2006

Report to Shareholders with Form 10-K

READER'S DIGEST ASSOCIATION

We are a global publisher and direct marketer of products and services that inform, entertain and inspire people of all ages and cultures around the world. We create customer relationships and communities with people of like minds and interests.

Financial Highlights

Dollars in millions, except per share data

	2006	2005
Revenues	**$2,386**	$2,390
Operating loss (1)	**$ (45)**	$ (34)
Net loss (2)	**$ (117)**	$ (91)
Basic and diluted loss per share	**$ (1.24)**	$ (0.95)

(1) *The table below reflects our operating results by reportable segment. See Note 14 in our Notes to Consolidated Financial Statements for information on our segments.*

	2006	*2005*
Operating profit (loss)		
RD North America	***$ 115***	*$ 91*
RD International	***78***	*76*
Consumer Business Services	***(3)***	29
Corporate Unallocated	***(40)***	*(38)*
	150	*158*
Deferred promotion amortization	**—**	*(77)*
Goodwill charge	***(188)***	*(129)*
Other operating items, net (*)	***(7)***	*14*
Total operating (loss)	***$ (45)***	*$(34)*

(*) *See Note 3 in our Notes to Consolidated Financial Statements for information on other operating items, net. In previous periods, gains on sales of certain non-strategic assets were classified as other expense, net, and have been reclassified to other operating items, net to conform to the current year presentation. In Fiscal 2006 and 2005 we recognized gains on sales of certain non-strategic assets of $3 and $14, respectively.*

(2) *Fiscal 2006 results include $(10) or $(0.07) per share in restructuring charges, $(188) or $(1.96) per share goodwill charge at Books Are Fun, and $(7) or $(0.04) per share Books Are Fun inventory charge.*

Fiscal 2005 results include $(129) or $(1.32) per share goodwill charge at Books Are Fun and $(77) or $(0.50) per share deferred promotion amortization charge.

As further described in Management's Discussion and Analysis, the letter to our shareholders and subsequent text essay sections include "forward-looking statements" that address future results or occurrences.

To Our Shareholders

Charles Darwin said, the most successful of the species usually is "the one most responsive to change." So it is with today's business environment, where the pace of change is relentless – and where creative responses separate companies that lead from ones that follow.

Reader's Digest Association is a $2.4 billion global publisher and direct marketer that is profoundly changing. Through our strategic plan, we have been redefining ourselves and our position in the marketplace. Our plan includes investing in new initiatives, monetizing unproductive assets and building our existing businesses where we see the best opportunities for growth.

In Fiscal 2006 we grew the active customer base of the entire company for the first time in many years. This might sound like a small point, but it looms large. Given the dynamics of a global direct-marketing business that thrives on new customer growth, this may be the most important predictor of future performance.

During Fiscal 2006, we took actions designed to reach new audiences and increase revenues and profits. We acquired Allrecipes.com, the world's leading website for home cooks and an ideal companion to our industry-leading food and cooking print properties. We launched Taste of Home Entertaining, a new home party plan business. We started book businesses in six international markets and rolled out *Reader's Digest* magazine in Romania, Croatia and Slovenia, our 48th, 49th and 50th editions. We scored big with the introduction of *Every Day with Rachael Ray*, a fast-growing magazine that is far outstripping its advertising and circulation goals. And we tested and launched new magazines in several countries around the world using our successful Reiman reader-participation formula.

We are committed to making the Internet a part of everything we do.

Operating results for the year were mixed, reflecting strength in much of our business, but weakness in part of one segment. Our two largest divisions, RD North America and RD International, representing 83 percent of our revenues, had strong years. The third segment, Consumer Business Services, had sharply lower results because of the continuing challenges at Books Are Fun and the cost of the investments we are making to turn it around.

Company revenues improved slightly, currency neutral, for the first time in five years, a significant step. We grew both revenues and profits at RD North America and RD International. Also, we increased profits at QSP for the year.

In the face of change and competitive challenges, we are responding decisively. We recognize that for RDA to realize its full potential and reward our shareholders, all parts of the company need to deliver at the same time. That is precisely our goal.

How will we get there? By executing on our strategy, which is to: (1) diversify and strengthen the core business, (2) deepen customer relationships around selected affinities, and (3) leverage our global scale. Underlying these three strategic imperatives is the commitment to make the Internet and other digital technologies a part of everything we do. On the pages that follow, we offer more on our strategy and the vibrant products behind it. These products, and the talented RDA employees who create and market them, are the drivers of our future success.

As we move from fixing and stabilizing our businesses to expanding them, we anticipate more robust revenue growth, increased profitability and a return to strong free cash flow, which we will use to enhance shareholder value through share repurchases, debt reduction and payment of dividends. As of June 30, 2006, we had repurchased $70 million of RDA shares since the inception of our $100 million share repurchase authorization, and we expect to complete the repurchase program in Fiscal 2007.

I would like to close by thanking Tom Ryder, RDA's Chairman whom I succeeded as CEO in January 2006. RDA is a much more responsive and diversified company thanks to Tom's efforts. He also has given generously of his time and insights during the transition, for which I am grateful. Please join me in wishing all the best to Tom.

Sincerely,

Eric W. Schrier
President and Chief Executive Officer

1.

diversifying the core

Our first strategic imperative is, "Diversify and strengthen the core business." This means keeping our key businesses healthy by **developing new products, marketing channels and promotion techniques.** Increasingly, we are strengthening our businesses by expanding the use of marketing channels beyond direct mail and by better leveraging the channels we own, such as QSP and Books Are Fun.

In Fiscal 2006, we continued to launch new books and other products in diverse markets and innovative formats. We repurposed our best-seller book, *Extraordinary Uses for Ordinary Things*, which sold 675,000 units via direct mail, for sale at retail as a colorful "bookazine." We extended our successful Interactive Storybooks, creating a multimedia book-and-telescope package featuring Johnny Depp's image from the *Pirates of the Caribbean* sequel. We successfully marketed new products, like a CD collection, *The Magic of Melody*, and a video set, *Great Canadian Wilderness*, across many countries.

One of our best-selling books ever, *Foods That Harm, Foods That Heal*, crossed the remarkable 6 million mark in cumulative unit sales. With an eye on our next winner, we prepared to launch *The Taste of Home Cookbook*, designed to become a kitchen mainstay for a new generation of cooks.

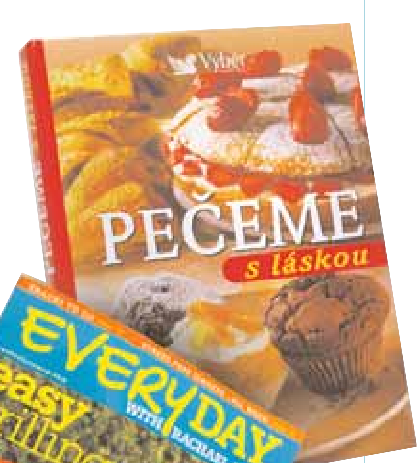
2. deepening custom

The second imperative is, "Deepen customer relationships around selected affinities." We achieve this by building and **intensifying our relationships with customers** around affinities where we are strong in content and consumer trust: food, home and garden, health and language learning.

In Fiscal 2006, for example, the company acquired Allrecipes.com, the world's largest online community for home cooks. We launched *Every Day with Rachael Ray*, a new magazine featuring the popular author and TV food personality, which quickly became a circulation and advertising hit. And we rolled out Taste of Home Entertaining, a new business that sells home entertaining products through networks of friends.

er relationships

Our business is more than publishing or direct marketing – it's about building lasting customer relationships in everything we do. We now own the largest collection of cooking assets of any publisher in the world. RDA food properties include *Taste of Home*, the world's highest-circulation food magazine. In Fiscal 2006, in the food and cooking category we had 7 million in magazine subscription sales — and sold 10 million magazines at retail, 3 million cookbooks and 1 million bookazines. Our cooking franchise is our most developed affinity, but we will also follow a similar path for health, home and garden, and language learning, in each instance complemented by community-building websites.



Strategic

imperative No. 3 is,

"Leverage our global scale."

We are growing our international customer

base by expanding businesses into new markets and

creating products that sell into more than 70 countries. In Fiscal 2006, for example, our businesses in 26 countries published one or more of *Extraordinary Uses for Ordinary Things*, *Curing Everyday Ailments the Natural Way* and *Discovering the Wonders of Our World*, producing about $40 million in revenues.

We launched new book businesses in Bosnia, Serbia, Lithuania, Bulgaria, Kazakhstan and the United Arab Emirates; *Daheim in Deutschland* magazine in Germany; and new editions of *Reader's Digest* in Romania, Croatia and Slovenia – where together we also sold 50,000 *Viva La Fiesta* CD sets. We continued to grow our global language-learning business with *English in 20 Minutes a Day*, which will be marketed in 22 countries in Fiscal 2007. And we built on partnerships with several publishing companies to sell their products to our audiences or to help us reach new customers.

3.

leveraging

our

obal

scale

Our goal is to become a bigger, stronger, more diversified publishing company. We are strengthening our ability to reach new and existing customers, where and how they want to be reached, with products and services delivered in their channel of choice.

new ideas + new prod

ucts = new customers

Management Team

Bonnie K. Bachar *
President, U.S. Publishing

Thomas D. Barry
Vice President and Controller

Michael A. Brennan
Senior Vice President and President, Latin America and Asia-Pacific

Michael A. Brizel *
Senior Vice President and General Counsel

Richard E. Clark *
Senior Vice President, Investor Relations and Global Communications

Lisa A. Cribari
Vice President, Global Human Resources

Clifford H.R. DuPree
Vice President, Corporate Secretary and Associate General Counsel

Thomas D. Gardner *
Executive Vice President and President, International

Michael S. Geltzeiler *
Senior Vice President and Chief Financial Officer

Jodi G. Kahn
President, Digital Business

Patricia Killen
President, Western Europe

David A. Krishock
President, Books Are Fun

Emma Lawson
Vice President, Global Marketing and Publishing

Albert L. Perruzza
Senior Vice President, Global Operations and Business Redesign

Gary S. Rich *
Senior Vice President and President, QSP, Inc.

Thomas O. Ryder *
Chairman

Eric W. Schrier *
President and Chief Executive Officer

Jeffrey S. Spar
Senior Vice President and Chief Information Officer

Jeremy Thompson
President, Central and Eastern Europe

Dawn M. Zier *
President, North American Consumer Marketing

* Executive Officers

Board of Directors

Jonathan B. Bulkeley [1, 3]
Chief Executive Officer
ScanBuy
Director since 2001

Herman Cain [3, 4]
President and Chief Executive Officer
THE New Voice, Inc.
Director since 2001

Lee Caudill [3, 4]
President
SeniorTrak Consulting
Director since 2005

Walter Isaacson [2, 3]
President and Chief Executive Officer
Aspen Institute
Director since 2003

William E. Mayer [2, 3, 4]
Partner
Park Avenue Equity Partners, L.P.
Director since 2003

John T. Reid [1, 3]
Retired Division Chief Technological Officer
Colgate-Palmolive Company
Director since 2005

Lawrence R. Ricciardi [1, 2, 3]
Senior Advisor to Jones Day and Lazard Frères & Co.
Senior Advisor and Retired Senior Vice President and General Counsel
International Business Machines Corporation
Director since 1998

Thomas O. Ryder
Chairman
The Reader's Digest Association, Inc.
Director since 1998

Eric W. Schrier
President and Chief Executive Officer
The Reader's Digest Association, Inc.
Director since 2006

William J. White [1, 2, 3]
Professor
Robert R. McCormick School of Engineering and Applied Science
Northwestern University
Retired Chairman and Chief Executive Officer
Bell & Howell Company
Director since 1996

Ed Zschau [3, 4]
Visiting Lecturer with Rank of Professor
Princeton University
Director since 1999

[1] Audit Committee
[2] Compensation and Nominating Committee
[3] Corporate Governance Committee
[4] Finance Committee

Form 10-K

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

FORM 10-K

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

For the fiscal year ended June 30, 2006

Commission File Number: 1-10434

THE READER'S DIGEST ASSOCIATION, INC.

(Exact name of registrant as specified in its charter)

Delaware	**13-1726769**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
Pleasantville, New York	**10570-7000**
(Address of principal executive offices)	*(Zip Code)*

Registrant's telephone number, including area code: (914) 238-1000

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock par value $.01 per share	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act. Yes ☒ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ☒ No ☐

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

The aggregate market value of registrant's voting and non-voting equity held by non-affiliates of registrant, as of December 30, 2005, the last business day of the registrant's most recently completed second fiscal quarter, was approximately $1,451,000,000 based on the closing price of registrant's Common Stock on the New York Stock Exchange--Composite Transactions on such date.

At July 31, 2006, 94,914,698 shares of the registrant's Common Stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Annual Report to Stockholders of The Reader's Digest Association, Inc. for the fiscal year ended June 30, 2006. Certain information therein is incorporated by reference into Part I and Part II hereof.

Proxy Statement for the Annual Meeting of Stockholders of The Reader's Digest Association, Inc. to be held on November 17, 2006. Certain information therein is incorporated by reference into Part III hereof.

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Unless the context otherwise requires, references in this Annual Report on Form 10-K to "Reader's Digest," "we," "us" and "our" are to The Reader's Digest Association, Inc. and its subsidiaries.

PART I

ITEM 1. BUSINESS

GENERAL

The Reader's Digest Association, Inc. is a global leader in publishing and direct marketing. We create and deliver products and content that inform, enrich, entertain and inspire, including magazines, books, recorded music collections, home videos and online websites.

Although our company is best known for *Reader's Digest* magazine, which is published in 50 editions and 21 languages with a monthly worldwide circulation of approximately 18 million and a global readership of approximately 80 million, our flagship magazine is just one of twenty eight magazines we publish. Of the other titles we publish, seven other titles have circulations in excess of 1 million. These magazines contribute to our expansive content of food, home and garden, language, learning, travel and health.

Books are our largest-selling products. Our book topics are diverse, ranging from gardening to computers to natural wonders. Our Consumer Business Services segment is a leader in the display marketing and school and youth fundraising industries.

We are a Delaware corporation, originally incorporated in New York in 1926, then reincorporated in Delaware in 1951. We became a public company in 1990.

REPORTABLE SEGMENTS

Our internal management organization reflects three reportable segments: Reader's Digest North America, Reader's Digest International and Consumer Business Services. For financial and further information about each of our reportable segments, refer to Note 14 of our Notes to Consolidated Financial Statements set forth in Part II, "Item 8. Financial Statements and Supplemental Data" of this report, which is incorporated by reference herein.

Reader's Digest North America

This segment comprises our operations in the United States and Canada that primarily publish and market magazines and books and home entertainment products. In particular, Reader's Digest North America publishes and primarily direct markets:

- *Reader's Digest* magazine
- Reiman Media Group, Inc. (Reiman) magazines and books
- special interest magazines
- books and home entertainment products related to the reading, home and health, and entertainment affinities, including:
  - Reader's Digest Select Editions books
  - Reader's Digest Young Families products
  - series and general books
  - music and video products

In addition to our direct marketing products, our Trade Publishing unit, including Children's Publishing, sells books and home entertainment products primarily through retail marketing.

Complementing the Reader's Digest North America businesses, on April 20, 2006 we acquired *Allrecipes.com*, a U.S. website for home cooks, and on May 1, 2006 we launched Taste of Home Entertaining, a home party plan business.

In fiscal 2006, Reader's Digest North America contributed $939 million and $115 million to our revenues and operating (loss) profit, respectively.

Reader's Digest International

This segment comprises our operations outside of the United States and Canada that primarily publish and market magazines and books and home entertainment products. In particular, Reader's Digest International publishes and primarily direct markets:

- *Reader's Digest* magazine in numerous editions and languages
- books and home entertainment products (described above)
- special interest magazines

Part of the mission of Reader's Digest International is to establish and develop new business initiatives, including entering new geographic markets, developing new products, acquiring customers through new channels and expanding U.S. business models into markets outside North America, including display marketing. During 2006, we launched new book businesses in Bulgaria, Kazakhstan, United Arab Emirates, Serbia, Bosnia and Lithuania, and we launched new editions of *Reader's Digest* in Romania, Slovenia and Croatia.

In fiscal 2006, Reader's Digest International contributed $1,031 million and $78 million to our revenues and operating (loss) profit, respectively.

Consumer Business Services

This segment comprises Books Are Fun, Ltd. (Books Are Fun), QSP, Inc. (QSP), and Quality Service Programs, Inc. (QSP Canada).

Books Are Fun operates in the United States and Canada and works with independent sales representatives who sell books and gift items by display marketing products on-site at schools and businesses.

QSP and QSP Canada help schools and other youth groups launch, promote and organize fundraising campaigns that sell our magazines, other publishers' magazines and food and gift products, such as World's Finest Chocolate products.

In fiscal 2006, Consumer Business Services contributed $446 million and $(3) million to our revenues and operating (loss) profit, respectively.

PRODUCT LINES

Books and Home Entertainment Products

Our books and home entertainment products consist of Reader's Digest Select Editions, Reader's Digest Young Families, series books, general books, Reiman books, recorded music collections and series, and home video products and series. We market these products principally by direct mail through our Reader's Digest North America and Reader's Digest International reportable segments. Consumer Business Services also sells Reader's Digest books and home entertainment products by display marketing those products on-site at schools and businesses through Books Are Fun and through the youth fundraising campaigns of QSP. For more information about how we market our books and home entertainment products, please refer to the section of this report captioned "MARKETING."

Reader's Digest Select Editions

Reader's Digest Select Editions, which were formerly called "Condensed Books" in many markets, are continuing series of condensed versions of current popular fiction. A condensed work reduces the length of an existing text while retaining the author's style, integrity and purpose. We publish Select Editions in 14 languages and sell them in the United States, Canada and 26 other countries. We generally publish six volumes of Select Editions each year. Some of our international subsidiaries publish four or five volumes a year.

International editions of Select Editions generally include some material from the U.S. edition or from other international editions, translated and edited as appropriate. International editions also include some condensed versions of locally published works. Each local editorial staff determines the appropriateness of existing Select Editions works for its own local market.

Reader's Digest Young Families

Reader's Digest Young Families sells products for children up to age eight, primarily through direct mail and telemarketing. The division's products include interactive books, such as Sesame Street ABCs, and videos, such as The Country Mouse and the City Mouse. Young Families sells its products principally in the United States.

Series Books

We market two types of series books—reading series and illustrated series. These book series may be either open-ended and continuing or closed-ended, consisting of a limited number of volumes. We publish reading series books in four languages and sell them in the United States, Canada and 10 other countries. One of our series is *The World's Best Reading*, which consists of full-length editions of classic literature. We publish six volumes of *The World's Best Reading* each year in the United States, Canada and two other countries and in two languages. We also publish illustrated series, which are generally closed-ended, in six languages and sell them in 11 countries.

General Books

Our general books consist primarily of reference books, cookbooks, health books, "how-to" and "do-it-yourself" books, and children's books, some of which we publish in series. We also publish books on subjects such as history, travel, religion, nature, home, computers and puzzles. We publish general books in 23 languages and sell them in the United States, Canada and 42 other countries.

New general books are usually original Reader's Digest books, but may also be books acquired from other publishers. During the development period for an original Reader's Digest book, we conduct extensive research and prepare an appropriate marketing strategy for the book.

Reiman Books

Reiman books are books published by Reiman Media Group and whose editorial content derives principally from material contributed to Reiman magazines by its readers. Reiman books are created to complement the Reiman magazines and leverage the magazines' brand equity, reader loyalty and editorial capability. Reiman principally markets annual editions of books that are mostly created from prior year magazine content; it also markets single sales products. Reiman has 12 annual book programs and two calendar programs (including one book program that was launched in fiscal 2006) that are marketed on a continuity basis, with customers agreeing to receive future editions of the books unless they respond to an annual prepublication notice.

Music

We release our music collections on compact discs and cassettes in the United States and 38 other countries. These releases span a broad range of musical styles, ranging from classical to pop and from local folk to "relaxation" music. We offer both international and local repertoires that reflect our customers' tastes and expectations. In most markets, we also sell series products in various musical genres.

We license existing recordings from major record companies and sponsor our own recordings with the world's most renowned orchestras and with international and local artists. We also continue to acquire rights to master recordings. Our music vault consists of approximately 10,000 selections, which we use in our music collections around the world. We have digitized a major part of these selections and are now offering an increasing number of tracks through various online providers. We also license our selections to third parties for retail sales or for movie synchronization.

We are a member of the Recording Industry Association of America in the United States, and we have been recognized with 51 gold, platinum and multi-platinum certificates. We are also a member of the International Federation of the Phonographic Industry in several other countries.

Video

We market our range of video products in 27 countries. Our home video products reflect the interests of our global customers—travel, natural history, history, and children's animated programs. Our high editorial and production standards make our programs stand out in a competitive marketplace.

Our original special interest documentaries are produced with award-winning production companies in Europe, Australia and the United States. To ensure we are able to create programs cost effectively, we are developing partnerships with international broadcasters and prestigious moving image archives.

When we film for our original programs we archive the valuable footage for potential use in future productions. We are responding to technological innovation by filming in high definition. We are keeping pace with DVD penetration in all markets worldwide.

Production and Fulfillment

We hire independent contractors to print and bind the various editions of Select Editions. We have an agreement through 2007 with a printing company for printing the English-language Select Editions distributed in the United States and Canada. For all other North American direct mail books, we have an agreement through 2009 with a printing company. We have a U.S. based manufacturing contract for entertainment products that will expire at the end of calendar year 2006, and we are currently negotiating a global contract for this business. Our European operations use several manufacturing companies for the production of books. The majority of our home entertainment products are produced throughout Europe by three major manufacturers. On a global basis, we have contracts through 2008 with three printers for conventional books printed in China.

Paper is the principal raw material necessary for production of our Select Editions, series books and general books. Our exclusive agreement with a major supplier to globally supply paper for Select Editions expires in December 2006. We purchase paper for series books and general books for each printing. We believe that our existing contractual arrangements and other available sources of paper provide us with an adequate supply of paper at competitive prices. We use independent contractors who arrange for us to acquire some of the necessary raw materials to manufacture music and video products.

We hire independent contractors to handle our fulfillment, warehousing, customer service and payment processing. We have an agreement with a single independent contractor to handle order and payment processing for most of our U.S. books and home entertainment business. That agreement expires in December 2012. In addition, in July 2006, we entered a four-year contract with a single fulfillment company to handle warehousing and fulfillment for our United States direct mail business units. The printers or suppliers of our products generally package and deliver those products directly to the postal service. For information about postal rates and postal services, please refer to the section of this report captioned "MARKETING."

We believe that, generally, there is an adequate supply of alternative production and fulfillment services available to us at competitive prices should the need arise. Nevertheless, significant short-term disruption could occur. We have contingency plans to minimize recovery time should our current contractors be unable to meet our production and fulfillment requirements.

Magazines

Reader's Digest *Magazine*

Reader's Digest magazine is a monthly, general interest magazine that features original articles, previously published articles in condensed form, and a condensed version of a previously published or soon-to-be published full-length book. The United States English-language edition of *Reader's Digest* also contains monthly humor columns, such as "Laughter, The Best Medicine®," "Life in These United States®" and "All In A Day's Work®," and other regular features, including "Quotable Quotes®," "Word Power®," "Only in America," "Everyday Heroes," "That's Outrageous!®" and "RD Living." We publish *Reader's Digest* in several editions in the United States, including an English-language edition, a Spanish-language edition entitled *Selecciones* and *Reader's Digest Large Print for Easier Reading.* We license independent contractors to publish a braille edition and a recorded edition in the United States.

Reader's Digest is a reader-driven, family magazine. Its editorial content is, therefore, crucial to the loyal subscriber base that constitutes the cornerstone of our operations. The editorial mission of *Reader's Digest* is to inform, enrich, entertain and inspire. The articles, book section and features included in *Reader's Digest* cover a broad range of contemporary issues and reflect an awareness of traditional values.

A substantial portion of the selections in *Reader's Digest* are original articles written by freelance writers or staff writers. The balance is selected from existing published sources and is condensed or excerpted by *Reader's Digest* editors. We employ a professional staff to research and fact-check all published pieces.

The content of and editorial procedures for the international editions of *Reader's Digest* are similar to those of the U.S. editions. Each international edition has a local editorial staff responsible for the editorial content of the edition. The mix of locally generated editorial material, material taken from the U.S. edition and material taken from other international editions varies greatly among editions. In general, our larger international editions, for example, those in France, Germany, Mexico and the United Kingdom, carry more original or locally adapted material than do smaller editions.

The *rd.com* website extends the experience of reading *Reader's Digest* through audio, graphic, text and video enhancements, interactive discussions and reader involvement, and additional content relating to *Reader's Digest*. We also utilize *rd.com* to market our products through e-mail and the Internet, as well as to communicate with and provide service to our customers online. For more information about *rd.com*, please refer to the section of this report captioned "MARKETING."

Globally, *Reader's Digest* is published in 50 editions and 21 languages. We license independent contractors to publish *Reader's Digest* in India, Italy, Korea, Denmark, Norway, South Africa, Slovenia, Croatia and Indonesia. These magazines are sold primarily through direct marketing.

Reiman Magazines

Reiman publishes 12 bi-monthly magazines and one quarterly magazine in the United States and Canada, including *Cooking for 2*, which we launched in the third quarter of fiscal 2005, and *Birds & Blooms Extra*, which we launched in the fourth quarter of fiscal 2005.

Reiman editorial philosophy includes the following core principles: (1) concentration on positive aspects of people and their lifestyles; (2) encouragement of reader involvement; (3) maintenance of low editorial costs; and (4) emphasis on product quality. As a result, about 80% of the editorial content of Reiman magazines is contributed by readers and there is nominal advertising.

Special Interest Magazines

We publish several special interest magazines that we believe are consistent with our image, editorial philosophy and market expertise.

In fiscal 2006, we launched or tested a variety of new special interest magazines. These magazines include *Every Day with Rachael Ray*, our new food and lifestyle magazine in the United States; *Daheim in Deutschland* in Germany and *Meidän Suomi* in Finland, both general interest magazines with a strong local flavor; *JOY*, a women's magazine in Mexico; and *Young Family* magazine in Russia. Also in Mexico, we began publishing two special interest magazines – *Crecer Feliz* and *Car and Driver Mexico* – under a license from another publisher.

These launches are in addition to our existing special interest magazines. In the United States, we publish *The Family Handyman* and *American Woodworker*. *The Family Handyman* provides instructions and guidance for "do-it-yourself" home improvement projects. *American Woodworker* provides information, instruction and guidance for professional and serious amateur woodworkers. Internationally, we publish *Receptar*, a leading Czech do-it-yourself and gardening monthly magazine, *Handyman* in Australia and *Our Canada*, a bi-monthly general interest magazine with principally reader-contributed content.

We promote most of our special interest magazines to our *Reader's Digest* customer list. We also promote other products to each magazine's customer list, as appropriate. This strategy helps us to expand the customer base for all of our products.

We also publish other limited-edition special interest publications in the United States and internationally. These include a special homeowners' edition of *The Family Handyman* that is used by real estate brokers in the United States. In addition, we publish a series of monthly check-out counter magazines branded as *RD Specials* and *Taste of Home Specials* that consist primarily of repurposed content from our books and magazines relating to the topics of home, health and food.

Reader's Digest Trade Publishing

Trade Publishing sells books and products for both children and adults and comprises two divisions: Reader's Digest Children's Publishing and Adult Trade Publishing. Reader's Digest Children's Publishing produces books, games and other products for children up to age 12 under the Reader's Digest Children's Publishing imprint. Its products are sold through retail channels as well as through our other businesses (including display marketing and catalogs) and other channels, including the Internet. The products represent such popular brands as Barbie, Disney (classic Disney and Pixar characters), Nickelodeon, Sesame Street, Fisher-Price, Marvel and NASCAR. The book products have been translated into 39 localized editions and are marketed in the United States, Canada and 40 other countries.

Our Adult Trade Publishing group originates books in many illustrated reference categories, including gardening, crafts, travel, do-it-yourself, history, and family reference. These books are sold through retail channels, catalogs, book clubs, Books Are Fun, QSP, television, and through our domestic and international divisions.

Circulation and Advertising

The following table shows fiscal 2006 circulation and advertising information for our portfolio of magazines:

Magazines	Circulation	Advertising Pages Carried
Reader's Digest magazine[1]	18,324,000	10,520
Reiman magazines[2]	14,168,000	8
Special interest magazines	3,725,000	2,535

(1) In Canada and international markets, *Reader's Digest* magazine is published in multiple editions and languages. Circulation for these editions constitutes a rate base.

(2) Reiman magazines do not have a guaranteed circulation rate base and are not audited by the Audit Bureau of Circulations, a not-for-profit organization that audits circulation in the United States and Canada. The amount indicated in the table above represents their average circulation for the year for all of their publications.

Circulation generated approximately 70% of total U.S. fiscal 2006 revenues for *Reader's Digest* and advertising generated approximately 30% of total revenues. Circulation levels for all Reiman titles fluctuate throughout the year. The overall circulation level for Reiman titles is managed in total to maximize the profitability of the entire portfolio, which may cause year-over-year increases or decreases in the average circulation for individual titles. Substantially all of the Reiman magazines do not accept on-page advertising and rely on subscriptions for approximately 90% of their revenue, with newsstand sales supplying the balance. "Bonus Books" of coupons are poly-bagged with the food magazines.

We have determined that the U.S. edition of *Reader's Digest* has the largest paid circulation of any U.S. magazine, other than those automatically distributed to all members of the American Association of Retired Persons. Our determination is based on the most recent audit report issued by the Audit Bureau of Circulations. Subscriptions account for approximately 95% of the U.S. paid circulation of *Reader's Digest*, while single copy sales—via newsstands, supermarkets and similar retail establishments—account for the remainder. We also sell our special interest magazines by subscription and at newsstands.

We maintain the circulation rate base for *Reader's Digest* through annual subscription renewals and new subscriptions. We sell subscriptions in the United States through a variety of direct response marketing techniques and by direct mail in international markets. We typically sell the largest percentage of subscriptions between July and December of each fiscal year. Subscribers to *Reader's Digest* may cancel their subscriptions at any time and we will refund any unused balance of the subscription price. For additional information regarding direct marketing of subscriptions, please refer to the section of this report captioned "MARKETING."

We believe that many international editions of *Reader's Digest* have the largest paid circulation for monthly magazines both in the individual countries and in the regions in which they are published. For most international editions of *Reader's Digest*, subscriptions comprise more than 90% of circulation. The balance is attributable to newsstand and other retail sales. Approximately 80% of total international fiscal 2006 revenues for *Reader's Digest* were generated by circulation revenues and 20% by advertising revenues.

The U.S. editions and the larger international editions of *Reader's Digest* offer advertisers different regional editions, major market editions and demographic editions. These editions, which usually contain the same editorial material, permit advertisers to concentrate their advertising in specific markets or to target specific audiences. *Reader's Digest* sells advertising principally through an internal advertising sales force. We sell advertisements in multiple *Reader's Digest* editions worldwide and offer discounts for placing advertisements in more than one edition.

