceeds) of senior subordinated discount notes due 2015 (the “Senior Subordinated Discount Notes” and, together with the Senior Notes, the

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“Notes”). The Company incurred \$21.3 million of related financing costs for the issuance of the Notes, which is included in “Deferred financing costs” on the Consolidated Balance Sheet and is being amortized over the term of the Notes.

Interest on the Senior Notes accrues at the rate of 10.50% per annum and is payable in cash semi-annually in arrears on January 15 and July 15 of each year, commencing on January 15, 2008. The Senior Subordinated Discount Notes will not accrue cash interest prior to July 15, 2009. Thereafter, cash interest will accrue on the Senior Subordinated Discount Notes at the rate of 13.25 % per annum and is payable on January 15 and July 15 of each year, commencing on January 15, 2010.

The Notes are unsecured senior obligations. The Senior Subordinated Discount Notes are subordinate to all senior indebtedness, including the Senior Credit Facilities and the Senior Notes. The Notes are guaranteed by Cengage Learning Holdings II L.P. and each of its domestic subsidiaries that guarantee the Senior Credit Facilities.

In accordance with regulations issued by the IRS, to the extent the Senior Subordinated Discount Notes are considered applicable high yield discount obligations, the Company must make a mandatory principal redemption plus accrued interest at the end of each accrual period ending after July 2012.

The Company has agreed to use its reasonable best efforts to exchange the Notes for new notes registered under the Securities Act of 1933, as amended, with terms substantially identical in all material respects as to the Notes. In the event that the exchange offer registration statement is not filed with the Securities and Exchange Commission on, or prior to the 360<sup>th</sup> day after the original issuance date of the Notes, additional interest will accrue on the Notes.

The indentures that govern the Notes contain certain customary covenants, agreements and events of default.

#### **Senior Bridge Loan Credit Facility**

The senior bridge loan credit agreement (the “Senior Bridge Facility”) provides the Company with financing of \$540.0 million. At the Company’s option, all interest thereunder may be paid in cash, or capitalized through an increase in the principal amount outstanding (“PIK interest”). This election must be made in advance of each rollover. Concurrent with the Acquisition, the Company borrowed \$540.0 million under the Senior Bridge Facility and incurred \$10.7 million of related financing costs. Such costs are included in “Deferred financing costs” on the Consolidated Balance Sheet and are being amortized over the full term of the Senior Bridge Facility.

The initial loans will mature on July 5, 2008 and, to the extent they are then unpaid, will automatically be converted into term loans and the term loans will mature on July 5, 2015. At any time on, or after July 5, 2008, the lenders under the Senior Bridge Facility may request to exchange their loans for senior unsecured PIK notes (the “PIK exchange notes”). The Company is not required to initially issue any PIK exchange notes until it has received exchange requests in an aggregate principal amount of \$50,000,000. Thereafter, requests must be for at least \$1,000,000 in aggregate principal amount. Any PIK exchange notes issued will mature on July 5, 2015. Holders of any PIK exchange notes will have registration rights.

Under the Senior Bridge Facility, the Company can elect the tenor of each loan rollover, as well as which benchmark interest rate would apply, plus a predefined margin. Borrowings under the Senior Bridge Facility currently bear interest at the applicable LIBOR rate plus a margin of 7.75%. Borrowings under the Senior Bridge Facility for the period July 5, 2007 to September 30, 2007 bore interest at an average annual rate of 13.13%. The applicable margin increases by 50 basis points on January 5, 2008 and will increase by an additional 50 basis points at the end of every three month period, up to a maximum interest rate of 13.75% per annum.

The Company elected to capitalize the interest due on the loan through its scheduled rollover date of December 31, 2007. In accordance with regulations issued by the IRS, to the extent these loans are considered applicable high yield discount obligations, the Company must make mandatory principal prepayments and accrued interest beginning in the second half of 2012.

On or after January 6, 2008 and prior to July 5, 2008, the arrangers of the Senior Bridge Facility may request the Company to issue bonds and use the proceeds to repay the loans outstanding under the Senior Bridge Facility.

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Loans under the Senior Bridge Facility are guaranteed on an unsecured basis by Cengage Learning Holdings II L.P.

The Senior Bridge Facility contains certain customary affirmative covenants, negative covenants and events of default.

## **9. FINANCIAL INSTRUMENTS**

Cengage Learning is exposed to market risk from foreign currency exchange rates and interest rates, which could affect operating results, financial position and cash flows. Exposure to these market risks is managed through the regular operating and financing activities and, when appropriate, through the use of derivative financial instruments. These derivative financial instruments are utilized to hedge economic exposures as well as reduce earnings and cash flow volatility resulting from shifts in market rates. As permitted, certain of these derivative contracts may be designated for hedge accounting treatment under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. However, certain of these instruments may not qualify for hedge accounting treatment and, accordingly, the results of operations may be exposed to some level of volatility. Volatility to our results of operations will vary with the type and amount of derivative hedges outstanding, as well as fluctuations in the currency and interest rate market during the period.

The Company periodically may enter into limited types of derivative contracts, including interest rate and cross currency interest rate swap agreements and interest rate collars to manage interest rate exposures, and foreign currency spot, forward, swap and option contracts to manage foreign currency exposures. The fair market values of all these derivative contracts change with fluctuations in interest rates and/or currency rates and are designed so that any changes in their values are offset by changes in the values of the underlying exposures. Derivative financial instruments are held solely as risk management tools and not for trading or speculative purposes.

By their nature, all derivative instruments involve, to varying degrees, elements of market and credit risk not recognized in our financial statements. The market risk associated with these instruments resulting from currency exchange and interest rate movements is expected to offset the market risk of the underlying transactions, assets and liabilities being hedged. The Company's policy is to deal with counterparties having a single A or better credit rating. Credit risk is managed through the continuous monitoring of exposures to such counterparties.

### **Interest Rate Risk Management**

Interest rate swap agreements are used to manage interest rate exposure in order to achieve a desired proportion of variable and fixed rate debt. These derivatives may be designated as fair value hedges or cash flow hedges depending on the nature of the risk being hedged. Thomson Learning did not hold any interest rate swap instruments as of June 30, 2007.

The Company entered into three interest rate swaps with an amortizing aggregate notional amount of \$3,056 million which were designated and accounted for as cash flow hedges. These swaps were structured to hedge the variable LIBOR interest rate component of the term loan borrowings under the Senior Credit Facilities, converting a declining percentage of the debt from a variable rate commitment to a fixed rate commitment, starting initially at 90%, and reducing to 40% over four years. No amount of ineffectiveness was recorded in the Consolidated Statement of Operations and all components of each derivative's gain or loss was included in the assessment of hedge effectiveness.

