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# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION
**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2006

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number
333-121322

# WMG ACQUISITION CORP.
**(Exact name of Registrant as specified in its charter)**

| | |
|---|---|
| **Delaware** | **13-4271875** |
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |

**75 Rockefeller Plaza**
**New York, NY 10019**
**(Address of principal executive offices)**

**(212) 275-2000**
**(Registrant's telephone number, including area code)**

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes ☒  No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐  Accelerated filer ☐  Non-accelerated filer ☒

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.):  Yes ☐  No ☒

As of May 2, 2006, the number of shares of the Registrant's common stock, par value $0.001 per share, outstanding was 1,000. All of the registrant's common stock is indirectly owned by Warner Music Group Corp.

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## ITEM 1. FINANCIAL STATEMENTS

**WMG Acquisition Corp.**
**Consolidated Balance Sheets**

| | March 31, 2006 (unaudited) | September 30, 2005 (audited) |
|---|---|---|
| | (in millions) | |
| **Assets** | | |
| Current assets: | | |
| Cash and equivalents | $ 311 | $ 247 |
| Short-term investments | 27 | — |
| Accounts receivable, less allowances of $230 and $218 million | 530 | 637 |
| Due from parent companies | 1 | 8 |
| Inventories | 44 | 52 |
| Royalty advances expected to be recouped within one year | 196 | 190 |
| Deferred tax assets | 32 | 36 |
| Other current assets | 56 | 39 |
| Total current assets | 1,197 | 1,209 |
| Royalty advances expected to be recouped after one year | 196 | 190 |
| Investments | 24 | 21 |
| Property, plant and equipment, net | 147 | 157 |
| Goodwill | 876 | 869 |
| Intangible assets subject to amortization, net | 1,737 | 1,815 |
| Intangible assets not subject to amortization | 100 | 100 |
| Other assets | 102 | 100 |
| Total assets | $ 4,379 | $ 4,461 |
| **Liabilities and Shareholder’s Equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 211 | $ 246 |
| Accrued royalties | 1,088 | 1,057 |
| Taxes and other withholdings | 43 | 23 |
| Current portion of long-term debt | 17 | 17 |
| Other current liabilities | 327 | 403 |
| Total current liabilities | 1,686 | 1,746 |
| Long-term debt | 2,044 | 2,055 |
| Deferred tax liabilities, net | 192 | 201 |
| Other noncurrent liabilities | 223 | 224 |
| Total liabilities | 4,145 | 4,226 |
| **Commitments and Contingencies** (See Note 9) | | |
| Shareholder’s equity: | | |
| Common stock | — | — |
| Additional paid-in capital | 350 | 428 |
| Accumulated deficit | (144) | (214) |
| Accumulated other comprehensive income, net | 28 | 21 |
| Total shareholder’s equity | 234 | 235 |
| Total liabilities and shareholder’s equity | $ 4,379 | $ 4,461 |

See accompanying notes.

**WMG Acquisition Corp.**
**Consolidated Statements of Operations (Unaudited)**
**Three Months Ended March 31, 2006 and 2005**

| | Three Months Ended March 31, 2006 | | Three Months Ended March 31, 2005 |
|---|---|---|---|
| | | (in millions) | |
| Revenues (b) | $ 796 | | $ 767 |
| Costs and expenses: | | | |
| Cost of revenues (a) | (409) | | (400) |
| Selling, general and administrative expenses (a)(b) | (294) | | (293) |
| Amortization of intangible assets | (48) | | (47) |
| Total costs and expenses | (751) | | (740) |
| Operating income | 45 | | 27 |
| Interest expense, net | (41) | | (35) |
| Equity in the gains of equity-method investees, net | 1 | | — |
| Other income, net | 2 | | — |
| Income before income taxes | 7 | | (8) |
| Income tax expense | (10) | | (10) |
| Net loss | $ (3) | | $ (18) |
| (a) Includes depreciation expense of | $ (11) | | $ (14) |
| (b) Includes the following expenses resulting from transactions with related companies: | | | |
| Revenues | $ 4 | | $ — |
| Selling, general and administrative expense | $ (3) | | $ (3) |

See accompanying notes.

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**WMG Acquisition Corp.**
**Consolidated Statements of Operations (Unaudited)**
**Six Months Ended March 31, 2006 and 2005**

| | Six Months Ended March 31, 2006 | Six Months Ended March 31, 2005 |
|---|---|---|
| | (in millions) | |
| Revenues (b) | $ 1,840 | $ 1,855 |
| Costs and expenses: | | |
| Cost of revenues (a) | (939) | (981) |
| Selling, general and administrative expenses (a)(b) | (617) | (624) |
| Amortization of intangible assets | (95) | (93) |
| Total costs and expenses | (1,651) | (1,698) |
| Operating income | 189 | 157 |
| Interest expense, net | (82) | (71) |
| Equity in the gains (losses) of equity-method investees, net | 1 | (1) |
| Other income, net | 2 | 4 |
| Income before income taxes | 110 | 89 |
| Income tax expense | (40) | (42) |
| Net income | $ 70 | $ 47 |
| (a) Includes depreciation expense of | $ (22) | $ (28) |
| (b) Includes the following expenses resulting from transactions with related companies: | | |
| Revenues | $ 4 | $ — |
| Selling, general and administrative expense | $ (8) | $ (5) |

See accompanying notes.

**WMG Acquisition Corp.**
**Consolidated Statements of Cash Flows (Unaudited)**
**Six Months Ended March 31, 2006 and 2005**

| | Six Months Ended March 31, 2006 | Six Months Ended March 31, 2005 |
|---|---|---|
| | (in millions) | |
| **Cash flows from operating activities** | | |
| Net income | $ 70 | $ 47 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 117 | 121 |
| Non-cash interest expense | 18 | 17 |
| Non-cash, stock-based compensation expense | 8 | 9 |
| Deferred taxes | (2) | 2 |
| Equity in the (gains) losses of equity-method investees, including distributions | (1) | 1 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 108 | 103 |
| Inventories | 8 | 1 |
| Royalty advances | (29) | 9 |
| Accounts payable and accrued liabilities | (66) | (23) |
| Other balance sheet changes | (26) | 10 |
| Net cash provided by operating activities | 205 | 297 |
| **Cash flows from investing activities** | | |
| Investments and acquisitions | (18) | (48) |
| Investments in short-term investments | (27) | — |
| Investment proceeds | — | 1 |
| Capital expenditures | (12) | (14) |
| Net cash used in investing activities | (57) | (61) |
| **Cash flows from financing activities** | | |
| Quarterly debt repayments | (8) | (6) |
| Change in inter-company | 8 | (4) |
| Dividends and returns of capital paid | (86) | (344) |
| Net cash used in financing activities | (86) | (354) |
| Effect of foreign currency exchange rate changes on cash | 2 | 3 |
| Net increase (decrease) in cash and equivalents | 64 | (115) |
| Cash and equivalents at beginning of period | 247 | 555 |
| Cash and equivalents at end of period | $ 311 | $ 440 |

See accompanying notes.

**WMG Acquisition Corp.**
**Consolidated Statement of Shareholder's Equity (Unaudited)**
**Six Months Ended March 31, 2006**

| (in millions) | Additional Paid-in Capital | Retained Earnings (Deficit) | Accumulated Other Comprehensive Income (Loss) | Total Shareholder's Equity |
|---|---|---|---|---|
| Balance at September 30, 2005 | $ 428 | $ (214) | $ 21 | $ 235 |
| Comprehensive income: | | | | |
| Net income | — | 70 | — | 70 |
| Foreign currency translation adjustment | — | — | (2) | (2) |
| Deferred gains on derivative financial instruments | — | — | 9 | 9 |
| Total comprehensive income | — | 70 | 7 | 77 |
| Dividends | (86) | — | — | (86) |
| Issuance of stock options and restricted shares of common stock of Parent | 8 | — | — | 8 |
| Balance at March 31, 2006 | $ 350 | $ (144) | $ 28 | $ 234 |

See accompanying notes.

**WMG Acquisition Corp.**
**Notes to Consolidated Interim Financial Statements (Unaudited)**

**1. Description of Business**

WMG Acquisition Corp. (the "Company") is one of the world's major music companies and the successor to the interests of the recorded music and music publishing businesses of Time Warner Inc. ("Time Warner"). Effective March 1, 2004, the Company acquired such interests from Time Warner for approximately $2.6 billion (the "Acquisition"). The Company is a direct, wholly owned subsidiary of WMG Holdings Corp. ("Holdings"). Holdings, in turn, is a direct wholly owned subsidiary of Warner Music Group Corp. ("Parent"). Parent, Holdings and the Company were formed in November 2003 by a private equity consortium of Investors (the "Investor Group") to facilitate the Acquisition.

The Company classifies its business interests into two fundamental areas: recorded music and music publishing. A brief description of those operations is presented below.

The Company's business is seasonal. Therefore, operating results for the three and six month periods ended March 31, 2006 are not necessarily indicative of the results that may be expected for fiscal 2006.

*Recorded Music Operations*

The Company's recorded music operations consist of the discovery and development of artists and the related marketing and distribution of recorded music produced by such artists. In addition to the more traditional methods of discovering and developing artists, the Company has implemented new initiatives to identify and nurture artists earlier in the development process and reduce development costs by leveraging its independent distribution network. The Company refers to these new business models as incubator initiatives. Asylum and East West are the current recorded music incubator labels. In addition, the Company launched Cordless Recordings an "e-label" that gives artists the ability to come to market with one or several songs in digital formats without the need to create an entire album. Asylum, East West and Cordless Recordings make up the Company's Independent Label Group ("ILG"). The Company has also entered into strategic ventures with other record labels.

The Company's recorded music operations also include a catalog division called Rhino Entertainment ("Rhino"). Rhino specializes in marketing the Company's music catalog through compilations and reissuances of previously released music and video titles, as well as in the licensing of tracks to/from third parties for various uses, including film and television soundtracks.

The Company's principal recorded music distribution operations include Warner-Elektra-Atlantic Corporation ("WEA Corp."), which primarily distributes the Company's music products to retailers and wholesale distributors in the United States; a 90% interest in Alternative Distribution Alliance ("ADA"), a distribution company which primarily distributes the products of independent record labels to retailers and wholesale distributors; various distribution centers and ventures operated internationally; and an 80% interest in Word Entertainment, whose distribution operations specialize in the distribution of music products in the Christian retail marketplace.

The Company has signed a definitive agreement to acquire Ryko Corporation, a leading independent, integrated music and entertainment company. The acquisition is expected to close during the third quarter of fiscal 2006. See Note 3.

The Company plays an integral role in virtually all aspects of the music value chain from discovering and developing talent, to producing albums and promoting artists and their product. After an artist has entered into a contract with one of the Company's record labels, a master recording of the artist's music is created. The recording is then replicated for sale to consumers primarily in CD and digital formats. In the U.S., WEA Corp. and ADA market, sell and deliver products, either directly or through sub-distributors and wholesalers, to thousands of record stores, mass merchants and other retailers throughout the country. Recorded music products are also sold in physical form to Internet physical retailers. In addition, the Internet and wireless networks have become increasingly important sales channels for records in non-physical forms.

In the U.S., the Company's recorded music operations are conducted principally through its major record labels—Warner Bros. Records and The Atlantic Records Group. In markets outside the U.S., recorded music activities are conducted through the Warner Music International ("WMI") division and its various subsidiaries, affiliates and non-affiliated licensees.

*Music Publishing Operations*

The Company's music publishing business is focused on the exploitation of songs as intellectual property. In return for promoting, placing, marketing and administering the creative output of a songwriter, or engaging in those activities for other rightsholders, the Company's music publishing business garners a share of the revenues generated. In addition to the more traditional methods, the Company has implemented new initiatives to promote and develop emerging songwriters. For example, the Company's music publishing business has its own incubator label, Perfect Game Recording Co.

Warner/Chappell is the Company's global music publishing company, headquartered in Los Angeles, with operations in over 50 countries through various subsidiaries, affiliates and non-affiliated licensees. The Company owns or controls rights to more than one million musical compositions, including numerous pop hits, American standards, folk songs and motion picture and theatrical compositions. The music publishing library includes many standard titles that span multiple music genres. Warner/Chappell also administers the music and soundtracks of several third-party television and film producers and studios, including Lucasfilm, Ltd. and Hallmark Entertainment.

The Company also previously owned Warner Bros. Publications ("WBP"), which printed and distributed a broad selection of sheet music, books and educational materials, orchestrations, folios, personality books, and arrangements from the catalogs of Warner/Chappell and other music publishers. On May 31, 2005, the Company sold WBP to Alfred Publishing. See Note 3.

Music publishing revenues are derived from four main sources:

- *Mechanical:* the licensor receives royalties with respect to compositions embodied in recordings sold in any format or configuration, including singles, albums, CDs, digital downloads and mobile phone ringtones.
- *Performance:* the licensor receives royalties when the composition is performed publicly (*e.g.*, broadcast radio and television, movie theater, concert, nightclub or Internet and wireless streaming).
- *Synchronization:* the licensor receives royalties or fees for the right to use the composition in combination with visual images (*e.g.*, in films, television commercials and programs and videogames).
- *Other:* the licensor receives royalties from other uses such as stage productions.

**2. Basis of Presentation**

**Interim Financial Statements**

The accompanying consolidated financial statements are unaudited but, in the opinion of management, contain all the adjustments (consisting of those of a normal recurring nature) considered necessary to present fairly the financial position and the results of operations and cash flows for the periods presented in conformity with accounting principles generally accepted in the U.S. ("U.S. GAAP") applicable to interim periods. The accompanying consolidated financial statements should be read in conjunction with the audited consolidated financial statements of the Company included in its Annual Report on Form 10-K (Registration No. 333-121322).

### Reclassifications

Certain reclassifications have been made to the prior period's financial information in order to confirm to the current period's presentation.

### Basis of Consolidation

The consolidated accounts include 100% of the assets, liabilities, revenues, expenses, income, losses and cash flows of the Company and all entities in which the Company has a controlling voting interest and/or variable interest entities required to be consolidated in accordance with U.S. GAAP. Significant intercompany balances and transactions have been eliminated in consolidation.

### Short-term Investments

The Company considers all investments with maturities greater than three months, but less than one year, when purchased to be short-term investments. Short-term investments include high-quality, investment grade securities such as taxable auction rate securities as well as commercial paper and corporate bonds. Auction rate securities are classified as available for sale and are carried at fair value. Unrealized gains and losses on such securities are included in accumulated other comprehensive income (loss). Commercial paper and corporate bonds that the Company has both the positive intent and ability to hold to maturity are carried at cost and classified as held to maturity.

### Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123(R), "Share-Based Payment," ("FAS 123(R)") which revises FASB Statement No. 123, "Accounting for Stock-Based Compensation" ("FAS 123"). FAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized as compensation expense based on their fair value. Effective March 1, 2004, in connection with the Acquisition, the Company adopted the fair value recognition provisions of FAS 123 to account for all stock-based compensation plans adopted subsequent to the Acquisition. Under the fair value recognition provisions of FAS 123, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the vesting period. The Company expenses deferred stock-based compensation on an accelerated basis over the vesting period of the stock award. Effective October 1, 2005, the Company adopted FAS 123(R) using the modified prospective method. There was no impact to the Company's results of operations or financial position as a result of the adoption of FAS 123(R).

### Comprehensive (Loss) Income

Comprehensive (loss) income consists of net (loss) income and other gains and losses affecting equity that, under U.S. GAAP, are excluded from net income. For the Company, the components of other comprehensive income primarily consist of foreign currency translation gains and losses and deferred gains and losses on financial instruments designated as hedges under FASB Statement No. 133, "Accounting for Derivative and Hedging Activities", which include interest-rate swaps and foreign exchange contracts. The following summary sets forth the components of comprehensive (loss) income, net of related taxes, for the three and six months ended March 31, 2006 and 2005 (in millions):

| | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 | Six Months Ended March 31, 2006 | Six Months Ended March 31, 2005 |
|---|---|---|---|---|
| Net (loss) income | $ (3) | $ (18) | $ 70 | $ 47 |
| Foreign currency translation gains (losses) | — | 13 | (2) | (12) |
| Derivative financial instruments gains | 2 | 7 | 9 | 10 |
| Comprehensive (loss) income | $ (1) | $ 2 | $ 77 | $ 45 |

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## 3. Significant Acquisitions and Dispositions

### Acquisition of Ryko Corporation

In March 2006, the Company entered into a definitive agreement to acquire Ryko Corporation ("Ryko"), a leading independent, integrated music and entertainment company, for approximately $67.5 million, subject to post-closing purchase price adjustments. Ryko consists of a recorded music label, Rykodisc, which focuses on a range of contemporary music and comedy releases and numerous film and television soundtracks and Ryko Distribution, which distributes music and DVD releases from Rykodisc as well as from independent third-party record and video labels. Additionally, Ryko owns a catalog of more than 1,000 titles of rock, folk, jazz, world, blues and alternative albums including Restless Records' catalog of punk, new wave and soundtrack recordings. The catalog and roster includes artists such as Frank Zappa, Joe Jackson, Soul Asylum, The Flaming Lips and They Might Be Giants. Completion of the transaction is subject to customary closing conditions including regulatory clearances, and is expected to close in the third quarter of fiscal 2006. Under the purchase method of accounting the acquisition cost will be allocated to the underlying net assets based on their fair values, including identifiable intangible assets such as music catalog and artist contracts. The excess of the purchase price over the estimated fair value of the net assets acquired, if any, will be recorded primarily as goodwill.

### Bad Boy Records LLC Joint Venture

On April 8, 2005, the Company entered into an agreement with an affiliate of Sean "Diddy" Combs to form Bad Boy Records LLC ("Bad Boy"), a joint venture, owned 50% by the Company and 50% by the affiliate. The Company purchased its 50% membership interest in Bad Boy Records LLC for approximately $30 million in cash. Mr. Combs is the CEO of the joint venture and supervises its staff and day-to-day operations. The Company provides funding, marketing, promotion and certain back-office services for the joint venture. The transaction was accounted for under the purchase method of accounting, and the results of operations of Bad Boy are included in the Company's results of operations from its acquisition date.

### Sale of Warner Bros. Publications

In May 2005 the Company sold WBP, which conducted the Company's sheet music operations, to Alfred Publishing. As part of the transaction, the Company agreed to license the right to use its music publishing copyrights in the exploitation of printed sheet music and songbooks for a twenty-year period of time. No gain or loss was recognized on the transaction as the historical book basis of the net assets being sold was adjusted to fair value in connection with the accounting for the Acquisition. Due to the Company's continuing involvement with Warner Bros. Publications, it was not reported as discontinued operations.

The sale is not expected to have a material effect on the future operating results and financial condition of the Company. For the three months ended March 31, 2005, the operations sold generated revenues of approximately $11 million; an operating loss of $1 million; an operating loss before depreciation and amortization expense of $1 million; and a net loss of approximately $1 million. For the six months ended March 31, 2005, the operations sold generated revenues of approximately $26 million and had no operating income, operating income before depreciation and amortization expense, or net income.

### Maverick

In November 2004, the Company acquired an additional 30% interest in Maverick Recording Company ("Maverick") from its existing partner for approximately $17 million and certain amounts previously owed by such partner to the Company. The transaction was accounted for under the purchase method of accounting and the purchase price was allocated to the underlying net assets of Maverick in proportion to the estimated fair value, principally artist contracts and recorded music catalog. As part of the transaction, the Company and the remaining partner in Maverick entered into an agreement pursuant to which either party can elect to have the Company purchase the remaining 20% interest in Maverick that it does not own by December 2007.

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**4. Inventories**

Inventories consist of the following (in millions):

| | March 31, 2006 (unaudited) | September 30, 2005 (audited) |
|---|---|---|
| Compact discs, cassettes and other music-related products | $ 80 | $ 84 |
| Published sheet music and song books | 2 | 2 |
| | 82 | 86 |
| Less reserve for obsolescence | (38) | (34) |
| | $ 44 | $ 52 |

**5. Intangible Assets**

Intangible assets consist of the following (in millions):

| | September 30, 2005 (audited) | Acquisitions | Other (a) | March 31, 2006 (unaudited) |
|---|---|---|---|---|
| Intangible assets subject to amortization: | | | | |
| Record music catalog | $ 1,242 | $ 4 | $ (2) | $ 1,244 |
| Music publishing copyrights | 817 | 9 | 2 | 828 |
| Artist contracts | 31 | 4 | — | 35 |
| Trademarks | 10 | — | — | 10 |
| Other intangible assets | 4 | — | — | 4 |
| | 2,104 | 17 | — | 2,121 |
| Accumulated amortization | (289) | | | (384) |
| Total net intangible assets subject to amortization | 1,815 | | | 1,737 |
| Intangible assets not subject to amortization: | | | | |
| Trademarks and brands | 100 | | | 100 |
| Total net other intangible assets | $ 1,915 | | | 1,837 |

(a) Other represents foreign currency translation adjustments.