Production and Fulfillment

We hire independent contractors to print all editions of *Reader's Digest* and our special interest magazines. We have an exclusive contract with a U.S. printer to print the U.S. editions of *Reader's Digest*. The contract is scheduled to expire in October 2011. We have two printers to print our Reiman magazines under contracts expiring in 2008.

Lightweight coated and uncoated papers are the principal raw materials used in the production of *Reader's Digest*, Reiman and special interest magazines. Our global paper supply contract for *Reader's Digest* and Reiman magazines expires in June 2008. We believe that our supply contracts will continue to provide an adequate supply of paper for our needs and that, in any event, alternative sources are available at competitive prices. A variety of factors affect paper prices, including demand, capacity, pulp supply and general economic conditions.

We have an agreement with a single independent contractor to handle order and payment processing for *Reader's Digest*, the U.S. special interest magazines and the Reiman magazines. This agreement expires in December 2012. The same contractor also handles these matters for most of our U.S. books and home entertainment operations.

We deliver subscription copies of the U.S. edition of *Reader's Digest*, the special interest magazines and the Reiman magazines through the United States Postal Service as "periodicals" class mail. Subscription copies of international editions of *Reader's Digest* are delivered through the postal service in each country of publication. For additional information about postal rates and service, please refer to the section of this report captioned "MARKETING."

In the United States, a distribution network handles newsstand and other retail distribution. We have also contracted in each country with a newsstand magazine distributor for the distribution of *Reader's Digest*.

In Europe, we have several multi-country agreements with independent contractors as well as in-country independent contractors to handle fulfillment, warehousing, customer service, and payment and order processing. We have two primary printing companies for printing *Reader's Digest* magazine in Europe.

We believe that, generally, there is an adequate supply of alternative production and fulfillment services available to us at competitive prices should the need arise. Nevertheless, significant short-term disruption could occur. We have contingency plans to minimize recovery time should our current contractors be unable to meet our production and fulfillment requirements.

Allrecipes.com

On April 20, 2006, we acquired *Allrecipes.com* for approximately $66 million. *Allrecipes.com* is an online community food and cooking website that leverages an active and growing network of home cooks and generates revenue from advertising sponsorships and retail licensing. *Allrecipes.com* was launched in 1997 as a place for home cooks to "meet" and share their favorite recipes. Since its launch, *Allrecipes.com* has become the world's largest online community of home cooks, with more than 1.8 million registered members. Each month, the website attracts an average of 6 million unique visitors who collectively view more than 70 million pages; during peak holiday months, traffic spikes to more than 9 million visitors and 111 million page views. *Allrecipes.com* also includes 30,000 recipes, which are created, tested and reviewed by participating home cooks.

Taste of Home Entertaining

On May 1, 2006, we launched a new direct selling business as an extension of our *Taste of Home* magazine brand in the United States. Revenues are generated from independent sales consultants selling food and décor products to their party guests. As of June 30, 2006, more than 4,000 consultants have joined and the number of shipped parties exceeds 7,000.

CONSUMER BUSINESS SERVICES

This reportable segment consists of Books Are Fun and QSP, which do not create their own products, but rather have specific ways to market the products of our other business units, as well as products that they acquire from other businesses.

Books Are Fun

Our Books Are Fun subsidiary sells premium quality books and gift items, including Reader's Digest books and home entertainment products, at discount prices. It display markets those products on-site at schools and businesses in all 50 states of the United States and across Canada through book fairs and other displays. Book categories sold by Books Are Fun include best-selling novels, cookbooks, children's books and education, sports, hobby, nature, travel and self-help titles. Non-book categories include bath and beauty products, music, videos and gift items. Books Are Fun's products are sold by more than 800 independent sales representatives, who service approximately 70,000 schools, 15,000 large corporations and institutions, 14,000 daycare centers and 50,000 small businesses. Since many individuals purchase these products for gift giving, Books Are Fun's sales cycle is largely seasonal and typically experiences substantial volume in the second quarter of our fiscal year.

Books Are Fun purchases book titles, gifts and other products from more than 500 publishers and vendors worldwide. Most products are test marketed by the purchase of a modest number of units in advance of purchasing larger quantities. Books Are Fun uses an extensive network of independent public warehousing facilities and carriers to store and transport products.

QSP

QSP, Inc. operates in the United States and markets and sells subscriptions to *Reader's Digest*, the Reiman magazines, the special interest magazines and other publishers' magazines, as well as food, gift, music and book products. QSP works directly with schools and youth groups on fundraising campaigns in which participants sell those products. QSP derives its revenues through services rendered in connection with fundraising events. A substantial majority of QSP's sales occurs during the first half of our fiscal year, which coincides with the fall school semester. QSP currently has approximately 420 sales representatives.

QSP is party to a licensing agreement with World's Finest Chocolate, Inc. that requires QSP to purchase annual minimum amounts of World's Finest Chocolate products and gives QSP the exclusive right to sell those products for fundraising purposes and through other channels, under specified circumstances, through 2020.

Quality Service Programs, Inc., our Canadian subsidiary, conducts operations in Canada substantially similar to those conducted by QSP in the United States.

In the United States, operations at QSP are supplemented by *eFundraising.com*, which uses the Internet to enhance fundraising activities. *eFundraising.com* uses proprietary software that enables e-mail messages to be sent on behalf of students about their school or youth group's fundraising activities to family and friends. The e-mail directs the recipients to the school or youth group's website, where they may purchase magazine subscriptions and a variety of gift and food products. *eFundraising.com* also provides fundraising products, mainly scratch cards and chocolate, to organizations conducting fundraisers.

Several hundred other publishers make magazine subscriptions available to QSP at competitive discounted prices. QSP also obtains music products from a large music publisher. A substantial portion of QSP's chocolate food products are obtained from World's Finest Chocolate. QSP engages independent contractors to process and fulfill gift, food, magazine, music and book orders.

MARKETING

We sell magazine subscriptions, Select Editions, series books, general books, music and video products, and certain other products principally through direct mail solicitations to households on our customer lists, as well as to customer lists rented or purchased from third parties. Our books and home entertainment products and product offers and many international magazine subscription offers are often accompanied by sweepstakes entries and, in some cases, premium merchandise offers. It is our direct marketing policy that a customer may return any book or home entertainment product to us, either before or after payment, and receive a refund of the amount paid. We believe that our returned goods policy is essential to our reputation and that it elicits a greater number of orders. Most of our customers are satisfied with our books and keep them. Sales of our books and home entertainment products are seasonal. In the direct marketing industry as a whole, more consumers respond in the fall and winter months (especially before Christmas) than during the rest of the year.

While we sell most copies of general books through initial promotional single offer mailings, we also sell substantial additional copies through other channels including catalog, package inserts and the Internet. We also distribute our general books for retail sale in stores via independent distributors and via Books Are Fun and QSP.

Reiman markets most of its books through direct mail and cross-promotion on its magazines. Reiman sells its books by offering a free preview period during which the customer agrees to examine the book before purchasing it. If they do not wish to purchase the book, they can return it without further obligation. In addition, Reiman markets magazines principally via direct mail, package inserts, the Internet and cross-promotion of titles within its magazine group. It markets products to its customer database of approximately 47 million current and former customers, combined with selective rental of outside customer lists. Reiman test markets new magazine ideas and titles, which rely on reader-submitted editorial content, with current subscribers of their own magazines and with selected readers from outside lists.

As part of our growth strategy and to better manage distribution and customer acquisition costs, we are increasing sales of our products through direct channels other than direct mail. These other distribution channels include our Consumer Business Services segment, direct-response television, package inserts, free-standing inserts, telemarketing, the Internet, display marketing and other direct sales. *Reader's Digest* magazine and our other magazine publications, including Reiman, obtain and renew the vast majority of its subscribers in the United States through non-sweepstakes promotions.

We are adapting the editorial content and marketing methods of our magazines and books and home entertainment products to new technologies. Our *rd.com* website links to our many international and domestic websites and to our multiple online stores for shopping and information about our products. We also market subscriptions on *rd.com.* In fiscal 2006, *rd.com* (including *changeone.com* and other sub-sites) had over 17 million visitors from around the world. We are also utilizing electronic direct marketing to offer magazine subscriptions and books through one-click e-mail.

To promote the sale of our books and home entertainment products in the United States, we usually offer a sweepstakes in our promotional mailings. Prizes totaled about $2.6 million for the 2006 edition of the sweepstakes. Generally, each of our international subsidiaries sponsors its own sweepstakes. The mechanics of the sweepstakes vary from jurisdiction to jurisdiction, depending upon local law.

From time to time we are involved in legal, regulatory and investigative proceedings concerning our sweepstakes and other direct marketing practices. Also, from time to time jurisdictions in which we do business consider more restrictive laws or regulations governing sweepstakes or direct marketing. Although some of these proceedings may have negatively affected our direct marketing business, we do not believe that any current proceedings or currently proposed laws and regulations will have a material adverse effect on our direct marketing business.

In 2001, we entered into a voluntary comprehensive agreement with attorneys general for 32 states (and subsequently with four additional states) and the District of Columbia regarding standards for direct mail sweepstakes promotions. Pursuant to the agreement, we are promoting consumer education and have adopted standards for promotions in the United States similar to those agreed to by other direct marketing and publishing companies.

We are subject to postal rate increases, which affect our product deliveries, promotional mailings and billings. Postage is one of the largest expenses in our promotional and billing activities. Increases in the postal rate are factored into our pricing strategies and operating plans. Higher postal rates or other delivery charges usually increase the total cost to the customer, which may have a negative effect on sales. As a result, we may strategically determine the extent, if any, to which we will pass these cost increases on to our customers.

We rely on postal delivery service for timely delivery of most of our products and promotional mailings. In the United States and most international markets, delivery service is generally satisfactory. Some international jurisdictions, however, experience periodic work stoppages in postal delivery service or less than adequate postal efficiency.

In some states in the United States and in some international jurisdictions, some or all of our products are subject to sales tax or value added tax. Taxes, like delivery costs, are generally stated separately on bills, where permitted by applicable law. Higher taxes increase the total cost to the customer, which may have a negative effect on sales. In jurisdictions where applicable tax must be included in the purchase price, we may be unable to fully recover from customers the amount of any tax increase or new tax.

INFORMATION TECHNOLOGY AND CUSTOMER DATABASE ENHANCEMENT

The size and quality of our databases of current and prospective customers in the countries where we operate contribute significantly to our business. We are constantly striving to improve our customer databases. We believe that our U.S. databases of more than 70 million households—over half the total number of households in the country—are one of the largest direct response databases in the United States. Our international databases include a total of almost 55 million households.

We continue to make significant investments in our database management and related information technology to improve our operating efficiencies, to increase the level of service we provide for our customer base and to facilitate globalization of our operations.

The United States and some international jurisdictions, particularly in Europe, have data protection laws or regulations that prohibit or limit exchanging the type of information that we maintain. Some jurisdictions also prohibit the retention of information, other than certain basic facts, about noncurrent customers. Although these regulations may hinder our ability to collect, retain and use customer information, we believe that current laws and regulations do not prevent us from engaging in activities necessary to operate our current businesses.

COMPETITION AND TRADEMARKS

Although *Reader's Digest* is a unique and well-established institution in the publishing industry, it competes with other magazines for subscribers and with magazines and all other media, including television, radio and the Internet, for advertising.

We own numerous trademarks that we use in our businesses worldwide. Two of our most important trademarks are "Reader's Digest" and the "Pegasus" logo. In addition, our significant trademarks include "QSP", "Books Are Fun", "Taste of Home", *"Allrecipes.com"*, "Select Editions" and the names of many of our magazines, features and other products. We believe that the name recognition, reputation and image that we have developed in each of our markets significantly enhance customer response to our direct marketing sales promotions. For these reasons, trademarks are important to our business, and we aggressively defend our trademarks.

We believe that our company names, image and reputation, as well as the quality of our customer databases, provide a significant competitive advantage over many other direct marketers. However, our books and home entertainment businesses, QSP and Books Are Fun compete with companies selling similar products at retail as well as by direct marketing through various channels, including display marketing and the Internet. Because tests show that consumer responses to direct marketing promotions can be adversely affected by the overall volume of direct marketing promotions, we also compete with all other direct marketers, regardless of whether their products are similar to our products. Our books and home entertainment businesses compete principally on the basis of direct marketing customer service, product popularity and price.

Reader's Digest magazine and our special interest magazines compete with other magazines of similar respective genres for readers and advertising and our Reiman magazines compete for readers in their respective genres. QSP competes with other sellers of products similar to those sold by QSP, whether through fundraising services, direct marketing or retail. Nearly all of our products are in competition with other products and services that compete for a potential purchaser's leisure activity time and disposable income.

EMPLOYEES

As of June 30, 2006, we employed about 4,300 people worldwide. We employed about 2,400 in the United States and about 1,900 in our international subsidiaries. Our relationship with our employees is generally satisfactory.

EXECUTIVE OFFICERS

The following is information about our executive officers.

Name and Age	Positions With Reader's Digest and Recent Business Experience
Thomas O. Ryder (62)	In April 1998, Mr. Ryder joined Reader's Digest and was named Chairman of the Board and Chief Executive Officer. He retired as Chief Executive Officer on January 1, 2006 but continues as Chairman of the Board.
Eric W. Schrier (54)	Mr. Schrier became President and Chief Executive Officer of Reader's Digest in January 2006. Prior to that he had been President, Reader's Digest North America, since February 2003. Also, he was Senior Vice President and Global Editor-in-Chief from January 2000, when he joined Reader's Digest, until February 2003.
Bonnie K. Bachar (44)	Ms. Bachar has been President, U.S. Publishing since August 2005. She was General Manager of the Reader's Digest North American Publishing Group from March 2004 to August 2005 and Vice President and General Manager of *The Family Handyman* Group prior to March 2004. She joined Reader's Digest in 1998.
Michael A. Brizel (49)	Mr. Brizel has been Senior Vice President and General Counsel of Reader's Digest since July 2002. Before July 2002, he was Vice President and General Counsel of Reader's Digest. Mr. Brizel joined Reader's Digest in July 1989.
Richard E. Clark (42)	Mr. Clark has been Senior Vice President, Investor Relations and Global Communications, since November 2004. He joined Reader's Digest as Vice President, Investor Relations, in March 2000.
Thomas D. Gardner (48)	Mr. Gardner has been Executive Vice President of Reader's Digest since January 2006 and has been President, Reader's Digest International, since February 2003. Mr. Gardner has also had responsibility for the oversight of Books Are Fun since January 2006. He was President, North America Books and Home Entertainment, from January 2001 to February 2003 and was Senior Vice President, U.S. New Business Development, of Reader's Digest prior to January 2001. Mr. Gardner joined Reader's Digest in February 1992.
Michael S. Geltzeiler (47)	Mr. Geltzeiler joined Reader's Digest as Senior Vice President and Chief Financial Officer in September 2001. In August 2004, Mr. Geltzeiler's responsibilities were expanded to include oversight of Global Operations and Information Technology.

Name and Age	Positions With Reader's Digest and Recent Business Experience
Gary S. Rich (45)	Mr. Rich has been President, QSP, and a Senior Vice President of Reader's Digest since February 2002. He was Senior Vice President, Human Resources of Reader's Digest from August 1998, when he joined Reader's Digest, to February 2002.
Dawn M. Zier (41)	Ms. Zier has been President, North American Consumer Marketing and U.S. Books and Home Entertainment since August 2005. She was Vice President, Consumer Marketing, U.S. Magazines prior to August 2005. She joined Reader's Digest in February 1992.

Our By-Laws state that officers serve at the pleasure of our board of directors. We elect our officers annually and they serve until their successors are elected and qualified.

AVAILABLE INFORMATION

We file annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and other documents with the U.S. Securities and Exchange Commission (the "SEC"). The public may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site at *http://www.sec.gov* that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC.

We make available free of charge on or through our Internet website—*http://www.rd.com*—our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

Copies of the following Reader's Digest documents are also available on our website.

Corporate Governance Guidelines
Audit Committee Charter
Compensation and Nominating Committee Charter
Corporate Governance Committee Charter
Finance Committee Charter
Ethical, Legal and Business Conduct Policies

Information contained on our website and the SEC's website is not a part of this report.

Copies of any of the information referred to above are also available in print to any stockholder who requests. Requests for printed or electronic copies should be addressed to The Reader's Digest Association, Inc., Attention: Investor Relations, Reader's Digest Road, Pleasantville, NY 10570-7000 or via e-mail to: *carlos_jimenez@rd.com.*

ITEM 1A. RISK FACTORS

You should carefully consider the following risks associated with our businesses. Any of the following risks could have a material adverse effect on our businesses, financial condition or results of operations. The risks described below are not the only ones we face. Our businesses may also be materially adversely affected by risks that are not presently known to us or that we currently believe to be immaterial. For additional information regarding risk factors, see Item 7 of this report.

We cannot assure you that we will attain the goals of our fiscal 2006-2008 three-year strategic plan by fiscal 2008.

During fiscal 2006, we launched a three-year strategic plan, shifting our focus from stabilization of our businesses to sustainable top- and bottom-line growth by (1) diversifying the core business, (2) deepening customer relationships and (3) leveraging our global scale. The failure to achieve the overall goal or the components of the three-year strategic plan could have a material adverse effect on our results of operations and financial condition.

We may not be able to achieve the proper balance between circulation rate base and advertising revenues.

Like most companies that publish magazines, we must balance our circulation rate base goals, in particular those for the U.S. *Reader's Digest* magazine, with our advertising revenue objectives. This effort requires both effective management of the circulation rate base and the acquisition of new subscribers through cost-effective marketing methods. To maintain our circulation rate base, we may incur significant additional costs. We cannot assure you that we will be able to retain and acquire a sufficient number of magazine subscribers in an economically efficient manner. Failure to do so could require further reductions of our circulation rate base, which could negatively affect our advertising revenues and materially and adversely affect our results of operations and financial condition.

Failure to efficiently manage our direct marketing initiatives or to protect the integrity of our customer databases could negatively affect our business.

One of our most valuable assets is our customer list, which is a database containing information about our current and prospective customers. We rely on this database to develop and implement our direct marketing initiatives. Managing the frequency of our direct marketing initiatives and delivering appropriately tailored products in such initiatives is crucial to maintaining and increasing our customer base and achieving adequate results from our direct marketing efforts. Enhancing the database, maintaining the ability to utilize the information available from the database and properly utilizing the available information are vital to the success of our business, and our failure to do so could materially and adversely affect our results of operations and financial condition.

Changes in privacy law could adversely affect our ability to effectively market our products.

We collect information from our customers in the various markets in which we operate and we utilize that information principally for marketing and promotion purposes. Our collection, transfer and use of this information is limited by privacy and data protection laws and regulations in those jurisdictions, including the National Do Not Call Registry operated by the U.S. Federal Trade Commission, the U.S. Federal CAN-SPAM Act of 2003 and the European Data Protection Directive. Our compliance with additional regulations in these areas may increase our operating costs and adversely affect our ability to effectively market our products. Our failure to comply with these regulations could result in fines, sanctions and other penalties and additional restrictions on our collection, transfer or use of personal data. These developments could materially and adversely affect our results of operations and financial condition.

Changes in the legal and regulatory environment could increase our costs, restrict our operations and limit our marketing and other business activities.

The marketing and sale of our products is subject to various laws, regulations and policies administered by U.S. federal, state and local and foreign governments in markets in which we operate our businesses. Changes in these laws, regulations and policies, or in their interpretation, could increase our costs and liabilities and limit the manner in which we market our products and conduct our other business operations.

We currently rely on the use of sweepstakes as an important component of most of our direct marketing techniques in attracting and retaining customers in non-U.S. markets. If significant legislative or regulatory restrictions on these techniques occur in these markets, we will be forced to revise our marketing practices in those markets. We cannot assure you that revised practices would yield equally favorable results, and the failure to do so could materially and adversely affect our results of operations and financial condition.

We also rely on the use of sweepstakes as an important component of our direct marketing efforts in our U.S. Books and Home Entertainment business. Legislative and regulatory developments and agreements with state attorneys general in the United States have reduced the effectiveness of sweepstakes as a marketing method. As a result, we have increasingly tested other direct marketing techniques in an effort to diversify our overall marketing strategy in our Books and Home Entertainment business and to attract and retain new customers of this business. We cannot assure you that non-sweepstakes marketing techniques will be as effective as sweepstakes were. If we fail to effectively utilize alternative marketing techniques in our Books and Home Entertainment business, our business may be materially and adversely affected, which would materially and adversely affect our results of operations and financial condition.

We may not be able to successfully achieve the expected benefits of acquisitions and other ventures.

In the recent past, we have acquired companies and we may in the future make acquisitions intended to support and strengthen our businesses. Future acquisitions may divert our management's attention for our other business operations. Future acquisitions also may require us to incur additional debt and contingent liabilities, which could materially and adversely affect our results of operations and financial condition. Also, our failure to effectively integrate newly acquired operations—including, among other things, (1) the failure to maintain important business relationships, (2) the failure to retain key employees and (3) the occurrence of unforeseen costs and complexities, could prevent us from realizing our expected rate of return on an acquired business and could have a material and adverse affect on our results of operations and financial condition.

Our earnings and net worth could be materially and adversely affected by impairment in the carrying value of goodwill or other intangible assets.

The carrying value of goodwill represents the fair value of an acquired business in excess of identifiable assets and liabilities as of the acquisition date. The carrying value of other intangibles represents the fair value of trademarks, trade names, and other acquired intangibles as of the acquisition date. Goodwill and other acquired intangibles expected to contribute indefinitely to the cash flows of the Company are not amortized, but must be evaluated by management at least annually for impairment. We assess our goodwill and other intangibles for impairment during the third fiscal quarter of each year, and on an interim basis should indicators of impairment become apparent. If carrying value exceeds current fair value, the intangible is considered impaired and is reduced to fair value via a charge to earnings. During fiscal 2006 and 2005, we incurred impairment charges totaling $316.8 million related to Books Are Fun goodwill. Should management's assessment of the fair value of any of our acquired intangible assets decline, our earnings and net worth may be materially and adversely affected. For additional information, see Note 6 to our Consolidated Financial Statements referred to in Item 8 of this report.

We operate in highly competitive industries and must launch new products to attract new and younger customers to augment and replenish our maturing customer base while maintaining the quality of existing products.

We operate in highly competitive industries both in the United States and in our foreign markets. We compete on the basis of the following, among other things: (1) the variety, quality and attractiveness of our products and services; (2) the pricing of our products and services; (3) the manner in which we market and promote our products and services; and (4) the effectiveness of the distribution of our products and services and our customer service. Numerous well-established and smaller entrepreneurial companies produce, market and sell products that compete with the products that our businesses offer. Our magazines compete with other magazines for subscribers and with all media, including television, radio, newspapers and the Internet, for advertising. Our Books and Home Entertainment and Books Are Fun businesses compete with companies selling similar products at retail outlets, through direct and display marketing and on the Internet. QSP competes with companies selling similar products through fundraising services, direct marketing, the Internet and retail outlets.

Our success in attracting and retaining new and younger consumers to augment and replenish our maturing customer base depends in large part on our ability to identify customer trends and preferences and to develop new products across our business lines and to acquire and effectively manage the inventory of new products in our display marketing businesses in response to those trends and preferences. If we fail to launch a broadly appealing mix of new products, we may not be able to attract new customers and it is possible that our existing customers will seek product offerings from our competitors, which could materially and aversely affect our results of operations and financial condition.

We face additional risks associated with significant non-U.S. operations and we continue to expand into foreign markets.

We are committed to expanding our business internationally. As we enter new markets, we may, among other things: (1) utilize some portion of the attention of existing regional personnel; (2) identify, recruit, hire, train, develop and retain qualified and effective local personnel; (3) establish local internal business systems; (4) establish external business relationships, including outsourcing, joint venturing and licensing core business functions and (5) compete with established local competitors that may be more familiar with the particular tastes of the consumers in such markets. We cannot guarantee that we will be successful. If we fail to accomplish these matters effectively, our expansion opportunities could be limited and our results of operations and financial condition could be materially and adversely affected.

Economic weakness in the United States and abroad could negatively affect our business.

Most of our products are recreational in nature and, therefore, involve discretionary spending on the part of consumers. This makes our products particularly sensitive to general economic conditions and economic cycles and trends in advertising placements. Also, we derive a portion of our revenues from the sale of advertising in our publications. Our advertising revenues are susceptible to fluctuations in economic cycles. Sustained economic weakness in the United States or in Europe and in other markets where we generate a significant amount of our revenues, would likely further reduce consumer spending in our markets and negatively affect our business, which could materially and adversely affect our results of operations and financial condition.

Currency exchange rate fluctuations could reduce our revenue and net income.

We operate globally, through operations in various locations around the world. In fiscal 2006, we generated 50% of our revenue in markets outside of the United States. We purchase a significant portion of our inventory and raw materials primarily in U.S. dollars. The functional currency for most of our foreign operations is the applicable local currency. In preparing our financial statements, we translate revenues and expenses in foreign countries from their local currencies into U.S. dollars using weighted average exchange rates. If the U.S. dollar strengthens relative to local currencies, our reported revenues, gross profits and net income will likely be reduced. Given our inability to predict the degree of exchange rate fluctuations, we cannot estimate the effect these fluctuations may have upon future reported results, product pricing or our overall financial condition, but they could materially and adversely affect our results of operations and financial condition.

Increases in postage costs or paper prices could negatively affect our results.

Because the price of postage and paper are two of our largest operating expenses, our income may be reduced by increases in either postage or paper prices.

We expect to incur postage and delivery service costs of approximately $400 million in fiscal 2007. We largely use the United States Postal Service in the United States and a variety of carriers outside of the United States. Postage costs increase periodically and can be expected to increase in the future. Higher postal rates or other delivery charges increase the total cost of our products to the customers, which may have a negative effect on sales.

Paper is the principal raw material used in our business. We expect to incur costs of approximately $200 million in fiscal 2007 for paper for printed products and promotional material. The price of paper may fluctuate significantly in the future. Although we have attempted to ensure adequate, competitively priced, long-term supplies of paper, changes in the market supply of or demand for paper could affect delivery times and prices. We cannot be sure that we will not need to find alternative sources for paper from time to time and that we will continue to have access to paper in the necessary amounts or at reasonable prices or that any increases in the cost of paper will not have a material adverse effect on our business.

Our inability to absorb the impact of increases in postage and paper costs or our strategic determination not to pass on all or a portion of these increases to the customers could materially and adversely affect our results of operations and financial condition.

We may not be able to obtain at favorable prices the third-party products that we sell.

Our profit margins in our Books Are Fun and QSP businesses are highly dependent on the costs to obtain the books, gifts and magazines that they sell. Although these products have been available to us on negotiated, competitive terms in the past, there can be no assurance that we will have access to these products at comparable prices in the future.

A failure by QSP to meet minimum purchase requirements in one of its agreements could materially and adversely affect our results of operations and financial condition.

QSP entered into a long-term licensing agreement with World's Finest Chocolate, Inc. in May 2000 pursuant to which QSP is licensed to sell World's Finest Chocolate products as part of QSP's fundraising support business. The agreement was amended in 2002 to reduce the minimum purchase requirements and extend the term of the agreement. Under a long-term licensing agreement with World's Finest Chocolate, Inc. originally entered into in May 2000, QSP must satisfy estimated minimum annual purchase requirements of chocolate products ranging from approximately $56 million in fiscal 2007 to approximately $75 million in each year from fiscal 2008 to fiscal 2021. For additional information about this agreement, see Note 6 to our Consolidated Financial Statements referred to in Item 8 of this report. QSP is required to meet these minimum annual purchase requirements regardless of whether QSP would otherwise use that amount of World's Finest Chocolate products in the operation of its business. During the fourth quarter of fiscal 2006, we determined that it was probable that we will not meet the calendar 2006 minimum tonnage purchase commitment under this agreement and accordingly, recorded a charge of $6 million. We cannot assure you that QSP will be able to satisfy these minimum requirements throughout the remainder of the term of the agreement. A significant failure of QSP to meet the minimum annual purchase requirements under the agreement could materially and adversely affect our results of operations and financial condition.

We may not be able to retain or attract the key management, creative, editorial, marketing and sales personnel that we need to remain competitive and grow.

We operate in a number of highly visible industry segments where there is intense competition for experienced and highly effective key employees. Our successful operations in these segments may increase the market visibility of members of our key management and creative and editorial teams and result in their recruitment by other businesses.

We depend on our ability to identify, recruit, hire, train, develop and retain qualified and effective personnel. A loss of a significant number of skilled creative and editorial personnel could have a negative effect on the quality of our products. Similarly, a loss of a significant number of experienced and effective sales personnel would likely result in fewer sales of our products and could materially and adversely affect our results of operations and financial condition. We expend significant resources and management time in identifying and training our creative, editorial, marketing and sales personnel. Our ability to identify, recruit, hire, train, develop and retain qualified and effective personnel in these areas depends, however, on numerous factors, including factors that we cannot control, such as competition and conditions in the local employment markets in which we operate.

Furthermore, we depend on the continued services of our senior management team. This team is familiar with our industries and our business strategies and the departure of key management personnel could adversely affect our business, which could materially and adversely affect our results of operations and financial condition.

Increases in sales or other taxes could reduce our revenues.

In some markets, our products are subject to local and national sales taxes and other taxes such as value added taxes. Higher taxes will either increase the cost of our products to consumers, which could have a negative effect on the sales of our products, or reduce profit margins on these products if we do not pass on the increase to customers. This could materially and adversely affect our results of operations and financial condition.

Events that are beyond our control may disrupt the marketing and promotion and delivery of our products and services.

The success of our businesses is largely contingent on the availability of direct access to consumers. A significant portion of our business relies on postal services for delivery of products and for promotional marketing activity. For example, our Consumer Business Services segment requires direct personal access to consumers through offices and schools for display marketing and access to schools and youth groups for fund-raising activities. As a result, any event that disrupts or limits our direct access to consumers could materially and adversely affect our business, which could materially and adversely affect our results of operations and financial condition. Some of these events may be beyond our control, such as: adverse weather conditions; war; political instability or civil unrest; terrorism and related heightened security measures; natural and other disasters and catastrophic events; pandemics; increased energy costs; strikes and other labor-related supply chain disruptions.

Our businesses are largely seasonal and could be significantly unfavorably affected by adverse events during the principal selling season.

Our businesses are largely seasonal, with more marketing activity occurring during the Northern Hemisphere's fall and early winter. Shifts in the timing of important holding selling seasons relative to our fiscal quarters also may affect our results. Higher seasonal and holiday demand for our products and services increases, among other things, our inventory requirements and our borrowing and liquidity requirements. The occurrence of unfavorable events—whether within or outside of our control—during the periods of seasonally high demand or our failure to effectively manage our seasonal inventory could have a disproportionately unfavorable effect on our business, which could materially and adversely affect our results of operations and financial condition.

We may not be able to adequately protect our intellectual property, our brand and our reputation.

