

Warner Music Group Corp.  
Form 10-K  
November 29, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-K**

(Mark One)

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

For the fiscal year ended September 30, 2007

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-32502

**Warner Music Group Corp.**

(Exact name of Registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of

incorporation or organization)

**75 Rockefeller Plaza**

**New York, NY**  
(Address of principal executive offices)

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

**13-4271875**  
(I.R.S. Employer

Identification No.)

**10019**  
(Zip Code)

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

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| <b>Title of each class</b>            | <b>Name of each exchange on which registered</b> |
|---------------------------------------|--|
| <b>Common Stock, \$.001 par value</b> | <b>New York Stock Exchange</b>                   |

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

**None**

Indicate by check mark whether 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 the 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 amendments to this Form 10-K.

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

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

As of March 31, 2007, the aggregate market value of the registrant's common stock held by non-affiliates was approximately \$613,012,238, based on the closing price of the common stock of \$17.06 per share on that date as reported on the New York Stock Exchange. Shares of common stock held by the executive officers and directors and our controlling shareholders have been excluded from this calculation because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of November 27, 2007, the number of shares of the Registrant's common stock, par value \$0.001 per share, outstanding was 149,522,471.81.

**DOCUMENTS INCORPORATED BY REFERENCE**

Certain information required by Part III of this report is incorporated by reference from the Registrant's proxy statement to be filed pursuant to Regulation 14A with respect to the Registrant's fiscal 2007 annual meeting of stockholders.

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**WARNER MUSIC GROUP CORP.**

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**ITEM 1. BUSINESS**

**FORWARD-LOOKING STATEMENTS**

*This Annual Report on Form 10-K includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements are based on current expectations, estimates, forecasts and projections about the industry in which we operate, management's beliefs and assumptions made by management. Words such as may, will, expect, intend, estimate, anticipate, believe, or continue or the negative thereof or variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions, which are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. We disclaim any duty to update or revise any forward-looking statements whether as a result of new information, future events or otherwise. See Management's Discussion and Analysis of Financial Condition and Results of Operations Safe Harbor Statement Under Private Securities Litigation Reform Act of 1995.*

**Our Company**

We are one of the world's major music content companies. Our company is composed of two businesses: Recorded Music and Music Publishing. We believe we are the world's third-largest recorded music company and also the world's third-largest music publishing company. We are a global company, generating over half of our revenues in more than 50 countries outside of the U.S. We generated revenues of \$3.385 billion during our fiscal year ended September 30, 2007.

Our Recorded Music business produces revenue primarily through the marketing, sale and licensing of recorded music in various physical (such as CDs, cassettes, LPs and DVDs) and digital (such as downloads and ringtones) formats. We have one of the world's largest and most diverse recorded music catalogs, including 29 of the top 100 U.S. best-selling albums of all time more than any other recorded music company, including *The Eagles: Their Greatest Hits 1971-1975* (the best-selling album of all time), *Led Zeppelin IV* and *Rumours* by Fleetwood Mac. Our Recorded Music business is also expanding its participation in image and brand rights associated with artists, including merchandising, sponsorships, touring and artist management. Prior to corporate and revenue eliminations, our Recorded Music business generated revenues of \$2.837 billion during our fiscal year ended September 30, 2007.

Our Music Publishing business owns and acquires rights to musical compositions, exploits and markets these compositions and receives royalties or fees for their use. We publish music across a broad range of musical styles. We hold rights in over one million copyrights from over 65,000 songwriters and composers. Prior to corporate and revenue eliminations, our Music Publishing business generated revenues of \$570 million during our fiscal year ended September 30, 2007.

**Our Business Strengths**

We believe the following competitive strengths will enable us to continue to generate stable cash flow through our diverse base of recorded music and music publishing assets:

***Industry Leading Recording Artists and Songwriters.*** We have been able to consistently attract, develop and retain successful recording artists and songwriters. Our talented artist and repertoire (A&R) teams are focused on finding and nurturing future successful recording artists and songwriters, as evidenced by our recent recorded music album and music publishing successes. This has enabled us to develop a large and varied catalog of recorded music and music publishing assets that generate stable cash flows. We believe these assets demonstrate our historical success in developing talent and will help to attract future talent in order to enable our continued success.

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**Stable, Highly Diversified Revenue Base.** Our revenue base is derived primarily from relatively stable and recurring sources such as our music publishing library, our catalog of recorded music and new releases from our existing base of established artists. In any given year, we believe that generally less than 10% of our total revenues depend on artists without an established track record, with none of these artists typically representing more than 1% of our revenues. We have built a large and diverse catalog of recordings and compositions that covers a wide breadth of musical styles including pop, rock, jazz, country, R&B, hip-hop, rap, reggae, Latin, alternative, folk, blues, gospel and other Christian music. We are a significant player in each of our major geographic regions.

**Flexible Cost Structure With Low Capital Expenditure Requirements.** We have a highly variable cost structure, with substantial discretionary spending and minimal capital requirements. We spent \$29 million in capital expenditures for our fiscal year ended 2007 and \$30 million in capital expenditures for each of our fiscal years ended September 30, 2006 and 2005. We continue to seek sensible opportunities to convert fixed costs to variable costs, such as the sale of our CD and DVD manufacturing, packaging and physical distribution operations in 2003 and to enhance our effectiveness, flexibility, structure and performance by reducing and realigning long-term costs. As part of our realignment plan in fiscal 2007, we implemented changes to better align our workforce with the changing nature of the music industry by continuing to shift resources from our physical sales channels to efforts focused on digital distribution and emerging technologies and other new revenue streams. Part of the realignment plan also resulted in the outsourcing of some back-office functions as a cost-savings measure. Finally, we have contractual flexibility with regard to the timing and amounts of advances paid to existing recording artists and songwriters as well as discretion regarding future investment in new artists and songwriters, which further allows us to respond to changing industry conditions. The vast majority of our contracts cover multiple deliverables, many of which are only deliverable at our option.

**Digital Leadership.** We see ourselves as a music-based content company, earning revenue from different digital models and products, including digital downloads of single tracks and albums, online subscription services, custom and non-interactive webcasting, streaming and downloads of music videos and all forms of ringtones and other mobile music products. We have integrated the development of innovative digital products and strategies throughout our business and established a culture of product innovation across the company aimed at leveraging our assets to drive creative product development. We continue to initiate and sustain strategic relationships with key retailers, operators, technology companies, device managers and next generation digital providers, including our strategic partnerships with YouTube, Last.fm, PremiumTV, imeem and LALA.com, among others. Through our digital initiatives we are establishing strong relationships with our customers, developing new products and have become a leader in the expanding worldwide mobile music business. Through the first three quarters of calendar 2007, our shares of digital recorded music track and album sales in the U.S. as measured by SoundScan were higher than our overall recorded music album share in the U.S., which we believe reflects the relative strength of our content and in particular our catalog content, as well as the success of our digital innovation efforts. We also continue to be a leader in premium-priced digital album bundles, created by combining our existing assets with new assets such as bonus tracks, music videos and behind the scenes footage, which we believe further reflects the success of our product innovation efforts. Our repertoire comprised over 50% of all premium-priced album bundles sold on iTunes in the U.S. for the fiscal year ended September 30, 2007. We are also taking advantage of an expanding wireless telephone universe and upgrades to next-generation wireless networks to foster growth in mobile music, including recent strategic partnerships around the world with Beeline, one of Russia's leading mobile networks, China Unicom, the world's third-largest mobile operator, and SK Telecom, Korea's foremost broadband and wireless provider.

**Focus on Innovative A&R.** We believe our relative size, the strength of our management team, our ability to respond to industry and consumer trends and challenges, our diverse array of genres, our large catalog of hit releases and our valuable music publishing library have and will help us continue to successfully build our roster of recording artists and songwriters. We are constantly looking for new, innovative ways to develop and execute our A&R strategy. For example, in the U.S., we have established our Independent Label Group ( ILG ), which leverages our strong independent distribution network to identify major acts of the future at a lower cost. We

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continue to realize significant success in A&R. In the U.S. we achieved a 10-year album share record for Warner Music Group for both the second quarter and the first half of calendar 2007 at 21% and 20%, respectively. In addition, it was noted in the trade publication Music & Copyright that Warner Music Group became the third-largest Recorded Music business by global market share in 2006, rising from fourth-largest demonstrating the ongoing success of our A&R strategy.

**Leader in Independent Distribution.** The combined strength of our U.S distribution companies, Warner-Elektra-Atlantic Corporation ( WEA Corp. ), Ryko Distribution (acquired in May 2006 as part of our acquisition of Ryko Corporation ( Ryko )) and Alternative Distribution Alliance ( ADA ), has established us as the independent music distribution leader in the U.S.

## **Our Strategy**

We intend to increase revenues and cash flow through the following business strategies:

**Attract, Develop and Retain Established and Emerging Recording Artists and Songwriters.** A critical element of our strategy is to find, develop and retain recording artists and songwriters who achieve long-term success and we intend to enhance the value of our assets by continuing to attract and develop new recording artists and songwriters with staying power and market potential. Our A&R teams seek to sign talented recording artists with strong potential, whose new releases will generate a meaningful level of sales and increase the enduring value of our catalog by continuing to generate sales on an ongoing basis, with little additional marketing expenditure. We also work to identify promising songwriters who will write musical compositions that will augment the lasting value and stability of our music publishing library. We intend to continue to employ profitable and creative A&R strategies in this effort, such as the establishment of ILG. Additionally, we intend to continually evaluate our recording artist and songwriter roster to ensure we remain focused on developing the most promising and profitable talent and remain committed to maintaining financial discipline in evaluating agreements with artists. We will also continue to evaluate opportunities to add to our catalog or acquire or make investments in companies engaged in businesses that are similar or complementary to ours, such as our acquisitions of Ryko and Roadrunner, our acquisition of Ferret Music's recorded music, publishing, management, tour and merchandise businesses, our recent acquisition of Non-Stop Music, a leading production music library, and our exclusive license with The Grateful Dead to manage the band's intellectual property.

**Maximize the Value of our Music Assets and Capitalize on the Growth Areas of the Music Industry.** Our relationships with our recording artists and songwriters, our recorded music catalog and our music publishing library are our most valuable assets. We intend to continue to exploit the value of these assets through a variety of distribution channels, formats and products to generate significant cash flow from our music content. We believe that the ability to monetize our music content should improve over time as new distribution channels and the number of formats increase. We will seek to exploit the potential of previously unmonetized content in new channels, formats and product offerings, including premium-priced album bundles, ringtones and full-track video and song downloads on mobile phones. For example, we have a large catalog of music videos that we have yet to fully monetize as well as unexploited album art, lyrics and B-side tracks that have never been released. We will also continue to work with our partners to explore creative approaches and constantly experiment with new deal structures and product offerings to take advantage of new distribution channels. In addition, we intend to expand our ability to capitalize on the growth areas of the music industry by diversifying revenues beyond our traditional businesses and partnering with artists in other areas of their career to expand our participation across the artist brand, including merchandising, sponsorships, touring and artist management.

**Focus on Continued Management of Our Cost Structure.** We will continue to maintain a disciplined approach to cost management in our business and to pursue additional cost savings. We will also continue to monitor industry conditions to ensure that our business remains aligned with industry trends. For example, subsequent to the acquisition of substantially all of our recorded music and music publishing businesses from Time Warner effective March 1, 2004 (the Acquisition ), we implemented a broad restructuring plan in order to

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adapt our cost structure to the changing economics of the music industry. The restructuring plan included the consolidation of our Elektra Records and Atlantic Records labels, rationalization of our global network, dropping approximately 30% of our artist roster and an approximately 20% reduction in our global workforce. We completed substantially all of these restructuring efforts in fiscal 2005, implementing approximately \$250 million of annualized cost savings. Subsequently, during the second quarter of fiscal 2007, we implemented a realignment plan to more aggressively shift resources from our physical sales channels to efforts focused on digital distribution, emerging technologies and other new revenue streams.

***Capitalize on Digital Distribution and Emerging Technologies.*** Emerging digital formats should continue to produce new means for the distribution and exploitation of our recorded music and music publishing assets. We believe that the development of legitimate online and mobile channels for the purchase of music content continues to hold significant promise and opportunity for the industry. In particular, new and emerging third-party digital distribution outlets are not only reasonably priced for the consumer, but also offer a superior customer experience relative to illegal alternatives, as they are easy to use, offer uncorrupted, high-quality song files and integrate seamlessly with increasingly popular portable music players such as Apple's iPod line or Microsoft's Zune player, and a wide variety of PlaysForSure compatible devices from Creative, iRiver, Samsung and Sandisk and now phones from Motorola and Nokia and the iPhone. In addition, we believe digital distribution will stimulate incremental catalog sales given the ability to offer enhanced presentation and searchability of our catalog. As networks and phone handsets become more sophisticated, our music is increasingly becoming available on mobile phone platforms through mobile service providers via ringtones, ringback tones, full-track downloads and music video downloads. We believe the mobile business offers a more secure environment than does the online business and thereby reduces our exposure to piracy in areas where piracy is more widespread, such as Asia. We intend to continue to extend our global reach by executing new deals in new marketplaces and developing optimal business models in new formats and emerging channels.

***Enhance Our Physical Business by Developing and Optimizing Our Physical Distribution Channel Strategies and Creating New Physical Formats.*** We will continue to develop innovative programs with our physical distribution partners to achieve greater sales volume. The physical distribution channels for records are evolving as new outlets develop, the mix of channels and retailers change, new formats for our content are created and pricing models multiply to meet a wide range of needs. Our Recorded Music business will continue to cooperate with its physical distribution channel partners in order to implement forward-looking strategies for our mutual benefit. We will also invest to meet the needs of our channel partners to create more efficient collaboration, such as direct-to-retail distribution strategies and vendor-managed inventory. We also intend to continue to develop next generation physical music formats that represent a physical manifestation of our digital strategy to create a more connected relationship with the consumer in order to reinvigorate the physical platform and foster interest in digital music offerings.

***Contain Digital Piracy.*** Containing piracy is a major focus of the music industry and we, along with the rest of the industry, are taking multiple measures through technological innovation, litigation, education and the promotion of legislation to combat piracy. We will continue to take a leadership role in the music industry's war against piracy, as we did by championing the industry-wide development of the new physical formats and partnering with Apple on its security model for its Macintosh and PC launches of iTunes. In addition, we continue to support the aggressive measures taken by the Recording Industry Association of America (RIAA), the International Federation of the Phonographic Industry (IFPI) and the National Music Publishers' Association (NMPA), including civil lawsuits, education programs, lobbying for tougher anti-piracy legislation and international efforts to preserve music copyrights. We also believe new technologies geared towards degrading the illegal file-sharing process and tracking the source of pirated music offer a means to reduce piracy. Furthermore, recent legal actions by our industry, both in and outside the U.S., have been designed to educate consumers that obtaining music through unauthorized peer-to-peer networks is against the law and to deter illegal downloads. The industry has also been working with educational institutions to implement controls to prohibit students from illegally downloading copyrighted material. We believe that consumer awareness of the illegality of piracy has increased as a result of these initiatives. We believe these actions, in addition to the expansive

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growth of legitimate online and wireless music offerings, will help to limit the revenues lost to digital piracy. See *Industry Overview Recorded Music Piracy*.

### **Company History**

Our history dates back to 1929, when Jack Warner, president of Warner Bros. Pictures, founded Music Publishers Holding Company (MPHC) to acquire music copyrights as a means of providing inexpensive music for films. Encouraged by the success of MPHC, Warner Bros. extended its presence in the music industry with the founding of Warner Bros. Records in 1958 as a means of distributing movie soundtracks and further exploiting actors' contracts. For over 45 years, Warner Bros. Records has led the industry both creatively and financially with the discovery of many of the world's biggest recording artists. Warner Bros. Records acquired Frank Sinatra's Reprise Records in 1963. Atlantic Records was launched in 1947 by Ahmet Ertegun and Herb Abramson as a small New York-based label focused on jazz and R&B and Elektra Records was founded in 1950 by Jac Holzman as a folk music label. Atlantic Records and Elektra Records were merged in 2004 to form The Atlantic Records Group.

Since 1970, we have operated internationally through Warner Music International (WMI). WMI is responsible for the sale and marketing of our U.S. artists abroad as well as the discovering and development of international artists. Warner Music Group is today home to a collection of record labels, including Asylum, Atlantic, Bad Boy, Cordless, East West, Elektra, Lava, Nonesuch, Reprise, Rhino, Roadrunner, Rykodisc, Sire, Warner Bros. and Word. Chappell & Intersong Music Group was acquired in 1987, expanding our Music Publishing business. We continue to diversify our presence through acquisitions and joint ventures with various labels, such as the acquisition of Word Entertainment in 2002, a joint venture with Bad Boy in 2005, our acquisition of Ryko in 2006, our acquisition of a majority interest in Roadrunner Music Group B.V. (Roadrunner) in 2007 and the acquisition of music publishing catalogs and businesses, such as the Non-Stop Music production music catalog.

In 2004, an investor group consisting of Thomas H. Lee Partners L.P. and its affiliates (THL), Bain Capital, LLC and its affiliates (Bain Capital), Providence Equity Partners, Inc. and its affiliates (Providence Equity) and Music Capital Partners L.P. (collectively, the Investor Group) acquired Warner Music Group from Time Warner Inc. (Time Warner). Warner Music Group became the only stand-alone music content company with publicly traded common stock in the U.S. in May 2005.

### **Recorded Music (83%, 85%, and 83% of consolidated revenues, before corporate and revenue eliminations, in fiscal 2007, 2006 and 2005, respectively)**

Our Recorded Music business consists of the discovery and development of artists and the related marketing, distribution and licensing of recorded music produced by such artists. In addition to the more traditional methods of discovering and developing artists, we established ILG to discover artists earlier in their careers and at a lower cost by leveraging our independent distribution network.

In the U.S., our recorded music operations are conducted principally through our major record labels Warner Bros. Records and The Atlantic Records Group. Our Recorded Music operations also include Rhino Entertainment (Rhino), a division that specializes in marketing our music catalog through compilations and reissues of previously released music and video titles, as well as in the licensing of recordings to and from third parties for various uses, including film and television soundtracks.

Outside the U.S., our recorded music activities are conducted in more than 50 countries through WMI and its various subsidiaries, affiliates and non-affiliated licensees. WMI engages in the same activities as our U.S. labels: discovering and signing artists and distributing, marketing and selling their recorded music. In most cases, WMI also markets and distributes the records of those artists for whom our domestic record labels have international rights. In certain smaller countries, WMI licenses to unaffiliated third-party record labels the right to distribute its records.



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Our Recorded Music distribution operations include WEA Corp., which markets and sells music and DVD products to retailers and wholesale distributors in the U.S.; ADA, which distributes the products of independent labels to retail and wholesale distributors in the U.S.; Ryko Distribution, which distributes music and DVD releases from Rykodisc, Ryko's record music label, and third-party record and video labels; various distribution centers and ventures operated internationally; an 80% interest in Word Entertainment, which specializes in the distribution of music products in the Christian retail marketplace; and ADA U.K., which provides ADA's distribution services to independent labels in the U.K.

We play an integral role in virtually all aspects of the music value chain from discovering and developing talent, to producing albums and promoting artists and their products. After an artist has entered into a contract with one of our record labels, a master recording of the artist's music is created. The recording is then replicated for sale to consumers primarily in the CD format, and now, digital formats. In the U.S., WEA Corp., ADA, Ryko Distribution and Word market, sell and deliver product, either directly or through sub-distributors and wholesalers, to thousands of record stores, mass merchants and other retailers. Our recorded music products are also sold in physical form to online physical retailers such as Amazon.com, barnesandnoble.com and bestbuy.com and in digital form to online digital retailers like Apple's iTunes and LALA.com and mobile full track-download stores such as those operated by Verizon or Sprint.

We have integrated the sale of digital content into all aspects of our Recorded Music and Music Publishing businesses including A&R, marketing, promotion and distribution. Our new media executives work closely with the A&R departments of our labels to make sure that while a record is being made, digital assets are also created with all of our distribution channels in mind, including subscription services such as Rhapsody and satellite radio, social networking sites such as MySpace, user-generated content sites such as YouTube, Internet portals and music-centered destinations, such as Slacker, Pandora and imeem. We also work side by side with our mobile and online partners to test new concepts. We believe existing and new digital businesses will be a significant source of growth for the next several years and will provide new opportunities to monetize our assets and create new revenue streams. As a music content company, we have assets that go beyond our recorded music and music publishing catalogs, such as our music video library, that we now have the opportunity to monetize through digital channels. In general, digital music content is sold through two primary channels: online and mobile. The proportion of digital revenues attributed to each distribution channel varies by region, with online making up a larger percentage of revenues in the U.S. and mobile music currently representing a larger percentage of digital revenues outside of the U.S, especially in Europe and Asia. However, digital music is in the early stages of growth and these proportions may change as the roll-out of new technologies continues. As an owner of musical content, we believe we are well positioned to take advantage of growth in digital distribution and emerging technologies to maximize the value of our assets.

We are also diversifying our revenues beyond our traditional businesses by partnering with artists in other areas of their career. We are building capabilities and platforms for exploiting a broader set of music-related rights to participate across the artist brands we help create. Expansion of our capabilities in this area have included strategic acquisitions and partnerships with companies involved in artist management, strategic marketing and brand management, ticketing and touring, original programming and video entertainment. We believe enhancement of these capabilities will permit us to diversify revenue streams to better capitalize on the growth areas of the music industry, permit us to build stronger, long-term relationships with artists and more effectively connect artists and fans.

### *Artists and Repertoire ( A&R )*

We have a decades-long history of identifying and contracting with recording artists who become commercially successful. Our ability to select artists who are likely to be successful is a key element of our Recorded Music business strategy. Our ability to select artists spans all music genres and all major geographies and includes artists who achieve national, regional and international success. We believe that this success is directly attributable to our experienced global team of A&R executives, to the longstanding reputation and relationships that we have developed in the artistic community and to our effective management of this vital business function.

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In the U.S., our major record labels identify potentially successful recording artists, sign them to recording agreements, collaborate with them to develop recordings of their work and market and sell these finished recordings to retail stores and legitimate digital channels. Our labels scout and sign talent across all major music genres, including pop, rock, jazz, country, R&B, hip-hop, rap, reggae, Latin, alternative, folk, blues, gospel and other Christian music. WMI markets and sells U.S. and local repertoire from its own network of affiliates and numerous licensees in more than 50 countries. With a roster of local artists performing in 25 languages, WMI has an ongoing commitment to developing local talent aimed at achieving national, regional or international success.

A significant number of our recording artists have continued to appeal to audiences long after we cease to release their new recordings. Our recorded music catalog includes the U.S. best-selling album of all time, *The Eagles: Their Greatest Hits 1971-1975*, which has sold more than 29 million units in the U.S. to date. We have an efficient process for generating continued sales across our catalog releases, as evidenced by the fact that catalog albums generally generate approximately 40% of our recorded music sales in a typical year. Relative to our new releases, we spend comparatively small amounts on marketing for catalog sales.

We maximize the value of our catalog of recorded music through our Rhino business unit and through activities of each of our record labels. We use our catalog as a source of material for re-releases, compilations, box sets and special package releases, which provide consumers with incremental exposure to familiar songs and artists.

**Representative Worldwide Recorded Music Artists**

|                     |                  |                     |                       |                          |
|---------------------|------------------|---------------------|-----------------------|--------------------------|
| The Academy Is...   | The Eagles       | Killswitch Engage   | Notorious B.I.G.      | Slayer                   |
| Avenged Sevenfold   | Missy Elliott    | Mark Knopfler       | Paolo Nutini          | Smashing Pumpkins        |
| Bee Gees            | Enya             | k.d. lang           | Panic! At the Disco   | The Smiths               |
| Big & Rich          | Lupé Fiasco      | Larry the Cable Guy | Paramore              | Regina Spektor           |
| James Blunt         | Flaming Lips     | Led Zeppelin        | Sean Paul             | Staind                   |
| Boyz N Da Hood      | Fleetwood Mac    | Lil Flip            | Laura Pausini         | Serj Tankian             |
| Michelle Branch     | Genesis          | Lil Scrappy         | Plies                 | The Streets              |
| Michael Bublé       | Gnarls Barkley   | Linkin Park         | Daniel Powter         | Rob Thomas               |
| Ray Charles         | Goo Goo Dolls    | Madonna             | Pretty Ricky          | T.I.                     |
| Cher                | Josh Groban      | Maná                | The Ramones           | Trans-Siberian Orchestra |
| Eric Clapton        | Grateful Dead    | Mastadon            | R.E.M.                | Trey Songz               |
| Phil Collins        | Green Day        | matchbox twenty     | Red Hot Chili Peppers | Twista                   |
| The Corrs           | Gym Class Heroes | MC Solaar           | Rilo Kiley            | Uncle Kracker            |
| Cowboy Troy         | H.I.M.           | Metallica           | Damien Rice           | The Used                 |
| The Darkness        | Emmylou Harris   | Luis Miguel         | Todd Rundgren         | Paul Wall                |
| Danity Kane         | Hard-Fi          | Alanis Morissette   | Alejandro Sanz        | Westernhagen             |
| Craig David         | Faith Hill       | Jason Mraz          | Seal                  | The White Stripes        |
| Death Cab for Cutie | Jaheim           | Muse                | Blake Shelton         | Wilco                    |
| Deftones            | Jet              | Musiq Soulchild     | Shinedown             | Neil Young               |
| Diddy               | Mike Jones       | My Chemical Romance | Paul Simon            | Young Dro                |
| Disturbed           | Juvenile         | New Order           | Simple Plan           | Youssou N Dour           |
| The Doors           | Kid Rock         | Nickelback          | Frank Sinatra         | Yung Joc                 |

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### *Recording Artists Contracts*

Our artists contracts define the commercial relationship between our recording artists and our record labels. We negotiate recording agreements with artists that define our rights to use the artists copyrighted recordings. In accordance with the terms of the contract, the artists receive royalties based on sales and other forms of exploitation of the artists recorded works. We customarily provide up-front payments to artists called advances, which are recoupable by us from future royalties otherwise payable to artists. We also typically pay costs associated with the recording and production of albums, which are treated in certain countries as advances recoupable from future royalties. Our typical contract for a new artist covers a single initial album and provides us with a series of options to acquire subsequent albums from the artist. Royalty rates and advances are often increased for optional albums. Many of our contracts contain a commitment from the record label to fund video production costs, at least a portion of which are generally an advance recoupable from future royalties.