**6. Restructuring Costs**

**Acquisition-Related Restructuring Costs**

As of March 31, 2006, the Company had approximately $36 million of liabilities for Acquisition-related restructuring costs that were recognized as part of the cost of the Acquisition. These liabilities represent estimates of future cash obligations for all restructuring activities that have been implemented, as well as for all restructuring activities that have been committed to by management but have yet to occur. The outstanding balance of these liabilities primarily relates to extended payment terms for severance obligations and long-term lease obligations for vacated facilities. These remaining lease obligations are expected to be settled by 2019. The Company expects to pay the majority of the remaining employee termination costs in fiscal 2006.

| | Employee Terminations | Other Exit Costs (in millions) | Total |
|---|---|---|---|
| **Liability as of September 30, 2005** | **$ 14** | **$ 35** | **$ 49** |
| Cash paid during the six months ended March 31, 2006 | (7) | (1) | (8) |
| Non-cash reductions during the six months ended March 31, 2006 (a) | — | (2) | (2) |
| Reversal of excess liabilities (b) | (1) | (2) | (3) |
| **Liability as of March 31, 2006** | **$ 6** | **$ 30** | **$ 36** |

(a) Principally relates to changes in foreign currency exchange rates and the non-cash write-off of the carrying value of advances relating to terminating certain artist, songwriter and co-publisher contracts.

(b) Excess liabilities were reversed through the statement of operations.

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**7. Debt**

The Company's long-term debt consists of (in millions):

| | March 31, 2006 (unaudited) | September 30, 2005 (audited) |
|---|---|---|
| Senior secured credit facility: | | |
| Revolving credit facility | $ — | $ — |
| Term loan | 1,422 | 1,430 |
| | 1,422 | 1,430 |
| 7.375% U.S. dollar-denominated Senior Subordinated Notes due 2014 | 465 | 465 |
| 8.125% Sterling-denominated Senior Subordinated Notes due 2014 | 174 | 177 |
| Total debt | 2,061 | 2,072 |
| Less current portion | (17) | (17) |
| Total long term debt | $ 2,044 | $ 2,055 |

**Holdings Debt**

The Company's immediate parent company, Holdings, issued debt in December 2004. While Holdings is the issuer of such debt, it is a holding company that conducts substantially all of its business operations through the Company, its only asset and wholly owned subsidiary. As such, Holdings will be relying on the Company to make any payments of principal and interest as they become due.

Holdings issued $847 million principal amount at maturity of debt consisting of (i) $250 million principal amount of Floating Rate Senior Notes due 2011 (the "Holdings Floating Rate Notes"), (ii) $397 million principal amount at maturity of 9.5% Senior Discount Notes due 2014, which had an initial issuance discount of $147 million (the "Holdings Discount Notes"), and (iii) $200 million principal amount of Floating Rate Senior PIK Notes due 2014 (the "Holdings PIK Notes", and collectively, the "Holdings Notes"), which had an initial discount of $4 million. The gross proceeds of $696 million received from the issuance of the Holdings Notes were used to (i) redeem the remaining shares of cumulative preferred stock of Holdings at a redemption price of $209 million, including $9 million of accrued and unpaid dividends, (ii) pay a return of capital to Parent's shareholders in the aggregate amount of $472 million, and (iii) pay debt-related issuance costs of approximately $15 million.

In June 2005, using proceeds from Parent's initial common stock offering and cash received through a dividend from the Company of approximately $57 million, Holdings redeemed all of the Holdings Floating Rate Notes, all of the Holdings PIK Notes, and 35% of the aggregate outstanding principal at maturity of Holdings Discount Notes.

The Holdings Discount Notes were issued at a discount and have an initial accreted value of $630.02 per $1,000 principal amount at maturity. Prior to December 15, 2009, no cash interest payments are required. However, interest accrues on the Holdings Discount Notes in the form of an increase in the accreted value of such notes such that the accreted value of the Holdings Discount Notes will equal the principal amount at maturity on December 15, 2009. Thereafter, cash interest on the Holdings Discount Notes is payable semiannually at a fixed rate of 9.5% per annum. The Holdings Discount Notes mature on December 15, 2014. Holdings redeemed 35% of the Holdings Discount Notes on June 15, 2005.

The indentures limit Holdings' ability and the ability of its restricted subsidiaries, including the Company, to (i) incur additional indebtedness or issue certain preferred shares; (ii) to pay dividends on or make other distributions in respect of its capital stock or make other restricted payments; (iii) to make certain investments;

(iv) to sell certain assets; (v) to create liens on certain debt without securing the notes; (vi) to consolidate, merge, sell or otherwise dispose of all or substantially all of its assets; (vii) to enter into certain transactions with affiliates; and (viii) to designate its subsidiaries as unrestricted subsidiaries.

**8. Shareholder's Equity**

**Return of Capital and Dividends Paid**

In the fall of 2004, the Company used its available excess cash to pay a return of capital to Holdings in the amount of approximately $352 million. Of such aggregate amount, approximately $8 million was declared and paid in September 2004 and the balance of approximately $344 million was declared and paid in October 2004. Accordingly, whereas the September 2004 dividend was reflected in the Company's fiscal 2004 audited financial statements, the October 2004 dividend has been reflected in the accompanying interim financial statements.

During the six months ended March 31, 2006, the Company declared and paid two dividends to Holdings, its immediate parent. The Company declared and paid a dividend of $4 million to enable Holdings to settle certain inter-company balances. Additionally, the Company declared and paid a dividend of $82 million, which Holdings subsequently declared and paid to Parent to enable Parent to fund current and future dividends to its shareholders.

During the six months ended March 31, 2006, 1,244,822 shares of restricted stock of Parent purchased by or awarded to certain employees of the Company vested.

The following table represents the expense recorded by the Company with respect to its stock-based awards for the three and six month periods ended March 31, 2006 and 2005 by segment and on a consolidated basis (in millions):

| | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 | Six Months Ended March 31, 2006 | Six Months Ended March 31, 2005 |
|---|---|---|---|---|
| Recorded Music | $ 1 | $ 4 | $ 4 | $ 6 |
| Music Publishing | — | 1 | 1 | 1 |
| Corporate expenses | 1 | 2 | 3 | 2 |
| Total | $ 2 | $ 7 | $ 8 | $ 9 |

**9. Commitments and Contingencies**

*Radio Promotion Activities*

In 2004 and 2005, the Attorney General of the State of New York served the Company with requests for information in connection with an industry-wide investigation of the relationship between music companies and radio stations, including the use of independent promoters and accounting for any such payments. The investigation was pursuant to New York Executive Law §63(12) and New York General Business Law §349, both of which are consumer fraud statutes. On November 22, 2005, the Company reached a settlement with the Attorney General in connection with this investigation. As part of such settlement, the Company agreed to make $5 million in charitable payments and to abide by a list of permissible and impermissible promotional activities. On July 25, 2005, Sony BMG reached a settlement with the Attorney General in connection with the same industry-wide investigation. Subsequent to the Company's settlement, two independent labels have filed related antitrust suits against the Company alleging that its radio promotion activities are anticompetitive. *Radikal Records, Inc. v. Warner Music Group, et al.* was filed on March 21, 2006 in U.S. District Court in the Central District of California, Western Division. *TSR Records, Inc. v. Warner Music Group, et al.* was filed on March 28, 2006 in U.S. District Court in the Central District of California, Western Division. The Company intends to defend against these lawsuits vigorously, but is unable to predict the outcome of these suits. Any litigation the Company may become involved in as a result of the settlement with the Attorney General, regardless of the merits of the claim, could be costly and divert the time and resources of management.

*Pricing of Digital Music Downloads*

On December 20, 2005 and February 3, 2006, the Attorney General of the State of New York served the Company with requests for information in the form of a subpoena duces tecum and subpoena ad testificandum in connection with an industry-wide investigation as to whether the practices of industry participants concerning the pricing of digital music downloads violate Section 1 of the Sherman Act, New York State General Business Law §§ 340 et seq., New York Executive Law §63(12), and related statutes. On February 28, 2006, the U.S. Department of Justice served the Company with a request for information in the form of a Civil Investigative Demand as to whether its activities relating to the pricing of digitally downloaded music violate Section 1 of the Sherman Act (15 U.S.C. Section 1). The Company intends to fully cooperate with the Attorney General's and Department of Justice's industry-wide inquiries. Subsequent to the announcements of the above governmental investigations, the Company has been named in a total of fourteen class action lawsuits (five in New York, eight in California and one in Washington D.C.) related to the pricing of digital music downloads, which are expected to be consolidated into one case. The lawsuits are all based on the same general subject matter as the Attorney General's request for information alleging conspiracy among record companies to fix prices for downloads. The complaints generally seek unspecified compensatory, statutory and treble damages. The Company intends to defend against these lawsuits vigorously, but is unable to predict the outcome of these suits. Any litigation the Company may become involved in as a result of the inquiries of the Attorney General and Department of Justice, regardless of the merits of the claim, could be costly and divert the time and resources of management.

*Other Matters*

In addition to the matters discussed above, the Company is involved in other litigation arising in the normal course of our business. Management does not believe that any legal proceedings pending against the Company will have, individually, or in the aggregate, a material adverse effect on its business. However, the Company cannot predict with certainty the outcome of any litigation or the potential for future litigation. Regardless of the outcome, litigation can have an adverse impact on the Company, including its brand value, because of defense costs, diversion of management resources and other factors.

**10. Derivative Financial Instruments**

During the six months ended March 31, 2006, the Company did not enter into additional interest rate swap agreements to hedge the variability of its expected future cash interest payments or any new foreign currency hedge programs. As of March 31, 2006, the Company had interest rate swap agreements to hedge a total notional debt amount of $897 million and recorded deferred gains in comprehensive income of $16 million. Additionally, as of March 31, 2006 the Company had approximately $1 million of deferred net gains in comprehensive income related to foreign currency hedging.

**11. Segment Information**

As discussed more fully in Note 1, based on the nature of its products and services, the Company classifies its business interests into two fundamental areas: recorded music and music publishing. Information as to each of these operations is set forth below.

The Company evaluates performance based on several factors, of which the primary financial measure is operating income (loss) before non-cash depreciation of tangible assets and non-cash amortization of intangible assets ("OIBDA"). The Company has supplemented its analysis of OIBDA results by segment with an analysis of operating income (loss) by segment.

The Company accounts for inter-segment sales at fair value as if the sales were to third parties. While intercompany transactions are treated like third-party transactions to determine segment performance, the revenues (and corresponding expenses recognized by the segment that is counterparty to the transaction) are eliminated in consolidation and, therefore, do not themselves impact consolidated results.

| | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 | Six Months Ended March 31, 2006 | Six Months Ended March 31, 2005 |
|---|---|---|---|---|
| | | (in millions) | | |
| **Revenues** | | | | |
| Recorded music | $ 676 | $ 621 | $ 1,596 | $ 1,561 |
| Music publishing | 129 | 154 | 260 | 309 |
| Corporate expenses and eliminations | (9) | (8) | (16) | (15) |
| Total revenues | $ 796 | $ 767 | $ 1,840 | $ 1,855 |

| | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 | Six Months Ended March 31, 2006 | Six Months Ended March 31, 2005 |
|---|---|---|---|---|
| | | (in millions) | | |
| **OIBDA** | | | | |
| Recorded music | $ 81 | $ 72 | $ 287 | $ 266 |
| Music publishing | 47 | 47 | 68 | 71 |
| Corporate expenses and eliminations | (24) | (31) | (49) | (59) |
| Total OIBDA | $ 104 | $ 88 | $ 306 | $ 278 |

| | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 | Six Months Ended March 31, 2006 | Six Months Ended March 31, 2005 |
|---|---|---|---|---|
| | | (in millions) | | |
| **Depreciation of Property, Plant and Equipment** | | | | |
| Recorded music | $ 7 | $ 9 | $ 14 | $ 18 |
| Music publishing | 1 | 1 | 2 | 2 |
| Corporate expenses and eliminations | 3 | 4 | 6 | 8 |
| Total depreciation | $ 11 | $ 14 | $ 22 | $ 28 |

| | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 | Six Months Ended March 31, 2006 | Six Months Ended March 31, 2005 |
|---|---|---|---|---|
| | | (in millions) | | |
| **Amortization of Intangibles Assets** | | | | |
| Recorded music | $ 34 | $ 33 | $ 67 | $ 66 |
| Music publishing | 14 | 14 | 28 | 27 |
| Corporate expenses and eliminations | — | — | — | — |
| Total amortization | $ 48 | $ 47 | $ 95 | $ 93 |

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| | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 | Six Months Ended March 31, 2006 | Six Months Ended March 31, 2005 |
|---|---|---|---|---|
| | | (in millions) | | |
| **Operating Income (Loss)** | | | | |
| Recorded music | $ 40 | $ 30 | $ 206 | $ 182 |
| Music publishing | 32 | 32 | 38 | 42 |
| Corporate expenses and eliminations | (27) | (35) | (55) | (67) |
| Total operating income | $ 45 | $ 27 | $ 189 | $ 157 |

| | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 | Six Months Ended March 31, 2006 | Six Months Ended March 31, 2005 |
|---|---|---|---|---|
| | | (in millions) | | |
| **Reconciliation of OIBDA to Operating Income** | | | | |
| OIBDA | $ 104 | $ 88 | $ 306 | $ 278 |
| Depreciation expense | (11) | (14) | (22) | (28) |
| Amortization expense | (48) | (47) | (95) | (93) |
| Operating income | $ 45 | $ 27 | $ 189 | $ 157 |

## 12. Additional Financial Information

### Cash Interest and Taxes

The Company made interest payments of approximately $71 million during the six months ended March 31, 2006 and $66 million during the six months ended March 31, 2005. The Company paid approximately $26 million and $23 million of income and withholding taxes in the six months ended March 31, 2006 and 2005, respectively. The Company received $4 million and $9 million of income tax refunds in the six months ended March 31, 2006 and 2005, respectively.

### Non-cash Transactions

There were no significant non-cash investing and financing activities during the six months ended March 31, 2006 and 2005.

## 13. Subsequent Event

Certain of the stock options and restricted shares of common stock of Parent awarded by the Company vest upon the occurrence of a 3x liquidity event, which is defined with respect to the awards as the occurrence of an event that implies an aggregate value for the equity held by the Investor Group of 3x its initial value, as adjusted for prior dividends or other returns of capital received. In April 2006, the 3x liquidity event, as defined, occurred, which resulted in the vesting of 1,169,932 shares of restricted common stock of Parent awarded to or purchased by employees of the Company and 516,719 stock options awarded to employees of the Company. In accordance with the requirements of FAS 123(R), the Company recognizes the compensation for these awards over the employee’s requisite service period. Accordingly, there is no impact of this event to the Company’s statement of operations.

**WMG Acquisition Corp.**
**Supplementary Information**
**Condensed Consolidating Financial Statements**

WMG Acquisition Corp. (the “Company”) is one of the world’s major music companies and the successor to the interests of the recorded music and music publishing businesses of Time Warner Inc. (“Time Warner”). Effective March 1, 2004, the Company acquired such interests from Time Warner for approximately $2.6 billion.

The Company issued (i) $465 million principal amount of 7.375% Senior Subordinated Notes due 2014 and (ii) £100 million Sterling principal amount of 8.125% Senior Subordinated notes due 2014 (the “Notes). The Notes are guaranteed by all of the Company’s domestic wholly owned subsidiaries on a senior subordinated basis. These guarantees are full, unconditional, joint and several. The following condensed consolidating financial statements are presented for the information of the holders of the Notes and present the results of operations, financial position and cash flows of (i) the Company, which is the issuer of the Notes, (ii) the guarantor subsidiaries of the Company, (iii) the non-guarantor subsidiaries of the Company and (iv) the eliminations necessary to arrive at the information for the Company on a consolidated basis. Investments in consolidated subsidiaries are presented under the equity method of accounting. There are no restrictions on the Company’s ability to obtain funds from any of its wholly owned subsidiaries through dividends, loans or advances.

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**WMG Acquisition Corp.**
**Supplementary Information**
**Condensed Consolidating Balance Sheet (unaudited)**
**March 31, 2006**

| | WMG Acquisition Corp. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | WMG Acquisition Corp. Consolidated |
|---|---|---|---|---|---|
| | | | (in millions) | | |
| **Assets:** | | | | | |
| Current assets: | | | | | |
| Cash and equivalents | $ — | $ 187 | $ 124 | $ — | $ 311 |
| Short-term investments | — | 27 | — | — | 27 |
| Accounts receivable, net | — | 314 | 216 | — | 530 |
| Intercompany receivables | (119) | 292 | (256) | 84 | 1 |
| Inventories | — | 17 | 27 | — | 44 |
| Royalty advances expected to be recouped within one year | — | 102 | 94 | — | 196 |
| Deferred tax assets | — | — | 32 | — | 32 |
| Other current assets | — | 25 | 31 | — | 56 |
| Total current assets | (119) | 964 | 268 | 84 | 1,197 |
| Royalty advances expected to be recouped after one year | — | 102 | 94 | — | 196 |
| Investments in and advances to (from) consolidated subsidiaries | 2,356 | 490 | — | (2,846) | — |
| Investments | — | 18 | 6 | — | 24 |
| Property, plant and equipment, net | — | 93 | 54 | — | 147 |
| Goodwill | — | 222 | 654 | — | 876 |
| Intangible assets subject to amortization, net | — | 1,123 | 614 | — | 1,737 |
| Intangible assets not subject to amortization | — | 100 | — | — | 100 |
| Other assets | 89 | 4 | 9 | — | 102 |
| **Total assets** | $ 2,326 | $ 3,116 | $ 1,699 | $ (2,762) | $ 4,379 |
| **Liabilities and Shareholder’s Equity:** | | | | | |
| Current liabilities: | | | | | |
| Accounts payable | $ 2 | $ 140 | $ 69 | $ — | $ 211 |
| Accrued royalties | — | 612 | 476 | — | 1,088 |
| Taxes and other withholdings | — | 5 | 38 | — | 43 |
| Current portion of long-term debt | 17 | — | — | — | 17 |
| Other current liabilities | 33 | 129 | 165 | — | 327 |
| Total current liabilities | 52 | 886 | 748 | — | 1,686 |
| Long-term debt | 2,044 | — | — | — | 2,044 |
| Deferred tax liabilities, net | — | — | 192 | — | 192 |
| Other noncurrent liabilities | — | 151 | 72 | — | 223 |
| Total liabilities | 2,096 | 1,037 | 1,012 | — | 4,145 |
| Total shareholder’s equity | 230 | 2,079 | 687 | (2,762) | 234 |
| **Total liabilities and shareholder’s equity** | $ 2,326 | $ 3,116 | $ 1,699 | $ (2,762) | $ 4,379 |

