Warner Music Group Corp.
Form 10-Q
August 03, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

OR

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

Commission File Number 001-32502

Warner Music Group 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 x 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 x

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

As of July 27, 2006, the number of shares of the Registrant s common stock, par value $0.001 per share, outstanding was 148,505,691.787.

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WARNER MUSIC GROUP CORP.

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ITEM 1. FINANCIAL STATEMENTS

Warner Music Group Corp.

Consolidated Balance Sheets

	June 30, 2006	September 30, 2005
	(unaudited)	(audited)
	(in millions)	
Assets		
Current assets:		
Cash and equivalents	$ 306	$ 288
Short-term investments	29	
Accounts receivable, less allowances of $205 and $218 million	524	637
Inventories	50	52
Royalty advances expected to be recouped within one year	209	190
Deferred tax assets	40	36
Other current assets	47	39
Total current assets	1,205	1,242
Royalty advances expected to be recouped after one year	209	190
Investments	24	21
Property, plant and equipment, net	144	157
Goodwill	946	869
Intangible assets subject to amortization, net	1,746	1,815
Intangible assets not subject to amortization	100	100
Other assets	109	104
Total assets	$ 4,483	$ 4,498
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	$ 202	$ 247
Accrued royalties	1,146	1,057
Taxes and other withholdings	34	23
Current portion of long-term debt	17	17
Dividends payable	22	
Other current liabilities	336	404
Total current liabilities	1,757	1,748
Long-term debt	2,234	2,229
Dividends payable	3	5
Deferred tax liabilities, net	193	201
Other noncurrent liabilities	216	226
Total liabilities	4,403	4,409

Commitments and Contingencies (See Note 10)		
Shareholders equity:		
Common stock ($0.001 par value; 500,000,000 shares authorized; 148,503,900 and 148,455,313 shares issued and outstanding)		
Additional paid-in capital	560	548
Accumulated deficit	(509)	(480)
Accumulated other comprehensive income, net	29	21
Total shareholders equity	80	89
Total liabilities and shareholders equity	$ 4,483	$ 4,498

See accompanying notes.

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Warner Music Group Corp.

Consolidated Statements of Operations (Unaudited)

Three Months Ended June 30, 2006 and 2005

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
	(in millions, except per share amounts)	
Revenues (b)	$ 822	$ 742
Costs and expenses:		
Cost of revenues (a)	(445)	(396)
Selling, general and administrative expenses (a) (b)	(301)	(318)
Amortization of intangible assets	(48)	(47)
Loss on termination of management agreement		(73)
Total costs and expenses	(794)	(834)
Operating income (loss)	28	(92)
Interest expense, net	(45)	(50)
Net investment related gains		1
Loss on repayment of Holdings Notes		(35)
Other income, net	1	1
Loss before income taxes	(16)	(175)
Income tax benefit (expense)	2	(4)
Net loss	$ (14)	$ (179)
Net loss per common share:		
Basic and diluted	$ (0.10)	$ (1.41)
Weighted average common shares:		
Basic and diluted	143.7	127.0
(a) Includes depreciation expense of	$ (10)	$ (12)
(b) Includes the following expenses resulting from transactions with related companies:		
Revenues	$ 8	$
Selling, general and administrative expense	$ (2)	$ (1)

See accompanying notes.

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Warner Music Group Corp.

Consolidated Statements of Operations (Unaudited)

Nine Months Ended June 30, 2006 and 2005

	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
	(in millions, except per share amounts)	
Revenues (b)	$ 2,662	$ 2,597
Costs and expenses:		
Cost of revenues (a)	(1,384)	(1,377)
Selling, general and administrative expenses (a) (b)	(918)	(942)
Amortization of intangible assets	(143)	(140)
Loss on termination of management agreement		(73)
Total costs and expenses	(2,445)	(2,532)
Operating income	217	65
Interest expense, net (b)	(135)	(140)
Net investment related gains		1
Equity in the gains (losses) of equity-method investees, net	1	(1)
Loss on repayment of Holdings Notes		(35)
Unrealized gain on warrants		17
Minority interest expense (b)		(5)
Other income, net	3	5
Income (loss) before income taxes	86	(93)
Income tax expense	(38)	(46)
Net income (loss)	$ 48	$ (139)
Net income (loss) per common share:		
Basic	$ 0.34	$ (1.22)
Diluted	$ 0.32	$ (1.22)
Weighted average common shares:		
Basic	142.3	114.1
Diluted	150.8	114.1
(a) Includes depreciation expense of	$ (32)	$ (40)
(b) Includes the following expenses resulting from transactions with related companies:		

Revenues	12	
Selling, general and administrative expense	(10)	(6)
Interest expense		(1)
Minority interest expense		(5)

See accompanying notes.

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Warner Music Group Corp.

Consolidated Statements of Cash Flows (Unaudited)

Nine Months Ended June 30, 2006 and 2005

	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
	(in millions)	
Cash flows from operating activities		
Net income (loss)	$ 48	$ (139)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	175	180
Non-cash interest expense	39	52
Non-cash, stock-based compensation expense	12	18
Deferred taxes	(17)	(7)
Net investment related gains		(1)
Equity in the (gains) losses of equity-method investees, including distributions	(1)	1
Loss on repayment of debt		35
Unrealized gain on warrants		(17)
Minority interest expense		5
Changes in operating assets and liabilities:		
Accounts receivable	121	77
Inventories	3	6
Royalty advances	(54)	(2)
Accounts payable and accrued liabilities	(81)	(22)
Other balance sheet changes	(22)	(14)
Net cash provided by operating activities	223	172
Cash flows from investing activities		
Investments and acquisitions	(95)	(84)
Investments in short-term investments	(29)	
Investment proceeds		50
Capital expenditures	(18)	(20)
Net cash used in investing activities	(142)	(54)
Cash flows from financing activities		
Borrowings, net of financing costs		926
Debt repayments	(13)	(584)
Cash paid to repurchase warrant		(138)
Proceeds from the issuance of common stock		554
Costs to issue common stock		(27)
Proceeds from the issuance of restricted shares		1
Repurchase of subsidiary preferred stock		(200)
Dividends paid on subsidiary preferred stock		(9)
Dividends and returns of capital paid	(55)	(917)
Loans to third parties		(10)
Other		(3)

Net cash used in financing activities	(68)	(407)
Effect of foreign currency exchange rate changes on cash	5	(1)
Net increase (decrease) in cash and equivalents	18	(290)
Cash and equivalents at beginning of period	288	555
Cash and equivalents at end of period	$ 306	$ 265

See accompanying notes.

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Warner Music Group Corp.

Consolidated Statement of Shareholders Equity (Unaudited)

Nine Months Ended June 30, 2006

	Common Stock		Additional Paid-in Capital	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
	Shares	Value				
	(in millions, except number of common shares)					
Balance at September 30, 2005	148,455,313	$	$ 548	$ (480)	$ 21	$ 89
Comprehensive income:						
Net income				48		48
Foreign currency translation adjustment					(4)	(4)
Deferred gains on derivative financial instruments					12	12
Total comprehensive income				48	8	56
Dividends				(76)		(76)
Issuance of stock options and restricted shares of common stock, net	48,587		12			12
Other				(1)		(1)
Balance at June 30, 2006	148,503,900	$	$ 560	$ (509)	$ 29	$ 80

See accompanying notes.

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited)

1. Description of Business

Warner Music Group Corp. (the Company) was formed by a private equity consortium of Investors (the Investor Group) on November 21, 2003. The Company is the direct parent of WMG Holdings Corp. (Holdings), which is the direct parent of WMG Acquisition Corp. (Acquisition Corp.). Acquisition Corp. is one of the world s major music content companies and the successor to substantially all of the interests of the recorded music and music publishing businesses of Time Warner Inc. (Time Warner). Effective March 1, 2004, Acquisition Corp. acquired such interests from Time Warner for approximately $2.6 billion (the Acquisition). On May 10, 2005, the Company sold 32,600,000 shares of its common stock in an initial public offering (the Initial Common Stock Offering) and became a public company.

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 nine month periods ended June 30, 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 are a part of 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 and from third parties for various uses, including film and television soundtracks.

On May 31, 2006, the Company completed the acquisition of Ryko Corporation (Ryko), a leading independent, integrated music and entertainment company. See Note 3.

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 U.S.; 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; Ryko Distribution, which distributes music and DVD releases from Rykodisc, Ryco s recorded music label, and third-party record and video labels; various distribution centers and ventures operated internationally; an 80% interest in Word Entertainment, whose distribution operations specialize in the distribution of music products in the Christian retail marketplace; and ADA U.K., which provides ADA s distribution services to independent labels in Europe.

In the U.S., the Company s recorded music operations are conducted principally through its major record labels Warner Bros. Records Inc. 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.

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)

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.

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

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)

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 for the fiscal year ended September 30, 2005 (Registration No. 001-32502).

Recapitalization

As discussed above, on May 10, 2005, the Company sold 32,600,000 shares of its common stock in the Initial Common Stock Offering. In connection with the Initial Common Stock Offering, the Company (i) converted all its formerly outstanding shares of Class L Common Stock into shares of Class A Common Stock, (ii) renamed all of its formerly outstanding shares of Class A Common Stock as common stock , which had the effect of eliminating from the Company s authorized capital stock the Class L Common Stock, and Class A Common Stock and (iii) authorized an approximately 1,139 to 1 split of the Company s common stock (collectively, the Recapitalization).

Accordingly, historical financial statements have been restated to reflect the Recapitalization for all periods occurring after the Acquisition that was effective as of March 1, 2004. Such restatement primarily related to common stock and equivalent shares information, net income per common share computations and stock-based compensation disclosures.

Reclassifications

Certain reclassifications have been made to the prior period s financial information in order to conform 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

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)

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 nine months ended June 30, 2006 and 2005 (in millions):

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
Net (loss) income	$ (14)	$ (179)	$ 48	$ (139)
Foreign currency translation gains (losses)	(2)	13	(4)	1
Derivative financial instruments gains	3		12	10
Comprehensive (loss) income	$ (13)	$ (166)	$ 56	$ (128)

Net Income (Loss) Per Common Share

The Company computes net income (loss) per common share in accordance with FASB Statement No. 128, Earnings per Share (FAS 128). Under the provisions of FAS 128, basic net income (loss) per common share is computed by dividing the net income (loss) applicable to common shares after preferred dividend requirements, if any, by the weighted average of common shares outstanding during the period. Diluted net income (loss) per common share adjusts basic net income (loss) per common share for the effects of stock options, warrants and other potentially dilutive financial instruments, only in the periods in which such effect is dilutive.

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)

The following table sets forth the computation of basic and diluted net income (loss) per common share (in millions, except per share amounts):

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
Basic and diluted net (loss) income per common share:				
Numerator:				
Net (loss) income for basic calculation	$ (14)	$ (179)	$ 48	$ (139)
Net (loss) income for diluted calculation	$ (14)	$ (179)	$ 48	$ (139)
Denominator:				
Weighted average common shares outstanding for basic calculation (a)	143.7	127.0	142.3	114.1
Weighted average common outstanding shares for diluted calculation	143.7	127.0	150.8	114.1
Net income (loss) per common share basic	$ (0.10)	$ (1.41)	$ 0.34	$ (1.22)
Net income (loss) per common share diluted	$ (0.10)	$ (1.41)	$ 0.32	$ (1.22)

(a) The denominator excludes the effect of unvested common shares subject to repurchase or cancellation.

The calculation of diluted net income (loss) per common share for each of the periods includes the effects of the assumed exercise of any outstanding stock options or warrants and the assumed vesting of shares of restricted stock where dilutive. The assumed exercise of outstanding stock options and warrants and the assumed vesting of restricted stock represent the following dilutive effect (in millions of shares):

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
Stock options	3.0	3.0	2.8	6.3

Restricted stock	4.5	6.6	5.7	2.2
Warrants				1.5
	7.5	9.6	8.5	10.0

The Company recognized a net loss for the three months ended June 30, 2006, the three months ended June 30, 2005 and the nine months ended June 30, 2005. Therefore, the effects from the assumed exercise of any outstanding stock options or warrants, or the assumed vesting of shares of restricted stock, during such periods would be antidilutive. Accordingly, they have not been included in the presentation of diluted net income (loss) per common share for the respective periods.

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)

See Note 19 in the Company s audited consolidated financial statements for the year ended September 30, 2005 for a summary of the terms of the warrants that were issued to Time Warner in connection with the Acquisition. In connection with the Initial Common Stock Offering, the Company repurchased the warrants from Time Warner in May 2005 for approximately $138 million, which approximated fair value at that date.