Our established artists contracts generally provide for greater advances and higher royalty rates. Typically, established artists contracts entitle us to fewer albums, and, of those, fewer are optional albums. In contrast to new artists contracts, which typically give us ownership in the artists work for the full term of copyright, some established artists contracts provide us with an exclusive license for some fixed period of time. It is not unusual for us to renegotiate contract terms with a successful artist during a term of an existing agreement, sometimes in return for an increase in the number of albums that the artist is required to deliver.

We are also continuing to transition to other forms of business models with recording artists to adapt to changing industry conditions, sometimes entering into agreements where we share in the touring, merchandising, music publishing or other revenues associated with a particular recording artist.

### *Marketing and Promotion*

WEA Corp., ADA, Ryko Distribution and Word market and sell our recorded music product in the U.S. Our approach to marketing and promoting our artists and their recordings is comprehensive. Our goal is to maximize the likelihood of success for new releases as well as stimulate the success of previous releases. We seek to maximize the value of each artist and release, and to help our artists develop an image that maximizes appeal to consumers.

We work to raise the profile of our artists, through an integrated marketing approach that covers all aspects of their interactions with music consumers. These activities include helping the artist develop creatively in each album release, setting strategic release dates and choosing radio singles, creating concepts for videos that are complementary to the artists work, and coordinating promotion of albums to radio and television outlets. We are also experimenting with ways to promote our artists through digital channels with initiatives such as windowing of content and creating product bundles by combining our existing assets with new assets that are created simultaneously with the album such as bonus tracks and music videos. Through digital distribution channels we have greater marketing flexibility that can be more cost effective. For example, direct marketing is possible through access to consumers via websites and pre-release activity can be customized. When possible, we seek to add an additional personal component to our promotional efforts by facilitating television and radio coverage or live appearances for our key artists. Our corporate, label and artist websites provide additional marketing venues for our artists.

In further preparation for and subsequent to the release of an album, we coordinate and execute a marketing plan that addresses specific digital and physical retail strategies to promote the album. Aspects of these promotions include in-store appearances, advertising, displays and placement in album listening stations. These activities are overseen by our label marketing staffs to ensure that maximum visibility is achieved for the artist and the release.

Our approach to the marketing and promotion of recorded music is carefully coordinated to create the greatest sales momentum, while maintaining financial discipline. We have significant experience in our

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marketing and promotion departments, which we believe allows us to achieve an optimal balance between our marketing expenditure and the eventual sales of our artists' recordings. We use a budget-based approach to plan marketing and promotions, and we monitor all expenditures related to each release to ensure compliance with the agreed-upon budget. These planning processes are evaluated based on updated artist retail sales reports and radio airplay data, so that a promotion plan can be quickly adjusted if necessary.

While marketing efforts extend to our catalog albums, most of the expenditure is directed toward new releases. Rhino specializes in marketing our catalog through compilations and reissues of previously released music and video titles, licensing tracks to third parties for various uses and coordinating film and television soundtrack opportunities with third-party film and television producers and studios.

### *Manufacturing, Packaging and Physical Distribution*

We have entered into manufacturing, packaging and physical distribution arrangements with Cinram for our CDs and DVDs in the U.S. and Europe. Cinram is currently our exclusive supplier of manufacturing, packaging and physical distribution services in North America and most of Europe. We believe that the terms of the Cinram agreements reflect market rates. We also have arrangements with other suppliers and distributors as part of our manufacturing, packaging and physical distribution operations throughout the rest of the world.

### *Sales*

Most of our sales represent purchases by a wholesale or retail distributor. Our return policies are in accordance with wholesale and retailer requirements, applicable laws and regulations, territory- and customer-specific negotiations, and industry practice. We attempt to minimize the return of unsold product by monitoring shipments and sell-through data.

We generate sales from the new releases of current artists and our catalog of recordings. In addition, we actively repackage and remarket music from our catalog to form new compilations. Most of our sales are currently generated through the CD format, although we also sell our music through both historical formats, such as cassettes and vinyl albums, and newer emerging digital and physical formats.

We sell our recorded music products through a variety of different retail and wholesale outlets including music specialty stores, general entertainment specialty stores, supermarkets, mass merchants and discounters, independent retailers and other traditional retailers. Although some of our retailers are specialized, many of our customers offer a substantial range of products other than music.

We believe that the online channel has become an increasingly important sales channel. Online sales include sales of traditional physical formats through both the online distribution arms of traditional retailers such as fye.com and walmart.com and traditional online physical retailers such as amazon.com, bestbuy.com and barnesandnoble.com. In addition, there has been a proliferation of legitimate online sites, which sell digital music on a per album or per track basis or offer subscription and streaming services. Several carriers also offer their subscribers the ability to download music on mobile devices. We currently partner with a broad range of online and mobile providers, such as iTunes, Napster, Rhapsody, Yahoo, Cingular, Helio, Sprint, T-mobile, Verizon Wireless, Orange, Vodafone, Virgin Mobile, SK Telecom, Motorola, China Unicom, Vimpelcom, Telenor, YouTube, Last.fm, imeem and LALA.com, and are actively seeking to develop and grow this business. In digital formats, per unit costs related directly to physical products such as manufacturing, distribution, inventory and return costs do not apply. While there are some digital-specific variable costs and infrastructure investments needed to produce, market and sell digital products, it is reasonable to expect that we will generally derive a higher contribution margin from digital sales than physical sales.

Our agreements with online and mobile service providers generally last one to two years. We believe that the short-term nature of our contracts enables us to maintain the flexibility that we need given the infancy of the digital business models.

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We enter into agreements with digital service providers to make our masters available for sale in digital formats (e.g., mobile ringtones, digital downloads, etc.). We then provide digital assets for our masters to digital service providers in saleable form. Our agreements with digital service providers establish wholesale prices or license fees which vary based on the type of product being sold. We typically receive sales accounting reports from digital service providers on a monthly basis, detailing the sales activity, with payments rendered on a monthly or quarterly basis.

### **Music Publishing (17%, 15%, and 17% of consolidated revenues, before corporate and revenue eliminations, in fiscal 2007, 2006 and 2005, respectively)**

Where recorded music is focused on exploiting a particular recording of a song, music publishing is an intellectual property business focused on the exploitation of the song itself. In return for promoting, placing, marketing and administering the creative output of a songwriter, or engaging in those activities for other rights holders, our music publishing business garners a share of the revenues generated from use of the song.

Our music publishing operations include Warner/Chappell, our global music publishing company headquartered in Los Angeles with operations in over 50 countries through various subsidiaries, affiliates and non-affiliated licensees. We own or control rights to more than one million musical compositions, including numerous pop hits, American standards, folk songs and motion picture and theatrical compositions. Assembled over decades, our award-winning catalog includes over 65,000 songwriters and composers and a diverse range of genres including pop, rock, jazz, country, R&B, hip-hop, rap, reggae, Latin, folk, blues, symphonic, soul, Broadway, techno, alternative, gospel and other Christian music. Our best-selling songwriter or song owner and song accounted for less than 2% and 1% of our music publishing revenues, respectively, for the fiscal year ended September 30, 2007. Moreover, our music publishing library includes many standard titles that span multiple music genres and has demonstrated the ability to generate consistent revenues over extended periods of time. For example, over the last ten years, our top 10 earning songs, which include such titles as *Happy Birthday to You* and *Winter Wonderland* have generally generated annual revenues of between \$1.0 million and \$2.0 million per song. Warner/Chappell also administers the music and soundtracks of several third-party television and film producers and studios, including Lucasfilm, Ltd. and Hallmark Entertainment. In 2007, we entered the production music library business with the acquisition of Non-Stop Music. Production music is a complimentary alternative to licensing standards and contemporary hits for television, film and advertising producers.

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

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**Music Publishing Portfolio**

*Representative Songwriters*

India Arie  
 Burt Bacharach  
 Michelle Branch  
 Michael Bublé  
 Andreas Carlsson  
 Eric Capton  
 Bryan-Michael Cox  
 Dido  
 Dr. Dre  
 George and Ira Gershwin  
 Greenday  
 Michael Jackson  
 Led Zeppelin

Little big Town  
 Madonna  
 Maná  
 Johnny Mercer  
 George Michael  
 Muse  
 Randy Newman  
 New York Dolls  
 Tim Nichols  
 Nickelback  
 Harry Nilsson  
 Cole Porter  
 Radiohead

The Ramones  
 R.E.M.  
 Damien Rice  
 Alejandro Sanz  
 Staind  
 T.I.  
 Timbaland  
 Van Halen  
 Van Morrison  
 Kurt Weill  
 Barry White  
 John Williams  
 Lucinda Williams

*Representative Songs*

**1950s and Prior**

Summertime  
 Happy Birthday to You  
 Night and Day  
 The Lady is a Tramp  
 Too Marvelous for Words  
 Dancing in the Dark  
 Winter Wonderland  
 Ain't She Sweet  
 Frosty the Snowman  
 When I Fall In Love  
 Misty

The Party's Over

On the Street Where You Live

Blueberry Hill

Makin' Whoopee

Dream a Little Dream of Me

It Had To Be You

You Go To My Head

**1980s**

Eye of the Tiger  
 Slow Hand  
 The Wind Beneath My Wings  
 Endless Love  
 Morning Train  
 What You Need  
 Beat It

**1960s**

People  
 I Only Want to Be With You  
 When a Man Loves a Woman  
 I Got a Woman  
 People Get Ready  
 Love is Blue  
 For What It's Worth  
 This Magic Moment  
 Save the Last Dance for Me  
 Viva Las Vegas  
 Walk On By

Build Me Up Buttercup

Everyday People

Whole Lotta Love

**1990s**

Unbelievable  
 Creep  
 Macarena  
 Sunny Came Home  
 Amazed  
 This Kiss  
 Believe

**1970s**

Behind Closed Doors  
 Ain't No Stopping Us Now  
 For the Love of Money  
 A Horse With No Name  
 Moondance  
 Peaceful Easy Feeling  
 Layla  
 Staying Alive  
 Star Wars Theme  
 Killing Me Softly  
 Does Anybody Really Know What Time It Is?

Saturday in the Park

Stairway to Heaven

**2000 and After**

It's Been Awhile  
 Photograph  
 Complicated  
 You Got It Bad  
 Crazy in Love  
 Cry Me a River  
 White Flag

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Jump  
We Are the World  
Indiana Jones Theme  
Celebration  
Like a Prayer

Smooth  
Livin' La Vida Loca  
Losing My Religion  
Gonna Make You Sweat  
All Star

Dilemma  
Work It  
Miss You  
Burn  
American Idiot  
The Reason  
Save a Horse (Ride a Cowboy)  
We Belong Together  
Promiscuous  
Crazy  
Gold Digger  
Hey There Delilah  
Sexy Back

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### *Music Publishing Royalties*

Warner/Chappell, as a copyright owner and/or administrator of copyrighted musical compositions, is entitled to receive royalties for the exploitation of musical compositions. We continually add new musical compositions to our catalog, and seek to acquire rights in songs that will generate substantial revenue over long periods of time.

Music publishers generally receive royalties pursuant to mechanical, public performance, synchronization and other licenses. In the U.S., music publishers collect and administer mechanical royalties, and statutory ceilings are established by the U.S. Copyright Act of 1976, as amended, for the royalty rates applicable to musical compositions for sales of recordings embodying those musical compositions. In the U.S., public performance royalties are typically administered and collected by performing rights organizations and in most countries outside the U.S., collection, administration and allocation of both mechanical and performance income are undertaken and regulated by governmental or quasi-governmental authorities. Throughout the world, each synchronization license is generally subject to negotiation with a prospective licensee and, by contract, music publishers pay a contractually required percentage of synchronization income to the songwriters or their heirs and to any co-publishers.

Warner/Chappell acquires copyrights or portions of copyrights and/or administration rights from songwriters or other third-party holders of rights in compositions. Typically, in either case, the grantor of rights retains a right to receive a percentage of revenues collected by Warner/Chappell. As an owner and/or administrator of compositions, we promote the use of those compositions by others. For example, we encourage recording artists to record and include our songs on their albums, offer opportunities to include our compositions in filmed entertainment, advertisements and digital media and advocate for the use of our compositions in live stage productions. Examples of music uses that generate publishing revenues include:

Mechanical: sale of recorded music in various formats

Physical recordings (*e.g.*, CDs, DVDs)

Internet and mobile downloads

Mobile phone ringtones

Performance: performance of the song to the general public

Broadcast of music on television, radio, cable and satellite

Live performance at a concert or other venue (*e.g.*, arena concerts, nightclubs)

Broadcast of music at sporting events, restaurants or bars

Online and mobile streaming

Performance of music in staged theatrical productions

Synchronization: use of the song in combination with visual images



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Films or television programs

Television commercials

Videogames

Other:

Toys or novelty items

Licensing of copyrights for use in sheet music

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### *Composers and Lyricists Contracts*

Warner/Chappell derives its rights through contracts with composers and lyricists (songwriters) or their heirs, and with third-party music publishers. In some instances, those contracts grant either 100% or some lesser percentage of copyright ownership in musical compositions and/or administration rights. In other instances, those contracts only convey to Warner/Chappell rights to administer musical compositions for a period of time without conveying a copyright ownership interest. Our contracts grant us exclusive exploitation rights in the territories concerned excepting any pre-existing arrangements. Many of our contracts grant us rights on a worldwide basis. Contracts typically cover the entire work product of the writer or composer for the duration of the contract. As a result, Warner/Chappell customarily possesses the rights for every musical composition created by the writer or composer during the duration of the contract.

While the duration of the contract may vary, many of our contracts grant us ownership and/or administration rights for the duration of copyright. See *Intellectual Property- Copyrights* . U.S. copyright law permits authors or their estates to terminate an assignment or license of copyright (for the U.S. only) after a set period of time.

### *Marketing and Promotion*

We actively seek, develop and maintain relationships with songwriters. We actively market our copyrights to licensees such as recorded music companies (including our Recorded Music business), filmed entertainment, television and other media companies, advertising and media agencies, event planners and organizers, computer and video game companies and other multimedia producers. We also market our musical compositions for use in live stage productions and merchandising. In addition, we actively seek new and emerging outlets for the exploitation of songs such as ringtones for mobile phones, new wireless and online uses and webcasting.

## **Competition**

In both recorded music and music publishing we compete based on price (to retailers in recorded music and to various end users in music publishing), on marketing and promotion (including both how we allocate our marketing and promotion resources as well as how much we spend on a dollar basis) and on recording artist and songwriter signings. We believe we currently compete favorably in these areas.

Our Recorded Music business is also dependent on technological development, including access to, selection and viability of new technologies, and is subject to potential pressure from competitors as a result of their technological developments. In recent years, due to the growth in piracy, we have been forced to compete with illegal channels such as unauthorized online peer-to-peer file-sharing and downloading and industrial duplication. See *Industry Overview Piracy*. Additionally, we compete, to a lesser extent, with alternative forms of entertainment such as motion pictures on home devices (e.g., VHS and DVD) or at the box office and with videogames for disposable consumer income.

The recorded music industry is highly competitive based on consumer preferences, and is rapidly changing. At its core, the recorded music business relies on the exploitation of artistic talent. As such, competitive strength is predicated upon the ability to continually develop and market new artists whose work gains commercial acceptance. According to Music and Copyright, in 2006, the four largest major record companies were Universal, Sony BMG Music Entertainment ( Sony BMG ), EMI Recorded Music ( EMI ) and WMG, which accounted for approximately 73% of worldwide recorded music sales. There are many mid-sized and smaller players in the industry that accounted for the remaining 27%, including independent music companies. Universal was the market leader with a 26% global market share in 2006, followed by Sony BMG with a 21% share. WMG and EMI held a 14% and 13% share of global recorded music sales, respectively. While market shares change moderately year-to-year, none of these players have gained or lost more than 3 percentage points of share in the last 5 years through 2004 (taking into account combined shares of Sony and BMG for years prior to the formation of Sony BMG in 2006). On July 13, 2006, the European Court of First Instance annulled the European Commission's decision approving the formation of Sony BMG. Sony and Bertelsmann re-applied to the European Commission and the formation of Sony BMG was re-approved in October 2007.

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The music publishing business is also highly competitive. The top four music publishers collectively account for over 65% of the market. Based on Music & Copyright's most recent estimates in 2005, EMI Music Publishing and WMG (Warner/Chappell) were the market leaders in music publishing, holding 17% and 16% shares, respectively. They were followed by BMG at 13%, Universal at 12% and Sony/ATV Music Publishing LLC (Sony/ATV) at 7%. Independent music publishers represent the balance of the market, as well as many individual songwriters who published their own works. In September 2006, it was announced that Universal had agreed to acquire BMG Music Publishing Group from Bertelsmann. The acquisition has been approved and the combination has resulted in the formation of the largest music publishing company with a share of global revenues potentially in excess of 25%, making Universal both the largest recorded music company and music publishing company. EMI has now become the second-largest music publishing company and we have now become the world's third-largest music publishing company taking into account the completion of the acquisition.

## **Intellectual Property**

### ***Copyrights***

Our business, like that of other companies involved in music publishing and recorded music, rests on our ability to maintain rights in musical works and recordings through copyright protection. In the U.S., copyright protection for works created as works made for hire (e.g., works of employees or specially commissioned works) after January 1, 1978 lasts for 95 years from first publication or 120 years from creation, whichever expires first. The period of copyright protection for musical compositions and sound recordings that are not works made for hire lasts for the life of the author plus 70 years for works created on or after January 1, 1978. U.S. works created prior to January 1, 1978 generally enjoy a total copyright life of 95 years, subject to compliance with certain statutory provisions including notice and renewal. In the U.S., sound recordings created prior to February 15, 1972 are not subject to copyright protection but are protected by common law rights or state statutes, where applicable. Copyright in the E.U. has recently been harmonized such that the period of copyright protection for musical compositions in all member states lasts for the life of the author plus 70 years. In certain E.U. countries, such as the U.K., the period of protection for musical compositions was recently extended from 50 years to 70 years, which has restored copyright protection in certain compositions in which our rights lapsed. In the E.U., the term of copyright for sound recordings lasts for 50 years from the date of release.

We are largely dependent on legislation in each territory to protect our rights against unauthorized reproduction, distribution, public performance or rental. In all territories where we operate, our products receive some degree of copyright protection, although the period of protection varies widely. In a number of developing countries, the protection of copyright remains inadequate. The U.S. enacted the Digital Millennium Copyright Act of 1998, creating a powerful framework for the protection of copyrights covering musical compositions and recordings in the digital world.

The potential growth of new delivery technologies, such as digital broadcasting, the Internet and entertainment-on-demand has focused attention on the need for new legislation that will adequately protect the rights of producers. We actively lobby in favor of industry efforts to increase copyright protection and support the efforts of organizations such as the World Intellectual Property Organization (WIPO).

In December 1996, two global copyright treaties, the WIPO Copyright Treaty and the WIPO Performances and Phonograms Treaty, were signed, securing the basic legal framework for the international music industry to trade and invest in online music businesses. The WIPO treaties have been ratified by the requisite number of countries, including the U.S.

The European Union has implemented these treaties through the European Copyright Directive, which was adopted by the E.U. in 2001. Legislation implementing the Directive in each of the member states is underway. The Directive harmonizes copyright laws across Europe and extends substantial protection for copyrighted works online. The E.U. has also put forward legislation aimed at assuring cross border coordination of the enforcement of laws related to counterfeit goods, including musical recordings.

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### ***Trademarks***

An important part of our business is our trademarks. Our major trademarks are registered in every country where we believe the protection of these trademarks is important for our business. Our major trademarks include Atlantic, Elektra, Sire, Reprise and Warner/Chappell. We use certain trademarks pursuant to royalty-free license agreements. The duration of the license relating to the WARNER and WARNER MUSIC marks and W logo is perpetual. The duration of the license relating to the WARNER BROS. RECORDS mark and WB & Shield designs is fifteen years from February 29, 2004. Each of the licenses may be terminated under certain limited circumstances, which include material breaches of the agreement, certain events of insolvency, and certain change of control events if we were to become controlled by a major filmed entertainment company. We actively monitor and protect against activities that might infringe, dilute, or otherwise harm our trademarks.

### **Joint Ventures**

We have entered into joint venture arrangements pursuant to which we or our various subsidiary companies manufacture, distribute and market (in most cases, domestically and internationally) recordings owned by the joint ventures. An example of these arrangements is Bad Boy Records, a joint venture between us and Sean "Diddy" Combs.

### **Employees**

As of September 30, 2007, we employed approximately 3,800 persons worldwide, including temporary and part-time employees. None of our employees in the U.S. are subject to collective bargaining agreements, although certain employees in our non-domestic companies are covered by national labor agreements. We believe that our relationship with our employees is good.

### **Environmental Matters**

Our wholly and partially owned pick, pack and ship facilities throughout the world, which are not a significant part of our business, are subject to laws and regulations and international agreements governing the protection of the environment, natural resources, human health and safety and the use, management and disposal of hazardous substances. In particular, our operations are subject to stringent requirements for packaging content and recycling, air and water emission, and waste management. We believe that we comply substantially with all applicable environmental requirements. Although the costs of maintaining such compliance have not materially affected us to date, we cannot predict the costs of complying with requirements that may be imposed in the future. In connection with some of our existing facilities, we also have been, and may become again, responsible for the costs of investigating or cleaning up contaminated properties. Such costs or related third-party personal injury or property damage claims could have a material adverse affect on our business, results of operations or financial condition.

### **Financial Information About Segments and Foreign and Domestic Operations**

Financial and other information by segment, and relating to foreign and domestic operations, for each of the last three fiscal years is set forth in Note 20 to the Consolidated Audited Financial Statements.

## **INDUSTRY OVERVIEW**

### **Recorded Music**

Recorded music is one of the primary mediums of entertainment for consumers worldwide and in calendar 2006, according to IFPI, generated \$31.8 billion in retail value of sales. Over time, major recorded music companies have built significant recorded music catalogs, which are long-lived assets that are exploited year after year. The sale of catalog material is typically more profitable than that of new releases, given lower development costs and more limited marketing costs. In the first three quarters of calendar 2007, according to SoundScan, 40% of all U.S. album unit sales were from recordings more than 18-months old, and 28% were from recordings more than three-years old.

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According to IFPI, the top five territories (the U.S., Japan, the U.K., Germany and France) accounted for 74% of the related sales in the recorded music market in 2006. The U.S., which is the most significant exporter of music, is also the largest territory for recorded music sales, constituting 33% of total 2006 recorded music sales. In addition, the U.S. and Japan are largely local music markets, with 93% and 75% of their 2006 sales consisting of domestic repertoire, respectively. In contrast, the U.K, German and French territories are made up of a higher percentage of international sales, with domestic repertoire constituting only 50%, 47% and 61% of these markets, respectively.

There has been a major shift in distribution of recorded music from specialty shops towards mass-market and online retailers. According to RIAA, record stores' share of U.S. physical music sales has declined from 52% in 1997 to 35% in 2006. Over the course of the last decade, U.S. mass-market and other stores' share grew from 32% in 1997 to 54% in 2004, and with the subsequent growth of sales via online channels since that time, their share contracted to 33% in 2006. In recent years, online sales of physical product as well as digital downloads have grown to represent an increasing share of U.S. sales and combined they accounted for 16% of music sales in 2006. In terms of genre, rock remains the most popular style of music, representing 34% of 2006 U.S. unit sales, although genres such as rap/hip-hop, R&B, Country and Latin music have become increasingly popular.

According to RIAA, from 1990 to 1999, the U.S. recorded music industry grew at a compound annual growth rate of 7.6%, twice the rate of total entertainment spending. This growth was driven by demand for music, the replacement of LPs and cassettes with CDs, price increases and strong economic growth and was largely paralleled around the world. The industry began experiencing negative growth rates in 1999, on a global basis, primarily driven by an increase in digital piracy. Other drivers of this decline were and are the overall recessionary economic environment, bankruptcies of record retailers and wholesalers, growing competition for consumer discretionary spending and retail shelf space, and the maturation of the CD format, which has slowed the historical growth pattern of recorded music sales. Since that time, annual dollar sales of physical music product in the U.S. are estimated to have declined at a compound annual growth rate of 6%, although there was a 2.5% year-over-year increase recorded in 2004. In 2006, the physical business experienced a 14% year-over-year decline on a value basis. According to SoundScan, through November 4, 2007, calendar year-to-date U.S. recorded music sales (excluding sales of digital tracks) are down approximately 15% year-over-year. According to SoundScan, adding digital track sales to the album totals, based on SoundScan's standard ten tracks per album equivalent, the U.S. music industry is down 9% through November 4, 2007. Similar declines have occurred in international markets, with the extent of declines driven primarily by differing penetration levels of piracy-enabling technologies, such as broadband access and CD-R technology, and economic conditions.

Notwithstanding these factors, we believe that the music industry could improve based on the recent mobilization of the industry as a whole against piracy and the development of legitimate digital distribution channels.