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The following is a summary of our cash flow hedges as of September 30, 2007:

<u>Date of Execution</u>	<u>Commencement Date</u>	<u>Initial Notional Amount</u>	<u>Fixed Interest Rate</u>	<u>Basis</u>	<u>Maturity</u>	<u>Fair Value Liability</u>
July 24, 2007	September 28, 2007	\$1,375,000	5.314%	LIBOR	2011	\$ 24,449
July 26, 2007	September 28, 2007	1,375,000	5.194%	LIBOR	2011	20,245
August 23, 2007	September 28, 2007	306,000	4.885%	LIBOR	2009	1,678
		<u>\$3,056,000</u>				<u>\$ 46,372</u>

The fair value of our interest rate swap agreements are classified within our Balance Sheets as follows:

	<u>Successor September 30, 2007</u>	<u>Predecessor June 30, 2007</u>
Other current liabilities	\$ 13,830	\$ -
Other non-current liabilities	32,542	-
	<u>\$ 46,372</u>	<u>\$ -</u>

#### **Accumulated Other Comprehensive Loss (“AOCL”)**

During the period July 5, 2007 to September 30, 2007, a \$46,372 after-tax decrease in the fair value of cash flow hedges was recorded in AOCL. This resulted in an ending unrealized loss position relating to derivative instruments in AOCL of the same amount as of September 30, 2007.

There was no AOCL activity associated with derivative financial instruments during the period July 1, 2007 to July 4, 2007.

During the three months ended September 30, 2006, a \$47 after-tax decrease in the fair value of cash flow hedges was recorded in AOCL. No amounts were transferred to earnings as a result of scheduled payments and receipts on our cash flow hedges during the period, which resulted in an ending unrealized loss position relating to derivative instruments in AOCL of \$47 as of September 30, 2006.

## **10. EQUITY**

Under the Cengage Learning Holdings II L.P. partnership agreement, Cengage Learning Holdings II L.P.’s income is allocated to the general partner and the limited partners on a pro rata basis in accordance with the amount of the partners’ contributions to Cengage Learning Holdings II L.P. Partners make capital contributions to Cengage Learning Holdings II L.P. (the “Partnership”) in such amounts and at such times as they mutually agree. The General Partner has absolute discretion to make any distributions to a partner, which include a return of all or any part of such partner’s capital contribution, provided that upon the dissolution of the Partnership, the assets of the Partnership must be distributed as provided in Section 17-804 of the Delaware Revised Uniform Limited Partnership Act.

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**11. CONTINGENCIES AND GUARANTEES**

**Claims and Legal Actions**

Cengage Learning is involved in ordinary and routine litigation incidental to its business. In the opinion of management, there are no pending legal proceedings that would have a material adverse effect on Cengage Learning's business, financial condition or results of operations.

**Guarantees**

Under Cengage Learning's standard terms and conditions of sale, Cengage Learning warrants ownership of its products and provides certain warranties and indemnifications in relation thereto. Cengage Learning is not aware of any instances that would result in payments being made as a result of these warranties and indemnifications, and therefore, no reserve has been recorded in the Financial Statements in relation thereto.

**12. RESTRUCTURING**

**Acquisition-related Programs**

In connection with the Acquisition, management initiated programs related to downsizing the employee base, exiting certain activities and engaging in other actions designed to reduce Cengage Learning's cost structure and improve productivity. Accordingly, Cengage Learning recorded restructuring liabilities in its July 5, 2007 opening balance sheet of \$11,135 (Domestic Higher Education - \$4,295; Domestic Library Reference - \$688; International - \$1,268; Corporate and Other - \$4,884). The liabilities relate to the severance costs associated with the elimination of approximately 300 positions throughout the organization. The restructuring is expected to be completed by June 30, 2008 and all payments are expected to be completed by that time.

The following is a summary of activity in the Acquisition-related restructuring liabilities:

	<u>Severance</u>
July 5, 2007	\$ 11,135
Additions	-
Utilization	(65)
Adjustments	-
September 30, 2007	<u>\$ 11,070</u>

**Pre-Acquisition (Predecessor) Programs**

In 2006, a plan was initiated to centralize the Domestic Higher Education and Domestic Library Reference editorial production and manufacturing processes into one function. The total restructuring costs of \$3,369 (Domestic Higher Education - \$584; Domestic Library Reference - \$2,785) included severance and relocation of employees as well as contract cancellation costs and property and equipment write downs associated with the closure of associated facilities and are included in "Selling, general & administrative, excluding depreciation stated below" on the Combined Statement of Operations. The restructuring was completed by June 30, 2007 and the payments are expected to be completed in 2009.

In 2005, the Domestic Higher Education segment initiated a plan to consolidate three of its office locations and restructure the management of two businesses. The total restructuring costs of \$2,010, which were incurred in 2005 and 2006,

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are included in "Selling, general & administrative, excluding depreciation stated below" on the Combined Statement of Operations. Such costs included severance and relocation of employees as well as contract cancellation costs associated with the closure of these facilities. The restructuring was completed in 2006 and payments are expected to be completed in 2009.

The following is a summary of activity in the Pre-Acquisition (Predecessor) restructuring liabilities:

	<b>Contract Cancellation Costs and</b>		
	<b>Severance</b>	<b>Other</b>	<b>Total</b>
June 30, 2006	\$ 2,580	\$ 1,131	\$ 3,711
Additions	-	252	252
Utilization	(1,072)	(125)	(1,197)
Adjustments	-	-	-
September 30, 2006	<u>\$ 1,508</u>	<u>\$ 1,258</u>	<u>\$ 2,766</u>

	<b>Contract Cancellation Costs and</b>		
	<b>Severance</b>	<b>Other</b>	<b>Total</b>
June 30, 2007	\$ 156	\$ 925	\$ 1,081
Additions	-	-	-
Utilization	(1)	(5)	(6)
Adjustments	-	-	-
July 4, 2007	<u>\$ 155</u>	<u>\$ 920</u>	<u>\$ 1,075</u>
July 5, 2007	\$ 155	\$ 920	\$ 1,075
Additions	-	-	-
Utilization	(4)	(108)	(112)
Adjustments	-	-	-
September 30, 2007	<u>\$ 151</u>	<u>\$ 812</u>	<u>\$ 963</u>

### 13. BENEFIT PLANS

#### Defined Benefit Pension Plans

Prior to the Acquisition, certain employees participated in certain defined benefit pension plans sponsored and administered by TOC. Under these defined benefit plans, Predecessor's cost of contributing to the plans for its employees was determined by TOC and charged to expense as incurred. Predecessor's expense, as allocated based primarily on the number of participants in the plan, was \$3,451 for the three months ended September 30, 2006.

Additionally, select employees participated in supplemental executive retirement plans. These plans provided qualified employees with additional retirement benefits above that received from the TOC qualified plans. The expense associated with these plans was \$429 for the three months ended September 30, 2006.

Predecessor's allocated expense for these plans for the period July 1, 2007 through July 4, 2007 was not significant.

Effective July 5, 2007, all Predecessor employee participants of both the defined benefit pension plans and the supplemental executive retirement plans ceased to be active participants of those plans. Post-Acquisition, Cengage Learning did not retain any obligations under or liabilities with respect to any of these plans.

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**Defined Contribution Plans**

Prior to the Acquisition, certain Predecessor employees in the United States of America (U.S.) participated in a defined contribution savings plan, administered by TOC, under Section 401(k) of the Internal Revenue Code. The plan covered substantially all U.S.-based employees who meet minimum age and service requirements and allows participants to defer a portion of their annual compensation on a pre-tax basis. In addition, certain employees based outside the U.S. participated in similar plans sponsored by TOC. Under these defined contribution plans, the cost of contributing to the plans is charged to expense as incurred. Upon Acquisition, all Predecessor employee participants of these plans ceased to be active participants of the TOC administered plans.