3. Significant Acquisitions and Dispositions

Acquisition of Ryko Corporation

On May 31, 2006, the Company completed the acquisition of Ryko, a leading independent, integrated music and entertainment company, for approximately $67.5 million in cash. 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. The transaction was accounted for under the purchase method of accounting, and the results of operations of Ryko are included in the Company s results of operations from the acquisition date of Ryko. The purchase price was preliminarily allocated to the underlying net assets acquired in proportion to the estimated fair value, principally recorded music catalog and goodwill.

Formation of Bad Boy Records LLC

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 WBP, it was not

reported as discontinued operations.

For the three months ended June 30, 2005, the operations sold generated revenues of approximately $8 million; operating income of $1 million; operating income before depreciation and amortization expense of $1 million; and net income of approximately $1 million. For the nine months ended June 30, 2005, the operations sold generated revenues of approximately $34 million; operating income of $1 million; operating income before depreciation and amortization expense of $1 million; and net income of approximately $1 million.

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)

Acquisition of Maverick Recording Company

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, bringing its total interest in Maverick to 80%. 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.

On July 14, 2006, the Company acquired the remaining 20% interest in Maverick from its existing partner. The additional purchase price will be allocated to the underlying net assets of Maverick in proportion to the estimated fair value, principally goodwill.

4. Inventories

Inventories consist of the following (in millions):

	June 30, 2006	September 30, 2005
	(unaudited)	(audited)
Compact discs, cassettes and other music-related products	$ 89	$ 84
Published sheet music and song books	2	2
	91	86
Less reserve for obsolescence	(41)	(34)
	$ 50	$ 52

5. Intangible Assets

Intangible assets consist of the following (in millions):

	September 30, 2005	Acquisitions	Other (a)	June 30, 2006
	(audited)			(unaudited)
Intangible assets subject to amortization:				
Record music catalog	$ 1,242	$ 32	$ 6	$ 1,280
Music publishing copyrights	817	16	18	851
Artist contracts	31	5		36
Trademarks	10			10
Other intangible assets	4			4
	2,104	53	24	2,181
Accumulated amortization	(289)			(435)
Total net intangible assets subject to amortization	1,815			1,746
Intangible assets not subject to amortization:				
Trademarks and brands	100			100
Total net other intangible assets	$ 1,915			$ 1,846

(a) Other represents foreign currency translation adjustments.

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)

6. Restructuring Costs

Acquisition-Related Restructuring Costs

As of June 30, 2006, the Company had approximately $34 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	Total
		(in millions)	
Liability as of September 30, 2005	**$ 14**	**$ 35**	**$ 49**
Cash paid during the nine months ended June 30, 2006	(8)		(8)
Non-cash reductions during the nine months ended June 30, 2006 (a)		(3)	(3)
Reversal of excess liabilities (b)	(1)	(3)	(4)
Liability as of June 30, 2006	**$ 5**	**$ 29**	**$ 34**

(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, or were recorded as a reduction of the initial purchase price of the Acquisition.

7. Debt

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

	June 30, 2006	September 30, 2005

	(unaudited)	(audited)
Senior secured credit facility:		
Revolving credit facility	$	$
Term loan	1,417	1,430
	1,417	1,430
7.375% U.S. dollar-denominated Senior Subordinated Notes due 2014 Acquisition Corp	465	465
8.125% Sterling-denominated Senior Subordinated Notes due 2014 Acquisition Corp	183	177
9.5% Senior Discount Notes due 2014 Holdings	186	174
Total debt	2,251	2,246
Less current portion	(17)	(17)
Total long term debt	$ 2,234	$ 2,229

The Holdings Refinancing

In December 2004, 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

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)

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 the Company s shareholders in the aggregate amount of $472 million and (iii) pay debt-related issuance costs of approximately $15 million.

The Holdings Redemption

In June 2005, using proceeds from the Company s Initial Common Stock Offering and approximately $57 million of cash on hand, 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 the 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. The Company redeemed 35% of the Holdings Discount Notes on June 15, 2005.

In connection with the redemption of the Holdings Floating Rate Notes and 35% of the Holdings Discount Notes, the Company was required to pay redemption premiums of $10 million and $9 million, respectively, which the Company paid on June 15, 2005 and recorded as a loss on the repayment of the notes in the consolidated statement of operations for the three and nine months ended June 30, 2005. The Company also wrote off the remaining balance of debt-issuance costs of $12 million related to the notes redeemed and the remaining unamortized original issue discount of $4 million related to the Holdings PIK Notes. Such amounts, $35 million in the aggregate, were recorded as a loss on the repayment of the notes in the consolidated statement of operations for the three- and nine-month periods ended June 30, 2005.

The Company was also required to pay all accrued interest as of the redemption date related to the Holdings Notes that were redeemed. This amount consisted of $5 million related to the Holdings Floating Rate Notes, $9 million related to the Holdings PIK notes, and $4 million in accreted value of the 35% of the Holdings Discount Notes redeemed. Of such amount, $8 million had been expensed in previous quarters and $10 million was recorded as interest expense in the consolidated statement of operations for the three months ended June 30, 2005.

The Company has fully and unconditionally guaranteed the remaining Holdings Discount Notes. The Holdings Discount Notes are unsecured and subordinated to all of Holdings existing and future secured debt, including Holdings guarantee of borrowings by Acquisition Corp. under the Company s senior secured credit facility. In addition, the Holdings Discount Notes are structurally subordinated to the Senior Subordinated Notes of Acquisition Corp.

The indenture governing the Holdings Notes limits Holdings ability and the ability of its restricted subsidiaries to (i) incur additional indebtedness or issue certain preferred shares, (ii) pay dividends on or make other distributions in respect of its capital stock or make other restricted payments, (iii) make certain

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)

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

Restricted Net Assets

The Company is a holding company that conducts substantially all its business operations through its subsidiary, Acquisition Corp. and its subsidiaries. Accordingly, the ability of the Company to obtain funds from its subsidiaries is restricted by the senior secured credit facility of Acquisition Corp., the indenture for the Acquisition Corp. Senior Subordinated Notes issued by Acquisition Corp. and the indenture for the Holdings Notes.

8. Stock-based Compensation

The following table represents the expense recorded by the Company with respect to its stock-based awards for the three- and nine-month periods ended June 30, 2006 and 2005 by segment and on a consolidated basis (in millions):

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
Recorded Music	$ 3	$ 6	$ 7	$ 12
Music Publishing		1	1	2
Corporate expenses	1	2	4	4
Total	$ 4	$ 9	$ 12	$ 18

Certain of the stock options and restricted shares of common stock 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 awarded to or purchased by employees of the Company and 516,719 stock options awarded to employees of the Company. In addition, the Company paid out accrued dividends owed to restricted stockholders of $1.3 million upon the occurrence of the 3x liquidity event and the subsequent vesting of their restricted shares. 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 for the three- and nine-month periods ended June 30, 2006.

Payments Relating to Executive Compensation

Concurrent with the Initial Common Stock Offering, the Company determined that certain shares of restricted stock issued in 2004 and early 2005 may have been sold at prices below fair market value on the applicable date of sale and certain options to purchase shares of the Company s stock granted may have had exercise prices below fair market value on the applicable date of grant. As a result, certain U.S. employee holders of the restricted stock who made elections under Section 83(b) of the Internal Revenue Code would be subject to additional ordinary income tax to the extent of the fair market value of the restricted stock received over the purchase price they paid for such stock. In other cases, certain employees who did not make such an election will be subject to higher taxes on their restricted shares at the time of vesting than would have been the case had they

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purchased the shares for fair market value. In addition, under the provisions of the American Jobs Creation Act of 2004, signed into law in October 22, 2004, U.S. employee option holders whose options vest with exercise prices below fair market value on the date of grant are subject to significant penalties under new Section 409A of the Internal Revenue Code. IRS Notice 2005-1 provides transitional guidance on the application of Section 409A which, among other things, permits options with exercise prices below the fair market value of the underlying stock on the date of grant to be amended or replaced with new options having an exercise price at least equal to the fair market value on the grant date. Non-U.S. employee holders of restricted stock or options may be subject to similar or other related issues. In order for the Company to address these issues the Company s Board of Directors, based on a re-assessment of fair market values on the applicable dates, approved the actions discussed below.

Restricted Stock

The Company was authorized to pay a cash bonus to each employee who purchased restricted stock at prices that were below fair market value on the date of purchase. The bonus was calculated as either an amount equal to the tax liability incurred by the employee on the grant date or an estimate of the additional future tax which would be incurred by the employee upon the vesting of the shares, depending upon the employee s Section 83(b) election. Additionally, the Company paid the employees an amount necessary to pay the related taxes on the bonus. This resulted in total cash payments of approximately $10 million, which the Company expensed in the quarter ended June 30, 2005.

Options

The Company revised the exercise prices of certain options to purchase its common stock to prices equal to the applicable re-determined fair market values of the common stock on the dates of the respective grants. The Company compensated the grantees with a cash bonus representing the loss of value created by this adjustment to the option exercise prices. This resulted in total cash bonuses paid of approximately $9 million. The Company treated the revision of the exercise prices as a modification of these awards and $6 million related to the modification was expensed in the quarter ended June 30, 2005.

Further, in connection with the $100.5 million cash dividend the Company declared and paid to holders of its common stock, consisting of the Investor Group and certain members of management who held shares of common stock prior to the Initial Common Stock Offering, the Company made an adjustment to all options to purchase common stock outstanding at the time of declaration of the dividend. The adjustment consisted of a cash make-whole payment to each option holder equal to the pro-rata amount that would have been received per share had all outstanding options been exercised at the time of the declaration of the dividend. The amounts were adjusted down to reflect a present value discount based on the earliest possible exercise dates. The Company recorded approximately $3 million of expense related to such payments in the quarter ended June 30, 2005.

9. Shareholders Equity

Return of Capital and Dividends Paid

In September 2004, the Company declared a $342 million dividend to its Class L common shareholders in the form of a note payable. The note payable was paid in October 2004 using proceeds received from a return of capital previously invested in Acquisition Corp.

In connection with the Holdings Refinancing, the Company paid a $465 million return of capital to its Class L common shareholders, of which $422 million was paid in December 2004 and $43 million was paid in March 2005. The remaining $7 million from the Holdings Refinancing was declared and paid as a dividend to the Company s shareholders in May 2005.

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)

On October 3, 2005, December 29, 2005, March 14, 2006 and June 7, 2006, the Company 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, May 3, 2006, and July 27, 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 nine months ended June 30, 2006, 2,479,501 shares of restricted stock purchased by or awarded to certain employees vested.

10. Commitments and Contingencies

Radio Promotion Activities

On September 7, 2004, November 22, 2004 and March 31, 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. The Attorney General has also reached settlements with all of the other major music companies in connection with this investigation. 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 filed a Notice of Related Case and was successful in having both of these cases consolidated. On May 23, 2006, the Company filed a Motion to Dismiss in both cases. Decisions on these motions are pending. 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, a total of twenty-seven putative class action lawsuits concerning the pricing of digital music downloads have been filed. The Company has not yet been served in some of the cases but expects they will all 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 a conspiracy among record companies to fix prices for downloads, and, accordingly to some of the complaints, protect allegedly inflated prices for compact discs. 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

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)

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.

11. Derivative Financial Instruments

During the nine months ended June 30, 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. However, the Company extended the terms of certain existing interest rate swap agreements. As of June 30, 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 $21 million. Additionally, as of June 30, 2006 the Company had less than $1 million of deferred net losses in comprehensive income related to foreign currency hedging.

The Company recorded unrealized gains of $17 million on its stock warrants issued to Time Warner in connection with the Acquisition for the nine-months ended June 30, 2005. On May 16, 2005, the Company repurchased the three-year warrants from Time Warner at a cost of approximately $138 million, which approximated fair value at that date.