Our copyrights, trademarks, service marks patents, trade secrets and all of our other intellectual property rights are important assets. We rely on copyright, patent, trademark and other laws in the United States and other jurisdictions to protect our proprietary rights. It may be more difficult to protect our intellectual property rights in some foreign jurisdictions. Our significant proprietary rights could be infringed or invalidated. In addition, our business activities could be alleged or determined to infringe upon the proprietary rights of others. We could incur significant costs to protect our rights or to defend against infringement claims by others. If we are unsuccessful, our results of operations and financial condition could be materially and adversely affected.

Our brand and our reputation are also important assets as our ability to attract and retain customers is in part dependent upon the external perceptions of our Company, the quality of its products and services, and its integrity. Damage to our reputation or negative publicity or perceptions about us, including by association with adverse developments in the industries in which we conduct our businesses, could cause a loss of consumer confidence in our Company, as well as unfavorable regulatory scrutiny.

Our substantial indebtedness, and the potential for increased indebtedness, could adversely affect our financial condition, which could adversely affect our liquidity and results of operations.

As of June 30, 2006, we had significant leverage consisting of approximately $395.0 million of indebtedness outstanding under our $500 million Five-Year Revolving Credit Agreement (the "Revolving Credit Facility") and $300 million in 6½% senior unsecured notes due 2011 (the "Senior Unsecured Notes"). This level of indebtedness could have important consequences to stockholders, including the following:

- it may limit our ability to borrow money for capital expenditures, acquisitions, debt service requirements and general corporate or other purposes;
- it may limit our flexibility in planning for, or reacting to, changes in our business and future business opportunities and changing market conditions;
- we may be more highly leveraged than some of our competitors, which may place us at a competitive disadvantage;

- it may make us more vulnerable than a less leveraged company to a downturn in our business or in the economy;
- there would be a material adverse effect on our business, results of operations and financial condition if we were unable to service our indebtedness.

The interest rate under our Revolving Credit Facility is based in part on our leverage ratio and LIBOR, the prime rate or the federal funds rate then in effect. Increases in our leverage ratio or increases in LIBOR, the prime rate or the federal funds rate could result in an increase in our interest rates, which would increase our interest payment obligations and would have an adverse effect on us.

We maintain liquidity to fund the ongoing cash needs of our businesses, including the repayment of outstanding indebtedness, the payment of dividends and the repurchase of our stock, principally through our operating cash flow and our borrowings. Our ability to make payments on and to refinance our indebtedness will depend on our ability to generate cash from our operations in the future and manage our working capital. To the extent that our operating cash flow is insufficient and we are unable to access the capital markets on terms acceptable to us, we may decrease our business expenditures or we may increase our indebtedness under our existing Revolving Credit Facility or through additional financings, or we may do both. In order to obtain additional financing, we may be required to refinance our existing credit facilities. Our failure to obtain any necessary refinancing or additional financing on terms and conditions that are comparably favorable to us could materially and adversely affect our results of operations and financial condition.

Based on our current level of operations, we believe our cash flow from operations, available cash and available borrowings under our Revolving Credit Facility and other borrowing facilities will be adequate to meet our future liquidity needs for the foreseeable future.

We cannot assure you, however, that our business will generate sufficient cash flow from operations or that future borrowings will be available to us in an amount sufficient to enable us to pay our indebtedness or to fund our other liquidity needs. If we cannot service our indebtedness, we may have to take actions such as selling assets, seeking additional equity or forgoing, reducing or delaying capital expenditures, strategic acquisitions, investments and alliances. We cannot assure you that any such actions, if necessary, could be effected on commercially reasonable terms, or at all.

Restrictive covenants in our credit facilities and the indenture governing our Senior Unsecured Notes may restrict our ability to pursue our business strategies.

Our Revolving Credit Facility and, in some cases, the indenture governing our Senior Unsecured Notes will limit our ability, among other things, to:

- incur additional indebtedness;
- issue preferred stock;
- incur liens;
- consolidate, merge, sell or otherwise dispose of all or substantially all of our assets;
- sell assets, including capital stock of subsidiaries;
- pay dividends or make distributions in respect of our capital stock or make certain other restricted payments or investments, subject to certain exceptions;
- make certain types of investments, loans, guarantees or acquisitions;
- enter into transactions with our affiliates;
- agree to payment restrictions affecting our subsidiaries; and
- make capital expenditures.

In addition, our Revolving Credit Facility requires us to achieve specified financial and operating results and maintain compliance with specified financial ratios. If we fail to comply with the covenants containing these requirements, we would be in default and, under certain circumstances, the lenders under the Revolving Credit Facility could declare all amounts owed to them to be due and payable, which could have a material and adverse effect on our results of operations and financial condition.

Significant changes in pension fund investment performance or assumptions relating to pension costs may have a material effect on the valuation of pension obligations, the funded status of pension plans and our pension cost.

Our funding policy for pension plans is to accumulate plan assets that, over the long run, will approximate the present value of projected benefit obligations. Although our U.S. qualified pension plan is overfunded, some of our foreign pension plans are under-funded. Our pension cost is materially affected by the discount rate used to measure pension obligations, the level of plan assets available to fund those obligations at the measurement date and the expected long-term rate of return on plan assets. Significant changes in investment performance or a change in the portfolio mix of invested assets can result in corresponding increases and decreases in the valuation of plan assets, particularly equity securities, or in a change of the expected rate of return on plan assets. A change in the discount rate would result in a significant increase or decrease in the valuation of pension obligations, affecting the reported funded status of our pension plans as well as the net periodic pension cost in the following fiscal years. Similarly, changes in the expected return on plan assets can result in significant changes in the net periodic pension cost of the following fiscal years. Significant variations in pension performance could produce volatility in our reported results and significant under-funding in our foreign pension plans could necessitate higher company contributions to those plans.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

The table below shows our headquarters and other properties that we own or lease. These locations house our executive, administrative, editorial, advertising sales and operational offices and warehouse and other facilities.

Location	Area (sq. ft.)
Westchester County, NY	278,536 leased
Greendale, WI	164,800 owned
Fairfield, IA	105,393 owned
New York, NY	99,200 leased
Various U.S. cities	72,788 leased
International	363,981 owned; 364,452 leased

In December 2004, we completed the sale and partial leaseback of our headquarters in Westchester County, New York. During fiscal 2005 we sold our local headquarters buildings in Australia and Portugal, and during fiscal 2006 we sold our local headquarters building in Mexico.

We believe that our current facilities, together with expansions and upgrades of facilities presently underway or planned, are adequate to meet our present and reasonably foreseeable needs. We also believe that adequate space will be available to replace any leases that expire in the near future.

ITEM 3. LEGAL PROCEEDINGS

We and our subsidiaries are defendants in various lawsuits and claims arising in the regular course of business. Based on the opinions of management and counsel for these matters, we believe that recoveries, if any, by plaintiffs and claimants would not materially affect our financial position or results of operations.

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

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The information contained under the captions "Selected Quarterly Financial Data and Dividend and Market Information" and "Corporate and Shareholder Information" in Exhibit 13 to this report is incorporated into this Item by reference.

ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares (or Units) Purchased[1]	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs[2]	(d) Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs[2]
April 1-30, 2006	79,433	$13.76	75,000	48,601,320
May 1–31, 2006	1,350,000	$13.73	1,350,000	30,066,759
June 1–30, 2006	835	$14.00	—	30,066,759
Total	1,430,268	$13.73	1,425,000	

(1) The shares purchased in April and June 2006 include 4,433 and 835 shares, respectively, of the Company's Common Stock surrendered to the Company by employees in order to fulfill tax withholding obligations of employees upon vesting of restricted stock.

(2) On April 28, 2005, we announced our repurchase of up to $100.0 million of our Common Stock over the succeeding two years.

RECENT SALES OF UNREGISTERED SECURITIES

Shown in the table below are securities of the registrant that were not registered under the Securities Act of 1933 and were sold by the registrant during the fiscal year ended June 30, 2006. The securities were sold to employees of subsidiaries of the Company located outside of the United States pursuant to international employee stock purchase plans that permitted the participants to purchase shares of the Company's Common Stock, generally at a purchase price of 95% of the fair market value of the stock on the last day of a six-month period. These sales were made outside of the United States in reliance on the safe harbor under Regulation S under the Securities Act of 1933.

Class of security	Date of sale	Number of shares sold	Aggregate purchase price
Common Stock	December 31, 2005	4,120	$53,539
Common Stock	June 30, 2006	3,591	$47,503

ITEM 6. SELECTED FINANCIAL DATA

The information contained under the caption "Selected Quarterly Financial Data and Dividend and Market Information" and "Selected Financial Data" in Exhibit 13 to this report is incorporated into this Item by reference.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

The information contained under the caption "Management's Discussion and Analysis" in Exhibit 13 to this report is incorporated into this Item by reference.

This report contains or incorporates by reference "forward-looking statements" within the meaning of the U.S. federal securities laws. Forward-looking statements include any statements that address future results or occurrences. These forward-looking statements inherently involve risks and uncertainties that could cause actual future results and occurrences to differ materially from the forward-looking statements. Some of these risks and uncertainties include factors relating to:

- the effects of potentially more restrictive privacy and other governmental regulation relating to our marketing methods;
- the effects of modified and varied promotions;
- our ability to identify customer trends;
- our ability to continue to create and acquire a broadly appealing mix of new products;
- our ability to attract and retain new and younger magazine subscribers and product customers in view of the maturing of an important portion of our customer base;
- our ability to attract and retain subscribers and customers in an economically efficient manner;
- the effects of selective adjustments in pricing;
- our ability to expand and more effectively utilize our customer database;
- our ability to expand into new international markets and to introduce new product lines into new and existing markets;
- our ability to expand into new channels of distribution;
- our ability to negotiate and implement productive acquisitions, strategic alliances and joint ventures;
- our ability to successfully integrate newly acquired and newly formed businesses;
- the strength of relationships of newly acquired and newly formed businesses with their employees, suppliers and customers;
- the accuracy of the basis of forecasts relating to newly acquired and newly formed businesses;
- our ability to achieve financial savings related to restructuring programs;
- our ability to contain and reduce costs, especially through global efficiencies;
- the cost and effectiveness of our reengineering of business processes and operations;
- the accuracy of our management's assessment of the current status of our business;
- the evolution of our organizational and structural capabilities;
- our ability to respond to competitive pressures within and outside the direct marketing and direct sales industries, including the Internet;
- our ability to recruit, train and retain effective sales personnel;
- the effects of worldwide paper and postage costs;
- the effects of possible postal disruptions on deliveries of promotions, products and payments;
- the effects of foreign currency fluctuations;
- the accuracy of our management's assessment of the future effective tax rate and the effects of initiatives to reduce the rate;
- the adequacy of our financial resources;
- the effects of the terms of, and increased leverage resulting from additional borrowings under, our credit facilities;
- the effects of interest rate fluctuations;
- the effects of downgrades of our credit ratings;
- the effects of economic and political changes in the markets where we compete;
- the effects of weather in limiting our access to consumers; and
- the economic effects of terrorist activity and related events, especially those limiting our access to consumers and otherwise affecting the direct marketing and direct sales industries.

For additional information regarding risk factors, see Item 1A of this report.

We do not undertake to update any forward-looking statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information contained under the caption "Management's Discussion and Analysis" in the section entitled "Quantitative and Qualitative Disclosures About Market Risk" in Exhibit 13 to this report is incorporated into this Item by reference.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our Consolidated Financial Statements, together with the reports of Ernst & Young LLP as of and for the year ended June 30, 2006 and KPMG LLP as of and for the years ended June 30, 2005 and 2004 in Exhibit 13 to this report, are incorporated into this Item by reference.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

DISCLOSURE CONTROLS AND PROCEDURES

Our management evaluated, with the participation of our principal executive officer and principal financial officer, the effectiveness of our disclosure controls and procedures (as defined in rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

INTERNAL CONTROL OVER FINANCIAL REPORTING

The information contained under the captions "Report of Management" and "Report of Independent Registered Public Accounting Firm" in Exhibit 13 to this report are incorporated into this Item by reference. There has been no change in the Company's internal control over financial reporting during the fiscal quarter ended June 30, 2006, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

Not applicable.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information required by this Item with respect to our directors under the captions "Proposal 1: Election of Directors" and "Governance Information" in the Proxy Statement for our Annual Meeting of Stockholders to be held on November 17, 2006, is incorporated into this Item by reference.

Information required by this Item with respect to our executive officers appears under the caption "Executive Officers" in Item 1 of Part I of this report and is incorporated into this Item by reference.

Information required by this Item with respect to compliance with Section 16 of the Securities Exchange Act of 1934 appears under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement for our Annual Meeting of Stockholders to be held on November 17, 2006, and is incorporated into this Item by reference.

CODE OF ETHICS

Our Ethical, Legal and Business Conduct Policies, which are a "code of ethics" within the meaning of Item 406 of the Securities and Exchange Commission's Regulation S-K, apply to all of our Directors and employees, including our principal executive officer, principal financial officer and principal accounting officer, or persons performing similar functions. These Policies are available on our Internet website at *www.rd.com*. We intend to post on our website (or disclose by any other means permitted under SEC rules) any amendment to, or waiver from, any provision of the Policies that applies to our principal executive officer, principal financial officer or principal accounting officer, or persons performing similar functions.

ITEM 11. EXECUTIVE COMPENSATION

Information required by this Item with respect to executive compensation under the captions "Executive Compensation," "Report of the Compensation and Nominating Committee" and "Performance Graph" in the Proxy Statement for our Annual Meeting of Stockholders to be held on November 17, 2006, is incorporated into this Item by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

EQUITY COMPENSATION PLAN INFORMATION

The following table sets forth information as of June 30, 2006, with respect to compensation plans under which equity securities of Reader's Digest may be issued. The equity securities to be issued under the plans are Reader's Digest Common Stock.

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights[1] (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	14,439,021	$ 19.81	4,110,484
Equity compensation plans not approved by security holders	—	—	—
Total	14,439,021	$ 19.81	4,110,484

[(1)] Includes 3,597,890 shares available for future grants under the Company's 2005 Key Employee Long Term Incentive Plan. This plan provides for the grant of stock options, stock appreciation rights, restricted stock, performance shares, performance units and other stock-based awards. Includes 73,750 shares available for future grant under the Company's Director Compensation Program. Includes 241,934 shares available for issuance under the Company's Employee Stock Purchase Plan, which permits U.S. employees to purchase shares from Reader's Digest at a discount. Includes 196,910 shares available for issuance under the Company's International Employee Stock Ownership Plan, which comprises our international employee stock purchase plans for non-U.S. employees and our U.K. Share Incentive Plan, which provides for compensatory share awards to U.K. employees.

SECURITY OWNERSHIP INFORMATION

Information required by this Item with respect to security ownership of certain beneficial owners and management under the caption "Equity Security Ownership" in the Proxy Statement for our Annual Meeting of Stockholders to be held on November 17, 2006, is incorporated into this Item by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Not applicable.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information required by this Item with respect to principal accountant fees and services under the captions "Audit Committee Report" and "Ratification of Independent Registered Public Accounting Firm" in the Proxy Statement for our Annual Meeting of Stockholders to be held on November 17, 2006, is incorporated into this Item by reference.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) 1 **Financial Statements**

An index of our Consolidated Financial Statements appears on page 32 of this report.

2 **Financial Statement Schedules**

All schedules have been omitted since the information required to be submitted has been included in the Consolidated Financial Statements or Notes thereto or has been omitted as not applicable or not required.

3 **Exhibits**

3.1 Restated Certificate of Incorporation of The Reader's Digest Association, Inc. filed with the State of Delaware on July 8, 2003, filed as Exhibit 4.1 to our Registration Statement on Form S-3 (Registration No. 333-107278) filed on July 23, 2003, is incorporated herein by reference.

3.2 Amended and Restated By-Laws of The Reader's Digest Association, Inc., effective December 13, 2002, filed as Exhibit 3.2 to Amendment No. 1 to our Registration Statement on Form 8-A/A (Registration No. 001-10434) filed on December 13, 2002, is incorporated herein by reference.*

4.1 Indenture, dated as of March 3, 2004, between The Reader's Digest Association, Inc., as issuer, and JPMorgan Chase Bank, as trustee, filed as Exhibit 4.1 to our Registration Statement on Form S-4 (Registration No. 333-113961) filed on March 26, 2004, is incorporated herein by reference.

4.2 Registration Rights Agreement, dated as of March 3, 2004, by and among The Reader's Digest Association, Inc., J.P.Morgan Securities Inc., ABN AMRO Incorporated, Commerzbank Aktiengesellschaft, The Royal Bank of Scotland, plc and Wachovia Securities Inc., filed as Exhibit 4.2 to our Registration Statement on Form S-4 (Registration No. 333-113961) filed on March 26, 2004, is incorporated herein by reference.

10.1 The Reader's Digest Association, Inc. Management Incentive Compensation Plan (Amendment and Restatement as of July 1, 1994), filed as Exhibit 10.1 to our Annual Report on Form 10-K for the year ended June 30, 1994, is incorporated herein by reference.*

10.2 The Reader's Digest Association, Inc. 1989 Key Employee Long Term Incentive Plan, as amended effective April 13, 2001, filed as Exhibit 10.29 to our Quarterly Report on Form 10-Q for the quarter ended March 31, 2001, is incorporated herein by reference.*

10.3 The Reader's Digest Association, Inc. Deferred Compensation Plan (Amendment and Restatement as of July 8, 1994) filed as Exhibit 10.4 to our Annual Report on Form 10-K for the year ended June 30, 1994, is incorporated herein by reference.*

10.4 Excess Benefit Retirement Plan of The Reader's Digest Association, Inc. (Amendment and Restatement as of July 1, 1994), filed as Exhibit 10.7 to our Annual Report on Form 10-K for the year ended June 30, 1994, is incorporated herein by reference.*

10.5 The Reader's Digest 1992 Executive Retirement Plan (Amendment and Restatement as of October 10, 1996), filed as Exhibit 10.12 to our Annual Report on Form 10-K for the year ended June 30, 1997, is incorporated herein by reference.*

10.6 Amendment No. 1 to The Reader's Digest Association, Inc. Management Incentive Compensation Plan (effective as of April 11, 1996) filed as Exhibit 10.1.1 to our Quarterly Report on Form 10-Q for the quarter ended March 31, 1996, is incorporated herein by reference.*

10.7 The Reader's Digest Association, Inc. Deferred Compensation Plan for Directors, amended and restated as of January 1, 2003 filed as Exhibit 10.10 to our Annual Report on Form 10-K for the year ended June 30, 2003, is incorporated herein by reference.*

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* Management contract or compensatory contract, plan or arrangement.

10.8 Employment Agreement dated as of April 28, 1998, between The Reader's Digest Association, Inc. and Thomas O. Ryder, filed as Exhibit 10.33 to our Quarterly Report on Form 10-Q for the quarter ended March 31, 1998, is incorporated herein by reference.*

10.9 The Reader's Digest Association, Inc. 2001 Income Continuation Plan for Senior Management, filed as Exhibit 10.21 to our Quarterly Report on Form 10-Q for the quarter ended March 31, 2001, is incorporated herein by reference.*

10.10 Termination Agreement dated as of April 23, 2001, between The Reader's Digest Association, Inc. and Eric W. Schrier, filed as Exhibit 10.18 to our Annual Report on Form 10-K for the year ended June 30, 2001, is incorporated by reference.*

10.11 Termination Agreement dated as of December 18, 2001, between The Reader's Digest Association, Inc. and Michael S. Geltzeiler filed as Exhibit 10.14 to our Annual Report on Form 10-K for the year ended June 30, 2003, is incorporated herein by reference.*

10.12 Termination Agreement dated as of April 23, 2001, between The Reader's Digest Association, Inc. and Thomas D. Gardner, filed as Exhibit 10.17 to our Annual Report on Form 10-K for the year ended June 30, 2002, is incorporated herein by reference.*

10.13 Termination Agreement dated as of April 23, 2001, between The Reader's Digest Association, Inc. and Gary S. Rich filed as Exhibit 10.16 to our Annual Report on Form 10-K for the year ended June 30, 2003, is incorporated herein by reference.*

10.14 The Reader's Digest Association, Inc. Senior Management Incentive Plan, filed as Exhibit 10.27 to our Annual Report on Form 10-K for the year ended June 30, 1999, is incorporated herein by reference.*

10.15 Assurance of Voluntary Compliance or Discontinuance dated February 26, 2001, by and among the State Attorneys General and the registrant, filed as Exhibit 99.2 to our Current Report on Form 8-K dated March 9, 2001, is incorporated herein by reference.

10.16 The Reader's Digest Association, Inc. 1994 Key Employee Long Term Incentive Plan, amended and restated as of September 18, 2002, filed as Exhibit 10.24 to our Annual Report on Form 10-K for the year ended June 30, 2002, is incorporated herein by reference.*

10.17 The Reader's Digest Association, Inc. 2002 Key Employee Long Term Incentive Plan, filed as Exhibit 10.25 to our Annual Report on Form 10-K for the year ended June 30, 2002, is incorporated herein by reference.*

10.18 The Reader's Digest Association, Inc. Director Compensation Program, amended and restated as of January 1, 2003 filed as Exhibit 10.23 to our Annual Report on Form 10-K for the year ended June 30, 2003, is incorporated herein by reference.*

10.19 Form of Indemnification Agreement between The Reader's Digest Association, Inc. and individual directors and Named Executive Officers of The Reader's Digest Association, Inc., filed as Exhibit 10.27 to our Quarterly Report on Form 10-Q for the quarter ended March 31, 2003, is incorporated herein by reference.*

10.20 FlexNet Program summary description filed as Exhibit 10.28 to our Annual Report on Form 10-K for the year ended June 30, 2003, is incorporated herein by reference.*

10.21 Financial counseling plan summary description filed as Exhibit 10.29 to our Annual Report on Form 10-K for the year ended June 30, 2003, is incorporated herein by reference.*

10.22 Amendment to Employment Agreement dated as of November 21, 2003, between The Reader's Digest Association, Inc. and Thomas O. Ryder, filed as Exhibit 10.31 to our Quarterly Report on Form 10-Q for the quarter ended December 31, 2003, is incorporated herein by reference.*

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* Management contract or compensatory contract, plan or arrangement.

10.23 Form of stock option award terms and conditions to Named Executive Officers under The Reader's Digest Association, Inc. 1994 and 2002 Key Employee Long Term Incentive Plans, filed as Exhibit 10.34 to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, is incorporated herein by reference.*

10.24 Form of restricted stock award terms and conditions to Named Executive Officers under The Reader's Digest Association, Inc. 1994 and 2002 Key Employee Long Term Incentive Plans, filed as Exhibit 10.35 to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, is incorporated herein by reference.*

10.25 Addendum effective January 1, 2005 to The Reader's Digest Association, Inc. Director Compensation Program, filed as Exhibit 10.34 to our Current Report on Form 8-K dated November 18, 2004, is incorporated herein by reference.*

10.26 Amended and Restated Sale Purchase Agreement between The Reader's Digest Association, Inc. and GAP III Properties LLC and Summit Development, LLC dated as of November 18, 2004, but effective as of September 10, 2004, filed as Exhibit 10.35 to our Current Report on Form 8-K dated November 18, 2004, is incorporated herein by reference.

10.27 Description of operation of the executive incentive program of The Reader's Digest Association, Inc., including the Senior Management Incentive Plan (fiscal 2006 awards), the Management Incentive Compensation Plan (fiscal 2006 awards) and the 2002 Key Employee Long Term Incentive Plan (fiscal 2005 and 2006 awards), included in Item 1.01 of our Current Report on Form 8-K dated March 11, 2005, is incorporated herein by reference.*

10.28 Five-Year Revolving Credit Agreement, dated as of April 14, 2005, among The Reader's Digest Association, Inc., as Borrower and Guarantor, Books Are Fun, Ltd., QSP, Inc. and Reiman Media Group, Inc., as Borrowing Subsidiaries and Subsidiary Guarantors, the Lenders party thereto, filed as Exhibit 10.1 to our Current Report on Form 8-K dated April 14, 2005, is incorporated herein by reference.

10.29 The Reader's Digest Association, Inc. 2005 Key Employee Long Term Incentive Plan, filed as Exhibit 10.6 to our Current Report on Form 8-K dated August 12, 2005, is incorporated herein by reference.*

10.30 Director Phantom Stock Option Plan, filed as Exhibit 10.45 to our Annual Report on Form 10-K for the year ended June 30, 2006, is incorporated herein by reference.*

10.31 Form of award letter and terms and conditions of fiscal 2006 stock option grants to Named Executive Officers under The Reader's Digest Association, Inc. 2002 and 2005 Key Employee Long Term Incentive Plans (including amendments to previous awards under The Reader's Digest Association, Inc. 1989 and 1994 Key Employee Long Term Incentive Plans), filed as Exhibit 10.1 to our Current Report on Form 8-K dated August 12, 2005, is incorporated herein by reference.*

10.32 Form of award letter and terms and conditions of fiscal 2006 restricted stock grants to Named Executive Officers under The Reader's Digest Association, Inc. 2002 and 2005 Key Employee Long Term Incentive Plans (including amendments to previous awards under The Reader's Digest Association, Inc. 1989 and 1994 Key Employee Long Term Incentive Plans), filed as Exhibit 10.2 to our Current Report on Form 8-K dated August 12, 2005, is incorporated herein by reference.*

10.33 Form of award letter and terms and conditions of fiscal 2005-2007 restricted stock unit grants to Named Executive Officers under The Reader's Digest Association, Inc. 2002 Key Employee Long Term Incentive Plan, filed as Exhibit 10.4 to our Current Report on Form 8-K dated August 12, 2005, is incorporated herein by reference.*

10.34 Form of award letter and terms and conditions of fiscal 2006-2008 restricted stock unit grants to Named Executive Officers under The Reader's Digest Association, Inc. 2002 Key Employee Long Term Incentive Plan, filed as Exhibit 10.5 to our Current Report on Form 8-K dated August 12, 2005, is incorporated herein by reference.*

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* Management contract or compensatory contract, plan or arrangement.

10.35 Description of performance criteria for fiscal 2005-2007 and 2006-2008 restricted stock units awarded to Named Executive Officers of The Reader's Digest Association, Inc., included in Item 1.01 of our Current Report on Form 8-K dated August 12, 2005, is incorporated herein by reference.*

10.36 Letter agreement dated as of October 31, 2005 between The Reader's Digest Association, Inc. and Thomas O. Ryder, filed as Exhibit 10.53 to our Current Report on Form 8-K dated October 31, 2005, is incorporated herein by reference.*

10.37 Noncompetition, Nonsolicitation and Confidentiality Agreement dated October 28, 2005 between The Reader's Digest Association, Inc. and Eric W. Schrier, filed as Exhibit 10.54 to our Current Report on Form 8-K dated October 31, 2005, is incorporated herein by reference.*

10.38 Merger Agreement dated March 31, 2006 by and among The Reader's Digest Association, Inc., RD Merger Sub, Inc. and Allrecipes.com, Inc. filed as Exhibit 2.1 to our Current Report on Form 8-K dated March 31, 2006, in incorporated herein by reference.

10.39 Form of Support Agreement dated March 31, 2006 by and among The Reader's Digest Association, Inc., RD Merger Sub, Inc. and the signatories thereto, filed as Exhibit 10.1 to our Current Report on Form 8-K dated March 31, 2006, in incorporated herein by reference.

10.40 First Amendment, dated as of April 19, 2006, to the $400,000,000 Five-Year Revolving Credit Agreement, dated as of April 14, 2005, among The Reader's Digest Association, Inc., the Borrowing Subsidiaries party thereto, the Lenders party thereto, JPMorgan Chase Bank, as administrative agent and collateral agent, and the co-documentation agents party thereto, filed as Exhibit 10.58 to our Current Report on Form 8-K dated April 19, 2006, is incorporated herein by reference.

10.41 The Reader's Digest Association, Inc. 2006 Income Continuation Plan for Senior Management.*

10.42 The Reader's Digest Association, Inc. Executive Cash Balance Plan (Amended & Restated June 30, 2006).*

10.43 Compensation information regarding a Named Executive Officer, included in Item 1.01 of our Current Report on Form 8-K dated November 18, 2005, is incorporated herein by reference.*

10.44 Form of award letter and terms and conditions of fiscal 2007 stock option grants to Named Executive Officers under The Reader's Digest Association, Inc. 2005 Key Employee Long Term Incentive Plan, filed as Exhibit 10.1 to our Current Report on Form 8-K dated August 17, 2006, is incorporated herein by reference.*

10.45 Form of award letter and terms and conditions of fiscal 2007-2009 restricted stock unit grants to Named Executive Officers under The Reader's Digest Association, Inc. 2005 Key Employee Long Term Incentive Plan, filed as Exhibit 10.2 to our Current Report on Form 8-K dated August 17, 2006, is incorporated herein by reference.*

10.46 Form of retention restricted stock unit grants to Named Executive Officers under The Reader's Digest Association, Inc. 2005 Key Employee Long Term Incentive Plan, filed as Exhibit 10.3 to our Current Report on Form 8-K dated August 17, 2006, is incorporated herein by reference.*

10.47 Description of operation of the Senior Management Incentive Plan (Fiscal 2007) and the Management Incentive Compensation Plan (Fiscal 2007) of The Reader's Digest Association, Inc., included in Item 1.01 of our Current Report on Form 8-K dated August 17, 2006, is incorporated herein by reference.*

10.48 Compensation information regarding Named Executive Officers, included in Item 1.01 of our Current Report on Form 8-K dated August 17, 2006, is incorporated herein by reference.*

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* Management contract or compensatory contract, plan or arrangement.

13 Financial information to be included in our 2006 Annual Report to Stockholders (furnished for the information of the Securities and Exchange Commission only and not to be deemed filed as part of this Annual Report on Form 10-K, except for the portions thereof that are specifically incorporated herein by reference).

14 Ethical, Legal and Business Conduct Policies, effective September 30, 2004, filed as Exhibit 14 to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, is incorporated herein by reference.

16.1 Letter of KPMG LLP to the Securities and Exchange Commission dated August 29, 2005, filed as Exhibit 16.1 to our Current Report on Form 8-K dated August 23, 2005, is incorporated herein by reference.

16.2 Letter of KPMG LLP to the Securities and Exchange Commission dated August 31, 2005, filed as Exhibit 16.2 to our Current Report on Form 8-K dated August 30, 2005, is incorporated herein by reference.

21 Subsidiaries of The Reader's Digest Association, Inc.

23.1 Consent of independent registered public accounting firm (Ernst & Young LLP).

23.2 Consent of independent registered public accounting firm (KPMG LLP).

24 Power of attorney.

31.1 Certification of Chief Executive Officer of registrant pursuant to rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934.

31.2 Certification of Chief Financial Officer of registrant pursuant to rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934.

32 Certifications of Chief Executive Officer and Chief Financial Officer of registrant pursuant to rule 13a-14(b)/15d-14(b) of the Securities Exchange Act of 1934.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

THE READER'S DIGEST ASSOCIATION, INC.