Subsequent to the Acquisition, the Company initiated the Cengage Learning 401(k) Savings Plan in the U.S. The Company matches 100% of employee contributions up to the first 4% of the employee contribution. These matching contributions vest based upon an employee's years of service, including years of service earned as an employee of Predecessor, and become fully vested after four years of service. The Company also initiated defined contribution plans for employees outside the U.S.

**Other Post-Retirement Benefits Plans**

Prior to the Acquisition, certain employees in the U.S. participated in a defined post-retirement benefit plan sponsored and administered by TOC. The plan called for certain medical costs, after deductibles, to be paid for after an eligible employee's retirement. The plan had been closed to new participants since 1993. Predecessor's expense, as allocated by TOC based primarily on the number of participants in the plan, was \$420 for the three months ended September 30, 2006. Certain employees based outside the U.S. participated in similar plans sponsored by TOC. The expense associated with these plans was not significant for the three months ended September 30, 2006.

Predecessor's allocated expense for the period July 1, 2007 through July 4, 2007, for all plans, was not significant. Effective July 5, 2007, all Predecessor employee participants ceased to be active participants of these plans. Post acquisition, Cengage Learning did not retain any obligations under or liabilities with respect to any of these plans.

**14. STOCK-BASED COMPENSATION**

**Employee Stock Purchase Plan**

Prior to the Acquisition, certain eligible employees in the U.S. participated in an Employee Stock Purchase Plan under which participants could purchase common shares of TOC. Effective July 5, 2007, all Predecessor employee participants ceased to be active participants of this plan. Post-Acquisition, Cengage Learning did not retain any obligations under or liabilities with respect to this plan.

**Stock Appreciation Rights**

Prior to the Acquisition, certain employees participated in a TOC-administered plan that provided for the granting of stock appreciation rights ("SAR"). These rights provided the holder with the opportunity to earn a cash award equal to the fair market value of TOC's common shares less the price at which the SAR was issued. Effective July 5, 2007, all Predecessor employee participants ceased to be active participants of this plan. Post-Acquisition, Cengage Learning did not retain any obligations under or liabilities with respect to this plan.

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**Stock Incentive Plan**

Prior to the Acquisition, certain employees also participated in a TOC-administered stock-option plan. Effective July 5, 2007, all outstanding stock-options became fully vested and participants were granted a limited period during which to exercise such options. Predecessor employee participants also ceased to be active participants of this plan. Post-Acquisition, Cengage Learning did not retain any obligations under or liabilities with respect to this plan.

**15. INCOME TAXES**

Cengage Learning's effective income tax rate for the period July 5, 2007 to September 30, 2007 is 2.8%. The effective tax rates for the Predecessor periods July 1, 2007 to July 4, 2007 and the three months ended September 30, 2006 were 37.1% and 38.8% respectively. The Company's effective tax rate reflects the impact of projected loss-making jurisdictions on a full year basis where the associated tax benefits are not anticipated to be realized. For these jurisdictions, no tax provision or benefit is recorded, however due to seasonality of income before tax, these jurisdictions are profitable in the period July 5, 2007 to September 30, 2007.

Cengage Learning had \$3,918 of unrecognized tax benefits as of September 30, 2007. Pursuant to the terms of the Acquisition, TOC agreed to indemnify Cengage Learning against certain taxes and associated expenses imposed on or payable by the Company for any taxable period that ends on or before July 5, 2007 or is allocable to the period ending on the same date. In addition, as a result of the Acquisition, unrecognized tax benefits in the amount of \$6,566 lapsed due to the change in ownership and associated tax grouping statutes within a specific tax jurisdiction.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

Balance at July 1, 2007	\$ 10,484
Decrease due to change in ownership on July 5, 2007	<u>(6,566)</u>
Balance at September 30, 2007	<u><u>\$ 3,918</u></u>

If recognized, all of these benefits would favorably affect income tax expense. As of September 30, 2007, Cengage Learning had accrued an aggregate of \$1,585 for interest and penalties associated with these tax positions.

Prior to the Acquisition, the entities within the Combined Financial Statements were included within consolidated tax returns filed by certain TOC affiliates. As of September 30, 2007, the tax years subject to examination for these TOC affiliates by major jurisdiction were as follows:

<b>Jurisdiction</b>	<b>Tax Year</b>
United States - Federal	2003 - 2006
United Kingdom	2005 - 2006

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**16. SUPPLEMENTAL CASH FLOW INFORMATION**

Details of “Changes in working capital and other items, net of acquisitions” are:

	<u>Successor</u>	<u>Predecessor</u>	
	<u>Period</u> <u>July 5, 2007 to</u> <u>September 30,</u> <u>2007</u>	<u>Period</u> <u>July 1, 2007</u> <u>to July 4,</u> <u>2007</u>	<u>Three Months</u> <u>Ended</u> <u>September 30,</u> <u>2006</u>
Accounts receivable, net	\$ (161,774)	\$ (8,894)	\$ (147,668)
Inventories	14,233	812	26,627
Prepaid expenses and other current assets	(4,193)	(1,037)	(2,770)
Accounts payable and accrued expenses	56,000	9,208	56,516
Accrued interest payable	32,423	-	-
Deferred revenue	35,356	3,784	28,545
Other, net	2,390	(308)	(1,330)
	<u>\$ (25,565)</u>	<u>\$ 3,565</u>	<u>\$ (40,080)</u>

Cash paid for interest expense on debt, including borrowings under the revolving credit facility and the capital lease, and excluding net borrowings from TOC (prior to July 5, 2007), amounted to \$66,600 for the period July 5, 2007 to September 30, 2007 and \$409 for the three months ended September 30, 2006. Amounts paid for interest for the period July 1, 2007 to July 4, 2007 was not significant.

**Non Cash Transactions**

Concurrent with the Acquisition, TOC converted the net amount outstanding under “Notes payable to TOC” and “Notes receivable from TOC” to equity.

During the period July 5, 2007 to September 30, 2007, the Company capitalized the interest accrued on its Senior Bridge Loan Facility of \$17,316.

**17. RELATED PARTY TRANSACTIONS**

Because of the related party relationships outlined below and elsewhere within these Financial Statements, it is possible that the terms of these transactions are not the same as those that would result from transactions among wholly unrelated parties.

**Pre-Acquisition Transactions**

In accordance with Securities and Exchange Commission Staff Accounting Bulletin 1-B, *Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity*, the Combined Financial Statements include an allocation of TOC corporate expenses. The nature of these costs relate to the office of the chief executive and chief financial officers, internal and external audit fees, treasury, investor relations, strategic sourcing and risk management. Such costs were allocated to Thomson Learning based on Thomson Learning’s revenue in proportion to the total revenue of TOC. The amounts allocated to Thomson Learning were \$821 for the period July 1, 2007 through July 4, 2007 and \$11,580 for the three months ended September 30, 2006. Such amounts were selling, general and administrative in nature and are included in “Allocation of management costs from TOC” on the Combined Statements of Operations.

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Thomson Learning generated revenue from related parties of \$2 and \$2,754 during the period from July 1, 2007 through July 4, 2007 and for the three months ended September 30, 2006, respectively.