### *Piracy*

One of the industry's biggest challenges is combating piracy. Music piracy exists in two primary forms: digital (which includes illegal downloading and CD-R piracy) and industrial:

*Digital piracy* has grown dramatically, enabled by the increasing penetration of broadband Internet access and the ubiquity of powerful microprocessors, fast optical drives (particularly with writable media, such as CD-R) and large inexpensive disk storage in personal computers. The combination of these technologies has allowed consumers to easily, flawlessly and almost instantaneously make high-quality copies of music using a home computer by ripping or converting musical content from CDs into digital files, stored on local disks. These digital files can then be distributed for free over the Internet through anonymous peer-to-peer file sharing networks such as Ares, eDonkey, Limewire and WinMX or websites such as allofmp3.com ( illegal downloading ). Alternatively, these files can be burned onto multiple CDs for physical distribution ( CD-R piracy ). IFPI estimates that almost 20 billion songs were illegally downloaded in 2006.

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*Industrial piracy* (also called counterfeiting or physical piracy) involves mass production of illegal CDs and cassettes in factories. This form of piracy is largely concentrated in developing regions, and has existed for more than a decade. The sale of legitimate recorded music in these developing territories is limited by the dominance of pirated products, which are sold at substantially lower prices than legitimate products. IFPI states that industrial pirated physical music products totaled 1.2 billion units in 2006, or approximately one-third of all CDs purchased (legal or otherwise). IFPI also believes that industrial piracy is most prevalent in territories such as China, Ecuador, Greece, India, Indonesia, Nigeria, Mexico, Pakistan, Paraguay, Russia, and the Ukraine, where piracy levels are in excess of 50%.

In 2003, the industry launched an intensive campaign to limit piracy that focused on four key initiatives:

*Technological:* The technological measures against piracy are geared towards degrading the illegal file-sharing process and tracking providers and consumers of pirated music. These measures include spoofing, watermarking, copy protection, the use of automated web crawlers and access restrictions. In addition, the industry continues to experiment with new DVD-related technologies that contain more robust encryption protection.

*Educational:* Led by RIAA and IFPI, the industry has launched an aggressive campaign of consumer education designed to spread awareness of the illegality of various forms of piracy through aggressive print and television advertisements. Data collected by RIAA in August and September 2007 reflect that nearly one-half (46%) of the U.S. music-consuming population age 13 and older are aware of the recording industry's efforts to educate consumers about obtaining music legally, and of those, three-fourths believe that these efforts have been effective in helping them understand what is permissible in terms of obtaining music. The data also show that only a small minority of the U.S. music-consuming population age 13 and older currently believes that there is legal justification for engaging in file-sharing activities—one-third or less say that it is legal to make their music collections available for others to download or copy, and/or to download or copy music from someone else's collection.

*Legal:* In conjunction with its educational efforts, the industry has taken aggressive legal action against file-sharers and is continuing to fight industrial pirates. These actions include civil lawsuits in the U.S. and E.U. against individual pirates, arrests of pirates in Japan and raids against file-sharing services in Australia. U.S. lawsuits have largely targeted individuals who share large quantities of illegal music content. RIAA has announced its plans to continue these lawsuits in the U.S. IFPI has brought similar actions in Argentina, Austria, Brazil, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Ireland, Italy, Hong Kong, Mexico, Netherlands, Poland, Portugal, Romania, Singapore, Sweden, Switzerland and the U.K. and it may pursue similar actions in other countries. A number of recent court decisions, including the decisions in the cases involving Grokster and KaZaA, have held that one who distributes a device, such as P2P software, with the object of promoting its use to infringe copyright can be liable for the resulting acts of infringement by third parties using the device regardless of the lawful uses of the device.

*Development of online and mobile alternatives:* We believe that the development and success of legitimate digital music channels will be an important driver of recorded music sales going forward, as they represent both an incremental revenue stream and a potential inhibitor of piracy. The music industry has been encouraged by the recent proliferation and early success of legitimate digital music distribution options. We believe that these legitimate online distribution channels offer several advantages to illegal peer-to-peer networks, including greater ease of use, higher quality and more consistent music product, faster downloading, better search capabilities and seamless integration with portable digital music players. For example, legitimate online download stores and subscription music services began to be established between early 2002 and April 2003 beginning with the launch of Rhapsody in late 2001 and continuing through the launch of Apples iTunes music store in April 2003. Since then, many others (both large and small) have launched download and subscription music services, offering a variety of models, including per track pricing, per album pricing and monthly

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subscriptions. Already, according to IFPI in their 2007 Recording Industry in Numbers publication, there are more than 500 legal online music sites providing alternatives to illegal file-sharing in markets around the world. The mobile music business is also growing rapidly, with mobile music revenues rising to over \$1 billion in trade value in 2006, according to IFPI. While most mobile revenue is currently derived from ringtones, new mobile phones equipped with new capabilities are increasingly offering the capability for full track downloads and streaming audio and video, further expanding legitimate options.

These efforts are incremental to the long-standing push by organizations such as IFPI to curb industrial piracy around the world. In addition to these actions, the music industry is increasingly coordinating with other similarly impacted industries (such as software and filmed entertainment) to combat piracy.

We believe these actions are beginning to have a positive effect. A survey conducted by The NPD Group, a market research firm, in December 2006 shows that 31% of U.S. Internet users aged 13 or older who downloaded music from a file-sharing service at any point in the past two years stopped or decreased their usage of such file-sharing services in the past year.

## **Music Publishing**

### *Background*

Music publishing involves the acquisition of rights to, and licensing of, musical compositions (as opposed to recordings) from songwriters, composers or other rights holders. Music publishing revenues are derived from four main royalty sources: Mechanical, Performance, Synchronization and Other.

In the U.S., mechanical royalties are collected directly by music publishers from recorded music companies or via The Harry Fox Agency, a non-exclusive licensing agent affiliated with NMPA, while outside the U.S., performing rights organizations and collection societies perform this function. Once mechanical royalties reach the publisher (either directly from record companies or from collection societies), percentages of those royalties are paid to any co-owners of the copyright in the composition and to the writer(s) and composer(s) of the composition. Mechanical royalties are paid at a penny rate of 9.1 cents per song per unit in the U.S. (although recording agreements sometimes contain controlled composition provisions pursuant to which artist/songwriters license their rights to their record companies at as little as 75% of this rate) and as a percentage of wholesale price in most other territories. In the U.S., these rates are set pursuant to industry negotiations and rate proceedings contemplated by the U.S. Copyright Act and have been increasing at two-year intervals. For example, through December 2005 we received 8.5 cents per song and then on January 1, 2006, the rate increased to 9.1 cents per song until December 31, 2007. Recordings in excess of 5 minutes attract a higher rate. In international markets, these rates are determined by multi-year collective bargaining agreements and rate tribunals. A Copyright Royalty Board (CRB) proceeding currently being conducted will set new mechanical royalty rates in the U.S. for the five years from January 1, 2008 to December 31, 2012. The CRB will set the mechanical royalty rates for physical and digital products, including subscription services.

Throughout the world, performance royalties are typically collected on behalf of publishers and songwriters by performance rights organizations and collection societies. Key performing rights organizations and collection societies include: The American Society of Composers, Authors and Publishers (ASCAP), SESAC and Broadcast Music, Inc. (BMI) in the U.S.; Mechanical-Copyright Protection Society and The Performing Right Society in the U.K.; The German Copyright Society in Germany and the Japanese Society for Rights of Authors, Composers and Publishers in Japan. The societies pay a percentage (which is set in each country) of the performance royalties to the copyright owner(s) or administrators (i.e., the publisher(s)), and a percentage directly to the songwriter(s), of the composition. Thus, the publisher generally retains the performance royalties it receives other than any amounts attributable to co-publishers.

The music publishing market has proven to be more resilient than the recorded music market in recent years as revenue streams other than mechanical royalties are largely unaffected by piracy, and are benefiting from additional sources of income from digital exploitation of music in downloads and mobile phone ringtones. The

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worldwide music publishing market- including professional and self-publishers- was estimated to have generated approximately \$6.9 billion in revenues in 2006 according to figures contained in the March 2007 report by Enders Analysis. Trends in music publishing vary by royalty source:

*Mechanical:* Although the decline in the physical business has begun to have an impact on mechanical royalties, this decline has been partly offset by the regular and predictable biennial statutory increases in the mechanical royalty rate in the U.S., the increasing efficiency of local collection societies worldwide and the growth of new revenue sources such as mobile phone ringtones and legitimate online and mobile downloads.

*Performance:* According to the March 2007 report from Enders Analysis, performance royalties experienced steady growth from 2001 to 2005. Continued growth is expected, largely driven by television advertising, live performance and online streaming and advertising royalties.

*Synchronization:* We believe synchronization revenues have experienced strong growth in recent years and will continue to do so, benefiting from the proliferation of media channels, a recovery in advertising, robust videogames sales and growing DVD film sales/rentals.

In addition, major publishers have the opportunity to generate significant value by the acquisition of small publishers by extracting cost savings (as acquired libraries can be administered with little or no incremental cost) and by increasing revenues through more aggressive marketing efforts.

**Executive Officers**

The following table sets forth information as to our executive officers as of November 15, 2007, together with their positions and ages.

| <b>Name</b>         | <b>Age</b> | <b>Position</b>   |
|---------------------|------------|---|
| Edgar Bronfman, Jr. | 52         | Chairman of the Board and CEO                                       |
| Lyor Cohen          | 48         | Chairman and CEO, U.S. Recorded Music                               |
| Patrick Vien        | 41         | Chairman and CEO, Warner Music International                        |
| David H. Johnson    | 61         | CEO, Warner/Chappell Music  |
| Michael D. Fleisher | 42         | Executive Vice President and Chief Financial Officer                |
| Paul M. Robinson    | 49         | Executive Vice President and General Counsel                        |
| Caroline Stockdale  | 44         | Executive Vice President, Global Human Resources                    |
| Alex Zubillaga      | 39         | Executive Vice President, Digital Strategy and Business Development |

Our executive officers are appointed by, and serve at the discretion of, the Board of Directors. Each executive officer is an employee of Warner Music Group or one of its subsidiaries. Mr. Zubillaga is the brother-in-law of Mr. Bronfman. There are no other family relationships among any executive officers of Warner Music Group. The following information provides a brief description of the business experience of each of our executive officers.

*Edgar Bronfman, Jr.* has served as our Chairman of the Board and CEO since March 1, 2004. Before joining Warner Music Group, Mr. Bronfman served as Chairman and CEO of Lexa Partners LLC, which he founded, from April 2002. Prior to Lexa Partners, Mr. Bronfman was appointed Executive Vice Chairman of Vivendi Universal in December 2000. He resigned from his position as an executive officer of Vivendi Universal on December 6, 2001, resigned as an employee of Vivendi Universal on March 31, 2002, and resigned as Vice Chairman of Vivendi Universal's Board of Directors on December 2, 2003. Prior to the December 2000 formation of Vivendi Universal, Mr. Bronfman was President and CEO of The Seagram Company Ltd., a post he held since June 1994. During his tenure as the CEO of Seagram, he consummated \$85 billion in transactions and transformed the company into one of the world's leading media and communications companies. From 1989 until June 1994, Mr. Bronfman served as President and COO of Seagram. Between 1982 and 1989, he held a series of senior executive positions for The Seagram Company Ltd. in the U.S. and in Europe. Mr. Bronfman





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serves on the boards of InterActiveCorp, New York University Medical Center and the board of Governors of The Joseph H. Lauder Institute of Management and International Studies at the University of Pennsylvania. He is also the Chairman of the Board of Endeavor Global, Inc. and is a Member of the JP Morgan National Advisory Board and the Council on Foreign Relations. Mr. Bronfman also serves as general partner at Accretive, LLC, a venture capital firm specializing in the business process outsourcing area.

*Lyor Cohen* has served as the Chairman and CEO of our U.S. Recorded Music operations since March 1, 2004. From 2002 to 2004, Mr. Cohen was the Chairman and CEO of Universal Music Group's Island Def Jam Music Group. Mr. Cohen served as President of Def Jam from 1988 to 2002. Previously, Mr. Cohen served in various capacities at Rush Management, a hip-hop management company, which he founded with partner Russell Simmons. Mr. Cohen is widely credited with expanding Island Def Jam beyond its hip-hop roots to include a wider range of musical genres.

*Patrick Vien* has served as Chairman and CEO of Warner Music International since February 13, 2006. Prior to joining Warner Music Group, Mr. Vien was the President of NBC Universal's Global Networks Division. Before joining NBC Universal, Mr. Vien was President of Universal's Television Network Enterprises. Prior to this position at Universal, Mr. Vien was President and COO of North American Television (NATV). Mr. Vien earned a master's degree in business communications from the Annenberg School of Communications at the University of Southern California and graduated from McGill University in Montreal with a bachelor's degree in economics. He is a member of the Young Presidents Organization, a global association of business leaders under the age of 50.

*David H. Johnson* has served as the CEO of Warner/Chappell Music since December 2006. He was previously Warner Music Group's Acting CEO of Warner/Chappell Music since January 2006 and Executive Vice President and General Counsel since 1999. Prior to joining Warner Music Group, Mr. Johnson spent nine years as Senior Vice President and General Counsel for Sony Music Entertainment. He also held several posts at CBS and was an associate in the law firm Mayer, Nussbaum, Katz & Baker. Mr. Johnson received a B.A. in political science from Yale University, a J.D. from the University of Pennsylvania Law School and an L.L.M. from New York University School of Law.

*Michael D. Fleisher* has served as our Executive Vice President and Chief Financial Officer since January 1, 2005. Prior to joining Warner Music Group, Mr. Fleisher was Chairman and Chief Executive Officer of Gartner, Inc. Mr. Fleisher joined Gartner in 1993 and served in several roles including Chief Financial Officer prior to being named CEO in 1999. Previous to Gartner, he was at Bain Capital. Mr. Fleisher holds a bachelor's degree from the Wharton School of the University of Pennsylvania.

*Paul M. Robinson* has served as our Executive Vice President and General Counsel since December 2006. Mr. Robinson joined Warner Music Group's legal department in 1995. From 1995 to December 2006, Mr. Robinson held various positions with Warner Music Group, including Acting General Counsel and Senior Vice President, Deputy General Counsel. Before joining Warner Music Group, Mr. Robinson was a partner in the New York City law firm Mayer, Katz, Baker, Leibowitz & Roberts. Mr. Robinson has a B.A. in English from Williams College and a J.D. from Fordham University School of Law.

*Caroline Stockdale* has served as Executive Vice President, Global Human Resources since August 2005. Prior to joining Warner Music Group, Ms. Stockdale was Senior Vice President, Relationship Leader Human Resources, at American Express Financial Advisors/Global Financial Services since 2002. Before joining American Express Financial Advisors in 2002, Ms. Stockdale held a variety of human resources leadership positions at General Electric (GE) Capital Corporation in Europe and the United States beginning in 1997, including Executive Vice President and Global Human Resources Leader at GE Capital Corporation's Aviation Services division. Ms. Stockdale qualified as a chartered accountant and graduated with a B.A. Honors degree from the University of Sheffield in Sheffield, England.

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*Alex Zubillaga* has served as Executive Vice President, Digital Strategy and Business Development since August 2005. Prior to being designated as Executive Vice President, Digital Strategy and Business Development, Mr. Zubillaga held various positions with Warner Music Group since joining the company in March 2004, including Senior Vice President, Digital Strategy and Business Development and Vice President, Office of the Chairman. Prior to joining Warner Music Group, Mr. Zubillaga served as managing director and co-founder of Lexa Partners LLC. Previously, Mr. Zubillaga was founder and managing partner of E-Quest Partners. Prior to that, Mr. Zubillaga served as founder, Chairman and CEO of NETUNO, a leading provider of broadband communication services in Venezuela. Mr. Zubillaga graduated from Babson College with a degree in Business Administration.

## **WHERE YOU CAN FIND MORE INFORMATION**

We are required to file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission. These filings are not deemed to be incorporated by reference in this report. You may read and copy any documents filed by us at the Public Reference Section of the SEC, 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Our filings with the SEC are also available to the public through the SEC's website at <http://www.sec.gov>. Our common stock is listed on the NYSE under the symbol **WMG**. You can inspect and copy reports, proxy statements and other information about us at the NYSE's offices at 20 Broad Street, New York, New York 10005. We also maintain an Internet site at [www.wmg.com](http://www.wmg.com). We make available on our Internet website free of charge our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K as soon as practicable after we electronically file such reports with the SEC. In addition, copies of our (i) Corporate Governance Guidelines, (ii) charters for the Audit Committee, Compensation Committee and Executive, Nominating and Corporate Governance Committee and (iii) Code of Conduct which is applicable for all of our employees including our principal executive, financial and accounting officers, are available at our Internet site under Investor Relations Corporate Governance. Copies will be provided to any stockholder upon written request to Investor Relations, 75 Rockefeller Plaza, New York, New York 10019, via electronic mail at [Investor.Relations@wmg.com](mailto:Investor.Relations@wmg.com) or by contacting Investor Relations at (212) 275-2000. Our website and the information posted on it or connected to it shall not be deemed to be incorporated by reference into this report.

**Table of Contents****ITEM 1A. RISK FACTORS**

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

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

The industry began experiencing negative growth rates in 1999, on a global basis and the worldwide recorded music market has contracted considerably (20% since 2000 according to IFPI). Illegal downloading of music from the Internet, CD-R piracy, industrial piracy, economic recession, bankruptcies of record wholesalers and retailers and growing competition for consumer discretionary spending and retail shelf space may all be contributing to a declining recorded music industry. Additionally, the period of growth in recorded music sales driven by the introduction and penetration of the CD format has ended. While CD sales still generate most of the recorded music revenues, CD sales continue to decline industry-wide and we expect that trend to continue. However, new formats for selling recorded music product have been created, including the legal downloading of digital music using the Internet, physical format product innovations such as the recently-launched MVI disc and the distribution of music on mobile devices, and revenue streams from these new channels are beginning to emerge. These new digital revenue streams are important to offset declines in physical sales and represent the fastest growing area of our business. According to RIAA, the overall retail value of the U.S. record industry was \$11.5 billion in 2006, a 6.2% decline compared to 2005. RIAA additionally reported that the value of CD shipments to retail and specialty outlets in the U.S. totaled \$9.2 billion in 2006, a 12.9% drop from the previous year, while sales of digital music content via online as well as mobile outlets rose 73% in value to \$1.9 billion. For 2006, according to SoundScan, total album sales were down 5% on a unit basis compared with the same period last year. However, when including Track Equivalent Albums, total album sales were down 1.2% for 2006. Track Equivalent Albums convert digital track sales to album sales using SoundScan's standard of ten tracks per album. This SoundScan comparison with the prior year also does not reflect the impact of ringtone and ringback tone sales on mobile devices or online subscription sales. IFPI also reported that sales of physical and digital recorded music dropped by 5% in 2006 worldwide, totaling \$19.6 billion in revenues to record companies. The IFPI comparison with the prior year excludes licensing income, synchronization and revenues generated from advertising-supported business models. These new revenue streams are a growing income source for record companies and if included in the analysis, would have a positive impact on the comparisons. Digital sales through online and mobile platforms grew by 85% to \$2.1 billion and a total of 795 million single tracks were downloaded online, up 89% from 2005. Digital sales in 2006 accounted for 11% of music sales, up from 2% in 2004. Despite the increase in digital sales, they have yet to completely offset declining physical sales on a worldwide industry basis. According to IFPI, in both Japan and South Korea, in 2006 the increase in digital sales offset the decline in physical sales. Nevertheless, it is too soon to determine the impact of sales of music through new channels might have on the industry and the recorded music industry performance may continue to negatively impact our operating results. While, according to IFPI, digital sales have grown as expected, physical sales have fallen more than expected in the first three quarters of calendar 2007 and we cannot determine when the decline in physical sales might be offset by the increase in digital sales. While it is believed within the recorded music industry, that growth in digital sales will re-establish a growth pattern for all Recorded Music sales, the timing of the recovery cannot be established with accuracy nor can the impact of how these changes will affect individual markets. A declining recorded music industry is likely to lead to reduced levels of revenue and operating income generated by our Recorded Music business. Additionally, a declining recorded music industry is also likely to have a negative impact on our Music Publishing business, which generates a significant portion of its revenues from mechanical royalties, primarily from the sale of music in CD and other recorded music formats.

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

There are a variety of factors that could cause us to reduce our prices and reduce our profit margins. They are, among others, increased price competition among record companies resulting from the Universal and Sony BMG recorded music duopoly, price competition from the sale of motion pictures in DVD-Video format and videogames, the negotiating leverage of mass merchandisers, big box retailers and distributors of digital music, the increased costs of doing business with mass merchandisers and big box retailers as a result of complying with operating procedures that are unique to their needs, the adoption by record companies of initially lower-margin physical formats such as MVI and any changes in costs associated with new digital formats. In addition, we are currently dependent on a small number of leading online music stores, which allows them to significantly influence the prices we can charge in connection with the distribution of digital music. Over the course of the last decade, U.S. mass-market and other stores' share of U.S. physical music sales has continued to grow. While we cannot predict how future competition will impact music retailers, as the music industry continues to transform it is possible that the share of music sales by mass-market retailers such as Wal-Mart and Target and online music stores such as Apple's iTunes will continue to grow as a result of the decline of specialty music retailers, which could increase their negotiating leverage. Several large specialty music retailers, including Tower Records and Musicland, have filed for bankruptcy protection. The declining number of specialty music retailers may not only put pressure on profit margins, but could also impact catalog sales as mass-market retailers generally sell top chart albums only, with a limited range of back catalog. See Risk Factors We may be materially and adversely affected by the formation of Sony BMG Music Entertainment and Risk Factors We are substantially dependent on a limited number of online music stores, in particular Apple iTunes Music Store, for the online sale of our music recordings and they are able to significantly influence the pricing structure for online music stores.

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

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

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

The combined effect of the decreasing cost of electronic and computer equipment and related technology such as CD burners and the conversion of music into digital formats have made it easier for consumers to create unauthorized copies of our recordings in the form of, for example, burned CDs and MP3 files. An estimated 20 billion songs were illegally swapped or downloaded worldwide in 2006, according to IFPI. In addition, while growth of music-enabled mobile consumers offers distinct opportunities for music companies such as ours, it also opens the market up to certain risks from behaviors such as sideloading of unauthorized content and illegitimate user-created ringtones. A substantial portion of our revenue comes from the sale of audio products

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that are potentially subject to unauthorized consumer copying and widespread dissemination on the Internet without an economic return to us. The impact of digital piracy on legitimate music sales is hard to quantify but we believe that illegal file-sharing has a substantial negative impact on music sales. We are working to control this problem through litigation, by lobbying governments for new, stronger copyright protection laws and more stringent enforcement of current laws and technological means and by establishing legitimate new media business models. We cannot give any assurances that such measures will be effective. If we fail to obtain appropriate relief through the judicial process or the complete enforcement of judicial decisions issued in our favor (or if judicial decisions are not in our favor), if we are unsuccessful in our efforts to lobby governments to enact and enforce stronger legal penalties for copyright infringement or if we fail to develop effective means of protecting our intellectual property (whether copyrights or other rights such as patents, trademarks and trade secrets) or entertainment-related products or services, our results of operations, financial position and prospects may suffer.

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

The global organized commercial pirate trade is a significant threat to the music industry. Worldwide, industrial pirated music (which encompasses unauthorized physical copies manufactured for sale but does not include Internet downloads or home CD burning) is estimated to have generated around \$4.5 billion in revenues in 2006, according to IFPI. IFPI estimates that 1.2 billion pirated units were purchased in 2006. According to IFPI estimates, approximately one in three music CDs sold worldwide in 2006 were pirated. Unauthorized copies and piracy have contributed to the decrease in the volume of legitimate sales and put pressure on the price of legitimate sales. They have had, and may continue to have, an adverse effect on our business.

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

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

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

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

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

Our business is seasonal. For the fiscal year ended September 30, 2007, we derived approximately 84% of our revenues from our Recorded Music business. In the Recorded Music business, purchases have historically been heavily weighted towards the last three months of the calendar year, which represent our first quarter under our September 30 fiscal year. Historically, we have realized approximately 35% of Recorded Music net sales

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worldwide during the last three months of the calendar year, making those three months (*i.e.*, our first fiscal quarter) material to our full-year performance. We realized 28%, 32% and 32% of recorded music calendar year net sales during the last three months of calendar 2006, 2005 and 2004, respectively. This sales seasonality affects our operating cash flow from quarter to quarter. We cannot assure you that our recorded music net sales for the last three months and subsequent quarters of any calendar year will continue to be sufficient to meet our obligations or that they will be higher than such net sales for our other quarters. In the event that we do not derive sufficient recorded music net sales in such last three months, we may not be able to meet our debt service requirements, working capital requirements, capital expenditure requirements, payment of regular dividends on our common stock and other obligations. As digital revenue increases as a percentage of our total revenue, this may affect the overall seasonality of our business. For example, sales of MP3 players or gift cards to purchase digital music sold in the holiday season tend to result in sales of digital music in subsequent periods. However, seasonality with respect to the sale of music in new formats, such as digital, is still developing.

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

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

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

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

limited legal protection and enforcement of intellectual property rights;

restrictions on the repatriation of capital;

differences and unexpected changes in regulatory environment, including environmental, health and safety, local planning, zoning and labor laws, rules and regulations;

varying tax regimes which could adversely affect our results of operations or cash flows, including regulations relating to transfer pricing and withholding taxes on remittances and other payments by subsidiaries and joint ventures;

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exposure to different legal standards and enforcement mechanisms and the associated cost of compliance;

difficulties in attracting and retaining qualified management and employees or rationalizing our workforce;

tariffs, duties, export controls and other trade barriers;

longer accounts receivable settlement cycles and difficulties in collecting accounts receivable;

recessionary trends, inflation and instability of the financial markets;

higher interest rates; and

political instability.