**WMG Acquisition Corp.**
**Supplementary Information**
**Condensed Consolidating Balance Sheet (audited)**
**September 30, 2005**

| | WMG Acquisition Corp. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | WMG Acquisition Corp. Consolidated |
|---|---|---|---|---|---|
| | | | (in millions) | | |
| **Assets** | | | | | |
| Current assets: | | | | | |
| Cash and equivalents | $ — | $ 89 | $ 158 | $ — | $ 247 |
| Accounts receivable, net | 4 | 363 | 270 | — | 637 |
| Intercompany receivable | (61) | 353 | (368) | 84 | 8 |
| Inventories | — | 22 | 30 | — | 52 |
| Royalty advances expected to be recouped within one year | — | 94 | 96 | — | 190 |
| Deferred tax assets | — | (2) | 38 | — | 36 |
| Other current assets | — | 18 | 23 | (2) | 39 |
| Total current assets | (57) | 937 | 247 | 82 | 1,209 |
| Royalty advances expected to be recouped after one year | — | 94 | 96 | — | 190 |
| Investments in and advances to (from) consolidated subsidiaries | 2,305 | 387 | — | (2,692) | — |
| Investments | — | 15 | 6 | — | 21 |
| Property, plant and equipment, net | — | 101 | 56 | — | 157 |
| Goodwill | — | 219 | 650 | — | 869 |
| Intangible assets subject to amortization | — | 1,188 | 627 | — | 1,815 |
| Intangible assets not subject to amortization, net | — | 100 | — | — | 100 |
| Other assets | 87 | 3 | 10 | — | 100 |
| **Total assets** | $ 2,335 | $ 3,044 | $ 1,692 | $ (2,610) | $ 4,461 |
| **Liabilities and Shareholder's Equity** | | | | | |
| Current liabilities: | | | | | |
| Accounts payable | $ 1 | $ 160 | $ 85 | $ — | $ 246 |
| Accrued royalties | — | 581 | 476 | — | 1,057 |
| Taxes and other withholdings | — | 16 | 7 | — | 23 |
| Current portion of long-term debt | 16 | — | 1 | — | 17 |
| Other current liabilities | 32 | 172 | 199 | — | 403 |
| Total current liabilities | 49 | 929 | 768 | — | 1,746 |
| Long-term debt | 2,055 | — | — | — | 2,055 |
| Deferred tax liabilities, net | — | (2) | 203 | — | 201 |
| Other noncurrent liabilities | — | 150 | 74 | — | 224 |
| Total liabilities | 2,104 | 1,077 | 1,045 | — | 4,226 |
| Total shareholder's equity | 231 | 1,967 | 647 | (2,610) | 235 |
| **Total liabilities and shareholder's equity** | $ 2,335 | $ 3,044 | $ 1,692 | $ (2,610) | $ 4,461 |

**WMG Acquisition Corp.**
**Supplementary Information**
**Condensed Consolidating Statements of Operations (unaudited)**
**For The Three Months Ended March 31, 2006 and March 31, 2005**

| | Three months ended March 31, 2006 | | | | |
|---|---|---|---|---|---|
| | WMG Acquisition Corp. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries (in millions) | Eliminations | WMG Acquisition Corp. Consolidated |
| Revenues | $ — | $ 463 | $ 464 | $ (131) | $ 796 |
| Costs and expenses: | | | | | |
| Cost of revenues | — | (281) | (259) | 131 | (409) |
| Selling, general and administrative expenses | — | (144) | (150) | — | (294) |
| Amortization of intangible assets | — | (32) | (16) | — | (48) |
| Total costs and expenses | — | (457) | (425) | 131 | (751) |
| Operating income | — | 6 | 39 | — | 45 |
| Interest expense, net | (35) | (7) | (1) | 2 | (41) |
| Equity in the gains (losses) of consolidated subsidiaries | 42 | 17 | — | (59) | — |
| Equity in the gains (losses) of equity method investees | — | — | 1 | — | 1 |
| Other income, net | — | 4 | (4) | 2 | 2 |
| Income before income taxes | 7 | 20 | 35 | (55) | 7 |
| Income tax expense | (10) | (3) | (6) | 9 | (10) |
| Net (loss) income | $ (3) | $ 17 | $ 29 | $ (46) | $ (3) |

| | Three months ended March 31, 2005 | | | | |
|---|---|---|---|---|---|
| | WMG Acquisition Corp. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries (in millions) | Eliminations | WMG Acquisition Corp. Consolidated |
| Revenues | $ — | $ 445 | $ 462 | $ (140) | $ 767 |
| Costs and expenses: | | | | | |
| Cost of revenues | — | (243) | (296) | 139 | (400) |
| Selling, general and administrative expenses | (2) | (150) | (142) | 1 | (293) |
| Amortization of intangible assets | — | (32) | (15) | — | (47) |
| Total costs and expenses | (2) | (425) | (453) | 140 | (740) |
| Operating income | (2) | 20 | 9 | — | 27 |
| Interest expense, net | (27) | (5) | (3) | — | (35) |
| Equity in the gains (losses) of consolidated subsidiaries | 21 | 2 | — | (23) | — |
| Income before income taxes | (8) | 17 | 6 | (23) | (8) |
| Income tax expense | (10) | (8) | (6) | 14 | (10) |
| Net (loss) income | $ (18) | $ 9 | $ — | $ (9) | $ (18) |

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**WMG Acquisition Corp.**
**Supplementary Information**
**Condensed Consolidating Statements of Operations (unaudited)**
**For The Six Months Ended March 31, 2006 and March 31, 2005**

| | Six months ended March 31, 2006 | | | | |
|---|---|---|---|---|---|
| | WMG Acquisition Corp. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries (in millions) | Eliminations | WMG Acquisition Corp. Consolidated |
| Revenues | $ — | $ 892 | $ 1,083 | $ (135) | $ 1,840 |
| Costs and expenses: | | | | | |
| Cost of revenues | — | (508) | (566) | 135 | (939) |
| Selling, general and administrative expenses | — | (251) | (366) | — | (617) |
| Amortization of intangible assets | — | (65) | (30) | — | (95) |
| Total costs and expenses | — | (824) | (962) | 135 | (1,651) |
| Operating income | — | 68 | 121 | — | 189 |
| Interest expense, net | (69) | (11) | (4) | 2 | (82) |
| Equity in the gains (losses) of equity method investees | — | — | 1 | — | 1 |
| Equity in the gains (losses) of consolidated subsidiaries | 179 | 62 | — | (241) | — |
| Other income, net | — | 4 | (4) | 2 | 2 |
| Income before income taxes | 110 | 123 | 114 | (237) | 110 |
| Income tax expense | (40) | (22) | (32) | 54 | (40) |
| Net income (loss) | $ 70 | $ 101 | $ 82 | $ (183) | $ 70 |

| | Six months ended March 31, 2005 | | | | |
|---|---|---|---|---|---|
| | WMG Acquisition Corp. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries (in millions) | Eliminations | WMG Acquisition Corp. Consolidated |
| Revenues | $ — | $ 972 | $ 1,131 | $ (248) | $ 1,855 |
| Costs and expenses: | | | | | |
| Cost of revenues | — | (522) | (703) | 244 | (981) |
| Selling, general and administrative expenses | (5) | (322) | (301) | 4 | (624) |
| Amortization of intangible assets | — | (64) | (29) | — | (93) |
| Total costs and expenses | (5) | (908) | (1,033) | 248 | (1,698) |
| Operating income | (5) | 64 | 98 | — | 157 |
| Interest expense, net | (54) | (10) | (7) | — | (71) |
| Equity in the gains (losses) of equity method investees, net | — | — | (1) | — | (1) |
| Equity in the gains (losses) of consolidated subsidiaries | 144 | 64 | — | (208) | — |
| Other income, net | 4 | — | — | — | 4 |
| Income before income taxes | 89 | 118 | 90 | (208) | 89 |
| Income tax expense | (42) | (32) | (34) | 66 | (42) |
| Net income (loss) | $ 47 | $ 86 | $ 56 | $ (142) | $ 47 |

**WMG Acquisition Corp.**
**Supplementary Information**
**Condensed Consolidating Statement of Cash Flows (unaudited)**
**For The Six Months Ended March 31, 2006**

| | WMG Acquisition Corp. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | WMG Acquisition Corp. Consolidated |
|---|---|---|---|---|---|
| | | | (in millions) | | |
| **Cash flows from operating activities:** | | | | | |
| Net income (loss) | $ 70 | $ 101 | $ 82 | $ (183) | $ 70 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | | | |
| Depreciation and amortization | — | 82 | 35 | — | 117 |
| Non-cash interest expense | 7 | 11 | — | — | 18 |
| Non-cash stock compensation expense | — | 7 | 1 | — | 8 |
| Deferred taxes | — | — | (2) | — | (2) |
| Equity in the (gains) losses of equity method investees | — | — | (1) | — | (1) |
| Equity in the losses of consolidated subsidiaries | (138) | (49) | — | 187 | — |
| Changes in operating assets and liabilities: | | | | | |
| Accounts receivable | 4 | 49 | 55 | — | 108 |
| Inventories | — | 5 | 3 | — | 8 |
| Royalty advances | — | (35) | 6 | — | (29) |
| Accounts payable and accrued liabilities | 2 | (42) | (26) | — | (66) |
| Other balance sheet changes | 92 | (59) | (55) | (4) | (26) |
| Net cash (used in) provided by operating activities | 37 | 70 | 98 | — | 205 |
| **Cash flows from investing activities:** | | | | | |
| Investments and acquisitions | — | (1) | (17) | — | (18) |
| Investments of cash in short-term investments | — | (27) | — | — | (27) |
| Capital expenditures | — | (8) | (4) | — | (12) |
| Net cash used in investing activities | — | (36) | (21) | — | (57) |
| **Cash flows from financing activities:** | | | | | |
| Quarterly debt repayments | (8) | — | — | — | (8) |
| Return of capital and dividends paid | (86) | | | | (86) |
| Change in intercompany | 57 | 64 | (113) | — | 8 |
| Net cash provided by (used in) financing activities | (37) | 64 | (113) | — | (86) |
| Effect of foreign currency exchange rate changes on cash | — | — | 2 | — | 2 |
| Net increase (decrease) in cash and equivalents | — | 98 | (34) | — | 64 |
| Cash and equivalents at beginning of period | — | 89 | 158 | — | 247 |
| Cash and equivalents at end of period | $ — | $ 187 | $ 124 | $ — | $ 311 |

**WMG Acquisition Corp.**
**Supplementary Information**
**Condensed Consolidating Statement of Cash Flows (unaudited)**
**For The Six Months Ended March 31, 2005**

| | WMG Acquisition Corp. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | WMG Acquisition Corp. Consolidated |
|---|---|---|---|---|---|
| | | | (in millions) | | |
| **Cash flows from operating activities:** | | | | | |
| Net income (loss) | $ 47 | $ 86 | $ 56 | $ (142) | $ 47 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | | | |
| Depreciation and amortization | — | 85 | 36 | — | 121 |
| Deferred taxes | — | — | 2 | — | 2 |
| Non-cash interest expense | 6 | 11 | — | — | 17 |
| Equity in the losses of equity-method investees, including distributions | — | — | 1 | — | 1 |
| Equity in the losses of consolidated subsidiaries | (102) | (40) | — | 142 | — |
| Non-cash stock compensation expense | — | 7 | 2 | — | 9 |
| Changes in operating assets and liabilities: | | | | | |
| Accounts receivable | (2) | 50 | 55 | — | 103 |
| Inventories | — | 1 | — | — | 1 |
| Royalty advances | — | 1 | 8 | — | 9 |
| Accounts payable and accrued liabilities | (6) | 39 | (56) | — | (23) |
| Other balance sheet changes | 23 | (28) | 15 | — | 10 |
| Net cash (used in) provided by operating activities | (34) | (212) | 119 | — | 297 |
| **Cash flows from investing activities:** | | | | | |
| Investments and acquisitions | — | (24) | (24) | — | (48) |
| Investment proceeds | — | 1 | — | — | 1 |
| Capital expenditures | — | (9) | (5) | — | (14) |
| Net cash used in investing activities | — | (32) | (29) | — | (61) |
| **Cash flows from financing activities:** | | | | | |
| Debt repayments | (6) | — | — | — | (6) |
| Decrease in amounts due to parent companies | (4) | — | — | — | (4) |
| Return of capital and dividends paid | (344) | — | — | — | (344) |
| Return of capital received | — | — | — | — | — |
| Change in intercompany | 388 | (398) | 10 | — | — |
| Net cash provided by (used in) financing activities | 34 | (398) | 10 | — | (354) |
| Effect of foreign currency exchange rate changes on cash | — | — | 3 | — | 3 |
| Net increase (decrease) in cash and equivalents | — | (218) | 103 | — | (115) |
| Cash and equivalents at beginning of period | 2 | 433 | 120 | — | 555 |
| Cash and equivalents at end of period | $ 2 | 215 | $ 223 | $ — | $ 440 |

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion of our results of operations and financial condition with the unaudited interim financial statements included elsewhere in this Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2006 (the "Quarterly Report"). This discussion contains forward-looking statements and involves numerous risks and uncertainties. Actual results may differ materially from those contained in any forward-looking statements.

We make available on our Internet website free of charge our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K as soon as practicable after we electronically file such reports with the SEC. Our website address is www.wmg.com. The information contained in our website is not incorporated by reference in this Quarterly Report.

## "SAFE HARBOR" STATEMENT UNDER PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Quarterly Report includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements other than statements of historical facts included in this Quarterly Report, including, without limitation, statements regarding our future financial position, business strategy, budgets, projected costs, savings and plans and objectives of management for future operations, are forward-looking statements. In addition, forward-looking statements generally can be identified by the use of forward-looking terminology such as "may," "will," "expect," "intend," "estimate," "anticipate," "believe" or "continue" or the negative thereof or variations thereon or similar terminology. Such statements include, among others, statements regarding our ability to develop talent and attract future talent, to reduce future capital expenditures, to monetize our music content, including through new distribution channels and formats, to effectively deploy our capital, the development of digital music and the effect of digital distribution channels on our business, including whether or not the Internet will become an important sales channel and whether we will be able to achieve higher margins from digital sales, our success in limiting piracy, our ability to compete in the highly competitive markets in which we operate, the growth of the music industry and the effect of our and the music industry's efforts to combat piracy on the industry, our intention to pay regular quarterly dividends to fund the regular dividends of Parent, the adequacy of our existing sources of cash to support our existing operations the next twelve months and the effect of litigation and other investigations on us. Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to have been correct.

There are a number of risks and uncertainties that could cause our actual results to differ materially from the forward-looking statements contained in this Quarterly Report. Additionally important factors could cause our actual results to differ materially from the forward-looking statements we make in this Quarterly Report. As stated elsewhere in this Quarterly Report, such risks, uncertainties and other important factors include, among others:

- the impact of our substantial leverage on our ability to raise additional capital to fund our operations, on our ability to react to changes in the economy or our industry and on our ability to meet our obligations under our indebtedness;
- the decline over the past five years in the global physical recorded music industry and the rate of overall decline in the music industry;
- our ability to continue to identify, sign and retain desirable talent at manageable costs;
- the threat posed to our business by piracy of music by means of home CD-R activity and Internet peer-to-peer file-sharing;
- the significant threat posed to our business and the music industry by organized industrial piracy;

- the popular demand for particular recording artists and/or songwriters and albums and the timely completion of albums by major recording artists and/or songwriters;
- the diversity and quality of our portfolio of songwriters;
- the diversity and quality of our album releases;
- significant fluctuations in our results of operations and cash flows due to the nature of our business;
- our involvement in intellectual property litigation;
- the possible downward pressure on our pricing and profit margins;
- the seasonal and cyclical nature of recorded music sales;
- our ability to continue to enforce our intellectual property rights in digital environments;
- the ability to develop a successful business model applicable to a digital environment;
- the ability to maintain product pricing in a competitive environment;
- the impact of heightened and intensive competition in the recorded music and music publishing businesses and our inability to execute our business strategy;
- risks associated with our non-U.S. operations, including limited legal protections of our intellectual property rights and restrictions on the repatriation of capital;
- the impact of legitimate music distribution on the Internet or the introduction of other new music distribution formats;
- the impact of rate regulations on our music publishing business;
- the impact of rates on other income streams that may be set by arbitration proceedings on our business;
- risks associated with the fluctuations in foreign currency exchange rates;
- our ability and the ability of our joint venture partners to operate our existing joint ventures satisfactorily;
- the enactment of legislation limiting the terms by which an individual can be bound under a “personal services” contract could impair our ability to retain the services of key artists;
- potential loss of catalog if it is determined that recording artists have a right to recapture recordings under the U.S. Copyright Act;
- changes in law and government regulations;
- legal or other developments related to pending litigation or investigations by the Attorney General of the State of New York and the Department of Justice;
- trends that affect the end uses of our musical compositions (which include uses in broadcast radio and television, film and advertising businesses);
- the growth of other products that compete for the disposable income of consumers;
- risks inherent in relying on one supplier for manufacturing, packaging and distribution services in North America and Europe;
- risks inherent in our acquiring or investing in other businesses;
- the possibility that our owners’ interests will conflict with ours or yours;
- our ability to act as a stand-alone company;
- increased costs and diversion of resources associated with complying with the internal control reporting or other requirements of Sarbanes-Oxley;

- weaknesses in our internal controls related to U.S. royalties that could affect our ability to ensure reliable financial reports;
- the effects associated with the formation of Sony BMG Music Entertainment; and
- failure to attract and retain key personnel.

There may be other factors not presently known to us or which we currently consider to be immaterial that may cause our actual results to differ materially from the forward-looking statements.

All forward-looking statements attributable to us or persons acting on our behalf apply only as of the date of this Quarterly Report and are expressly qualified in their entirety by the cautionary statements included in this Quarterly Report. We disclaim any duty to publicly update or revise forward-looking statements to reflect events or circumstances after the date made or to reflect the occurrence of unanticipated events.

## INTRODUCTION

WMG Acquisition Corp (the “Company”) is one of the world’s major music content companies and the successor to the interests of the recorded music and music publishing businesses of Time Warner Inc. (“Time Warner”). Such predecessor were acquired effective March 1, 2004, by the Company, for approximately $2.6 billion (the “Acquisition”). The Company is a direct, wholly owned subsidiary of WMG Holdings Corp. (“Holdings”). Holdings, in turn, is a direct, wholly owned subsidiary of Warner Music Group Corp. (“Parent”). Parent, Holdings and the Company were formed in November 2003 by a private equity consortium of Investors (the “Investor Group”) to facilitate the Acquisition.

Management’s discussion and analysis of results of operations and financial condition (“MD&A”) is provided as a supplement to the unaudited financial statements and footnotes included elsewhere herein to help provide an understanding of our financial condition, changes in financial condition and results of our operations. MD&A is organized as follows:

- *Overview.* This section provides a general description of our business, as well as recent developments that we believe are important in understanding our results of operations and financial condition and in anticipating future trends.
- *Results of operations.* This section provides an analysis of our results of operations for the three and six month periods ended March 31, 2006 and 2005. This analysis is presented on both a consolidated and segment basis.
- *Financial condition and liquidity.* This section provides an analysis of our cash flows for the six months ended March 31, 2006 and 2005, as well as a discussion of our financial condition and liquidity as of March 31, 2006. The discussion of our financial condition and liquidity includes (i) our available financial capacity under the revolving credit portion of our senior secured credit facility and (ii) a summary of our key debt compliance measures under our debt agreements.

## Use of OIBDA

We evaluate our operating performance based on several factors, including our primary financial measure of operating income (loss) before non-cash depreciation of tangible assets and non-cash amortization of intangible assets (which we refer to as “OIBDA”). We consider OIBDA to be an important indicator of the operational strengths and performance of our businesses, including the ability to provide cash flows to service debt. However, a limitation of the use of OIBDA as a performance measure is that it does not reflect the periodic costs of certain capitalized tangible and intangible assets used in generating revenues in our businesses. Accordingly, OIBDA should be considered in addition to, not as a substitute for, operating income (loss), net income (loss) and other measures of financial performance reported in accordance with U.S. GAAP.

## OVERVIEW

### Description of Business

We are one of the world's major music content companies. Effective as of March 1, 2004, substantially all of Time Warner's music division was acquired from Time Warner by us for approximately $2.6 billion.

We classify our business interests into two fundamental areas: Recorded Music and Music Publishing. A brief description of each of those operations is presented below.

Our business is seasonal. Therefore, operating results for the three and six month periods ended March 31, 2006 are not necessarily indicative of the results that may be expected for fiscal 2006.

*Recorded Music Operations*

Our Recorded Music business consists of the discovery and development of artists and the related marketing, distribution and licensing of recorded music produced by such artists. In the U.S., our operations are conducted principally through our major record labels—Warner Bros. Records Inc. and The Atlantic Records Group. Internationally, our Recorded Music operations are conducted through our Warner Music International division ("WMI"), which includes various subsidiaries, affiliates and non-affiliated licensees in more than 50 countries outside the United States. In addition to the more traditional methods of discovering and developing artists, we have implemented new initiatives to identify and nurture artists earlier in the development process and reduce development costs by leveraging our independent distribution network. We refer to these new business models as incubator initiatives. Asylum and East West are the current recorded music incubator labels. In addition, we have recently launched Cordless Recordings, an "e-label" that gives its artists the ability to come to market with one or several songs in the digital formats without the need to create an entire album. Asylum, East West and Cordless Recordings make up our Independent Label Group ("ILG"). We have also entered into strategic ventures with other record labels.