**Acquisition and Post-acquisition Transactions**

**Advisory Fee Agreements**

Concurrent with the consummation of the Acquisition, Cengage Learning entered into advisory fee agreements with Apax and OMERS, respectively (together, the “Advisory Fee Agreements”). Pursuant to the agreement with Apax, Cengage Learning paid a fee of \$36.4 million upon closing of the Acquisition in consideration of services, advice and assistance provided in connection with the Acquisition. In addition, Cengage Learning is obligated to pay an aggregate annual fee of \$10.0 million, payable quarterly in advance on the first day of each quarter during the term of the Advisory Fee Agreements, in consideration of the services provided under these Advisory Fee Agreements. The Company is also obligated to pay associated out of pocket expenses incurred by Apax and OMERS.

At any time in connection with or in anticipation of a change of control or an initial public offering, Apax and OMERS may elect to receive their advisory fees payable under the Advisory Fee Agreements in a single lump sum cash payment equal to the present value of the then unpaid current and future advisory fees payable under the applicable Advisory Fee Agreement, assuming each agreement terminates on the tenth anniversary of the notice date of such election.

Payment of the fees under the Advisory Fee Agreements is subject to deferral due to restrictions imposed upon Cengage Learning in connection with debt financing. Deferred payments will bear interest at an annual rate of 10%, compounded quarterly, until paid.

The fees under the Advisory Fee Agreements may be increased, by mutual agreement of the parties, in the event that Cengage Learning enters into a significant acquisition.

Each Advisory Fee Agreement terminates upon the earlier of (i) the date on which Apax’s or OMERS’ direct or indirect ownership is below 5%; (ii) payment of the remaining advisory fees in a lump sum; or (iii) as agreed between the parties to each Advisory Fee Agreement.

The Company recorded \$2,361 of expense for Advisory Fees for the period July 5, 2007 to September 30, 2007, which is included in “Selling, general and administrative expense, excluding depreciation” in the Consolidated Statement of Operations. The accrued advisory fees and accrued interest of \$59 are included in “Accounts payable and accrued expenses” on the Consolidated Balance Sheet.

**Agreements with Nelson**

Cengage Learning entered into a Master Services Agreement with Nelson Education, Ltd. (“Nelson”). Nelson is majority owned by funds affiliated with OMERS, with Apax holding the minority interest. Under the Master Services Agreement, Cengage Learning is to provide Nelson with various services including services relating to business and technology services, content services, commission’s services, customer service and operations, management services, fulfillment services and business information support services and Nelson is to provide Cengage Learning with certain real estate services. The cost of each of the services to be provided under the Master Services Agreement is based on a set fee. No fees are payable under the Master Services Agreement for services provided prior to July 1, 2008.

All services under the Master Services Agreement are to be provided for a specified period of time, and Nelson can generally terminate those services in advance upon 30 days written notice without penalty.

In addition, Cengage Learning is party to an Operating Agreement with Nelson under which Nelson is our exclusive authorized distributor for sale and /or distribution of print and electronic publications in Canada. Nelson also has the exclusive right to adapt, customize and translate Cengage Learning publications. The Operating Agreement sets certain

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restrictions on the use of Cengage Learning content, including restricting Nelson's ability to adapt certain texts, limiting the dollar amount of sales of "first edition" texts and restricting Nelson from marketing adaptations or translations it has created outside of Canada.

Nelson is required by the Operating Agreement to pay Cengage Learning royalties of a percentage of net sales for certain specified publications, adaptations of textbooks created by Nelson, translations of textbooks by Nelson and certain Nelson customized products.

Initially the Operating Agreement has an 11-year term to January 1, 2018, and thereafter it is subject to automatic one year extensions unless cancelled by one of the parties. The Operating Agreement may also be terminated upon material breach, bankruptcy or the mutual agreement of the parties.

Cengage Learning recorded revenue from Nelson of \$9,327 for the period July 5, 2007 to September 30, 2007 which is included in "Accounts receivable, net" on the Consolidated Balance Sheet.

## **18. SEGMENT INFORMATION**

Cengage Learning operates in three reportable segments worldwide. Such segments are strategic business groups that offer products and services to target markets. The accounting policies applied by the segments are the same as those applied by the Company. All transactions between reportable segments are eliminated upon consolidation or combination and reflected in the Corporate and other segment. Cengage Learning's segments are:

*Domestic Higher Education.* The Domestic Higher Education segment publishes higher-education textbooks and provides tailored learning solutions for students and professionals.

*Domestic Library Reference.* The Domestic Library Reference segment is a publisher for libraries, schools, and businesses. With its reference content, Cengage Learning creates and maintains databases that are published online, in print and in microform.

*International.* The International segment of Cengage Learning provides learning solutions in various formats to individuals and businesses located outside the U.S..

Cengage Learning discloses information about its reportable segments based on the measures used by management in assessing the performance of those reportable segments. Cengage Learning uses "Segment operating profit", which is operating income before allocation of corporate management costs from TOC (Predecessor) and amortization of identifiable intangible assets, to measure the operating performance of its segments. Management uses this measure because the allocation of corporate management costs from TOC (Predecessor) and the amortization of identifiable intangible assets are not considered to be controllable operating costs for purposes of assessing the current performance of the segments. Segment operating profit does not have any standardized meaning prescribed by GAAP. Total asset information by segment is not shown because it is not provided to or reviewed by the chief operating decision maker.

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Select financial information for Cengage Learning's segments is as follows:

	<b>Successor</b>		<b>Predecessor</b>			
	<b>Period</b>		<b>Period</b>		<b>Three Months</b>	
	<b>July 5, 2007 to September 30, 2007</b>		<b>July 1, 2007 to July 4, 2007</b>		<b>ended September 30, 2006</b>	
	<b>Segment Operating</b>		<b>Segment Operating</b>		<b>Segment Operating</b>	
	<b>Revenues</b>	<b>Profit (Loss)</b>	<b>Revenues</b>	<b>Profit (Loss)</b>	<b>Revenues</b>	<b>Profit (Loss)</b>
Domestic Higher Education	\$ 458,806	\$ 223,964	\$ 14,364	\$ 6,849	\$ 441,256	\$ 198,509
Domestic Library Reference	74,459	24,024	1,426	(158)	80,729	25,271
International	97,395	12,277	2,751	(497)	88,576	9,135
Segment totals	<u>630,660</u>	<u>260,265</u>	<u>18,541</u>	<u>6,194</u>	<u>610,561</u>	<u>232,915</u>
Corporate and other <sup>1</sup>	805	(17,277)	135	(2,123)	7,127	(8,296)
Total	<u>\$ 631,465</u>	<u>\$ 242,988</u>	<u>\$ 18,676</u>	<u>\$ 4,071</u>	<u>\$ 617,688</u>	<u>\$ 224,619</u>

<sup>1</sup> Corporate and other includes shipping and handling revenue, revenue from administrative services, inter-segment eliminations and corporate costs, and the continuing effect of purchase accounting on deferred revenue relating to the Acquisition.