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

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

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

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

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

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

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

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

We have positioned ourselves to take advantage of online and mobile technology as a sales distribution channel and believe that the development of legitimate channels for digital music distribution holds promise for us in the future. Digital revenue streams of all kinds are important to offset continued declining revenues from CD sales industry-wide over time. However, legitimate channels for digital distribution are a recent development and we cannot predict their impact on our business. In digital formats, certain costs associated with physical





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products such as manufacturing, distribution, inventory and return costs do not apply. While there are some digital-specific variable costs and infrastructure investments necessary to produce, market and sell music in digital formats, we believe it is reasonable to expect that we will generally derive a higher contribution margin from digital sales than physical sales. However, we cannot assure you that we will generally continue to achieve higher margins from digital sales. Any legitimate digital distribution channel that does develop may result in lower or less profitable sales for us than comparable physical sales. In addition, the transition to greater sales through digital channels introduces uncertainty regarding the potential impact of the unbundling of the album on our business. While recent studies have indicated that consumers spend more on music in general when they begin to purchase music in digital form than previously, it remains unclear how consumer behavior will change when faced with the opportunity to purchase only their favorite tracks from a given album rather than the entire album. In addition, if piracy continues unabated and legitimate digital distribution channels fail to gain consumer acceptance, our results of operations could be harmed. In addition, as new distribution channels continue to develop we have to implement systems to process royalties on these new revenue streams. If we are not able to successfully expand our processing capability or introduce technology to allow us to determine and pay royalty amounts due in a timely manner and automate these tasks, we may experience delays as we increase the volume of our digital sales, which could have a negative effect on our relationships with artists and brand identity.

**We are substantially dependent on a limited number of online music stores, in particular Apple iTunes Music Store, for the online sale of our music recordings and they are able to significantly influence the pricing structure for online music stores.**

We derive an increasing portion of our revenue from sales of music through digital distribution channels. We are currently dependent on a small number of leading online music stores that sell to consumers digital music. Currently, the largest U.S. online music store, iTunes, charges U.S. consumers \$0.99 per single track download. We have limited ability to increase our wholesale prices to digital service providers for digital downloads as we believe Apple's iTunes controls more than 70% of the legitimate digital music download business. If iTunes were to adopt a lower pricing model for our music recordings or if there is a structural change to other download pricing models, we may receive substantially less per download for our music recordings, which could cause a material reduction in our revenue, unless it is offset by a corresponding increase in the number of downloads. Additionally, Apple's iTunes and other online music stores at present accept and post for sale all the recordings that we and other distributors deliver to them. However, if online stores in the future decide to limit the types or amount of music they will accept from music content owners like us, our revenue could be significantly reduced.

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

Mechanical royalties and performance royalties are the two largest sources of income to our Music Publishing business and mechanical royalties are a significant expense to our Recorded Music business. In the U.S., mechanical rates are set pursuant to industry negotiations contemplated by the U.S. Copyright Act and performance rates are set by performing rights societies and subject to challenge by performing rights licensees. Outside the U.S., mechanical and performance rates are typically negotiated on an industry-wide basis. The mechanical and performance rates set pursuant to such processes may adversely affect us by limiting our ability to increase the profitability of our Music Publishing business. If the mechanical rates are set too high it may also adversely affect us by limiting our ability to increase the profitability of our Recorded Music business. The U.S. Copyright Office recently decided that the use of compositions as ringtones fall under the compulsory license provisions of section 115 of the Copyright Act. If this decision is not reversed, it will likely lower the cost of mechanical licenses for ringtones, which is favorable for our Recorded Music business but unfavorable for our Music Publishing business. In addition, rates our Recorded Music business receives in the U.S. for, among other sources of income and potential income, webcasting and satellite radio are set by an arbitration process under the U.S. Copyright Act unless rates are determined through voluntary negotiations. It is important as sales shift from

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physical to diversified distribution channels that we receive fair value for all of the uses of our intellectual property as our business model now depends upon multiple revenue streams from multiple sources. If the rates for these and other income sources are set too low through this process, it could have a material adverse impact on our Recorded Music business or our business prospects.

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

The reporting currency for our financial statements is the U.S. dollar. We have substantial assets, liabilities, revenues and costs denominated in currencies other than U.S. dollars. To prepare our consolidated financial statements, we must translate those assets, liabilities, revenues and expenses into U.S. dollars at then-applicable exchange rates. Consequently, increases and decreases in the value of the U.S. dollar versus other currencies will affect the amount of these items in our consolidated financial statements, even if their value has not changed in their original currency. These translations could result in significant changes to our results of operations from period to period. For the fiscal year ended September 30, 2007, approximately 51% of our revenues related to operations in foreign territories. From time to time, we enter into foreign exchange contracts to hedge the risk of unfavorable foreign currency exchange rate movements. As of September 30, 2007, we have hedged our material foreign currency exposures related to royalty payments remitted between our foreign affiliates and our U.S. affiliates for the next fiscal year.

### **We may not have full control and ability to direct the operations we conduct through joint ventures and we do not control minority (equity method) investments.**

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

We also have several cost-method equity investments. We do not control these investments and could lose some or all of our investment in these entities. While we have made several minority investments in the past year and may make further investments in the future, such investments are not material to the overall financial position of our operating results.

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

California Labor Code Section 2855 ( Section 2855 ) limits the duration of time any individual can be bound under a contract for personal services to a maximum of seven years. In 1987, Subsection (b) was added, which provides a limited exception to Section 2855 for recording contracts, creating a damages remedy for record companies. Legislation was introduced in California to repeal Subsection (b) and then withdrawn. A bill regarding personal service contracts has been introduced into the California legislature. Unlike in certain prior years, the bill does not seek to repeal sections applying to the music industry. Legislation was also reintroduced in New York in January 2007 to create a statute similar to Section 2855 to limit contracts between artists and record companies to a term of three years, potentially affecting the duration of artist contracts. There is no assurance that California will not reintroduce legislation in the future seeking to repeal Subsection (b). The repeal of Subsection (b) of Section 2855 and/or the passage of legislation similar to Section 2855 by other states could materially affect our results of operations and financial position.

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

The U.S. Copyright Act provides authors (or their heirs) a right to terminate licenses or assignments of rights in their copyrighted works. This right does not apply to works that are works made for hire . Since the effective date of U.S. copyright liability for sound recordings (February 15, 1972), virtually all of our agreements

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

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

We may acquire, make investments in, or enter into strategic alliances or joint ventures with, companies engaged in businesses that are similar or complementary to ours. If we make such acquisitions or investments or enter into strategic alliances, we will face certain risks inherent in such transactions. For example, gaining regulatory approval for significant acquisitions or investments could be a lengthy process and there can be no assurance of a successful outcome and we could increase our leverage in connection with acquisitions or investments. We could face difficulties in managing and integrating newly acquired operations. Additionally, such transactions would divert management resources and may result in the loss of artists or songwriters from our rosters. If we invest in companies involved in new businesses or develop our own new business opportunities, we will need to integrate and effectively manage these new businesses before any new line of business can become successful, and as such its progress and success are uncertain. In addition, investments in new business may result in an increase in capital expenditures to build infrastructure to support our new initiatives. We cannot assure you that if we make any future acquisitions, investments, strategic alliances or joint ventures that they will be completed in a timely manner, that they will be structured or financed in a way that will enhance our credit-worthiness and allow for continued payment of regular dividends or that they will meet our strategic objectives or otherwise be successful. We also may not be successful in implementing appropriate operational, financial and management systems and controls to achieve the benefits expected to result from these transactions. Failure to effectively manage any of these transactions could result in material increases in costs or reductions in expected revenues, or both. In addition, if any new business in which we invest or which we attempt to develop does not progress as planned, we may not recover the funds and resources we have expended and this could have a negative impact on our businesses or our company as a whole.

### **Our realignment plan may not be successful and may adversely affect our business.**

In the second quarter of fiscal 2007 we began to implement a realignment plan aimed at better aligning our workforce with the changing nature of the music industry. These changes are part of the continued evolution from a traditional record- and songs-based business to a music-based content company and the ongoing management of our cost structure. The changes include a continued redeployment of resources to focus on new business initiatives to help us diversify our revenue streams, including digital opportunities. The realignment plan is also designed to improve the operating effectiveness of our current businesses and to realign our management structure to, among other things, effectively address the continued development of digital distribution channels along with declining physical sales. Our future competitiveness depends upon our continued success in implementing these initiatives throughout our operations. Although we will seek to successfully implement these actions in a manner that does not negatively impact our results of operations or impair our ability to compete successfully, we cannot be certain that these actions will accomplish their intended objective. Substantially all of the restructuring charges associated with the realignment plan have required or will require the outlay of cash.

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

The Investor Group controls a majority of our common stock on a fully diluted basis. In addition, representatives of the Investor Group occupy substantially all of the seats on our board of directors and pursuant to a

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

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

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

On March 13, 2007, we entered into amendments to our existing manufacturing, packaging and physical distribution arrangements with Cinram for our physical products in North America and most of Europe. Cinram will remain our exclusive supplier of manufacturing, packaging and physical distribution services in North America and most of Europe. The terms of the Cinram agreements remain substantially the same as the terms of the original agreements. We believe that the terms of these agreements, as amended, continue to reflect market rates. The agreements, as amended, now expire on December 31, 2010.

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

In August 2004, Sony Music Entertainment ( Sony ) and Bertelsmann Music Group ( BMG ) merged their recorded music businesses to form Sony BMG. As a result, the recorded music industry now consists of four major players (Universal, Sony BMG, EMI and us) rather than five (Universal, Sony, BMG, EMI and us). Prior to the formation of Sony BMG, there was one appreciably larger major, Universal, with approximately 25% of the global recorded music revenues and four other majors relatively equal in size ranging between 11% and 14% of recorded music revenues. Now there are two appreciably larger majors, Universal and Sony BMG, and two significantly smaller majors, EMI and us. On July 13, 2006, the European Court of First Instance annulled the European Commission's decision approving the formation of Sony BMG. Sony and Bertelsmann re-applied to the European Commission and the formation of Sony BMG was re-approved by the European Commission in October 2007. We cannot predict what impact the final decision regarding the formation of Sony BMG might have on us.

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### **Risks Related to our Leverage**

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

We are highly leveraged. As of September 30, 2007, our total consolidated indebtedness was \$2.273 billion. In addition, as of September 30, 2007, we had an additional \$250 million available for borrowing under the revolving portion of our senior secured credit facility (less \$4 million in letters of credit).

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

making it more difficult for us and our subsidiaries to make payments on indebtedness;

increasing our vulnerability to general economic and industry conditions;

requiring a substantial portion of cash flow from operations to be dedicated to the payment of principal and interest on indebtedness, therefore reducing our ability to use our cash flow to fund our operations, capital expenditures, dividends, and future business opportunities;

exposing us to the risk of increased interest rates as certain of the borrowings of our subsidiaries, including borrowings under our senior secured credit facility, will be at variable rates of interest;

limiting our ability and the ability of our subsidiaries to obtain additional financing for working capital, capital expenditures, product development, debt service requirements, acquisitions and general corporate or other purposes; and

limiting our ability to adjust to changing market conditions and placing us at a competitive disadvantage compared to our competitors who are less highly leveraged.

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

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

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

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

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WMG Holdings Corp. ( Holdings ), our immediate subsidiary, also will be relying on WMG Acquisition Corp. ( Acquisition Corp. ) and its subsidiaries to make payments on its borrowings. If Acquisition Corp. does not dividend funds to Holdings in an amount sufficient to make such payments, Holdings may default under the

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indenture governing its borrowings, which would result in all such notes becoming due and payable. Because Acquisition Corp.'s debt agreements have covenants that limit its ability to make payments to Holdings, Holdings may not have access to funds in an amount sufficient to service its indebtedness.

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

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

incur additional indebtedness or issue certain preferred shares;

pay dividends on or make distributions in respect of our common stock or make other restricted payments;

make certain investments;

sell certain assets;

create liens on certain indebtedness without securing the notes;

consolidate, merge, sell or otherwise dispose of all or substantially all of our assets;

enter into certain transactions with our affiliates; and

designate our subsidiaries as unrestricted subsidiaries.

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

### **Risks Related to our Common Stock**

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

The Investor Group controls a majority of our outstanding common stock. As a result, we are a controlled company within the meaning of the New York Stock Exchange corporate governance standards. Under the New York Stock Exchange rules, a company of which more than 50% of the voting power is held by an individual, a group, or another company is a controlled company and may elect not to comply with certain New York Stock Exchange corporate governance requirements, as applicable, including (1) the requirement that a majority of the board of directors consist of independent directors, (2) the requirement that we have a nominating/corporate governance committee that is composed entirely of independent directors with a written charter addressing the committee's purpose and responsibilities and (3) the requirement that we have a



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compensation committee that is composed entirely of independent directors with a written charter addressing the committee's purpose and responsibilities. We are and intend to continue to utilize these exemptions while we are a controlled company. As a result, we will not have a majority of independent directors and neither our

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nominating and corporate governance committee, which also serves as our executive committee, nor our compensation committee will consist entirely of independent directors. Accordingly, you will not have the same protections afforded to stockholders of companies that are subject to all of the New York Stock Exchange corporate governance requirements.

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

The market price of our common stock could decline as a result of sales of a large number of shares of common stock in the market or the perception that such sales could occur. These sales, or the possibility that these sales may occur, also might make it more difficult for us to sell equity securities in the future at a time and at a price that we deem appropriate. As of September 30, 2007 we had approximately 149.5 million shares of common stock outstanding. Approximately 93.3 million shares are held by the Investor Group and are eligible for resale from time to time, subject to contractual and Securities Act restrictions. The Investor Group has the ability to cause us to register the resale of their shares and certain other holders of our common stock, including members of our management and certain other parties that have piggyback registration rights, will be able to participate in such registration. In addition, in 2005, we registered approximately 8.3 million shares of restricted common stock and approximately 8.4 million shares underlying options issued and securities that may be issued in the future pursuant to our benefit plans and arrangements on registration statements on Form S-8. Shares registered on these registration statements on Form S-8 may be sold as provided in the respective registration statements on Form S-8.

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

Securities markets worldwide experience significant price and volume fluctuations. This market volatility, as well as general economic, market or potential conditions, could reduce the market price of our common stock in spite of our operating performance. In addition, our operating results could be below the expectations of securities analysts and investors, and in response, the market price of our common stock could decrease significantly. As a result, the market price of our common stock could decline below the price at which you purchase it. You may be unable to resell your shares of our common stock at or above such price. Among the other factors that could affect our stock price are:

actual or anticipated variations in operating results;

changes in financial estimates or investment recommendations by research analysts;

actual or anticipated changes in economic, political or market conditions, such as recessions or international currency fluctuations;

actual or anticipated changes in the regulatory environment affecting the music industry;

changes in the retailing environment;

changes in the market valuations of other content on media companies or diversified media companies that are also engaged in some of the business in which we are engaged that may be deemed our peers; and

announcements by us or our competitors of significant acquisitions, strategic partnerships, divestitures, joint ventures or other strategic initiatives.

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



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

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

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2. PROPERTIES**

We own studio and office facilities and also lease certain facilities in the ordinary course of business. Our executive offices are located at 75 Rockefeller Plaza, New York, NY 10019. We have a ten-year lease ending on July 31, 2014 for our headquarters at 75 Rockefeller Plaza, New York, New York 10019. We also have a long-term lease ending on December 31, 2020, for office space in a building located at 3400 West Olive Avenue, Burbank, California 91505, used primarily by our Recorded Music business, and also another lease ending on June 30, 2012 for office space at 1290 Avenue of the Americas, New York, New York 10104, used primarily by our Recorded Music business. We also have a five-year lease for office space at 10585 Santa Monica Boulevard, Los Angeles, California 90025, used primarily by our Music Publishing business. We consider our properties adequate for our current needs.

**ITEM 3. LEGAL PROCEEDINGS**

**Litigation**

*Radio Promotion Activities*

Two independent labels filed antitrust suits against the Company alleging that its radio promotion activities are anticompetitive. *Radikal Records, Inc. v. Warner Music Group, et al.* was filed on March 21, 2006 in U.S. District Court in the Central District of California, Western Division. *TSR Records, Inc. v. Warner Music Group, et al.* was filed on March 28, 2006 in U.S. District Court in the Central District of California, Western Division. The Company filed a Notice of Related Case and was successful in having both of these cases consolidated. On May 16, 2006, the Company filed a Motion to Dismiss in both cases. On October 11, 2006, the court denied the Company's Motion to Dismiss as to the antitrust claims but granted the motion, with leave to amend, as to the state tort claim for interference with prospective economic advantage. On October 24, 2006, the plaintiffs filed amended complaints, attempting to cure the defects in their tort claim. The Company again moved to dismiss the state court claims and on January 31, 2007, the court granted the Company's motion, but allowed plaintiffs to replead. On June 5, 2007, the court again granted the Company's motion to dismiss the plaintiffs' claims for interference with prospective economic advantage, but granted the plaintiffs one final chance to amend their complaints.

On July 27, 2007, the parties filed a stipulation in the U.S. District Court in the Central District of California to dismiss both cases with prejudice after the Company reached a settlement with both plaintiffs wherein the Company admitted no wrongdoing. The Company paid each of the two plaintiffs \$43,500.00, inclusive of

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attorneys' fees and all other cost and expenses, to settle all claims arising from the allegations in both lawsuits. On August 9, 2007, the court approved the parties' stipulation and dismissed both cases with prejudice, thereby concluding these actions.

*Pricing of Digital Music Downloads*

On December 20, 2005 and February 3, 2006, the Attorney General of the State of New York served the Company with requests for information in connection with an industry-wide investigation as to whether the practices of industry participants concerning the pricing of digital music downloads violate Section 1 of the Sherman Act, New York State General Business Law §§ 340 et seq., New York Executive Law §63(12), and related statutes. On February 28, 2006, the Antitrust Division of the U.S. Department of Justice served the Company with a request for information in the form of a Civil Investigative Demand as to whether its activities relating to the pricing of digitally downloaded music violate Section 1 of the Sherman Act. The Company has provided documents and other information in response to these requests and intends to continue to fully cooperate with the New York Attorney General's and Department of Justice's industry-wide inquiries. Subsequent to the announcements of the above governmental investigations, more than thirty putative class action lawsuits concerning the pricing of digital music downloads have been filed. On August 15, 2006, the Judicial Panel on Multidistrict Litigation consolidated these actions for pre-trial proceedings in the Southern District of New York. The consolidated amended complaint, filed on April 13, 2007, alleges conspiracy among record companies to delay the release of their content for digital distribution, inflate their pricing of CDs and fix prices for digital downloads. The complaint seeks unspecified compensatory, statutory and treble damages. All defendants, including the Company, filed a motion to dismiss the consolidated amended complaint on July 30, 2007. That motion, will likely be argued during the latter part of 2007. The Company intends to defend against these lawsuits vigorously, but is unable to predict the outcome of these suits. Any litigation the Company may become involved in as a result of the inquiries of the Attorney General and Department of Justice, regardless of the merits of the claim, could be costly and divert the time and resources of management.

*Statement of Objections*

On March 30, 2007, the European Commission ( "EC" ) issued a Statement of Objections to Apple Inc., iTunes S.a.r.l. and one of our subsidiaries, WEA International Inc. ( "WEA" ). Similar Statements of Objections were also issued to Apple Inc. and each of the other major recorded music companies. The Statement of Objections targets Apple Inc.'s practice of applying certain territorial restrictions in relation to its iTunes stores in the European Economic Area ( "EEA" ). The EC alleges that these restrictions arise, among other ways, as a result of the agreement between Apple Inc. and WEA for the sale of downloaded music in the EEA. In the EC's preliminary view, these restrictions may lead to a distortion of competition, infringing Article 81 of the EC Treaty. In particular, the EC asserts that (i) consumers resident in a particular EEA country in which iTunes does not operate a dedicated online store are prevented from acquiring downloaded music from iTunes and (ii) consumers resident in a particular EEA country may be required to pay a higher price for the same download than consumers resident in another EEA country or may not have access to the same downloads as are available to consumers resident in another EEA country. The EC, if it finds an infringement, may require that the alleged restriction be eliminated and also has the authority to impose fines on the parties to any infringement. The Company is cooperating with the EC and, on June 29, 2007, submitted its response to the Statement of Objections to the Commission. We continue to believe that our practices have not infringed Article 81 of the EC Treaty and presented arguments to that effect in our response.

*Settlement with Bertelsmann AG Regarding Napster*

In April 2007, the Company entered into an agreement with Bertelsmann AG ( "Bertelsmann" ) related to a settlement of contingent claims held relating to Bertelsmann's relationship with Napster in 2000-2001. The settlement covers the resolution of the related legal claims against Bertelsmann by our Recorded Music and Music Publishing businesses. As part of the settlement, the Company has received \$110 million which it has

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shared with its artists and songwriters. The Company recorded \$64 million of other income in the twelve months ended September 30, 2007 related to the settlement, the Company allocated 90% of the settlement to our Recorded Music business and 10% of the settlement to our Music Publishing business. Of such amount, \$61 million was recorded as income to Recorded Music and \$3 million was recorded as income to Music Publishing. These amounts were recorded net of amounts payable to recording artists and songwriters.

*Other Matters*

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

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

No matter was submitted to a vote of security holders of Warner Music Group Corp. during the fourth quarter of 2007.

**Table of Contents****PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Warner Music Group Corp.'s common stock is listed on the New York Stock Exchange under the symbol WMG. The following table presents the high and low closing prices for the common stock on the New York Stock Exchange during the periods indicated and the dividends declared during such periods:

|   | High     | Low      | Dividends<br>Paid |
|---|----------|----------|-------------------|
| 2006:                                     |          |          |                   |
| First Quarter                             | \$ 19.27 | \$ 15.25 | \$ 0.13           |
| Second Quarter                            | \$ 22.21 | \$ 19.84 | \$ 0.13           |
| Third Quarter                             | \$ 29.48 | \$ 22.16 | \$ 0.13           |
| Fourth Quarter                            | \$ 30.08 | \$ 22.42 | \$ 0.13           |
| 2007:                                     |          |          |                   |
| First Quarter                             | \$ 26.94 | \$ 22.92 | \$ 0.13           |
| Second Quarter                            | \$ 23.60 | \$ 15.90 | \$ 0.13           |
| Third Quarter                             | \$ 17.49 | \$ 14.40 | \$ 0.13           |
| Fourth Quarter                            | \$ 15.00 | \$ 9.74  | \$ 0.13           |
| 2008:                                     |          |          |                   |
| First Quarter (through November 27, 2007) | \$ 11.29 | \$ 6.89  | \$ 0.13           |

As of September 30, 2007 there were 47 registered holders of record of our common stock. Because many of our shares of common stock are held by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of stockholders represented by these record holders. We believe there are more than 8,000 beneficial holders of our common stock. The closing price of the common stock on the New York Stock Exchange on November 27, 2007, was \$6.89.

**Repurchases of Equity Securities During 2006**

The following table provides information about purchases by us during the fiscal year ending September 30, 2007 of equity securities that are registered by us pursuant to Section 12 of the Securities Act:

**Issuer Purchases of Equity Securities**

| Period           | Total Number of<br>Shares Purchased | Average Price<br>Paid per Share | Total Number of<br>Shares Purchased as<br>Part of Publicly<br>Announced | Maximum Number<br>of Shares that May<br>Yet Be Purchased<br>Under the |
|------------------|-------------------------------------|---------------------------------|---|---|
|                  |                                     |                                 | Plans or Programs   | Plans or Programs   |
| 10/1/06-10/31/06 | 10,841(1)                           | \$ 25.95                        |   |   |
| 3/1/07-3/31/07   | 28,498(2)                           | \$ 16.54                        |   |   |
| 4/1/07-4/30/07   | 59,747(3)                           | \$ 1.04                         |   |   |
| 9/1/07-9/30/07   | 5,125(2)                            | \$ 10.97                        |   |   |
| <b>Total</b>     | <b>104,211</b>                      | <b>\$ 8.36</b>                  |   |   |

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- (1) Reflects shares of common stock withheld from restricted stock that vested during fiscal year 2007 that were surrendered to satisfy withholding tax requirements related to the vesting of the awards. The value of these shares was determined based on the average of the high and low prices of our common stock on the day prior to the date of vesting.



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- (2) Reflects shares of common stock withheld from restricted stock that vested during fiscal year 2007 that were surrendered to the Company to satisfy withholding tax requirements related to the vesting of the awards. The value of these shares was determined based on the closing price of our common stock on the date of vesting.
- (3) Reflects the repurchase of restricted stock from an employee that was unvested at the time of termination of employment. The purchase price represents the original purchase price paid for the shares by the employee.

### **Sales of Unregistered Securities During the Fourth Quarter of Fiscal 2007**

None.

### **Dividend Policy**

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

On December 29, 2006, March 8, 2007, June 5, 2007 and September 4, 2007 we declared dividends on our outstanding common stock at a rate of \$0.13 per share. The dividends were paid on February 16, 2007, April 27, 2007, July 25, 2007 and October 24, 2007, respectively, except for the portion of the dividends with respect to unvested restricted stock, which will be paid at such time as such shares become vested.

During the fiscal year ended September 30, 2007, 1,979,768 shares of restricted stock purchased by or awarded to certain employees of the Company vested. As of September 30, 2007, there were 2,440,870 unvested shares of restricted stock outstanding.