Our Recorded Music operations also include a catalog division named Rhino Entertainment ("Rhino"). Rhino specializes in marketing our music catalog through compilations and reissuances of previously released music and video titles, as well as in the licensing of recordings to/from third parties for various uses, including film and television soundtracks.

Our principal Recorded Music distribution operations include Warner-Elektra-Atlantic Corporation ("WEA Corp."), which primarily markets and sells music products to retailers and wholesale distributors in the U.S.; a 90% interest in Alternative Distribution Alliance, an distribution company that primarily distributes the products of independent labels to retail and wholesale distributors in the United States; various distribution centers and ventures operated internationally; and an 80% interest in Word Entertainment, whose distribution operations specialize in the distribution of music products in the Christian retail marketplace.

We have signed a definitive agreement to acquire Ryko Corporation, a leading independent, integrated music and entertainment company. The acquisition is expected to close during the third quarter of fiscal 2006.

Our principal recorded music revenue sources are sales of CDs, digital downloads and other recorded music products and license fees received for the ancillary uses of our recorded music catalog. The principal costs associated with our Recorded Music operations are as follows:

- artist and repertoire costs—the costs associated with (i) signing and developing artists, (ii) creating master recordings in the studio, (iii) creating artwork for album covers and liner notes and (iv) paying royalties to artists, producers, songwriters, other copyright holders and trade unions;
- manufacturing, packaging and distribution costs—the costs to manufacture and distribute product to wholesale and retail distribution outlets;

- marketing and promotion costs—the costs associated with the promotion of artists and recorded music products, including costs to produce music videos for promotional purposes and artist tour support; and
- administration costs—the costs associated with general overhead and other administrative costs, as well as costs associated with anti-piracy initiatives.

*Music Publishing Operations*

Our Music Publishing operations include Warner/Chappell Music, Inc. and its wholly owned subsidiaries, and certain other music publishing affiliates. We own or control the rights to more than one million musical compositions, including numerous pop music hits, American standards, folk songs and motion picture and theatrical compositions. Our Music Publishing operations also formerly included Warner Bros. Publications ("WBP"), which marketed printed versions of our music throughout the world. On May 31, 2005, we sold WBP to Alfred Publishing. The sale is not expected to have a material effect on our future operating results and financial condition. In addition to the more traditional methods, we have implemented new initiatives to promote and develop emerging songwriters. For example, our music publishing business has its own incubator label, Perfect Game Recording Co.

Publishing revenues are derived from four main sources:

- *Mechanical:* the licensor receives royalties with respect to compositions embodied in recordings sold in any format or configuration, including singles, albums, CDs, digital downloads and mobile phone ringtones.
- *Performance:* the licensor receives royalties if the composition is performed publicly (e.g., broadcast radio and television, movie theater, concert, nightclub or Internet and wireless streaming).
- *Synchronization:* the licensor receives royalties or fees for the right to use the composition in combination with visual images (e.g., in films, television commercials and programs and videogames).
- *Other:* the licensor receives royalties from other uses such as stage productions.

The principal costs associated with our Music Publishing operations are as follows:

- artist and repertoire costs—the costs associated with (i) signing and developing songwriters and (ii) paying royalties to songwriters, co-publishers and other copyright holders in connection with income generated from the exploitation of their copyrighted works; and
- administration costs—the costs associated with general overhead and other administrative costs.

**Factors Affecting Results of Operations and Financial Condition**

*Market Factors*

Over the past five years, the recorded music industry has been unstable, which has adversely affected our operating results. The industry-wide decline can be attributed primarily to digital piracy. Other drivers of this decline are the bankruptcies of record retailers and wholesalers, growing competition for consumer discretionary spending and retail shelf space, and the maturation of the CD format, which has slowed the historical growth pattern of recorded music sales. However, new avenues for selling recorded music product have been created, including the legal downloading of digital music using the Internet and DVD-Audio formats and the distribution of music on mobile devices, and revenue streams from these new sources are beginning to emerge. As reported by the International Federation of the Phonographic Industry (IFPI), sales of music via the Internet and mobile phones generated sales of $1.1 billion for record companies in 2005, up from $380 million in the prior year. As of April 30, 2006, year-to-date U.S. recorded music sales (excluding sales of digital tracks) are down approximately 2.03% year-over-year. However, sales of music through new avenues are beginning to offset the declines seen in prior years. It is too soon to determine if the industry has stabilized or the impact of sales of music through new channels might have on the industry and the recorded music industry performance may continue to negatively impact our operating results. In addition, a declining recorded music industry could continue to have an adverse impact on the music publishing business. This is because our music publishing business generates a significant portion of its revenues from mechanical royalties received from the sale of music in CD and other recorded music formats.

*Restructuring*

Due in part to the development of the new channels mentioned above and ongoing anti-piracy initiatives, we believe that the recorded music industry is positioned to improve over the coming years. However, the industry may relapse into a period of decline. In addition, there can be no assurances as to the timing or the extent of any improvement in the industry. Accordingly, in connection with the Acquisition, we executed a number of cost-saving initiatives in an attempt to realign our cost structure with the changing economics of the industry. These initiatives, primarily implemented in fiscal 2004 and the first half of fiscal 2005, included significant headcount reductions from the consolidation of operations and the streamlining of corporate and label overhead, exiting certain leased facilities in an effort to consolidate locations and the sale of our manufacturing, packaging and physical distribution operations. We completed substantially all of our restructuring efforts in fiscal 2005.

*Holdings Refinancing and Redemption*

The Company's immediate parent company, Holdings, issued debt in December 2004. While Holdings is the issuer of such debt, it is a holding company that conducts substantially all of its business operations through the Company, a wholly owned subsidiary. As such, Holdings will be relying on the Company to make any payments of principal and interest as they become due.

Holdings issued $847 million principal amount of debt. The $847 million principal amount of Holdings' debt consisted of (i) $250 million principal amount of Floating Rate Senior Notes due 2011 (the "Holdings Floating Rate Notes"), (ii) $397 million principal amount at maturity of 9.5% Senior Discount Notes due 2014, which had an initial issuance discount of $147 million (the "Holdings Discount Notes") and (iii) $200 million principal amount of Floating Rate Senior PIK Notes due 2014 (the "Holdings PIK Notes", and collectively, the "Holdings Notes").

In connection with the initial common stock offering of Parent, Holdings used $517 million of proceeds from Parent's offering along with cash received through a dividend from us of approximately $57 million to redeem certain of the Holdings Notes outstanding. As of March 31, 2006, Holdings had $182 million of debt on its balance sheet relating to such securities, net of issuance discounts.

The Holdings Floating Rate Notes were redeemed in full on June 15, 2005. From the issuance date through the redemption date, the notes bore interest at a quarterly floating rate based on three-month LIBOR rates plus a margin equal to 4.375%. Interest was payable quarterly in cash beginning on March 15, 2005.

The Holdings Discount Notes were issued at a discount and had an initial accreted value of $630.02 per $1,000 principal amount at maturity. Prior to December 15, 2009, no cash interest payments are required. However, interest accrues on the Holdings Discount Notes in the form of an increase in the accreted value of such notes such that the accreted value of the Holdings Discount Notes will equal the principal amount at maturity on December 15, 2009. Thereafter, cash interest on the Holdings Discount Notes is payable semiannually at a fixed rate of 9.5% per annum. The Holdings Discount Notes mature on December 15, 2014. The Company redeemed 35% of the Holdings Discount Notes on June 15, 2005.

The Holdings PIK Notes were redeemed in full on June 15, 2005. From the date of issuance through the date of redemption, the notes bore interest at a semi-annual floating rate based on six-month LIBOR rates plus a margin equal to 7%. Interest was accrued in the form of additional PIK notes at the election of the Company. Such amounts were also repaid in connection with the redemption.

*Termination of Management/ Monitoring Agreement*

As described in Note 17 to our audited consolidated financial statements for the year ended September 30, 2005, we entered into a management monitoring agreement (the “Management Agreement”) with the Investor Group in connection with the Acquisition.

Under the Management Agreement, we were required to pay the Investor Group an aggregate annual fee of $10 million per year (the “Periodic Fees”) in consideration for ongoing consulting and management advisory services.

The Management Agreement provided that it would continue in full force and effect until December 30, 2014, provided, however, that the Investor Group could cause the agreement to terminate at any time. In the event of the termination of the Management Agreement, the Company, Holdings and Acquisition Corp. were required by the terms of the agreement to pay each of the Investor Group any unpaid portion of the Periodic Fees, any Subsequent Fees and any expenses due with respect to periods prior to the date of termination plus the net present value (using a discount rate equal to the then yield on U.S. Treasury Securities of like maturity) of the Periodic Fees that would have been payable with respect to the period from the date of termination until December 30, 2014.

The Investor Group terminated the Management Agreement and on May 16, 2005, we paid the Investor Group a $73 million termination fee, which was reflected in our statement of operations for the fiscal year ended September 30, 2005. As a result, certain fees paid in prior periods do not appear in subsequent periods. We paid $2.5 million and $5 million of Periodic Fees under the Management Agreement during the three and six months ended March 31, 2005, respectively. We no longer pay any Periodic Fees following the termination of the agreement.

*Sale of Warner Bros. Publications*

In May 2005, we sold Warner Bros. Publications, which conducted our sheet music operations, to Alfred Publishing. No gain or loss was recognized on the transaction, as the historical book basis of the net assets being sold was adjusted to fair value in connection with the accounting for the Acquisition. Due to our continuing involvement with Warner Bros. Publications, it was not reported as discontinued operations. The sale is not expected to have a material effect on our future operating results and financial condition. For the three months ended March 31, 2005, the operations sold generated revenues of approximately $11 million; an operating loss of $1 million; an operating loss before depreciation and amortization expense of $1 million; and a net loss of approximately $1 million. For the six months ended March 31, 2005, the operations sold generated revenues of approximately $26 million and had no operating income, operating income before depreciation and amortization expense, or net income.

## RESULTS OF OPERATIONS

### Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2005

The following table summarizes our historical results of operations:

| | Three Months Ended March 31, 2006 (unaudited) | | Three Months Ended March 31, 2005 (unaudited) |
|---|---|---|---|
| | | (in millions) | |
| Revenues | $ 796 | | $ 767 |
| Costs and expenses: | | | |
| Cost of revenues (1) | (409) | | (400) |
| Selling, general and administrative expenses (1) | (294) | | (293) |
| Amortization of intangible assets | (48) | | (47) |
| Total costs and expenses | (751) | | (740) |
| Operating income | 45 | | 27 |
| Interest expense, net | (41) | | (35) |
| Equity in gains of equity-gains in consolidated subsidiaries, net | 1 | | — |
| Other income, net | 2 | | — |
| Income before income taxes | 7 | | (8) |
| Income tax expense | (10) | | (10) |
| Net loss | $ (3) | | $ (18) |

(1) Includes depreciation expense of: $11 million and $14 million for the three months ended March 31, 2006 and 2005, respectively.

### *Consolidated Historical Results*

*Revenues*

Our revenues increased $29 million, or 4%, to $796 million for the three months ended March 31, 2006 as compared to $767 million for the three months ended March 31, 2005. Excluding a $31 million unfavorable impact of foreign currency exchange rates and prior year revenue of $11 million related to our sheet music business, which was sold in May 2005, total revenue increased by $71 million or 10%. Recorded Music revenues increased by $55 million, to $676 million for the three months ended March 31, 2006. Excluding a $21 million unfavorable impact of foreign currency exchange rates, Recorded Music revenues rose $76 million, or 13%, comprised of a $21 million increase in physical sales and a $55 million increase in digital sales. Music Publishing revenues declined by $25 million to $129 million for the three months ended March 31, 2006. Excluding a $10 million unfavorable impact of foreign currency exchange rates and the prior year revenue related to our sold sheet music business, Music Publishing revenue declined $4 million or 3%. International operations represented $379 million of consolidated revenues for the three months ended March 31, 2006 as compared to $404 million for the three months ended March 31, 2005, comprising 48% and 53% of total revenues, respectively.

Overall digital revenues grew to $90 million for the three months ended March 31, 2006, as compared to $69 million for the three months ended December 31, 2005 and $35 million for the three months ended March 31, 2005. Digital revenues represented 11% of consolidated revenues for the three months ended March 31, 2006, up from 7% in the most recent reported quarter and 5% in the prior year same quarter. Total digital revenues for the three months ended March 31, 2006 was comprised of U.S. revenues of $64 million, or 71% of total digital revenues, and international revenues of $26 million, or 29% of total digital revenues. The increase in digital revenues resulted from continued efforts to develop our digital business including efforts to further monetize existing content through new formats and new distribution channels and the increased usage of legal, online and mobile distribution channels for the music industry.

See “Business Segment Results” presented hereinafter for a discussion of revenue by business segment.

*Cost of revenues*

Our cost of revenues increased $9 million, or 2%, to $409 million for the three months ended March 31, 2006 as compared to $400 million for the three months ended March 31, 2005. Expressed as a percent of revenues, cost of revenues was 51% and 52% for the three months ended March 31, 2006 and 2005, respectively, or 51% for each of the three months ended March 31, 2006 and 2005, excluding the impact of changes in foreign currency exchange rates and the sale of our sheet music business. Excluding a $21 million benefit of foreign currency exchange rates and $8 million of costs related to our sheet music business, which was sold in May 2005, our cost of revenues increased by $38 million. The increase was primarily due to increases in product costs of $27 million, which were a result of higher physical sales as well as the increased costs related to a number of special edition physical products sold in the quarter, such as CD/DVD box sets. As a percentage of revenues, artist and repertoire costs declined for the three months ended March 31, 2006 as compared to the three months ended March 31, 2005, excluding the impact of foreign currency exchange rates. The decrease relates to changes in product mix in the current quarter as compared to the prior-year quarter.

*Selling, general and administrative expenses*

Our selling, general and administrative expenses increased by $1 million, to $294 million for the three months ended March 31, 2006 as compared to $293 million for the three months ended March 31, 2005. Expressed as a percent of revenues, selling, general and administrative expenses were 37% and 38% for the three months ended March 31, 2006 and 2005, respectively. Excluding an $9 million benefit of foreign currency exchange rates and $4 million of expenses related to our print operations which were sold in May 2005, selling, general and administrative expenses increased by $14 million, or 5%, primarily related to a $13 million increase in selling and marketing expense which was the result of the timing of marketing costs incurred in relation to our product release schedule in the current quarter. General and administrative costs increased by $4 million, primarily due to a severance payment of $8 million related to the departure of the chairman of WMI, offset by the management fees incurred in the prior year of $2.5 million, due to the previously discussed termination of the Management Agreement. Additionally, depreciation expense decreased by $3 million as discussed below. Stock compensation expense amounted to $2 million for the three months ended March 31, 2006 and $7 million for the three months ended March 31, 2005.

***Reconciliation of Consolidated Historical OIBDA to Operating Income and Net Loss***

As previously described, we use OIBDA as our primary measure of financial performance. The following table reconciles OIBDA to operating income and further provides the components from operating income to net loss for purposes of the discussion that follows:

| | Three Months Ended March 31, 2006 (unaudited) | | Three Months Ended March 31, 2005 (unaudited) |
|---|---|---|---|
| | | (in millions) | |
| OIBDA | $ 104 | | $ 88 |
| Depreciation expense | (11) | | (14) |
| Amortization expense | (48) | | (47) |
| Operating income | 45 | | 27 |
| Interest expense, net | (41) | | (35) |
| Equity in gains of equity-gains in consolidated subsidiaries, net | 1 | | — |
| Other income, net | 2 | | — |
| Income before income taxes | 7 | | (8) |
| Income tax expense | (10) | | (10) |
| Net loss | $ (3) | | $ (18) |

*OIBDA*

Our OIBDA increased $16 million, or 18%, to $104 million for the three months ended March 31, 2006 as compared to $88 million for the three months ended March 31, 2005. Expressed as a percentage of revenues, total OIBDA margin was 13% for the three months ended March 31, 2006 as compared 11% for the three months ended March 31, 2005. Excluding an approximate $1 million unfavorable impact of foreign currency exchange rates, OIBDA increased by $17 million, which was primarily a result of the increases in revenues, offset by the increases in costs of revenues and selling, general and administrative expenses, which are more fully discussed above. See “Business Segment Results” presented hereinafter for a discussion of OIBDA by business segment.

*Depreciation expense*

Our depreciation expense decreased by $3 million to $11 million for the three months ended March 31, 2006 as compared to $14 million for the three months ended March 31, 2005. The decrease primarily relates to lower capital spending since the date of the Acquisition.

*Amortization expense*

Our amortization expense increased by $1 million, or 2%, to $48 million for the three months ended March 31, 2006 as compared to $47 million for the three months ended March 31, 2005. The increase is due to various acquisitions of recorded music catalog and music publishing copyrights since the prior year.

*Operating income*

Our operating income increased $18 million, to $45 million for the three months ended March 31, 2006 as compared to $27 million for the three months ended March 31, 2005. The increase in operating income was primarily a result of the increases in revenues, offset by increases in costs of revenues and selling, general and administrative expenses, which are more fully discussed above. See “Business Segment Results” presented hereinafter for a discussion of operating income by business segment.

*Interest expense, net*

Our interest expense increased to $41 million for the three months ended March 31, 2006 compared to $35 million for the three months ended March 31, 2005. The three months ended March 31, 2006 reflects an increase primarily due to the inclusion of interest expense related to an additional outstanding term loan of $250 million borrowed in May 2005, which is not reflected in the three months ended March 31, 2005 and an increase in interest rates. See “—Financial Condition and Liquidity” for more information.

*Equity in the gains of equity-method investees, net*

The three months ended March 31, 2006 includes $1 million of equity in the gains of equity-method investees. There was no comparable income for the three months ended March 31, 2005.

*Other Income, net*

We recognized other income, net, of $2 million for the three months ended March 31, 2006. Other income relates to favorable foreign currency exchange rate movements associated with intercompany receivables and payables that are short-term in nature, and therefore required to be recognized in the statement of operations under U.S. GAAP. There was no comparable income for the three months ended March 31, 2005.

*Income tax expense*

We provided income tax expense of $10 million for each of the three months ended March 31, 2006 and 2005. In connection with the Acquisition we made a joint election with Time Warner under Section 338(h)(10) of the U.S. Internal Revenue Code to treat the Acquisition as an asset purchase. There was no offsetting income tax benefit on U.S. domestic tax losses recognized due to the uncertain nature of these deferred tax assets. Our income tax expense for each of the three months ended March 31, 2006 and 2005 primarily relates to the tax provisions on foreign income.

*Net loss*

Our net loss decreased to a loss of $3 million for the three months ended March 31, 2006 as compared to net loss of $18 million for the three months ended March 31, 2005. The decrease is primarily due to the increase in operating income in the current year, offset by the increase in interest expense, both more fully described above.

**Business Segment Results**

Revenue, OIBDA and operating income (loss) by business segment are as follows:

| | Three Months Ended March 31, 2006 (unaudited) | | Three Months Ended March 31, 2005 (unaudited) |
|---|---|---|---|
| | | (in millions) | |
| Recorded Music | | | |
| Revenue | $ 676 | | $ 621 |
| OIBDA | $ 81 | | $ 72 |
| Operating income | $ 40 | | $ 30 |
| Music Publishing | | | |
| Revenue | $ 129 | | $ 154 |
| OIBDA | $ 47 | | $ 47 |
| Operating income | $ 32 | | $ 32 |
| Corporate and Revenue Eliminations | | | |
| Revenue eliminations | $ (9) | | $ (8) |
| OIBDA | $ (24) | | $ (31) |
| Operating loss | $ (27) | | $ (35) |
| Total | | | |
| Revenue | $ 796 | | $ 767 |
| OIBDA | $ 104 | | $ 88 |
| Operating income | $ 45 | | $ 27 |

*Recorded Music*

Recorded Music revenues increased by $55 million, or 9%, to $676 million for the three months ended March 31, 2006 from $621 million for the three months ended March 31, 2005. Excluding a $21 million unfavorable impact of foreign currency exchange rates, Recorded Music revenues increased by $76 million, or 13%, which was driven by an increase in digital sales of approximately $55 million and an increase in physical sales of $21 million. Digital sales totaled $86 million, or 13% of Recorded Music revenues for the three months ended March 31, 2006 compared to $31 million, or 5%, for the three months ended March 31, 2005. Digital sales totaled $64 million, or 7% for the immediately preceding three months ended December 31, 2005. U.S. physical sales increased by approximately $26 million as a result of several key releases in the three months ended March 31, 2006, as well as significant sales of several carryover releases. International physical sales declined slightly, excluding the impact of foreign currency exchange rates. The decrease in international physical sales was more than offset by the increase in international digital sales.