The following table reconciles Segment operating profit per the business segment information to operating income per the Consolidated and Combined Statements of Operations:

	<b>Successor</b>		<b>Predecessor</b>			
	<b>Period</b>		<b>Period</b>			
	<b>July 5, 2007 to September 30, 2007</b>		<b>July 1, 2007 to July 4, 2007</b>			
	<b>Three Months Ended</b>		<b>September 30, 2006</b>			
Segment operating profit	\$	242,988	\$	4,071	\$	224,619
Less: Allocation of management costs from TOC		-		(821)		(11,580)
Less: Amortization of identifiable intangible assets		(55,292)		(308)		(10,012)
Operating income	<u>\$</u>	<u>187,696</u>	<u>\$</u>	<u>2,942</u>	<u>\$</u>	<u>203,027</u>

## 19. SUBSEQUENT EVENTS

Due to the change in control of Thomson Learning resulting from the Acquisition, the capital lease of the building located in Farmington Hills, Michigan, terminated. The Company negotiated an extension of the current lease term and on October 31, 2007 purchased the property by settling the amount of the "Capital lease obligation".

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Throughout this document, references to “we”, “our”, the “Company” and “Cengage Learning” refer to Cengage Learning Holdings II L.P. and its consolidated subsidiaries, as successor to Thomson Learning, which was comprised of certain wholly-owned indirect subsidiaries and divisions of The Thomson Corporation (“TOC”) managed together by a single management team reflecting the assets, liabilities, revenues and expenses directly attributed to TOC’s Domestic Higher Education and Domestic Library Reference businesses as well as certain international businesses (hereinafter referred to as “Thomson Learning” for all periods ending prior to July 5, 2007).

The following discussion and analysis of our financial condition and results of operations contains forward-looking statements about our business, operations and industry that involve risks and uncertainties, such as statements regarding our plans, objectives, expectations and intentions. Our future results and financial condition may differ materially from those we currently anticipate. See “*Safe Harbor Statement Under the Private Securities Litigation Reform Act of 1995.*”

## **Overview**

We are a global print and electronic publisher of textbooks, reference materials and other educational resources for the higher education, professional training and library reference markets.

We operate in the following three reportable segments worldwide:

- *Domestic higher education segment* - publishes higher education textbooks and provides tailored learning solutions, including digital learning solutions, for students, faculty, institutions and professionals.
- *Domestic library reference segment* - provider of authoritative reference and educational content, primarily for academic, public and K-12 libraries.
- *International segment* - sells our U.S. textbooks into international markets, adapts U.S. textbooks for various international markets and publishes and sells textbooks by non-U.S. authors.

We categorize shipping and handling revenue, revenue from administrative services, intersegment elimination, purchase accounting adjustments relating to the Acquisition and corporate costs under a segment reporting line item referred to as “Corporate and other” which represents approximately 1% of our annual consolidated revenues.

## **Sources of Revenue**

*Products.* In our domestic higher education segment, the primary source of revenue is textbooks sold for use in two- and four-year colleges and universities, where professors drive the textbook “adoption” decision by selecting which textbooks will be used in their courses. We predominantly sell to the bookstores and other distribution channels. Students typically purchase textbooks through a college bookstore or online distribution channel. Some schools, like career and for-profit schools, make institutional purchases for all students in a course and charge for the textbooks as part of the course fee. Total revenue is gross textbook sales less the estimated value of returns. In the domestic library reference market, the primary decision makers for purchases are librarians. The sale is often direct, though some libraries purchase from distributors. In addition, some states, municipalities, etc. have formed coalitions to drive uniformity of purchases and achieve scale in their buying. We generate revenue from academic, K-12, public and special (corporate, government and hospital) libraries.

*Services and other.* Services and other revenues include revenues from the delivery of content in electronic format and administrative services such as distribution, warehousing and payroll. In our domestic higher education segment, the adoption and purchase decisions for digital services are similar to print. However, digital products are more likely to be purchased via online channels and typically have a finite time frame (i.e., a semester) after which a user’s access and support are terminated. In the domestic library reference market, providers attempt to encourage repurchase and up-sell by tracking online usage to demonstrate the product’s utility to library end-users.

Services and other revenues also include the continuing effect of purchase accounting on deferred revenue relating to the Acquisition.

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*Operating expenses.* Our operating expenses are comprised principally of:

- products cost of revenues, which are costs directly related to publishing our textbooks and printed proprietary reference materials such as the cost of paper, printing and binding costs and royalty payments to our authors;
- services and other cost of revenues, which are costs directly related to our digital services for the domestic higher education segment and publishing our digital proprietary reference materials such as hosting and subscription services costs and royalty payments to our authors;
- amortization of pre-publication costs, which are costs related to the creation of a book, reference material, or other media, and includes costs for the associated delivery method when such media is electronic;
- selling, general and administrative expenses, which are the salaries and related costs for our sales staff and our other employees and the marketing and administrative costs of operating our business; and
- depreciation and amortization, which represent the depreciation of our property, equipment and capitalized software for internal use as well as the amortization of our identifiable intangible assets.

### **Seasonality**

Typically, a greater portion of our revenue, operating profit and operating cash flow is derived in the first half of the fiscal year because customer buying patterns are concentrated during this period, while costs are incurred more evenly throughout the year. As a result, operating margins generally decrease as the fiscal year progresses. For these reasons, the performance of our businesses may not be comparable quarter to consecutive quarter and should be considered on the basis of results for the whole year or by comparing results in a quarter with results in the same quarter for the previous year.

### **The Acquisition and Related Financing Transactions**

On July 5, 2007, Cengage Learning Holdings II L.P. (i) acquired the stock of certain companies and certain assets; and (ii) assumed certain liabilities, of Thomson Learning from TOC in exchange for cash consideration of \$7,108.9 million, subject to working capital purchase price adjustments (the "Acquisition").

The Acquisition was financed through a common equity capital contribution of \$1,703.1 million and \$5,580.2 million in aggregate gross proceeds of debt financing, less \$90.7 million associated with financing fees, (the "Financing Transactions") as follows:

- \$1,215.6 million aggregate principal amount (\$1,200.1 million gross proceeds) of senior notes;
- \$519.0 million aggregate principal amount at maturity (\$400.1 million gross proceeds) of senior subordinated discount notes, for which no cash interest will accrue between the date of original issuance and July 15, 2009;
- \$3,440.0 million of borrowings under \$3,740.0 million of senior secured credit facilities; and
- \$540.0 million of borrowings under a senior bridge loan credit facility.

### **Transition Services Agreements with TOC**

Concurrent with the consummation of the Acquisition, we entered into a Transition Services Agreement with a subsidiary of TOC. Under the Transition Services Agreement, the TOC subsidiary will provide to us various services, including services relating to financial consolidation and reporting, payroll, technology infrastructure, real estate, treasury and cash management, telecommunications and information technology. Under the Transition Services Agreement, the cost of each transition service generally will be based on a flat fee.

Unless specifically indicated below, all services to be provided under the Transition Services Agreement will be provided for a specified period of time, and we can terminate those services in advance upon 30 days written notice without penalty and in certain circumstances, the TOC subsidiary can terminate some services. We have developed a plan to increase our own internal capabilities in the future to reduce our reliance on TOC for these services.

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We incurred costs under the Transition Services Agreement for the period July 5, 2007 to September 30, 2007 amounted to approximately \$200.