12. 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 June 30, 2006	Three Months Ended June 30, 2005	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
			(in millions)	
Revenues				
Recorded music	$ 678	$ 588	$ 2,274	$ 2,149
Music publishing	150	161	410	470
Corporate expenses and eliminations	(6)	(7)	(22)	(22)
Total revenues	$ 822	$ 742	$ 2,662	$ 2,597

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
			(in millions)	
OIBDA				
Recorded music	$ 92	$ 47	$ 379	$ 313
Music publishing	23	28	91	99
Corporate expenses and eliminations	(29)	(108)	(78)	(167)
Total OIBDA	$ 86	$ (33)	$ 392	$ 245

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
			(in millions)	
Depreciation of Property, Plant and Equipment				
Recorded music	$ 6	$ 7	$ 20	$ 25
Music publishing		2	2	4
Corporate expenses and eliminations	4	3	10	11
Total depreciation	$ 10	$ 12	$ 32	$ 40

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
			(in millions)	
Amortization of Intangibles Assets				
Recorded music	$ 34	$ 34	$ 101	$ 100
Music publishing	14	13	42	40
Corporate expenses and eliminations				
Total amortization	$ 48	$ 47	$ 143	$ 140

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
			(in millions)	
Operating Income (Loss)				
Recorded music	$ 52	$ 6	$ 258	$ 188
Music publishing	9	13	47	55
Corporate expenses and eliminations	(33)	(111)	(88)	(178)
Total operating income (loss)	$ 28	$ (92)	$ 217	$ 65

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
			(in millions)	
Reconciliation of OIBDA to Operating Income (Loss)				
OIBDA	$ 86	$ (33)	$ 392	$ 245
Depreciation expense	(10)	(12)	(32)	(40)
Amortization expense	(48)	(47)	(143)	(140)
Operating income	$ 28	$ (92)	$ 217	$ 65

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)

13. Additional Financial Information

Cash Interest and Taxes

The Company made interest payments of approximately $118 million and $129 million during the nine months ended June 30, 2006 and 2005, respectively. The Company paid approximately $49 million and $36 million of income and withholding taxes in the nine months ended June 30, 2006 and 2005, respectively. The Company received $5 million and $8 million of income tax refunds in the nine months ended June 30, 2006 and 2005, respectively.

Non-cash Transactions

There were no significant non-cash investing and financing activities during the nine months ended June 30, 2006 and 2005.

14. Subsequent Event

The major record companies have reached a global out-of-court settlement of international copyright litigation against the operators of the Kazaa peer-to-peer network. Under the terms of the settlement, the Kazaa defendants have agreed to pay $100,000,000 in compensation to the record companies that brought the action. Kazaa will also introduce filtering technologies to prevent the continued infringement in the Kazaa system. The settlement money is being held in escrow until the plaintiffs agree on the proper allocation of the funds. The Company does not know yet what its portion of the settlement will be.

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WARNER MUSIC GROUP CORP.

Supplementary Information

Condensed Consolidating Financial Statements of Registrant

The Company is the direct parent of Holdings, which is the direct parent of Acquisition Corp.

Holdings has issued and outstanding the Holdings Discount Notes. The Holdings Discount Notes are guaranteed by the Company. These guarantees are full, unconditional, joint and several. The following condensed consolidating financial statements are presented for the information of the holders of the Holdings Discount Notes and present the results of operations, financial position and cash flows of (i) the Company, which is the guarantor of the Holdings Discount Notes, (ii) Holdings, which is the issuer of the Holdings Discount Notes, (iii) the subsidiaries of Holdings (WMG Acquisition Corp. is the only direct subsidiary of Holdings) 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.

The Company and Holdings are holding companies that conduct substantially all their business operations through Acquisition Corp. Accordingly, the ability of the Company to obtain funds from its subsidiaries is restricted by the senior secured credit facility of Acquisition Corp., the indenture for the Senior Subordinated Notes issued by Acquisition Corp. and the indenture for the Holdings Notes.

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WARNER MUSIC GROUP CORP.

Supplementary Information

Condensed Consolidating Balance Sheet (unaudited)

June 30, 2006

	Warner Music Group Corp.	WMG Holdings Corp. (issuer)	WMG Acquisition Corp.	Eliminations	Warner Music Group Corp. Consolidated
			(in millions)		
Assets:					
Current assets:					
Cash and equivalents	$ 37	$	$ 269	$	$ 306
Short-term investments	28		1		29
Accounts receivable, net			524		524
Due from (to) affiliates	(3)		3		
Inventories			50		50
Royalty advances expected to be recouped within one year			209		209
Deferred tax assets			40		40
Other current assets			47		47
Total current assets	62		1,143		1,205
Royalty advances expected to be recouped after one year			209		209
Investments in and advances to (from) consolidated subsidiaries	46	228		(274)	
Investments			24		24
Property, plant and equipment			144		144
Goodwill			946		946
Intangible assets subject to amortization			1,746		1,746
Intangible assets not subject to amortization			100		100
Other assets		4	105		109
Total assets	$ 108	$ 232	$ 4,417	$ (274)	$ 4,483
Liabilities and Shareholders Equity:					
Current liabilities:					
Accounts payable	$	$	$ 202	$	$ 202
Accrued royalties			1,146		1,146
Taxes and other withholdings			34		34
Current portion of long-term debt			17		17
Dividends payable	22				22
Other current liabilities	3		333		336
Total current liabilities	25		1,732		1,757
Long-term debt		186	2,048		2,234
Dividends payable	3				3
Deferred tax liabilities, net			193		193

Other noncurrent liabilities			216		216
Total liabilities	28	186	4,189		4,403
Total shareholders equity	80	46	228	(274)	80
Total liabilities and shareholders equity	$ 108	$ 232	$ 4,417	$ (274)	$ 4,483

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WARNER MUSIC GROUP CORP.

Supplementary Information

Condensed Consolidating Balance Sheet (audited)

September 30, 2005

	Warner Music Group Corp.	WMG Holdings Corp. (issuer)	WMG Acquisition Corp.	Eliminations	Warner Music Group Corp. Consolidated
			(in millions)		
Assets:					
Current assets:					
Cash and equivalents	$ 40	$ 1	$ 247	$	$ 288
Accounts receivable, net			637		637
Due from (to) affiliates	15	(23)	8		
Inventories			52		52
Royalty advances expected to be recouped within one year			190		190
Deferred tax assets			36		36
Other current assets			39		39
Total current assets	55	(22)	1,209		1,242
Royalty advances expected to be recouped after one year			190		190
Investments in and advances to (from) consolidated subsidiaries	43	235		(278)	
Investments			21		21
Property, plant and equipment			157		157
Goodwill			869		869
Intangible assets subject to amortization			1,815		1,815
Intangible assets not subject to amortization			100		100
Other assets		4	100		104
Total assets	$ 98	$ 217	$ 4,461	$ (278)	$ 4,498
Liabilities and Shareholders Equity:					
Current liabilities:					
Accounts payable	$ 1	$	$ 246	$	$ 247
Accrued royalties			1,057		1,057
Taxes and other withholdings			23		23
Current portion of long-term debt			17		17
Other current liabilities	1		403		404
Total current liabilities	2		1,746		1,748
Long-term debt		174	2,055		2,229
Dividends payable	5				5
Deferred tax liabilities, net			201		201

Other noncurrent liabilities	2		224		226
Total liabilities	9	174	4,226		4,409
Total shareholders equity	89	43	235	(278)	89
Total liabilities and shareholders equity	$ 98	$ 217	$ 4,461	$ (278)	$ 4,498

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WARNER MUSIC GROUP CORP.

Supplementary Information

Condensed Consolidating Statements of Operations (unaudited)

For The Three Months Ended June 30, 2006 and June 30, 2005

	Three months ended June 30, 2006				
	Warner Music Group Corp.	WMG Holdings Corp. (issuer)	WMG Acquisition Corp.	Eliminations	Warner Music Group Corp. Consolidated
			(in millions)		
Revenues	$	$	$ 822	$	$ 822
Costs and expenses:					
Cost of revenues			(445)		(445)
Selling, general and administrative expenses			(301)		(301)
Amortization of intangible assets			(48)		(48)
Total costs and expenses			(794)		(794)
Operating income			28		28
Interest expense, net		(4)	(41)		(45)
Equity in the gains (losses) of consolidated subsidiaries	(14)	(10)		24	
Other expense, net			1		1
Income (loss) before income taxes	(14)	(14)	(12)	24	(16)
Income tax expense			2		2
Net (loss) income	$ (14)	$ (14)	$ (10)	$ 24	$ (14)

	Three months ended June 30, 2005				
	Warner Music Group Corp.	WMG Holdings Corp. (issuer)	WMG Acquisition Corp.	Eliminations	Warner Music Group Corp. Consolidated
			(in millions)		
Revenues	$	$	$ 742	$	$ 742
Costs and expenses:					
Cost of revenues			(396)		(396)

Selling, general and administrative expenses			(318)		(318)
Amortization of intangible assets			(47)		(47)
Loss on termination of management fee			(73)		(73)
Total costs and expenses			(834)		(834)
Operating income			(92)		(92)
Interest expense, net		(13)	(37)		(50)
Equity in the losses of equity-method investees, net	(179)	(131)		310	
Net investment related gains			1		1
Loss on repayment of Holdings debt		(35)			(35)
Other expense, net			1		1
(Loss) income before income taxes	(179)	(179)	(127)	310	(175)
Income tax expense			(4)		(4)
Net (loss) income	$ (179)	$ (179)	$ (131)	$ 310	$ (179)

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WARNER MUSIC GROUP CORP.

Supplementary Information

Condensed Consolidating Statements of Operations (unaudited)

For The Nine Months Ended June 20, 2006 and June 30, 2005

	Nine months ended June 30, 2006				
	Warner Music Group Corp.	WMG Holdings Corp. (issuer)	WMG Acquisition Corp.	Eliminations	Warner Music Group Corp. Consolidated
			(in millions)		
Revenues	$	$	$ 2,662	$	$ 2,662
Costs and expenses:					
Cost of revenues			(1,384)		(1,384)
Selling, general and administrative expenses			(918)		(918)
Amortization of intangible assets			(143)		(143)
Total costs and expenses			(2,445)		(2,445)
Operating income			217		217
Interest expense, net		(12)	(123)		(135)
Equity in the gains (losses) of equity method investees			1		1
Equity in the gains (losses) of consolidated subsidiaries	48	60		(108)	
Other income, net			3		3
Income before income taxes	48	48	98	(108)	86
Income tax expense			(38)		(38)
Net income (loss)	$ 48	$ 48	$ 60	$ (108)	$ 48

	Nine months ended June 30, 2005				
	Warner Music Group Corp.	WMG Holdings Corp. (issuer)	WMG Acquisition Corp.	Eliminations	Warner Music Group Corp. Consolidated
			(in millions)		
Revenues	$	$	$ 2,597	$	$ 2,597
Costs and expenses:					

Cost of revenues			(1,377)		(1,377)
Selling, general and administrative expenses			(942)		(942)
Amortization of intangible assets			(140)		(140)
Loss on termination of management fee			(73)		(73)
Total costs and expenses			(2,532)		(2,532)
Operating income			65		65
Interest expense, net	(1)	(31)	(108)		(140)
Net investment-related gains			1		1
Equity in the losses of equity-method investees, net	(155)	(84)	(1)	239	(1)
Loss on repayment of Holdings debt		(35)			(35)
Unrealized gain on warrant	17				17
Minority interest expense		(5)			(5)
Other expense, net			5		5
(Loss) income before income taxes	(139)	(155)	(38)	239	(93)
Income tax expense			(46)		(46)
Net (loss) income	$ (139)	$ (155)	$ (84)	$ 239	$ (139)

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WARNER MUSIC GROUP CORP.

Supplementary Information

Condensed Consolidating Statement of Cash Flows (unaudited)

For The Nine Months Ended June 30, 2006

	Warner Music Group Corp.	WMG Holdings Corp. (issuer)	WMG Acquisition Corp.	Eliminations	Consolidated
			(in millions)		
Cash flows from operating activities:					
Net income	$ 48	$ 48	$ 60	$ (108)	$ 48
Adjustments to reconcile net income to net cash provided by (used in) operating activities:					
Depreciation and amortization			175		175
Non-cash interest expense		12	27		39
Non-cash stock compensation expense			12		12
Deferred taxes			(17)		(17)
Equity in the losses of equity-method investees, including distributions			(1)		(1)
Equity in the losses of consolidated subsidiaries	(48)	(60)		108	
Changes in operating assets and liabilities:					
Accounts receivable			121		121
Inventories			3		3
Royalty advances			(54)		(54)
Accounts payable and accrued liabilities			(81)		(81)
Other balance sheet changes	(2)		(20)		(22)
Net cash (used in) provided by operating activities	(2)		225		223
Cash flows from investing activities:					
Investments and acquisitions			(95)		(95)
Investments in short term investments	(28)		(1)		(29)
Capital expenditures			(18)		(18)
Net cash used in investing activities	(28)		(114)		(142)
Cash flows from financing activities:					
Quarterly debt repayments			(13)		(13)
Capital contributions received/paid	(3)	3			
Increase in intercompany	3	(8)	5		
Returns of capital and dividends paid	27	4	(86)		(55)
Net cash provided by (used in) financing activities	27	(1)	(94)		(68)

Effect of foreign currency exchange rate changes on cash			5		5
Net increase (decrease) in cash and equivalents	(3)	(1)	22		18
Cash and equivalents at beginning of period	40	1	247		288
Cash and equivalents at end of period	$ 37	$	$ 269	$	$ 306

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WARNER MUSIC GROUP CORP.