By: /s/ERIC W. SCHRIER
ERIC W. SCHRIER
President and Chief Executive Officer

Date: August 17, 2006

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ ERIC W. SCHRIER ERIC W. SCHRIER	President and Chief Executive Officer	August 17, 2006
/s/ MICHAEL S. GELTZEILER MICHAEL S. GELTZEILER	Senior Vice President and Chief Financial Officer	August 17, 2006
/s/ THOMAS D. BARRY THOMAS D. BARRY	Vice President and Corporate Controller (chief accounting officer)	August 17, 2006
/s/ THOMAS O. RYDER THOMAS O. RYDER	Director, Chairman of the Board	August 17, 2006
/s/ JONATHAN B. BULKELEY* JONATHAN B. BULKELEY	Director	August 17, 2006
Herman Cain	Director	August 17, 2006
/s/ LEE CAUDILL* LEE CAUDILL	Director	August 17, 2006
/s/ WALTER ISAACSON* WALTER ISAACSON	Director	August 17, 2006
/s/ WILLIAM E. MAYER* WILLIAM E. MAYER	Director	August 17, 2006
/s/ JOHN T. REID* JOHN T. REID	Director	August 17, 2006
/s/ LAWRENCE R. RICCIARDI* LAWRENCE R. RICCIARDI	Director	August 17, 2006
/s/ WILLIAM J. WHITE* WILLIAM J. WHITE	Director	August 17, 2006
/s/ ED ZSCHAU* ED ZSCHAU	Director	August 17, 2006

*By: /s/ C.H.R. DUPREE
(C.H.R. DUPREE)
Attorney in Fact

THE READER'S DIGEST ASSOCIATION, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

MANAGEMENT'S DISCUSSION AND ANALYSIS

Dollars in millions, except per share data

Unless otherwise indicated, references in Management's Discussion and Analysis to "we," "our" and "us" are to The Reader's Digest Association, Inc. and its subsidiaries. All references to 2006, 2005 and 2004, unless otherwise indicated, are to fiscal 2006, fiscal 2005 and fiscal 2004, respectively. Our fiscal year represents the period from July 1 through June 30.

The following discussion and analysis provides information that we believe is relevant to an assessment and understanding of our consolidated results of operations and financial condition and has been written excluding the effect of foreign currency translation, except as specifically noted otherwise. This discussion should be read in conjunction with our Consolidated Financial Statements and related Notes. Certain amounts and percentages do not recalculate due to rounding.

RESULTS OF OPERATIONS: COMPANY-WIDE

Our Reportable Segments

Our businesses are structured into the same three reportable segments (Reader's Digest North America, Reader's Digest International and Consumer Business Services) that our chief operating decision maker uses to assess business performance. In addition to the reportable segments, we separately report Corporate Unallocated expenses, which are expenses not directly attributable to business unit performance. Similarly, we separately report the effects of previously deferred magazine promotion expense, goodwill charges and other operating items, net, because our chief operating decision maker does not factor in these items when assessing business unit performance. Here is a brief description of the activities included within our reportable segments.

Reader's Digest North America

This segment comprises our operations in the United States and Canada that publish and market *Reader's Digest* magazine, Reiman magazines and several special interest magazines. It also includes our operations in the United States and Canada that publish and market Books and Home Entertainment products (including Select Editions, Reader's Digest Young Families, music and video products, and series and general books related to the following affinities: reading, home and health, and entertainment) as well as two new businesses, *Allrecipes.com* and Taste of Home Entertaining. Growth initiatives in this segment include developing and launching new products and leveraging our existing products and brands.

These businesses have a common focus on the direct marketing aspect of new customer acquisition at a minimal cost. The performance of *Reader's Digest* magazine and our special interest magazines is driven primarily by circulation revenues and secondarily by advertising sales. Circulation is also the principal driver of performance for Reiman magazines, which have limited advertising revenues. The results of our Books and Home Entertainment business are driven by the size of our active customer base, new customer acquisition programs, response rates to promotional mailings, customer payment rates and membership in our continuity series business.

Reader's Digest International

This segment comprises our operations outside of the United States and Canada, with our most significant markets in the United Kingdom, Germany, Central Europe and France. The businesses in this segment publish and market *Reader's Digest* magazine (in numerous editions and languages) and books and home entertainment products (described above). Growth initiatives in this segment include entering new geographic markets, developing and launching new products, acquiring customers through new channels and expanding U.S. business models into markets outside of North America.

The performance of these businesses is driven by factors similar to those in the Reader's Digest North America segment, except that overall results are less sensitive to changes in individual geographic market conditions due to the number of markets in which we operate. The results for *Reader's Digest* magazine in international markets are driven primarily by circulation and secondarily by advertising revenues. The results of our books and home entertainment products in these markets are driven by the size of our active customer base, new customer acquisition programs, response rates to promotional mailings, customer payment rates and membership in our continuity series business.

Consumer Business Services

This segment comprises Books Are Fun, our display marketing business, and QSP, our youth fundraising businesses, in the United States and Canada. These businesses focus on increasing market penetration and expanding efficiency with existing accounts by leveraging our sales force.

Books Are Fun and QSP principally sell products through non-direct marketing channels, primarily through their sales forces. The performance of these businesses is driven by product selection, the number of accounts or events, the average sales per account or event, and the number of participants in fundraising programs.

Intercompany Eliminations and Corporate Unallocated Expenses

We present our segment revenues and operating (losses) profits consistently with how we manage our operations and how our chief operating decision maker reviews our results. Revenues and expenses attributable to intercompany transactions are included in the results of our reportable segments. Such amounts are eliminated (under the intercompany eliminations caption below) to reconcile our reportable segment amounts to consolidated amounts, as reported in the statements of operations. In addition to intercompany revenues and expenses, we separately report Corporate Unallocated expenses, which cover expenses that are not directly attributable to business unit performance. Corporate Unallocated expenses include the cost of governance and other corporate-related expenses, as well as income and expenses associated with our U.S. pension plans and retiree healthcare benefits, and stock and executive compensation programs that are not allocated to the reportable segments.

Summary of Reportable Segment Results

	Years ended June 30,		
	2006	**2005**	**2004**
Revenues			
Reader's Digest North America	**$ 939**	$ 917	$ 919
Reader's Digest International	**1,031**	1,012	970
Consumer Business Services	**446**	485	525
Intercompany eliminations	**(30)**	(24)	(26)
Total revenues	**$2,386**	**$2,390**	**$2,388**
Operating (loss) profit			
Reader's Digest North America	**$ 115**	$ 91	$ 76
Reader's Digest International	**78**	76	57
Consumer Business Services	**(3)**	29	59
Previously deferred magazine promotion expense(1)	**—**	(77)	(27)
Goodwill charge(2)	**(188)**	(129)	—
Corporate Unallocated	**(40)**	(38)	(44)
Other operating items, net(3)	**(7)**	14	(9)
Operating (loss) profit	**$ (45)**	**$ (34)**	**$ 112**
Intercompany eliminations			
Reader's Digest North America	**$ (11)**	$ (9)	$ (11)
Reader's Digest International	**(6)**	(4)	(4)
Consumer Business Services	**(13)**	(11)	(11)
Total intercompany eliminations	**$ (30)**	**$ (24)**	**$ (26)**

[1] In connection with our change to expensing magazine deferred promotion costs when the promotion is mailed to prospective customers, our reportable segment operating (loss) profit in 2005 includes such expenses as incurred. Amortization of previously deferred promotion costs in 2005 and our deferred promotion charge recorded in the fourth quarter of 2004 are not included in segment results reviewed by our chief operating decision maker. For the year ended June 30, 2005, 81% of amortization of previously capitalized magazine promotion costs was related to Reader's Digest North America and 19% to Reader's Digest International. For the year ended June 30, 2004, 45% of our magazine deferred promotion charge was related to Reader's Digest North America and 55% to Reader's Digest International.

[2] The goodwill charge related to Books Are Fun, part of the Consumer Business Services reportable segment, is not included in segment results reviewed by our chief operating decision maker. See Note 6, Goodwill and Other Intangible Assets, Net, in our Notes to Consolidated Financial Statements for additional information.

[3] Other operating items, net consists of gains on sales of certain non-strategic assets and restructuring charges. Such items are not included in segment results reviewed by our chief operating decision maker. See Note 3, Other Operating Items, Net, in our Notes to Consolidated Financial Statements for additional information. In previous periods, gains on sales of certain non-strategic assets were classified as other (expense) income, net, and have been reclassified to other operating items, net to conform to the current year presentation.

Overview

During 2005 we made many changes to right-size our businesses and invest in new market expansion. In 2006 we shifted our focus from stabilization to growth. As such, in 2006, we continued to invest in the future, while realizing some of the benefits from our investments. During the year, we launched *Every Day with Rachael Ray*, *Daheim in Deutschland* and three new editions of *Reader's Digest* magazine, and we started selling books and home entertainment products in six new international markets. These investments expanded both our product portfolio in key affinity groups and our global scale. Also, in the fourth quarter we launched Taste of Home Entertaining, and we acquired *Allrecipes.com*. Taste of Home Entertaining is a home party plan business that extends our Taste of Home brand, while *Allrecipes.com* provides us a platform to leverage our content in the food affinity to digital media. Each of these investments made positive contributions to revenues in either Reader's Digest North America or Reader's Digest International.

While revenues and profits in these segments improved, Consumer Business Services continued to experience challenges in 2006. Competitive pressures at Books Are Fun and turnover in our sales force adversely affected revenues and profits. As a result, Books Are Fun recorded a charge in the second quarter to write off its remaining goodwill. At QSP, the benefits of cost reduction measures were partially offset by a charge related to our calendar year 2006 World's Finest Chocolate minimum tonnage purchase commitment.

During the fourth quarter of 2006 we also recorded restructuring and inventory charges primarily related to the Books Are Fun turnaround plan and, to a lesser extent, to strategic downsizing activities at other business units.

Revenues and Operating (Loss) Profit

2006 v. 2005

Revenues

Revenues decreased to $2,386 in 2006, compared with $2,390 in 2005. The effect of foreign currency fluctuations reduced revenues in 2006 by $7. While revenues improved in Reader's Digest North America and Reader's Digest International, revenues declined at Consumer Business Services.

Revenues for Reader's Digest International increased principally because we began to realize the benefits of previous investments to expand our business in new markets, including Romania and Ukraine. Also, growth in our active customer base translated into increased promotional activity and, consequently, higher revenues in certain established markets, including Russia, Brazil and Australia. These increases were partially offset by lower revenues in the United Kingdom, Poland, the Nordic region and Portugal, where our active customer base contracted.

Revenues also increased for Reader's Digest North America in part because we realized the benefits of previous investments in the business. Increased circulation revenues were driven by new magazine titles, while the additions of our home party plan business and *Allrecipes.com* made positive contributions. These increases were partially offset by continued weakness in certain established Reiman-inspired book annual products, lower promotion activity in Reader's Digest Young Families and lower circulation revenues for *Reader's Digest* magazine.

Lower revenues for Consumer Business Services were driven by fewer corporate events held by Books Are Fun because of turnover in our independent sales force and competitive pressures in certain regions. In addition, lower average sales per school event at Books Are Fun contributed to the decline. Revenues were also lower at QSP, where lower magazine volumes were partially offset by higher food and gift sales.

Operating (Loss) Profit

In 2006, our operating loss was $(45), compared with a loss of $(34) in 2005. The comparability of results was affected by two significant items: a $(59) higher goodwill charge recorded in 2006 when compared with the charge recorded in 2005, offset by the absence of $(77) of expense recorded in 2005 related to the amortization of previously deferred magazine promotion costs (see *Previously Deferred Magazine Promotion Expense* below). Also, lower profitability for Consumer Business Services and higher Corporate Unallocated expenses were partially offset by higher profits for Reader's Digest North America and Reader's Digest International.

Product, distribution and editorial expenses increased 3% to $(997) in 2006, compared with $(971) in 2005. Increased costs were principally driven by the addition of printing and paper expenses for new magazine titles, including *Every Day with Rachael Ray* and *Cooking for 2*, higher postage costs in Reader's Digest North America, and a charge related to our calendar year 2006 World's Finest Chocolate minimum tonnage purchase commitment. Also, product costs were higher in certain international markets, commensurate with the increase in revenues and due to an inventory charge at Books Are Fun to lower the value of old and discontinued items. These increases were partially offset by supply chain savings in certain international markets.

Promotion, marketing and administrative expenses decreased 7% to $(1,240) in 2006, compared with $(1,337) in 2005. The comparability of these amounts was affected by the inclusion of amortization of previously deferred magazine promotion costs of $(77) in 2005 (see *Previously Deferred Magazine Promotion Expense* below). Also, promotion, marketing and administrative expenses declined because certain intangible assets established when we acquired Reiman reached the end of their useful lives in 2005, and thus we recorded $21 of lower amortization; we also had lower promotion costs in Reader's Digest North America. The effects of cost reduction measures at QSP, and lower commission expense at Books Are Fun because of lower sales, further lowered costs. These decreases were partially offset by increased costs in certain international markets, commensurate with the increase in revenues.

Reportable Segments

The loss for Consumer Business Services was driven by the effects of competitive pressures, costs associated with recruiting and retaining members of the independent sales force, and a charge to lower the value of old and discontinued inventory. Also, in the fourth quarter of 2006, we recorded a charge of $(6) associated with the calendar year 2006 minimum tonnage purchase commitment in our World's Finest Chocolate licensing agreement. These factors were partially offset by the effects of cost reduction measures at QSP.

The improvement in profits for Reader's Digest North America was principally driven by $21 of lower amortization of intangible assets at Reiman and lower promotion costs. This improvement was partially offset by costs associated with new initiatives.

Higher profits for Reader's Digest International were driven by increased revenues, partially offset by investments in the business.

Corporate Unallocated

Corporate Unallocated expenses reflect the cost of governance and centrally managed expenses, as well as the accounting for U.S. pension plans, postretirement healthcare costs, and stock and executive compensation programs that are not allocated to the reportable segments. These expenses were $(40) in 2006, compared with $(38) in 2005. Increased costs were driven by stock option expense and lower net pension income, partially offset by the reversal of $4 from a litigation-related accrual recorded in previous periods that is no longer necessary and by lower incentive compensation expenses.

Other Operating Items, Net

Other operating items, net decreased to an expense of $(7) in 2006, compared with income of $14 in 2005. In 2006, restructuring charges comprised $(6) related to the Books Are Fun turnaround plan and $(5) related to various businesses, mostly in international markets. These charges were partially offset by gains of $3 from the sale of non-strategic assets and restructuring reversals of $1, principally related to severance accruals recorded in previous periods that are no longer necessary.

To implement our turnaround strategy at Books Are Fun, we recorded severance of $(3) to lower our cost base, streamline processes and restructure the management team. Actions associated with these restructuring initiatives are expected to be completed by the end of fiscal 2007. In addition, we recorded $(3) to write off capitalized software costs for abandoned assets.

We also recorded restructuring charges of $(5), principally severance, to lower our cost base and streamline operations across various businesses, mostly in international markets. Actions associated with these initiatives are expected to be completed by the end of fiscal 2007.

In 2005, we recorded income of $14 in other operating items, net. This amount comprises gains on the sales of non-strategic assets, including the sale of properties in various international markets and the sale of certain magazines, and restructuring reversals of $4 related to severance and other charges recorded in previous periods that are no longer necessary, partially offset by severance charges of $(4).

Goodwill Charge

We are required to assess the recoverability of goodwill and our indefinite-lived intangible assets at least annually. Due to a shortfall in Books Are Fun's operating performance relative to our expectations during its peak selling season, we recorded a charge of $(188) in 2006 to write off its remaining goodwill. Similarly, in 2005 we recorded a goodwill charge of $(129). The fair value of Books Are Fun was determined by a third-party appraiser using a combination of discounted future net cash flows and an assessment of comparable companies in the marketplace. For further information, see Note 6, Goodwill and Other Intangible Assets, Net, in our Notes to Consolidated Financial Statements.

2005 v. 2004

Revenues

Revenues were relatively flat in 2005 when compared with 2004. The effect of foreign currency fluctuations increased revenues in 2005 by 3%. While revenues were lower for all three of our reportable segments, the declining trend that Reader's Digest North America and Reader's Digest International have reported in recent years appears to have stabilized.

Lower revenues for Consumer Business Services were driven by both Books Are Fun and QSP. Books Are Fun continues to be adversely affected by lower average sales per event and fewer events. QSP revenues were lower principally because of magazine and gift volume declines driven by lower participation in fundraising programs. Both Books Are Fun and QSP continued to experience competitive pressure for accounts, which adversely affected profit margins.

Revenues for Reader's Digest International decreased slightly in 2005, compared with double-digit declines in 2004 and 2003, due to lower membership in series products and a decline in our active customer base. Planned reductions in circulation for *Reader's Digest* magazine in certain markets to improve profitability, and the elimination of *Moneywise* magazine in the United Kingdom contributed to the decline. The largest declines were in Germany, Brazil, Mexico and the United Kingdom. Partially offsetting these declines were strength in single sales products and increased mail quantities in Australia as well as positive results from new markets and new products.

The slight revenue decline in Reader's Digest North America was principally driven by the planned elimination of marginally profitable and unprofitable activity in Reader's Digest Young Families and lower membership in series products. In addition, lower circulation revenues for *Reader's Digest* magazine, due in part to the January 2004 reduction in the rate base, contributed to the decline. Partially offsetting these declines were improved revenues in Canada and our special interest magazines, and new revenues from products launched within the last two years. Reiman revenues in 2005 were flat compared with 2004.

Operating (Loss) Profit

Operating profit decreased significantly to a loss of $(34) in 2005, compared with a profit of $112 in 2004. The operating loss was principally driven by the goodwill charge of $(129) related to Books Are Fun and $(77) related to amortization of previously deferred magazine promotion costs (described in further detail below). The effect of foreign currency fluctuations reduced our operating loss in 2005 by $9. Lower profits for Consumer Business Services and investments in new products and geographic markets contributed to the decline. Despite lower revenues, profits at Reader's Digest North America and Reader's Digest International improved because of lower costs. Combined with lower Corporate Unallocated expenses and gains on sales of certain non-strategic assets of $14, these factors partially offset profit declines elsewhere.

Product, distribution and editorial expenses decreased to $(971) in 2005, compared with $(973) in 2004. The effect of foreign currency fluctuations increased these costs in 2005 by 3%. Lower overall sales volumes, and lower manufacturing and delivery costs for *Reader's Digest* magazine due to reductions in the rate bases in various markets, including the January 2004 rate base reduction in the United States, principally drove the decline. These decreases were partially offset by costs incurred to enter new markets.

Promotion, marketing and administrative expenses increased 3% to $(1,337) for 2005, compared with $(1,294) in 2004. The effect of foreign currency fluctuations increased these costs in 2005 by 3%. In 2005, these expenses included amortization of previously deferred magazine promotion costs of $(77), while in 2004 these expenses included a charge of $(27) related to magazine deferred promotion costs (described below). In addition to this increase in magazine promotion costs, promotion, marketing and administrative expenses increased slightly because of costs incurred to enter new markets. These increases were partially offset by lower costs due to a reduced rate base for *Reader's Digest* magazine, lower mail quantities for books and home entertainment products in various markets and for certain Reiman products, and the effects of cost reduction measures initiated in previous periods, including staff reductions.

Reportable Segments

Profits for Consumer Business Services declined principally because of lower sales activity and increased incentives at both QSP and Books Are Fun.

Improved profits for Reader's Digest North America were driven by effective management of overhead costs, and by lower promotion and production costs because of lower overall promotion activity and the January 2004 reduction in the rate base for *Reader's Digest* magazine. Partially offsetting this improvement were costs incurred to launch two new Reiman-inspired magazines, *Cooking for 2* and *Birds & Blooms Extra*.

Profits for Reader's Digest International improved because of increased response rates to promotional mailings for single sales products, more efficient mailings and the results of cost reduction measures initiated in previous periods. These improvements were partially offset by costs incurred to develop new products and enter new geographic markets, a critical component of the growth initiatives for this reportable segment.

Corporate Unallocated

Corporate Unallocated expenses reflect the cost of governance and centrally managed expenses, as well as the accounting for U.S. pension plans, postretirement healthcare costs, and stock and executive compensation programs that are not allocated to the reportable segments. These expenses were $(38) in 2005, compared with $(44) in 2004. Lower expenses were driven by an $8 increase in net pension income (from our over-funded U.S. pension plan) and a $2 decrease in postretirement healthcare costs (due to changes in our healthcare plans and recognition of a government Medicare subsidy announced in January 2004). We also had lower costs of $2 due to the favorable settlement of prior property taxes and due to the sale and partial leaseback of our Westchester, New York headquarters facility. These items were partially offset by a $(4) increase in employee compensation expenses.

Other Operating Items, Net

Other operating items, net was $14 in 2005, compared with $(9) in 2004. This includes gains from the sales of certain non-strategic assets totaling $14 and $6, respectively. The primary factors affecting comparability related to these gains were:

- a gain of $7 from the sale of buildings in Portugal and Australia in 2005, compared with a gain of $6 from the sale of a building in Hong Kong in 2004
- gains of $3 from the sale of *Moneywise* magazine in the United Kingdom and *Crafting Traditions* magazine in the United States, both of which occurred in the second quarter of 2005
- a gain of $4 from the sale of other non-strategic assets in 2005, principally fine art

In addition, restructuring charges of $(4) (principally related to severance actions in the United States) in 2005 were offset by reversals of $4 related to severance and other charges recorded in previous periods that were no longer necessary. We review our restructuring plans periodically to determine the appropriateness of existing accruals in light of current circumstances. Accordingly, these charges were reversed because of the occurrence of events that affected our original plans.

Restructuring charges recorded in the second, third and fourth quarters of 2004 comprised $(14) for severance and $(3) for contract terminations, asset impairments and pension curtailments. Reversals of $2, principally related to severance, partially offset these charges.

Charges of $(14) for severance related to streamlining operations in certain international markets, domestic businesses and corporate departments. Charges of $(3) for contract terminations, asset impairments and pension curtailments principally represented costs associated with closing our Norway location and a lease termination at Books Are Fun.

These charges were partially offset by reversals of $2, principally severance, recorded in the third quarter of 2004 related to charges recorded in previous periods that were no longer necessary.

Previously Deferred Magazine Promotion Expense

After reassessing our accounting for magazine promotion costs in the fourth quarter of 2004, we began expensing magazine promotion costs when the promotion is mailed to prospective customers instead of deferring and amortizing such costs. In the fourth quarter of 2004 we recorded a $(27) charge related to this change. Similarly, in 2005 we expensed $(77) related to promotion costs capitalized as of June 30, 2004. Such amount is included as a component of promotion, marketing and administrative expenses on the statements of operations. As of June 30, 2005, there are no deferred magazine promotion costs for promotions that were capitalized as of June 30, 2004.

Goodwill Charge

The third quarter of the fiscal year is our designated annual period to assess the recoverability of goodwill and our indefinite-lived intangible assets. Based on our assessment, Books Are Fun recorded a goodwill charge of $(129) in the third quarter of 2005 because the performance of our product portfolio and competitive pressures on margin resulted in revenue and operating profits falling short of our expectations. The fair value of Books Are Fun was determined independently using a combination of discounted future net cash flows and an assessment of comparable companies in the marketplace.

Other (Expense) Income, Net

2006 v. 2005

Other (expense) income, net was $(41) in 2006, compared with $(46) in 2005. The most significant component of other (expense) income, net was interest expense of $(48) and $(54) in 2006 and 2005, respectively. Interest expense in 2005 included $(7), principally related to the write-off of deferred financing fees because of refinancing activities consummated in the fourth quarter.

2005 v. 2004

Other (expense) income, net remained flat at $(46) in 2005, compared with 2004. The most significant component of other (expense) income, net was interest expense of $(54) and $(55) in 2005 and 2004, respectively. Interest expense in both periods included $(7), principally related to the write-off of deferred financing fees because of refinancing activities (see Liquidity and Capital Resources for additional information).

Income Taxes

2006 v. 2005

Since pre-tax losses in 2006 and 2005 were the result of non-deductible goodwill charges at Books Are Fun, we recorded income tax expense of $(31) and $(12), respectively. Tax expense in these years was also affected by certain discrete tax benefits. In 2006, we recorded discrete tax benefits of $6 due to the settlement of tax audits in foreign countries, and $2 due to changes in our estimates of permanent book-to-tax differences, as a result of filing our tax return for fiscal 2005. Tax expense in 2005 included benefits of $6 due to the reversal of tax liabilities resulting from various settlements of U.S. federal and state tax audits, partially offset by a reduction in the value of certain deferred tax assets as a result of a change to the tax law of a foreign jurisdiction.

2005 v. 2004

Since the pre-tax loss in 2005 was a result of non-deductible goodwill charges at Books Are Fun, we recorded an income tax expense of $(12), compared with a tax expense of $(17) in 2004. Income tax expense in both 2005 and 2004 were favorably affected by a reduction in tax liabilities resulting from various settlements of U.S. federal, state and foreign audits.

Net (Loss) Income

2006 v. 2005

As a result of the items discussed above, net loss in 2006 was $(117) or $(1.24) per share for both basic and diluted loss per share. In 2005, net loss was $(91) or $(0.95) per share for both basic and diluted loss per share. For both 2006 and 2005, the effect of potentially dilutive shares was not considered in the calculation of loss per share because such shares would have been anti-dilutive.

2005 v. 2004

As a result of the items discussed above, net loss in 2005 was $(91) or $(0.95) per share for both basic and diluted loss per share. For 2005, the effect of potentially dilutive shares was not considered in the calculation of loss per share because such shares would have been anti-dilutive. In 2004, net income was $49 or $0.49 per share on a diluted-earnings basis ($0.50 per share for basic earnings per share).

RESULTS OF OPERATIONS: REPORTABLE SEGMENTS

Reader's Digest North America

2006 v. 2005

Revenues for Reader's Digest North America increased 2% to $939 in 2006, compared with $917 in 2005. The effect of foreign currency fluctuations increased revenues in 2006 by $8. Revenues increased principally because we have started to realize the benefits of previous investments to grow our business, including new magazine titles and the addition of our home party plan business. Also, advertising revenues were slightly higher. These increases were partially offset by lower books and home entertainment revenues.

Circulation revenue growth was driven by new magazine titles, including *Every Day with Rachael Ray* (launched in the second quarter of 2006), *Cooking for 2* (launched in the third quarter of 2005) and *Birds & Blooms Extra* (launched in the fourth quarter of 2005), and by expansion of our themed newsstand specials. These improvements were partially offset by lower circulation revenue for certain Reiman-inspired cooking titles and for *Reader's Digest* magazine due to a change in the mix of the renewal pool to newer subscribers and less reliance on agents.

Higher advertising revenues, due to the addition of *Every Day with Rachael Ray* and increased advertising pages in *Reader's Digest* magazine, were partially offset by fewer advertising pages in our special interest magazines.

Lower books and home entertainment revenues were driven by lower sales of certain established Reiman-inspired book annual products, planned reductions in promotional activity in Reader's Digest Young Families to improve profitability and lower membership in Select Editions. These declines were partially offset by increased sales of products in our home & health affinity, due to stronger products, and higher retail sales.

Operating profit increased 26% to $115 in 2006, compared with $91 in 2005. The increase in profitability was principally driven by $21 of lower amortization of certain intangible assets that were established when we acquired Reiman, because the assets reached the end of their useful lives in 2005, and lower promotion costs. Although investments in growth initiatives positively affected revenues in 2006, costs incurred to launch these businesses lowered profits. Higher postage costs also adversely affected profits.

2005 v. 2004

Revenues for Reader's Digest North America were relatively flat in 2005 when compared with 2004. The effect of foreign currency fluctuations increased revenues in 2005 by $9. Lower revenues for U.S. Books and Home Entertainment and *Reader's Digest* magazine were partially offset by increased revenues in Canada and for our special interest magazines.

Lower revenues for U.S. Books and Home Entertainment were driven by the planned elimination of marginally profitable and unprofitable activity in Reader's Digest Young Families and a continued decline in Select Editions membership. Strong performance of certain single sales products, due in part to increased mail quantities, and increased Trade Publishing revenues partially offset these declines.

Circulation revenues for *Reader's Digest* magazine were lower principally due to the January 2004 reduction in the rate base and a continued decline in renewal pools. However, the circulation decline shows signs of stabilizing following the reduction in the rate base and a decreased reliance on subscriptions generated by agents. Also, newsstand volume declined 9% because of industry-wide softness in this market, while fewer prescription drug and automotive pages drove a slight decline in advertising revenues.

Lower revenues at Reiman were attributable to lower renewal rates for certain cooking titles and the absence of revenues from *Crafting Traditions* magazine (sold in the second quarter of 2005). In addition, sales of annual book products declined slightly because weaker performance of established titles was partially offset by the performance of newer titles. These declines were offset by increased revenues from *Backyard Living* (a magazine launched in the third quarter of 2004) and increased catalog and ancillary sales.

Partially offsetting the declines described above were increased revenues in Canada, the addition of revenues from new products and stronger performance from certain special interest magazines.

Increased revenues in Canada were driven by *Our Canada*, a new magazine launched in the third quarter of 2004, and strong performance of single sales products, due to increased mail quantities and response rates to promotional mailings. Advertising revenues from our special interest magazines increased, particularly *The Family Handyman* and *Selecciones.*

As part of our program to invest in the business, in 2005 we launched two new Reiman-inspired magazines: *Cooking for 2* and *Birds & Blooms Extra*. Both of these titles made positive contributions to revenues during the year.

Operating profit increased 19% to $91 in 2005, compared with $76 in 2004. The increase in profit was principally driven by effective management of overhead costs and lower promotion costs. Lower production costs for *Reader's Digest* magazine, due to the January 2004 reduction in the rate base, contributed to the improvement. These increases were partially offset by investments in new products.

Reader's Digest International

2006 v. 2005

Revenues for Reader's Digest International increased 2% to $1,031 in 2006, compared with $1,012 in 2005. The effect of foreign currency fluctuations lowered revenues in 2006 by $17. The increase in revenues was driven by previous investments to extend our global scale and by investments in new customer acquisition. Growth in new markets, including Romania, Ukraine, Bulgaria and certain southeastern European markets, significantly contributed to the increase in revenues. Similarly, growth in our active customer base resulted in increased promotional mailings. Coupled with improved products or promotions, these factors translated into increased revenues in certain markets, including Russia, Brazil and Australia.

Revenues also benefited from the introduction of Reiman-inspired magazines in certain European markets as well as the introduction of new products in Asia.

While in the aggregate our active customer base increased, the number of active customers in certain markets decreased. This resulted in lower revenues in the United Kingdom, Poland, the Nordic region and Portugal. Also, revenues in Norway were lower because we licensed publication of *Reader's Digest* magazine to a third party in 2005.

Operating profit increased 3% to $78 in 2006, compared with $76 in 2005. The improvement in profits was principally driven by an increase in our active customer base in certain markets. The most significant profit improvements were in Russia, Australia and France. These increases were partially offset by investments in the business.

2005 v. 2004

Revenues for Reader's Digest International increased 4% to $1,012 in 2005, compared with $970 in 2004. The effect of foreign currency fluctuations increased revenues in 2005 by $66. Although revenues declined, the declining trend experienced in recent years appears to have become stable. Our active customer base has stabilized, after substantial declines in recent years. Other key indicators also showed progress, including improved response rates, strong performance of single sales products and stabilizing magazine circulation and series membership. Collectively, these trends indicate that actions taken to restore the business are positively affecting this segment.