The amounts available to us to pay further cash dividends will be restricted by the senior secured credit facility of our subsidiary Acquisition Corp. and the indentures governing our outstanding notes, including the indenture governing the outstanding 9.5% Senior Discount Notes due 2014 of Holdings and the indenture governing Acquisition Corp.'s 7/8% Senior Subordinated Dollar Notes due 2014 and 8 1/8% Senior Subordinated Sterling Notes due 2014 (the Acquisition Corp. Notes). Under Acquisition Corp.'s senior secured credit facility, generally neither Holdings nor Holdings' subsidiaries may pay dividends or otherwise transfer their assets to us. However, Acquisition Corp.'s senior secured credit facility permits such restricted payments in an amount not to exceed \$10 million, subject to increase up to \$50 million if the leverage ratio is less than 3.5 to 1, and subject to additional increase in an amount equal to 50% of excess cash flow that is not otherwise applied pursuant to Acquisition Corp.'s senior secured credit facility and allows distributions not in excess of \$90 million in any fiscal year to be applied to pay regular quarterly cash dividends to holders of our common stock. The indentures governing the Holdings Notes and the Acquisition Corp. Notes also limit the ability of Holdings, Acquisition Corp. and their subsidiaries to pay dividends to us. Under such indentures, generally our subsidiaries may pay dividends or make other restricted payments depending on a formula based on 50% of consolidated net income as defined in our indentures. In addition, Acquisition Corp. may also make such restricted payments if, on a pro forma basis after giving effect to any such payment, it has a net indebtedness to adjusted EBITDA ratio of no greater than 3.75 to 1.0 and a net senior indebtedness to adjusted EBITDA ratio of no greater than 2.5 to 1.0, and Holdings may make such restricted payments if, on a pro forma basis after giving effect to any such payment, it has a net indebtedness to adjusted EBITDA ratio of no greater than 4.25 to 1.0. Acquisition Corp. and Holdings may also make restricted payments under the indentures of up to \$45 million and \$75 million, respectively, without regard to any such provisions. The Holdings indenture also permits Holdings to dividend up to 6% per annum from proceeds of our initial public offering, which was subsequently invested as a capital contribution to Holdings. See Management's Discussion and Analysis of Financial Condition and Results of Operations Financial Condition and Liquidity Liquidity.

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### **Other Information**

In August 2006, certain of the Company's executive officers entered into written trading plans pursuant to the guidance specified by Rule 10b5-1 under the Securities Exchange Act of 1934. The Company's securities trading policy permits the enactment of pre-determined plans for trades of specified amounts of Company stock in accordance with Rule 10b5-1 of the Securities Exchange Act of 1934 and each plan adopted has been or will be approved pursuant to the terms of the Company's policies. Rule 10b5-1 enables corporate officers and directors to establish stock trading plans for the orderly sale of predetermined amounts of securities. Such plans may be initiated only when the officers and directors are not in possession of material and non-public information. The rule allows individuals adopting such plans to sell shares over a specified amount of time, at specific prices in the future, even if subsequent material and non-public information becomes available to them. Under these plans, insiders can gradually diversify their investment portfolios, spread stock trades out over an extended period of time to reduce market impact and avoid concerns about transactions occurring at a time when they might possess inside information. Insiders may have varied reasons in determining to effect transactions in the Company's common stock, including diversification, liquidity, the purchase of a home, tax and estate planning, payment of college tuition, establishment of a trust or other personal reasons. The executives that have adopted plans informed the Company that these stock sales are part of their individual programs for asset diversification.

The Company anticipates that other executive officers or directors may establish Rule 10b5-1 trading plans in the future. The Company does not undertake to report Rule 10b5-1 trading plans that may be adopted by any executive officers or directors of the Company in the future, or to report any modifications or termination of any publicly announced plan or to report any plan adopted by an employee who is not an executive officer, except to the extent required by law. The Company expects, however, that transactions effected pursuant to Rule 10b5-1 trading plans will be publicly disclosed by executive officers and directors as required by the rules of the Securities and Exchange Commission. Sales pursuant to these plans are reported to the Securities and Exchange Commission as required by law, and those reports will be available on the Company's web site [www.wmg.com](http://www.wmg.com).

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**ITEM 6. SELECTED FINANCIAL DATA**

Our summary balance sheet data as of September 30, 2007 and 2006, and the statement of operations and other data for each of (i) the twelve-month fiscal year ended September 30, 2007, (ii) the twelve-month year ended September 30, 2006, and (iii) the twelve-month fiscal year ended September 30, 2005 have been derived from our audited financial statements included in this annual report on Form 10-K. Our summary balance sheet data as of September 30, 2003 and our summary statement of operations and other data for the twelve months ended September 30, 2004, each of the ten months ended September 30, 2004 and 2003 and the five months ended February 29, 2004 have been derived from our unaudited financial statements that are not included in this annual report on Form 10-K. Our summary balance sheet data as of (i) September 30, 2005, (ii) September 30, 2004, (iii) February 29, 2004, and (iv) November 30, 2003 and the statement of operations and other data for the seven months ended September 30, 2004, the three months ended February 29, 2004 and the twelve-month fiscal year ended November 30, 2003 were derived from our audited financial statements that are not included in this annual report on Form 10-K.

The comparability of our historical financial data has been affected by a number of significant events and transactions. These include the acquisition of substantially all of our recorded music and music publishing businesses from Time Warner effective March 1, 2004 for approximately \$2.6 billion (the Acquisition) in 2004 and a change in our fiscal year to September 30 from November 30, which was enacted in 2004. For all periods prior to the Acquisition, the recorded music and music publishing businesses formerly owned by Time Warner are referred to as Old WMG or the Predecessor. For all periods subsequent to the Acquisition, the business is referred to as the Company or the Successor. Due to the change in our year-end, financial information for 2004 reflects a shortened ten-month period ended September 30, 2004 and is separated into two pre-acquisition and post-acquisition periods as a result of the change in accounting basis that occurred relating to the Acquisition.

In connection with the Acquisition, a new accounting basis was established for the Company as of the acquisition date based upon an allocation of the purchase price to the underlying net assets acquired. As such, financial information for the twelve months ended September 30, 2004 is separated into pre-acquisition and post-acquisition periods as a result of the change in accounting basis that occurred relating to the Acquisition. That is for the twelve-month period ended September 30, 2004, we have presented our operating results and cash flows separately for the pre-acquisition five-month period ended February 29, 2004 and the post-acquisition, seven-month period ended September 30, 2004. The financial information for the ten months ended September 30, 2004 is separated into the pre-acquisition three-month period ended February 29, 2004 and the post-acquisition, seven-month period ended September 30, 2004.

The split presentation mentioned above is required under accounting principles generally accepted in the United States ( U.S. GAAP ) in situations when a change in accounting basis occurs. This is because the new accounting basis requires that the historical carrying value of assets acquired and liabilities assumed be adjusted to fair value, which may yield results that are not strictly comparable on a period-to-period basis due to the different, and sometimes higher, cost basis associated with the allocation of the purchase price.

We believe that this split presentation may impede the ability of users of our financial information to understand our operating and cash flow performance. Consequently, in order to enhance an analysis of our operating results and cash flows, we have presented our operating results and cash flows on a combined basis for the full ten-month period and twelve-month period ended September 30, 2004. The combined presentation for the twelve-month period ended September 30, 2004 simply represents the mathematical addition of the pre-acquisition, five-month period ended February 29, 2004 and the post-acquisition, seven-month period ended September 30, 2004 and the combined presentation for the ten-month period ended September 30, 2004 represents the mathematical addition of the pre-acquisition three-month period ended February 29, 2004 and the post-acquisition seven-month period ended September 30, 2004. These are not intended to represent what our operating results would have been had the Acquisition occurred at the beginning of the period.

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The following table sets forth our selected historical financial and other data as of the dates and for the periods indicated.

|  | Fiscal Year Ended                    |                         |                    |                   |                     |                      | Twelve Months Ended | Twelve Months Ended | Twelve Months Ended | Twelve Months Ended |
|--|--------------------------------------|-------------------------|--------------------|-------------------|---------------------|----------------------|---------------------|---------------------|---------------------|---------------------|
|  | Twelve Months Ended                  | Ten Months Ended        | Three Months Ended | Five Months Ended | Seven Months Ended  | Ten Months Ended     |                     |                     |                     |                     |
|  | Nov. 30, 2003                        | Sept. 30, 2003          | Feb. 29, 2004      | Feb. 29, 2004     | Sept. 30, 2004      | Sept. 30, 2004       | Sept. 30, 2004      | Sept. 30, 2005      | Sept. 30, 2006      | Sept. 30, 2007      |
|  | 2003                                 | 2003                    | 2004               | 2004              | 2004                | 2004                 | 2004                | 2005                | 2006                | 2007                |
|  | (audited)                            | Predecessor (unaudited) | (audited)          | (unaudited)       | Successor (audited) | Combined (unaudited) | (unaudited)         | Successor (audited) | (audited)           | (audited)           |
|  | (in millions, except per share data) |                         |                    |                   |                     |                      |                     |                     |                     |                     |

**Statement of Operations Data:**

|   |            |          |         |            |           |          |            |           |          |           |
|---|------------|----------|---------|------------|-----------|----------|------------|-----------|----------|-----------|
| Revenues                                    | \$ 3,376   | \$ 2,487 | \$ 779  | \$ 1,668   | \$ 1,769  | \$ 2,548 | \$ 3,437   | \$ 3,502  | \$ 3,516 | \$ 3,385  |
| Net (loss) income (1)(2)                    | \$ (1,353) | \$ (201) | \$ (32) | \$ (1,184) | \$ (238)  | \$ (270) | \$ (1,422) | \$ (169)  | \$ 60    | \$ (21)   |
| Diluted (loss) income per common share (3): |            |          |         |            | \$ (2.21) |          |            | \$ (1.40) | \$ 0.40  | \$ (0.14) |
| Dividends per common share                  |            |          |         |            |           |          |            |           | \$ 0.52  | \$ 0.52   |

**Balance Sheet Data (at period end):**

|  |        |       |        |        |        |        |        |        |        |        |
|--|--------|-------|--------|--------|--------|--------|--------|--------|--------|--------|
| Cash and equivalents                                     | \$ 144 | \$ 80 | \$ 471 | \$ 471 | \$ 555 | \$ 555 | \$ 555 | \$ 288 | \$ 367 | \$ 333 |
| Total assets   | 4,484  | 5,255 | 4,560  | 4,560  | 5,090  | 5,090  | 5,090  | 4,498  | 4,520  | 4,572  |
| Total debt (including current portion of long-term debt) | 120    | 115   | 132    | 132    | 1,840  | 1,840  | 1,840  | 2,246  | 2,256  | 2,273  |
| Shareholders' equity                                     | 1,587  | 2,673 | 1,691  | 1,691  | 280    | 280    | 280    | 89     | 58     | (36)   |

**Cash Flow Data:**

Cash flows provided by (used in):

|                      |        |        |        |        |         |         |         |        |        |        |
|----------------------|--------|--------|--------|--------|---------|---------|---------|--------|--------|--------|
| Operating activities | \$ 278 | \$ 257 | \$ 321 | \$ 352 | \$ 86   | \$ 407  | \$ 438  | \$ 205 | \$ 307 | \$ 302 |
| Investing activities | (65)   | (73)   | 14     | 17     | (2,663) | (2,649) | (2,646) | (54)   | (153)  | (255)  |
| Financing activities | (121)  | (151)  | (10)   | 18     | 2,661   | 2,651   | 2,679   | (416)  | (81)   | (94)   |
| Capital expenditures | (51)   | (30)   | (3)    | (24)   | (15)    | (18)    | (39)    | (30)   | (30)   | (29)   |

(1) Net income (loss) for the twelve months ended September 30, 2004, the five months ended February 29, 2004 and the twelve months ended November 30, 2003 include an impairment loss on goodwill and other intangible assets of \$1.019 billion and a loss on the sale of physical distribution assets of \$12 million.

(2) Net income (loss) for the twelve months ended September 30, 2005 includes \$102 million of costs associated with the initial public offering, including a \$73 million loss on termination of the management agreement and \$29 million of one-time compensation expense.

(3) Net income (loss) per share is calculated by dividing net income (loss) by the weighted average common shares outstanding.

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

You should read the following discussion of our results of operations and financial condition with the audited financial statements included elsewhere in this Annual Report on Form 10-K for the fiscal year ended September 30, 2007 (the "Annual Report").

**SAFE HARBOR STATEMENT UNDER PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995**

This Annual Report includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements other than statements of historical facts included in this Annual Report, including, without limitation, statements regarding our future financial position, business strategy, budgets, projected costs, cost savings, industry trends and plans and objectives of management for future operations, are forward-looking statements. In addition, forward-looking statements generally can be identified by the use of forward-looking terminology such as may, will, expect, intend, estimate, anticipate, believe or continue or the negative thereof or variations thereon or similar terms. Such statements include, among others, statements regarding our ability to develop talent and attract future talent, to reduce future capital expenditures, to monetize our music content, including through new distribution channels and formats to capitalize on the growth areas of the music industry, to effectively deploy our capital, the development of digital music and the effect of digital distribution channels on our business, including whether or not the Internet will become an important sales channel and whether we will be able to achieve higher margins from digital sales, the success of strategic actions we are taking to accelerate our transformation as we redefine our role in the music industry, our success in limiting piracy, our ability to compete in the highly competitive markets in which we operate, the growth of the music industry and the effect of our and the music industry's efforts to combat piracy on the industry, the intention to pay quarterly dividends, our ability to fund our future capital needs and the effect of litigation on us. Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to have been correct.

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

the impact of our substantial leverage on our ability to raise additional capital to fund our operations, on our ability to react to changes in the economy or our industry and on our ability to meet our obligations under our indebtedness;

the continued decline in the global recorded music industry and the rate of overall decline in the music industry;

our ability to continue to identify, sign and retain desirable talent at manageable costs;

the threat posed to our business by piracy of music by means of home CD-R activity, Internet peer-to-peer file-sharing and sideloading of unauthorized content;

the significant threat posed to our business and the music industry by organized industrial piracy;

the popular demand for particular recording artists and/or songwriters and albums and the timely completion of albums by major recording artists and/or songwriters;

the diversity and quality of our portfolio of songwriters;

the diversity and quality of our album releases;



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significant fluctuations in our results of operations and cash flows due to the nature of our business;

our involvement in intellectual property litigation;

the possible downward pressure on our pricing and profit margins;

the seasonal and cyclical nature of recorded music sales;

our ability to continue to enforce our intellectual property rights in digital environments;

the ability to develop a successful business model applicable to a digital environment;

the ability to maintain product pricing in a competitive environment;

the impact of heightened and intensive competition in the recorded music and music publishing businesses and our inability to execute our business strategy;

risks associated with our non-U.S. operations, including limited legal protections of our intellectual property rights and restrictions on the repatriation of capital;

the impact of legitimate music distribution on the Internet or the introduction of other new music distribution formats;

the reliance on a limited number of online music stores and their ability to significantly influence the pricing structure for online music stores;

the impact of rate regulations on our Recorded Music and Music Publishing businesses;

the impact of rates on other income streams that may be set by arbitration proceedings on our business;

risks associated with the fluctuations in foreign currency exchange rates;

our ability and the ability of our joint venture partners to operate our existing joint ventures satisfactorily;

the enactment of legislation limiting the terms by which an individual can be bound under a personal services contract;

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potential loss of catalog if it is determined that recording artists have a right to recapture recordings under the U.S. Copyright Act;

changes in law and government regulations;

legal or other developments related to pending litigation or investigations by the Attorney General of the State of New York, the Department of Justice and the European Commission;

trends that affect the end uses of our musical compositions (which include uses in broadcast radio and television, film and advertising businesses);

the growth of other products that compete for the disposable income of consumers;

risks inherent in relying on one supplier for manufacturing, packaging and distribution services in North America and Europe;

risks inherent in our acquiring or investing in other businesses including our ability to successfully manage new businesses that we may acquire as we diversify revenue streams within the music industry;

the impact of our recently announced realignment plan on our business;

the possibility that our owners' interests will conflict with ours or yours;

the effects associated with the formation of Sony BMG Music Entertainment; and

failure to attract and retain key personnel.



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

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

## **INTRODUCTION**

Warner Music Group Corp. (the **Company** or **Parent**) was formed by a private equity consortium of Investors (the **Investor Group**) on November 21, 2003. The Company is the direct parent of WMG Holdings Corp. (**Holdings**), which is the direct parent of WMG Acquisition Corp. (**Acquisition Corp.**). Acquisition Corp is one of the world's major music companies and the successor to the interests of the recorded music and music publishing businesses of Time Warner Inc. (**Time Warner**). Such predecessor interests formerly owned by Time Warner are hereinafter referred to as **Old WMG** or the **Predecessor**. Effective March 1, 2004, Acquisition Corp. acquired Old WMG from Time Warner for approximately \$2.6 billion (the **Acquisition**). The original Investor Group included Thomas H. Lee Partners, L.P. and its affiliates (**THL**), Bain Capital and its affiliates (**Bain**), Providence Equity Partners, Inc. and its affiliates (**Providence**) and Music Capital Partners, L.P. (**Music Capital**). Music Capital's partnership agreement required that the Music Capital partnership dissolve and commence winding up by the second anniversary of the Company's May 2005 initial public offering. As a result, on May 7, 2007, Music Capital made a pro rata distribution of all shares of common stock of the Company held by it to its partners. The shares held by Music Capital had been subject to a stockholders agreement among Music Capital, THL, Bain and Providence and certain other parties. As a result of the distribution, the shares distributed by Music Capital ceased to be subject to the voting and other provisions of the stockholders agreement and Music Capital was no longer part of the Investor Group subject to the stockholders agreement.

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

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

*Overview.* This section provides a general description of our business, as well as recent developments that we believe are important in understanding our results of operations and financial condition and in anticipating future trends.

*Results of operations.* This section provides an analysis of our results of operations for the twelve-month periods ended September 30, 2007, 2006 and 2005. This analysis is presented on both a consolidated and segment basis.

*Financial condition and liquidity.* This section provides an analysis of our cash flows for the twelve-month periods ended September 30, 2007 and 2006, as well as a discussion of our financial condition and liquidity as of September 30, 2007. The discussion of our financial condition and liquidity includes (i) our available financial capacity under the revolving credit portion of our senior secured credit facility and (ii) a summary of our key debt compliance measures under our debt agreements.

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### **Use of OIBDA**

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

### **OVERVIEW**

We are one of the world's major music content companies. We classify our business interests into two fundamental operations: Recorded Music and Music Publishing. A brief description of each of those operations is presented below.

#### *Recorded Music Operations*

Our Recorded Music business consists of the discovery and development of artists and the related marketing, distribution and licensing of recorded music produced by such artists. In addition to the more traditional methods of discovering and developing artists, we established ILG to discover artists earlier in their careers and at a lower cost by leveraging our independent distribution network.

In the U.S., our recorded music operations are conducted principally through our major record labels Warner Bros. Records and The Atlantic Records Group. Our Recorded Music operations also include Rhino, a division that specializes in marketing our music catalog through compilations and reissues of previously released music and video titles, as well as in the licensing of recordings to and from third parties for various uses, including film and television soundtracks. On May 31, 2006, the Company completed the acquisition of Ryko, a leading independent, integrated music and entertainment company. In January 29, 2007, the Company acquired a majority interest in Roadrunner, which includes Roadrunner Records, one of the leading hard rock and heavy metal labels.

Outside the U.S., our recorded music activities are conducted in more than 50 countries through WMI and its various subsidiaries, affiliates and non-affiliated licensees. WMI engages in the same activities as our U.S. labels: discovering and signing artists and distributing, marketing and selling their recorded music. In most cases, WMI also markets and distributes the records of those artists for whom our domestic record labels have international rights. In certain smaller countries, WMI licenses to unaffiliated third-party record labels the right to distribute its records.

Our Recorded Music distribution operations include WEA Corp, which markets and sells music and DVD products to retailers and wholesale distributors in the U.S.; ADA, which distributes the products of independent labels to retail and wholesale distributors in the U.S.; Ryko Distribution, which distributes music and DVD releases from Rykodisc, Ryko's record music label, and third-party record and video labels; various distribution centers and ventures operated internationally; an 80% interest in Word Entertainment, which specializes in the distribution of music products in the Christian retail marketplace; and the ADA U.K., which provides ADA's distribution services to independent labels in the U.K.

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

royalty costs and artist and repertoire costs the costs associated with (i) paying royalties to artists, producers, songwriters, other copyright holders and trade unions, (ii) signing and developing artists, (iii) creating master recordings in the studio and (iv) creating artwork for album covers and liner notes;

product costs the costs to manufacture, package and distribute product to wholesale and retail distribution outlets;

selling and marketing costs the costs associated with the promotion and marketing of artists and recorded music products, including costs to produce music videos for promotional purposes and artist tour support; and

general and administrative costs the costs associated with general overhead and other administrative costs.

### *Music Publishing Operations*

Where recorded music is focused on exploiting a particular recording of a song, music publishing is an intellectual property business focused on the exploitation of the song itself. In return for promoting, placing, marketing and administering the creative output of a songwriter, or engaging in those activities for other rights holders, our music publishing business garners a share of the revenues generated from use of the song.

Our music publishing operations include Warner/Chappell, our global music publishing company headquartered in Los Angeles with operations in over 50 countries through various subsidiaries, affiliates and non-affiliated licensees. We own or control rights to more than one million musical compositions, including numerous pop hits, American standards, folk songs and motion picture and theatrical compositions. Assembled over decades, our award-winning catalog includes over 65,000 songwriters and composers and a diverse range of genres including pop, rock, jazz, country, R&B, hip-hop, rap, reggae, Latin, folk, blues, symphonic, soul, Broadway, techno, alternative, gospel and other Christian music. Warner/Chappell also administers the music and soundtracks of several third-party television and film producers and studios, including Lucasfilm, Ltd. and Hallmark Entertainment.

Warner/Chappell also previously owned WBP, which printed and distributed a broad selection of sheet music, books and educational materials, orchestrations, folios, personality books and arrangements from the catalogs of Warner/Chappell and other music publishers. On May 31, 2005, we sold our printed sheet music business to Alfred Publishing.

Publishing revenues are derived from four main sources:

*Mechanical:* the licensor receives royalties with respect to compositions embodied in recordings sold in any format or configuration, including physical recordings (*e.g.*, CDs, DVDs, video cassettes), online and wireless downloads and mobile phone ringtones.

*Performance:* the licensor receives royalties if the composition is performed publicly through broadcast of music on television, radio, cable and satellite, live performance at a concert or other venue (*e.g.*, arena concerts, nightclubs), online and wireless streaming and performance of music in staged theatrical productions.

*Synchronization:* the licensor receives royalties or fees for the right to use the composition in combination with visual images such as in films or television programs, television commercials and videogames.

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*Other:* the licensor receives royalties from other uses such as in toys or novelty items and for use in sheet music.

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

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

administration costs the costs associated with general overhead and other administrative costs.

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

#### *Market Factors*

Since 1999, the recorded music industry has been unstable, which has adversely affected our operating results. The industry-wide decline can be attributed primarily to digital piracy. Other drivers of this decline are the bankruptcies of record retailers and wholesalers, growing competition for consumer discretionary spending and retail shelf space, and the maturation of the CD format, which has slowed the historical growth pattern of recorded music sales. While CD sales still generate most of the recorded music revenues, CD sales continue to decline industry-wide and we expect that trend to continue. While new formats for selling recorded music product have been created, including the legal downloading of digital music using the Internet, DVD-Audio formats and the distribution of music on mobile devices, significant revenue streams from these new markets are just beginning to emerge. The recorded music industry performance may continue to negatively impact our operating results. In addition, a declining recorded music industry could continue to have an adverse impact on the music publishing business. This is because our music publishing business generates a significant portion of its revenues from mechanical royalties received from the sale of music in recorded music formats such as the CD.

#### *Realignment Plan for Fiscal Year 2007*

In the second quarter of fiscal year 2007, the Company announced plans to implement changes intended to better align the Company's workforce with the changing nature of the music industry. These changes are part of the Company's continued evolution from a traditional record and songs-based business to a music-based content company and its ongoing management of its cost structure. The changes include a continued redeployment of resources to focus on new business initiatives to help the Company diversify its revenue streams, including digital opportunities. The realignment plan was also designed to improve the operating effectiveness and efficiency of our current businesses and to realign our management structure to, among other things, effectively address the continued development of digital distribution channels along with the decline of industry-wide CD sales.

The Company intends to enhance its effectiveness, flexibility, structure, and performance by reducing and realigning long-term costs. The realignment plan primarily consisted of the reorganization of management structures to more adequately and carefully address regional needs and new business requirements, to reduce organizational complexity and to improve leadership channels. The Company also continued to shift resources from our physical sales channels to efforts focused on digital distribution and emerging technologies and other new revenue streams. Part of the plan also resulted in the outsourcing of some back-office functions as a cost-savings measure.

The changes described above were implemented by the end of the fiscal year 2007. The Company incurred all of the costs associated with the realignment plan in fiscal year 2007. Approximately \$50 million of restructuring costs and \$13 million of implementation costs have been incurred since the realignment plan was implemented, and primarily all of these costs were paid in cash. To implement such changes, the Company reduced headcount by approximately 400 employees. The Company expects the majority of any cost savings to be offset by new business initiatives such as digital distribution and video.

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*Payments Relating to Executive Compensation*

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

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

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

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

*Holdings Refinancing and Redemption*

In December 2004, Holdings issued \$847 million principal amount of debt. The \$847 million principal amount of Holdings' debt consisted of (i) \$250 million principal amount of Floating Rate Senior Notes due 2011 (the Holdings Floating Rate Notes), (ii) \$397 million principal amount at maturity of 9.5% Senior Discount Notes due 2014, which had an initial issuance discount of \$147 million (the Holdings Discount Notes) and (iii) \$200 million principal amount of Floating Rate Senior PIK Notes due 2014 (the Holdings PIK Notes), and collectively, the Holdings Notes).