Supplementary Information

Condensed Consolidating Statement of Cash Flows (unaudited)

For The Nine Months Ended June 30, 2005

	Warner Music Group Corp.	WMG Holdings Corp. (issuer)	WMG Acquisition Corp.	Eliminations	Consolidated
			(in millions)		
Cash flows from operating activities:					
Net loss	$ (139)	$ (155)	$ (84)	$ 239	$ (139)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:					
Depreciation and amortization			180		180
Deferred taxes			(7)		(7)
Loss on repayment of debt		35			35
Non-cash interest expense		26	26		52
Non-cash stock compensation expense			18		18
Net investment-related gains			(1)		(1)
Equity in the losses of equity-method investees, including distributions	155	84	1	(239)	1
Minority interest		5			5
Unrealized gain on warrant	(17)				(17)
Changes in operating assets and liabilities:					
Accounts receivable			77		77
Inventories			6		6
Royalty advances			(2)		(2)
Accounts payable and accrued liabilities			(22)		(22)
Other balance sheet changes	1	2	(17)		(14)
Net cash provided by (used in) operating activities		(3)	175		172
Cash flows from investing activities:					
Investments and acquisitions			(84)		(84)
Investment proceeds			50		50
Capital expenditures			(20)		(20)
Net cash used in investing activities			(54)		(54)
Cash flows from financing activities:					
Borrowings, net of financing costs		679	247		926
Debt repayments		(574)	(10)		(584)
Capital contributions	(590)	517	73		
Proceeds from the issuance of common stock	554				554
Costs to issue common stock	(27)				(27)
Repurchase of warrants	(126)	(12)			(138)
Repurchase of subsidiary preferred stock		(200)			(200)
Dividends paid to minority interest shareholders		(9)			(9)
Proceeds from the issuance of restricted shares	1				1
Return of capital received	1,157	742		(1,899)	
Return of capital paid	(917)	(1,157)	(742)	1,899	(917)
Change in inter-company	(12)	18	(6)		

Loan to third party			(10)		(10)
Other			(3)		(3)
Net cash provided by (used in) financing activities	40	4	(451)		(407)
Effect of foreign currency exchange rate changes on cash			(1)		(1)
Net increase (decrease) in cash and equivalents	40	1	(331)		(290)
Cash and equivalents at beginning of period			555		555
Cash and equivalents at end of period	$ 40	$ 1	$ 224	$	$ 265

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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 June 30, 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 Securities and Exchange Commission (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 t 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, the adequacy of our existing sources of cash to support our existing operations the next twelve months, the effect of litigation and other investigations on us and the impact of recent developments regarding EMI Group plc (EMI) and Sony BMG Music Entertainment (Sony BMG) 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;

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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;

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;

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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; 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

Warner Music Group Corp. (the Company) was formed by a private equity consortium of Investors (the Investor Group) on November 21, 2003. The Company is the direct parent of WMG Holdings Corp. (Holdings), which is the direct parent of WMG Acquisition Corp. (Acquisition Corp.). Acquisition Corp. is one of the world s major music content companies and the successor to substantially all of the interests of the recorded music and music publishing businesses of Time Warner Inc. (Time Warner). Effective March 1, 2004, Acquisition Corp. acquired such interests from Time Warner for approximately $2.6 billion (the Acquisition).

The Company and Holdings are holding companies that conduct substantially all of their business operations through their subsidiaries. The terms we, us, our, ours, and the Company refer collectively to Warner Music Group Corp. and its consolidated subsidiaries, except where otherwise indicated.

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 nine months ended June 30, 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 nine months ended June 30, 2006 and 2005, as well as a discussion of our financial condition and liquidity as of June 30, 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.

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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. 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 nine-month periods ended June 30, 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 U.S. 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 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 are a part of 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 and from third parties for various uses, including film and television soundtracks.

On May 31, 2006, we completed our acquisition of Ryko Corporation, a leading independent, integrated music and entertainment company.

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, a distribution company that primarily distributes the products of independent labels to retail and wholesale distributors in the U.S.; Ryko Distribution, which distributes music and DVD releases from Rykodisc, Ryko s record music label, and third-party record and video labels, various distribution

centers and ventures operated internationally; an 80% interest in Word Entertainment, whose distribution operations specialize in the distribution of music products in the Christian retail marketplace; and ADA U.K., which provides ADA s distribution services to independent labels in Europe.

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;

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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. 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.

Recent Developments

EMI

On May 1, 2006, EMI made an unsolicited proposal to acquire the Company for $28.50 per share (consisting of $20 per share in cash and $8.50 per share in EMI stock). Our board unanimously rejected that proposal on May 2, 2006, determining that it was not in the best interests of our shareholders. On June 14, 2006, we made a proposal to purchase EMI for 315 pence per share in cash. EMI rejected that proposal on June 23, 2006, when it made its revised proposal to acquire us for $31 per share in cash. On June 27, 2006, our board unanimously rejected EMI s revised proposal, determining that it was not in the best interests of our shareholders. We simultaneously made a revised proposal to purchase EMI for 320 pence per share in cash. On June 28, 2006, EMI rejected our revised proposal. On July 13, 2006, the European Court of First Instance annulled the European Commission s decision approving the formation of Sony BMG. Sony and Bertelsmann

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will now have to re-apply to the European Commission to seek clearance for the formation of Sony BMG and the European Commission will have to re-examine the combination. As a result of this re-examination, the European Commission could clear the transaction without conditions, clear the transaction with conditions or block the transaction forcing Sony BMG to unwind. In the interim, the European Commission, Sony or Bertelsmann can appeal the ruling to the European Court of Justice. We cannot predict what actions will be taken by the European Commission, Sony or Bertelsmann as a result of the ruling or the outcome or timing of the European Commission s re-examination of Sony BMG or the appeal of the ruling. On July 27, 2006, EMI announced that, against this backdrop, the Board of EMI has decided not to pursue a combination with us for the time being. The EMI Board noted that it will review this position in the light of future developments. Later on July 27, 2006, we announced that the ruling of the European Court of First Instance regarding Sony BMG had created uncertainty regarding a potential combination of us and EMI. We further announced that we would monitor the situation carefully, but until matters become clearer, for instance as a result of the re-review of Sony BMG by the European Commission or through an appeal to the European Court of Justice, we did not believe that it would be prudent to pursue a combination of us and EMI. Accordingly, we do not intend to make an offer for EMI at this time. There can be no certainty that any transaction between the two companies will take place.

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 July 30, 2006, year-to-date U.S. recorded music sales (excluding sales of digital tracks) are down approximately 5.5% 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.

Initial Common Stock Offering

In May 2005, we completed the initial public offering of our common stock (the Initial Common Stock Offering). Prior to the consummation of the Initial Common Stock Offering, we, among other things, renamed all of our outstanding shares of Class A Common Stock as common stock and authorized an approximately 1,139 for 1 split of our common stock. We contributed the net proceeds from the Initial Common Stock Offering of

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$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 Acquisition Corp. to redeem its outstanding notes as discussed below.

In addition, in connection with the Initial Common Stock Offering, we, among other things, repurchased the warrants issued as part of the initial purchase price consideration for the Acquisition from Time Warner for $138 million, we declared and paid a dividend to our stockholders prior to the Initial Common Stock Offering of $100.5 million, terminated a management agreement with the Investor Group as discussed below, borrowed an additional $250 million under the term loan portion of our senior secured credit facility and paid a $10 million cash bonus to our employees.

Payments Relating to Executive Compensation

Concurrent with the Initial Common Stock Offering, we determined that certain shares of restricted stock issued in 2004 and early 2005 may have been sold at prices below fair market value on the applicable date of sale and certain options to purchase shares of our stock granted may have had exercise prices below fair market value on the applicable date of grant. As a result, certain U.S. employee holders of the restricted stock who made elections under Section 83(b) of the Internal Revenue Code would be subject to additional ordinary income tax to the extent of the fair market value of the restricted stock received over the purchase price they paid for such stock. In other cases, certain employees who did not make such an election will be subject to higher taxes on their restricted shares at the time of vesting than would have been the case had they purchased the shares for fair market value. In addition, under the provisions of the American Jobs Creation Act of 2004, signed into law in October 22, 2004, U.S. employee option holders whose options vest with exercise prices below fair market value on the date of grant are subject to significant penalties under new Section 409A of the Internal Revenue Code. IRS Notice 2005-1 provides transitional guidance on the application of Section 409A which, among other things, permits options with exercise prices below the fair market value of the underlying stock on the date of grant to be amended or replaced with new options having an exercise price at least equal to the fair market value on the grant date. Non-U.S. employee holders of restricted stock or options may be subject to similar or other related issues. In order for us to address these issues our Board of Directors, based on a re-assessment of fair market values on the applicable dates, approved the actions discussed below.

Restricted Stock. We were authorized to pay a cash bonus to each employee who purchased restricted stock at prices that were below fair market value on the date of purchase. The bonus was calculated as either an amount equal to the tax liability incurred by the employee at the grant date or an estimate of the additional tax which would be incurred by the employee upon vesting of the shares, depending upon the employee s Section 83(b) election. Additionally, we paid the employees an amount necessary to pay the related taxes on the bonus. This resulted in total cash payments of approximately $10 million, which we expensed in the quarter ended June 30, 2005.

*Options. W*e revised the exercise prices of certain options to purchase our common stock to prices equal to the applicable re-determined fair market values of the common stock on the dates of the respective grants. We compensated the grantees with a cash bonus representing the loss of value created by this adjustment to the option exercise prices. This resulted in total cash bonuses paid of approximately $9 million. The revision of the exercise prices was treated as a modification of these awards and $6 million related to this modification was expensed in the quarter ended June 30, 2005.

Further, in connection with the $100.5 million cash dividend we declared and paid to holders of our common stock, consisting of the Investor Group and certain members of management who held shares of common stock prior to the Initial Common Stock Offering, we made an adjustment to all options to purchase common stock outstanding at the time of declaration of the dividend. The adjustment consisted of a cash make- whole payment to each option holder equal to the pro-rata amount that would have been received per share had all outstanding options been exercised at the time of the declaration of the dividend. The amounts were adjusted down to reflect a present value discount based on the earliest possible exercise dates. We recorded approximately $3 million of expense related to such payments in the quarter ended June 30, 2005.

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Holdings Refinancing and Redemption

In December 2004, 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, we used $517 million of proceeds from the offering along with $57 million of available cash to redeem certain of the Holdings Notes outstanding. As of June 30, 2006, Holdings had $186 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.

In connection with the redemption of the Holdings Floating Rate Notes and 35% of the Holdings Discount Notes, we were required to pay redemption premiums of $10 million and $9 million, respectively, which the we paid on June 15, 2005 and recorded as a loss on the repayment of the notes in the consolidated statement of operations for the three and nine months ended June 30, 2005. We also wrote off the remaining balance of debt-issuance costs of $12 million related to the notes redeemed and the remaining unamortized original issue discount of $4 million related to the Holdings PIK Notes. Such amounts $35 million in the aggregate, were recorded as a loss on the repayment of the notes in the consolidated statement of operations for the three months and nine ended June 30, 2005.

Termination of Management/Monitoring Agreement

As described in Note 20 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,

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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 three and nine months ended June 30, 2005. As a result, certain fees paid in prior periods do not appear in subsequent periods. We paid $1 million and $6 million of Periodic Fees under the Management Agreement during the three and nine months ended June 30, 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 WBP, 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 WBP, it was not reported as discontinued operations. For the three months ended June 30, 2005, the operations sold generated revenues of approximately $8 million; operating income of $1 million; operating income before depreciation and amortization expense of $1 million; and net income of approximately $1 million. For the nine months ended June 30, 2005, the operations sold generated revenues of approximately $34 million; operating income of $1 million; operating income before depreciation and amortization expense of $1 million; and net income of approximately $1 million.

RESULTS OF OPERATIONS

Three Months Ended June 30, 2006 Compared to Three Months Ended June 30, 2005

The following table summarizes our historical results of operations:

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
	(unaudited)	(unaudited)
	(in millions)	
Revenues	$ 822	$ 742
Costs and expenses:		
Cost of revenues	(445)	(396)
Selling, general and administrative expenses (1)	(301)	(318)
Amortization of intangible assets	(48)	(47)
Loss on termination of management agreement		(73)
Total costs and expenses	(794)	(834)

Operating income (loss)	28	(92)
Interest expense, net	(45)	(50)
Net investment-related gains		1
Loss on repayment of Holdings Notes		(35)
Other income, net	1	1
Loss before income taxes	$ (16)	$ (175)
Income tax benefit (expense)	2	(4)
Net loss	$ (14)	$ (179)

(1) Includes depreciation expense of $10 million and $12 million for the three months ended June 30, 2006 and 2005, respectively.