The decrease in revenues was driven by Germany, Brazil, Mexico and the United Kingdom as a result of lower sales of books and home entertainment products due to declining continuity series membership, lower response rates to promotional mailings and a decline in our active customer base. In addition, revenues for *Reader's Digest* magazine were lower because of planned reductions in circulation to better manage customer acquisition costs, improve profitability and achieve a sustainable circulation level.

Also, revenues were $(9) lower because we sold *Moneywise* magazine in the United Kingdom (in the second quarter of 2005) and because we licensed publication of *Reader's Digest* magazine to a third party in Norway.

Increased revenues from single sales books and home entertainment products in Australia, Asia, and from new markets, including Romania and Ukraine, partially offset revenue declines elsewhere. The increase in revenues in Australia was driven by increased mail quantities due to an increased active customer base and improved response rates to promotional mailings, while revenues in Asia improved because of the introduction of new products.

Operating profit increased 34% to $76 in 2005, compared with $57 in 2004. The effect of foreign currency fluctuations improved profits in 2005 by $8. Improved profits were driven by the United Kingdom, Germany, Australia and the addition of new markets. The increase in profits was attributable to increased response rates to promotional mailings for single sales products, more efficient mailings, lower customer acquisition costs, the benefits of continuing cost reduction measures and lower product and distribution costs.

Consumer Business Services

2006 v. 2005

Revenues for Consumer Business Services decreased 8% to $446 in 2006, compared with $485 in 2005. The decline was principally driven by Books Are Fun and, to a much lesser extent, by QSP.

Revenues at Books Are Fun decreased 15% principally due to fewer corporate events held because of turnover of independent sales representatives and the resulting vacancies in certain territories. Also, because of softer performance of our product portfolio in the fourth quarter of 2006, average sales per school event were lower.

QSP revenues declined 2%, primarily due to an 8% decline in magazine volumes because of lower renewal rates. This decline was mitigated by an improvement in same school sales in 2006 when compared with 2005. Also, a 5% increase in World's Finest Chocolate volumes despite the after-effects of Hurricanes Katrina and Rita, and increased gift revenues, because of a higher-priced mix of products sold, partially offset the decline.

In 2006, we incurred a loss of $(3), compared with a profit of $29 in 2005. The revenue changes described above, the effects of competitive pressures, and costs associated with recruiting and retaining members of the independent sales force at Books Are Fun principally drove the loss. We also recorded a charge at Books Are Fun to lower the value of old and discontinued items. While certain products were reserved to position them for sale through alternate channels, other products were written-off as we terminated certain non-core lines of business. At QSP, the benefits of cost reduction measures were partially offset by a charge of $(6) associated with the calendar year 2006 minimum tonnage purchase commitment in our World's Finest Chocolate licensing agreement, despite increased sales volumes.

2005 v. 2004

Revenues for Consumer Business Services decreased 8% to $485 in 2005, compared with $525 in 2004. Both QSP and Books Are Fun contributed to the decline.

Revenues at Books Are Fun decreased 8% due to lower average sales per school event and fewer business display and corporate events held. Average sales per school event were lower because of weaker performance of our product portfolio and a shift in the mix of products sold to lower-priced products. Although we experienced significant sales force turnover in the school market early in the year, in the second half of the year we recovered lost events through intensive recruiting efforts. The decline in business events was driven by turnover in the independent sales force, due to increased competition, while turnover in accounts resulted in fewer corporate events. In contrast to the school market, our recruiting efforts were not as successful in recovering lost events. Also, because new representatives generally require a certain amount of time to build their territories, these representatives did not significantly affect revenues. During the year, the number of sales representatives in our primary lines of business, the school and corporate markets, decreased 1%.

Double-digit declines in magazine and gift sales volumes due to lower participation in fundraising programs drove the 8% decline in revenues at QSP. These declines were partially offset by increased sales of music and food products. Sales of World's Finest Chocolate products increased 9% due to efforts to convert more of our food business to these products.

Operating profit for 2005 decreased 50% to $29, compared with $59 in 2004. The revenue changes described above along with increased incentives at Books Are Fun drove most of the decline in profits. Investments at QSP, including additional incentives, enhanced promotional materials and costs to integrate new products, contributed to the decline.

These declines were partially offset by the effect of cost reduction measures at QSP that were initiated during the second half of 2005.

LIQUIDITY AND CAPITAL RESOURCES
(includes forward-looking information)

The consolidated statement of cash flows for the year ended June 30, 2006 is summarized below:

Cash and cash equivalents at June 30, 2005	**$ 38**
Net change in cash due to:	
Operating activities	48
Investing activities	(82)
Financing activities	29
Effect of exchange rate fluctuations on cash and cash equivalents	2
Net change in cash and cash equivalents	**(3)**
Cash and cash equivalents at June 30, 2006	**$ 35**

Cash and cash equivalents decreased 8% to $35 as of June 30, 2006, compared with $38 as of June 30, 2005. Cash flow from operations decreased to $48 in 2006, compared with $139 in 2005, principally driven by lower operating profits in Consumer Business Services and changes in working capital as we shifted our focus from stabilization to growth. Also, spending related to restructuring actions and programs to retain members of our independent sales force at Books Are Fun further lowered operating cash flow. Aside from these items, significant sources (uses) of cash were:

- net proceeds from borrowings of $136
- acquisition of *Allrecipes.com* for $(66)
- dividend payments of $(40)
- share repurchases of $(65)

Borrowings

Our primary debt obligations as of June 30, 2006 are our borrowings under our $500 Five-Year Revolving Credit Agreement (2005 Credit Agreement) and $300 in senior unsecured notes.

On April 14, 2005, we entered into a $400 Five-Year Revolving Credit Agreement to retire all outstanding borrowings under our Five-Year Revolving Credit and Competitive Advance Facility Agreement and $950 Term Loan Agreement (collectively referred to as the 2002 Credit Agreements) and for general corporate purposes. Financing fees of $(2) related to the 2005 Credit Agreement were deferred and are amortized on a straight-line basis over the life of the 2005 Credit Agreement. In connection with the termination of the 2002 Credit Agreements, we recorded a write-off of $(7) in the fourth quarter of 2005 related to the associated capitalized financing fees and the discontinuance of the related interest rate protection agreements.

On April 19, 2006, we entered into an amendment to our 2005 Credit Agreement, which increased the aggregate principal amount available to $500, increased the maximum leverage ratio (as defined in the amendment) and increased pricing when the leverage ratio is at higher levels. The interest rate on the 2005 Credit Agreement is currently at LIBOR plus 125 basis points and is subject to change based on our leverage ratio (as defined in the 2005 Credit Agreement). The 2005 Credit Agreement contains financial covenants that require us to maintain minimum interest coverage and maximum leverage ratios, and it is secured by the stock of a substantial portion of our subsidiaries.

During the third quarter of 2004, we completed a private placement, with registration rights, of $300 of 6½% senior unsecured notes due in 2011 (Senior Notes) in order to refinance amounts outstanding under the $950 Term Loan Agreement. In the fourth quarter of 2004, these notes were exchanged for notes that were registered under the Securities Act of 1933. The proceeds from this offering were used to repay $294 of principal outstanding under the 2002 Term Loan Agreement, with the remainder used to pay a portion of the financing costs.

At June 30, 2006 and 2005, we had borrowings of $695 and $559 outstanding, respectively, all of which are classified as long-term debt on the balance sheets.

In 2006, 2005 and 2004, we recorded interest expense, net of $(41), $(46), and $(50), respectively. Interest expense in 2005 included the write-off of financing fees of $(7) as a result of the termination of the 2002 Credit Agreements. Interest expense in 2004 included the write-off of financing fees of $(6) as a result of the refinancing and certain other transactions described above and the write-off of $(1) related to the termination of some of our interest rate caps that were no longer required (see Note 7, Financial Instruments, in our Notes to Consolidated Financial Statements for additional information). The weighted average interest rate on our borrowings charged by our lenders was 6.0%, 5.3% and 4.4%, respectively.

Other Liquidity Matters

International lines of credit and overdraft facilities totaled $32 at June 30, 2006 and $28 at June 30, 2005, of which $14 and zero were outstanding at June 30, 2006 and 2005, respectively. These lines of credit are subject to renewal annually.

On April 28, 2005, our Board of Directors authorized our repurchase of up to $100 of our Common Stock over the succeeding two years and rescinded its May 2001 authorization to repurchase up to $250 of our Common Stock. Under the April 2005 authorization, we repurchased 4 million shares for $63 in 2006. Since the April 2005 authorization, we repurchased 5 million shares for $70. We had not repurchased any shares under the May 2001 authorization since fiscal 2002.

On December 22, 2004, we completed the sale and partial leaseback of our corporate headquarters facility in Westchester, New York. Under the agreement, we received $49 in cash and will receive an additional $10 on the second anniversary of closing. The gain of $25, based on total consideration, was deferred and is being amortized over the initial 20-year lease term as a reduction in rent expense. During the lease term, we will make annual minimum lease payments of approximately $3, subject to increases every five years based on changes in the Consumer Price Index. In addition, we have leased additional space for three years in this facility at an annual cost of $1.

We believe that our liquidity, capital resources, cash flows and borrowing capacity are sufficient to fund normal capital expenditures, working capital requirements, the payment of dividends, debt service and the implementation of our strategic initiatives.

CONTRACTUAL OBLIGATIONS AND COMMITMENTS
(includes forward-looking information)

For information regarding debt and other obligations, including lease commitments and contingencies, see Note 6, Goodwill and Other Intangible Assets, Net; Note 11, Debt; and Note 13, Commitments and Contingencies, in our Notes to Consolidated Financial Statements.

In the normal course of business, we enter into long-term arrangements with suppliers for raw materials and merchandise and with other parties whose recordings or works we use in our products. These arrangements may contain minimum purchase requirements. We enter into these agreements to facilitate an adequate supply of materials and to enable us to develop better products for sale to our customers. The table below details our significant contractual obligations and the timing of payments due for those contracts with minimum purchase requirements.

Contractual Obligations	Less than one year	One to three years	Three to five years	More than five years
Debt obligations:				
Senior Notes[1]	—	—	300	—
2005 Revolving Credit facility[2]	—	—	395	—
Lease commitments:				
Operating leases	25	41	31	75
Purchase commitments:				
World's Finest Chocolate[3]	56	131	138	778
Royalty contracts	2	2	1	1
Pension and postretirement obligations[4]	60	121	124	322
Service and outsource contracts[5]	12	15	5	—
Total	**$155**	**$310**	**$994**	**$1,176**

(1) *In the third quarter of 2004, we issued 6½% Senior Notes in a private placement. We used the proceeds from this offering to refinance amounts outstanding under the Term Loan Agreement.*

(2) *This relates to our 2005 Credit Agreement, which we entered on April 14, 2005 and amended on April 19, 2006. See Note 11, Debt, in our Notes to Consolidated Financial Statements for additional information.*

(3) *In May 2000, QSP, Inc. entered into a licensing agreement with World's Finest Chocolate, Inc. to obtain the exclusive right to distribute World's Finest Chocolate products for fundraising purposes. This agreement has been amended several times, notably in 2003 when it was amended and extended. The commitments detailed above represent our minimum purchase requirements of chocolate products from fiscal 2007 until the agreement terminates in calendar 2020. During the fourth quarter of 2006, we determined that it was probable that we will not meet the calendar year 2006 minimum tonnage purchase commitment under this agreement.*

Accordingly, the fiscal 2007 purchase commitment in this table reflects lower purchases and the resulting $(6) charge. See Note 6, Goodwill and Other Intangible Assets, Net, in our Notes to Consolidated Financial Statements for additional information.

(4) *This item includes payments that are expected to be made for pension and postretirement benefits. Amounts in the "More than five years" category only include projected payments from fiscal 2012 through fiscal 2016. See Note 8, Pension Plans and Other Postretirement Benefits, in our Notes to Consolidated Financial Statements for additional information.*

(5) *This item includes a number of service contracts, such as product fulfillment agreements and information technology license and maintenance agreements. These contracts terminate at varying dates ranging from fiscal 2007 through fiscal 2010.*

FISCAL 2006 OUTLOOK
(includes forward-looking information)

During 2006, we launched a new three-year plan, shifting our focus from stabilization to sustainable, top- and bottom-line growth by (1) diversifying the core business, (2) deepening customer relationships and (3) leveraging our global scale. We made significant strides toward this goal as gains were driven both by contributions from established businesses, reflecting a more stable active customer base, and by contributions from new businesses.

In fiscal 2007, we expect to grow both revenues and profits in our reportable segments, principally driven by:

- Accelerating growth from newly launched initiatives including businesses in new international markets, the magazine *Every Day with Rachael Ray* and Taste of Home Entertaining.
- Further strengthening Reader's Digest North America, Reader's Digest International and QSP.
- Returning Books Are Fun to profitability through a five-part plan that includes new management, cost reduction, strengthening the sales force, focusing on the core book and gift businesses, and improving the business model. The goals of the plan are to maintain and expand Books Are Fun's leading position in the display marketing business, improve operating profit margins and position the business for long-term revenue growth.
- Expanding our digital presence by integrating our existing food and Web activities with *Allrecipes.com,* the recently acquired leading home cooks website.

We expect these efforts will result in fiscal 2007 financial results as follows:

- Total company revenues to grow mid-single digits.
- Total company profitability to improve significantly, although partially offset by increased legal expenses, as we move our Books Are Fun lawsuits to trial, and the absence of certain gains recorded in 2006, including the reversal of a legal accrual and lower management compensation.
- Earnings per share in the range of $0.88 to $0.98 per share, excluding restructuring charges and other items that cannot be forecasted at this time.

We expect year-over-year revenues to grow in each of the four quarters and operating profits to grow in every quarter, except the first quarter, when operating losses will increase significantly because of increased investment spending and a planned shift in the timing of customer-acquisition marketing activities.

CRITICAL ACCOUNTING POLICIES
(includes forward-looking information)

Our significant accounting policies are more fully described in Note 1, Organization and Summary of Significant Accounting Policies, in our Notes to Consolidated Financial Statements. The accounting policies described below are those that we believe are critical to an understanding of our financial statements and require management to make significant judgments. These judgments entail estimates and assumptions that are essential to determining the recorded amounts and their impact on our operating results. Due to the uncertainty inherent in these estimates and assumptions, actual results may differ. The determination of the accounting policies that are critical and the assumptions and estimates that we have made have been reviewed and discussed with the Audit Committee of our Board of Directors.

Revenue Recognition

Our primary revenue recognition policies for our key products are described below.

Magazines

Sales of our magazine subscriptions, less estimated cancellations, are deferred and recognized as revenues proportionately over the subscription period. Revenues from sales of magazines through the newsstand are recognized at the issue date, net of an allowance for returns. Advertising revenues are recorded as revenues at the time the advertisements are published, net of discounts and advertising agency commissions.

Sponsor Fundraising Programs

Our sponsor fundraising program business, which operates principally through QSP, Inc., receives its revenues net of amounts due to its sponsors. Accordingly, we present revenues net of sponsors' earnings. Sales of subscriptions to magazines published by other companies and sales of music products are recorded as revenues at the time orders are submitted to the publisher, net of bad debts and remittances to magazine and music publishers.

Books, Display Marketing and Other Products

Revenues are recorded when title passes, net of provisions for estimated returns and bad debts. For our display marketing products, title passes either at the point of sale or at the time of shipment. In certain circumstances, our promotion entitles the customer to a preview period. Revenue generated by these promotions is recognized after the preview period lapses.

The most significant element in our revenue recognition policy is the estimate of returns and bad debts, as noted below.

Estimates of Returns and Bad Debt

Our ability to accurately estimate returns and bad debt is critical in determining the amount of revenue to recognize and of promotion and agent costs to defer. We present our revenues net of an allowance for returns and bad debt.

We estimate returns for all products, as well as cancellations of magazine subscriptions, based on historical data, method of promotion and results of market testing for the products. Reserve levels are adjusted as actual return data is received. On a consolidated basis, our estimates of returns have not differed significantly from actual results.

Estimates of bad debts are prepared using historical data based on the type of product and promotion and the source of customer. We review our bad debt reserves periodically to ensure they are appropriately stated. If actual results differ from our estimates, the reserve is adjusted as actual bad debt data is received. On a consolidated basis, our estimates of bad debts have not differed significantly from actual results.

Revenues for our books and home entertainment and magazine businesses are principally driven by direct mail and, therefore, are the most sensitive to changes in payment rates and returns. Our Consumer Business Services businesses are much less susceptible to changes in payment rates and returns because the businesses in this segment collect most of their cash at the point of sale.

Inventory Valuation

We periodically assess our inventory for obsolescence and to ensure it is recorded at the lower of cost or market value. In estimating the necessary inventory reserve, we forecast demand for products on hand and assess market conditions, including potential usage in future promotions. We also consider the shelf-life of our perishable inventory. Adjustments to inventory reserves are recorded in product, distribution and editorial expenses on the statements of operations.

Throughout the year approximately half of our net inventory relates to Books Are Fun. Because of the nature of the display marketing business model, inventory reserves as a percentage of total inventory at Books Are Fun are lower than in our other businesses. We continually monitor Books Are Fun's reserve levels and recorded a charge of \$(7) in 2006 to lower the value of old and discontinued items.

Inventory for our remaining businesses principally relates to magazine paper and other products. During the last few years, reserve levels have declined for our other businesses because of continued efforts to better manage inventories.

Deferred Promotion Costs and Related Amortization

Promotion costs for our books and home entertaining advertising costs are deferred only if certain criteria are met, including whether the future profit expected to be generated by a promotional campaign is greater than the costs deferred. Estimates of revenues and profits to be generated and of returns are made using historical data based on the type of product, method of promotion and customer targeted. As actual results for a specific promotional campaign are received, the campaign is reassessed. To the extent that capitalized costs of the campaign exceed the profit expected to be generated, the difference is expensed immediately. Amortization related to deferred promotion expenses is included in promotion, marketing and administrative expenses on the statements of operations. On a consolidated basis, our estimates have not differed significantly from actual results.

Pension Assumptions

The calculation of pension income (expense) is based on various actuarial assumptions. We review these assumptions annually, together with actuarial consultants, to determine reasonable rates.

During our periodic review of assumptions used in determining the net pension income (expense) to be recorded in 2006 (our measurement date is March 31 of the previous fiscal year), we examined the assumed long-term rate of return on pension assets and the discount rate. Currently, the long-term rate of return on pension assets is the most significant factor in determining our net pension income (expense). The assumed long-term rate of return on pension assets represents the rate of return we expect our pension assets to earn over an extended time horizon. Accordingly, significant changes in this rate due to short-term fluctuations in market conditions are not appropriate.

In 2006 and 2005, our assumed long-term rate of return on pension assets, used to determine net pension income for our over-funded U.S. plan, was 8.5%. Based on our projections and expectations of future performance, we have not changed our long-term rate of return on pension assets for 2007. A 25 basis point decrease in the long-term rate of return on pension assets used for 2006 would have decreased net pension income by \$(2). Because our U.S. Retirement Plan is over-funded, this would not have affected our funding strategy.

In 2006 and 2005, our assumed long-term rate of return on our international pension assets, used to determine the net pension expense, was 6.92%. Based on our projections and expectations of future performance, our long-term rate of return on international pension assets for fiscal 2007 remained flat at 6.94%. A 25 basis point decrease in the weighted average long-term rate of return on pension assets used for 2006 would have increased net pension expense by approximately \$(1).

The discount rate is currently not as significant an assumption in calculating the net pension income or benefit obligation for our U.S. plan because our plan is mature and includes a significant number of retirees who are currently receiving benefits. Accordingly, the period over which the obligation is discounted is much smaller than it would be for other employers' plans. In both 2006 and 2005, the discount rate used to determine the pension income for our U.S. plans was 5.75%. Our discount rate for the 2007 pension income will increase to 6.0%. A 25 basis point decrease in the discount rate would decrease pension income by \$(1). The discount rate is matched to yield curves reflective of the cash flows of our plan and also compared to indices of high-quality long-term corporate bonds of the appropriate duration.

For the international plans, the discount rate used to determine the pension expense was 5.36% and 5.50% in 2006 and 2005, respectively. The weighted average discount rate projected for pension expense in 2007 is expected to decrease to 4.92%. This is primarily driven by the decrease in rates of high-quality long-term corporate bonds in the United Kingdom. A 25 basis point decrease in the discount rate would have increased our 2006 pension expense by approximately \$(1). The discount rates are generally set by reference to yields of high-quality long-term corporate bonds of the appropriate duration.

Income and expenses associated with our pension plans are included in promotion, marketing and administrative expenses on the statements of operations. Impacts on respective countries vary depending on the nature of each individual plan.

Restructuring Charges

We establish restructuring accruals for severance costs, contract terminations and asset impairments as a result of costs incurred to streamline our organization and reposition certain businesses.

Restructuring charges are recorded in accordance with Financial Accounting Standards (SFAS) No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." This statement requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred, as opposed to when management is committed to an exit plan. Such liabilities are recorded based on their fair value, as defined. The provisions of this statement apply to all costs accrued related to restructuring activities, including one-time severance benefits. However, because our severance benefits are not considered one-time, we recognize these benefits under the provisions of SFAS No. 112, "Employers' Accounting for Postemployment Benefits," and SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits" (the impact of pension curtailments and settlements that are directly attributable to our restructuring actions were recorded in accordance with SFAS No. 88). As such, amounts for severance are recognized when a termination plan is developed and approved and when payment is probable and estimable. We review our restructuring plans periodically to determine the appropriateness of existing accruals and the accrual levels are adjusted accordingly. Restructuring charges for all other types of costs, such as contract terminations, are recorded in accordance with SFAS No. 146. Asset impairments are calculated in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

The impact of restructuring charges is recorded in other operating items, net on the statements of operations. See Note 3, Other Operating Items, Net, in our Notes to Consolidated Financial Statements for further information.

Long-Lived Assets

Goodwill and intangible assets with indefinite lives are assessed for impairment annually, or on an interim basis if indicators of impairment are present. These assessments, which require a great deal of judgment, involve management's estimates of future cash flows, market trends and other factors. If goodwill and intangibles with indefinite lives are determined to be impaired, a loss is recorded.

Management's estimates of future cash flows take into consideration market trends and our internal projections of performance relative to other constraints, including the efficiency and effectiveness of sales channels and potential changes in market penetration. External factors, such as competition and the health of regional economies, must also be considered. Although these factors are critical to assessing impairment, estimates of fair value are also sensitive to small changes in profit margins and discount rates.

Intangible assets with finite lives must be assessed for impairment whenever changes in circumstances indicate that the assets may be impaired. We assess recoverability by comparing the asset's carrying amount to the undiscounted future net cash flows expected to be generated by the asset. To the extent the carrying value of the asset exceeds its future cash flows, an impairment loss is recorded based on the fair value of the asset. Impairments are recorded in other operating items, net on the statements of operations. See Note 6, Goodwill and Other Intangible Assets, Net, in our Notes to Consolidated Financial Statements for further information.

In addition to the above, property, plant and equipment is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of that asset may not be recoverable in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." We assess recoverability by comparing the asset's carrying amount to the undiscounted future net cash flows expected to be generated by the asset. If we determine that the asset is impaired, the impairment recognized is the amount by which the carrying amount of the asset exceeds the fair value of the asset. Impairments are recorded in other operating items, net on the statements of operations. See Note 3, Other Operating Items, Net, in our Notes to Consolidated Financial Statements for further information.

Income Taxes

Income taxes are accounted for in accordance with SFAS No. 109, "Accounting for Income Taxes," which requires that deferred tax assets and liabilities be recognized, using enacted tax rates, for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. Deferred tax assets, including foreign tax credits and net operating losses, are reduced by a valuation allowance if it is "more likely than not" that some portion or all of the deferred tax assets will not be realized.

We are subject to tax in a number of locations, including many state and foreign jurisdictions. As might be expected, significant judgment is required when calculating our world-wide provision for income taxes. Because of this uncertainty, we establish consolidated tax liabilities based on an estimate of whether it is likely that additional taxes and interest will be due. In some cases, many years may elapse before an audit is completed with respect to items for which an accrual has been established. As settlements are reached, we adjust the corresponding accruals, if required, in the period in which the final determination is made.

Stock Compensation

In accordance with SFAS No. 123R, "Share Based Payment," compensation cost recognized in 2006 is measured using the fair-value method. The fair value of options granted are estimated on the date of their grant using the Black-Scholes option-pricing model. This model uses various weighted average assumptions including risk-free interest rates, expected life, expected volatility and expected dividend yield.

The risk-free interest rate for the periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. In 2005 and 2004, the expected life was based on historical exercises and terminations. Due to the insignificant number of stock option exercises during the past three fiscal years, in 2006 we have estimated the expected life of options granted to be the midpoint between the average vesting term and the contractual term. The expected volatility for the periods with the expected life of the option is determined using historical volatilities based on historical closing stock prices. The expected dividend yield is based on our annual dividend in relation to our historical average stock price. The increase in the dividend yield is attributed to the increased quarterly dividend beginning February 15, 2005.

See Note 9, Employee Equity Compensation Plans, in our Notes to Consolidated Financial Statements for further information.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
(includes forward-looking information)

The functional currency for our foreign operations is the local currency. In the normal course of business, significantly all of the transactions of our foreign operations occur in the local currency. We purchase forward contracts to minimize the effect of fluctuating currencies on specifically identifiable transactions. These transactions were minimal in 2006, 2005 and 2004. Based on our historical experience, we expect the foreign exchange gains and losses over the next year to be minimal.

Interest expense related to our 2005 Credit Agreement is sensitive to changes in the general level of U.S. interest rates. Based on our average debt outstanding under this agreement over the past twelve months, a 1% change in the interest rate charged on these borrowings would have affected our 2006 interest expense by $4.

Additional information is available in Note 7, Financial Instruments, in our Notes to Consolidated Financial Statements.

RECENT ACCOUNTING STANDARDS
(includes forward-looking information)

In June 2006, the FASB issued FASB Interpretation 48, "Accounting for Uncertainty in Income Taxes – an Interpretation of SFAS 109" (FIN 48). FIN 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on derecognition and measurement of tax positions. Disclosure requirements under this guidance will include a rollforward of the beginning and ending unrecognized tax benefits as well as specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within a year. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are still evaluating the impact of this standard on our financial statements.

THE READER'S DIGEST ASSOCIATION, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

In millions, except per share data	Years ended June 30, 2006	2005	2004
Revenues	**$ 2,386.2**	**$ 2,389.7**	**$ 2,388.5**
Product, distribution and editorial expenses	**(997.1)**	(970.9)	(972.9)
Promotion, marketing and administrative expenses	**(1,240.0)**	(1,337.5)	(1,294.5)
Goodwill charge	**(187.8)**	(129.0)	—
Other operating items, net	**(6.8)**	14.1	(8.8)
Operating (loss) profit	**(45.5)**	**(33.6)**	**112.3**
Other (expense) income, net	**(41.1)**	(45.8)	(46.2)
(Loss) income before provision for income taxes	**(86.6)**	**(79.4)**	**66.1**
Income tax provision	**(30.8)**	(11.5)	(16.6)
Net (loss) income	**$ (117.4)**	**$ (90.9)**	**$ 49.5**
Basic and diluted (loss) earnings per share			
Basic (loss) earnings per share			
Weighted average common shares outstanding	**95.9**	97.4	97.1
Basic (loss) earnings per share	**$ (1.24)**	**$ (0.95)**	**$ 0.50**
Diluted (loss) earnings per share			
Adjusted weighted average common shares outstanding	**95.9**	97.4	99.2
Diluted (loss) earnings per share	**$ (1.24)**	**$ (0.95)**	**$ 0.49**
Dividends per common share	**$ 0.40**	**$ 0.30**	**$ 0.20**

See accompanying Notes to Consolidated Financial Statements.

THE READER'S DIGEST ASSOCIATION, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

In millions, except share data	At June 30, 2006	2005
Assets		
Current assets		
Cash and cash equivalents	**$ 34.7**	$ 37.7
Accounts receivable, net	**261.9**	233.9
Inventories	**172.3**	162.4
Prepaid and deferred promotion costs	**62.3**	53.8
Prepaid expenses and other current assets	**173.1**	144.9
Total current assets	**704.3**	**632.7**
Property, plant and equipment, net	**119.3**	119.3
Goodwill	**744.1**	880.9
Other intangible assets, net	**134.4**	137.8
Prepaid pension assets	**324.6**	307.9
Other noncurrent assets	**95.4**	102.0
Total assets	**$ 2,122.1**	**$ 2,180.6**
Liabilities and stockholders' equity		
Current liabilities		
Accounts payable	**$ 128.2**	$ 109.8
Accrued expenses	**257.3**	267.4
Income taxes payable	**40.6**	34.5
Unearned revenues	**394.1**	395.5
Other current liabilities	**9.8**	12.4
Total current liabilities	**830.0**	**819.6**
Long-term debt	**695.0**	559.2
Unearned revenues	**131.2**	133.0
Accrued pension	**108.7**	121.5
Postretirement and postemployment benefits other than pensions	**94.2**	96.7
Other noncurrent liabilities	**87.9**	84.4
Total liabilities	**$ 1,947.0**	**$ 1,814.4**
Commitments and contingencies (Notes 6, 11 and 13)		
Stockholders' equity		
Preferred stock	**28.8**	28.8
Common stock (par value $0.01 per share; authorized 200,000,000 shares; 145,922,062 issued in 2006 and 2005; 95,047,776 and 99,256,958 outstanding in 2006 and 2005, respectively)	**1.5**	1.5
Unamortized restricted stock	**—**	(9.1)
Paid-in capital	**208.1**	206.8
Retained earnings	**1,064.3**	1,221.6
Accumulated other comprehensive loss	**(67.4)**	(84.1)
Treasury stock, at cost (50,874,286 and 46,665,104 shares in 2006 and 2005, respectively)	**(1,060.2)**	(999.3)
Total stockholders' equity	**175.1**	**366.2**
Total liabilities and stockholders' equity	**$ 2,122.1**	**$ 2,180.6**

See accompanying Notes to Consolidated Financial Statements.