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In connection with the initial public offering, we used \$517 million of proceeds from the offering along with \$57 million of available cash to redeem the Holdings Floating Rate Notes, the Holdings PIK Notes and 35% of the Holdings Discount Notes on June 15, 2005. In connection with the redemption, we were required to pay redemption premiums of \$10 million and \$9 million, respectively, which were paid on June 15, 2005 and recorded as a loss on the repayment of the notes in the consolidated statement of operations for the year ended September 30, 2005. We also wrote off the remaining balance of debt-issuance costs of \$12 million related to the notes redeemed and the remaining unamortized original issue discount of \$4 million related to the Holdings PIK Notes. Such amounts, \$35 million in the aggregate, were recorded as a loss on the repayment of the notes in the consolidated statement of operations for the twelve months ended September 30, 2005. See *Financial Condition and Liquidity* for more information.

### *Termination of Management/ Monitoring Agreement*

As described in Note 18 to our audited consolidated financial statements included herein, we entered into a management monitoring agreement (the *Management Agreement*) with the Investor Group in connection with the Acquisition.

Under the Management Agreement, we were required to pay the Investor Group an aggregate annual fee of \$10 million per year (the *Periodic Fees*) in consideration for ongoing consulting and management advisory services. The Investor Group terminated the Management Agreement on May 10, 2005 and on May 16, 2005, we paid the Investor Group a \$73 million termination fee which was reflected in our statement of operations for the twelve months ended September 30, 2005. As a result, certain fees paid in prior periods do not appear in subsequent periods. We paid \$6 million of Periodic Fees under the Management Agreement during the twelve months ended September 30, 2005. We no longer pay any Periodic Fees following the termination of the agreement.

### *Sale of Warner Bros. Publications*

In May 2005, we sold WBP, which conducted our sheet music operations, to Alfred Publishing. No gain or loss was recognized on the transaction, as the historical book basis of the net assets being sold was adjusted to fair value in connection with the accounting for the Acquisition. Due to our continuing involvement with WBP, it was not reported as discontinued operations. For the twelve months ended September 30, 2005, the operations sold generated revenues of approximately \$34 million; operating income of \$1 million; operating income before depreciation and amortization expense of \$1 million; and net income of approximately \$1 million.

### *Lava Records Restructuring*

The co-chairman of The Atlantic Records Group left our employ in August 2005 and we acquired the remaining interest of the Lava Records joint venture. As a result, in order to streamline our operations, we integrated the Lava operations into the operations of The Atlantic Records Group. In connection with the integration, certain employees were involuntarily terminated and certain artist contracts were terminated, which resulted in the recognition of \$7 million in restructuring costs and we also incurred other non-recurring charges of \$24 million, specifically related to the departure of the co-chairman of The Atlantic Records Group and the expensing of certain other amounts, in the twelve months ended September 30, 2005. Approximately \$20 million of these charges were non-cash.

### *Settlements*

In April 2007, we entered into an agreement with Bertelsmann AG ( *Bertelsmann* ) related to a settlement of contingent claims held by us relating to Bertelsmann's relationship with Napster in 2000-2001. The settlement covers the resolution of the related legal claims against Bertelsmann by our Recorded Music and Music Publishing businesses. As part of the settlement, we have received \$110 million which we have shared with our

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recording artists and songwriters. We recorded \$64 million of other income in the twelve months ended September 30, 2007 related to the settlement. We allocated 90% of the settlement to our Recorded Music business and 10% of the settlement to our Music Publishing business. Of such amount, \$61 million was recorded as income to Recorded Music and \$3 million was recorded as income to Music Publishing. These amounts were recorded net of amounts payable to our recording artists and songwriters.

In September 2006, the major record companies reached a global out-of-court settlement of international copyright litigation against the operators of the KaZaA peer-to-peer network. Under the terms of the settlement, the KaZaA defendants agreed to pay compensation to the record companies that brought the action, including us. We recorded approximately \$13 million of income related to this settlement in the twelve months ended September 30, 2006. These amounts were recorded net of the estimated amounts payable to our artists in respect of royalties. The cash related to this settlement was received in the first quarter of fiscal 2008.

We recorded \$5 million of expense related to the settlement of a government investigation into radio promotion practices by the New York State Attorney General in the twelve months ended September 30, 2005.

**RESULTS OF OPERATIONS****Year Ended September 30, 2007 Compared with Year Ended September 30, 2006 and Year Ended September 30, 2006 Compared with Year Ended September 30, 2005***Consolidated Historical Results**Revenues*

Our revenues were composed of the following amounts (in millions):

|   | For the Years Ended |                 |                 | 2007 vs 2006    |            | 2006 vs 2005 |             |
|---|---------------------|-----------------|-----------------|-----------------|------------|--------------|-------------|
|   | 2007                | 2006            | 2005            | \$ Change       | % Change   | \$ Change    | % Change    |
| <b>Revenue by Type</b>                  |                     |                 |                 |                 |            |              |             |
| Physical sales                          | \$ 2,159            | \$ 2,484        | \$ 2,585        | \$ (325)        | -13%       | \$ (101)     | -4%         |
| Digital                                 | 434                 | 335             | 137             | 99              | 30%        | 198          | 145%        |
| Licensing                               | 244                 | 186             | 202             | 58              | 31%        | (16)         | -8%         |
| <b>Total Recorded Music</b>             | <b>2,837</b>        | <b>3,005</b>    | <b>2,924</b>    | <b>(168)</b>    | <b>-6%</b> | <b>81</b>    | <b>3%</b>   |
| Mechanical                              | 228                 | 225             | 264             | 3               | 1%         | (39)         | -15%        |
| Performance                             | 213                 | 191             | 186             | 22              | 12%        | 5            | 3%          |
| Synchronization                         | 85                  | 83              | 97              | 2               | 2%         | (14)         | -14%        |
| Digital                                 | 27                  | 20              | 20              | 7               | 35%        |              | 0%          |
| Other                                   | 17                  | 19              | 40              | (2)             | -11%       | (21)         | -53%        |
| <b>Total Music Publishing</b>           | <b>570</b>          | <b>538</b>      | <b>607</b>      | <b>32</b>       | <b>6%</b>  | <b>(69)</b>  | <b>-11%</b> |
| Intersegment elimination                | (22)                | (27)            | (29)            | 5               | 19%        | 2            | -7%         |
| <b>Total Revenue</b>                    | <b>\$ 3,385</b>     | <b>\$ 3,516</b> | <b>\$ 3,502</b> | <b>\$ (131)</b> | <b>-4%</b> | <b>\$ 14</b> | <b>0%</b>   |
| <b>Revenue by Geographical Location</b> |                     |                 |                 |                 |            |              |             |
| U.S. Recorded Music                     | \$ 1,461            | \$ 1,483        | \$ 1,411        | \$ (22)         | -1%        | \$ 72        | 5%          |
| U.S. Publishing                         | 212                 | 220             | 266             | (8)             | -4%        | (46)         | -17%        |
| <b>Total U.S.</b>                       | <b>1,673</b>        | <b>1,703</b>    | <b>1,677</b>    | <b>(30)</b>     | <b>-2%</b> | <b>26</b>    | <b>2%</b>   |
| International Recorded Music            | 1,376               | 1,522           | 1,513           | (146)           | -10%       | 9            | 1%          |
| International Publishing                | 358                 | 318             | 341             | 40              | 13%        | (23)         | -7%         |



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|                            |                 |                 |                 |                 |            |              |            |
|----------------------------|-----------------|-----------------|-----------------|-----------------|------------|--------------|------------|
| <b>Total International</b> | <b>1,734</b>    | <b>1,840</b>    | <b>1,854</b>    | <b>(106)</b>    | <b>-6%</b> | <b>(14)</b>  | <b>-1%</b> |
| Intersegment eliminations  | (22)            | (27)            | (29)            | 5               | -19%       | 2            | -7%        |
| <b>Total Revenue</b>       | <b>\$ 3,385</b> | <b>\$ 3,516</b> | <b>\$ 3,502</b> | <b>\$ (131)</b> | <b>-4%</b> | <b>\$ 14</b> | <b>0%</b>  |

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*Total Revenue*

*2007 vs 2006*

Total revenues declined by \$131 million or 4% to \$3.385 billion, from \$3.516 billion for the fiscal year ended September 30, 2006. Excluding the favorable impact of foreign currency exchange rates, total revenues declined \$247 million or 7%. Recorded Music and Music Publishing revenues comprised 83% and 17% of total revenues for the twelve months ended September 30, 2007, respectively, compared to 85% and 15% for the twelve months ended September 30, 2006, respectively. U.S and international revenues comprised 49% and 51% of total revenues for the twelve months ended September 30, 2007, respectively, compared to 48% and 52% for the twelve month ended September 30, 2006, respectively.

Recorded Music revenues decreased by \$168 million, or 6%, and were favorably impacted by foreign exchange of approximately \$86 million for the year ended September 30, 2007. The decrease was primarily attributable to the decline in physical sales of \$325 million, or \$394 million, excluding the favorable impact of foreign currency exchange rates. This decline was driven by a number of factors including market declines, primarily in Europe, fewer significant releases and declines in catalog and carryover sales, and was partly offset by increases in digital and licensing revenue of \$99 million and \$58 million, respectively.

Excluding the favorable impact of foreign currency exchange rates, digital sales increased by \$95 million, which was the result of continued growth and development of new digital distribution channels. International digital sales increased to 32% of total digital sales from 28% in the prior year. Digital revenue represented 14% and 10% of consolidated revenues for the years ended September 30, 2007 and September 30, 2006, respectively. Total digital revenues for the twelve months ended September 30, 2007 were comprised of U.S. revenues of \$311 million, or 68% of total digital revenues, and international revenues of \$150 million, or 32% of total digital revenues. Total digital revenues also includes \$1 million of revenue eliminations.

Music Publishing revenues increased to \$570 million for the twelve months ended September 30, 2007 as compared to \$538 million for the twelve months ended September 30, 2006. Excluding the favorable impact of foreign currency exchange rates, Music Publishing revenues increased by \$4 million. The increase was due to growth in performance and digital revenues, partially offset by a decline in mechanical revenues.

*2006 vs 2005*

Our revenues increased \$14 million to \$3.516 billion for the twelve months ended September 30, 2006 as compared to \$3.502 billion for the twelve months ended September 30, 2005. Excluding a \$48 million unfavorable impact of foreign currency exchange rates, total revenue increased by \$62 million, or 2%, primarily due to significant increases in digital sales. Prior year revenue also included revenue of \$34 million related to our sheet music business, WBP, which was sold in May 2005. International operations represented \$1.813 billion and \$1.827 billion of consolidated revenues for the twelve months ended September 30, 2006 and 2005, respectively, comprising 52% of total revenues for each twelve-month period.

Recorded Music revenues increased by \$81 million, to \$3.005 billion for the twelve months ended September 30, 2006. Excluding the impact of foreign currency exchange rates, Recorded Music revenues increased by \$119 million or 4%, primarily driven by an increase in worldwide Recorded Music digital sales of \$198 million offset by a decrease in worldwide Recorded Music licensing revenue and physical sales of \$79 million.

Overall digital revenues grew \$198 million to \$355 million for the twelve months ended September 30, 2006, as compared to \$157 million for the twelve months ended September 30, 2005. Digital revenues represented 10% and 4% of consolidated revenues for the twelve months ended September 30, 2006 and 2005, respectively. Total digital revenues for the twelve months ended September 30, 2006 were comprised of U.S. revenues of \$252 million, or 71% of total digital revenues, and international revenues of \$103 million, or 29% of

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total digital revenues. The increase in digital revenues resulted from continued efforts to develop our digital business including efforts to further monetize existing content through new formats and new distribution channels and the increased usage of legal, online and mobile distribution channels for the music industry.

Music Publishing revenues declined by \$69 million, to \$538 million for the twelve months ended September 30, 2006. Excluding the impact of foreign currency exchange rates, Music Publishing revenues declined by \$59 million, or 10%. Excluding both the impact of foreign currency exchange rates and the prior-year revenue related to our sheet music business, WBP, Music Publishing revenues declined \$25 million, or 4%.

### *Revenue by Geographical Location*

#### *2007 vs 2006*

U.S. revenues decreased by \$30 million or 2%, due primarily to a decline in physical sales, offset by growth in U.S. digital revenues of \$53 million, which was driven by growth and development of new distribution channels. In addition, there was a decrease in U.S. Music Publishing revenues of \$8 million.

International revenues decreased by \$106 million or 6%, or \$220 million and 11% excluding the favorable impact of foreign currency exchange rates. This decrease was driven by factors similar to those in the U.S., primarily the decline in physical product sales of \$227 million, or \$296 million excluding the favorable impact of foreign currency exchange rates. This decrease was offset by a \$46 million increase attributable to the growth of digital sales which is being driven by increased digital music downloads and an expanding market for mobile music downloads. International Music Publishing revenues increased by \$40 million for the fiscal year ended September 30, 2007, or \$12 million, excluding the impact of foreign currency exchange rates, which was primarily due to an increase in performance revenue resulting from several successful live shows in Europe, several top performing hits, local artist growth and expanded television appearances.

#### *2006 vs 2005*

U.S. revenues increased by \$26 million or 2%, primarily due to the increase in digital revenues, as the U.S. has experienced faster growing digital sales. The growth in U.S. digital revenues of \$137 million was driven in part by the continued development of new distribution channels. In addition, the U.S. digital business has experienced growth due to a number of hit singles that have driven significant digital sales. This was offset in part by U.S. physical sales and licensing revenues which declined by \$65 million. In addition, U.S. Publishing revenues declined by \$46 million primarily related to the sale of our sheet music business, WBP, in May of 2005.

International revenues decreased by \$14 million, but increased by \$34 million or 2% excluding the impact of foreign currency exchange rates. This was driven primarily by the increase in digital revenue of \$61 million, offset in part by a decrease in physical sales and licensing revenues of \$14 million. Digital revenue continues to grow as new technologies develop, however at a slower pace than in the U.S. Physical sales declines reflect a decline in catalog and carryover sales, offset by the worldwide commercial success of a number of top-selling albums.

See *Business Segment Results* presented hereinafter for a discussion of revenue by type for each business segment.

**Table of Contents***Cost of revenues*

Our cost of revenues is composed of the following amounts (in millions):

|                               | For the Years Ended<br>September 30, |                 |                 | 2007 vs 2006 |           | 2006 vs 2005   |            |
|-------------------------------|--------------------------------------|-----------------|-----------------|--------------|-----------|----------------|------------|
|                               | 2007                                 | 2006            | 2005            | \$ Change    | % Change  | \$ Change      | % Change   |
| Artist and Repertoire Costs   | \$ 1,214                             | \$ 1,219        | \$ 1,274        | \$ (5)       | 0%        | \$ (55)        | -4%        |
| Product Costs                 | 609                                  | 603             | 576             | 6            | 1%        | 27             | 5%         |
| <b>Total Cost of Revenues</b> | <b>\$ 1,823</b>                      | <b>\$ 1,822</b> | <b>\$ 1,850</b> | <b>\$ 1</b>  | <b>0%</b> | <b>\$ (28)</b> | <b>-2%</b> |

*2007 vs 2006*

Our cost of revenues were relatively flat, but decreased by \$70 million, or 4%, excluding the impact of foreign currency exchange rates. Expressed as a percent of revenues, cost of revenues was 54% compared with 52% for the year ended September 30, 2006.

Artist and repertoire costs increased as a percentage of revenues from 35% in the prior year to 36% in the current year driven primarily by changes in product mix, including an increased number of digital products, CD/DVD combinations and box sets, which have varying royalty rates.

Product costs increased from 17% of revenues in the twelve months ended September 30, 2006 to 18% of revenues in the twelve months ended September 30, 2007. The increase was due to a change in product mix, including an increase in third-party distribution sales, due in part to an increase in our third-party distribution business as well as an increase in merchandising sales and the sale of higher cost products, including CD/DVD combinations and box sets.

*2006 vs 2005*

Our cost of revenues decreased by \$28 million, or 2%, to \$1.822 billion for the twelve months ended September 30, 2006 as compared to \$1.850 billion for the twelve months ended September 30, 2005. Expressed as a percent of revenues, cost of revenues was 52% and 53% for the twelve months ended September 30, 2006 and 2005, respectively. Excluding a \$30 million favorable impact of foreign currency exchange rates and \$22 million of prior-year expenses related to our sheet music business, which was sold in May 2005, our cost of revenues increased \$24 million, or 1%.

Excluding the impact of foreign currency exchange rates, artist and repertoire costs decreased by \$42 million due primarily to \$7 million of royalty expense related to the sheet music business, WBP, sold by us in May 2005, in the twelve months ended September 30, 2005 and \$21 million less of unrecoverable advances in the current year offset in part by an increase in royalty expense and licensing costs of \$11 million related to the increase in current year revenues and the current year product mix, which includes certain top-selling albums with higher applicable royalty rates.

Excluding the impact of foreign currency exchange rates, product costs increased by \$32 million, however excluding \$15 million of product costs relating to our sheet music business in the twelve months ended September 30, 2005, product costs increased by \$47 million, or 7%, due primarily to an increase in costs related to our third-party distribution business related to current year sales increases as well as an increase in product costs related to sales of higher-cost physical product in the current year.

**Table of Contents***Selling, general and administrative expenses*

Our selling, general and administrative expenses are composed of the following amounts:

|  | For the Years Ended<br>September 30, |                 |                 | 2007 vs 2006   |            | 2006 vs 2005   |            |
|--|--------------------------------------|-----------------|-----------------|----------------|------------|----------------|------------|
|  | 2007                                 | 2006            | 2005            | \$ Change      | % Change   | \$ Change      | % Change   |
| General and Administrative Expense (1)                   | \$ 548                               | \$ 534          | \$ 632          | \$ 14          | 3%         | \$ (98)        | -16%       |
| Selling and Marketing Expense                            | 547                                  | 619             | 598             | (72)           | -12%       | 21             | 4%         |
| Distribution Expense                                     | 69                                   | 79              | 75              | (10)           | -13%       | 4              | 5%         |
| <b>Total Selling, General and Administrative Expense</b> | <b>\$ 1,164</b>                      | <b>\$ 1,232</b> | <b>\$ 1,305</b> | <b>\$ (68)</b> | <b>-6%</b> | <b>\$ (73)</b> | <b>-6%</b> |

(1) Includes depreciation expense of \$40 million, \$42 million and \$51 million for the years ended September 30, 2007, 2006 and 2005, respectively.  
*2007 vs 2006*

Selling, general and administrative expenses decreased by \$68 million, or 6%, to \$1.164 billion for the year ended September 30, 2007. Expressed as a percent of revenues, selling, general and administrative expenses were 34% and 35% for the twelve months ended September 30, 2007 and 2006, respectively. Excluding the impact of foreign currency exchange rates, selling, general and administrative expenses decreased by \$100 million.

Excluding the impact of foreign currency exchange rates, general and administrative costs increased by \$3 million compared to the twelve months ended September 30, 2006. General and administrative costs reflect severance and consultancy costs incurred during the implementation of our cost-management efforts of \$13 million and \$9 million of costs related to the previously disclosed proposed acquisition of EMI, offset by a decrease in annual bonus compensation expense and a reduction in costs related to our cost-management efforts. In addition, prior year general and administrative costs reflect higher bad debt expense related to the large music retailers bankruptcies.

Excluding the impact of foreign currency exchange rates, sales and marketing costs decreased by \$90 million and distribution costs decreased by \$13 million. Sales and marketing costs declined due to fewer significant releases during the current year along with our cost-saving initiatives implemented during 2007. Distribution costs decreased in line with the decrease in physical sales.

*2006 vs 2005*

Our selling, general and administrative expenses decreased by \$73 million, or 6%, to \$1.232 billion for the twelve months ended September 30, 2006 as compared to \$1.305 billion for the twelve months ended September 30, 2005. Expressed as a percent of revenues, selling, general and administrative expenses were 35% and 37% for the twelve months ended September 30, 2006 and 2005, respectively. Excluding a \$13 million favorable impact of foreign currency exchange rates and \$11 million of prior-year expenses related to our sold sheet music business, selling, general and administrative expenses decreased by \$49 million, or 4%.

The prior-year general and administrative costs include the following expenses that occurred during the twelve months ended September 30, 2005: (i) \$29 million in compensation expense, consisting of a \$10 million one-time bonus to employees related to the Company's initial public offering and \$19 million of one-time payments to holders of the Company's restricted stock and stock options, primarily to compensate them for certain amounts related to stock awards issued at prices that were below fair value at the grant date, (ii) \$24 million of expense related to the departure of the co-chairman of The Atlantic Records Group and the expensing

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of certain amounts paid in connection with the acquisition of Lava Records and (iii) \$6 million of management fees incurred related to the terminated Management Agreement described below.

Excluding these items, general and administrative costs decreased by \$29 million, which includes a decrease in depreciation expense of \$9 million. The twelve months ended September 30, 2006 included a severance payment of \$8 million related to the departure of the chairman of WMI in February 2006 and an increase in bad debt expense of \$10 million related to the bankruptcies of large music retailers in the current year. The remaining \$38 million decrease was due in part to the Lava Records restructuring in the prior year, which resulted in decreased headcount, along with a continued focus on cost management and cost reduction, a decrease in professional fees and a decrease in stock-based compensation of \$9 million.

Excluding the impact of foreign currency exchange rates and excluding \$4 million of selling and marketing costs related to our sheet music business, WBP, sold in May 2005, for the twelve months ended September 30, 2005, selling and marketing costs increased by \$33 million due to increased marketing for a larger number of releases selling in excess of one million units and timing of our release schedule.

### *Other income, net*

#### *2007 vs 2006*

Other income, net increased by \$59 million, to \$73 million for the year ended September 30, 2007 as compared to \$14 million for the year ended September 30, 2006. Other income for the current period is primarily related to the settlement of contingent claims held by us relating to Bertelsmann's relationship with Napster in 2000-2001 that occurred in 2007. We recorded \$64 million, which relates to the amounts we received in the settlement, net of the amounts payable or paid to recording artists and songwriters with respect to royalties.

#### *2006 vs 2005:*

Other income, net increased by \$10 million, to \$14 million for the twelve months ended September 30, 2006 as compared to \$4 million for the twelve months ended September 30, 2005. The increase is primarily related to the KaZaA copyright infringement lawsuit settlement. We recorded \$13 million, based on an estimate of the amounts we expected to receive as a result of the settlement, net of the amounts estimated payable to our recording artists in respect of royalties. We received the cash from the settlement in the first quarter of fiscal 2008.

### *Loss on termination of management agreement*

#### *2007 vs 2006:*

Not applicable for this comparison.

#### *2006 vs 2005:*

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

**Table of Contents***Restructuring costs**2007 vs 2006:*

We recognized \$50 million in restructuring costs in the twelve months ended September 30, 2007. These are mainly severance costs incurred in connection with our realignment plan.

*2006 vs 2005:*

We recognized \$7 million in restructuring costs in the twelve months ended September 30, 2005 related to termination benefits paid to certain employees who were involuntarily terminated and the costs of terminating certain artist contracts. These activities occurred in connection with the integration of Lava Records' operations into the operations of The Atlantic Records Group subsequent to our acquisition of the remaining interest in the Lava Records joint venture.

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

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

|   | For the Years Ended<br>September 30, |              |                 | 2007 vs 2006               |              | 2006 vs 2005 |              |
|---|--------------------------------------|--------------|-----------------|----------------------------|--------------|--------------|--------------|
|   | 2007                                 | 2006         | 2005            | \$ Change<br>(in millions) | % Change     | \$ Change    | % Change     |
| OIBDA   | \$ 461                               | \$ 518       | \$ 322          | \$ (57)                    | -11%         | \$ 196       | 61%          |
| Depreciation expense                          | (40)                                 | (42)         | (51)            | 2                          | -5%          | 9            | -18%         |
| Amortization expense                          | (206)                                | (193)        | (187)           | (13)                       | 7%           | (6)          | 3%           |
| <b>Operating income</b>                       | <b>215</b>                           | <b>283</b>   | <b>84</b>       | <b>(68)</b>                | <b>-24%</b>  | <b>199</b>   | <b>237%</b>  |
| Interest expense, net                         | (182)                                | (180)        | (182)           | (2)                        | 1%           | 2            | -1%          |
| Net investment-related gains                  |                                      |              | 1               |                            |              | (1)          |              |
| Equity in the gains (losses) of equity-method |                                      | 1            | (1)             | (1)                        | -100%        | 2            | -200%        |
| Loss on repayment of Holdings Notes           |                                      |              | (35)            |                            |              | 35           |              |
| Unrealized gain on warrants                   |                                      |              | 17              |                            |              | (17)         |              |
| Minority interest expense                     | (5)                                  |              | (5)             | (5)                        | -100%        | 5            |              |
| Other income, net                             |                                      | 3            | 7               | (3)                        | -100%        | (4)          | -57%         |
| <b>Income (loss) before income taxes</b>      | <b>28</b>                            | <b>107</b>   | <b>(114)</b>    | <b>(79)</b>                | <b>-74%</b>  | <b>221</b>   | <b>-194%</b> |
| Income tax expense                            | (49)                                 | (47)         | (55)            | 2                          | 4%           | 8            | -15%         |
| <b>Net income (loss)</b>                      | <b>\$ (21)</b>                       | <b>\$ 60</b> | <b>\$ (169)</b> | <b>\$ (81)</b>             | <b>-135%</b> | <b>229</b>   | <b>-136%</b> |

*OIBDA**2007 vs 2006*

Our OIBDA decreased by \$57 million to \$461 million for the twelve months ended September 30, 2007 as compared to \$518 million for the twelve months ended September 30, 2006. Expressed as a percentage of revenues, total OIBDA margin was 14% for the twelve month ended September 30, 2007 as compared to 15% for the twelve months ended September 30, 2006. The decrease in OIBDA reflects the decline in physical sales and the costs associated with our realignment plan, offset in part by the settlement with Bertelsmann and the increase in digital sales, all previously discussed.