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Consolidated Historical Results

Revenues

Our revenues increased $80 million, or 11%, to $822 million for the three months ended June 30, 2006 as compared to $742 million for the three months ended June 30, 2005. Excluding a $4 million unfavorable impact of foreign currency exchange rates and prior-year revenue of $8 million related to our sheet music business, which was sold in May 2005, total revenue increased by $92 million or 13%. Recorded Music revenues increased by $90 million, to $678 million for the three months ended June 30, 2006. Excluding a $4 million unfavorable impact of foreign currency exchange rates, Recorded Music revenues rose $94 million, or 16%, comprised of a $44 million increase in physical sales and a $50 million increase in digital sales. Music Publishing revenues declined by $11 million to $150 million for the three months ended June 30, 2006. Excluding $8 million of prior-year revenue related to our sheet music business sold in May 2005, Music Publishing revenue declined $3 million or 2%. International operations represented $416 million of consolidated revenues for the three months ended June 30, 2006 as compared to $375 million for the three months ended June 30, 2005, comprising 51% of total revenues for each period.

Overall digital revenues grew to $92 million for the three months ended June 30, 2006, as compared to $90 million for the three months ended March 31, 2006 and $44 million for the three months ended June 30, 2005. Digital revenues represented 11% of consolidated revenues for the three months ended June 30, 2006, consistent with the most recent reported quarter and up from 6% in the prior-year quarter. Total digital revenues for the three months ended June 30, 2006 was comprised of U.S. revenues of $68 million, or 74% of total digital revenues, and international revenues of $24 million, or 26% 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 $49 million, or 12%, to $445 million for the three months ended June 30, 2006 as compared to $396 million for the three months ended June 30, 2005. Excluding a $2 million benefit of foreign currency exchange rates and $5 million of costs related to our sheet music business, which was sold in May 2005, our cost of revenues increased by $56 million. Expressed as a percent of revenues, cost of revenues was 54% and 53% for the three months ended June 30, 2006 and 2005, respectively. The increase related primarily to an increase in product costs of $20 million as a result of higher physical sales and an increase in artist and repertoire costs and licensing costs of $36 million related to increased royalty expense resulting from the increases in both physical and digital sales. While recorded music artist and repertoire costs remained consistent as a percentage of sales, music publishing artist and repertoire costs, excluding the impact of the sheet music business, increased as a percentage of sales due to increased investment in our music publishing business.

Selling, general and administrative expenses

Our selling, general and administrative expenses decreased by $17 million, to $301 million for the three months ended June 30, 2006 as compared to $318 million for the three months ended June 30, 2005. Expressed as a percent of revenues, selling, general and administrative expenses were 37% and 43% for the three months ended June 30, 2006 and 2005, respectively. Excluding a $1 million benefit of foreign

currency exchange rates and $2 million of expenses related to our print operations which were sold in May 2005, selling, general and administrative expenses decreased by $14 million, or 4%, primarily related to $29 million of one-time compensation expenses recorded in the three months ended June 30, 2005, consisting of a $10 million one-time

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bonus to employees related to the Company s Initial Common Stock Offering and $19 million of one-time payments to holders of restricted stock and stock options primarily to compensate them for certain amounts related to stock awards issued at prices that were below fair value at the grant date. This decline was offset by a $6 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, and a $6 million increase in distribution costs, directly related to the increase in physical sales. Stock compensation expense amounted to $4 million for the three months ended June 30, 2006 and $9 million for the three months ended June 30, 2005.

Loss on termination of management agreement

Concurrent with our Initial Common Stock Offering, the Investor Group terminated the Management Agreement with us. Under the Management Agreement, we were required to pay the Investor Group annual fees in consideration for ongoing consulting and management advisory services and transaction based fees for services provided in connection with any future acquisition, disposition or financing. The Investor Group terminated the Management Agreement on May 10, 2005 and on May 16, 2005 we paid a $73 million termination fee.

Reconciliation of Consolidated Historical OIBDA to Operating Income (Loss) and Net Loss

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

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
	(unaudited)	(unaudited)
	(in millions)	
OIBDA	$ 86	$ (33)
Depreciation expense	(10)	(12)
Amortization expense	(48)	(47)
Operating income (loss)	28	(92)
Interest expense, net	(45)	(50)
Net investment-related gains		1
Loss on repayment of Holdings Notes		(35)
Other income, net	1	1
Loss before income taxes	$ (16)	$ (175)
Income tax benefit (expense)	2	(4)
Net loss	$ (14)	$ (179)

OIBDA

Our OIBDA increased $119 million to $86 million for the three months ended June 30, 2006 as compared to a loss of $33 million for the three months ended June 30, 2005. Expressed as a percentage of revenues, total OIBDA margin was 11% for the three months ended June 30, 2006 as compared to (4)% for the three months ended June 30, 2005. The increase was primarily a result of the increased revenues and absence of certain one-time expenses which were included in the three months ended June 30, 2005, including the $73 million payment on termination of the Management Agreement and $29 million of one-time compensation expenses, consisting of a $10 million one-time bonus to employees related to the Company s Initial Common Stock Offering and $19 million of one-time payments to holders of restricted stock and stock options primarily to compensate them for certain amounts related to stock awards issued at prices that were below fair value at the grant date, which are more fully discussed above. See Business Segment Results presented hereinafter for a discussion of OIBDA by business segment.

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Depreciation expense

Our depreciation expense decreased by $2 million to $10 million for the three months ended June 30, 2006 as compared to $12 million for the three months ended June 30, 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 June 30, 2006 as compared to $47 million for the three months ended June 30, 2005. The increase is due to various acquisitions of recorded music catalogs and music publishing copyrights since the prior-year.

Operating income (loss)

Our operating income increased $120 million, to $28 million for the three months ended June 30, 2006 as compared to an operating loss of $92 million for the three months ended June 30, 2005. The increase in operating income was primarily a result of the increase in OIBDA, which is 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 decreased to $45 million for the three months ended June 30, 2006 compared to $50 million for the three months ended June 30, 2005. The decrease in interest expense is due to a higher average debt balance in the prior-year, as the three months ended June 30, 2005 included interest expense related to the outstanding Holdings Floating Rate Notes and Holdings PIK Notes, which were fully redeemed in June 2005, as well as the Holdings Discount Notes, which were partially redeemed in June 2005. The decline was partially offset by the additional interest on an additional $250 million borrowed under the term loan portion of our senior secured credit facility in connection with the Initial Common Stock Offering in May 2005, as well as higher interest rates on outstanding debt during the current period. See Financial Condition and Liquidity for more information.

Net investment-related gains

We recognized a $1 million investment-related gain for the three months ended June 30, 2005 primarily related to the sale of our interest in an equity-method investment. We did not recognize any investment-related gains or losses for the three months ended June 30, 2006.

Loss on repayment of Holdings Notes

In June 2005, we redeemed all of the outstanding Holdings Floating Rate Notes, all of the outstanding Holdings PIK Notes and 35% of the outstanding Holdings Discount Notes. In connection with the redemption, we paid approximately $19 million of redemption premiums, and wrote off approximately $12 million related to the carrying value of the unamortized debt issuance costs related to our Holdings Notes and approximately $4 million related to the carrying value of the unamortized discount on the issuance of the Holdings Notes. See Financial Condition and Liquidity for more information.

Other income, net

Other income, net relates to 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. We recognized $1 million of other income, net for each of the three months ended June 30, 2006 and 2005 as a result of favorable foreign currency exchange rate movements.

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Income tax benefit (expense)

We provided an income tax benefit of $2 million and income tax expense of $4 million for the three months ended June 30, 2006 and 2005, respectively. The current quarter tax benefit related to a discreet period item that resulted from the completion in the current quarter of an analysis of the allocation of our operating expenses charged to affiliates. The analysis resulted in a higher percentage of operating expenses being allocated to foreign income, thereby reducing foreign income taxes. 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 three months ended June 30, 2005 primarily relates to the tax provisions on foreign income.

Net loss

Our net loss declined $165 million, to a net loss of $14 million for the three months ended June 30, 2006 as compared to a net loss of $179 million for the three months ended June 30, 2005. The decrease is primarily the result of increases in revenues and the absence of certain one-time expenses which were included in the three months ended June 30, 2005, including the $73 million payment on termination of the Management Agreement, $29 million of one-time compensation expenses and the $35 million loss on the repayment of the Holdings Notes, which are more fully discussed above.

Business Segment Results

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

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
	(unaudited)	(unaudited)
	(in millions)	
Recorded Music		
Revenue	$ 678	$ 588
OIBDA	$ 92	$ 47
Operating income	$ 52	$ 6
Music Publishing		
Revenue	$ 150	$ 161
OIBDA	$ 23	$ 28
Operating income	$ 9	$ 13
Corporate and Revenue Eliminations		
Revenue	$ (6)	$ (7)
OIBDA	$ (29)	$ (108)
Operating loss	$ (33)	$ (111)

Total		
Revenue	$ 822	$ 742
OIBDA	$ 86	$ (33)
Operating income (loss)	$ 28	$ (92)

Recorded Music

Recorded Music revenues increased by $90 million, or 15%, to $678 million for the three months ended June 30, 2006 from $588 million for the three months ended June 30, 2005. Excluding a $4 million unfavorable impact of foreign currency exchange rates, Recorded Music revenues increased by $94 million, or 16%, which was driven by an increase in digital sales of approximately $50 million and an increase in physical sales of $44

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million. Digital sales totaled $88 million, or 13% of Recorded Music revenues for the three months ended June 30, 2006 compared to $38 million, or 6%, for the three months ended June 30, 2005. Digital sales totaled $86 million, or 13% for the immediately preceding three months ended March 31, 2006. Worldwide physical sales increased as a result of significant sales of new releases in the three months ended June 30, 2006, as well as increased sales of a number of carryover and catalog releases. Domestic physical sales increased $18 million, and excluding the impact of foreign currency exchange rates, international physical sales increased $26 million.

Recorded Music revenues represented 82% and 79% of consolidated revenues, prior to corporate and revenue eliminations, for the three months ended June 30, 2006 and 2005, respectively. U.S. Recorded Music revenues were $347 million and $292 million, or 51% and 50% of consolidated Recorded Music revenues for the three months ended June 30, 2006 and 2005, respectively. International Recorded Music revenues were $331 million and $296 million, or 49% and 50% of consolidated Recorded Music revenues for the three months ended June 30, 2006 and 2005, respectively.

Recorded Music OIBDA increased by $45 million, to $92 million for the three months ended June 30, 2006 compared to $47 million for the three months ended June 30, 2005. Expressed as a percentage of Recorded Music revenues, Recorded Music OIBDA was 14% and 8% for the three months ended June 30, 2006 and 2005, respectively. The increase in OIBDA was primarily a result of the $90 million increase in revenues more fully described above and a $22 million decrease in general and administrative expense, primarily due to the absence of a $20 million impact related to one-time compensation expenses consisting of a one-time bonus to employees related to the Company s Initial Common Stock Offering and one-time payments to holders of restricted stock and stock options primarily to compensate them for certain amounts related to stock awards issued at prices that were below fair value at the grant date. These increases in OIBDA were offset by (i) a $20 million increase in product costs and a $6 million increase in distribution costs directly related to the increase in physical sales previously described and (ii) a $24 million increase in artist and repertoire costs primarily related to increased royalty expense as a result of our increases in both physical and digital sales previously described. As a percentage of Recorded Music revenues, artist and repertoire costs were flat, excluding the impact of foreign currency exchange rates, as compared to the prior-year quarter.