THE READER'S DIGEST ASSOCIATION, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

	Years ended June 30,		
In millions	**2006**	**2005**	**2004**
Cash flows from operating activities			
Net (loss) income	**$(117.4)**	$ (90.9)	$ 49.5
Depreciation and amortization	**36.8**	56.9	63.2
Magazine deferred promotion charge	**—**	—	27.2
Asset impairments	**190.6**	129.0	1.1
Amortization of debt issue costs	**1.5**	10.3	12.1
Stock-based compensation	**14.3**	11.2	10.2
Net gain on sales of long-term assets	**(4.1)**	(14.3)	(10.0)
Changes in assets and liabilities, net of effects of acquisitions and dispositions			
Accounts receivable, net	**(19.1)**	3.6	34.1
Inventories	**(7.8)**	(7.7)	6.4
Prepaid and deferred promotion costs (including the amortization of previously deferred promotion costs)	**(7.5)**	54.0	0.7
Other assets	**(25.7)**	13.6	4.3
Unearned revenues	**(9.2)**	(9.0)	(12.7)
Income and deferred taxes, net	**(0.3)**	0.1	1.6
Accounts payable and accrued expenses	**1.9**	(7.1)	(6.8)
Other liabilities	**(6.3)**	(10.7)	(6.5)
Net change in cash due to operating activities	**47.7**	**139.0**	**174.4**
Cash flows from investing activities			
Proceeds from sales of other long-term assets	**0.9**	6.7	3.8
Proceeds from sales of property, plant and equipment	**3.7**	62.8	7.1
Purchase of *Allrecipes.com*, net of cash acquired	**(65.9)**	—	—
Purchases of intangible assets	**(0.5)**	—	(1.3)
Capital expenditures	**(19.9)**	(23.5)	(16.1)
Net change in cash due to investing activities	**(81.7)**	**46.0**	**(6.5)**
Cash flows from financing activities			
Proceeds / (repayments) from borrowings, net	**135.8**	214.6	43.9
Proceeds from Senior Notes offering	**—**	—	300.0
Repayments of term loan	**—**	(377.0)	(488.4)
Cash paid for financing fees	**(0.3)**	(2.2)	(7.6)
Proceeds from employee stock purchase plan and exercise of stock options	**2.2**	3.3	2.5
Dividends paid	**(39.9)**	(30.5)	(20.7)
Treasury stock repurchases	**(65.2)**	(5.0)	—
Other, net	**(3.7)**	(3.0)	0.5
Net change in cash due to financing activities	**28.9**	**(199.8)**	**(169.8)**
Effect of exchange rate fluctuations on cash and cash equivalents	**2.1**	**2.2**	**0.9**
Net change in cash and cash equivalents	**(3.0)**	**(12.6)**	**(1.0)**
Cash and cash equivalents at beginning of year	**37.7**	50.3	51.3
Cash and cash equivalents at end of year	**$ 34.7**	**$ 37.7**	**$ 50.3**
Supplemental information			
Cash paid for interest	**$ 38.7**	$ 36.8	$ 34.2
Cash paid for income taxes	**$ 34.1**	$ 21.2	$ 28.7

See accompanying Notes to Consolidated Financial Statements.

THE READER'S DIGEST ASSOCIATION, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Stockholder's Equity

In millions	Capital Stock: Preferred Stock	Capital Stock: Common Stock	Capital Stock: Unamortized Restricted Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Treasury Stock, at Cost	Total
Balance at June 30, 2003	**$28.8**	**$1.5**	**$ (12.7)**	**$215.0**	**$ 1,314.2**	**$ (109.2)**	**$ (1,024.7)**	**$412.9**
Comprehensive income								
Net income					49.5			**49.5**
Other comprehensive income:								
Translation gain						5.8		**5.8**
Net unrealized gain on investments, net of deferred taxes of $(0.1)						0.2		**0.2**
Reclassification adjustments for investment gains that are included in net income, net of deferred taxes of $0.3						(0.5)		**(0.5)**
Net realized loss on derivatives, net of nominal deferred taxes						(0.1)		**(0.1)**
Reclassification adjustments for derivative losses that are included in net income, net of deferred taxes of $(0.5)						0.9		**0.9**
Minimum pension liability, net of deferred taxes of $(7.7)						13.5		**13.5**
Total comprehensive income								**69.3**
Stock issued under various plans			0.2	(4.9)			18.9	**14.2**
Common Stock dividends					(19.4)			**(19.4)**
Preferred Stock dividends					(1.3)			**(1.3)**
Balance at June 30, 2004	**$28.8**	**$1.5**	**$ (12.5)**	**$210.1**	**$ 1,343.0**	**$ (89.4)**	**$ (1,005.8)**	**$475.7**

THE READER'S DIGEST ASSOCIATION, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Stockholder's Equity

In millions	Capital Stock: Preferred Stock	Capital Stock: Common Stock	Capital Stock: Unamortized Restricted Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Treasury Stock, at Cost	Total
Balance at June 30, 2004	**$28.8**	**$1.5**	**$ (12.5)**	**$210.1**	**$ 1,343.0**	**$ (89.4)**	**$(1,005.8)**	**$ 475.7**
Comprehensive loss								
Net loss					(90.9)			**(90.9)**
Other comprehensive income:								
Translation gain						8.1		**8.1**
Reclassification adjustments for derivative losses that are included in net income, net of nominal deferred taxes						0.5		**0.5**
Minimum pension liability, net of deferred taxes of $1.9						(3.3)		**(3.3)**
Total comprehensive loss								**(85.6)**
Stock issued under various plans			3.4	(3.3)			13.5	**13.6**
Common Stock repurchased							(7.0)	**(7.0)**
Common Stock dividends					(29.2)			**(29.2)**
Preferred Stock dividends					(1.3)			**(1.3)**
Balance at June 30, 2005	**$28.8**	**$1.5**	**$ (9.1)**	**$206.8**	**$ 1,221.6**	**$ (84.1)**	**$ (999.3)**	**$ 366.2**
Comprehensive loss								
Net loss								
Other comprehensive income:					(117.4)			**(117.4)**
Translation gain						9.4		**9.4**
Minimum pension liability, net of deferred taxes of $(3.7)						7.3		**7.3**
Total comprehensive loss								**(100.7)**
Reclassification of Unamortized Restricted Stock to Paid-In Capital			9.1	(9.1)				**—**
Stock issued under various plans				10.4			2.3	**12.7**
Common Stock repurchased							(63.2)	**(63.2)**
Common Stock dividends					(38.6)			**(38.6)**
Preferred Stock dividends					(1.3)			**(1.3)**
Balance at June 30, 2006	**$28.8**	**$1.5**	**$ —**	**$208.1**	**$ 1,064.3**	**$ (67.4)**	**$(1,060.2)**	**$ 175.1**

Accumulated Other Comprehensive Loss, net of tax, is comprised of foreign currency translation adjustments of ($31.8), ($42.5) and ($50.6) at June 30, 2006, 2005 and 2004 respectively; minimum pension liabilities of ($35.6), ($41.6) and ($38.3) at June 30, 2006, 2005 and 2004, respectively; and unrealized losses on derivatives of ($0.5) at December 31, 2004.

See accompanying Notes to Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Unless otherwise indicated, references in Notes to Consolidated Financial Statements to "we," "our" and "us" are to The Reader's Digest Association, Inc. and its subsidiaries. All references to 2006, 2005 and 2004, unless otherwise indicated, are to fiscal 2006, fiscal 2005 and fiscal 2004, respectively. Our fiscal year represents the period from July 1 through June 30.

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Our Business

We are a diversified media company that produces and distributes books, magazines and other products worldwide. We sell these and other products through direct marketing and direct sales channels. Our best known trademark is our flagship magazine, *Reader's Digest*. We conduct business through three reportable segments: Reader's Digest North America, Reader's Digest International and Consumer Business Services. For further commentary regarding these segments, see Management's Discussion and Analysis and Note 14, Segments.

Basis of Presentation and Use of Estimates

The accompanying consolidated financial statements include the accounts of The Reader's Digest Association, Inc. and its majority-owned subsidiaries. Intercompany transactions and accounts have been eliminated in consolidation. These financial statements are prepared in conformity with U.S. generally accepted accounting principles, which require management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of operating revenues and expenses during the reporting period. These estimates are based on management's knowledge of current events and actions that we may undertake in the future; however, actual results may ultimately differ from those estimates. The primary estimates underlying our consolidated financial statements include allowances for returns and doubtful accounts, valuations of inventories, recoverability of direct response advertising and subscriber acquisition costs, recoverability of goodwill and other intangible assets, income taxes, estimates of pension, postemployment and postretirement benefits and valuations of our stock options.

Concentrations of Credit Risk

Financial instruments that potentially expose us to concentrations of credit risk consist primarily of trade accounts receivable. However, we believe our concentrations of credit risk with respect to trade receivables are limited due to our large number of customers, their low individual dollar balances and their dispersion across many different geographic and economic environments.

Cash and Cash Equivalents

We consider all highly liquid investments with original maturities of three months or less at the date of purchase to be cash equivalents. The carrying amount approximates fair value based upon the short-term maturity of these investments.

Inventories

Inventories consist primarily of finished goods and raw materials (including paper) and are stated at the lower of cost or market value. For all inventories, cost is determined using the weighted average cost method, which approximates the first-in, first-out (FIFO) method.

Long-Lived Assets

Property, Plant and Equipment, Net

Assets that comprise property, plant and equipment, net are stated at cost less accumulated depreciation and amortization. Depreciation expense is generally calculated on a straight-line basis over the estimated useful lives of the assets: 10–40 years for buildings; 3–10 years for equipment, furniture and fixtures; and 5 years for software. Leasehold improvements are amortized on a straight-line basis over the initial term of the lease or the useful life of the improvement, whichever is shorter.

Goodwill and Other Intangible Assets, Net

Goodwill comprises the excess of costs over the fair value of net assets of acquired businesses. Other intangible assets, net comprises licensing agreements, customer lists, tradenames and other items. Acquired intangibles with finite lives are amortized, on a straight-line basis, over their estimated useful lives. See Note 6, Goodwill and Other Intangible Assets, Net, for additional information.

Impairment of Long-Lived Assets

We review for recoverability, at least annually, the carrying amount of goodwill and intangibles with indefinite lives. This assessment involves comparing the fair value of the reporting unit or asset, as applicable, to its carrying value. Recognition of the impairment, if any, is determined in accordance with the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets." See Note 6, Goodwill and Other Intangible Assets, Net, for additional information.

Intangible assets with finite lives and property, plant and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of that asset may not be recoverable in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." We assess recoverability by comparing the asset's carrying amount to the undiscounted future net cash flows expected to be generated by the asset. If we determine that the asset is impaired, the impairment recognized is the amount by which the carrying amount of the asset exceeds the fair value of the asset.

Debt Issuance Costs

Debt issuance costs consist of fees and expenses incurred in connection with our borrowings. These fees are amortized over the terms of the related debt agreements, which range from five to seven years. Capitalized debt issuance costs are included in other noncurrent assets on the balance sheets. To the extent we retire a significant portion of our borrowings, a proportionate amount of debt issue costs related to those borrowings is written off.

Stock-Based Compensation

Effective July 1, 2005, we adopted the fair-value recognition provision of SFAS No. 123R, "Share-Based Payment" (SFAS No. 123R) and Securities and Exchange Commission Staff Accounting Bulletin No. 107 (SAB 107), using the modified prospective transition method; therefore prior periods have not been restated. Prior to July 1, 2005, we accounted for stock-based compensation under SFAS No. 123, "Accounting for Stock-Based Compensation" (SFAS No. 123). As permitted by SFAS No. 123, compensation cost was recognized for stock-based compensation using the intrinsic value method under Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees" (APB No. 25). Under this method, compensation cost was the excess, if any, of the quoted market price of the stock at the grant date over the amount an employee must pay to acquire the stock. Since we grant stock options with an exercise price equal to the market price at the date of grant, no compensation cost was recognized. Additional information is presented in Note 9, Employee Equity Compensation Plans.

Financial Instruments

Due to the short-term maturities of our cash, cash equivalents, receivables and payables, the carrying value of these financial instruments approximates their fair values. Due to variable interest rates and current market prices, the fair value of our $500.0 Revolving Credit Agreement and Senior Notes, respectively, approximate their carrying values. See Note 11, Debt, for additional information on our debt instruments.

Pensions and Postretirement Benefits Other Than Pensions

We account for our pension and postretirement benefits in accordance with SFAS No. 87, "Employers' Accounting for Pensions," SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits" and SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." Pursuant to these statements, obligations are determined using actuarial models that incorporate estimates for employee turnover and mortality, increases in employee compensation and healthcare costs, and an employee's age at retirement. These estimates are reviewed annually with actuarial consultants to determine the reasonableness of our assumptions. While these models help determine the obligation, SFAS No. 87 and No.106 attempt to match recognition of the obligation with the period over which our employees earn benefits. Because employees earn benefits over many years of service, the accounting rules require the recognition of certain events (including plan amendments and certain gains and losses) over multiple years rather than the year the event occurs. This principle also applies to recognition of the expected return on plan assets. Although the rate represents our expectation of the long-term performance of our asset portfolio, performance will likely vary in the short term. We amortize the difference between the actual and expected return on assets over a five-year period. Income and expenses associated with our pension plans are included in promotion, marketing and administrative expenses on the statements of operations.

In addition, pursuant to SFAS No. 87, we recognize a minimum pension liability in certain instances where the plan's accumulated benefit obligation as of our measurement date, March 31, exceeds the fair value of plan assets. This amount is adjusted based on whether we have a net pension asset or liability. The minimum pension liability, as adjusted, is included in the accrued pension caption on our balance sheets. The offset is first applied to any unrecognized prior service cost and the remainder is included in accumulated other comprehensive loss in stockholders' equity on our balance sheets.

Revenues

Magazines

Sales of our magazine subscriptions, less estimated cancellations, are deferred and recognized as revenues proportionately over the subscription period. Revenues from sales of magazines through the newsstand are recognized at the issue date, net of an allowance for returns. Advertising revenues are recorded as revenues at the time the advertisements are published, net of discounts and advertising agency commissions.

Sponsor Fundraising Programs

Our sponsor fundraising program business, which operates principally through QSP, Inc., receives its revenues net of amounts due to its sponsors. Accordingly, we present revenues net of sponsors' earnings. Sales of subscriptions to magazines published by other companies and sales of music products are recorded as revenues at the time orders are submitted to the publisher, net of bad debts and remittances to magazine and music publishers.

Books, Display Marketing and Other Products

Revenues are recorded when title passes, net of provisions for estimated returns and bad debts. For our display marketing products, title passes either at the point of sale or at the time of shipment. In certain circumstances, our promotion entitles the customer to a preview period. Revenue generated by these promotions is recognized after the preview period lapses.

When we recognize revenues for most of our products, we also record an estimate of bad debts and returns. These estimates are based on historical data and the method of promotion. Reserve levels are adjusted as actual data is received. In the direct marketing business, returns and bad debts are tied to customer responses to our promotional efforts. Accordingly, we deduct estimates of returns and bad debts from gross revenue.

Shipping and Handling

Costs for shipping products to customers and the associated handling costs are expensed as incurred and are included in product, distribution and editorial expenses on the statements of operations.

In certain circumstances, shipping and handling costs are billed to the customer. These billings are recognized in revenue.

Promotion Costs

Non-direct advertising, including internal advertising costs and market testing and fulfillment costs, are expensed as incurred.

Direct response advertising consists primarily of promotion costs incurred, such as paper and postage, in connection with the sale of magazine subscriptions, books and other products. We account for costs of direct response advertising under the American Institute of Certified Public Accountants Statement of Position (SOP) 93-7, "Reporting on Advertising Costs." Under SOP 93-7, costs associated with direct response advertising that can be directly linked to eliciting sales and result in probable future benefits are capitalized on a cost-pool-by-cost-pool basis. Books and home entertainment advertising costs are amortized over a period that is generally less than one year. We assess the carrying amount of our capitalized direct response advertising costs for recoverability on a periodic basis. Magazine related direct response advertising costs are expensed when the related promotion is mailed.

During the fourth quarter of 2004, we reassessed our accounting for magazine promotion costs in response to changes in our business, as well as the strategies and initiatives being undertaken by our magazine business. As a result of these changes and pursuant to SOP 93-7, effective July 1, 2004, we began expensing magazine deferred promotion costs when the promotion is mailed to prospective customers instead of deferring and amortizing such costs. As of June 30, 2004, we recorded a pre-tax charge of $(27.2) to reflect the impact of this change in circumstances on our existing asset. The remaining balance of $(77.1) was amortized in 2005, over the initial subscription period, generally one year. These amounts are included as a component of promotion, marketing and administration expenses on the statements of operations.

Promotion expense, which consists of both amortization of promotion costs and costs expensed as incurred, included on the statements of operations totaled $(700.7) in 2006; $(724.7) in 2005, including $(77.1) related to previously deferred magazine promotion costs; and $(678.5) in 2004, including $(27.2) related to our magazine deferred promotion charge. Prepaid and deferred promotion costs included on the balance sheets were $62.3 and $53.8 as of June 30, 2006 and 2005, respectively.

Commissions earned by agents for new magazine subscribers are included in promotion, marketing and administrative expenses on the statements of operations. These costs are deferred and amortized over the related subscription term, typically one to three years. Amounts deferred and included in prepaid expenses and other current assets on the balance sheets were $21.7 and $22.7 as of June 30, 2006 and 2005, respectively. Amounts included in other noncurrent assets on the balance sheets were $25.5 and $25.8 as of June 30, 2006 and 2005, respectively.

Income Taxes

Income taxes are accounted for under the provisions of SFAS No. 109, "Accounting for Income Taxes." In accordance with SFAS No. 109, deferred income taxes, net of valuation allowances, reflect the future tax consequences of differences between the financial statement and tax bases of assets and liabilities. These deferred taxes are calculated by applying currently enacted tax rates. Valuation allowances are recorded when it is "more likely than not" that a deferred tax asset will not be realized.

Basic and Diluted (Loss) Earnings Per Share

Basic (loss) earnings per share is computed by dividing net (loss) income less preferred stock dividend requirements ($1.3 for each of 2006, 2005 and 2004) by the weighted average number of shares of Common Stock outstanding during the year.

Diluted earnings per share is computed in the same manner except that the weighted average number of shares of Common Stock outstanding assumes the exercise and conversion of certain stock options and vesting of certain restricted stock. For the years ended June 30, 2006 and 2005, 14.4 million and 15.2 million stock options and shares of restricted stock outstanding, respectively, were excluded from the diluted-loss per share calculations since the effect of including them would have been anti-dilutive. Accordingly, our diluted loss per share for these years is calculated using the basic weighted average number of common shares outstanding.

For 2004, the assumed exercise and conversion of stock options and vesting of restricted stock were 2.2 million shares. In addition, stock options to purchase approximately 10.8 million shares of Common Stock that were outstanding during 2004 were not included in the computation of diluted earnings per share since the effect of including these options would have been anti-dilutive.

Foreign Currency Translation

The functional currency for our foreign operations is the local currency. Revenues and expenses denominated in foreign currencies are translated at average monthly exchange rates prevailing during the year. The assets and liabilities of international subsidiaries are translated into U.S. dollars at the rates of exchange in effect at the balance sheet date. The resulting translation adjustment is reflected as a separate component of stockholders' equity in accumulated other comprehensive (loss) income.

Recent Accounting Standards

In June 2006, the FASB issued FASB Interpretation 48, "Accounting for Uncertainty in Income Taxes – an Interpretation of SFAS 109" (FIN 48). FIN 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on derecognition and measurement of tax positions. Disclosure requirements under this guidance will include a rollforward of the beginning and ending unrecognized tax benefits as well as specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within a year. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are still evaluating the impact of this standard on our consolidated financial statements.

Reclassifications and Prior Period Adjustment

Certain reclassifications have been made to amounts in prior periods to conform to the current period presentation.

During the fourth quarter of 2005, we recorded an adjustment of $12.6, net of deferred taxes of $7.8, to retained earnings as of the earliest period presented. The adjustment reduced an over accrual for certain long-term employee-related liabilities which should have been adjusted in a period prior to fiscal 2001. The adjustment has been considered immaterial for all periods and has no impact on the statements of operations or the statements of cash flows for the periods presented.

NOTE 2 ACQUISITIONS

On April 20, 2006, we purchased 100% of the outstanding stock of *Allrecipes.com* for $66.5, net of cash acquired of $2.5. Included in the purchase price is $5.3 of consideration held in escrow to indemnify us for any potential breaches of the purchase agreement. This amount is expected to be released from escrow by the first half of fiscal 2008. *Allrecipes.com* is an online community food and cooking website that leverages an active and growing network of home cooks to generate revenue from advertising sponsorships and retail licensing. This acquisition provides us with a digital platform to further leverage our food and cooking titles. This synergy resulted in $50.5 of goodwill, which is not deductible for tax purposes.

The acquisition was accounted for using the purchase method of accounting. *Allrecipes.com* operating results have been included in our consolidated financial statements since April 20, 2006 as part of our Reader's Digest North America reportable segment. Pro forma results of operations, as if the *Allrecipes.com* acquisition had been made as of July 1, 2004, were not presented due to immateriality.

Acquired identified finite-lived intangibles, totaling \$8.3, are comprised of: licenses, advertising relationships, non-compete agreements, website content and developed technologies. These intangible assets are amortized over their estimated useful lives, with a weighted-average amortization period of 5.3 years. The acquired tradename is considered an indefinite-lived intangible asset. The following table represents the fair values of assets acquired and liabilities assumed at the date of acquisition:

	Amortization Life (in years)	Fair Market Value
Identified finite-lived intangible assets:		
Licenses	3	\$ 1.3
Advertising relationships	4	1.9
Non-compete agreements	2	0.1
Website content	10	2.1
Developed technology	4	2.9
Indefinite-lived tradename		3.6
Goodwill		50.5
Other net assets acquired		4.1
Total purchase price net of cash acquired		**\$ 66.5**

NOTE 3 OTHER OPERATING ITEMS, NET

Items included in Other Operating Items, Net consist of: 1) gains from the sales of certain non-strategic assets and 2) restructuring charges, representing the streamlining of our organizational structure and the strategic repositioning of our businesses, including associated asset impairments.

Gains from the sales of certain non-strategic assets for the years ended June 30, 2006, 2005 and 2004 were \$3.4, \$14.1 and \$6.2, respectively. Gains in 2006 included \$2.5 from the sale of our building in Mexico and \$0.5 from the sale of certain fine art. Gains in 2005 included \$7.0 from the sale of our buildings in Australia and Portugal, \$3.0 from the sale of *Moneywise* magazine in the United Kingdom and *Crafting Traditions* magazine in the United States, \$3.2 from the sales of certain fine art and \$1.0 from the sale of other non-strategic assets. Gains in 2004 included \$6.1 from the sale of our building in Hong Kong.

Restructuring charges are recorded in accordance with SFAS No. 146, “Accounting for Costs Associated with Exit or Disposal Activities.” Under SFAS No. 146, costs associated with restructuring actions, including one-time severance benefits, are only recorded once a liability has been incurred. SFAS No. 146 does not consider severance benefits determined pursuant to an existing formula as one-time benefits. As our severance programs do not qualify as one-time benefits, we recognize severance amounts pursuant to SFAS No. 112, “Employers’ Accounting for Postemployment Benefits” and SFAS No. 88, “Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits” (the impact of pension curtailments and settlements that are directly attributable to our restructuring actions are recorded in accordance with SFAS No. 88). Severance charges represent the cost to separate employees from our operations to streamline the organization. The separation is accomplished through a combination of voluntary and involuntary severance programs. As such, severance amounts are recorded when a termination plan is developed and approved, including the identification of positions to be separated, and when payment is probable and estimable. Other amounts related to restructuring actions, including charges to terminate contractual obligations in connection with streamlining activities, are recorded in accordance with SFAS No. 146. Asset impairments related to the carrying value of certain long-lived assets are calculated in accordance with the provisions of SFAS No. 144.

We recorded restructuring charges on the statements of operations of \$(10.2) in 2006 and \$(15.0) in 2004. In certain instances, circumstances arose that resulted in decisions to retain employees previously identified for termination, and in certain other instances the costs associated with actions identified were settled for less than originally anticipated. In these instances, the associated charges were reversed.

The table below outlines the activity related to the restructuring actions recorded in 2006 and previous years.

Initial year of charge	Balance at June 30, 2005	(Adjustments)/ Accruals	Spending	Balance at June 30, 2006
2005 & prior	$10.1	$ (0.8)	$ (6.1)	$ 3.2
2006	—	$ 7.5	$ (1.0)	$ 6.5
Total	$10.1	$ 6.7	$ (7.1)	$ 9.7

During 2006, restructuring activities comprised:

- Charges of \$(2.8) for severance, \$(2.6) for asset impairments, and \$(0.5) for other costs associated with the restructuring plan at Books Are Fun. These charges were taken at Books Are Fun to lower the cost base, upgrade the management team and sales force, and improve the business model. The actions associated with these initiatives are expected to be completed by the end of fiscal 2007. Asset impairment charges were primarily attributed to write-offs of capitalized software costs related to abandoned assets. The remaining costs are those incurred to close the Books Are Fun jewelry business and to terminate contractual lease obligations.
- Charges of \$(3.5) for severance, \$(0.2) for asset impairments, and \$(1.4) in other costs to lower our cost base commensurate with our current revenues and in an effort to streamline our operations. Approximately 29%, 54% and 17% of these costs related to Reader's Digest North America, Reader's Digest International and Consumer Business Services, respectively. These actions will be completed by the end of fiscal 2007.
- Income of \$(0.8) related to reversals, primarily of severance, of charges recorded in previous years. We review our restructuring plans periodically to determine the appropriateness of existing accruals in light of current circumstances. Accordingly, these charges were reversed because of the occurrence of events that affected our original plans.

During 2005, restructuring activities comprised:

- Charges of \$(3.6), primarily related to severance costs. These charges were taken to lower our cost base in commensuration with our current revenues and in an effort to streamline our operations. These severance costs, related to the termination of positions, were substantially completed by June 30, 2006, and of which 48% were located in Reader's Digest North America, 22% were located in Reader's Digest International, 20% were located in Consumer Business Services and 10% related to Corporate.
- Income of \$3.6 related to reversals, primarily severance, of charges recorded in previous years. We review our restructuring plans periodically to determine the appropriateness of existing accruals in light of current circumstances. Accordingly, these charges, principally consisting of severance, were reversed because of the occurrence of events that affected our original plans.

During 2004, restructuring activities comprised:

- Charges of \$(13.7) for severance and \$(4.3) for contract terminations, asset impairments and costs associated with closing our Norway location. The severance charges related to streamlining operations in certain international markets and corporate departments. As a result of these actions, the employees were severed by June 30, 2006, of which 50% were located in Reader's Digest North America, 39% were located in Reader's Digest International and 11% related to Corporate.
- Income of \$1.3 related to pension curtailments as a result of employee terminations.
- These charges were partially offset by \$1.7 of reversals of charges recorded in previous periods that are no longer necessary. We review our restructuring plans periodically to determine the appropriateness of existing accruals in light of current circumstances. Accordingly, these charges, principally consisting of severance, were reversed because of the occurrence of events that affected our original plans.

NOTE 4 OTHER (EXPENSE) INCOME, NET

	2006	2005	2004
Interest income	**$ 6.9**	$ 7.4	$ 5.2
Interest expense[1]	**(47.9)**	(53.6)	(55.0)
Net gain on the sales of certain investments[2]	**—**	—	3.8
Net (loss) gain on foreign exchange	**(0.5)**	—	(0.1)
Other (expense) income, net	**0.4**	0.4	(0.1)
Total other (expense) income, net	**$ (41.1)**	**$ (45.8)**	**$ (46.2)**

(1) *In connection with the termination of the 2002 Credit Agreements, interest expense in 2005 included $(7.3) related to the expensing of the associated capitalized financing fees and the discontinuance of the related interest rate protection agreements. Interest expense in 2004 included $(7.3) related to the expensing of deferred financing fees because we refinanced a portion of our existing indebtedness, terminated some of our interest rate caps and repriced a portion of our borrowings. See Note 11, Debt, for additional information.*

(2) *Net gain on the sales of certain investments in 2004 included proceeds of $2.7 received in exchange for our interest in Schoolpop, Inc., which merged into an unrelated third party. This item also included sales of our shares in LookSmart, Ltd. of $0.8 in 2004.*

NOTE 5 SUPPLEMENTAL BALANCE SHEET INFORMATION

The components of certain balance sheet accounts as of June 30 are as follows:

Accounts Receivable, Net

	2006	2005
Gross accounts receivable, trade	**$ 422.4**	**$ 401.3**
Beginning reserve for returns	**(69.3)**	(56.3)
Additions to allowances[1]	**(417.7)**	(387.3)
Actual returns[2]	**424.9**	374.3
Ending reserve for returns	**(62.1)**	**(69.3)**
Beginning reserve for bad debts	**(98.1)**	(98.1)
Additions to allowances[1]	**(100.4)**	(97.0)
Actual bad debts[2]	**100.1**	97.0
Ending reserve for bad debts	**(98.4)**	**(98.1)**
Ending reserve for returns and bad debts	**(160.5)**	**(167.4)**
Accounts receivable, net	**$ 261.9**	**$ 233.9**

(1) *Additions to allowances represent estimated reserves established at the time of revenue recognition for returns and bad debts in accordance with SFAS No. 48, "Revenue Recognition When Right of Return Exists." Amounts are recorded as an offset to revenues.*

(2) *Actual returns and bad debts include actual experience during the period and the effects of foreign currency translation.*

Inventories

	2006	2005
Raw materials	**$ 12.8**	$ 11.9
Work in process	**7.2**	5.6
Finished goods	**195.6**	188.4
Gross inventory	**215.6**	**205.9**
Beginning inventory reserve	**(43.5)**	(42.7)
Additions to reserve	**(10.7)**	(7.5)
Inventory write-offs	**10.9**	6.7
Ending inventory reserve	**(43.3)**	(43.5)
Inventories, net	**$172.3**	**$162.4**

Property, Plant and Equipment, Net

	2006	2005
Land	**$ 10.0**	$ 10.1
Buildings and building improvements	**87.3**	85.2
Furniture, fixtures and equipment	**89.9**	97.2
Software	**75.9**	67.9
Leasehold improvements	**25.6**	19.6
	288.7	**280.0**
Accumulated depreciation and amortization*	**(169.4)**	(160.7)
Total property, plant and equipment, net	**$ 119.3**	**$ 119.3**

* *Depreciation and amortization expense related to property, plant and equipment amounted to $20.3, $20.0 and $23.6 for the years ended June 30, 2006, 2005 and 2004, respectively.*

Other Noncurrent Assets

	2006	2005
Deferred tax assets	**$ 46.2**	$ 39.4
Other, principally operating assets	**49.2**	62.6
Total other noncurrent assets	**$ 95.4**	**$ 102.0**

Accrued Expenses

	2006	2005
Compensation and other employee benefits	**$ 71.1**	$ 80.5
Royalties and copyrights payable	**14.0**	16.6
Taxes, other than income taxes	**8.2**	7.3
Accrued interest	**11.6**	9.0
Other operating items, net (see Note 3)	**9.7**	10.1
Other, principally operating expenses	**142.7**	143.9
Total accrued expenses	**$ 257.3**	**$ 267.4**

Other Noncurrent Liabilities

	2006	2005
Deferred tax liabilities	**$ 11.6**	$ 8.0
Deferred gain related to our Westchester, NY facility sale and leaseback (see Note 13)	**21.6**	22.8
Other, principally operating liabilities	**54.7**	53.6
Total other noncurrent liabilities	**$ 87.9**	**$ 84.4**

NOTE 6 GOODWILL AND OTHER INTANGIBLE ASSETS, NET

The changes in the carrying amount of goodwill by reportable segment for the fiscal year ended June 30, 2006 are as follows:

	Reader's Digest North America	Consumer Business Services	Total
Balance as of June 30, 2005	**$ 687.5**	**$ 193.4**	**$ 880.9**
Additions as a result of the *Allrecipes.com* acquisition (see Note 2)	50.5	—	**50.5**
Impact of foreign currency translation on goodwill balances outside the United States	—	0.5	**0.5**
Goodwill charge	—	(187.8)	**(187.8)**
Balance as of June 30, 2006	**$ 738.0**	**$ 6.1**	**$ 744.1**

At least annually (in the third quarter), we review the carrying amount of goodwill and other intangibles with indefinite lives in our reporting units for recoverability. Reiman and Books Are Fun are our primary reporting units in Reader's Digest North America and Consumer Business Services, respectively. In interim periods, we continually monitor changes in our businesses for indicators of impairment. Due to the shortfall in Books Are Fun's operating performance relative to our expectations during our peak selling season, we were required to review goodwill balances related to this business in the second quarter of 2006. The decline in performance was attributed to competitive pressure on margin and turnover of independent sales representatives. Based on our assessment, Books Are Fun recorded a charge of $(187.8) in the second quarter of 2006 to write off its remaining goodwill. During our annual review in 2005, we also recorded a goodwill charge of $(129.0). The fair value of Books Are Fun was determined by a third-party appraiser using a combination of discounted net cash flows and an assessment of comparable companies in the marketplace. The annual recoverability tests for the other reporting units were performed during the third quarter and we determined that no other goodwill and intangible losses have occurred.