Recorded Music revenues represented 85% and 81% of consolidated revenues, prior to corporate and revenue eliminations, for the three months ended March 31, 2006 and 2005, respectively. U.S. Recorded Music revenues were $361 million and $296 million, or 53% and 48% of consolidated Recorded Music revenues for the three months ended March 31, 2006 and 2005, respectively. International Recorded Music revenues were $315 million and $325 million, or 47% and 52% of consolidated Recorded Music revenues for the three months ended March 31, 2006 and 2005, respectively.

Recorded Music OIBDA increased by $9 million, or 13%, to $81 million for the three months ended March 31, 2006 compared to $72 million for the three months ended March 31, 2005. Expressed as a percentage of Recorded Music revenues, Recorded Music OIBDA was 12% for each of the three months ended March 31, 2006 and 2005. Excluding a $2 million unfavorable impact of foreign currency exchange rates, OIBDA increased $11 million primarily as a result of the $76 million increase in revenues more fully described above, offset by (i) a $27 million increase in product costs due to the increase in physical sales and changes to product mix previously described, (ii) a $13 million increase in selling and marketing expenses related to the timing of marketing costs incurred in relation to our product release schedule in the current quarter, (iii) an $11 million increase in general and administrative expenses due primarily to the $8 million severance payment made related to the departure of the chairman of WMI and (iv) an $11 million increase in artist and repertoire costs due to the increases in physical and digital sales previously described. As a percentage of Recorded Music revenues, artist and repertoire costs declined, excluding the impact of foreign currency exchange rates, as compared to the prior-year quarter.

Recorded Music operating income was $40 million for the three months ended March 31, 2006 as compared to $30 million for the three months ended March 31, 2005. Recorded Music operating income included the following components:

| | Three Months Ended March 31, 2006 (unaudited) | | Three Months Ended March 31, 2005 (unaudited) |
|---|---|---|---|
| | | (in millions) | |
| OIBDA | $ 81 | | $ 72 |
| Depreciation and amortization | (41) | | (42) |
| Operating income | $ 40 | | $ 30 |

The $10 million increase in Recorded Music operating income related to the $9 million increase in Recorded Music OIBDA more fully discussed above, and a decrease in Recorded Music depreciation and amortization of $1 million.

*Music Publishing*

Music Publishing revenues decreased to $129 million for the three months ended March 31, 2006 as compared to $154 million for the three months ended March 31, 2005. Excluding a $10 million unfavorable impact of foreign currency exchange rates, and prior year revenue of $11 million from our sheet music business, which was sold in May 2005, Music Publishing revenues declined $4 million, or 3%, and such decline was comprised of a $8 million decrease in mechanical revenue and a $2 million decline in synchronization revenue, offset by increases in performance revenue of $3 million and other revenues of $3 million. Mechanical revenue declines reflect prior-year industry declines in physical record sales. Music Publishing revenues consisted of $58 million of mechanical revenues, $42 million of performance revenues, $20 million of synchronization revenues, $4 million of revenues from digital sales and $5 million of other revenues. Digital sales represented 3% of Music Publishing revenues for the three months ended March 31, 2006 and 2005. Music Publishing revenues represented 16% and 20% of consolidated revenues, prior to corporate and revenue eliminations, for the three months ended March 31, 2006 and 2005, respectively.

Music Publishing OIBDA was a flat $47 million for the three months ended March 31, 2006 and 2005. Excluding a $3 million unfavorable impact of changes in foreign currency exchange rates and a $1 million prior year OIBDA loss from our sheet music business, OIBDA increased by $2 million primarily as a result of a decrease in artist and repertoire costs, offset by the $4 million decrease in revenue discussed above. Expressed as a percentage of Music Publishing revenues, Music Publishing OIBDA was 36% and 31% for the three months ended March 31, 2006 and 2005, respectively.

Music Publishing operating income was a flat $32 million for the three months ended March 31, 2006 and 2005. Music Publishing operating income includes the following components:

| | Three Months Ended March 31, 2006 (unaudited) | | Three Months Ended March 31, 2005 (unaudited) |
|---|---|---|---|
| | | (in millions) | |
| OIBDA | $ 47 | | $ 47 |
| Depreciation and amortization | (15) | | (15) |
| Operating income | $ 32 | | $ 32 |

*Corporate Expenses and Eliminations*

Corporate expenses before depreciation and amortization expense decreased $7 million, to $24 million for the three months ended March 31, 2006 as compared to $31 million for the three months ended March 31, 2005. The decrease primarily related to the absence of the management fees incurred in the prior year of $2.5 million, due to the previously discussed termination of the Management Agreement, along with a decrease in depreciation.

**Six Months Ended March 31, 2006 Compared to Six Months Ended March 31, 2005**

The following table summarizes our historical results of operations:

| | Six Months Ended March 31, 2006 (unaudited) | | Six Months Ended March 31, 2005 (unaudited) |
|---|---|---|---|
| | | (in millions) | |
| Revenues | $ 1,840 | | $ 1,855 |
| Costs and expenses: | | | |
| Cost of revenues (1) | (939) | | (981) |
| Selling, general and administrative expenses (1) | (617) | | (624) |
| Amortization of intangible assets | (95) | | (93) |
| Total costs and expenses | (1,651) | | (1,698) |
| Operating income | 189 | | 157 |
| Interest expense, net | (82) | | (71) |
| Equity in the gains (losses) of equity-method investees, net | 1 | | (1) |
| Other income, net | 2 | | 4 |
| Income before income taxes | 110 | | 89 |
| Income tax expense | (40) | | (42) |
| Net income | $ 70 | | $ 47 |

(1) Includes depreciation expense of: $22 million and $28 million for the six months ended March 31, 2006 and 2005, respectively.

***Consolidated Historical Results***

*Revenues*

Our revenues decreased $15 million, or 1%, to $1.840 billion for the six months ended March 31, 2006 as compared to $1.855 billion for the six months ended March 31, 2005. Excluding a $58 million unfavorable impact of foreign currency exchange rates and prior year revenue of $26 million related to our sheet music business, which was sold in May 2005, total revenue increased by $69 million, or 4%, primarily due to significant increases in digital sales. Recorded Music revenues increased by $35 million, to $1.596 billion for the six months ended March 31, 2006. Excluding the impact of foreign currency exchange rates, Recorded Music revenues increased by $79 million or 5%, primarily driven by a decline of $19 million in worldwide Recorded Music physical sales, which was more than offset by an increase in worldwide Recorded Music digital sales of $98 million. Music Publishing revenues declined by $49 million, to $260 million for the six months ended March 31, 2006. Excluding the impact of foreign currency exchange rates and the prior year revenue related to our sold sheet music business, Music Publishing revenue declined $9 million, or 3%. International operations represented $964 million of consolidated revenues for the six months ended March 31, 2006 as compared to $1.005 billion for the six months ended March 31, 2005, comprising 52% and 54% of total revenues, respectively.

Overall digital revenues grew $99 million to $159 million for the six months ended March 31, 2006 as compared to $60 million for the six months ended March 31, 2005. Digital revenues represented 9% and 3% of consolidated revenues for the six months ended March 31, 2006 and 2005, respectively. Total digital revenues for the six months ended March 31, 2006 were comprised of U.S revenues of $113 million, or 71% of total digital revenues, and international revenues of $46 million, or 29% of total digital revenues. The increase in digital revenues resulted from continued efforts to develop our digital business including efforts to further monetize existing content through new formats and new distribution channels and the increased usage of legal, online and mobile distribution channels for the music industry.

See “Business Segment Results” presented hereinafter for a discussion of revenue by business segment.

*Cost of revenues*

Our cost of revenues decreased by $42 million, or 4%, to $939 million for the six months ended March 31, 2006 as compared to $981 million for the six months ended March 31, 2005. Expressed as a percent of revenues, cost of revenues was 51% and 53% for the six months ended March 31, 2006 and 2005, respectively. Excluding a $36 million favorable impact of foreign currency exchange rates and $17 million of expenses related to our sheet music business, which was sold in May 2005, our cost of revenues increased $11 million, or 1%. The increase was primarily due to increases in product costs of $24 million, which is related to the sale of special edition physical products, such as CD/DVD box sets in the current quarter, and was offset by a $17 million decrease in artist and repertoire costs related to the change in mix of products sold as well as fewer unrecoverable artist advances.

*Selling, general and administrative expenses*

Our selling, general and administrative expenses decreased by $7 million, or 1%, to $617 million for the six months ended March 31, 2006 as compared to $624 million for the six months ended March 31, 2005. Expressed as a percent of revenues, selling, general and administrative expenses were 34% for the six months ended March 31, 2006 and 2005. Excluding a $16 million benefit of foreign currency exchange rates and $9 million of expenses related to our sold sheet music business, selling, general and administrative expenses increased by $18 million, or 3%, primarily due to a $29 million increase in selling and marketing expense which was the result of the timing of marketing costs incurred in relation to our product release schedule in the current period, and a severance payment of $8 million related to the termination of the chairman of WMI. These increases were offset by a $4 million decrease in general and administrative costs, which was primarily the result of the absence of $5 million of management fees incurred in the prior year related to the terminated Management Agreement described above, and the decrease in depreciation of $6 million as further discussed below. Stock compensation expense amounted to $8 million for the six months ended March 31, 2006 and $9 million for the six months ended March 31, 2005.

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***Reconciliation of Consolidated Historical OIBDA to Operating Income and Net Income***

As previously described, we use OIBDA as our primary measure of financial performance. The following table reconciles OIBDA to operating income and further provides the components from operating income to net loss for purposes of the discussion that follows:

| | Six Months Ended March 31, 2006 (unaudited) | (in millions) | Six Months Ended March 31, 2005 (unaudited) |
|---|---|---|---|
| OIBDA | $ 306 | | $ 278 |
| Depreciation expense | (22) | | (28) |
| Amortization expense | (95) | | (93) |
| Operating income | 189 | | 157 |
| Interest expense, net | (82) | | (71) |
| Equity in the gains (losses) of equity-method investees, net | 1 | | (1) |
| Other income, net | 2 | | 4 |
| Income before income taxes | 110 | | 89 |
| Income tax expense | (40) | | (42) |
| Net income | $ 70 | | $ 47 |

*OIBDA*

Our OIBDA increased $28 million, or 10%, to $306 million for the six months ended March 31, 2006 as compared to $278 million for the six months ended March 31, 2005. Expressed as a percentage of revenues, total OIBDA margin was 17% for the six months ended March 31, 2006 as compared 15% for the six months ended March 31, 2005. Excluding an approximate $6 million unfavorable impact of foreign currency exchange rates, OIBDA increased by $34 million, or 13%, which was primarily a result of the increase in revenues offset by the increases in costs of revenues and selling, general and administrative expenses, which are more fully discussed above.

*Depreciation expense*

Our depreciation expense decreased by $6 million to $22 million for the six months ended March 31, 2006 as compared to $28 million for the six months ended March 31, 2005. The decrease primarily relates to lower capital spending since the date of Acquisition.

*Amortization expense*

Our amortization expense increased by $2 million, or 2%, to $95 million for the six months ended March 31, 2006 as compared to $93 million for the six months ended March 31, 2005. The increase is due to various acquisitions of recorded music catalog and music publishing copyrights since the prior year.

*Operating income*

Our operating income increased $32 million, or 20%, to $189 million for the six months ended March 31, 2006 as compared to $157 million for the six months ended March 31, 2005. The increase in operating income was primarily a result of the increase in revenues offset by the increases in costs of revenues and selling, general and administrative expenses, which are more fully discussed above. See “Business Segment Results” presented hereinafter for a discussion of operating income by business segment.

*Interest expense, net*

Our interest expense increased to $82 million for the six months ended March 31, 2006 compared to $71 million for the six months ended March 31, 2005. The six months ended March 31, 2006 reflects an increase primarily due to the inclusion of interest expense related to an additional outstanding term loan of $250 million borrowed in May 2005, which is not reflected in the six months ended March 31, 2005 and an increase in interest rates.

*Equity in the gains (losses) of equity-method investees, net*

The six months ended March 31, 2006 includes $1 million of equity in the gains of equity-method investees, as compared to $1 million of equity in the losses of equity-method investees during the six months ended March 31, 2005.

*Other Income, net*

We recognized other income, net of $2 million for the six months ended March 31, 2006 as compared to $4 million for the six months ended March 31, 2005. Other income relates to favorable foreign currency exchange rates movements associated with intercompany receivables and payables that are short-term in nature, and therefore required to be recognized in the statement of operations under U.S. GAAP.

*Income tax expense*

We provided income tax expense of $40 million for the six months ended March 31, 2006 as compared to $42 million for the six months ended March 31, 2005. In connection with the Acquisition we made a joint election with Time Warner under Section 338(h)(10) of the U.S. Internal Revenue Code to treat the Acquisition as an asset purchase. There was no offsetting income tax benefit on U.S. domestic tax losses recognized due to the uncertain nature of these deferred tax assets. Our income tax expense for the six months ended March 31, 2006 and 2005 primarily relates to the tax provisions on foreign income.

*Net income*

Our net income increased $23 million to $70 million for the six months ended March 31, 2006 as compared to $47 million for the six months ended March 31, 2005. The increase is the primarily the result of the increases in operating income described above.

**Business Segment Results**

Revenue, OIBDA and operating income (loss) by business segment are as follows:

| | Six Months Ended March 31, 2006 (unaudited) | | Six Months Ended March 31, 2005 (unaudited) |
|---|---|---|---|
| | | (in millions) | |
| Recorded Music | | | |
| Revenue | $ 1,596 | | $ 1,561 |
| OIBDA | $ 287 | | $ 266 |
| Operating income | $ 206 | | $ 182 |
| Music Publishing | | | |
| Revenue | $ 260 | | $ 309 |
| OIBDA | $ 68 | | $ 71 |
| Operating income | $ 38 | | $ 42 |
| Corporate and Revenue Eliminations | | | |
| Revenue eliminations | $ (16) | | $ (15) |
| OIBDA | $ (49) | | $ (59) |
| Operating loss | $ (55) | | $ (67) |
| Total | | | |
| Revenue | $ 1,840 | | $ 1,855 |
| OIBDA | $ 306 | | $ 278 |
| Operating income | $ 189 | | $ 157 |

*Recorded Music*

Recorded Music revenues increased by $35 million, or 2%, to $1.596 billion for the six months ended March 31, 2006 from $1.561 billion for the six months ended March 31, 2005. Excluding a $44 million unfavorable impact of foreign currency exchange rates, Recorded Music revenues increased by $79 million, or 5%, which was primarily driven by an increase in digital sales of $98 million offset by a decline in licensing revenue and physical sales of $19 million. Digital sales totaled $150 million, or 9% of Recorded Music revenues for the six months ended March 31, 2006 and $52 million, or 3%, for the six months ended March 31, 2005. Worldwide digital gains more than offset declines in licensing revenue and physical sales, which was comprised of declines in international physical sales of $5 million, international licensing revenue declines of $5 million and U.S physical sales declines of $9 million.

Recorded Music revenues represented 87% and 84% of consolidated revenues, prior to corporate and revenue eliminations, for the six months ended March 31, 2006 and 2005, respectively. U.S. Recorded Music revenues were $768 million and $709 million, or 48% and 45% of consolidated Recorded Music Revenues for the six months ended March 31, 2006 and 2005, respectively. International Recorded Music revenues were $828 million and $852 million, or 52% and 55% of consolidated Recorded Music Revenues for the six months ended March 31, 2006 and 2005, respectively.

Recorded Music OIBDA increased by $21 million, or 8%, to $287 million for the six months ended March 31, 2006 compared to $266 million for the six months ended March 31, 2005. Expressed as a percentage of Recorded Music revenues, Recorded Music OIBDA was 18% and 17% for the six months ended March 31, 2006 and 2005, respectively. Excluding a $6 million unfavorable impact of foreign currency exchange rates, OIBDA increased $27 million, or 10%, primarily as a result of the $79 million increase in revenues more fully described above and a $10 million decrease in artist and repertoire costs related to the change in product mix and a decrease in unrecoverable artist royalty advances, which were offset by (i) a $28 million increase in selling and marketing expense related to the timing of marketing costs incurred related to our product release schedule in the current period, (ii) a $24 million increase in product costs, due to changes in product mix as compared to the same period in the prior year and (iii) a $9 million increase in general and administrative expenses primarily due to the $8 million severance payment made related to the departure of the chairman of WMI.

Recorded Music operating income was $206 million for the six months ended March 31, 2006 as compared to $182 million for the six months ended March 31, 2005. Recorded Music operating income included the following components:

| | Six Months Ended March 31, 2006 (unaudited) | | Six Months Ended March 31, 2005 (unaudited) |
|---|---|---|---|
| | | (in millions) | |
| OIBDA | $ 287 | | $ 266 |
| Depreciation and amortization | (81) | | (84) |
| Operating income | $ 206 | | $ 182 |

The $24 million increase in Recorded Music operating income related to the $21 million increase in Recorded Music OIBDA, more fully discussed above, and a decrease in Recorded Music depreciation and amortization of $3 million.

*Music Publishing*

Music Publishing revenues decreased to $260 million for the six months ended March 31, 2006 as compared to $309 million for the six months ended March 31, 2005. Excluding a $14 million unfavorable impact of foreign currency exchange rates, and prior year revenue of $26 million of revenue from our sheet music business, which was sold in May 2005, Music Publishing revenues declined $9 million, or 3%, which was comprised of a $12 million decrease in mechanical revenue and a $2 million decline in synchronization revenue, offset by an increase in other revenues of $5 million. Performance revenue was flat. Mechanical revenue declines reflect prior-year industry declines in physical record sales. Music Publishing revenues consisted of $117 million of mechanical revenues, $87 million of performance revenues, $38 million of synchronization revenues, $9 million of revenues from digital sales and $9 million of other revenues. Digital sales represented 3% of Music Publishing revenues for the six months ended March 31, 2006 and 2005. Music Publishing revenues represented 14% and 17% of consolidated revenues, prior to corporate and revenue eliminations, for the six months ended March 31, 2006 and 2005, respectively.

Music Publishing OIBDA decreased $3 million to $68 million for the six months ended March 31, 2006 as compared to $71 million for the six months ended March 31, 2005. Expressed as a percentage of Music Publishing revenues, Music Publishing OIBDA was 26% and 23% for the six months ended March 31, 2006 and 2005, respectively. OIBDA decreased primarily as a result of the decrease in revenue more fully discussed above, which was offset by (i) a decrease in product costs of $12 million, (ii) a decrease in royalty expenses of $22 million and (iii) a decrease in general and administrative expenses of $8 million. These decreases in expenses were primarily due to the sale of our sheet music business.

Music Publishing operating income decreased to $38 million for the six months ended March 31, 2006 as compared to $42 million for the six months ended March 31, 2005. Music Publishing operating income includes the following components:

| | Six Months Ended March 31, 2006 (unaudited) | | Six Months Ended March 31, 2005 (unaudited) |
|---|---|---|---|
| | | (in millions) | |
| OIBDA | $ 68 | | $ 71 |
| Depreciation and amortization | (30) | | (29) |
| Operating income | $ 38 | | $ 42 |

The $4 million decrease in Music Publishing operating income related to the $3 million decrease in Music Publishing OIBDA described above and a $1 million increase in depreciation and amortization.

*Corporate Expenses and Eliminations*

Corporate expenses before depreciation and amortization expense decreased $10 million, to $49 million for the six months ended March 31, 2006 as compared to $59 million for the six months ended March 31, 2005. The decrease primarily relates to the absence of management fees in the current period of $5 million, due to the previously discussed termination of the Management Agreement, along with a decrease in consulting fees.