Recorded Music operating income was $52 million for the three months ended June 30, 2006 as compared to $6 million for the three months ended June 30, 2006. Recorded Music operating income included the following components:

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
	(unaudited)	(unaudited)
	(in millions)	
OIBDA	$ 92	$ 47
Depreciation and amortization	(40)	(41)
Operating income	$ 52	$ 6

The $46 million increase in Recorded Music operating income related to the $45 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 $11 million, or 7%, to $150 million for the three months ended June 30, 2006 as compared to $161 million for the three months ended June 30, 2005. Excluding prior-year revenue of $8 million from our sheet music business, which was sold in May 2005, Music Publishing revenues

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declined $3 million, or 2%, and such decline was comprised of a $4 million decrease in mechanical revenue and a $12 million decline in synchronization revenue, offset by increases in performance revenue of $8 million and other revenues of $5 million. Mechanical revenue declines reflect prior-year industry declines in physical record sales. Synchronization revenues declined as a result of variability in the film and television commercial markets as well as the timing of payments received from key licensors of our copyrights. The increase in performance revenue reflects a change in the timing of payments received from a U.S. performing rights organization. Other revenue consists primarily of print licensing fees and royalties from other sources such as stage productions. Music Publishing revenues consisted of $62 million of mechanical revenues, $58 million of performance revenues, $21 million of synchronization revenues, $4 million of revenues from digital sales and $5 million of other revenues. Digital sales represented 3% and 4% of Music Publishing revenues for the three months ended June 30, 2006 and 2005, respectively. Music Publishing revenues represented 18% and 22% of consolidated revenues, prior to corporate and revenue eliminations, for the three months ended June 30, 2006 and 2005, respectively.

Music Publishing OIBDA declined $5 million to $23 million for the three months ended June 30, 2006 as compared to $28 million for the three months ended June 30, 2005. Excluding $1 million in prior-year OIBDA from our sheet music business, OIBDA decreased by $4 million primarily as a result of the decrease in revenues discussed above. Expressed as a percentage of Music Publishing revenues, Music Publishing OIBDA was 15% and 17% for the three months ended June 30, 2006 and 2005, respectively.

Music Publishing operating income was $9 million for the three months ended June 30, 2006 as compared to $13 million for the three months ended June 30, 2005. Music Publishing operating income includes the following components:

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
	(unaudited)	(unaudited)
	(in millions)	
OIBDA	$ 23	$ 28
Depreciation and amortization	(14)	(15)
Operating income	$ 9	$ 13

The $4 million decline in Music Publishing operating income related to the $5 million decrease in Music Publishing OIBDA, more fully discussed above, and a $1 million decrease in depreciation and amortization.

Corporate Expenses and Eliminations

Corporate expenses before depreciation and amortization expense decreased $79 million to $29 million for the three months ended June 30, 2006 as compared to $108 million for the three months ended June 30, 2005. Corporate expenses decreased primarily due to the lack of a $73 million payment on termination of management fee, described more fully above. Additionally, prior-year corporate expenses were impacted by $8 million of one-time payments to holders of restricted stock and stock options primarily to compensate them for certain amounts related to stock awards issued at prices that were below fair value at the grant date.

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Nine Months Ended June 30, 2006 Compared to Nine Months Ended June 30, 2005

The following table summarizes our historical results of operations:

	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
	(unaudited)	(unaudited)
	(in millions)	
Revenues	$ 2,662	$ 2,597
Costs and expenses:		
Cost of revenues(1)	(1,384)	(1,377)
Selling, general and administrative expenses	(918)	(942)
Amortization of intangible assets	(143)	(140)
Loss on termination of management agreement		(73)
Total costs and expenses	(2,445)	(2,532)
Operating income	217	65
Interest expense, net	(135)	(140)
Net investment-related gains		1
Equity in the gains (losses) of equity-method investees, net	1	(1)
Loss on repayment of Holdings Notes		(35)
Unrealized gain on warrants		17
Minority interest expense		(5)
Other income, net	3	5
Income (loss) before income taxes	86	(93)
Income tax expense	(38)	(46)
Net income (loss)	$ 48	$ (139)

(1) Includes depreciation expense of $32 million and $40 million for the nine months ended June 30, 2006 and 2005, respectively.

Consolidated Historical Results

Revenues

Our revenues increased $65 million, or 3%, to $2.662 billion for the nine months ended June 30, 2006 as compared to $2.597 billion for the nine months ended June 30, 2005. Excluding a $62 million unfavorable impact of foreign currency exchange rates and prior-year revenue of $34 million related to our sheet music business, which was sold in May 2005, total revenue increased by $161 million, or 6%, primarily due to significant increases in digital sales. Recorded Music revenues increased by $125 million, to $2.274 billion for the nine months ended June 30,

2006. Excluding the impact of foreign currency exchange rates, Recorded Music revenues increased by $173 million or 8%, primarily driven by an increase in worldwide Recorded Music digital sales of $148 million and an increase in worldwide Recorded Music licensing revenue and physical sales of $25 million. Music Publishing revenues declined by $60 million, to $410 million for the nine months ended June 30, 2006. Excluding the impact of foreign currency exchange rates and the prior-year revenue related to our sheet music business, Music Publishing revenue declined $12 million, or 3%. International operations represented $1.380 billion of consolidated revenues for each of the nine months ended June 30, 2006 and 2005, comprising 52% and 53% of total revenues, respectively.

Overall digital revenues grew $147 million to $251 million for the nine months ended June 30, 2006 as compared to $104 million for the nine months ended June 30, 2005. Digital revenues represented 9% and 4% of consolidated revenues for the nine months ended June 30, 2006 and 2005, respectively. Total digital revenues for the nine months ended June 30, 2006 were comprised of U.S revenues of $181 million, or 72% of total digital

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revenues, and international revenues of $70 million, or 28% 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 by $7 million, or 1%, to $1.384 billion for the nine months ended June 30, 2006 as compared to $1.377 billion for the nine months ended June 30, 2005. Expressed as a percent of revenues, cost of revenues was 52% and 53% for the nine months ended June 30, 2006 and 2005, respectively. Excluding a $38 million favorable impact of foreign currency exchange rates and $22 million of expenses related to our sheet music business, which was sold in May 2005, our cost of revenues increased $67 million, or 5%. The increase was primarily due to an increase in product costs of $45 million, directly related to our higher physical sales and a $22 million increase in artist and repertoire and licensing expenses related primarily to increased royalty expense as a result of our increases in physical and digital sales.

Selling, general and administrative expenses

Our selling, general and administrative expenses decreased by $24 million, or 3%, to $918 million for the nine months ended June 30, 2006 as compared to $942 million for the nine months ended June 30, 2005. Expressed as a percent of revenues, selling, general and administrative expenses were 34% and 36% for the nine months ended June 30, 2006 and 2005, respectively. Excluding a $17 million benefit of foreign currency exchange rates and $11 million of expenses related to our sheet music business, selling, general and administrative expenses increased by $4 million. The increase primarily related to (i) a $35 million increase in selling and marketing due to the timing of marketing costs incurred in relation to our product release schedule in the current period and (ii) a $7 million increase in distribution costs related to our increase in physical sales. These increases were offset by an $18 million decrease in general and administrative expenses, primarily due to the absence of $29 million of one-time compensation expenses recorded in the nine months ended June 30, 2005, consisting of a $10 million one-time bonus to employees related to the Company s Initial Common Stock Offering and $19 million of one-time payments to holders of restricted stock and stock options primarily to compensate them for certain amounts related to stock awards issued at prices that were below fair value at the grant date and $6 million of management fees incurred related to the terminated Management Agreement described below. This was partially offset by a severance payment of $8 million related to the departure of the chairman of WMI recorded in the nine months ended June 30, 2006. Additionally, the increase was offset by an $8 million decrease in depreciation expense, discussed more fully below. Stock compensation expense amounted to $12 million for the nine months ended June 30, 2006 and $18 million for the nine months ended June 30, 2005.

Loss on termination of management agreement

Concurrent with our Initial Common Stock Offering, the Investor Group terminated the Management Agreement. Under the Management Agreement, we were required to pay the Investor Group annual fees in consideration for ongoing consulting and management advisory services and transaction based fees for services provided in connection with any future acquisition, disposition, or financing. The Investor Group terminated the Management Agreement on May 10, 2005 and on May 16, 2005 we paid a $73 million termination fee.

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Reconciliation of Consolidated Historical OIBDA to Operating Income and Net Income (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 income (loss) for purposes of the discussion that follows:

	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
	(unaudited)	(unaudited)
	(in millions)	
OIBDA	$ 392	$ 245
Depreciation expense	(32)	(40)
Amortization expense	(143)	(140)
Operating income	217	65
Interest expense, net	(135)	(140)
Net investment-related gains		1
Equity in the gains (losses) of equity-method investees, net	1	(1)
Loss on repayment of Holdings Notes		(35)
Unrealized gain on warrants		17
Minority interest expense		(5)
Other income, net	3	5
Income (loss) before income taxes	86	(93)
Income tax expense	(38)	(46)
Net income (loss)	$ 48	$ (139)

OIBDA

Our OIBDA increased $147 million to $392 million for the nine months ended June 30, 2006 as compared $245 million for the nine months ended June 30, 2005. Expressed as a percentage of revenues, total OIBDA margin was 15% for the nine months ended June 30, 2006 as compared to 9% for the nine months ended June 30, 2005. The increase was primarily a result of the increase in Recorded Music revenue and the absence of certain one-time expenses which were included in the nine months ended June 30, 2005, including the $73 million payment on termination of the Management Agreement and $29 million of one-time compensation expenses, consisting of a $10 million one-time bonus to employees related to the Company s Initial Common Stock Offering and $19 million of one-time payments to holders of restricted stock and stock options primarily to compensate them for certain amounts related to stock awards issued at prices that were below fair value at the grant date, 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 $8 million to $32 million for the nine months ended June 30, 2006 as compared to $40 million for the nine months ended June 30, 2005. The decrease primarily relates to lower capital spending since the date of the Acquisition.

Amortization expense

Our amortization expense increased by $3 million, or 2%, to $143 million for the nine months ended June 30, 2006 as compared to $140 million for the nine months ended June 30, 2005. The increase is due to various acquisitions of recorded music catalogs and music publishing copyrights since the prior-year.

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Operating income

Our operating income increased $152 million, to $217 million for the nine months ended June 30, 2006 as compared to $65 million for the nine months ended June 30, 2005. The increase in operating income was primarily a result of the increase in OIBDA and the decrease in depreciation expense, 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 decreased $5 million to $135 million for the nine months ended June 30, 2006 as compared to $140 million for the nine months ended June 30, 2005. The nine months ended June 30, 2005 include several months of interest expense related the outstanding Holdings Floating Rate Notes and Holdings PIK Notes, which were issued in December 2004 and fully redeemed in June 2005, as well as the Holdings Discount Notes, which were issued in December 2004 and partially redeemed in June 2005. The decline is partially offset by interest expense related to an additional outstanding term loan of $250 million borrowed in May 2005, which is reflected in only one of the nine months ended June 30, 2005, as well as higher interest rates on outstanding debt during the current period. See Financial Condition and Liquidity for more information.

Net investment-related gains

We recognized a $1 million investment-related gain for the nine months ended June 30, 2005 primarily related to the sale of our interest in an equity-method investment. We did not recognize any investment-related gains or losses for the nine months ended June 30, 2006.

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

The nine months ended June 30, 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 nine months ended June 30, 2005.

Loss on repayment of Holdings Notes

In June 2005 we redeemed all of the outstanding Holdings Floating Rate Notes, all of the outstanding Holdings PIK Notes and 35% of the outstanding Holdings Discount Notes. In connection with the redemption, we paid approximately $19 million of redemption premiums, and wrote off approximately $12 million related to the carrying value of the unamortized debt issuance costs related to our Holdings Notes and approximately $4 million related to the carrying value of the unamortized discount on the issuance of the Holdings Notes. See Financial Condition and Liquidity for more information.

Unrealized gain on warrants

We recognized a $17 million unrealized gain to mark-to-market the value of the warrants issued to Time Warner in connection with the Acquisition for the nine months ended June 30, 2005. In connection with the Company s Initial Common Stock Offering, we repurchased the warrants at a cost of approximately $138 million, which approximated fair value at that date.

Minority interest expense

We recognized minority interest expense of $5 million for the nine months ended June 30, 2005. This expense related to dividends on preferred stock of Holdings that was held directly by the Investor Group and was issued in connection with the initial funding of the purchase price for the Acquisition effective March 1, 2004. The preferred stock was fully redeemed in December 2004 from the proceeds of the Holdings Notes. As such, there is no comparable charge recognized during the nine months ended June 30, 2006.

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Other Income, net

We recognized $3 million and $5 million of other income, net for the nine months ended June 30, 2006 and 2005, respectively. Other income, net relates to favorable foreign currency exchange rate movements associated with inter-company 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 $38 million for the nine months ended June 30, 2006 as compared to $46 million for the nine months ended June 30, 2005. The tax provision for the nine months ended June 30, 2006 included a discreet period item that resulted from the completion in the current period of an analysis of the allocation of our operating expenses charged to affiliates. The analysis resulted in a higher percentage of operating expenses being allocated to foreign income, thereby reducing foreign income taxes. 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 nine months ended June 30, 2006 and 2005 primarily relates to the tax provisions on foreign income.