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*2006 vs 2005*

Our OIBDA increased \$196 million to \$518 million for the twelve months ended September 30, 2006 as compared to \$322 million for the twelve months ended September 30, 2005. Expressed as a percentage of revenues, total OIBDA margin was 15% for the twelve month ended September 30, 2006 as compared to 9% for the twelve months ended September 30, 2005. The increase was primarily a result of the increase in Recorded Music revenue, the previously described KaZaA copyright infringement settlement and the absence of certain expenses which were included in the twelve months ended September 30, 2005, including (i) the \$73 million loss on termination of the Management Agreement described above, (ii) \$29 million of one-time compensation expenses, including \$10 million of bonuses paid in connection with the Company's initial public offering and \$19 million of one-time payments associated with our restricted stock and stock option awards granted at prices that may have been below fair value, (iii) \$24 million of non-recurring charges incurred in connection with the departure of the co-chairman of The Atlantic Records Group and the expensing of certain amounts paid in connection with the acquisition of the remaining interest in the Lava Records joint venture and (iv) \$7 million of restructuring costs, which are more fully discussed above.

See **Business Segment Results** presented hereinafter for a discussion of OIBDA by business segment.

*Depreciation expense*

*2007 vs 2006*

Our depreciation expense decreased by \$2 million to \$40 million for year ended September 30, 2007. The decrease primarily relates to lower capital spending as well as a larger balance of fully depreciated assets, due to the acquisition of assets with shorter useful lives.

*2006 vs 2005*

Our depreciation expense decreased by \$9 million to \$42 million for the twelve months ended September 30, 2006 as compared to \$51 million for the twelve months ended September 30, 2005. The decrease primarily relates to lower capital spending since the date of the Acquisition.

*Amortization expense*

*2007 vs 2006*

Amortization expense for the twelve months ended September 30, 2007 increased by \$13 million, or 7%, to \$206 million. Excluding the impact of foreign currency exchange rates of \$4 million, amortization expense increased by \$9 million, which relates to the recent acquisitions of certain recorded music catalog assets, including Ryko and Roadrunner, and the acquisition of various music publishing copyrights.

*2006 vs 2005*

Our amortization expense increased by \$6 million, or 3%, to \$193 million for the twelve months ended September 30, 2006 as compared to \$187 million for the twelve months ended September 30, 2005. The increase is due to various acquisitions of recorded music catalogs and music publishing copyrights since the prior year.

*Operating income*

*2007 vs 2006*

Our operating income decreased \$68 million, to \$215 million for the year ended September 30, 2007 as compared to \$283 million for the prior year. The decrease in operating income was primarily a result of the decrease in OIBDA and the increase in amortization expense, offset by the decrease in depreciation expense, which are all more fully discussed above.

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### *2006 vs 2005*

Our operating income increased \$199 million, to \$283 million for the twelve months ended September 30, 2006 as compared to \$84 million for the twelve months ended September 30, 2005. The increase in operating income was primarily a result of the increase in OIBDA, and the decrease in depreciation expense, partially offset by the increase in amortization expense, which are all more fully discussed above.

See **Business Segment Results** presented hereinafter for a discussion of operating income by business segment.

### *Interest expense, net*

#### *2007 vs 2006*

Our interest expense, net, increased \$2 million to \$182 million for the year ended September 30, 2007 as compared to \$180 million for the prior year. This was primarily related to increased interest expense, which was the result of higher interest rates on our variable rate debt, offset by an increase in interest income due to higher average cash balances.

#### *2006 vs 2005*

Our interest expense decreased \$2 million to \$180 million for the twelve months ended September 30, 2006 as compared to \$182 million for the twelve months ended September 30, 2005. The twelve months ended September 30, 2005 include several months of interest expense related to the outstanding Holdings Floating Rate Notes and Holdings PIK Notes, which were issued in December 2004 and fully redeemed in June 2005, as well as the Holdings Discount Notes, which were issued in December 2004 and partially redeemed in June 2005. The decline due to the absence of the redeemed notes is partially offset by interest expense related to an additional outstanding term loan of \$250 million borrowed in May 2005, which is reflected in only five of the twelve months ended September 30, 2005, as well as higher interest rates on outstanding debt during the current period.

See **Financial Condition and Liquidity** for more information.

### *Net investment-related gains*

#### *2007 vs 2006:*

Not applicable for this comparison.

#### *2006 vs 2005*

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

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

#### *2007 vs 2006:*

Not applicable for this comparison.

#### *2006 vs 2005*

The twelve months ended September 30, 2006 includes \$1 million of equity in the gains of equity-method investees, as compared to \$1 million of equity in the losses of equity-method investees during the twelve months ended September 30, 2005.

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*Loss on repayment of Holdings Notes*

*2007 vs 2006:*

Not applicable for this comparison.

*2006 vs 2005*

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

*Unrealized gain on warrants*

*2007 vs 2006:*

Not applicable for this comparison.

*2006 vs 2005*

We recognized a \$17 million unrealized gain to mark to market the value of the warrants issued to Time Warner in connection with the Acquisition for the twelve months ended September 30, 2005. In connection with the Company's initial public offering, we repurchased the warrants at a cost of approximately \$138 million, which approximated fair value at that date.

*Minority interest expense*

*2007 vs 2006*

Minority interest expense for the twelve months ended September 30, 2007 was \$5 million, which relates to the acquisition of several majority-owned affiliates during the current year.

*2006 vs 2005*

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

*Other Income, net*

*2007 vs 2006*

Other income (expense), net for the twelve months ended September 30, 2007 includes offsetting amounts of gains and losses which represent currency exchange movements associated with inter-company receivables and payables that are short term in nature.

*2006 vs 2005*

We recognized \$3 million and \$7 million of other income, net for the twelve months ended September 30, 2006 and 2005, respectively. Other income, net relates to favorable foreign currency exchange rate movements associated with inter-company receivables and payables that are short term in nature.



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*Income tax expense*

*2007 vs 2006*

We provided income tax expense of \$49 million for the twelve months ended September 30, 2007 as compared to \$47 million for the twelve months ended September 30, 2006. The tax provision for the twelve months ended September 30, 2007 was higher as a percentage of pre-tax income, due to income earned in high tax rate jurisdictions.

*2006 vs 2005*

We provided income tax expense of \$47 million for the twelve months ended September 30, 2006 as compared to \$55 million for the twelve months ended September 30, 2005. The tax provision for the twelve months ended September 30, 2006 was reduced primarily because a higher percentage of shared service operating expenses, which support both domestic and international operations, were allocated to foreign income, thereby reducing foreign income taxes. We recharge centralized support costs (e.g., information technology support and professional fees) that originate at our shared service centers in London, New York and Burbank to our affiliates under our management service fee agreements. The centralized costs are recharged in accordance with the applicable tax rules and regulations (e.g., OECD guidelines, IRS and local tax regulations). The amount of the costs recharged have varied in each year for a variety of reasons, including the fact that fiscal 2004 (our first year of operation as a stand-alone company) was a partial fiscal year and because we completed a study in 2006 related to the recharged costs which resulted in final adjustments in fiscal 2006. We believe that going forward the recharge process will result in an allocation of costs that is consistent on a year-over-year basis.

In addition, there was a tax benefit on a portion of the U.S. domestic tax losses utilized in the current year. In connection with the Acquisition we made a joint election with Time Warner under Section 338(h)(10) of the U.S. Internal Revenue Code to treat the Acquisition as an asset purchase. On the remaining U.S. domestic tax losses, a valuation allowance exists due to the uncertain nature of recognizing these deferred tax assets. Our income tax expense for the twelve months ended September 30, 2006 and 2005 primarily relates to the tax provisions on foreign income.

*Net income (loss)*

*2007 vs 2006*

Our net income decreased by \$81 million, to a net loss of \$21 million for the year ended September 30, 2007 as compared to net income of \$60 million for the twelve months ended September 30, 2006. The decrease in net income is primarily the result of the decrease in physical sales and the additional costs associated with our realignment plan and cost-savings initiatives, offset in part by the income from the settlement with Bertelsmann and the increase in digital sales, all which are more fully discussed above.

*2006 vs 2005*

Our net income increased by \$229 million, to net income of \$60 million for the twelve months ended September 30, 2006 as compared to a net loss of \$169 million for the twelve months ended September 30, 2005. The increase in net income is primarily the result of the absence of certain one-time expenses which were included in the twelve months ended September 30, 2005, including (i) the \$73 million loss on termination of the Management Agreement, (ii) \$10 million of one-time bonuses paid in connection with the Company's initial public offering, (iii) \$19 million of one-time payments associated with our restricted stock and stock option awards granted at prices below fair value, (iv) \$24 million of non-recurring charges incurred in connection with the departure of the co-chairman of The Atlantic Records Group and the expensing of certain amounts paid in connection with the acquisition of the remaining interest in the Lava Records joint venture and (v) the \$35 million loss on repayment of the Holdings Notes, which are more fully discussed above. Net income for the twelve months ended September 30, 2006 also includes a \$13 million accrued benefit related to the KaZaA copyright infringement lawsuit settled in our favor.

**Table of Contents****Business Segment Results**

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

|  | For the Years Ended<br>September 30, |                   |                   | 2007 vs 2006 |          | 2006 vs 2005 |          |
|--|--------------------------------------|-------------------|-------------------|--------------|----------|--------------|----------|
|  | 2007<br>(audited)                    | 2006<br>(audited) | 2005<br>(audited) | \$ Change    | % Change | \$ Change    | % Change |
| <b>Recorded Music</b>                      |                                      |                   |                   |              |          |              |          |
| Revenue                                    | \$ 2,837                             | \$ 3,005          | \$ 2,924          | \$ (168)     | -6%      | \$ 81        | 3%       |
| OIBDA (1)                                  | 409                                  | 480               | 380               | (71)         | -15%     | 100          | 26%      |
| Operating Income (1)                       | \$ 237                               | \$ 317            | \$ 215            | \$ (80)      | -25%     | \$ 102       | 47%      |
| <b>Music Publishing</b>                    |                                      |                   |                   |              |          |              |          |
| Revenue                                    | \$ 570                               | \$ 538            | \$ 607            | \$ 32        | 6%       | \$ (69)      | -11%     |
| OIBDA                                      | 160                                  | 144               | 141               | 16           | 11%      | 3            | 2%       |
| Operating Income                           | \$ 98                                | \$ 84             | \$ 82             | \$ 14        | 17%      | \$ 2         | 2%       |
| <b>Corporate Expenses and Eliminations</b> |                                      |                   |                   |              |          |              |          |
| Revenue                                    | \$ (22)                              | \$ (27)           | \$ (29)           | \$ 5         | -19%     | \$ 2         | -7%      |
| OIBDA                                      | (108)                                | (106)             | (199)             | (2)          | 2%       | 93           | -47%     |
| Operating Loss                             | \$ (120)                             | \$ (118)          | \$ (213)          | \$ (2)       | 2%       | \$ 95        | -45%     |
| <b>Total</b>                               |                                      |                   |                   |              |          |              |          |
| Revenue                                    | \$ 3,385                             | \$ 3,516          | \$ 3,502          | \$ (131)     | -4%      | \$ 14        | 0%       |
| OIBDA (1)                                  | 461                                  | 518               | 322               | (57)         | -11%     | 196          | 61%      |
| Operating income (1)                       | \$ 215                               | \$ 283            | \$ 84             | \$ (68)      | -24%     | \$ 199       | 237%     |

(1) OIBDA and operating income for the twelve months ended September 30, 2007 have been reduced by \$50 million of restructuring costs. Of such amount, \$46 million relates to Recorded Music, \$2 million relates to Music Publishing and \$2 million relates to Corporate.

*Recorded Music**Revenues**2007 vs 2006*

Recorded Music revenues decreased by \$168 million, or 6%, to \$2.837 billion for the twelve months ended September 30, 2007 from \$3.005 billion for the twelve months ended September 30, 2006. Total revenues from Recorded Music were favorably impacted by foreign exchange of approximately \$86 million for the year ended September 30, 2007. Recorded Music revenues represented 83% and 85% of consolidated revenues, prior to corporate and revenue eliminations, for the year ended September 30, 2007 and 2006, respectively. International Recorded Music revenues were \$1.376 billion and \$1.522 billion, or 49% and 51% of consolidated Recorded Music revenues for the year ended September 30, 2007 and 2006, respectively.

The decrease in Recorded Music revenues is primarily attributable to the decline in physical sales which was driven by the overall industry decline in physical sales, which we believe is related to continuing piracy, the shift from physical to digital, the closing of music-only retailers resulting in more limited space and competition with other media products such as video games and movies. In addition, the decline in physical sales reflects fewer major artist releases and weaker international markets, primarily in Europe, offset in part by increases in sales of domestic repertoire in the Asia Pacific region.

The physical decrease is partially offset by the continued increase in digital sales which was comprised of an increase in U.S. digital sales of \$53 million and an increase in international digital sales of \$46 million. The increase in our digital revenue reflects our continued efforts to develop our digital business including efforts to

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further monetize existing content through new formats and new distribution channels and the increased usage of legal, online and mobile distribution channels for the music industry. Digital sales comprised approximately 15% of Recorded Music revenues for the year ended September 30, 2007, up from 11% of Recorded Music revenues from the prior year which is reflective the shifting market to digital from physical media.

Also offsetting the overall decline from physical revenues was an increase in licensing revenue of \$58 million or 31% to \$244 million. The increase represents the result of the Company's focus to identify opportunities to further expand the use of our Recorded Music catalog.

*2006 vs 2005*

Recorded Music revenues increased by \$81 million, or 3%, to \$3.005 billion for the twelve months ended September 30, 2006 from \$2.924 billion for the twelve months ended September 30, 2005. Excluding a \$38 million unfavorable impact of foreign currency exchange rates, Recorded Music revenues increased by \$119 million, or 4%. Recorded Music revenues represented 85% and 83% of consolidated revenues, prior to corporate and revenue eliminations, for the twelve months ended September 30, 2006 and 2005, respectively. International Recorded Music revenues were \$1.522 billion and \$1.513 billion, or 51% and 52% of consolidated Recorded Music revenues for the twelve months ended September 30, 2006 and 2005, respectively.

The decrease in physical sales was driven primarily by industry conditions as previously discussed as well as fewer significant releases in the fourth fiscal quarter of 2006 as compared with the fourth fiscal quarter of the prior year, which included significant releases and considerable carryover sales.

Digital sales increased \$198 million, to a total of \$335 million, or 11% of Recorded Music revenues for the twelve months ended September 30, 2006 and \$137 million, or 5%, for the twelve months ended September 30, 2005.

*OIBDA and Operating Income*

Recorded Music operating income was \$237 million for the year ended September 30, 2007 as compared to \$317 million for the year ended September 30, 2006. Recorded Music operating income included the following (in millions):

|                               | For the Years Ended<br>September 30, |        |        | 2007 vs 2006 |          | 2006 vs 2005 |          |
|-------------------------------|--------------------------------------|--------|--------|--------------|----------|--------------|----------|
|                               | 2007                                 | 2006   | 2005   | \$ Change    | % Change | \$ Change    | % Change |
| OIBDA                         | \$ 409                               | \$ 480 | \$ 380 | \$ (71)      | -15%     | \$ 100       | 26%      |
| Depreciation and amortization | (172)                                | (163)  | (165)  | (9)          | 6%       | 2            | -1%      |
| Operating Income              | \$ 237                               | \$ 317 | \$ 215 | \$ (80)      | -25%     | \$ 102       | 47%      |

Recorded Music cost of revenues is composed of the following amounts (in millions):

|                               | For the Years Ended<br>September 30, |                 |                 | 2007 vs 2006   |            | 2006 vs 2005 |           |
|-------------------------------|--------------------------------------|-----------------|-----------------|----------------|------------|--------------|-----------|
|                               | 2007                                 | 2006            | 2005            | \$ Change      | % Change   | \$ Change    | % Change  |
| Artist and Repertoire Costs   | \$ 877                               | \$ 902          | \$ 920          | \$ (25)        | -3%        | \$ (18)      | -2%       |
| Product Costs                 | 609                                  | 603             | 561             | 6              | 1%         | 42           | 7%        |
| <b>Total Cost of Revenues</b> | <b>\$ 1,486</b>                      | <b>\$ 1,505</b> | <b>\$ 1,481</b> | <b>\$ (19)</b> | <b>-1%</b> | <b>\$ 24</b> | <b>2%</b> |

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Recorded Music selling, general and administrative expenses are composed of the following amounts (in millions):

|  | For the Years Ended<br>September 30, |                 |                 | 2007 vs 2006   |            | 2006 vs 2005   |            |
|--|--------------------------------------|-----------------|-----------------|----------------|------------|----------------|------------|
|  | 2007                                 | 2006            | 2005            | \$ Change      | % Change   | \$ Change      | % Change   |
| General and Administrative Expense (1)                   | \$ 379                               | \$ 371          | \$ 430          | \$ 8           | 2%         | \$ (59)        | -14%       |
| Selling and Marketing Expense                            | 536                                  | 610             | 587             | (74)           | -12%       | 23             | 4%         |
| Distribution Expense                                     | 69                                   | 79              | 74              | (10)           | -13%       | 5              | 7%         |
| <b>Total Selling, General and Administrative Expense</b> | <b>\$ 984</b>                        | <b>\$ 1,060</b> | <b>\$ 1,091</b> | <b>\$ (76)</b> | <b>-7%</b> | <b>\$ (31)</b> | <b>-3%</b> |

(1) Includes depreciation expense of \$26 million, \$27 million and \$32 million for the years ended September 30, 2007, 2006 and 2005, respectively.  
2007 vs 2006

Recorded Music operating income decreased by \$80 million due to the decreases in OIBDA described below as well as an increase in depreciation and amortization expense.

Recorded Music OIBDA decreased by \$71 million, or 15% to \$409 million for the year ended September 30, 2007 compared to \$480 million for the prior year ended. Expressed as a percentage of Recorded Music revenues, Recorded Music OIBDA was 14% and 16% for the year ended September 30, 2007 and 2006, respectively. Excluding a \$10 million impact of foreign currency exchange rates, OIBDA decreased by \$81 million, which was primarily caused by the decline in physical sales previously described, as well as the relative increase of costs as a percentage of sales as discussed below.

*Cost of revenues*

Excluding the impact of foreign currency exchange rates, Recorded Music cost of revenues decreased by \$67 million. This was composed of a decrease in product costs of \$6 million and a decrease in artist and repertoire costs of \$61 million. The decrease in product costs was driven by the decline in physical sales, however products costs increased by 1% of sales due primarily to the expansion of third-party distribution networks and an increase in lower-margin merchandising sales. Artist and repertoire costs decreased in line with the decrease in physical sales and reflected changes in product mix, including an increased number of digital products, CD/DVD combinations and box sets, which have varying royalty rates.

*Selling, general and administrative costs*

Excluding the impact of foreign currency exchange rates, selling, general and administrative costs decreased by \$105 million, which was primarily the result of a decrease in selling and marketing costs of \$92 million driven by fewer significant releases and cost-management efforts. In addition, distribution expense decreased by \$12 million, which was in line with the decline in physical sales. General and administrative costs increased by \$1 million, which reflects an increase in depreciation expense of \$1 million.

Recorded Music OIBDA also reflects \$46 million in restructuring costs associated with our realignment plan and an increase in other income from the prior year of \$49 million, which was primarily due to the settlement with Bertelsmann.



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*2006 vs 2005*

Recorded Music operating income was \$317 million for the twelve months ended September 30, 2006 as compared to \$215 million for the twelve months ended September 30, 2005. The increase was due to the increases in OIBDA discussed below as well as the decrease in amortization and depreciation expense.

Recorded Music OIBDA increased by \$100 million, or 26%, to \$480 million for the twelve months ended September 30, 2006 compared to \$380 million for the twelve months ended September 30, 2005. Expressed as a percentage of Recorded Music revenues, Recorded Music OIBDA was 16% and 13% for the twelve months ended September 30, 2006 and 2005, respectively. Excluding a \$3 million unfavorable impact of foreign currency exchange rates, OIBDA increased \$103 million, or 27%, primarily as a result of the \$119 million increase in revenues more fully described above, a \$10 million increase in other income related to the \$13 million benefit from the settlement of the Kazaa lawsuit and a decrease in general and administrative costs.

*Cost of revenues*

Excluding the impact of foreign currency exchange rates, cost of revenues increased by \$49 million. This was comprised of a \$36 million increase in product costs and a \$13 million increase in artist and repertoire costs and licensing expense. The increase in product costs related to increased sales of special edition physical products and other higher-priced products in the current year. The increase in artist and repertoire costs and licensing expense relates to an increase in royalties related to increase in revenues previously described and to the mix of products sold during the period offset in part by a decrease in unrecoverable artist advances of \$22 million.

*Selling, general and administrative expenses*

Excluding the impact of foreign currency exchange rates, selling, general and administrative expenses decreased by \$21 million, comprised of a decrease in general and administrative costs of \$58 million, offset by an increase in sales and marketing costs of \$32 million due to increased marketing for a larger number of releases selling in excess of one million units and timing of our release schedule and an increase in distribution costs of \$5 million.

In fiscal 2005, general and administrative costs included \$20 million of compensation expenses related to employee bonuses paid in connection with the initial public offering and payments associated with our restricted stock and stock option awards granted at prices below fair value and \$24 million of non-recurring charges incurred in connection with the departure of the co-chairman of The Atlantic Records Group and the expensing of certain amounts paid in connection with the acquisition of the remaining interest in the Lava Records joint venture. General and administrative costs for the twelve months ended September 30, 2006 included an \$8 million severance payment made related to the departure of the chairman of WMI in February 2006 and additional bad debt expense of \$10 million related to the bankruptcies of large music retailers in the current year. Excluding these amounts, general and administrative costs decreased by \$32 million which was due in part to the Lava Records restructuring in the prior year, which resulted in decreased headcount, a decrease in depreciation of \$5 million, and the continued focus on cost management and cost reduction.

In addition, there was a \$10 million increase in other income related to a \$13 million benefit from the settlement of the Kazaa lawsuit. The twelve months ended September 30, 2006 also included \$7 million of restructuring costs.

**Table of Contents***Music Publishing**Revenues**2007 vs 2006*

Music Publishing revenues increased to \$570 million for the twelve months ended September 30, 2007 as compared to \$538 million for the twelve months ended September 30, 2006. Excluding a \$28 million unfavorable impact of foreign currency exchange rates, Music Publishing revenues increased by \$4 million, or 1%.

Excluding the impact of foreign currency exchange rates, mechanical revenue decreased by \$10 million which reflected the continued decline in physical sales across various territories. Synchronization revenue declined by \$1 million as a result of variability in the film and television commercial business as well as due to the timing of payments. Performance revenue increased by \$11 million due to improved results from copyright investments in recent periods, which led to expanded use in television programming, more successful live tours and performance of local hits. Digital revenue increased by \$6 million.

Digital sales represented 5% and 4% of Music Publishing revenues for the twelve months ended September 30, 2007 and 2006, respectively. Music Publishing revenues represented 17% and 15% of consolidated revenues, prior to corporate and revenue eliminations, for the twelve months ended September 30, 2007 and 2006, respectively.

*2006 vs 2005*

Music Publishing revenues decreased to \$538 million for the twelve months ended September 30, 2006 as compared to \$607 million for the twelve months ended September 30, 2005. Excluding a \$10 million unfavorable impact of foreign currency exchange rates, and prior-year revenue of \$34 million of revenue from our sheet music business, which was sold in May 2005, Music Publishing revenues declined \$25 million, or 4%, which was comprised of a \$35 million decrease in mechanical revenue and a \$13 million decline in synchronization revenue, offset by an \$9 million increase in performance revenue and a \$14 million increase in other revenues. Mechanical revenue declines reflect prior-year industry declines in physical record sales and lack of prior period investments. Synchronization revenues declined as a result of variability in the film and television commercial business as well as the timing of payments from key licensors of our copyrights. The increase in performance revenue reflects a change in the timing of payments received from a U.S. performing rights organization as well as improved results from copyright investments in recent periods. Other revenue consists primarily of print licensing fees and royalties from other sources such as stage productions and merchandising.

Music Publishing revenues consisted of \$225 million of mechanical revenues, \$191 million of performance revenues, \$83 million of synchronization revenues, \$20 million of revenues from digital sales and \$19 million of other revenues. Digital sales represented 4% and 3% of Music Publishing revenues for the twelve months ended September 30, 2006 and 2005, respectively. Music Publishing revenues represented 15% and 17% of consolidated revenues, prior to corporate and revenue eliminations, for the twelve months ended September 30, 2006 and 2005, respectively.