## FINANCIAL CONDITION AND LIQUIDITY

### Financial Condition

At March 31, 2006, we had $2.061 billion of debt, $311 million of cash and equivalents, $27 million of short-term investments (net debt of $1.723 billion, defined as total debt less cash and equivalents and short-term investments) and $234 million of shareholder's equity. This compares to $2.072 billion of debt, $247 million of cash and equivalents (net debt of $1.825 billion) and $235 million of shareholder's equity at September 30, 2005. Net debt decreased by $102 million as a result of (i) a $64 million increase in cash and equivalents, (ii) a $27 million increase in short-term investments, (iii) an $8 million reduction related to our quarterly repayments of our term loans under the senior secured credit facility and (iv) a $3 million impact of foreign currency exchange rates on our Sterling-denominated notes.

Short-term investments include high-quality, investment grade securities such as taxable auction rate securities as well as commercial paper and corporate bonds with maturities greater than 90 days but less than one year. We have expanded our investment portfolio in order to increase yield while maintaining safety of principal consistent with an investment policy approved by the Board of Directors.

The $1 million increase in shareholder's equity that occurred during the six months ended March 31, 2006 related to $70 million of net income for the six months ended March 31, 2006, deferred gains on derivative financial instruments of $9 million and stock compensation of $8 million for the six months ended March 31, 2006. These increases were offset by $86 million of dividends declared and paid to Holdings, which was comprised of a $4 million dividend to enable Holdings to settle certain inter-company balances and an $82 million dividend, which Holdings subsequently declared and paid to Parent to enable Parent to fund current and future dividends to its shareholders.

### Cash Flows

The following table summarizes our historical cash flows. The financial data for the six months ended March 31, 2006 and 2005 are unaudited and are derived from our interim financial statements included elsewhere herein.

| | Six Months Ended March 31, 2006 (unaudited) | | Six Months Ended March 31, 2005 (unaudited) |
|---|---|---|---|
| | | (in millions) | |
| Cash provided by (used in): | | | |
| Operating activities | $ 205 | | $ 297 |
| Investing activities | (57) | | (61) |
| Financing activities | (86) | | (354) |

*Operating Activities*

Cash provided by operations was $205 million for the six months ended March 31, 2006 compared to $297 million for the six months ended March 31, 2005. The $92 million decrease in cash provided by operations was primarily due to higher royalty advance payments in connection with contractual obligations and the timing of releases and additional royalty payments related to the timing of releases.

*Investing Activities*

Cash used in investing activities was $57 million for the six months ended March 31, 2006 compared to $61 million for the six months ended March 31, 2005. The $57 million of cash used in investing activities in the six months ended March 31, 2006 primarily reflects $27 million of cash invested in auction rate securities and other short-term investments, $12 million of capital expenditures and the acquisition of a small independent record label in Australia. The $61 million of cash used in investing activities in the six months ended March 31, 2005 primarily reflects $14 million of capital expenditures, the acquisition of an additional 30% interest in Maverick and various acquisitions of music publishing copyrights.

*Financing Activities*

Cash used in financing activities was $86 million for the six months ended March 31, 2006, a $268 million decrease as compared to $354 million for the six months ended March 31, 2005. Cash used in financing activities for the six months ended March 31, 2005 reflected returns of capital to the Investor Group prior to Parent's Initial Common Stock Offering. Cash used in financing activities for the six months ended March 31, 2006 primarily consisted of the payment of dividends to Holdings.

**Liquidity**

Our primary sources of liquidity are the cash flow generated from our subsidiaries' operations, availability under the undrawn $250 million (less $2 million of outstanding letters of credit as of March 31, 2006) revolving credit portion of our senior secured credit facility and available cash and equivalents and short-term investments. These sources of liquidity are needed to fund our debt service requirements, working capital requirements, capital expenditure requirements, dividends to fund the regular quarterly dividends of Parent and the remaining one-time costs associated with the execution of our restructuring plan. We believe that our existing sources of cash will be sufficient to support our existing operations over the next twelve months.

As of March 31, 2006, our long-term debt consisted of $1.422 billion of borrowings (including $17 million of debt that is classified as a current obligation) under the term loan portion of our senior secured credit facility and $639 million of senior subordinated notes. There were no borrowings under the revolving portion of our senior secured credit facility as of March 31, 2006.

*Senior Secured Credit Facility*

The senior secured credit facility consists of a $1.422 billion outstanding term loan portion and an undrawn $250 million revolving credit portion. The term loan portion of the facility matures in February 2011. We are required to prepay outstanding term loans, subject to certain exceptions and conditions, with excess cash flow or in the event of certain asset sales and casualty and condemnation events and incurrence of debt. We are required to make minimum repayments under the term loan portion of our facility in quarterly principal amounts of approximately $4 million through November 2010, with a remaining balloon payment in February 2011. The revolving credit portion of the senior secured credit facility matures in February 2010. There are no mandatory reductions in borrowing availability for the revolving credit portion of the facility through its term.

Borrowings under both the term loan and revolving credit portion of the senior secured credit facility currently bear interest at a rate equal to an applicable margin plus, at our option, either (a) a base rate determined by reference to the higher of (1) the prime rate of Bank of America, N.A. and (2) the federal funds rate plus $^{1}/2$ of 1% or (b) a LIBOR rate determined by reference to the costs of funds for deposits in the currency of such borrowing for the interest period relevant to such borrowing adjusted for certain additional costs. As of March 31, 2006, the applicable margins with respect to base rate borrowings and LIBOR borrowings were 1.25% and 2.25%, respectively, for borrowings under the revolving credit facility. The applicable margins are variable subject to changes in certain leverage ratios. For borrowings under the term loan facility, the margins with respect to the base rate borrowings and LIBOR borrowings are 1.00% and 2.00%, respectively, but will be 0.75% and 1.75%, respectively if the senior secured debt of Acquisition Corp. is rated at least BB by S&P and at least Ba2 by Moody's. As of May 4, 2006 our term loan facility was rated B+ by S&P and Ba2 by Moody's.

In addition to paying interest on outstanding principal under the senior secured credit facility, we are required to pay a commitment fee to the lenders under the revolving credit facility in respect of the unutilized commitments. As of March 31, 2006, the commitment fee rate was 0.375%. The commitment fee rate is variable subject to changes in certain of our leverage ratios. We also are required to pay customary letter of credit fees, as necessary.

The senior secured credit facility contains a number of covenants that, among other things, restrict, subject to certain exceptions, our ability and the ability of our subsidiaries to sell assets, incur additional indebtedness or issue preferred stock, repay other indebtedness, pay dividends and distributions or repurchase capital stock, create liens on assets, make investments, loans or advances, make certain acquisitions, engage in mergers or consolidations, engage in certain transactions with affiliates, amend certain material agreements, change the business conducted by us and enter into agreements that restrict dividends from subsidiaries. In addition, the senior secured credit facility requires us to maintain the following financial covenants: a maximum total leverage ratio and a minimum interest coverage ratio, both tested quarterly, and a maximum annual capital expenditures limitation.

*Senior Subordinated Notes of Acquisition Corp.*

Acquisition Corp. has outstanding two tranches of senior subordinated notes due 2014: $465 million principal amount of U.S. dollar-denominated notes and £100 million principal amount of Sterling-denominated notes (collectively, the "Senior Subordinated Notes"). The Senior Subordinated Notes mature on April 15, 2014. The Senior Subordinated Notes bear interest at a fixed rate of 7 $^{3}/8$% per annum on the $465 million dollar notes and 8 $^{1}/8$% per annum on the £100 million Sterling notes. The indenture governing the notes limits our ability and the ability of our restricted subsidiaries to incur additional indebtedness or issue certain preferred shares; to pay dividends on or make other distributions in respect of its capital stock or make other restricted payments; to make certain investments; to sell certain assets; to create liens on certain debt without securing the notes; to consolidate, merge, sell or otherwise dispose of all or substantially all of our assets; to enter into certain transactions with affiliates; and to designate our subsidiaries as unrestricted subsidiaries. Subject to certain exceptions, the indenture governing the notes permits us and our restricted subsidiaries to incur additional indebtedness, including secured indebtedness, and to make certain restricted payments and investments.

*Holdings Notes*

Our immediate parent company, Holdings, issued debt in December of 2004. While Holdings is the issuer of such debt, it is a holding company that conducts substantially all of its business operations through us, its only asset and wholly owned subsidiary. As such, Holdings will be relying on us to make any payments of principal and interest as they become due.

In December 2004, Holdings issued the Holdings Notes. In connection with the Parent's initial common stock offering, Holdings used $517 million of proceeds from Parent's offering along with $57 million of available cash received as a dividend from us to redeem certain of the Holdings Notes outstanding. As of March 31, 2006, Holdings had $182 million of debt on its balance sheet relating to such securities, net of issuance discounts.

The Holdings Floating Rate Notes were redeemed in full on June 15, 2005. From the issuance date through the redemption date, the notes bore interest at a quarterly floating rate based on three-month LIBOR rates plus a margin equal to 4.375%. Interest was payable quarterly in cash beginning on March 15, 2005.

The Holdings Discount Notes were issued at a discount and had an initial accreted value of $630.02 per $1,000 principal amount at maturity. Prior to December 15, 2009, no cash interest payments are required. However, interest accrues on the Holdings Discount Notes in the form of an increase in the accreted value of such notes such that the accreted value of the Holdings Discount Notes will equal the principal amount at maturity on December 15, 2009. Thereafter, cash interest on the Holdings Discount Notes is payable semiannually at a fixed rate of 9.5% per annum. The Holdings Discount Notes mature on December 15, 2014. The Company redeemed 35% of the Holdings Discount Notes on June 15, 2005.

The Holdings PIK Notes were redeemed in full on June 15, 2005. From the date of issuance through the date of redemption, the notes bore interest at a semi-annual floating rate based on six-month LIBOR rates plus a margin equal to 7%. Interest was accrued in the form of additional PIK notes at the election of the Company. Such amounts were also repaid in connection with the redemption.

Holdings' primary source of liquidity to service its indebtedness will be cash flow generated from the operations of the Company. However, the terms of certain of the debt instruments governing our existing notes significantly restrict us and Holdings' other subsidiaries from paying dividends, making distributions and otherwise transferring assets to Holdings. For example, our ability to make such payments is generally governed by a formula based on 50% of its consolidated net income (which, as defined in the indenture governing our existing notes, excludes goodwill impairment charges and any after-tax extraordinary, unusual or nonrecurring gains and losses) accruing from June 1, 2004. In addition, as a condition to making such payments to Holdings based on such formula, we must have a ratio of Adjusted EBITDA to fixed charges ("Fixed Charge Coverage Ratio") of at least 2.0 to 1.0 after giving effect to any such payments. The Company may also make payments to Holdings or other restricted payments if, on a pro forma basis after giving effect to any such payment, it has a Net Indebtedness to Adjusted EBITDA ratio of no greater than 3.75 to 1.0 and a Net Senior Indebtedness to Adjusted EBITDA Ratio of no greater than 2.5 to 1.0. The Company may also pay up to $45 million to Holdings or make other restricted payments without regard to any such provisions. Finally, the Company's senior secured credit agreement permits it to make payments to Holdings so that Holdings can pay interest in cash on its indebtedness (including on its notes) up to a maximum amount of $35 million in any fiscal year for the next five years. Thereafter, the credit agreement will permit Holdings to pay cash interest when due if it is then required to be paid in cash, assuming there has been no event of default under the credit agreement.

*Initial Common Stock Offering*

In May 2005, Parent completed the initial public offering of its common stock (the "Initial Common Stock Offering"). Prior to the consummation of the Initial Common Stock Offering, Parent, among other things, renamed all of its outstanding shares of Class A Common Stock as common stock and authorized an approximately 1,139 for 1 split of its common stock. Parent contributed the net proceeds from the Initial Common Stock Offering of $517 million to Holdings as an equity capital contribution. Holdings used all of such funds and approximately $57 million of cash received through dividends from us to redeem all outstanding Holdings Floating Rate Notes, all outstanding Holdings PIK Notes and 35% of the aggregate principal amount of the outstanding Holdings Discount Notes, including redemption premiums and interest obligations through the date of redemption.

*Dividends*

Parent has disclosed that it intends to pay regular quarterly dividends on its common stock outstanding in an amount not to exceed $80 million per year. We may be required to fund these dividends through dividends to our parent companies. The ability of Parent to pay this dividend is dependent on the cash flows and operations of the Company.

On October 3, 2005, December 29, 2005 and March 14, 2006, Parent declared dividends on its outstanding common stock at a rate of $0.13 per share. The dividends were paid on November 23, 2005, February 17, 2006 and May 3, 2006, respectively, except for the portion of the dividends with respect to unvested restricted stock, which will be paid at such time as such shares become vested.

During the six months ended March 31, 2006, 1,244,822 shares of restricted stock of Parent purchased by or awarded to certain employees of the Company vested.

**Covenant Compliance**

Our senior secured credit facility requires us to maintain certain covenants including a Leverage Ratio and an Interest Coverage Ratio, as such terms are defined in the credit facility. The credit facility also contains covenants that, among other things, restrict our ability to incur additional debt. The occurrence of an event of default under the credit facility could result in all amounts outstanding under the facility to be immediately due and payable, which could have a material adverse impact on our results of operations, financial position and cash flow. As of March 31, 2006, we were in compliance with all covenants under the credit facility.

Our Subordinated Notes contain certain financial covenants, which limit the ability of our restricted subsidiaries, as defined in the indenture governing the notes, to, among other things, incur additional indebtedness, issue certain preferred shares, pay dividends, make certain investments, sell certain assets, and consolidate, merge, sell or otherwise dispose of all, or some of, our assets. In order for us to incur additional debt or make certain restricted payments using certain exceptions provided for in the indenture governing the notes, the Fixed Charge Coverage Ratio, as defined in the indenture governing the notes, must exceed a 2.0 to 1.0 ratio. Fixed Charges are defined in the indenture governing the notes as consolidated interest expense excluding certain non-cash interest expense.

In order for us to make certain restricted payments, including payments to Holdings on a pro forma basis after giving effect to such payments, our Net Indebtedness to Adjusted EBITDA ratio and Net Senior Indebtedness to Adjusted EBITDA ratio, as defined in the indenture governing the notes, need to be lower than 3.75x and 2.5x, respectively, at the time of the restricted payment.

We may make additional restricted payments using certain other exceptions provided for in the indenture governing the Subordinated Notes.

**Summary**

Management believes that future funds generated from our operations and available borrowing capacity will be sufficient to fund our debt service requirements, working capital requirements, capital expenditure requirements, payment of regular dividends to fund the regular dividends of Parent and the remaining one-time costs associated with the execution of the restructuring plan for the foreseeable future. However, our ability to continue to fund these items and to reduce debt may be affected by general economic, financial, competitive, legislative and regulatory factors, as well as other industry-specific factors such as the ability to control music piracy.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As discussed in Note 19 to our audited consolidated financial statements for the twelve months ended September 30, 2005, the Company is exposed to market risk arising from changes in market rates and prices, including movements in foreign currency exchange rates and interest rates. As of March 31, 2006, other than as described below, there have been no material changes to the Company's exposure to market risk since September 30, 2005.

We have transactional exposure to changes in foreign currency exchange rates relative to the U.S. dollar due to the global scope of our operations. We use foreign exchange contracts, primarily to hedge the risk that unremitted or future royalties and license fees owed to our domestic companies for the sale, or anticipated sale, of U.S.-copyrighted products abroad may be adversely affected by changes in foreign currency exchange rates. We focus on managing the level of exposure to the risk of foreign current exchange rate fluctuations on our major currencies, which include the British pound sterling, euro, Japanese yen, Canadian dollar, and Australian dollar. The Company did not enter into any significant foreign exchange forward contracts during the six months ended March 31, 2006 or subsequent to March 31, 2006.

We are exposed to foreign currency exchange rate risk with respect to our £100 million principal amount of Sterling-denominated notes that were issued in April 2004. These sterling notes mature on April 15, 2014. As of March 31, 2006, the carrying value of these Sterling notes was $174 million. However, a weakening or strengthening of the U.S. dollar compared to the British Pound Sterling would not have an impact on the fair value of these Sterling notes, as these notes are completely hedged as of March 31, 2006. We did not enter into any additional hedges related to this debt subsequent to March 31, 2006.

We are exposed to interest rate risk with respect to our floating rate debt. During the six months ended March 31, 2006, we did not enter into additional interest rate swap agreements. As of March 31, 2006 we had total interest rate swap agreements in place to hedge total notional amounts of $897 million. Under existing interest rate swap agreements, we agreed to receive floating-rate payments (based on three-month LIBOR rates) in exchange for fixed-rate payments. Subsequent to March 31, 2006, we entered into additional interest rate swap agreements to extend the terms to extend the terms of certain existing interest rate swap agreements.

We monitor our positions with, and the credit quality of, the financial institutions that are party to any of our financial transactions. Credit risk relating to the interest rate swaps is considered low because the swaps are entered into with strong, credit-worthy counterparties, and the credit risk is confined to the net settlement of the interest over the remaining life of the swaps.

## ITEM 4. CONTROLS AND PROCEDURES

*Certification*

The certifications of the principal executive officer and the principal financial officer (or persons performing similar functions) required by Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the "Certifications") are filed as exhibits to this report. This section of the report contains the information concerning the evaluation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) ("Disclosure Controls") and changes to internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) ("Internal Controls") referred to in the Certifications and this information should be read in conjunction with the Certifications for a more complete understanding of the topics presented.

*Introduction*

We became subject to the periodic and other reporting requirements of the Exchange Act on February 10, 2005, the effective date of our registration statement relating to the exchange offer to exchange outstanding unregistered notes for freely tradeable exchange notes that were registered under the Securities Act of 1933, as amended. Warner Music Group Corp., our indirect parent, became subject to the periodic and other reporting requirements of the Securities Exchange Act of 1934, as amended, on May 10, 2005, the effective date of Warner Music Group Corp.'s registration statement relating to its Initial Common Stock Offering.

SEC rules define "disclosure controls and procedures" as controls and procedures that are designed to ensure that information required to be disclosed by public companies in the reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms.

SEC rules define "internal control over financial reporting" as a process designed by, or under the supervision of, a public company's principal executive and principal financial officers, or persons performing similar functions, and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles, or U.S. GAAP, including those policies and procedures that: (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company, (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. GAAP, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Our management, including the principal executive officer and principal financial officer, does not expect that our Disclosure Controls or Internal Controls will prevent or detect all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the limitations in any and all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. Further, the design of any control system is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Because of these inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected even when effective Disclosure Controls and Internal Controls are in place.

*Internal Controls*

In connection with our audit for our 2005 fiscal year-end, our outside auditors identified a material weakness in our internal controls. A material weakness, as defined by the Public Company Accounting Oversight

Board, is a significant deficiency that by itself, or in combination with other significant deficiencies, results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Specifically, our outside auditors noted that our domestic operations currently use different royalty systems, which has created certain complexities in reconciling royalty expense and payables. While we recognize that additional staff and enhancements to our current royalty systems are needed to cope with current requirements in royalty processing until a new system can be developed, we may not be able to hire and train additional staff. See also “Risk Factors—Our outside auditors have identified weaknesses in our internal controls that could affect our ability to ensure reliable financial reports.”

*Evaluation of Disclosure Controls and Procedures*

Based on our management’s evaluation (with the participation of our principal executive officer and principal financial officer), as of the end of the period covered by this report and as a result of the weakness in our internal controls described above and below, our principal executive officer and principal financial officer have concluded that our Disclosure Controls need to be improved so that they will provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act will be recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. In addition, we continue to review our disclosure controls and procedures during the transition to a stand-alone business with the objective of implementing comprehensive periodic reporting standards as well as addressing the weaknesses in Internal Controls identified by our outside auditors. We will continue to devote resources to improve our controls and remedy the weakness related to our royalty systems identified during the completion of the most recent audit for the 2005 fiscal year-end.

*Changes in Internal Control over Financial Reporting*

We are committed to maintaining high standards of internal control over financial reporting, corporate governance and public disclosure and continue to improve and refine our Internal Controls as an ongoing process and will continue to take corrective actions and implement improvements as appropriate.

There have been no changes in our Internal Controls over financial reporting or other factors during the period ended March 31, 2006 that have materially affected, or are reasonably likely to materially affect, our Internal Controls.