Net income (loss)

Our net income increased by $187 million, to net income of $48 million for the nine months ended June 30, 2006 as compared to a net loss of $139 million for the nine months ended June 30, 2005. The increase in net income is primarily the result of the absence of certain one-time expenses which were included in the nine months ended June 30, 2005, including the $73 million payment on termination of the Management Agreement, $29 million of one-time compensation expenses and the $35 million loss on repayment of the Holdings Notes, which are more fully discussed above.

Business Segment Results

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

	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
	(unaudited)	(unaudited)
	(in millions)	
Recorded Music		
Revenue	$ 2,274	$ 2,149
OIBDA	$ 379	$ 313
Operating income	$ 258	$ 188
Music Publishing		

Revenue	$ 410	$ 470
OIBDA	$ 91	$ 99
Operating income	$ 47	$ 55
Corporate and Revenue Eliminations		
Revenue	$ (22)	$ (22)
OIBDA	$ (78)	$ (167)
Operating (loss)	$ (88)	$ (178)
Total		
Revenue	$ 2,662	$ 2,597
OIBDA	$ 392	$ 245
Operating income	$ 217	$ 65

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Recorded Music

Recorded Music revenues increased by $125 million, or 6%, to $2.274 billion for the nine months ended June 30, 2006 from $2.149 billion for the nine months ended June 30, 2005. Excluding a $48 million unfavorable impact of foreign currency exchange rates, Recorded Music revenues increased by $173 million, or 8%, which was primarily driven by an increase in digital sales of $148 million and an increase in licensing revenue and physical sales of $25 million. Digital sales totaled $238 million, or 10% of Recorded Music revenues for the nine months ended June 30, 2006 and $90 million, or 4%, for the nine months ended June 30, 2005.

Recorded Music revenues represented 85% and 83% of consolidated revenues, prior to corporate and revenue eliminations, for the nine months ended June 30, 2006 and 2005, respectively. U.S. Recorded Music revenues were $1.115 billion and $1.001 billion, or 49% and 47% of consolidated Recorded Music Revenues for the nine months ended June 30, 2006 and 2005, respectively. International Recorded Music revenues were $1.159 billion and $1.148 billion, or 51% and 53% of consolidated Recorded Music Revenues for the nine months ended June 30, 2006 and 2005, respectively.

Recorded Music OIBDA increased by $66 million, or 21%, to $379 million for the nine months ended June 30, 2006 compared to $313 million for the nine months ended June 30, 2005. Expressed as a percentage of Recorded Music revenues, Recorded Music OIBDA was 17% and 15% for the nine months ended June 30, 2006 and 2005, respectively. Excluding a $3 million unfavorable impact of foreign currency exchange rates, OIBDA increased $69 million, or 22%, primarily as a result of the $173 million increase in revenues more fully described above, offset by (i) a $45 million increase in product costs, due primarily to the increase in physical sales and to increased sales of special edition physical products, such as CD/DVD box sets in the current period, (ii) a $27 million increase in artist and repertoire costs and licensing costs due primarily to increased royalty expense related to our increases in physical and digital sales and (iii) a $34 million increase in selling and marketing costs related to the timing of marketing costs incurred related to our product release schedule in the current period and as well as a larger number of releases that sold in excess of one million units as compared to the prior year period. General and administrative costs declined $12 million due to prior-year one-time bonuses to employees related to the Company s Initial Common Stock Offering and one-time payments to holders of restricted stock and stock options primarily to compensate them for certain amounts related to stock awards issued at prices that were below fair value at the grant date amounting to $20 million, offset by the $8 million severance payment made related to the departure of the chairman of WMI in the nine months ended June 30, 2006.

Recorded Music operating income was $258 million for the nine months ended June 30, 2006 as compared to $188 million for the nine months ended June 30, 2005. Recorded Music operating income included the following components:

	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
	(unaudited)	(unaudited)
	(in millions)	
OIBDA	$ 379	$ 313
Depreciation and amortization	(121)	(125)
Operating income	$ 258	$ 188

The $70 million increase in Recorded Music operating income related to the $66 million increase in Recorded Music OIBDA, more fully discussed above, and a decrease in Recorded Music depreciation and amortization of $4 million.

Music Publishing

Music Publishing revenues decreased to $410 million for the nine months ended June 30, 2006 as compared to $470 million for the nine months ended June 30, 2005. Excluding a $14 million unfavorable impact of foreign

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currency exchange rates, and prior-year revenue of $34 million of revenue from our sheet music business, which was sold in May 2005, Music Publishing revenues declined $12 million, or 3%, which was comprised of a $16 million decrease in mechanical revenue and a $14 million decline in synchronization revenue, offset by an $8 million increase in performance revenue and a $11 million increase in other revenues. Mechanical revenue declines reflect prior-year industry declines in physical record sales. Synchronization revenues declined as a result of variability in the film and television commercial markets as well as the timing of payments from key licensors of our copyrights. The increase in performance revenue reflects a change in the timing of payments received from a U.S. performing rights organization. Other revenue consists primarily of print licensing fees and royalties from other sources such as stage productions. Music Publishing revenues consisted of $179 million of mechanical revenues, $145 million of performance revenues, $59 million of synchronization revenues, $13 million of revenues from digital sales and $14 million of other revenues. Digital sales represented 3% of Music Publishing revenues for the nine months ended June 30, 2006 and 2005. Music Publishing revenues represented 15% and 18% of consolidated revenues, prior to corporate and revenue eliminations, for the nine months ended June 30, 2006 and 2005, respectively.

Music Publishing OIBDA decreased $8 million to $91 million for the nine months ended June 30, 2006 as compared to $99 million for the nine months ended June 30, 2005. Expressed as a percent of Music Publishing revenues, Music Publishing OIBDA was 22% and 21% for the nine months ended June 30, 2006 and 2005, respectively. Excluding a $1 million unfavorable impact of foreign currency exchange rates, and prior-year OIBDA of $1 million from our sheet music business, which was sold in May 2005, Music Publishing OIBDA decreased $6 million, primarily as a result of the $12 million decrease in revenue more fully discussed above, which was offset by a $6 million decrease in royalty expenses related to the decrease in revenue discussed above.

Music Publishing operating income decreased to $47 million for the nine months ended June 30, 2006 as compared to $55 million for the nine months ended June 30, 2005. Music Publishing operating income includes the following components:

	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
	(unaudited)	(unaudited)
	(in millions)	
OIBDA	$ 91	$ 99
Depreciation and amortization	(44)	(44)
Operating income	$ 47	$ 55

The $8 million decrease in Music Publishing operating income related to the $8 million decrease in Music Publishing OIBDA, more fully discussed above.

Corporate Expenses and Eliminations

Corporate expenses before depreciation and amortization expense decreased by $89 million to $78 million for the nine months ended June 30, 2005, compared to $167 million for the nine months ended June 30, 2004. Corporate expenses primarily decreased due to the prior-year $73 million payment on termination of Management Agreement, more fully described above, as well as the absence of management fees amounting to $6 million related to such Management Agreement. Corporate expenses for the nine months ended June 30, 2005 also included $8 million of one-time compensation expenses consisting of a one-time bonus to employees related to the Company s Initial Common Stock Offering and one-time payments to holders of restricted stock and stock options primarily to compensate them for certain amounts related to stock awards

issued at prices that were below fair value at the grant date.

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FINANCIAL CONDITION AND LIQUIDITY

Financial Condition

At June 30, 2006, we had $2.251 billion of debt, $306 million of cash and equivalents, $29 million of short-term investments (net debt of $1.916 billion, defined as total debt less cash and equivalents and short-term investments) and $80 million of shareholders equity. This compares to $2.246 billion of debt, $288 million of cash and equivalents (net debt of $1.958 billion) and $89 million of shareholders equity at September 30, 2005. Net debt decreased by $42 million as a result of (i) an $18 million increase in cash and equivalents, (ii) a $29 million increase in short-term investments and (iii) a $13 million reduction of debt related to our quarterly repayments of our term loans under the senior secured credit facility. The declines were offset by a $6 million impact of foreign currency exchange rates on our Sterling-denominated notes and $12 million accretion of our Holdings Discount 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 $9 million decrease in shareholders equity during the nine months ended June 30, 2006 consisted of $48 million of net income for the nine months ended June 30, 2006, deferred gains on derivative financial instruments of $12 million and stock compensation of $12 million for the nine months ended June 30, 2006. These increases were primarily offset by $76 million of dividends, which was comprised of our $19.3 million dividend declared on October 3, 2005 and paid on November 23, 2005, our $19.3 million dividend declared on December 29, 2005 and paid on February 17, 2006, our $19.3 million dividend declared on March 14, 2006 and paid on May 3, 2006, and our $19.3 million dividend declared on June 7, 2006 and paid on July 27, 2006.

Cash Flows

The following table summarizes our historical cash flows. The financial data for the nine months ended June 30, 2006 and 2005 are unaudited and are derived from our interim financial statements included elsewhere herein.

	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
	(unaudited)	(unaudited)
	(in millions)	
Cash provided by (used in):		
Operating activities	$ 223	$ 172
Investing activities	(142)	(54)
Financing activities	(68)	(407)

Operating Activities

Cash provided by operations was $223 million for the nine months ended June 30, 2006 compared to $172 million for the nine months ended June 30, 2005. The $51 million increase reflects the prior-year payment of the $73 million fee as a result of the termination of the Management Agreement, higher interest payments in the prior-year related to the additional Holdings debt outstanding, prior-year cash payments of $10 million to our employees in connection with the Company s Initial Common Stock Offering and cash payments for certain of the other one-time special bonuses paid to certain holders of restricted stock and stock options and cash paid in the prior-year in relation to our restructuring plan. The current-year cash provided by operations reflects higher cash collections due to consistently higher sales, offset by higher royalty advance payments in connection with contractual obligations and the timing of releases and additional royalty payments related to the timing of releases.

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Investing Activities

Cash used in investing activities was $142 million for the nine months ended June 30, 2006 compared to $54 million for the nine months ended June 30, 2005. The $142 million of cash used in investing activities in the nine months ended June 30, 2006 primarily reflects $63 million, net of cash acquired, paid for the completion of our acquisition of Ryko, $29 million of cash invested in auction-rate securities and other short-term investments, $18 million of capital expenditures as well as several small acquisitions in Australia, Singapore and South Africa. The $54 million of cash used in investing activities in the nine months ended June 30, 2005 primarily reflects $20 million of capital expenditures, the acquisition of an additional 30% interest in Maverick and various acquisitions of music publishing copyrights offset by $50 million of proceeds from the sale of certain assets.

Financing Activities

Cash used in financing activities was $68 million for the nine months ended June 30, 2006, a $339 million decrease as compared to $407 million for the nine months ended June 30, 2005. Cash used in financing activities for the nine months ended June 30, 2006 consisted of our quarterly repayment of debt and the payment of dividends. Cash used in financing activities for the nine months ended June 30, 2005 primarily relates to the repayment of a portion of the Holdings Notes for $574 million, quarterly term loan debt repayments of $10 million, the returns of capital paid to the Investor Group of $917 million, the $209 million redemption of subsidiary preferred stock as part of the Holdings Refinancing and $138 million paid to repurchase the three-year warrants from Time Warner. These uses of cash were offset principally by $525 million of net proceeds after stock-issuance costs from the Company s Initial Common Stock Offering, $681 million of net proceeds after debt-issuance costs from the issuance of debt as part of the Holdings Refinancing and $247 million of net proceeds after debt-issuance costs from the additional term loan borrowings under the senior secured credit facility.

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 June 30, 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, regular quarterly dividends 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 June 30, 2006, our long-term debt consisted of $1.417 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, $648 million of Acquisition Corp. senior subordinated notes and $186 million of Holdings Discount Notes. There were no borrowings under the revolving portion of our senior secured credit facility as of June 30, 2006.

Senior Secured Credit Facility

The senior secured credit facility consists of a $1.417 billion outstanding term loan portion and a $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

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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 June 30, 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 August 2, 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 June 30, 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

In December 2004, Holdings issued the Holdings Notes. In connection with the Company s Initial Common Stock Offering, we used $517 million of proceeds from the offering along with $57 million of available cash to redeem certain of the Holdings Notes outstanding. As of June 30, 2006, Holdings had $186 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 six-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.

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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.