The following categories of acquired intangible assets are included in other intangible assets, net as of June 30, 2006 and 2005:

	2006		2005	
	Gross	Net	Gross	Net
Intangible assets with indefinite lives:				
Tradenames	**$ 93.3**	**$ 93.3**	$ 89.7	$ 89.7
Intangible assets with finite lives:				
Licensing agreements	**60.0**	**28.2**	57.3	31.9
Customer lists	**138.3**	**6.1**	137.8	16.2
Other intangibles, including tradenames and noncompete agreements	**9.2**	**6.8**	3.0	—
Total intangible assets	**$300.8**	**$134.4**	$287.8	$137.8

Amortization related to intangible assets with finite lives amounted to $(16.5), $(36.9) and $(39.6) for the years ended June 30, 2006, 2005 and 2004, respectively. The remaining weighted average amortization period of our intangible assets is 3.1 years. Our World's Finest Chocolate licensing agreement (detailed below) is principally amortized over the initial 10-year contract term, with a portion being amortized over the remaining 15-year term of our amended agreement. Customer lists are being amortized principally between three and six years from the date of acquisition. Our most significant customer list intangible was purchased as part of the Reiman acquisition, which will be fully amortized over the next two years. See Note 2, Acquisitions, for details on the intangibles acquired as part of the *Allrecipes.com* acquisition.

Estimated fiscal year amortization expense for intangible assets with finite lives is as follows: fiscal 2007 – $12.7; fiscal 2008 – $8.2; fiscal 2009 – $7.6; fiscal 2010 – $7.0 and fiscal 2011 – $1.1.

Licensing Agreement

In May 2000, QSP, Inc. entered into a long-term licensing agreement with World's Finest Chocolate, Inc. The cost associated with the agreement was assigned to licensing agreements and is included in other intangible assets, net on the balance sheets. In September 2002, this agreement was amended to extend the term of the original agreement by 10 years, reduce the annual minimum tonnage purchase requirements, favorably adjust pricing and permit QSP to sell World's Finest Chocolate products through marketing channels other than fundraising, under specified circumstances. The cost associated with the agreement was assigned to licensing agreements and is included in other intangible assets, net on the balance sheets. Amounts paid to amend the agreement have been assigned to various amortization periods ranging from 5 to 15 years (the remaining period of the amended agreement). This asset will be substantially amortized by 2010.

The approximate annual minimum purchase amounts and related charges under the amended agreement by calendar year are: 2005 – $58.8; 2006 – $51.5; 2007 – $64.4; 2008 – $66.0; 2009 – $67.6; and approximately $78.7 per year from 2010 through 2020. These amounts are estimates based on defined minimum tonnage requirements, as stipulated in the amended agreement, and nominal price increases. During the fourth quarter of 2006, we determined that it was probable that we will not meet the calendar 2006 minimum tonnage purchase commitment under this agreement and, accordingly, recorded a charge of $(5.6). In 2005, we met the minimum purchase requirement under this agreement. However, in 2004, we did not meet the minimum purchase requirements and, accordingly, recorded a charge of $(0.8).

NOTE 7 FINANCIAL INSTRUMENTS

Risk Management and Objectives

The functional currency for our foreign operations is the local currency. In the normal course of business, substantially all of the transactions of our foreign operations occur in the local currency. We purchase forward contracts to minimize the effect of fluctuating currencies on specifically identifiable transactions. These transactions were minimal in 2006, 2005 and 2004.

As a matter of policy, we do not speculate in financial markets and, therefore, we do not hold financial instruments for trading purposes. We continually monitor foreign currency risk and our use of derivative instruments.

Derivative Instruments

Cash Flow Hedges – There were no material cash flow hedges as of June 30, 2006 or June 30, 2005. In 2004, we terminated our interest rate caps with a notional value of $250.0 and recognized the remaining unrealized loss on those instruments, $(1.3), in interest expense. In addition, in the fourth quarter of 2005, we terminated our 2002 Credit Agreements. As a result, we terminated our remaining interest rate caps with a notional value of $150.0 and recognized the remaining unrealized loss on those instruments, $(0.4) in interest expense.

As of June 30, 2004, the fair values of our interest rate caps were largely unchanged. For 2004, the fair value of our interest rate caps decreased, resulting in a loss of $(0.1), net of deferred taxes of zero. This change is reported in accumulated other comprehensive (loss) income, which is included in stockholders' equity on the balance sheets. The unrealized gains and losses were deferred and recognized in earnings when the related interest expense was recognized.

NOTE 8 PENSION PLANS AND OTHER POSTRETIREMENT BENEFITS

Defined Benefit Pension Plans

We offer defined benefit plans for all of our eligible employees in the United States and in several international markets. Our measurement date for these plans is March 31. Contributions to these plans meet the minimum funding requirements in each respective market. Benefit payments are principally based on a combination of years of service and compensation.

U.S. Plans

In the U.S. we maintain funded and unfunded defined benefit plans. The Reader's Digest Association, Inc. Retirement Plan (Retirement Plan) is our largest plan. It comprises almost 84% of our total U.S. benefit obligation and all of our U.S. plan assets.

Because the Retirement Plan is over-funded, we have not made any contributions in 2006, 2005 or 2004, nor do we expect to make any contributions in fiscal 2007.

Our unfunded plans were established for certain officers. Since these plans are only available to certain executives, they are not qualified under the Internal Revenue Code (IRC). We fund the benefit payments under these plans as they arise.

The overriding principle followed in managing our Retirement Plan assets is to obtain a reasonable rate of return in terms of both income and appreciation, consistent with the "Prudent Man" Rule of the Employee Retirement Income Security Act of 1974 (ERISA), while providing liquidity to satisfy short-term obligations.

The table below details our current and target asset allocation as of our measurement date.

Asset Class	Actual Allocation as of March 31, 2006	2005	Target Allocation Range
Equities	**69%**	68%	52% – 72%
Fixed income	**24%**	26%	23% – 35%
Other	**7%**	6%	0% – 19%
Total	**100%**	**100%**	

Equities include companies with both large and small market capitalizations, as well as listed companies in international markets. Our allocation tends to be heavily weighted in favor of large capitalized companies. More than half of the Retirement Plan's funds are invested in equity markets because these investments tend to provide better returns and offer some protection from inflation. Fixed income securities are included in the portfolio to protect the Retirement Plan's assets from inflation and to preserve capital. Other assets, including private equity and real estate investments, are utilized to a small extent to take advantage of investments that provide higher returns. The Retirement Plan allows investment managers to invest in derivative instruments, provided that certain criteria specified in the plan's investment policy are satisfied.

The expected rate of return on plan assets is a significant driver in calculating our net pension (benefit) cost. In order to calculate our 2006 and 2005 (benefit) cost, we used an expected return on plan assets of 8.50%. This rate was based on an analysis of historical returns generated by asset classes in which our funds are invested and on projected returns for portfolios with assets similar to ours.

Estimated benefit payments during the next 10 years are expected to be, by fiscal year: 2007 – $42.2; 2008 – $41.9; 2009 – $42.7; 2010 – $45.0; 2011 – $41.9 and from 2012 to 2016 – a total of $221.5.

International Plans

We also offer defined benefit pension plans in several markets outside the United States. For the material plans, in fiscal 2007, we expect to contribute $8.8.

The table below reflects the actual allocation of assets held for our international plans and the allocation required pursuant to our most recent investment policy for these plans. These percentages have been calculated on a weighted average basis because the assets comprised several plans.

Asset Class	Actual Allocation as of March 31, 2006	2005	Target Allocation
Equities	**68%**	64%	61%
Fixed income	**32%**	36%	39%
Total	**100%**	**100%**	

Similar to the U.S. plans, the expected rate of return on plan assets is a significant driver in calculating the net pension (benefit) cost for our international plans. In order to calculate our 2006, 2005 and 2004 expense, we used a return on plan assets of 6.92%, 6.92% and 6.77%, respectively. These rates were based on a methodology similar to that used to determine the rate of return for our Retirement Plan.

Estimated benefit payments during the next 10 years are expected to be, by fiscal year: 2007 – $11.8; 2008 – $11.8; 2009 – $13.0; 2010 – $12.7; 2011 – $13.2 and from 2012 to 2016 – a total of $75.7.

Assumptions

The table below outlines the weighted average assumptions used to determine our projected benefit obligation as of year-end and pension (benefit) cost for the fiscal year for:

U.S. plans:

Benefit obligation	**2006**	**2005**	**2004**
Discount rate	**6.00%**	5.75%	5.75%
Compensation increase rate	**4.00%**	4.00%	4.50%
Pension (benefit) cost			
Discount rate	**5.75%**	5.75%	6.25%
Compensation increase rate	**4.00%**	4.50%	4.50%
Long-term rate of return on plan assets	**8.50%**	8.50%	8.75%

International plans:

Benefit obligation	**2006**	**2005**	**2004**
Discount rate	**4.92%**	5.36%	5.50%
Compensation increase rate	**3.80%**	3.66%	3.70%
Pension (benefit) cost			
Discount rate	**5.36%**	5.50%	5.58%
Compensation increase rate	**3.66%**	3.70%	3.63%
Long-term rate of return on plan assets	**6.92%**	6.92%	6.77%

Components of net periodic pension (benefit) cost are as follows:

	U.S. Plans		
	2006	**2005**	**2004**
Service cost	**$ 10.2**	$ 11.2	$ 11.3
Interest cost	**29.7**	29.7	31.4
Expected return on plan assets	**(52.2)**	(55.0)	(50.1)
Amortization	**(0.7)**	(0.7)	(0.7)
Recognized actuarial loss	**4.2**	1.0	2.1
Net periodic pension (benefit) cost	**$ (8.8)**	**$(13.8)**	**$ (6.0)**

	International Plans		
	2006	**2005**	**2004**
Service cost	**$ 6.2**	$ 7.5	$ 7.4
Interest cost	**14.7**	14.8	13.4
Expected return on plan assets	**(16.8)**	(17.3)	(14.0)
Amortization	**(0.4)**	(0.4)	(0.5)
Recognized actuarial loss	**2.9**	2.2	3.1
Settlements	**(0.6)**	0.6	(1.5)
Curtailments and other items	**(0.4)**	(0.1)	0.4
Net periodic pension (benefit) cost	**$ 5.6**	**$ 7.3**	**$ 8.3**

A reconciliation of the beginning and ending balances of benefit obligations and fair value of plan assets and the funded status of the defined benefit pension plans is as follows:

	U.S. Plans		International Plans	
	2006	**2005**	**2006**	**2005**
Change in benefit obligation:				
Benefit obligation at beginning of year	**$540.6**	$542.0	**$279.7**	$267.4
Service cost	**10.2**	11.2	**6.2**	7.5
Interest cost	**29.7**	29.7	**14.7**	14.8
Participant contributions	**—**	—	**1.4**	2.0
Actuarial loss	**(10.7)**	1.1	**33.0**	8.3
Exchange rate changes	**—**	—	**13.7**	(0.6)
Settlements	**—**	—	**(4.3)**	(6.8)
Benefits paid	**(42.1)**	(43.4)	**(12.1)**	(12.9)
Benefit obligation at end of year	**527.7**	**540.6**	**332.3**	**279.7**
Change in plan assets:				
Fair value at beginning of year	**635.3**	626.4	**237.3**	221.5
Actual return on plan assets	**85.1**	44.8	**51.7**	20.8
Employer contribution	**7.9**	7.5	**6.1**	10.6
Participant contributions	**—**	—	**1.4**	2.0
Exchange rate changes	**—**	—	**13.5**	2.1
Settlements	**—**	—	**(4.3)**	(6.8)
Benefits paid	**(42.1)**	(43.4)	**(12.1)**	(12.9)
Fair value at end of year	**686.2**	**635.3**	**293.6**	**237.3**
Funded status	**158.5**	94.7	**(38.7)**	(42.4)
Unrecognized actuarial loss	**63.4**	111.0	**83.0**	83.5
Unrecognized transition (asset) obligation	**—**	—	**(1.0)**	(1.3)
Unrecognized prior service cost	**(4.0)**	(4.6)	**(3.5)**	(3.3)
Employer – fourth quarter contribution	**1.8**	1.9	**1.8**	1.7
Net amount recognized	**$219.7**	**$203.0**	**$ 41.6**	**$ 38.2**

The accumulated benefit obligation (the actuarial present value of benefits earned, excluding future compensation increase assumptions) for our U.S. plans was $519.7 and $531.6 as of June 30, 2006 and 2005, respectively. The accumulated benefit obligation for our international plans was $296.1 and $247.6 as of June 30, 2006 and 2005, respectively.

Other Postretirement Benefits

We provide medical and dental benefits to certain retired employees and their dependents. The plans that provide these benefits cover all of our eligible employees in the United States who were hired before July 1, 2005 and, to a lesser extent, employees in Canada.

The table below outlines the weighted average assumptions used to determine our postretirement benefit obligation as of year-end and our postretirement cost for the fiscal year:

	2006	2005	2004
Postretirement benefit obligation			
Discount rate	**6.00%**	5.75%	5.75%
Healthcare cost trend rate assumed for next year	**8.90%**	10.00%	11.50%
Rate to which the cost trend rate is assumed to decline	**5.00%**	5.00%	5.00%
Number of years to ultimate trend rate	**7**	8	9
Postretirement cost			
Discount rate	**5.75%**	5.75%	6.19%
Healthcare cost trend rate assumed for next year	**10.00%**	11.50%	13.00%
Rate to which the cost trend rate is assumed to decline	**5.00%**	5.00%	5.00%
Number of years to ultimate trend rate	**8**	9	10

Components of net periodic postretirement (benefit) cost are as follows:

	2006	2005	2004
Service cost	**$ 0.7**	$ 1.1	$ 1.3
Interest cost	**4.3**	5.1	6.0
Amortization	**(2.8)**	(1.8)	(1.0)
Net periodic postretirement (benefit) cost	**$ 2.2**	**$ 4.4**	**$ 6.3**

A reconciliation of the beginning and ending balances of benefit obligations and fair value of plan assets and the funded status of the plans is as follows:

	2006	2005
Change in benefit obligation:		
Benefit obligation at beginning of year	**$ 88.7**	$ $92.1
Service cost	**0.7**	1.1
Interest cost	**4.3**	5.1
Actuarial (gain)	**(12.6)**	(4.5)
Plan amendments	**(11.4)**	—
Exchange rate changes	**0.2**	0.2
Benefits paid	**(5.1)**	(5.3)
Benefit obligation at end of year	**64.8**	**88.7**
Change in plan assets:		
Fair value at beginning of year	**—**	—
Employer contribution	**5.1**	5.3
Benefits paid	**(5.1)**	(5.3)
Fair value at end of year	**—**	**—**
Funded status	**(64.8)**	(88.7)
Unrecognized actuarial gain	**(18.6)**	(5.9)
Unrecognized transition obligation	**0.5**	0.5
Unrecognized prior service cost	**(16.5)**	(8.0)
Employer contributions in the fourth quarter	**1.5**	1.2
Net amount recognized	**$(97.9)**	**$(100.9)**

On May 19, 2004, the FASB issued FSP 106-2 "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003" which supersedes FSP 106-1 "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003," which was issued on January 12, 2004. This guidance relates to the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Medicare Reform Act) signed into law on December 8, 2003. The Medicare Reform Act introduced a prescription drug benefit under Medicare Part D (Part D) and a federal subsidy for sponsors of retiree healthcare benefit plans that provide a benefit that is at least "actuarially equivalent" to Part D. Based on the level of benefits provided under our retiree healthcare plan, the majority of retiree participants are eligible to receive benefits that are at least "actuarially equivalent" to those provided by Part D. Therefore, as of our March 31, 2004 measurement date, we reflected an $11.2 benefit as an unrecognized actuarial gain. This gain will be amortized as a component of net periodic postretirement cost over ten years.

Assumed healthcare cost trend rates have a significant effect on the amounts reported for postretirement benefits. A one-percentage-point increase in assumed healthcare cost trend rates would increase the total of the service and interest cost components by $0.4 and the postretirement benefit obligation by $5.9 for the year ended June 30, 2006. A one-percentage-point decrease in assumed healthcare cost trend rates would decrease the total of the service and interest cost components by $(0.4) and the postretirement benefit obligation by $(5.1) for the year ended June 30, 2006.

Estimated benefit payments during the next 10 years are expected to be, by fiscal year: 2007 – $6.5; 2008 – $6.5; 2009 – $6.5; 2010 – $6.5; 2011 – $6.5; and from 2012 to 2016 – a total of $30.0. Estimated receipts pursuant to the Medicare Reform Act during the next 10 years are expected to be, by fiscal year: 2007 – $0.7; 2008 – $0.8; 2009 – $0.8; 2010 – $0.9; 2011 – $0.9; and from 2012 to 2016 – a total of $5.0.

Balance Sheet Classification

Amounts recognized on the balance sheets related to our material pension and postretirement plans are as follows:

	Pension Benefits		Other Benefits	
	2006	**2005**	**2006**	**2005**
Assets	**$ 325.0**	$ 308.0	**$ —**	$ —
Liabilities	**(114.9)**	(127.0)	**(97.9)**	(100.9)
Accumulated other comprehensive income	**51.2**	60.2	**—**	—
Net amount recognized	**$ 261.3**	**$ 241.2**	**$ (97.9)**	**$(100.9)**

Balances of pension plans with projected and accumulated benefit obligations in excess of the fair value of plan assets are as follows:

	Plans with Projected Benefit Obligations in Excess of Plan Assets		Plans with Accumulated Benefit Obligations in Excess of Plan Assets	
	2006	**2005**	**2006**	**2005**
Projected benefit obligation	**$370.5**	$325.1	**N/A**	N/A
Accumulated benefit obligation	**N/A**	N/A	**$340.5**	$299.9
Fair value of plan assets	**$222.6**	$172.1	**$222.6**	$172.1

NOTE 9 EMPLOYEE EQUITY COMPENSATION PLANS

We maintain several employee compensation plans relating to stock or stock-based awards, including stock options, restricted stock and phantom stock.

The Compensation and Nominating Committee of the Board of Directors (the Committee) approved the 2005 Key Employee Long-Term Incentive Plan (the 2005 Plan) in August 2005. Under the 2005 Plan, the Committee may grant stock options, stock appreciation rights, restricted stock, restricted stock units, deferred stock, performance units, performance shares and other stock-based awards to eligible employees. The Committee may grant up to a maximum of 2,900,000 underlying shares of Common Stock under the 2005 Plan. In addition, 566,790 underlying shares available for grant under the 2002 Key Employee Long-Term Incentive Plan became available for issuance under the 2005 Plan.

As discussed in Note 1, Organization and Summary of Significant Accounting Policies, effective July 1, 2005, we adopted the fair-value recognition provisions of SFAS No. 123R and SAB 107 using the modified prospective transition method; therefore, prior periods have not been restated. Compensation cost recognized in 2006 includes compensation cost for all share-based payments granted prior to, but not yet vested as of July 1, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and compensation cost for all share-based payments granted subsequent to July 1, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R.

Stock Options

Stock options are granted with exercise prices not less than the fair market value of our Common Stock at the time of the grant and with an exercise term (as determined by the Committee) not to exceed 10 years. The Committee determines the vesting period for our stock options. Generally, such stock options become exercisable equally over four years. Option awards usually provide for accelerated vesting upon retirement, death or disability. In 2006, 2005 and 2004, we granted 1.3 million, 1.9 million and 1.7 million options, respectively.

In accordance with APB No. 25, no stock-based compensation cost related to stock options was recognized in the statements of operations for 2005 and 2004, as all options granted in these periods had an exercise price equal to the market price at the date of grant. As a result of adopting SFAS No. 123R, our loss before taxes and net loss for 2006 are \$(6.6) and \$(4.2) higher, respectively, than if we had continued to account for stock-based compensation under APB No. 25. This resulted in an increase in our reported basic and diluted loss per share of \$(0.04) for 2006. Compensation expense is recognized in the promotion, marketing and administrative expenses line item of our statements of operations on a ratable basis over the vesting periods. There were no capitalized stock-based compensation costs at June 30, 2006. As of June 30, 2006, there was \$6.6 of total unrecognized compensation cost related to nonvested stock options to be recognized over a weighted-average period of 1.2 years.

The intrinsic values of options exercised during 2006 and 2005 were not significant. The total cash received from the exercise of stock options was \$0.7, \$1.0 and zero for 2006, 2005 and 2004, respectively, and is classified as financing cash flows. Shares are issued from treasury stock upon exercise of the options. Prior to the adoption of SFAS No. 123R, we presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the statements of cash flows. SFAS No. 123R requires that cash flows from tax benefits attributable to tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) be classified as financing cash flows. We did not have any excess tax benefits in 2006.

The fair values of the options granted were estimated on the date of their grant using the Black-Scholes option-pricing model on the basis of the following weighted average assumptions:

	2006	**2005**	**2004**
Risk-free interest rate	**4.2 %**	3.4%	3.3%
Expected life	**6.25 years**	4.1 years	4.1 years
Expected volatility	**31.7%**	32.9%	35.7%
Expected dividend yield	**2.6%**	1.2%	1.4%
Weighted-average fair value of options granted	**\$4.39**	\$4.43	\$3.72

The risk-free interest rate for the periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. In 2005 and 2004, the expected life was based on historical exercises and terminations. Due to the insignificant number of stock option exercises during the past three fiscal years, in 2006 we have estimated the expected life of options granted to be the midpoint between the average vesting term and the contractual term. The expected volatility for the periods with the expected life of the option is determined using historical volatilities based on historical closing stock prices. The expected dividend yield is based on our annual dividend in relation to our historical average stock price. The increase in the dividend yield is attributed to the increased quarterly dividend beginning February 15, 2005.

Changes in outstanding options are as follows:

	Options (000's)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (yrs.)	Aggregate Intrinsic Value
Outstanding at June 30, 2003	**12,167**	**$28.10**		
Granted	1,731	$13.42		
Exercised	—	—		
Canceled	(1,416)	$31.21		
Outstanding at June 30, 2004	**12,482**	**$25.66**		
Granted	1,855	$15.74		
Exercised	(66)	$14.59		
Canceled	(1,514)	$30.20		
Outstanding at June 30, 2005	**12,757**	**$23.76**		
Granted	1,337	$15.12		
Exercised	(46)	$14.26		
Canceled	(1,284)	$28.60		
Outstanding at June 30, 2006	**12,764**	**$22.41**	**5.1**	**$0.7**
Options vested or expected to vest at June 30, 2006	**12,380**	**$22.63**	**5.0**	**$0.7**
Options exercisable at June 30, 2006	**9,252**	**$25.19**	**3.9**	**$0.4**
Options available for grant at June 30, 2006	**3,598**			

The table below presents the pro forma effect on net (loss) income and basic and diluted (losses) earnings per share if we had applied the fair-value recognition provision to options granted under our stock option plans in 2005 and 2004. For purposes of this pro forma disclosure, the values of the options are estimated using the Black-Scholes option-pricing model and amortized to expense over the options' vesting periods.

		2005	2004
Net (loss) income	As reported	$(90.9)	$49.5
	Pro forma	$(97.1)	$38.8
(Loss) earnings per share	As reported – basic	$(0.95)	$0.50
	Pro forma – basic	$(1.01)	$0.39
	As reported – diluted	$(0.95)	$0.49
	Pro forma – diluted	$(1.01)	$0.38

For the years ended June 30, 2005 and 2004, $(6.9) and $(6.6), net of tax, respectively, of expenses related to restricted stock and other stock-based compensation are included in our net (loss) income and (loss) earnings per share, as reported.

Restricted and Deferred Stock

Restricted stock are shares of Common Stock that are subject to restrictions on transfer and risk of forfeiture until the fulfillment of specified conditions. In 2005 and 2004, the market value of restricted stock awards on the date of grant was recorded as a reduction of capital stock. In connection with the adoption of SFAS No. 123R in 2006, we reclassified the unamortized restricted stock to paid-in capital. Restricted stock is expensed ratably over the term of the restriction period, ranging from two to four years.

Deferred stock are rights to receive shares of Common Stock upon the fulfillment of specified conditions. We offer deferred stock outside the United States. Deferred stock is similar to restricted stock in all respects, except that deferred stock is issued to the employee at the completion of the vesting period.

We recognized expense for 2006, 2005 and 2004 of $(7.7), $(11.2) and $(10.2), respectively, before taxes of $2.9, $4.2 and $3.8, respectively, for these awards. We granted 102,850 shares, 511,000 shares and 764,300 shares of restricted stock to employees during 2006, 2005 and 2004, respectively. In addition, we granted 71,300 shares, 118,900 shares and 119,400 shares of deferred stock to employees during 2006, 2005 and 2004, respectively.

A summary of the status of our nonvested shares for both restricted and deferred stock as of June 30, 2006 is as follows:

Nonvested Shares	Shares (000's)	Weighted Average Grant Date Fair Value
Nonvested at June 30, 2005	2,416	$15.01
Granted	174	$15.09
Vested*	(810)	$15.58
Forfeitures	(105)	$14.76
Nonvested at June 30, 2006	**1,675**	**$14.76**

* *The shares vested during 2006 include approximately 242,000 shares of our Common Stock surrendered by employees in order to fulfill their tax withholding obligations.*

The fair value of nonvested shares is determined based on the average of the high and low stock price of our Common Stock on the grant date. The weighted-average grant date fair values of nonvested shares granted during 2006, 2005 and 2004 were $15.09, $15.64 and $13.53, respectively. As of June 30, 2006, there was $4.5 of total unrecognized compensation cost related to nonvested restricted and deferred stock arrangements to be recognized over a weighted-average period of 1.5 years.

Performance Shares

Performance shares give the recipients the right to receive cash equal to the value of shares of Common Stock that are earned if specific performance goals are achieved during a specific performance period. Compensation cost related to performance shares is based on management's best estimate as to whether or not the performance criteria will be satisfied and the market price of our shares on the date of the financial statements. This amount is recognized ratably over the performance period. Adjustments based on changes in our estimate of whether the performance criteria will be satisfied and changes in the market value of our shares are recorded in the period in which the change occurs. In 2004, we awarded performance shares for the 2004–2005 performance period. For this performance period, $4.9 was distributed in fiscal 2006. We have recorded $(1.9) and $(3.0) as expense during 2005 and 2004, respectively, for this award.

Restricted Stock Units

A restricted stock unit is the right to receive cash equal to the value of a share of Common Stock upon the fulfillment of specified conditions. Compensation cost related to restricted stock units granted in 2006 under the 2005–2007 and 2006–2008 plans are performance based awards. Compensation cost related to these awards is based on management's best estimate as to whether or not the performance criteria will be satisfied and the market price of our shares on the date of the financial statements. This amount is recognized ratably over the performance period. Adjustments based on changes in our estimate of whether the performance criteria will be satisfied and changes in the market value of our shares are recorded in the period in which the change occurs. We granted 973,310 restricted stock units in 2006 for the 2005-2007 and 2006-2008 performance periods. We have recorded $(3.7) and $(2.1) as expense during 2006 and 2005, respectively, for these awards.

Employee Stock Purchase Plans

Under the U.S. Employee Stock Purchase Plan (ESPP), we are authorized to issue up to 2,650,000 shares of Common Stock (330,000 shares per annum), principally to our full-time employees in the United States, nearly all of whom are eligible to participate. Under the terms of the ESPP, employees can choose every six months to have up to 10% of their annual base earnings withheld to purchase Common Stock. Effective July 1, 2005, the purchase price of the shares to 95% of the market price of the stock on the last day of the purchase period. Prior to July 1, 2005, the purchase price of the shares was 85% of the lower of the fair market values of the Common Stock on the first and last days of the six-month purchase period. In 2006, 2005 and 2004 approximately 22%, 27% and 25% of eligible employees participated in the ESPP, respectively.

Several of our international subsidiaries have employee stock purchase plans (international ESPP) under which we are authorized to issue up to 400,000 shares of Common Stock to our full-time employees. The terms of the international ESPP in most locations are essentially the same as the ESPP.

Under the ESPP and the international ESPP, employees purchased 110,663 shares in 2006, 196,707 shares in 2005, and 215,011 shares in 2004

Other Compensation Plans

Employee Ownership Plan and 401(k) Partnership (the 401(k) plan)

The 401(k) plan consists of both a profit-sharing plan and a savings plan under section 401(k) of the IRC. The savings plan component allows employees to make pre-tax contributions to their accounts, which may be invested in specified investment alternatives. We may match employee contributions to the extent determined by our Board of Directors. The matching contributions vest 20% per annum over a five-year period. Our contributions to the 401(k) plan, including matching contributions, were $3.6, $3.5 and $3.9 for 2006, 2005 and 2004, respectively.