*Institution of Internal Controls in compliance with Section 404 of Sarbanes-Oxley*

As a result of our registration with the Securities and Exchange Commission, we will be required to comply with Section 404 of the Sarbanes-Oxley Act of 2002 and regulations promulgated thereunder as of September 30, 2006. We are currently performing the system and process evaluation and testing required (and any necessary remediation) in an effort to comply with management certification and auditor attestation requirements of Section 404. In the course of our ongoing evaluation, we have identified areas of our internal controls requiring improvement, and plan to design enhanced processes and controls to address these and any other issues that might be identified through this review. As a result, we expect to incur additional expenses and diversion of management’s time. We cannot be certain as to the timing of completion of our evaluation, testing and remediation actions or the impact of the same on our operations and may not be able to ensure that the process is effective or that the internal controls are or will be effective in a timely manner. If we are not able to implement the requirements of Section 404 in a timely manner or with adequate compliance, our independent auditors may not be able to certify as to the effectiveness of our internal control over financial reporting and we may be subject to sanctions or investigation by regulatory authorities, such as the Securities and Exchange Commission. As a result, there could be an adverse reaction in the financial markets due to loss of confidence in the reliability of our financial statements. In addition, we may be required to incur costs in improving our internal control system and the hiring of additional personnel. Any such action could adversely affect our results. See also “Risk Factors—Our internal controls over financial reporting may not be adequate and our independent auditors may not be able to certify as to their adequacy, which could have a significant affect on our business and reputation.”

## PART II—OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

*Radio Promotion Activities*

In 2004 and 2005, the Attorney General of the State of New York served us with requests for information in connection with an industry-wide investigation of the relationship between music companies and radio stations, including the use of independent promoters and accounting for any such payments. The investigation was pursuant to New York Executive Law §63(12) and New York General Business Law §349, both of which are consumer fraud statutes. On November 22, 2005 we reached a settlement with the Attorney General in connection with this investigation. As part of such settlement, we agreed to make $5 million in charitable payments and to abide by a list of permissible and impermissible promotional activities. On July 25, 2005, Sony BMG reached a settlement with the Attorney General in connection with the same industry-wide investigation. Subsequent to our settlement, two independent labels have filed related antitrust suits against us alleging that our radio promotion activities are anticompetitive. *Radikal Records, Inc. v. Warner Music Group, et al.* was filed on March 21, 2006 in U.S. District Court in the Central District of California, Western Division. *TSR Records, Inc. v. Warner Music Group, et al.* was filed on March 28, 2006 in U.S. District Court in the Central District of California, Western Division. The Company intends to defend against these lawsuits vigorously, but is unable to predict the outcome of these suits. Any litigation we may become involved in as a result of our settlement with the Attorney General, regardless of the merits of the claim, could be costly and divert the time and resources of management.

*Pricing of Digital Music Downloads*

On December 20, 2005 and February 3, 2006, the Attorney General of the State of New York served Warner Music Group Corp. with requests for information in the form of a subpoena duces tecum and subpoena ad testificandum in connection with an industry-wide investigation as to whether the practices of industry participants concerning the pricing of digital music downloads violate Section 1 of the Sherman Act, New York State General Business Law §§ 340 et seq., New York Executive Law §63(12), and related statutes. On February 28, 2006, the U.S. Department of Justice served Warner Music Group Corp. with a request for information in the form of a Civil Investigative Demand as to whether its activities relating to the pricing of digitally downloaded music violate Section 1 of the Sherman Act (15 U.S.C. Section 1). The Company intends to fully cooperate with the Attorney General’s and Department of Justice’s industry-wide inquiries. Subsequent to the announcements of the above governmental investigations, the Company has been named in a total of fourteen class action lawsuits (five in New York, eight in California and one in Washington D.C.) related to the pricing of digital music downloads. The lawsuits are all based on the same general subject matter as the Attorney General’s request for information alleging conspiracy among record companies to fix prices for downloads. The complaints generally seek unspecified compensatory, statutory and treble damages. The Company expects all of the actions to be consolidated into one case. The Company intends to defend against these lawsuits vigorously, but is unable to predict the outcome of these suits. Any litigation we may become involved in as a result of the inquiries of the Attorney General and Department of Justice, regardless of the merits of the claim, could be costly and divert the time and resources of management.

*Other Matters*

In addition to the matters discussed above, we are involved in other litigation arising in the normal course of our business. Management does not believe that any legal proceedings pending against us will have, individually, or in the aggregate, a material adverse effect on our business. However, we cannot predict with certainty the outcome of any litigation or the potential for future litigation. Regardless of the outcome, litigation can have an adverse impact on us, including our brand value, because of defense costs, diversion of management resources and other factors.

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## ITEM 1A. RISK FACTORS

*You should carefully consider the following risks and other information in this report before making an investment decision with respect to shares of our common stock. Any of the following risks could materially and adversely affect our business, financial condition or results of operations.*

### Risks Related to our Business

**Increased costs associated with corporate governance compliance may significantly affect our results of operations.**

Prior to our acquisition by the Investor Group in 2004, we were a business division of Time Warner. In addition we completed our initial public offering in May 2005. Accordingly, we have limited experience operating as an independent public company implementing our own corporate governance practices. We expect the continued evaluation and implementation of corporate governance and securities disclosure and compliance practices in order to comply with these requirements will increase our legal compliance and financial reporting costs. In addition, they could make it more difficult for us to attract and retain qualified members of our board of directors, or qualified executive officers. Finally, director and officer liability insurance for public companies like us has become more difficult and more expensive to obtain, and we may be required to accept reduced coverage or incur higher costs to obtain coverage that is satisfactory to us and our officers or directors. We continue to evaluate and monitor regulatory developments and cannot estimate the timing or magnitude or additional costs we may incur as a result.

**Our internal controls over financial reporting may not be adequate and our independent auditors may not be able to certify as to their adequacy, which could have a significant and adverse effect on our business and reputation.**

We are evaluating our internal controls over financial reporting in order to allow management to report on, and our independent auditors to attest to, our internal controls over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act of 2002 and rules and regulations of the SEC there under, which we refer to as Section 404. Section 404 requires a reporting company such as ours to, among other things, annually review and disclose its internal controls over financial reporting, and evaluate and disclose changes in its internal controls over financial reporting quarterly. We will be required to comply with Section 404 as of September 30, 2006. We are currently performing the system and process evaluation and testing required (and any necessary remediation) in an effort to comply with management certification and auditor attestation requirements of Section 404. In the course of our ongoing evaluation, we have identified areas of our internal controls requiring improvement, and plan to design enhanced processes and controls to address these and any other issues that might be identified through this review. As a result, we expect to incur additional expenses and diversion of management’s time. We cannot be certain as to the timing of completion of our evaluation, testing and remediation actions or the impact of the same on our operations and may not be able to ensure that the process is effective or that the internal controls are or will be effective in a timely manner. If we are not able to implement the requirements of Section 404 in a timely manner or with adequate compliance, our independent auditors may not be able to certify as to the effectiveness of our internal control over financial reporting and we may be subject to sanctions or investigation by regulatory authorities, such as the Securities and Exchange Commission. As a result, there could be an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements. In addition, we may be required to incur costs in improving our internal control system and the hiring of additional personnel. Any such action could adversely affect our results.

**Our outside auditors have identified weaknesses in our internal controls that could affect our ability to ensure reliable financial reports.**

In addition to our evaluation of internal controls under Section 404 of the Sarbanes-Oxley Act and any areas requiring improvement that we identify as part of that process, in connection with our most recent audit, our outside auditors identified a material weakness related to our domestic royalty controls. A material weakness, as defined by the Public Company Accounting Oversight Board, is a significant deficiency that by itself, or in combination with other significant deficiencies, results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Our outside auditors noted that our domestic operations currently use different royalty systems, which has created certain complexities in reconciling royalty expense and payables. While we recognize that additional staff and enhancements to our current royalty systems are needed to cope with current requirements in royalty processing until a new system can be developed, we may not be able to hire and train additional staff. While we have begun to take actions to address the issues surrounding our royalty systems, including hiring outside resources to assist our internal personnel with royalties accounting and entering into a joint venture with Universal Music Group, Exigen Group and Lightspeed Venture Partners to build a new uniform royalty system for all U.S. operations, additional measures will be necessary and these measures along with other measures we expect to take to improve our internal controls may not be sufficient to address the issues identified by our outside auditors or ensure that our internal controls are effective. If we are unable to provide reliable financial reports our business and prospects could suffer material adverse effects and our share price could be adversely affected.

**The recorded music industry has been declining and may continue to decline, which may adversely affect our prospects and our results of operations.**

Illegal downloading of music from the Internet, CD-R piracy, industrial piracy, economic recession, bankruptcies of record wholesalers and retailers and growing competition for consumer discretionary spending and retail shelf space may all be contributing to a declining recorded music industry. Additionally, the period of growth in recorded music sales driven by the introduction and penetration of the CD format has ended. No significant new legitimate audio format has yet emerged to take the place of the CD. The value of worldwide sales (recorded music, excluding sales of digital tracks), as reported by the International Federation of the Phonographic Industry (IFPI) at fixed 2004 exchange rates, fell as the music industry witnessed a decline of 1.6% from 1999 to 2000, 1.3% from 2000 to 2001, 6.7% from 2001 to 2002, 7.4% from 2002 to 2003, 1.3% from 2003 to 2004 and 3.0% from 2004 to 2005. As of April 30, 2006 year-to-date U.S. recorded music sales (excluding sales of digital tracks) are down approximately 2.03% year-over-year. However, new formats for selling recorded music product have been created, including the legal downloading of digital music using the Internet and DVD-Audio formats and the distribution of music on mobile devices, and revenue streams from these new markets are beginning to emerge. As reported by the International Federation of the Phonographic Industry (IFPI), sales of music via the internet and mobile phones generated sales of $1.1 billion for record companies in 2005, up from $380 million in the prior year and sales of music through new avenues such as digital tracks are beginning to offset the declines seen in prior years. However, it is too soon to determine if the industry has stabilized or the impact of sales of music through new channels might have on the industry and the recorded music industry performance may continue to negatively impact our operating results. A declining recorded music industry is likely to lead to reduced levels of revenue and operating income generated by our Recorded Music business. Additionally, a declining recorded music industry is also likely to have a negative impact on our Music Publishing business, which generates a significant portion of its revenues from mechanical royalties, primarily from the sale of music in CD and other recorded music formats.

**There may be downward pressure on our pricing and our profit margins.**

There are a variety of factors which could cause us to reduce our prices and erode our profit margins. They are, among others, increased price competition among record companies resulting from the Universal and Sony BMG recorded music duopoly, price competition from the sale of motion pictures in DVD-Video format and videogames, the negotiating leverage of mass merchandisers, big box retailers and distributor of digital music, the increased costs of doing business with mass merchandisers and big box retailers as a result of complying with operating procedures that are unique to their needs, the adoption by record companies of initially lower-margin formats such as DVD-Audio and any changes in costs associated with new digital formats. See “Risk Factors—We may be materially and adversely affected by the formation of Sony BMG Music Entertainment.”

**Our prospects and financial results may be adversely affected if we fail to identify, sign and retain artists and songwriters and by the existence or absence of superstar releases and by local economic conditions in the countries in which we operate.**

We are dependent on identifying, signing and retaining artists with long-term potential, whose debut albums are well received on release, whose subsequent albums are anticipated by consumers and whose music will continue to generate sales as part of our catalog for years to come. The competition among record companies for such talent is intense. Competition among record companies to sell records is also intense and the marketing expenditures necessary to compete have increased as well. We are also dependent on signing and retaining songwriters who will write the hit songs of today and the classics of tomorrow under terms that are economically attractive to us. Our competitive position is dependent on our continuing ability to attract and develop talent whose work can achieve a high degree of public acceptance. Our financial results may be adversely affected if we are unable to identify, sign and retain such artists and songwriters under terms that are economically attractive to us. Our financial results may also be affected by the existence or absence of superstar artist releases during a particular period. Some music industry observers believe that the number of superstar acts with long-term appeal, both in terms of catalog sales and future releases, has declined in recent years. Additionally, our financial results are generally affected by the general economic and retail environment of the countries in which we operate, as well as the appeal of our recorded music catalog and our music publishing library.

**We may have difficulty addressing the threats to our business associated with home copying and Internet downloading.**

The combined effect of the decreasing cost of electronic and computer equipment and related technology such as CD burners and the conversion of music into digital formats have made it easier for consumers to create unauthorized copies of our recordings in the form of, for example, CDs and MP3 files. A substantial portion of our revenue comes from the sale of audio products that are potentially subject to unauthorized consumer copying and widespread dissemination on the Internet without an economic return to us. We are working to control this problem through litigation, by lobbying governments for new, stronger copyright protection laws and more stringent enforcement of current laws and by establishing legitimate new media business models. We cannot give any assurances that such measures will be effective. If we fail to obtain appropriate relief through the judicial process or the complete enforcement of judicial decisions issued in our favor (or if judicial decisions are not in our favor), if we are unsuccessful in our efforts to lobby governments to enact and enforce stronger legal penalties for copyright infringement or if we fail to develop effective means of protecting our intellectual property (whether copyrights or other rights such as patents, trademarks and trade secrets) or entertainment-related products or services, our results of operations, financial position and prospects may suffer.

**Organized industrial piracy may lead to decreased sales.**

The global organized commercial pirate trade is a significant threat to the music industry. Worldwide, industrial pirated music (which encompasses unauthorized physical copies manufactured for sale but does not include Internet downloads or home CD burning) is estimated to have generated over $4.6 billion in revenues in 2004, according to IFPI. IFPI estimates that 1.5 billion pirated units were manufactured in 2004. According to IFPI estimates, approximately 34% of all music CDs sold worldwide in 2004 were pirated. IFPI is in the process of gathering data for 2005, but final data is not yet available. Unauthorized copies and piracy contributed to the decrease in the volume of legitimate sales and put pressure on the price of legitimate sales. They have had, and may continue to have, an adverse effect on our business.

**Our involvement in intellectual property litigation could adversely affect our business.**

Our business is highly dependent upon intellectual property, a field that has encountered increasing litigation in recent years. If we are alleged to infringe the intellectual property rights of a third party, any litigation to defend the claim could be costly and would divert the time and resources of management, regardless of the merits of the claim. There can be no assurance that we would prevail in any such litigation. If we were to lose a litigation relating to intellectual property, we could be forced to pay monetary damages and to cease the sale of certain products or the use of certain technology. Any of the foregoing may adversely affect our business.

**Due to the nature of our business, our results of operations and cash flows may fluctuate significantly from period to period.**

Our net sales, operating income and profitability, like those of other companies in the music business, are largely affected by the number and quality of albums that we release, our release schedule, and, more importantly, the consumer demand for these releases. We also make advance payments to recording artists and songwriters, which impact our operating cash flows. The timing of album releases and advance payments is largely based on business and other considerations and is made without regard to the timing of the release of our financial results. We report results of operations quarterly and our results of operations and cash flows in any reporting period may be materially affected by the timing of releases and advance payments, which may result in significant fluctuations from period to period.

**Our operating results fluctuate on a seasonal and quarterly basis, and, in the event we do not generate sufficient net sales in our first fiscal quarter, we may not be able to meet our debt service and other obligations.**

Our business is seasonal. For the fiscal year ended September 30, 2005, we derived approximately 83% of our revenues from our Recorded Music business. In the recorded music business, purchases are heavily weighted towards the last three months of the calendar year, which represent our first quarter under our September 30 fiscal year. Historically, we have realized approximately 35% of recorded music net sales worldwide during the last three months of the calendar year, making those three months (i.e., our new first fiscal quarter) material to our full-year performance. We realized 32% of recorded music calendar year net sales during the last three months of calendar 2005 and 2004. This sales seasonality affects our operating cash flow from quarter to quarter. We cannot assure you that our recorded music net sales for the last three months of any calendar year will continue to be sufficient to meet our obligations or that they will be higher than such net sales for our other quarters. In the event that we do not derive sufficient recorded music net sales in such last three months, we may not be able to meet our debt service requirements, working capital requirements, capital expenditure requirements, payment of regular dividends on our common stock and other obligations. As digital revenue increases as a percentage of our total revenue, this may affect the overall seasonality of our business. For example, sales of MP3 players or gift cards to purchase digital music sold in the holiday season tend to result in sales of digital music in subsequent periods. However, seasonality with respect to the sale of music in new formats, such as digital, are still developing.

**We may be unable to compete successfully in the highly competitive markets in which we operate and we may suffer reduced profits as a result.**

The industry in which we operate is highly competitive, is based on consumer preferences and is rapidly changing. Additionally, the music industry requires substantial human and capital resources. We compete with other recorded music companies and music publishers to identify and sign new recording artists and songwriters who subsequently achieve long-term success and to renew agreements with established artists and songwriters. In addition, our competitors may from time to time reduce their prices in an effort to expand market share and introduce new services, or improve the quality of their products or services. We may lose business if we are unable to sign successful artists or songwriters or to match the prices or the quality of products and services, offered by our competitors. Our Music Publishing business competes not only with other music publishing companies, but also with songwriters who publish their own works. Our Recorded Music business is to a large extent dependent on technological developments, including access to and selection and viability of new technologies, and is subject to potential pressure from competitors as a result of their technological developments. For example, our Recorded Music business may be adversely affected by technological developments that facilitate the piracy of music, such as Internet peer-to-peer file-sharing and CD-R activity; by its inability to enforce our intellectual property rights in digital environments; and by its failure to develop a successful business model applicable to a digital online environment, including such channels of distribution as satellite radio. It also faces competition from other forms of entertainment and leisure activities, such as cable and satellite television, pre-recorded films on videocassettes and DVD, the Internet and computer and videogames.

**Our business operations in some countries subject us to trends, developments or other events in foreign countries which may affect us adversely.**

We are a global company with strong local presences, which have become increasingly important as the popularity of music originating from a country's own language and culture has increased in recent years. Our mix of national and international recording artists and songwriters provides a significant degree of diversification for our music portfolio. However, our creative content does not necessarily enjoy universal appeal. As a result, our results can be affected not only by general industry trends, but also by trends, developments or other events in individual countries, including:

- limited legal protection and enforcement of intellectual property rights;
- restrictions on the repatriation of capital;
- differences and unexpected changes in regulatory environment, including environmental, health and safety, local planning, zoning and labor laws, rules and regulations;
- varying tax regimes which could adversely affect our results of operations or cash flows, including regulations relating to transfer pricing and withholding taxes on remittances and other payments by subsidiaries and joint ventures;
- exposure to different legal standards and enforcement mechanisms and the associated cost of compliance;
- difficulties in attracting and retaining qualified management and employees or rationalizing our workforce;
- tariffs, duties, export controls and other trade barriers;
- longer accounts receivable settlement cycles and difficulties in collecting accounts receivable;
- recessionary trends, inflation and instability of the financial markets;
- higher interest rates; and
- political instability.

We may not be able to insure or hedge against these risks, and we may not be able to ensure compliance with all of the applicable regulations without incurring additional costs. Furthermore, financing may not be available in countries with less than investment-grade sovereign credit ratings. As a result, it may be difficult to create or maintain profit-making operations in developing countries.

In addition, our results can be affected by trends, developments and other events in individual countries. There can be no assurance that in the future other country-specific trends, developments or other events will not have such a significant adverse effect on our business, results of operations or financial condition.

**Our business may be adversely affected by competitive market conditions and we may not be able to execute our business strategy.**

We intend to increase revenues and cash flow through a business strategy which requires us to, among other things, continue to maximize the value of our music assets, significantly reduce costs to maximize flexibility and adjust to new realities of the market, continue to act to contain digital piracy and capitalize on digital distribution and emerging technologies.

Each of these initiatives requires sustained management focus, organization and coordination over significant periods of time. Each of these initiatives also requires success in building relationships with third parties and in anticipating and keeping up with technological developments and consumer preferences. The results of the strategy and the success of our implementation of this strategy will not be known for some time in the future. If we are unable to implement the strategy successfully or properly react to changes in market conditions, our financial condition, results of operations and cash flows could be adversely affected.

**Our ability to operate effectively could be impaired if we fail to attract and retain our executive officers.**

Our success depends, in part, upon the continuing contributions of our executive officers. Although we have employment agreements with our executive officers, there is no guarantee that they will not leave. The loss of the services of any of our executive officers or the failure to attract other executive officers could have a material adverse effect on our business or our business prospects.