The terms of the indentures governing the Acquisition Corp. Senior Subordinated Notes and Holdings Discount Notes significantly restrict Acquisition Corp., Holdings and other subsidiaries from paying dividends and otherwise transferring assets to us. For example, the ability of Acquisition Corp. and Holdings to make such payments is governed by a formula based on 50% of each of their consolidated net income (which, as defined in the indentures governing such notes, excludes goodwill impairment charges and any after-tax extraordinary, unusual or nonrecurring gains and losses) accruing from June 1, 2004 and July 1, 2004, respectively. In addition, as a condition to making such payments to us based on such formula, Acquisition Corp. and Holdings must each have an adjusted EBITDA to interest expense ratio of at least 2.0 to 1 after giving effect to any such payments. Acquisition Corp. may also make a restricted payment prior to April 15, 2009 if, immediately after giving pro forma effect to such restricted payment and any indebtedness incurred to finance such restricted payment, its net indebtedness to adjusted EBITDA ratio would not exceed 3.75 to 1 and its net senior indebtedness to adjusted EBITDA ratio would not exceed 2.50 to 1. In addition, Holdings may make a restricted payment if, immediately after giving pro forma effect to such restricted payment and any indebtedness incurred to finance such restricted payment, its net indebtedness to adjusted EBITDA ratio would not exceed 4.25 to 1.0. Notwithstanding such restrictions, the indentures permit an aggregate of $45.0 million and $75.0 million of such payments to be made by Acquisition Corp. and Holdings, respectively, whether or not there is availability under the formula or the conditions to its use are met. Acquisition Corp. s senior secured credit agreement permits Acquisition Corp. to make additional restricted payments to Holdings, the proceeds of which may be utilized by Holdings to make additional restricted payments, in an aggregate amount not to exceed $10.0 million (such amount subject to increase to $35.0 million if the leverage ratio as of the last day of the immediately preceding four fiscal quarters was less than 4.0 to 1 and to $50.0 million if the leverage ratio as of the last day of the immediately preceding four fiscal quarters was less than 3.5 to 1), and subject to further increase in an amount equal to 50% of cumulative excess cash flow that is not otherwise applied pursuant to Acquisition Corp. s senior secured credit agreement, and, in addition, permits Acquisition Corp. to make restricted payments to Holdings, the proceeds of which may be utilized by Holdings to make additional restricted payments not to exceed $90 million in any fiscal year, provided that the proceeds of such restricted payments shall be applied solely to pay cash dividends on the Company s common stock. Furthermore, Holdings subsidiaries will be permitted under the terms of Acquisition Corp. s existing senior secured credit agreement, as it may be amended, and under other indebtedness, to incur additional indebtedness that may restrict or prohibit the making of distributions, the payment of dividends or the making of loans by such subsidiaries to Holdings.

Initial Common Stock Offering

In May 2005, we completed the Initial Common Stock Offering. Prior to the consummation of the Initial Common Stock Offering, we, among other things, renamed all of our outstanding shares of Class A Common Stock as common stock and authorized an approximately 1,139 for 1 split of our common stock. We 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 Acquisition Corp. 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.

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Dividends

We intend to pay regular quarterly dividends on our common stock outstanding in an amount not to exceed $80 million per year. Any decision to declare and pay dividends in the future will be made at the discretion of our board of directors and will depend on, among other things, our results of operations, cash requirements, financial condition, contractual restrictions and other factors our board of directors may deem relevant.

On October 3, 2005, December 29, 2005, March 14, 2006 and June 7, 2006, we declared dividends on our outstanding common stock at a rate of $0.13 per share. The dividends were paid on November 23, 2005, February 17, 2006, May 3, 2006 and July 27, 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 nine months ended June 30, 2006, 2,479,501 shares of restricted stock 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 June 30, 2006, we were in compliance with all covenants under the credit facility.

Our borrowing arrangements, including the Holding Notes and the Acquisition Corp. Subordinated Notes contain certain financial covenants, which limit the ability of our restricted subsidiaries as defined in the indentures 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 Acquisition Corp. and Holdings Corp. to incur additional debt or make certain restricted payments using certain exceptions provided for in the indentures governing the Acquisition Corp Subordinated Notes and the Holdings Notes, the Fixed Charge Coverage Ratio, as defined in the indentures agreements governing the notes, must exceed a 2.0 to 1.0 ratio. Fixed Charges are defined in the indentures governing the Holdings Notes and the Acquisition Corp. Subordinated Notes as consolidated interest expense excluding certain non-cash interest expense.

In order for Acquisition Corp. to make certain restricted payments, including payments to Holdings on a pro forma basis after giving effect to such payments, its Net Indebtedness to Adjusted EBITDA ratio and Net Senior Indebtedness to Adjusted EBITDA ratio, as defined in the indenture agreement governing the Acquisition Corp. Subordinated Notes, need to be lower than 3.75x and 2.5x, respectively, at the time of the restricted payment. In order for Holdings to make certain restricted payments, including payments to Warner Music Group Corp., its Net Indebtedness to Adjusted EBITDA ratio, as defined in the indenture agreement governing the Holdings Notes, needs to be lower than 4.25x at the time of the restricted payment.

Acquisition Corp. and Holdings may make additional restricted payments using certain other exceptions provided for in the indentures governing the Acquisition Corp. Subordinated Notes and Holdings Notes, respectively.

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 on our common stock 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.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As discussed in Note 22 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 June 30, 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 nine months ended June 30, 2006 or subsequent to June 30, 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 June 30, 2006, the carrying value of these Sterling notes was $183 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 June 30, 2006. We did not enter into any additional hedges related to this debt subsequent to June 30,2006.

We are exposed to interest rate risk with respect to our floating rate debt. During the nine months ended June 30, 2006, we extended the terms of certain existing interest rate swap agreements. As of June 30, 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. We did not enter into any additional interest rate swap agreements subsequent to June 30, 2006.

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.

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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

The Company 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 our registration statement relating to our Initial Common Stock Offering. Acquisition Corp., our wholly owned subsidiary, became subject to the periodic and other reporting requirements of the Exchange Act on February 10, 2005, the effective date of Acquisition Corp. s registration statement relating to its exchange offer to exchange outstanding unregistered notes for freely tradeable exchange notes that were registered under the Securities Act of 1933, as amended.

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. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by public companies in the reports that they file or submit under the Exchange Act is accumulated and communicated to a company s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

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

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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 domestic 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 June 30, 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

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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.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Radio Promotion Activities

On September 7, 2004, November 22, 2004 and March 31, 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. The Attorney General has also reached settlements with all of the other major music companies in connection with this investigation. 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. We filed a Notice of Related Case and were successful in having both of these cases consolidated. On May 23, 2006, we filed a Motion to Dismiss in both cases. Decisions on these motions are pending. 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 us 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 us 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, a total of twenty-seven putative class action lawsuits concerning the pricing of digital music downloads have been filed. We have yet to be served in some of the cases, but we expect they will all 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 and, according to some of the complaints, protect allegedly inflated prices for compact discs. The complaints generally seek unspecified compensatory, statutory and treble damages. We intend to defend against these lawsuits vigorously, but are 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 thereunder, 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

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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. 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 July 30, 2006, year-to-date U.S. recorded music sales (excluding sales of digital tracks) are down approximately 5.5% 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 distributors 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.

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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. An estimated 20 billion songs were illegally swapped or downloaded worldwide in 2005, according to IFPI. 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 $4.5 billion in revenues in 2005, according to IFPI. IFPI estimates that 1.2 billion pirated units were manufactured in 2005. According to IFPI estimates, approximately 37% of all music CDs sold worldwide in 2005 were pirated. 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

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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

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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

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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

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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 nine months ended June 30, 2006, approximately 52% 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 June 30, 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

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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. See also Management s Discussion and Analysis of Financial Condition and Results of Operations Overview Recent Developments.

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

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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. See also Management s Discussion and Analysis of Financial Condition and Results of Operations Overview Recent Developments .

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 June 30, 2006, our total consolidated indebtedness was $2.251 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.

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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

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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.

Risks Related to our Common Stock

We are a controlled company within the meaning of the New York Stock Exchange rules and, as a result, will qualify for, and intend to rely on, exemptions from certain corporate governance requirements.

The Investor Group controls a majority of our outstanding common stock. As a result, we are a controlled company within the meaning of the New York Stock Exchange corporate governance standards. Under the New York Stock Exchange rules, a company of which more than 50% of the voting power is held by an individual, a group, or another company is a controlled company and may elect not to comply with certain New York Stock Exchange corporate governance requirements, as applicable, including (1) the requirement that a majority of the board of directors consist of independent directors, (2) the requirement that we have a nominating/corporate governance committee that is composed entirely of independent directors with a written charter addressing the committee s purpose and responsibilities and (3) the requirement that we have a compensation committee that is composed entirely of independent directors with a written charter addressing the committee s purpose and responsibilities. We are and intend to continue to utilize these exemptions while we are a controlled company. As a result, we will not have a majority of independent directors nor will our nominating and corporate governance committee, which also serves as our executive committee, and compensation committee consist entirely of independent directors. Accordingly, you will not have the same protections afforded to stockholders of companies that are subject to all of the New York Stock Exchange corporate governance requirements.

Future sales of our shares could depress the market price of our common stock.

The market price of our common stock could decline as a result of sales of a large number of shares of common stock in the market or the perception that such sales could occur. These sales, or the possibility that these sales may occur, also might make it more difficult for us to sell equity securities in the future at a time and at a price that we deem appropriate. As of June 30, 2006 we had approximately 148.5 million shares of common stock outstanding. Approximately 107.5 million shares are held by the Investor Group and are eligible for resale from time to time, subject to contractual and Securities Act restrictions. The Investor Group has the ability to cause us to register the resale of their shares and certain other holders of our common stock, including members of our management, will be able to participate in such registration. In addition we have registered approximately 8.3 million shares of restricted common stock and approximately 8.4 million shares underlying options issued and that may be issued in the future pursuant to our benefit plans and arrangements on registration statements on Form S-8 and such shares may be sold as provided therein.

The market price of our common stock may be volatile, which could cause the value of your investment to decline.

Securities markets worldwide experience significant price and volume fluctuations. This market volatility, as well as general economic, market or potential conditions, could reduce the market price of our common stock in spite of our operating performance. In addition, our operating results could be below the expectations of securities analysts and investors, and in response, the market price of our common stock could

decrease significantly. As a result, the market price of our common stock could decline below price at which you purchase

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it. You may be unable to resell your shares of our common stock at or above such price. Among other factors that could affect our stock price are:

- actual or anticipated variations in operating results;
- changes in financial estimates by research analysts;
- actual or anticipated changes in economic, political or market conditions, such as recessions or international currency fluctuations;
- actual or anticipated changes in the regulatory environment affecting the music industry;
- changes in the retailing environment;
- changes in the market valuations of other music industry peers; and
- announcements by us or our competitors of significant acquisitions, strategic partnerships, divestitures, joint ventures or other strategic initiatives.

See Risk Factors Due to the nature of our business, our results of operations and cash flows may fluctuate significantly from period to period. In the past, following periods of volatility in the market price of a company s securities, stockholders have often instituted class action securities litigation against those companies. Such litigation, if instituted, could result in substantial costs and a diversion of management attention and resources, which could significantly harm our profitability and reputation.

Provisions in our Charter and amended and restated bylaws and Delaware law may discourage a takeover attempt.

Provisions contained in our Charter and amended and restated bylaws (Bylaws) and Delaware law could make it more difficult for a third party to acquire us, even if doing so might be beneficial to our stockholders. Provisions of our Charter and Bylaws impose various procedural and other requirements, which could make it more difficult for shareholders to effect certain corporate actions. For example, our Charter authorizes our board of directors to determine the rights, preferences, privileges and restrictions of unissued series of preferred stock, without any vote or action by our shareholders. Thus, our board of directors can authorize and issue shares of preferred stock with voting or conversion rights that could adversely affect the voting or other rights of holders of our common stock. These rights may have the effect of delaying or deterring a change of control of our company. These provisions could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

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

Item 5 is not applicable and has been omitted.

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ITEM 6. EXHIBITS

3.1	Amended and Restated Certificate of Incorporation of Warner Music Group Corp. (1)
3.2	Amended and Restated Bylaws of Warner Music Group Corp. (1)
10.1	Sixth Supplemental Indenture, dated as of June 30, 2006, to the Indenture dated April 8, 2004, as amended, among WMG Acquisition Corp., the additional subsidiary guarantors party thereto and Wells Fargo Bank, National Association, as Trustee. (2)
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**

* 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 Warner Music Group Corp. s Form 10-Q for the period ended March 31, 2005.

(2) Incorporated by reference to Warner Music Group Corp. s Current Report on Form 8-K filed on June 30, 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.

August 3, 2006

WARNER MUSIC GROUP 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)