Concurrent with the consummation of the Acquisition, we also entered into a Human Resources Services Agreement with the same TOC subsidiary. Under the Human Resources Services Agreement, the TOC subsidiary will provide to us certain employee benefit plan, payroll, administration and other human resources services. Under the terms of the agreement, We are required to establish and maintain certain employee benefit plans pursuant to an administrative service contract, insurance or other arrangement entered into between ourselves and a vendor approved by the TOC subsidiary and the third-party service provider to be used by the TOC subsidiary in providing the services under the agreement.

The cost of each service provided under the Human Resources Services Agreement is based on either a flat fee or an allocation (based on size or usage) of the cost incurred by TOC in providing the service. All services to be provided under the Human Resources Services Agreement will be provided for a specified period of time, generally two years from the date of the Acquisition, and we do not have the ability to terminate those services or the Human Resources Services Agreement in advance. The TOC subsidiary can generally terminate the services upon six months prior notice.

We incurred costs under the Human Resources Services Agreement for the period July 5, 2007 to September 30, 2007 of \$676.

#### **Stand-alone Company**

Prior to the Acquisition, we operated as divisions of TOC and not as a stand-alone company. The combined financial statements included in this quarterly report have been derived from the accounting records of TOC using the historical results of operations and the historical basis of assets and liabilities directly attributable to Thomson Learning. The historical financial information included in this quarterly report may not reflect what our results of operations, financial position and cash flows would have been had we operated as a separate, stand-alone company without the shared resources of TOC for the periods presented and may not be indicative of our future results of operations, financial position and cash flows. We were allocated general corporate expenses from TOC for corporate-related functions based on our revenue in proportion to the total revenue of TOC. General corporate expense allocations include executive management, internal and external audit fees, treasury, investor relations, strategic sourcing and risk management. We were allocated general corporate expenses from TOC of \$821 and \$11,580 during the four day period ended July 4, 2007 and the three months ended September 30, 2006, respectively. We believe the assumptions and methodologies underlying the allocations of general corporate expenses from TOC are reasonable. However, such expenses are not indicative of, nor is it practical or meaningful for us to estimate for all historical periods presented, the actual level of expenses that would have been incurred had we been operating as a separate, stand-alone public or private company.

Concurrent with the consummation of the Acquisition, our employees ceased to be active participants in all TOC sponsored employee benefit and stock-based compensation plans. Post-Acquisition, we did not retain any obligations under or liabilities with respect to these plans.

#### **Change of Fiscal Year End**

On October 18, 2007, we changed our fiscal year end from December 31 to June 30.

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**Results of Operations**

**The Period July 5, 2007 to September 30, 2007 and the Period July 1, 2007 to July 4, 2007 (together, the "Cumulative Period Ended September 30, 2007") Compared With The Three Months Ended September 30, 2006**

The financial results for the period July 5, 2007 through September 30, 2007 relate to Cengage Learning and the financial results for the three months ended September 30, 2006 and the period July 1, 2007 through July 4, 2007 relate to Thomson Learning. For comparative purposes, we have aggregated the periods from July 1, 2007 through September 30, 2007 in our discussion below to enhance the reader's understanding of the results of operations for the periods presented. This aggregation, as presented in the column "Cumulative Period Ended September 30, 2007", is not a GAAP measure.

(Dollars in millions)	<b>Cumulative Period Ended September 30, 2007</b>	<b>Three Months Ended September 30, 2006</b>	<b>Percentage Change</b>
<b>Statement of Operations</b>			
Revenues:			
Domestic higher education	\$ 473.2	\$ 441.3	7.2 %
Domestic library reference	75.9	80.7	(5.9)%
International	100.1	88.6	13.0 %
Corporate and other	0.9	7.1	(87.3)%
Total revenues	<u>650.1</u>	<u>617.7</u>	5.2 %
Cost of revenues, excluding depreciation stated below:			
Products	212.6	204.7	3.9 %
Services and other	29.3	24.7	18.6 %
Amortization of pre-publication costs	45.0	46.2	(2.6)%
Total cost of revenues, excluding depreciation stated below	<u>286.9</u>	<u>275.6</u>	4.1 %
Selling, general & administrative, excluding depreciation stated below	102.0	103.9	(1.8)%
Allocation of management costs from TOC	0.8	11.6	(93.1)%
Depreciation	14.2	13.6	4.4 %
Amortization of identifiable intangible assets	55.6	10.0	NM
Total costs and expenses	<u>459.5</u>	<u>414.7</u>	10.8 %
Operating income	190.6	203.0	(6.1)%
Interest expense with TOC	-	(11.0)	(100.0)%
Interest expense, net	(130.8)	(1.5)	NM
Income before taxes	59.8	190.5	(68.6)%
Provision for income taxes	(2.7)	(73.9)	(96.3)%
Equity losses of investee, net of taxes	(1.4)	(1.6)	(12.5)%
Net income	<u>\$ 55.7</u>	<u>\$ 115.0</u>	(51.6)%

NM = Not meaningful

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**Revenues** increased by \$32.4 million, or approximately 5.2%, to \$650.1 million for the Cumulative Period ended September 30, 2007 from \$617.7 million for the three months ended September 30, 2006, due to growth in domestic higher education revenue and the impact of foreign currency translation, partially offset by a decline in domestic library reference revenue. In addition, the change reflects (i) the recognition of \$9.3 million of revenue during the Cumulative Period Ended September 30, 2007 on transactions with a former affiliate of Thomson Learning which was reported as a reduction of expenses in prior periods and (ii) an \$8 million reduction of revenue during the Cumulative Period Ended September 30, 2007 associated with purchase accounting adjustments to deferred revenue. Revenue on transactions with the former affiliate for the three months ended September 30, 2006, amounted to \$11 million.

Our domestic higher education revenue increased by \$31.9 million, or approximately 7.2%, to \$473.2 million for the Cumulative Period Ended September 30, 2007 from \$441.3 million for the three months ended September 30, 2006. The increase was driven by higher sales in the humanities & social sciences and business & economics disciplines, with an emphasis on custom products, and an increase across all career and professional disciplines, partially offset by lower school sales, as a result of fewer adoption opportunities. In addition, the change reflects the recognition of \$9.3 million of revenue during the Cumulative Period Ended September 30, 2007 on transactions with a former affiliate of Thomson Learning which was reported as a reduction of expenses in prior periods. Revenue on transactions with the former affiliate for the three months ended September 30, 2006, amounted to \$11 million. Included within the \$473.2 million revenue for the Cumulative Period Ended September 30, 2007 is \$14.4 million recognized during the period July 1, 2007 to July 4, 2007.

Our domestic library reference revenue decreased by \$4.8 million, or approximately 5.9%, to \$75.9 million for the Cumulative Period Ended September 30, 2007 from \$80.7 million for the three months ended September 30, 2006. The results reflect a decline in print reference material and microfilm partially offset by growth in digital products, such as digital archives and virtual reference libraries. Included within the \$75.9 million revenue for the Cumulative Period Ended September 30, 2007 is \$1.4 million recognized during the period July 1, 2007 to July 4, 2007.

Our international revenue increased by \$11.5 million, or approximately 13.0%, to \$100.1 million for the Cumulative Period Ended September 30, 2007 from \$88.6 million for the three months ended September 30, 2006. This increase results from growth in our English language training business in Asia, EMEA and Latin America, as well as foreign currency translation, partially offset by a decline in library reference in Australia and EMEA as well as lower school sales in Australia. Included within the \$100.1 million revenue for the Cumulative Period Ended September 30, 2007 is \$2.8 million recognized during the period July 1, 2007 to July 4, 2007.