**Legitimate channels for digital distribution of our creative content are a recent development, and their impact on our business is unclear and may be adverse.**

We have positioned ourselves to take advantage of the Internet and wireless technology as a sales distribution channel and believe that the development of legitimate channels for digital music distribution holds promise for us in the future. However, legitimate channels for digital distribution are a recent development and we cannot predict their impact on our business. In digital formats, certain costs associated with physical products such as manufacturing, distribution, inventory and return costs do not apply. While there are some digital-specific variable costs and infrastructure investments necessary to produce, market and sell music in digital formats, we believe it is reasonable to expect that we will generally derive a higher contribution margin from digital versus physical sales. However, we cannot assure you that we will generally continue to achieve higher margins from digital sales. Any legitimate digital distribution channel that does develop may result in lower or less profitable sales for us than comparable physical sales. In addition, the transition to greater sales through digital channels introduces uncertainty regarding the potential impact of the “unbundling” of the album on our business. While recent studies have indicated that consumers spend more on music in general when they begin to purchase music in digital form than previously, it remains unclear how consumer behavior will change when faced with the prospect of purchasing only their favorite tracks from a given album rather than the entire album. In addition, if piracy continues unabated and legitimate digital distribution channels fail to gain consumer acceptance, our results of operations could be harmed.

**A significant portion of our music publishing revenues is subject to rate regulation either by government entities or by local third-party collection societies throughout the world and rates on other income streams may be set by arbitration proceedings, which may limit our profitability.**

Mechanical royalties and performance royalties are the two largest sources of income to our Music Publishing business and mechanical royalties are a significant expense to our Recorded Music business. In the U.S., mechanical rates are set pursuant to industry negotiations contemplated by the U.S. Copyright Act and performance rates are set by performing rights societies and subject to challenge by performing rights licensees. Outside the U.S., mechanical and performance rates are typically negotiated on an industry-wide basis. The mechanical and performance rates set pursuant to such processes may adversely affect us by limiting our ability to increase the profitability of our Music Publishing business. If the mechanical rates are set too high it may also adversely affect us by limiting our ability to increase the profitability of our Recorded Music business. In addition, rates our Recorded Music business receives in the U.S. for, among other sources of income and potential income, the statutory license for eligible non-subscription services to perform sound recordings publicly by means of digital audio transmissions (“webcasting”), the statutory license to make ephemeral recordings of sound recordings for use of sound recordings and the statutory license for use of our content on satellite radio are set by an arbitration process under the U.S. Copyright Act unless rates are determined through voluntary negotiations. If the rates for these and other income sources are set too low through this process, it could have a material adverse impact on our Recorded Music business or our business prospects.

**Unfavorable currency exchange rate fluctuations could adversely affect our results of operations.**

The reporting currency for our financial statements is the U.S. dollar. We have substantial assets, liabilities, revenues and costs denominated in currencies other than U.S. dollars. To prepare our consolidated financial statements, we must translate those assets, liabilities, revenues and expenses into U.S. dollars at then-applicable exchange rates. Consequently, increases and decreases in the value of the U.S. dollar versus other currencies will affect the amount of these items in our consolidated financial statements, even if their value has not changed in their original currency. These translations could result in significant changes to our results of operations from period to period. For the fiscal year ended September 30, 2005, approximately 52% of our revenues related to operations in foreign territories. For the six months ended March 31, 2006, approximately 48% of our revenues related to operations in foreign territories. From time to time, we enter into foreign exchange contracts to hedge the risk of unfavorable foreign currency exchange rate movements. As of March 31, 2006, we have hedged our material foreign currency exposures related to royalty payments remitted between our foreign affiliates and our U.S. affiliates for the balance of the fiscal year.

**We may not have full control and ability to direct the operations we conduct through joint ventures.**

We currently have interests in a number of joint ventures and may in the future enter into further joint ventures as a means of conducting our business. In addition, we structure certain of our relationships with recording artists and songwriters as joint ventures. We may not be able to fully control the operations and the assets of our joint ventures, and we may not be able to make major decisions or may not be able to take timely actions with respect to our joint ventures unless our joint venture partners agree.

**The enactment of legislation limiting the terms by which an individual can be bound under a “personal services” contract could impair our ability to retain the services of key artists.**

California Labor Code Section 2855 (“Section 2855”) limits the duration of time any individual can be bound under a contract for “personal services” to a maximum of seven years. In 1987, Subsection (b) was added, which provides a limited exception to Section 2855 for recording contracts, creating a damages remedy for record companies. Legislation was introduced in California to repeal Subsection (b) and then withdrawn. Legislation was introduced in New York to create a statute similar to Section 2855, which did not advance. There is no assurance that New York, California or any other state will not reintroduce or introduce similar legislation in the future. In fact, legislation similar to Section 2855 has been introduced in the New York Assembly. The repeal of Subsection (b) of Section 2855 and/or the passage of legislation similar to Section 2855 by other states could materially affect our results of operations and financial position.

**We face a potential loss of catalog if it is determined that recording artists have a right to recapture rights in their recordings under the U.S. Copyright Act.**

The U.S. Copyright Act provides authors (or their heirs) a right to terminate licenses or assignments of rights in their copyrighted works. This right does not apply to works that are “works made for hire”. Since the effective date of U.S. copyrightability for sound recordings (February 15, 1972), virtually all of our agreements with recording artists provide that such recording artists render services under an employment-for-hire relationship. A termination right exists under the U.S. Copyright Act for musical compositions that are not "works made for hire". If any of our commercially available recordings were determined not to be "works made for hire", then the recording artists (or their heirs) could have the right to terminate the rights they granted to us, generally during a five-year period starting at the end of 35 years from the date of a post-1977 license or assignment (or, in the case of a pre-1978 grant in a pre-1978 recording, generally during a five-year period starting either at the end of 56 years from the date of copyright or on January 1, 1978, whichever is later). A termination of rights could have an adverse effect on our Recorded Music business. From time to time, authors (or their heirs) can terminate our rights in musical compositions. However, we believe the effect of those terminations is already reflected in the financial results of our Music Publishing business.

**If we acquire or invest in other businesses, we will face certain risks inherent in such transactions.**

We may acquire, make investments in, or enter into strategic alliances or joint ventures with, companies engaged in businesses that are similar or complementary to ours. If we make such acquisitions or investments or enter into strategic alliances, we will face certain risks inherent in such transactions. For example, gaining regulatory approval for significant acquisitions or investments could be a lengthy process and there can be no assurance of a successful outcome. We could face difficulties in managing and integrating newly acquired operations. Additionally, such transactions would divert management resources and may result in the loss of artists or songwriters from our rosters. We cannot assure you that if we make any future acquisitions, investments, strategic alliances or joint ventures that they will be completed in a timely manner, that they will be structured or financed in a way that will enhance our credit-worthiness and allow for continued payment of regular dividends or that they will meet our strategic objectives or otherwise be successful. Failure to effectively manage any of these transactions could result in material increases in costs or reductions in expected revenues, or both.

**We are controlled by entities that may have conflicts of interest with us.**

The Investor Group controls a majority of our capital stock on a fully diluted basis. In addition, representatives of the Investor Group occupy substantially all of the seats on our board of directors and pursuant to a stockholders agreement, will have the right to appoint all of the independent directors to our board. As a result, the Investor Group has the ability to control our policies and operations, including the appointment of management, the entering into of mergers, acquisitions, sales of assets, divestitures and other extraordinary transactions, future issuances of our common stock or other securities, the payments of dividends, if any, on our common stock, the incurrence of debt by us and the amendment of our certificate of incorporation and bylaws. The Investor Group will have the ability to prevent any transaction that requires the approval of our board of directors or the stockholders regardless of whether or not other members of our board of directors or stockholders believe that any such transaction is in their own best interests. For example, the Investor Group could cause us to make acquisitions that increase our indebtedness or to sell revenue-generating assets. Additionally, the Investor Group are in the business of making investments in companies and may from time to time acquire and hold interests in businesses that compete directly or indirectly with us. The Investor Group may also pursue acquisition opportunities that may be complementary to our business, and, as a result, those acquisition opportunities may not be available to us. So long as the Investor Group continues to hold a majority of our outstanding common stock the Investor Group will be entitled to nominate a majority of our board of directors, and will have the ability to effectively control the vote in any election of directors. In addition, so long as the Investor Group continues to own a significant amount of our equity, even if such amount is less than 50%, they will continue to be able to strongly influence or effectively control our decisions.

**Our reliance on one company for the manufacturing, packaging and physical distribution of our products in North America and Europe could have an adverse impact on our ability to meet our manufacturing, packaging and physical distribution requirements.**

Cinram is currently our exclusive supplier of manufacturing, packaging and physical distribution services in North America and most of Europe. Accordingly, our continued ability to meet our manufacturing, packaging and physical distribution requirements in those territories depends largely on Cinram's continued successful operation in accordance with the service level requirements mandated by us in our service agreements. If, for any reason, Cinram were to fail to meet contractually required service levels, we would have difficulty satisfying our commitments to our wholesale and retail customers, which could have an adverse impact on our revenues. Even though our agreements with Cinram give us a right to terminate based upon failure to meet mandated service levels, and there are several capable substitute suppliers, it might be difficult for us to switch to substitute suppliers for any such services, particularly in the short-term, and the delay and transition time associated with finding substitute suppliers could itself have an adverse impact on our revenues. In addition, our agreements with Cinram begin to expire in 2006. If we are unable to negotiate renewals of these agreements we would have to switch to substitute suppliers. Further, pricing negotiated with Cinram in future agreements may be less favorable than the existing agreements.

**We may be materially and adversely affected by the formation of Sony BMG Music Entertainment.**

In August 2004 Sony Music Entertainment ("Sony") and Bertelsmann Music Group ("BMG") merged their recorded music businesses to form Sony BMG Music Entertainment ("Sony BMG"). As a result, the recorded music market now consists of four major players (Universal, Sony BMG, EMI Recorded Music ("EMI") and us) rather than five (Universal, Sony, BMG, EMI and us). Prior to the formation of Sony BMG, there was one disproportionately large major, Universal, with approximately 25% market share and four other majors relatively equal in size with market shares ranging between 11% and 14%. Now there are two majors with 2004 global market shares over 25%, Universal and Sony BMG, and two significantly smaller majors, EMI and us, each with less than 15%. IFPI is in the process of gathering 2005 market data, but final data is not yet available. There is a threat that the change in the competitive landscape caused by the new Universal and Sony BMG duopoly could drive up the costs of artist signings and the costs of marketing and promoting records to our detriment.

## Risks Related to our Leverage

**Our substantial leverage on a consolidated basis could adversely affect our ability to raise additional capital to fund our operations, limit our ability to react to changes in the economy or our industry and prevent us from meeting our obligations under our indebtedness.**

We are highly leveraged. As of March 31, 2006, our total consolidated indebtedness was $2.061 billion. We have an additional $250 million available for borrowing under the revolving portion of our senior secured credit facility (less $2 million of current letters of credit).

Our high degree of leverage could have important consequences for you, including:

- making it more difficult for us and our subsidiaries to make payments on indebtedness;
- increasing our vulnerability to general economic and industry conditions;
- requiring a substantial portion of cash flow from operations to be dedicated to the payment of principal and interest on indebtedness, therefore reducing our ability to use our cash flow to fund our operations, capital expenditures and future business opportunities;
- exposing us to the risk of increased interest rates as certain of the borrowings of our subsidiaries, including borrowings under our senior secured credit facility, will be at variable rates of interest;
- limiting our ability and the ability of our subsidiaries to obtain additional financing for working capital, capital expenditures, product development, debt service requirements, acquisitions and general corporate or other purposes; and
- limiting our ability to adjust to changing market conditions and placing us at a competitive disadvantage compared to our competitors who are less highly leveraged.

We and our subsidiaries may be able to incur substantial additional indebtedness in the future, subject to the restrictions contained in our senior secured credit facility and the indentures relating to our outstanding notes. If new indebtedness is added to our current debt levels, the related risks that we and our subsidiaries now face could intensify.

**We may not be able to generate sufficient cash to service all of our indebtedness, and may be forced to take other actions to satisfy our obligations under our indebtedness, which may not be successful.**

Our ability to make scheduled payments on or to refinance our debt obligations depends on our financial condition and operating performance, which is subject to prevailing economic and competitive conditions and to certain financial, business and other factors beyond our control. We cannot assure you that we will maintain a level of cash flows from operating activities sufficient to permit us to pay the principal, premium, if any, and interest on our indebtedness, including the notes.

If our cash flows and capital resources are insufficient to fund our debt service obligations, we may be forced to reduce or delay investments in recording artists, and songwriters capital expenditures, or to sell assets, seek additional capital or restructure or refinance our indebtedness. These alternative measures may not be successful and may not permit us to meet our scheduled debt service obligations. In the absence of such operating results and resources, we could face substantial liquidity problems and might be required to dispose of material assets or operations to meet our debt service and other obligations. Our senior secured credit facility and the indenture governing our outstanding notes restrict our ability to dispose of assets and use the proceeds from dispositions. We may not be able to consummate those dispositions or to obtain the proceeds which we could realize from them and these proceeds may not be adequate to meet any debt service obligations then due.

Holdings also will be relying on Acquisition Corp. and its subsidiaries to make payments on the Holdings Notes. If Acquisition Corp. does not dividend funds to Holdings in an amount sufficient to make such payments, Holdings may default under the indenture governing the Holdings Notes, which would result in all such notes becoming due and payable. Because Acquisition Corp.'s debt agreements have covenants that limit its ability to make payments to Holdings, Holdings may not have access to funds in an amount sufficient to service its indebtedness.

**Our debt agreements contain restrictions that limit our flexibility in operating our business.**

Our senior secured credit agreement and the indentures governing our outstanding notes contain various covenants that limit our ability to engage in specified types of transactions. These covenants limit the ability of our restricted subsidiaries to, among other things:

- incur additional indebtedness or issue certain preferred shares;
- pay dividends on or make distributions in respect of our capital stock or make other restricted payments;
- make certain investments;
- sell certain assets;
- create liens on certain indebtedness without securing the notes;
- consolidate, merge, sell or otherwise dispose of all or substantially all of our assets;
- enter into certain transactions with our affiliates; and
- designate our subsidiaries as unrestricted subsidiaries.

In addition, under our senior secured credit agreement, our subsidiaries are required to satisfy and maintain specified financial ratios and other financial condition tests. Their ability to meet those financial ratios and tests can be affected by events beyond our control, and they may not be able to meet those ratios and tests. A breach of any of these covenants could result in a default under our senior secured credit agreement. Upon the occurrence of an event of default under our senior secured credit agreement, the lenders could elect to declare all amounts outstanding under our senior secured credit agreement to be immediately due and payable and terminate all commitments to extend further credit. If we were unable to repay those amounts, the lenders under our senior secured credit agreement could proceed against the collateral granted to them to secure that indebtedness. We have pledged a significant portion of our assets as collateral under our senior secured credit agreement. If the lenders under our senior secured credit agreement accelerate the repayment of borrowings, we may not have sufficient assets to repay our senior secured credit agreement, as well as any unsecured indebtedness.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Item 2 is not applicable and has been omitted.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Item 3 is not applicable and has been omitted.

## ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Item 4 is not applicable and has been omitted.

## ITEM 5. OTHER INFORMATION

The Company is in the process of finding one additional independent director and audit committee member in compliance with the New York Stock Exchange rules.

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**ITEM 6. EXHIBITS**

| | |
|---|---|
| 3.1 | Amended and Restated Certificate of Incorporation of WMG Acquisition Corp. (1) |
| 3.2 | Amended and Restated Bylaws of WMG Acquisition Corp. (1) |
| 10.1 | Employment Agreement, dated as of February 10, 2006, between Warner Music Inc. and Patrick Vien. (2) |
| 10.2 | Stock Option Agreement, dated as of February 17, 2006, between Warner Music Group Corp. and Patrick Vien. (4) |
| 10.3 | Director Restricted Stock Award Agreement, dated as of March 2, 2006, between Warner Music Group Corp. and Michele J. Hooper. (3) |
| 10.4 | Director Restricted Stock Award Agreement, dated as of March 2, 2006, between Warner Music Group Corp. and Shelby W. Bonnie. (3) |
| 31.1 | Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended* |
| 31.2 | Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-15(a) of the Securities Exchange Act, as amended* |
| 32.1 | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002** |
| 32.2 | Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002** |

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* Filed herewith.

** Pursuant to SEC Release No. 33-8212, this certification will be treated as “accompanying” this Quarterly Report on Form 10-Q and not “filed” as part of such report for purposes of Section 18 of the Securities Exchange Act, as amended, or otherwise subject the liability of Section 18 of the Securities Exchange Act, as amended, and this certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Securities Exchange Act, as amended, except to the extent that the registrant specifically incorporates it by reference.

(1) Incorporated by reference to WMG Acquisition Corp.’s Amendment No. 1 to the Form S-4 (File No. 333-121322) filed with the SEC on January 1, 2005.

(2) Incorporated by reference to Warner Music Group Corp.’s Current Report on Form 8-K filed on February 13, 2006.

(3) Incorporated by reference to Warner Music Group Corp.’s Current Report on Form 8-K filed on March 6, 2006.

(4) Incorporated by reference to Warner Music Group Corp.’s Form 10-Q for the period ended March 31, 2006.

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## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

May 5, 2006

WMG ACQUISITION CORP.

| | |
|---|---|
| By: | /s/ EDGAR BRONFMAN, JR. |
| Name: | **Edgar Bronfman, Jr.** |
| Title: | **Chief Executive Officer and Chairman of the Board of Directors (Principal Executive Officer)** |
| By: | /s/ MICHAEL D. FLEISHER |
| Name: | **Michael D. Fleisher** |
| Title: | **Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)** |

**Exhibit 31.1**

## CHIEF EXECUTIVE OFFICER CERTIFICATION

I, Edgar Bronfman, Jr., Chief Executive Officer and Chairman of the Board of Directors of WMG Acquisition Corp., certify that:

1. I have reviewed this quarterly report on Form 10-Q of WMG Acquisition Corp. (the “Registrant”);

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this quarterly report;

4. The Registrant’s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the Registrant and we have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared; and

   b) Evaluated the effectiveness of the Registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   c) Disclosed in this report any change in the Registrant’s internal control over financial reporting that occurred during the Registrant’s most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant’s internal control over financial reporting; and

5. The Registrant’s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant’s auditors and the audit committee of Registrant’s board of directors (or persons performing the equivalent functions):

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant’s ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant’s internal control over financial reporting.

Dated: May 5, 2006

/s/ EDGAR BRONFMAN, JR.

**Chief Executive Officer and Chairman of the Board of Directors (Principal Executive Officer)**

**Exhibit 31.2**

**CHIEF FINANCIAL OFFICER CERTIFICATION**

I, Michael D. Fleisher, Chief Financial Officer of WMG Acquisition Corp., certify that:

1. I have reviewed this quarterly report on Form 10-Q of WMG Acquisition Corp. (the "Registrant");
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this quarterly report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the Registrant and we have:
    a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared; and
    b) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
    c) Disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of Registrant's board of directors (or persons performing the equivalent functions):
    a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
    b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Dated: May 5, 2006

/s/ MICHAEL D. FLEISHER

**Chief Financial Officer (Principal Financial and Accounting Officer)**

**Exhibit 32.1**

**Certification of the Chief Executive Officer**
**Pursuant to 18 U.S.C. Section 1350,**
**As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the Quarterly Report of WMG Acquisition Corp. (the “Company”) on Form 10-Q for the period ended March 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Edgar Bronfman, Jr., Chief Executive Officer of WMG Acquisition Corp., certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: May 5, 2006

/s/ EDGAR BRONFMAN, JR.
**Edgar Bronfman, Jr.**
**Chief Executive Officer**

**Exhibit 32.2**

**Certification of the Chief Financial Officer**
**Pursuant to 18 U.S.C. Section 1350,**
**As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the Quarterly Report of WMG Acquisition Corp. (the "Company") on Form 10-Q for the period ended March 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Michael D. Fleisher, Chief Financial Officer of WMG Acquisition Corp., certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: May 5, 2006

/s/ MICHAEL D. FLEISHER

**Michael D. Fleisher**
**Chief Financial Officer**