NOTE 10 INCOME TAXES

Income (loss) before provision for income taxes is as follows:

	2006	2005	2004
United States	**$(189.1)**	$(176.1)	$33.0
International	**102.5**	96.7	33.1
Income (loss) before provision for income taxes	**$ (86.6)**	**$ (79.4)**	**$66.1**

Components of the provision (benefit) for income taxes attributable to income from operations are as follows:

	2006	2005	2004
Current			
U.S. federal	**$ 4.7**	$ 3.2	$ (9.5)
U.S. state and local	**(0.1)**	1.3	2.2
International	**28.5**	27.2	19.1
Total current	**$33.1**	**31.7**	**11.8**
Deferred			
U.S. federal	**$ (3.8)**	(15.9)	19.9
U.S. state and local	**3.0**	(2.7)	1.4
International	**(1.5)**	(1.6)	(16.5)
Total deferred	**$ (2.3)**	**(20.2)**	**4.8**
Provision for income taxes	**$30.8**	**$ 11.5**	**$ 16.6**

A reconciliation between the statutory U.S. federal income tax rate and the effective income tax rate is as follows:

	2006	2005	2004
U.S. statutory tax rate	35.0%	35.0%	35.0%
International operations	(1.0)	5.0	(11.6)
State taxes	(1.0)	3.8	3.6
Non taxable loss (gain) from disposition of assets	0.6	1.8	(3.2)
Changes in valuation allowance	3.9	(6.1)	7.9
Changes in tax accrual	(0.3)	6.2	(8.0)
Goodwill charge	(75.9)	(56.9)	—
Other operating items	(0.3)	—	0.2
Other	3.3	(3.3)	1.2
Effective tax rate	**(35.7)%**	**(14.5)%**	**25.1%**

Components of deferred tax assets and liabilities are as follows:

	2006	2005
Accounts receivable and other allowances	**$ 56.7**	52.8
Net operating loss carryforwards	**28.0**	26.4
Other operating items	**3.6**	4.7
Tax credit carryforwards	**69.8**	44.7
Deferred gain on sale of buildings	**13.5**	14.6
Other accrued items	**12.8**	14.0
Gross deferred tax assets	**184.4**	157.2
Valuation allowance	**(13.1)**	(17.1)
Total net assets	**171.3**	140.1
Deferred compensation and other employee benefits	**(26.6)**	(18.7)
Deferred promotion	**(11.2)**	(10.3)
Depreciation and amortization	**(37.7)**	(15.4)
Deferred agent commissions	**(17.6)**	(19.0)
Other	**(1.0)**	(2.6)
Total net liabilities	**(94.1)**	(66.0)
Net deferred taxes	**$ 77.2**	**$ 74.1**

Balance sheet classifications of deferred tax assets and liabilities are as follows:

	2006	2005
Prepaid expenses and other current assets	**$ 46.3**	$47.2
Other noncurrent assets	**46.2**	39.4
Other current liabilities	**(3.7)**	(4.5)
Other noncurrent liabilities	**(11.6)**	(8.0)
Net deferred taxes	**$ 77.2**	**$74.1**

We have concluded that it is more likely than not that the results of future operations will generate sufficient taxable income to realize the net deferred tax assets.

Net operating loss carryforwards of $129.8 at June 30, 2006, are available to reduce future tax obligations of certain foreign and U.S. companies. The net operating loss carryforwards have various expiration dates, the earliest being fiscal 2007, and others having indefinite carryforward periods. In addition, foreign tax credits carryforwards amounting to $58.4 and alternative minimum tax credit carryforwards of $7.9 are available as of June 30, 2006. Foreign tax credit carryforwards have various expiration dates beginning in fiscal 2012; alternative minimum tax credit carryforwards have an indefinite life.

Approximately \$3.7 of deferred tax expense and \$1.9 of deferred tax benefit are included as a component of stockholders' equity for 2006 and 2005, respectively.

A provision has not been made for U.S. income taxes and foreign withholding taxes that would be payable if undistributed earnings of the foreign subsidiaries of approximately \$153.9 as of June 30, 2006, were distributed to us in the form of dividends because the company intends to permanently reinvest such foreign earnings. A determination of the amount of the unrecognized deferred tax liability related to undistributed earnings is not practical.

The company is undergoing various federal, foreign, state and local audits. The company has reasonably estimated and appropriately accrued for its probable liabilities.

NOTE 11 DEBT

Our primary debt obligations as of June 30, 2006 are our borrowings under our \$500.0 Five-Year Revolving Credit Agreement (2005 Credit Agreement) and \$300.0 in senior unsecured notes.

2005 Credit Agreement

On April 14, 2005, we entered into a \$400.0 Five-Year Revolving Credit Agreement to retire all outstanding borrowings under our Five-Year Revolving Credit and Competitive Advance Facility Agreement and \$950.0 Term Loan Agreement (collectively referred to as the 2002 Credit Agreements) and for general corporate purposes. Financing fees of \$(1.6) related to the 2005 Credit Agreement were deferred and are amortized on a straight-line basis over the life of the 2005 Credit Agreement. In connection with the termination of the 2002 Credit Agreements, we recorded a write-off of \$(7.3) in the fourth quarter of 2005 related to the associated capitalized financing fees and the discontinuance of the related interest rate protection agreements.

On April 19, 2006, we entered into an amendment to our 2005 Credit Agreement, which increased the aggregate principal amount available to \$500.0, increased the maximum leverage ratio (as defined in the amendment) and increased pricing when the leverage ratio is at higher levels. The interest rate on the 2005 Credit Agreement is currently at LIBOR plus 125 basis points and is subject to change based on our leverage ratio (as defined in the 2005 Credit Agreement). The 2005 Credit Agreement contains financial covenants that require us to maintain minimum interest coverage and maximum leverage ratios, and it is secured by the stock of a substantial portion of our subsidiaries. Financing fees of \$(0.3) related to the amendment to the 2005 Credit Agreement were deferred and are amortized on a straight-line basis over the life of the 2005 Credit Agreement.

Senior Notes

During the third quarter of 2004, we completed a private placement, with registration rights, of \$300.0 of 6½% senior unsecured notes due in 2011 (Senior Notes) in order to refinance amounts outstanding under the \$950.0 Term Loan Agreement. In the fourth quarter of 2004, these notes were exchanged for notes that were registered under the Securities Act of 1933. The proceeds from this offering were used to repay \$294.0 of principal outstanding under the \$950.0 Term Loan Agreement, with the remainder used to pay a portion of the financing costs.

Debt Maturities and Interest Expense

Total debt maturities during the next five years are as follows:

2007	\$ —
2008	—
2009	—
2010	395.0
2011	300.0
Total	**\$695.0**

At June 30, 2006 and 2005, we had borrowings of \$695.0 and \$559.2 outstanding, respectively, which are classified as long-term debt on the balance sheets.

In 2006, 2005 and 2004, we recorded interest expense, net of $(41.0), $(46.2), and $(49.8), respectively. Interest expense in 2005 included the write-off of financing fees of $(6.9) as a result of the termination of the 2002 Credit Agreements as well as the associated discontinuance of the related interest rate protection agreements of $(0.4). Interest expense in 2004 included the write-off of financing fees of $(6.0) as a result of the refinancing and certain other transactions described above and the write-off of $(1.3) related to the termination of some of our interest rate caps that were no longer required (see Note 7, Financial Instruments). The weighted average interest rate on our borrowings charged by our lenders in 2006, 2005 and 2004 was 6.0%, 5.3% and 4.4%, respectively.

Lines of Credit

International lines of credit and overdraft facilities totaled $31.6 at June 30, 2006 and $27.7 at June 30, 2005, of which $13.7 and zero were outstanding at June 30, 2006 and 2005, respectively. These lines of credit are subject to renewal annually.

NOTE 12 CAPITAL STOCK

Preferred stock consists of the following as of June 30:

	2006	2005
First preferred stock,		
par value $1.00 per share;		
authorized 40,000 shares;		
issued and outstanding 29,720 shares	**$ 3.0**	$ 3.0
Second preferred stock,		
par value $1.00 per share;		
authorized 120,000 shares;		
issued and outstanding 103,720 shares	**10.3**	10.3
Third subordinated preferred stock,		
par value $1.00 per share;		
authorized 230,000 shares;		
issued and outstanding 155,022 shares	**15.5**	15.5
Preference stock,		
par value $0.01 per share;		
authorized 25,000,000 shares;		
issued and outstanding none	**—**	—
Total preferred stock	**$28.8**	**$28.8**

All shares of preferred stock have a preference in liquidation of $100.00 per share. The difference between the aggregate par value and liquidation preference has been appropriated from retained earnings and is shown as part of the value of preferred stock. At our option and at any time, all preferred stock is redeemable at $105.00 per share plus accrued dividends. The terms of the first preferred stock and the second preferred stock provide for annual cumulative dividends of $4.00 per share. The terms of the third subordinated preferred stock provide for annual cumulative dividends of $5.00 per share. Preferred stockholders do not have any voting rights.

Share Repurchase Authorization

On April 28, 2005, our Board of Directors authorized our repurchase of up to $100.0 of our Common Stock over the succeeding two years and rescinded its May 2001 authorization to repurchase up to $250.0 of our Common Stock. Under the April 2005 authorization, we repurchased 4.3 million shares for $63.2 in 2006. Since the April 2005 authorization, we repurchased 4.7 million shares for $70.2. We had not repurchased any shares under the May 2001 authorization since fiscal 2002.

NOTE 13 COMMITMENTS AND CONTINGENCIES

General Litigation

From time to time, we are involved in a variety of claims, lawsuits, investigations and proceedings that arise in the ordinary course of business. We cannot predict the ultimate outcome of these matters with certainty. Management believes that the ultimate outcome of these matters will not have a material adverse effect on our financial position or results of operations, although our results and cash flow could be significantly unfavorably affected in the reporting periods in which these matters are resolved.

Supply and Service Agreements

We maintain several long-term agreements with vendors primarily for the purchase of paper, printing and fulfillment services. These agreements expire at various times through fiscal 2010.

In the normal course of business, we enter into long-term arrangements with suppliers for raw materials and merchandise, including our agreement with World's Finest Chocolate (see Note 6, Goodwill and Other Intangible Assets, Net, for additional information), and with other parties whose recordings or works we use in our products. These arrangements may contain minimum purchase requirements. We enter into these agreements to facilitate an adequate supply of materials and to enable us to develop better products for sale to our customers.

Sale and Leaseback

On December 22, 2004, we completed the sale and partial leaseback of our corporate headquarters facility in Westchester, New York. Under the agreement, we received $48.5 in cash and will receive an additional $10.0 on the second anniversary of closing. The gain of $24.7, based on total consideration, was deferred and is being amortized over the initial 20-year lease term as a reduction in rent expense. During the lease term, we will make annual minimum lease payments of approximately $3.1, subject to increases every five years based on changes in the Consumer Price Index. In addition, we have leased additional space for three years in this facility at an annual cost of $0.7.

Lease Obligations

We occupy certain facilities under lease arrangements and lease certain equipment.

Rental expense and sublease income are as follows:

	2006	2005	2004
Rental expense	**$26.1**	$23.6	$18.3
Sublease income	**(5.8)**	(5.5)	(6.2)
Net rental expense	**$20.3**	**$18.1**	**$12.1**

Future minimum rental commitments, net of sublease income, for noncancelable operating leases for the next five fiscal years and thereafter (extending to 2025) are as follows:

	Minimum Rental Payments	Minimum Sublease Income	Net
2007	$ 25.3	$ (6.0)	$19.3
2008	$ 22.6	$ (5.7)	$16.9
2009	$ 18.2	$ (4.9)	$13.3
2010	$ 16.2	$ (2.8)	$13.4
2011	$ 14.6	$ (2.6)	$12.0
Later years	$ 75.1	$ (12.8)	$62.3

NOTE 14 SEGMENTS

Our businesses are structured into the same three reportable segments (Reader's Digest North America, Reader's Digest International and Consumer Business Services) that our chief operating decision maker uses to assess business performance. In addition to the reportable segments, we separately report Corporate Unallocated expenses, which are expenses not directly attributable to business unit performance. Similarly, we separately report the effects of previously deferred magazine promotion expense, goodwill charges and other operating items, net, because our chief operating decision maker does not factor in these items when assessing business unit performance. Here is a brief description of the activities included within our reportable segments.

Reader's Digest North America

This segment comprises our operations in the United States and Canada that publish and market *Reader's Digest* magazine, Reiman magazines and several special interest magazines. It also includes our operations in the United States and Canada that publish and market Books and Home Entertainment products (including Select Editions, Reader's Digest Young Families, music and video products, and series and general books related to the following affinities: reading, home and health, and entertainment) as well as two new businesses, *Allrecipes.com* and Taste of Home Entertaining.

These businesses have a common focus on the direct marketing aspect of new customer acquisition at a minimal cost. The performance of *Reader's Digest* magazine and our special interest magazines is driven primarily by circulation revenues and, secondarily, by advertising sales. Circulation is also the principal driver of performance for Reiman magazines, which have limited advertising revenues. The results of our Books and Home Entertainment business are driven by the size of our active customer base, new customer acquisition programs, response rates to promotional mailings, customer payment rates and membership in our continuity series business.

Reader's Digest International

This segment comprises our operations outside of the United States and Canada, with our most significant markets in the United Kingdom, Germany, Central Europe and France. The businesses in this segment publish and market *Reader's Digest* magazine (in numerous editions and languages) and books and home entertainment products (described above).

The performance of these businesses is driven by factors similar to those in the Reader's Digest North America segment, except that overall results are less sensitive to changes in individual geographic market conditions due to the number of markets in which we operate. The results for *Reader's Digest* magazine in international markets are driven primarily by circulation and secondarily by advertising revenues. The results of our books and home entertainment products in these markets are driven by the size of our active customer base, new customer acquisition programs, response rates to promotional mailings, customer payment rates and membership in our continuity series business.

Consumer Business Services

This segment comprises Books Are Fun, our display marketing business, and QSP, our youth fundraising businesses, in the United States and Canada.

Books Are Fun and QSP principally sell products through non-direct marketing channels, primarily through their sales forces. The performance of these businesses is driven by product selection, the number of accounts or events, the average sales per account or event, and the number of participants in fundraising programs.

Intercompany Eliminations and Corporate Unallocated Expenses

We present our segment revenues and operating (losses) profits consistently with how we manage our operations and how our chief operating decision maker reviews our results. Revenues and expenses attributable to intercompany transactions are included in the results of our reportable segments. Such amounts are eliminated (under the intercompany eliminations caption below) to reconcile our reportable segment amounts to consolidated amounts, as reported in the statements of operations. Accounting policies of our segments are the same as those described in Note 1, Organization and Summary of Significant Accounting Policies. In addition to intercompany revenues and expenses, we separately report Corporate Unallocated expenses, which cover expenses that are not directly attributable to business unit performance. Corporate Unallocated expenses include the cost of governance and other corporate-related expenses, as well as income and expenses associated with our U.S. pension plans and retiree healthcare benefits, and stock and executive compensation programs that are not allocated to the reportable segments.

We evaluate performance and allocate resources based on operating income from continuing operations excluding other operating items and Corporate Unallocated expenses. Identifiable assets by segment are those assets that are used in the operations of that business. Corporate assets consist primarily of cash and cash equivalents, certain prepaid expenses, marketable securities, certain pension assets, certain fixed assets and certain other current assets. Sales are attributed to countries based on selling location. Long-lived assets are primarily: property, plant and equipment, net; intangible assets, net; and prepaid pension benefits.

Reportable Segment Financial Information

	Years ended June 30,		
	2006	**2005**	**2004**
Revenues			
Reader's Digest North America	**$ 939.4**	$ 917.3	$ 919.5
Reader's Digest International	**1,031.2**	1,012.1	969.5
Consumer Business Services	**445.6**	485.1	525.1
Intercompany eliminations	**(30.0)**	(24.8)	(25.6)
Total revenues	**$2,386.2**	**$2,389.7**	**$2,388.5**
Operating (loss) profit			
Reader's Digest North America	**$ 114.5**	$ 90.8	$ 76.0
Reader's Digest International	**78.3**	76.1	57.0
Consumer Business Services	**(2.7)**	29.4	59.0
Previously deferred magazine promotion expense[1]	**—**	(77.1)	(27.2)
Goodwill charge[2]	**(187.8)**	(129.0)	—
Corporate Unallocated	**(41.0)**	(37.9)	(43.7)
Other operating items, net[3]	**(6.8)**	14.1	(8.8)
Total operating (loss) profit	**$ (45.5)**	**$ (33.6)**	**$ 112.3**
Intercompany eliminations			
Reader's Digest North America	**$ (11.3)**	$ (9.2)	$ (11.3)
Reader's Digest International	**(6.3)**	(4.0)	(3.3)
Consumer Business Services	**(12.4)**	(11.6)	(11.0)
Total intercompany eliminations	**$ (30.0)**	**$ (24.8)**	**$ (25.6)**
Assets			
Reader's Digest North America	**$1,172.7**	$1,084.8	$1,178.8
Reader's Digest International	**411.7**	387.8	421.8
Consumer Business Services	**133.0**	326.5	456.2
Corporate	**404.7**	381.5	378.1
Total assets	**$2,122.1**	**$2,180.6**	**$2,434.9**

(1) In connection with our change to expensing magazine deferred promotion costs when the promotion is mailed to prospective customers, our reportable segment operating (loss) profit in 2005 includes such expenses as incurred. Amortization of previously deferred promotion costs in 2005 and our deferred promotion charge recorded in the fourth quarter of 2004 are not included in segment results reviewed by our chief operating decision maker. For the year ended June 30, 2005, 81% of amortization of previously capitalized magazine promotion costs was related to Reader's Digest North America and 19% to Reader's Digest International. For the year ended June 30, 2004, 45% of our magazine deferred promotion charge was related to Reader's Digest North America and 55% to Reader's Digest International.

(2) The goodwill charge related to Books Are Fun, part of the Consumer Business Services reportable segment, is not included in segment results reviewed by our chief operating decision maker. See Note 6, Goodwill and Other Intangible Assets, Net, for additional information.

(3) Other operating items, net consists of gains on sales of certain non-strategic assets, asset impairments and restructuring charges. Such items are not included in segment results reviewed by our chief operating decision maker. See Note 3, Other Operating Items, Net, for further information. In previous periods, gains on sales of certain non-strategic assets were classified as other (expense) income, net, and have been reclassified to other operating items, net to conform to the current year presentation.

In 2006, other operating items, net includes: 1) net restructuring charge of ($7.4), principally comprising severance and contract terminations, attributed: 15% to Reader's Digest North America, 31% to Reader's Digest International and 54% to Consumer Business Services, 2) asset impairments of ($2.8), primarily related to Books Are Fun, and 3) gains of $3.4 related to the sales of certain non-strategic assets.

In 2005, other operating items, net includes gains of $14.1 related to the sales of certain non-strategic assets.

In 2004, other operating items, net includes: 1) a restructuring charge of ($15.0), principally comprising severance and contract terminations, attributed: 12% to Reader's Digest North America, 61% to Reader's Digest International, 22% to Consumer Business Services and 5% to corporate departments that benefit the entire organization, and 2) gains of $6.2 related to the sales of certain non-strategic assets.

	Years ended June 30,		
	2006	**2005**	**2004**
Depreciation, amortization and asset impairments			
Reader's Digest North America	**$ 16.0**	$ 36.5	$39.9
Reader's Digest International	**8.5**	7.3	8.1
Consumer Business Services	**12.0**	9.7	11.5
Goodwill charge	**187.8**	129.0	—
Corporate	**3.1**	3.4	4.8
Total depreciation, amortization and asset impairments	**$227.4**	**$185.9**	**$64.3**
Capital expenditures			
Reader's Digest North America	**$ 3.9**	$ 1.4	$ 1.9
Reader's Digest International	**6.6**	12.9	3.7
Consumer Business Services	**1.9**	1.4	2.2
Corporate	**7.5**	7.8	8.3
Total capital expenditures	**$ 19.9**	**$ 23.5**	**$16.1**

The following table presents our consolidated net revenues by product:

	Years ended June 30,		
	2006	**2005**	**2004**
Revenues			
Books	**$ 955.1**	$ 971.6	$ 968.5
Magazines – subscription and other	**683.7**	689.8	702.7
Magazines – advertising	**158.9**	153.2	150.0
Music and videos	**264.1**	262.7	240.3
Food and gift	**215.1**	215.0	228.7
Other	**109.3**	97.4	98.3
Total revenues	**$2,386.2**	**$2,389.7**	**$2,388.5**

Information about geographic areas is as follows:

	Years ended June 30,		
	2006	**2005**	**2004**
Revenues			
United States	$1,202.6	$1,232.6	$1,291.3
International	1,189.2	1,162.6	1,102.1
Inter-area	(5.6)	(5.5)	(4.9)
Total revenues	**$2,386.2**	**$2,389.7**	**$2,388.5**
Revenues inter-area			
United States	$ (3.5)	$ (3.1)	$ (2.6)
International	(2.1)	(2.4)	(2.3)
Total revenues inter-area	**$ (5.6)**	**$ (5.5)**	**$ (4.9)**
Long-lived assets, net			
United States	$1,309.7	$1,444.6	$1,638.1
International	61.9	63.8	75.3
Total long-lived assets, net	**$1,371.6**	**$1,508.4**	**$1,713.4**

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Stockholders and Board of Directors
The Reader's Digest Association, Inc.

We have audited the accompanying consolidated balance sheet of The Reader's Digest Association, Inc. and subsidiaries as of June 30, 2006, and the related consolidated statements of operations, stockholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of The Reader's Digest Association, Inc. and subsidiaries at June 30, 2006, and the consolidated results of their operations and their cash flows for the year ended June 30, 2006, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of The Reader's Digest Association, Inc.'s internal control over financial reporting as of June 30, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated August 17, 2006 expressed an unqualified opinion thereon.

As discussed in Note 1 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 123(R), effective July 1, 2005.

Ernst & Young LLP

Stamford, Connecticut
August 17, 2006

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Stockholders and Board of Directors
The Reader's Digest Association, Inc.

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that The Reader's Digest Association, Inc. and subsidiaries maintained effective internal control over financial reporting as of June 30, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Reader's Digest Association, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed 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. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that The Reader's Digest Association, Inc. and subsidiaries maintained effective internal control over financial reporting as of June 30, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, The Reader's Digest Association, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of June 30, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of The Reader's Digest Association, Inc. and subsidiaries as of June 30, 2006, and the related consolidated statements of operations, stockholders' equity, and cash flows for the year then ended, and our report dated August 17, 2006 expressed an unqualified opinion on those consolidated financial statements.

Ernst & Young LLP

Stamford, Connecticut
August 17, 2006

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
The Reader's Digest Association, Inc.:

We have audited the accompanying consolidated balance sheet of The Reader's Digest Association, Inc. and subsidiaries as of June 30, 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the years in the two-year period ended June 30, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The Reader's Digest Association, Inc. and subsidiaries as of June 30, 2005, and the results of their operations and their cash flows for each of the years in the two-year period ended June 30, 2005, in conformity with U.S. generally accepted accounting principles.

KPMG LLP

New York, New York
August 30, 2005

REPORT OF MANAGEMENT

MANAGEMENT RESPONSIBILITY FOR FINANCIAL INFORMATION

Management of the company is responsible for the preparation and integrity of the financial statements and the related financial information appearing in this Annual Report. The financial statements were prepared in accordance with accounting principles generally accepted in the United States of America. The financial statements include amounts that are based on management's best estimates and judgment. Financial information in this Annual Report is consistent with that in the financial statements.

Management is responsible for maintaining a system of internal accounting controls and procedures to provide reasonable assurance, at an appropriate cost/benefit relationship, that assets are safeguarded and that transactions are authorized, recorded and reported properly. The system of internal safeguards is characterized by a control oriented environment that includes written policies and procedures, careful selection and training of personnel, and audits by a professional staff of internal auditors.

Ernst & Young LLP, an independent registered public accounting firm, have audited and reported on our financial statements. Their report is also included in this Annual Report.

The Audit Committee of the Board of Directors, composed of independent directors, meets periodically with Ernst & Young LLP, the company's internal auditors and management representatives to review internal control, auditing and financial reporting matters. Both Ernst & Young LLP and the internal auditors have unrestricted access to the Audit Committee and may meet with the Committee with or without management present.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management is responsible for establishing and maintaining adequate internal control over financial reporting of the company as such term is defined in rule 13a-15(f) under the Securities Exchange Act of 1934.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. No evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of the company's management, including the company's principal executive and principal financial officers, the company conducted an assessment of the effectiveness of the company's internal control over financial reporting, based on *Internal Control–Integrated Framework,* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management concluded that the company's internal control over financial reporting was effective as of June 30, 2006.

Management's assessment of the effectiveness of the company's internal control over financial reporting has been audited by Ernst and Young LLP, an independent registered accounting firm, as stated in their report which is included in this Annual Report.

/s/Eric W. Schrier
Chief Executive Officer

/s/Michael S. Geltzeiler
Senior Vice President and Chief Financial Officer

SELECTED FINANCIAL DATA

In millions, except per share data	2006	2005	2004	2003	2002
Statement of Operation Data					
Revenues	**$ 2,386.2**	$ 2,389.7	$ 2,388.5	$ 2,474.9	$ 2,368.6
Operating (loss) profit*	**$ (45.5)**	$ (33.6)	$ 112.3	$ 141.1	$ 157.1
Net (loss) income	**$ (117.4)**	$ (90.9)	$ 49.5	$ 61.3	$ 91.2
Basic and diluted (loss) earnings per share	**$(1.24)/$(1.24)**	$(0.95)/$(0.95)	$0.50/$0.49	$0.61/$0.60	$ 0.90/$0.89
Dividends per common share	**$ 0.40**	$ 0.30	$ 0.20	$ 0.20	$ 0.20
Balance Sheet Data					
Cash and cash equivalents, short-term investments and marketable securities	**$ 34.7**	$ 37.7	$ 50.4	$ 52.1	$ 114.7
Total assets	**$ 2,122.1**	$ 2,180.6	$ 2,434.9	$ 2,591.7	$ 2,684.1
Long-term debt	**$ 695.0**	$ 559.2	$ 637.7	$ 834.7	$ 818.0
Stockholders' equity	**$ 175.1**	$ 366.2	$ 475.7	$ 412.9	$ 484.5
Weighted-average common shares outstanding (basic and diluted)	**95.9/95.9**	97.4/97.4	97.1/99.2	98.1/99.2	100.2/100.6
Book value per common share	**$ 1.84**	$ 3.76	$ 4.90	$ $4.21	$ $4.83

* In previous periods, gains (losses) on sales of certain non-strategic assets were included in other (expense) income, net, and have been reclassified to other operating items, net, to conform to the current period presentation. See Note 3, Other Operating Items, Net, for additional information.

SELECTED QUARTERLY FINANCIAL DATA AND DIVIDEND AND MARKET INFORMATION (UNAUDITED)

In millions, except per share data and shareholder information	Revenues	Operating (Loss) Profit **	Dividends Per Share	Net (Loss) Income Amount	Net (Loss) Income Per Share Basic	Net (Loss) Income Per Share Diluted	Stock Price Range High–Low Common Stock
2006							
First Quarter	**$ 516.4**	**$ (6.8)**	**$0.10**	**$ (8.2)**	**$(0.09)**	**$(0.09)**	**$17.31 – $14.88**
Second Quarter	**765.2**	**(76.2)*** **	**$0.10**	**(122.4)**	**(1.27)**	**(1.27)**	**$16.18 – $13.84**
Third Quarter	**547.4**	**10.0**	**$0.10**	**1.0**	**0.01**	**0.01**	**$16.30 – $14.33**
Fourth Quarter	**557.2**	**27.5**	**$0.10**	**12.2**	**0.13**	**0.13**	**$15.25 – $13.13**
	$2,386.2	**$ (45.5)**	**$0.40**	**$(117.4)**	**$(1.24)***	**$(1.24)***	**$17.31 – $13.13**
2005							
First Quarter	$ 490.0	$ (35.9)	$0.05	$ (30.3)	$(0.31)	$(0.31)	$16.07 – $12.50
Second Quarter	798.0	95.4	$0.05	57.8	0.59	0.58	$15.90 – $13.15
Third Quarter	544.9	(120.9)***	$0.10	(129.6)	(1.33)	(1.33)	$17.83 – $13.75
Fourth Quarter	556.8	27.8	$0.10	11.2	0.11	0.11	$18.00 – $16.34
	$2,389.7	**$ (33.6)**	**$0.30**	**$ (90.9)**	**$(0.95)***	**$(0.95)**	**$18.00 – $12.50**

As of June 30, 2006, our Common Stock was listed on the New York Stock Exchange under the symbol RDA. At that time there were approximately 1,525 holders of record of our Common Stock.

* *The sum of the four quarters' earnings per share does not equal the full-year earnings per share because each quarterly earnings per share is calculated using the weighted average number of shares of Common Stock for the quarter while the full-year earnings per share is calculated using the weighted average number of shares of Common Stock outstanding during the year.*

** *In previous periods, gains (losses) on sales of certain non-strategic assets were included in other (expense) income, net, and have been reclassified to other operating items, net, to conform to the current period presentation. See Note 3, Other Operating Items, Net, for additional information.*

*** *Includes goodwill charge of $(187.8) and $(129.0) in the second quarter of 2006 and third quarter of 2005, respectively. See Note 6, Goodwill and Other Intangible Assets, Net for further information.*

Reader's Digest Association

Corporate and Shareholder Information

Stock Listings:
Common Stock
New York Stock Exchange,
Symbol: RDA

RDA LISTED NYSE

Transfer Agent and Registrar:
Mellon Investor Services LLC
P.O. Box 3315
South Hackensack, NJ 07606
www.melloninvestor.com/isd

Shareholder Inquiries:
Domestic 800-230-2771
Foreign 201-680-6578
shrrelations@melloninvestor.com

ESPP Holder Inquiries:
800-774-5474

TDD Line:
Domestic 800-231-5469
Foreign 201-680-6610

Annual Meeting of Shareholders:
November 17, 2006, at 9:00 a.m.
RDA Corporate Headquarters
DeWitt Wallace Auditorium
Reader's Digest Road
Chappaqua, New York

Shareholder Reports:
Copies of the Proxy Statement and Annual Report on Form 10-K filed with the Securities and Exchange Commission are available upon request and also are available at www.rda.com.

Shareholder Information:
Individual shareholders may direct their questions to:
Carlos A. Jimenez
914-244-5308
carlos_jimenez@rd.com

SEC and NYSE Certifications:
The certifications of our Chief Executive Officer and Chief Financial Officer, required under Section 302 of the Sarbanes-Oxley Act of 2002, have been filed as exhibits to our 2006 Annual Report on Form 10-K. Also, our Chief Executive Officer submitted the Fiscal 2005 annual certification confirming our compliance with the NYSE corporate governance listing standards.

Direct Stock Purchase Investor Services Program:
This program offers a convenient way to buy Reader's Digest Common Stock. It includes features such as dividend reinvestment, optional cash investment and custodial service for stock certificates.
For complete information, contact:
Mellon Investor Services LLC
P.O. Box 3338
South Hackensack, NJ 07606
800-242-4653

Investor Relations:
Securities analysts, institutional investors and other investment professionals may direct their inquiries to:
Richard E. Clark
914-244-5425
richard_clark@rd.com

Media Relations:
Editors and reporters may direct their questions to:
William K. Adler
914-244-7585
william_adler@rd.com

Product Catalogs:
For more information on our products, including free catalogs, call 800-846-2100 or write to:
Customer Service at
The Reader's Digest
Association, Inc.

Global Corporate Headquarters:
The Reader's Digest
Association, Inc.
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RDA by the Numbers

8 We publish 8 magazines that each have at least 1 million in circulation.

10 We've launched businesses in 10 new countries in the past 3 years.

20 Our food and cooking publications are read by more than 20 million readers.

50 We sell 50 million books a year, generating approximately $1 billion in revenue.

60 We've compiled 60,000 recipes, with more being added every day from our food and cooking books, magazines and websites, including Allrecipes.com.

70 We sell our products in more than 70 countries around the world.

77 We publish 77 magazines worldwide; 50 distinct local editions of *Reader's Digest* plus 27 other magazines on food, gardening, home improvement, country living and other topics.

100 Our total circulation from magazines is 36 million, reaching well over 100 million readers worldwide.

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