Our Corporate and other revenue decreased by \$6.2 million, or approximately 87.3%, to \$0.9 million for the Cumulative Period Ended September 30, 2007 from \$7.1 million for the three months ended September 30, 2006 primarily reflecting an \$8 million reduction of revenue during the Cumulative Period Ended September 30, 2007 associated with purchase accounting adjustments to deferred revenue partially offset by increased revenue from shipping and handling activities and administrative services.

**Cost of revenues, excluding depreciation** increased by \$11.3 million, or approximately 4.1%, to \$286.9 million for the Cumulative Period Ended September 30, 2007 from \$275.6 million for the three months ended September 30, 2006, primarily reflecting increased costs to support our higher revenues.

Our products cost of revenues increased by \$7.9 million, or approximately 3.9%, to \$212.6 million for the Cumulative Period Ended September 30, 2007 from \$204.7 million for the three months ended September 30, 2006. These costs predominantly include paper, printing and binding costs, as well as author royalties, all of which vary as revenues increase or decrease. The increase was directly a result of revenue growth and the impact of foreign currency translation in our international operations, as well as an increase in indirect cost. Included within the products costs of revenues of \$212.6 million for the Cumulative Period Ended September 30, 2007 is \$6.8 million incurred during the period July 1, 2007 to July 4, 2007.

Our services and other cost of revenues increased by \$4.6 million, or approximately 18.6%, to \$29.3 million for the Cumulative Period Ended September 30, 2007 from \$24.7 million for the three months ended September 30, 2006. These

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costs include the variable cost of royalties, hosting and subscription-related costs. The increase was primarily due to an increase in digital revenues as well as an increase in indirect costs. Included within the services and other costs of revenues of \$29.3 million for the Cumulative Period Ended September 30, 2007 is \$1.3 million incurred during the period July 1, 2007 to July 4, 2007.

Amortization of pre-publication costs decreased by \$1.2 million, or approximately 2.6%, to \$45.0 million for the Cumulative Period Ended September 30, 2007 from \$46.2 million for the three months ended September 30, 2006. This marginal decrease was due primarily to reduced print sales in our domestic library reference business partially offset by higher sales and growth in our domestic higher education and international businesses. Included within the amortization of pre-publication costs of \$45.0 million for the Cumulative Period Ended September 30, 2007 is \$0.9 million incurred during the period July 1, 2007 to July 4, 2007

*Selling, general & administrative expense, excluding depreciation* decreased by \$1.9 million, or approximately 1.8%, to \$102.0 million for the Cumulative Period Ended September 30, 2007 from \$103.9 million for the three months ended September 30, 2006. This decrease reflects lower expenses from open positions and better expense management, offset by incremental costs, including \$2.4 million of advisory fees, and other costs incurred as we establish our own internal support infrastructure, previously provided by TOC. Included within selling, general & administrative expense, excluding depreciation of \$102.0 million for the Cumulative Period Ended September 30, 2007 is \$5.0 million incurred during the period July 1, 2007 to July 4, 2007.

*Allocation of management costs from TOC* decreased by \$10.8 million, or approximately 93.1%, to \$0.8 million for the Cumulative Period Ended September 30, 2007 from \$11.6 million for the three months ended September 30, 2006, reflecting the cessation of allocated costs from TOC as a result of the Acquisition. The entire \$0.8 million of expense for the Cumulative Period Ended September 30, 2007 was incurred during the period July 1, 2007 to July 4, 2007.

*Depreciation* increased by \$0.6 million, or approximately 4.4%, to \$14.2 million for the Cumulative Period Ended September 30, 2007 from \$13.6 million for the three months ended September 30, 2006. The increase reflects higher additions to property, equipment and computer software for internal use across the Company. Included within depreciation expense of \$14.2 million for the Cumulative Period Ended September 30, 2007 is \$0.6 million incurred during the period July 1, 2007 to July 4, 2007.

*Amortization of identifiable intangible assets* increased by \$45.6 million to \$55.6 million for the Cumulative Period Ended September 30, 2007 from \$10.0 million for the three months ended September 30, 2006. The increase is due to the fair value of amortizable identifiable intangible assets established in purchase accounting for the Acquisition. Included within amortization of identifiable intangible assets expense of \$55.6 million for the Cumulative Period Ended September 30, 2007 is \$0.3 million incurred during the period July 1, 2007 to July 4, 2007.

*Interest expense with TOC* decreased from \$11.0 million for the three months ended September 30, 2006 to \$0 in the Cumulative Period Ended September 30, 2007 due to the Acquisition, as notes payable with TOC were not acquired by Cengage Learning.

*Interest expense, net* increased by \$129.3 million to \$130.8 million for the Cumulative Period Ended September 30, 2007 from \$1.5 million for the three months ended September 30, 2006 resulting from debt incurred in connection with the Acquisition. Included within interest expense, net of \$130.8 million for the Cumulative Period Ended September 30, 2007 is net interest income of less than \$0.1 million earned during the period July 1, 2007 to July 4, 2007.

*Provision for income taxes* decreased by \$71.2 million to \$2.7 million for the Cumulative Period Ended September 30, 2007 from \$73.9 million for the three months ended September 30, 2006 due to lower income before taxes and the impact of projected loss-making jurisdictions for the full year that are not expected to realize the associated tax benefits. For those jurisdictions, no tax provision or benefit is recorded in any period and due to seasonality of income before taxes, these jurisdictions are profitable in the Cumulative Period Ended September 30, 2007, but no tax provision has been recorded.

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Included within the provision for income taxes of \$2.7 million for the Cumulative Period Ended September 30, 2007 is \$1.1 million incurred during the period July 1, 2007 to July 4, 2007.

Our effective tax rate for the Cumulative Period Ended September 30, 2007 is 4.5% and for the three months ended September 30, 2006 is 38.8%. Our effective tax rate is subject to change based on nonrecurring events as well as recurring factors including geographical mix of income or loss before taxes and the related tax rates in those jurisdictions. In addition, our effective tax rate will change based on discrete or other nonrecurring events (such as audit settlements) that may not be predictable.

*Equity losses of investee, net of taxes* decreased by \$0.2 million, or approximately 12.5%, to \$1.4 million for the Cumulative Period Ended September 30, 2007 from \$1.6 million for the three months ended September 30, 2006 due to reduced losses incurred by our equity investee. Included within the equity losses of investee, net of taxes, of \$1.4 million for the Cumulative Period Ended September 30, 2007 is \$0.1 million incurred during the period July 1, 2007 to July 4, 2007.

**Liquidity and Capital Resources**

The following table sets forth other financial data and our cash flows from operating, investing and financing activities for the Cumulative Period Ended September 30, 2007 and for the three months ended September 30, 2006 (Thomson Learning). As discussed above, the Cumulative Period Ended September 30, 2007 is provided to enhance the reader's understanding of the results of operations for the periods presented and is not a GAAP measure.

(Dollars in millions)	<b>Cumulative Period Ended September 30, 2007</b>	<b>Three Months Ended September 30, 2006</b>
<b>Other Financial Data</b>		
Additions to property, equipment and capitalized software for internal use	\$ 8.7	\$ 11.0
Additions to pre-publication costs	26.4	27.5
<b>Statements of Cash Flows</b>		
Net cash provided by operating activities	\$ 173.2	\$ 148.3
Net cash used by investing activities	(7,241.9)	(65.7)
Net cash provided (used) by financing activities	7,165.0	(78.5)
Impact on cash and cash equivalents from change in foreign currency	-	0.6
Net increase in cash and cash equivalents	<u>\$ 96.3</u>	<u>\$ 4.7</u>

**Cash Flows**

*Operating activities.* Net cash provided by operating activities for the Cumulative Period Ended September 30, 2007 increased by \$24.9 million, or approximately 16.8%, to \$173.2 million from \$148.3 million for the three months ended September 30, 2006. This increase was attributable primarily to improved operating results before amortization of identifiable intangibles and a positive working capital change resulting from the timing of interest payments for the Cumulative Period Ended September 30, 2007.

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**Investing activities.** Net cash used by investing activities for the three months ended September 30, 2007 was \$7,241.9 million as compared to \$65.7 million for the three months ended September 30, 2006 primarily reflecting the impact of the Acquisition.

**Financing activities.** Net cash provided by financing activities for the Cumulative Period Ended September 30, 2007 was \$7,165.0 million as compared to net cash used by financing activities of \$78.5 million for the three months ended September 30, 2006, primarily reflecting the Financing Transactions and the cessation of financing activities with TOC.

### **Cash Position and Indebtedness**

As of September 30, 2007, our total cash and cash equivalents were \$115.1 million and we had total indebtedness of approximately \$5,635.7 million. As of June 30, 2007 we had total cash and cash equivalents of \$18.8 million and total indebtedness of \$769.8 million, including Notes payable to TOC and Notes payable due in 2008 totaling \$743.8 million which we did not assume as part of the Acquisition.

### **Indebtedness and Liquidity**

Prior to the Acquisition, our principal sources of liquidity were our existing cash, internally generated cash flow from operations and borrowings under our arrangements with TOC. We periodically lent to or borrowed money from various subsidiaries of TOC as part of TOC's overall cash management and capitalization program. Certain of these arrangements were subject to written loan agreements specifying repayment terms and interest payments. These notes were reflected separately in the Combined Balance Sheet based on their legal form. Since these notes were part of TOC's overall capitalization of us, changes in the notes' balances were reflected as financing activities in the Combined Statement of Cash Flows.

As a result of the Acquisition and related Financing Transactions, we are highly leveraged and are incurring significant interest expense. See Note 8, "Debt" to the accompanying combined and consolidated interim financial statements (the "Financial Statements") for a detailed description of our indebtedness.

We are exposed to market risk from foreign currency exchange rates and interest rates, which could affect operating results, financial position and cash flows. We manage exposure to these market risks through our regular operating and financing activities and, when appropriate, through the use of derivative financial instruments. These derivative financial instruments are utilized to hedge economic exposures as well as reduce our earnings and cash flow volatility resulting from shifts in market rates. As permitted, we designate certain of these derivative contracts for hedge accounting treatment under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. However, certain of these instruments may not qualify for hedge accounting treatment and, accordingly, the results of our operations may be exposed to some level of volatility. Volatility in our results of operations will vary with the type and amount of derivative hedges outstanding, as well as fluctuations in the currency and interest rate market during the period.

Periodically we may enter into limited types of derivative contracts, including interest rate and cross currency interest rate swap agreements and interest rate collars to manage interest rate exposures, and foreign currency spot, forward, swap and option contracts to manage foreign currency exposures. The fair market values of all these derivative contracts change with fluctuations in interest rates and/or currency rates and are designed so that any changes in their values are offset by changes in the values of the underlying exposures. Derivative financial instruments are held solely as risk management tools and not for trading or speculative purposes.

By their nature, all derivative instruments involve, to varying degrees, elements of market and credit risk not recognized in our financial statements. The market risk associated with these instruments resulting from currency exchange and interest rate movements is expected to offset the market risk of the underlying transactions, assets and liabilities being hedged. The Company's policy is to deal with counterparties having a single A or better credit rating. We manage credit risk through the continuous monitoring of exposures to such counterparties.

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See Note 9, "Financial Instruments" to the Financial Statements for a detailed description of interest rate swaps we have entered into to hedge the variable interest rate component of certain of our indebtedness.

Post-Acquisition, our principal uses of cash will be to fund the payment of interest and principal on our outstanding debt, as well as planned operating expenditures and capital expenditures, including investments in products and technology offerings. Management expects our cash flows from operations, combined with availability under our new revolving credit facility, to provide sufficient liquidity to fund our current obligations, debt service requirements, projected working capital requirements, restructuring obligations, debt principal repayments and capital spending for the foreseeable future.

Our liquidity and our ability to service our debt, as well as fund purchase commitments, operating leases, working capital and capital expenditure requirements, is dependent on our future financial performance, which is subject to general economic, financial and other factors that are beyond our control. If those factors significantly change or other unexpected factors adversely affect us, our business may not generate sufficient cash flow from operations or we may not be able to obtain future financings to meet our liquidity needs. We anticipate that to the extent additional liquidity is necessary to fund our operations, it would be funded through borrowings under our revolving credit facility, the incurrence of other indebtedness, additional equity financings or a combination of these potential sources of liquidity. We may not be able to obtain this additional liquidity on terms acceptable to us or at all.

#### **Application of Critical Accounting Policies and Estimates**

In preparing the Financial Statements and accounting for the underlying transactions and balances, we apply various accounting policies. We consider the policies disclosed as critical to understanding our Financial Statements, as their application places the most significant demands on management's judgment, since financial reporting results rely on estimates of matters that are inherently uncertain. These significant accounting policies should be read in conjunction with similar disclosures made in our Transition Report for The Six Months Ended June 20, 2007 and Annual Report for The Years Ended December 31, 2006, 2005 and 2004 (the "Transition Report"). For a detailed discussion of the application of these accounting policies, refer to Note 4, "Critical Accounting Policies and Estimates" to the Financial Statements, as well as our Transition Report.

In accordance with our accounting policy, we have performed a preliminary allocation related to the purchase price of the Acquisition, and the fair valued the net assets acquired of Thomson Learning. The remaining excess cost of the Acquisition over the fair values attributed to underlying net tangible assets and identifiable intangible assets has been assigned to goodwill. As discussed in Note 2, "Acquisition of Thomson Learning" to the Financial Statements, this preliminary allocation reflects our estimates and may be subject to change.

There have been no changes in the application of critical accounting policies since June 30, 2007.

#### **Off-Balance Sheet Transactions**

Although we generally do not utilize off-balance sheet arrangements in our operations, in the ordinary course of business we may engage in financial transactions that are not recorded on the balance sheet, or may be recorded on the balance sheet in amounts that are different than the full contract or notional amount of the transactions, including operating leases and derivative instruments. See Note 9, "Financial Instruments" to the Financial Statements.

#### **Recent Accounting Pronouncements**

Please refer to Note 5, "Recent Accounting Pronouncements" to the Financial Statements for a discussion of recent accounting standards that we have not yet been required to implement, but which may affect us in the future.