*OIBDA and Operating Income*

Music Publishing operating income increased to \$98 million for the twelve months ended September 30, 2007 as compared to \$84 million for the twelve months ended September 30, 2006. Music Publishing operating income includes the following (in millions):

|                               | For the Years Ended September 30, |        |        | 2007 vs 2006 |          | 2006 vs 2005 |          |
|-------------------------------|-----------------------------------|--------|--------|--------------|----------|--------------|----------|
|                               | 2007                              | 2006   | 2005   | \$ Change    | % Change | \$ Change    | % Change |
| OIBDA                         | \$ 160                            | \$ 144 | \$ 141 | \$ 16        | 11%      | \$ 3         | 2%       |
| Depreciation and amortization | (62)                              | (60)   | (59)   | (2)          | 3%       | (1)          | 2%       |
| Operating Income              | \$ 98                             | \$ 84  | \$ 82  | \$ 14        | 17%      | \$ 2         | 2%       |



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Music Publishing cost of revenues is composed of the following amounts (in millions):

|                               | For the Years Ended September 30, |               |               | 2007 vs 2006 |           | 2006 vs 2005   |             |
|-------------------------------|-----------------------------------|---------------|---------------|--------------|-----------|----------------|-------------|
|                               | 2007                              | 2006          | 2005          | \$ Change    | % Change  | \$ Change      | % Change    |
| Artist and Repertoire Costs   | \$ 360                            | \$ 344        | \$ 387        | \$ 16        | 5%        | \$ (43)        | -11%        |
| Product Costs                 |                                   |               | 15            |              |           | (15)           | -100%       |
| <b>Total Cost of Revenues</b> | <b>\$ 360</b>                     | <b>\$ 344</b> | <b>\$ 402</b> | <b>\$ 16</b> | <b>5%</b> | <b>\$ (58)</b> | <b>-14%</b> |

Music Publishing selling, general and administrative expenses are comprised of the following amounts (in millions):

|  | For the Years Ended September 30, |              |              | 2007 vs 2006 |           | 2006 vs 2005   |             |
|--|-----------------------------------|--------------|--------------|--------------|-----------|----------------|-------------|
|  | 2007                              | 2006         | 2005         | \$ Change    | % Change  | \$ Change      | % Change    |
| General and Administrative Expense (1)                   | \$ 53                             | \$ 52        | \$ 65        | \$ 1         | 2%        | \$ (13)        | -20%        |
| Selling and Marketing Expense                            | 2                                 | 1            | 5            | 1            | 100%      | (4)            | -80%        |
| <b>Total Selling, General and Administrative Expense</b> | <b>\$ 55</b>                      | <b>\$ 53</b> | <b>\$ 70</b> | <b>\$ 2</b>  | <b>4%</b> | <b>\$ (17)</b> | <b>-24%</b> |

(1) Includes depreciation expense of \$3 million, \$3 million and \$5 million for the years ended September 30, 2007, 2006 and 2005, respectively.

2007 vs 2006

Music Publishing operating income increased by \$14 million due to the increase in OIBDA described below offset by the increase in depreciation and amortization.

Music Publishing OIBDA increased \$16 million to \$160 million for the twelve months ended September 30, 2007 as compared to \$144 million for the twelve months ended September 30, 2006. Expressed as a percent of Music Publishing revenues, Music Publishing OIBDA was 28% and 27% for the twelve months ended September 30, 2007 and 2006, respectively. Excluding a \$5 million favorable impact of foreign currency exchange, Music Publishing OIBDA increased \$12 million. The increase in OIBDA was due primarily to the decrease in costs described below, offset in part by the decline in revenue described above.

*Cost of revenues*

Excluding the impact of foreign currency exchange rates, Music Publishing artist and repertoire costs decreased by \$6 million, which was primarily related to the change in revenue mix as different royalty rates apply to the different revenue categories.

*Selling, general and administrative expenses*

Excluding the impact of foreign currency exchange rates, selling, general and administrative costs were relatively flat, which was primarily due to additional marketing costs and headcount hired to drive increases in our performance and synchronization businesses, offset by a decrease in annual bonus compensation expense.

Music Publishing OIBDA also reflected \$2 million of restructuring costs and \$4 million of other income primarily related to the settlement with Bertelsmann.

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### *2006 vs 2005*

The \$2 million increase in Music Publishing operating income related to the \$3 million increase in Music Publishing OIBDA, more fully discussed below, offset by a \$1 million increase in depreciation and amortization expenses.

Music Publishing OIBDA increased \$3 million to \$144 million for the twelve months ended September 30, 2006 as compared to \$141 million for the twelve months ended September 30, 2005. Expressed as a percent of Music Publishing revenues, Music Publishing OIBDA was 27% and 23% for the twelve months ended September 30, 2006 and 2005, respectively. Excluding a \$1 million unfavorable impact of foreign currency exchange rates and prior-year OIBDA of negative \$1 million from our sheet music business, WBP, which was sold in May 2005, Music Publishing OIBDA increased \$5 million. The increase in OIBDA was due primarily to the decrease in costs described below, offset by the decline in revenue described above.

### *Cost of revenues*

Music Publishing cost of revenues decreased from \$402 million for the twelve months ended September 30, 2005 to \$344 million for the twelve months ended September 30, 2006 and relates entirely to artist and repertoire costs. Excluding the impact of foreign currency exchange rates and \$22 million of costs related to our sheet music business, WBP, that was sold in May 2005, cost of revenues decreased by \$28 million. The decrease in cost of revenues represents a decrease in royalty expense as a result of the decline in revenues previously discussed as well as favorable royalty adjustments to accurately state our royalties payable balances.

### *Selling, general and administrative expenses*

Excluding the impact of foreign currency exchange rates and \$11 million of costs related to our sheet music business, WBP, that was sold in May of 2005, selling, general and administrative costs decreased by \$4 million. Prior year general and administrative costs included a one-time compensation expense related to employee bonuses paid in connection with the initial public offering of \$1 million. Excluding this item, the decrease of \$3 million was primarily due a decrease in depreciation of \$2 million and to cost-management and cost-reduction efforts.

Music Publishing operating income increased to \$84 million for the twelve months ended September 30, 2006 as compared to \$82 million for the twelve months ended September 30, 2005.

### *Corporate Expenses and Eliminations*

#### *2007 vs 2006*

Corporate expenses before depreciation and amortization expense increased by \$2 million to \$108 million for the twelve months ended September 30, 2007, compared to \$106 million for the twelve months ended September 30, 2006.

Corporate general and administrative costs increased from \$119 million for the twelve months ended September 30, 2006 to \$125 million for the twelve months ended September 30, 2007. The increase relates to \$3 million of implementation costs associated with the realignment plan, and \$9 million of costs related to the previously disclosed proposed acquisition of EMI. This was offset by a decrease in compliance costs, a decrease in corporate costs due to cost-management efforts and a decrease in annual bonus compensation expense. Our corporate expenses before depreciation and amortization also include \$2 million of restructuring costs.

#### *2006 vs 2005*

Corporate expenses before depreciation and amortization expense decreased by \$93 million to \$106 million for the twelve months ended September 30, 2006, compared to \$199 million for the twelve months ended September 30, 2005.

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Corporate general and administrative costs decreased from \$142 million for the twelve months ended September 30, 2005 to \$119 million for the twelve months ended September 30, 2006, which related entirely to general and administrative costs. General and administrative costs for the prior year included \$6 million related to our management fee agreement and \$8 million of one-time compensation expenses consisting of a one-time bonus to employees related to the Company's initial public offering and one-time payments to holders of restricted stock and stock options primarily to compensate them for certain amounts related to stock awards issued at prices that were below fair value at the grant date. The remaining decrease was due to a decrease in professional fees as well as efforts to manage and reduce costs.

Corporate expenses in the prior year also included a \$73 million payment on termination of Management Agreement, more fully described above.

**FINANCIAL CONDITION AND LIQUIDITY****Financial Condition at September 30, 2007**

At September 30, 2007, we had \$2.273 billion of debt, \$333 million of cash and equivalents, (net debt of \$1.940 billion, defined as total debt less cash and equivalents and short-term investments) and \$36 million of shareholders' deficit. This compares to \$2.256 billion of debt, \$367 million of cash and equivalents, \$18 million of short-term investments (net debt of \$1.871 billion, defined as total debt less cash and equivalent and short-term investments) and \$58 million of shareholders' equity at September 30, 2006. Net debt increased \$69 million as a result of (i) a \$34 million decrease in cash and cash equivalents, (ii) an \$18 million decrease in short-term investments, (iii) \$15 million impact of foreign exchange rates on our Sterling-denominated notes and (iv) \$19 million of accretion on our Holdings Discount Notes. These increases in net debt were offset by a \$17 million decrease in debt as a result of quarterly repayments of our term loans under the senior secured credit facility.

**Cash Flows**

The following table summarizes our historical cash flows. The financial data for the twelve-month periods ended September 30, 2007, 2006 and 2005 have been derived from our audited financial statements included elsewhere herein.

|                      | Twelve Months<br>Ended<br>September 30,<br>2007<br>(audited) | Twelve Months<br>Ended<br>September 30,<br>2006<br>(audited)<br>(in millions) | Twelve Months<br>Ended<br>September 30,<br>2005<br>(audited) |
|----------------------|--|---|--|
| Operating activities | \$ 302   | \$ 307  | \$ 205   |
| Investing activities | (255)  | (146)   | (64)   |
| Financing activities | (94)   | (88)  | (406)  |

*Operating Activities*

Cash provided by operations was \$302 million for the twelve months ended September 30, 2007 compared to \$307 million for the twelve months ended September 30, 2006. The \$5 million decrease reflects the significant declines in physical sales previously described, as well as cash paid for restructuring costs and consultancy and severance costs associated with the cost-savings initiatives. Cash provided by operations includes cash received from the settlement with Bertelsmann and reflects the variable timing of our working capital requirements in association with our business cycle.

*Investing Activities*

Cash used in investing activities was \$255 million for the twelve months ended September 30, 2007 compared to \$146 million for the twelve months ended September 30, 2006. The \$255 million of cash used in

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investing activities in the twelve months ended September 30, 2007 consisted primarily of payments to acquire an additional equity interest in Frontline Management of \$110 million, \$51 million paid to acquire Roadrunner, net of cash acquired, and \$14 million loaned to the seller of Roadrunner in connection with the acquisition. We also paid a total of approximately \$64 million to invest in or acquire several smaller companies, including an entertainment services company, a video production company in the U.K. and a digital distribution company in Germany, and we paid \$29 million for capital expenditures. This was offset by the receipt of approximately \$7 million related to the sale of certain buildings and \$18 million related to the liquidation of short-term investments, including auction-rate securities. The \$146 million of cash used in investing activities in the twelve months ending September 30, 2006 primarily reflects \$63 million, net of cash acquired, paid for the completion of the acquisition of Ryko, \$19 million of cash invested in auction-rate securities and other short-term investments, \$30 million of capital expenditures as well as several small acquisitions in Australia, Singapore and South Africa.

### *Financing Activities*

Cash used in financing activities for the twelve months ended September 30, 2007 and for the twelve months ended September 30, 2006 primarily consisted of our quarterly repayment of debt and the payment of dividends, and was partially offset by cash receipts from the exercise of stock options.

### **Liquidity**

Our primary sources of liquidity are the cash flow generated from our subsidiaries' operations, availability under the \$250 million (less \$4 million of outstanding letters of credit as of September 30, 2007) revolving credit portion of our senior secured credit facility and available cash and equivalents. These sources of liquidity are needed to fund our debt service requirements, working capital requirements, capital expenditure requirements, regular quarterly dividends and the remaining one-time costs associated with the execution of our restructuring plan that was substantially completed in fiscal 2005. We believe that our existing sources of cash will be sufficient to support our existing operations over the next twelve months.

As of September 30, 2007, our long-term debt consisted of \$1.396 billion of borrowings (including \$17 million of debt that is classified as a current obligation) under the term loan portion of our senior secured credit facility, \$667 million of Acquisition Corp. Subordinated Notes and \$210 million of Holdings Notes. There were no borrowings under the revolving portion of our senior secured credit facility as of September 30, 2007.

### *Senior Secured Credit Facility*

The senior secured credit facility consists of a \$1.396 billion outstanding term loan portion and a \$250 million revolving credit portion. The term loan portion of the facility matures in February 2011. We are required to prepay outstanding term loans, subject to certain exceptions and conditions, with excess cash flow or in the event of certain asset sales and casualty and condemnation events and incurrence of debt. We are required to make minimum repayments under the term loan portion of our facility in quarterly principal amounts of approximately \$4 million through November 2010, with a remaining balloon payment in February 2011. The revolving credit portion of the senior secured credit facility matures in February 2010. There are no mandatory reductions in borrowing availability for the revolving credit portion of the facility through its term.

Borrowings under both the term loan and revolving credit portion of the senior secured credit facility currently bear interest at a rate equal to an applicable margin plus, at our option, either (a) a base rate determined by reference to the higher of (1) the prime rate of Bank of America, N.A. and (2) the federal funds rate plus 1/2 of 1% or (b) a LIBOR rate determined by reference to the costs of funds for deposits in the currency of such borrowing for the interest period relevant to such borrowing adjusted for certain additional costs. As of September 30, 2007, the applicable margins with respect to base rate borrowings and LIBOR borrowings were 1.25% and 2.25%, respectively, for borrowings under the revolving credit facility. The applicable margins are

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variable subject to changes in certain leverage ratios. For borrowings under the term loan facility, the margins with respect to the base rate borrowings and LIBOR borrowings are 1.00% and 2.00%, respectively, but will be 0.75% and 1.75%, respectively, if the senior secured debt of Acquisition Corp. is rated at least BB by S&P and Ba2 by Moody's. As of November 27, 2007, our term loan facility was rated BB- by S&P and Ba2 by Moody's.

In addition to paying interest on outstanding principal under the senior secured credit facility, we are required to pay a commitment fee to the lenders under the revolving credit facility in respect of the unutilized commitments. As of September 30, 2007, the commitment fee rate was 0.375%. The commitment fee rate is variable subject to changes in certain of our leverage ratios. We also are required to pay customary letter of credit fees, as necessary.

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

### *Senior Subordinated Notes of Acquisition Corp.*

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

### *Holdings Notes*

In December 2004, Holdings issued the Holdings Notes. In connection with the Company's initial public offering, we used \$517 million of proceeds from the offering along with \$57 million of available cash to redeem certain of the Holdings Notes outstanding. As of September 30, 2007, Holdings had \$210 million of debt on its balance sheet relating to such securities, net of issuance discounts.

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

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



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The Company redeemed 35% of the Holdings Discount Notes on June 15, 2005, including amounts representing interest accreted on the notes redeemed through the date of redemption. The \$4 million of interest accreted through the date of redemption is included as cash paid in financing activities in our consolidated statement of cash flows for the year ended September 30, 2005.

The Holdings PIK Notes were redeemed in full on June 15, 2005. From the date of issuance through the date of redemption, the notes bore interest at a semi-annual floating rate based on six-month LIBOR rates plus a margin equal to 7%. Interest was accrued in the form of additional PIK notes at the election of the Company. In connection with the redemption of the Holdings PIK Notes, we paid \$9 million representing interest accrued in the form of additional PIK notes through the date of redemption, which was classified as cash paid in financing activities in our consolidated statement of cash flows for the year ended September 30, 2005.

The indenture governing the notes limits our ability and the ability of our restricted subsidiaries to incur additional indebtedness or issue certain preferred shares; to pay dividends on or make other distributions in respect of its capital stock or make other restricted payments; to make certain investments; to sell certain assets; to create liens on certain debt without securing the notes; to consolidate, merge, sell or otherwise dispose of all or substantially all of our assets; to enter into certain transactions with affiliates; and to designate our subsidiaries as unrestricted subsidiaries. Subject to certain exceptions, the indenture governing the notes permits us and our restricted subsidiaries to incur additional indebtedness, including secured indebtedness, and to make certain restricted payments and investments.

### *Initial Common Stock Offering*

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

### *Dividends*

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

On December 29, 2006, March 8, 2007, June 5, 2007 and September 4, 2007 we declared dividends on our outstanding common stock at a rate of \$0.13 per share. The dividends were paid on February 16, 2007, April 27, 2007, July 25, 2007 and October 24, 2007, respectively, except for the portion of the dividends with respect to unvested restricted stock, which will be paid at such time as such shares become vested.

During the year ended September 30, 2007, 1,979,768 shares of restricted stock purchased by or awarded to certain employees of the Company vested, and employees of the Company exercised 458,956 stock options.

### **Covenant Compliance**

Our senior secured credit facility requires us to maintain certain covenants including a Leverage Ratio and an Interest Coverage Ratio, as such terms are defined in the credit facility, and has a maximum annual capital expenditures limitation. The credit facility also contains covenants that, among other things, restrict our ability to incur additional debt. The occurrence of an event of default under the credit facility could result in all amounts outstanding under the facility to be immediately due and payable, which could have a material adverse impact on our results of operations, financial position and cash flow. As of September 30, 2007, we were in compliance with all covenants under the credit facility.

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

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

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

## **Summary**

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

**Table of Contents****Contractual and Other Obligations***Firm Commitments*

The following table summarizes the Company's aggregate contractual obligations at September 30, 2007, and the estimated timing and effect that such obligations are expected to have on the Company's liquidity and cash flow in future periods. We expect to fund the firm commitments with operating cash flow generated in the normal course of business and availability under the \$250 million revolving credit portion of the senior secured credit facility.

| Firm Commitments and Outstanding Debt                          | Fiscal years  |           |                        | Total    |
|--|---------------|-----------|------------------------|----------|
|  | 2008          | 2009-2011 | 2012 and<br>Thereafter |          |
|  | (in millions) |           |                        |          |
| Term loan facility   | \$ 17         | \$ 1,379  | \$                     | \$ 1,396 |
| Acquisition Corp. Subordinated Notes                           |               |           | 667                    | 667      |
| Interest expense on Acquisition Corp. Subordinated Notes       | 51            | 153       | 153                    | 357      |
| Holdings Notes (including interest expense)                    |               | 37        | 344                    | 381      |
| Operating leases   | 32            | 78        | 85                     | 195      |
| Artist, songwriter and co-publisher commitments                | 85            | 255       | 84                     | 424      |
| Minimum funding commitments to investees and other obligations | 10            | 2         |                        | 12       |
| Total firm commitments and outstanding debt                    | \$ 195        | \$ 1,904  | \$ 1,333               | \$ 3,432 |

The following is a description of our firmly committed contractual obligations at September 30, 2007:

Outstanding debt obligations consist of the term loan facility, the Acquisition Corp. Subordinated Notes and the Holdings Notes. These obligations have been presented based on the principal amounts due, current and long term as of September 30, 2007. Amounts do not include any fair value adjustments, bond premiums, discounts or interest payments. The interest expense obligations do not include interest expense related to our variable rate debt. See Note 12 to the audited financial statements for a description of our financing arrangements.

Holding Notes payments include cash interest payments of \$12 million for the year ending September 30, 2010, \$25 million for each year ending September 30, 2011, 2012, 2013, 2014 and \$12 million for the year ending September 30, 2015 as well as principal payments of \$258 million in the year ending September 30, 2015.

Operating lease obligations primarily relate to the minimum lease rental obligations for our real estate and operating equipment in various locations around the world. These obligations have been presented with the benefit of \$6 million of sublease income expected to be received under non-cancelable agreements. The future minimum payments reflect the amounts owed under our lease arrangements and do not include any fair market value adjustments that may have been recorded as a result of the Acquisition.

We enter into long-term commitments with artists, songwriters and co-publishers for the future delivery of music product. Aggregate firm commitments to such talent approximated \$424 million across hundreds of artists, songwriters, publishers, songs and albums at September 30, 2007. Such commitments, which are unpaid advances across multiple albums and songs, are payable principally over a ten-year period, generally upon delivery of albums from the artists or future musical compositions by songwriters and co-publishers. Because the timing of payment, and even whether payment occurs, is dependent upon the timing of delivery of albums and musical compositions from talent, the timing and amount of payment of these commitments as presented in the above summary can vary significantly.

We have minimum funding commitments and other related obligations to support the operations of various investments.

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**MARKET RISK MANAGEMENT**

We are exposed to market risk arising from changes in market rates and prices, including movements in foreign currency exchange rates and interest rates.

**Foreign Currency Risk**

We have significant transactional exposure to changes in foreign currency exchange rates relative to the U.S. dollar due to the global scope of our operations. For the twelve months ended September 30, 2007, approximately \$1.712 billion, or 51%, of our revenues were generated outside of the U.S. The top five revenue-producing international countries are the U.K., Japan, France, Germany and Italy, which use the British pound sterling, Japanese yen and euro as currencies, respectively. See Note 21 to our audited financial statements included elsewhere herein for information on our operations in different geographical areas.

Historically, we have used (and continue to use) foreign exchange contracts, primarily to hedge the risk that unremitted or future royalties and license fees owed to our domestic companies for the sale, or anticipated sale, of U.S.-copyrighted products abroad may be adversely affected by changes in foreign currency exchange rates. In addition, we hedge foreign currency risk associated with financing transactions such as third party and inter-company debt.

We focus on managing the level of exposure to the risk of foreign current exchange rate fluctuations on our major currencies, which include the euro, British pound sterling, Japanese yen, Canadian dollar, Mexican peso, Swedish krona, and Australian dollar. Additionally, prior to the closing of the Acquisition, Old WMG and Time Warner used foreign exchange contracts to manage this risk. See Note 20 to our audited financial statements included elsewhere herein for additional information.

The Company also is exposed to foreign currency exchange rate risk with respect to its £100 million principal amount of sterling-denominated notes that were issued in April 2004. These sterling notes mature on April 15, 2014. As of September 30, 2007, these sterling notes had a carrying value of \$202 million. Based on the principal amount of sterling-denominated notes outstanding as of September 30, 2007 and assuming that all other market variables are held constant (including the level of interest rates), a 10% weakening or strengthening of the U.S. dollar compared to the British pound sterling would not have an impact on the fair value of these sterling notes, since these notes are completely hedged as of September 30, 2007.

**Interest Rate Risk**

We had \$2.273 billion of total debt outstanding as of September 30, 2007, of which \$1.396 billion was variable rate debt. As such, we are exposed to changes in interest rates. In order to manage this exposure, and consistent with the requirement under our senior secured credit facility to maintain a fixed-to-floating debt ratio of at least 50% of our actual funded debt though at least April 2007, we entered into interest rate swap agreements to hedge notional debt amounts of \$300 million in 2004 and \$597 million in 2005. During the twelve months ended September 30, 2007, we did not enter into any additional interest rate swap or swap extension agreements. During 2006, we entered into \$700 million of interest rate swap agreements to extend the maturities of our existing interest rate swap portfolio. The total notional amount of debt hedged at September 30, 2007 and 2006 was \$897 million. Under our interest rate swap agreements, we agreed to receive floating-rate payments (based on three-month LIBOR rates) in exchange for fixed-rate payments.

Based on the amount of our floating-rate debt and our interest rate swap agreements outstanding as of September 30, 2007, each 25 basis point increase or decrease in interest rates would increase or decrease our annual interest expense and cash outlay by approximately \$1 million. This potential increase or decrease is based on the simplified assumption that the level of floating-rate debt remains constant with an immediate across the board increase or decrease as of September 30, 2007 with no subsequent change in rates for the remainder of the

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period. This increase or decrease in rates would partially be mitigated by an increase or decrease in interest income earned on the Company's cash balances, almost all of which are invested in short-term variable interest rate earning assets.

In addition to our \$1.396 billion of variable-rate debt, we had approximately \$877 million of fixed-rate debt outstanding at September 30, 2007. Based on the level of interest rates prevailing at September 30, 2007, the fair value of this fixed-rate debt was approximately \$778 million. Further, based on the amount of our fixed-rate debt and our related \$897 million of interest rate swap agreements noted above that were outstanding at September 30, 2007, a 25 basis point increase or decrease in the level of interest rates would increase or decrease the fair value of the fixed-rate debt by approximately \$13 million. This potential increase or decrease is based on the simplified assumption that the level of fixed-rate debt remains constant with an immediate across the board increase or decrease in the level of interest rates with no subsequent changes in rates for the remainder of the period.

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

## **CRITICAL ACCOUNTING POLICIES**

The SEC's Financial Reporting Release No. 60, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies* (FRR 60), suggests companies provide additional disclosure and commentary on those accounting policies considered most critical. FRR 60 considers an accounting policy to be critical if it is important to our financial condition and results, and requires significant judgment and estimates on the part of management in our application. We believe the following list represents the critical accounting policies of us as contemplated by FRR 60. For a summary of all of our significant accounting policies, see Note 3 our audited financial statements included elsewhere herein.

### **Purchase Accounting**

We account for our business acquisitions under the purchase method of accounting. The total cost of acquisitions is allocated to the underlying identifiable net assets based on their respective estimated fair values. The excess of the purchase price over the estimated fair values of the net assets acquired is recorded as goodwill. Determining the fair value of assets acquired and liabilities assumed requires management's judgment and often involves the use of significant estimates and assumptions, including assumptions with respect to future cash inflows and outflows, discount rates, asset lives and market multiples, among other items. In addition, reserves have been established on our balance sheet related to acquired liabilities and qualifying restructuring costs based on assumptions made at the time of acquisition. We evaluate these reserves on a regular basis to determine the adequacy or accuracy of the amounts estimated.

### **Accounting for Goodwill and Other Intangible Assets**

We account for our goodwill and other indefinite-lived intangible assets under Statement of Accountings Standards No. 142, *Goodwill and Other Intangible Assets* (FAS 142). Under FAS 142 the Company no longer amortizes goodwill, including the goodwill included in the carrying value of investments accounted for using the equity method of accounting, and certain other intangible assets deemed to have an indefinite useful life. FAS 142 requires that goodwill and certain intangible assets be assessed for impairment using fair value measurement techniques on an annual basis and when events occur that may suggest that the fair value of such assets cannot support the carrying value. Goodwill impairment is tested using a two-step process. The first step of the goodwill impairment test is used to identify potential impairment by comparing the fair value of a reporting unit with its net book value (or carrying amount), including goodwill. If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not impaired and the second step of

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the impairment test is unnecessary. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. The second step of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill. If the carrying amount of the reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination. That is, the fair value of the reporting unit is allocated to all of the assets and liabilities of that unit (including any unrecognized intangible assets) as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the purchase price paid to acquire the reporting unit. The impairment test for other intangible assets consists of a comparison of the fair value of the intangible asset with its carrying value. If the carrying value of the intangible asset exceeds its fair value, an impairment loss is recognized in an amount equal to that excess.

Determining the fair value of a reporting unit under the first step of the goodwill impairment test and determining the fair value of individual assets and liabilities of a reporting unit (including unrecognized intangible assets) under the second step of the goodwill impairment test is judgmental in nature and often involves the use of significant estimates and assumptions. Similarly, estimates and assumptions are used in determining the fair value of other intangible assets. These estimates and assumptions could have a significant impact on whether or not an impairment charge is recognized and also the magnitude of any such charge. We perform internal valuation analyses and consider other market information that is publicly available and, if deemed necessary, we obtain appraisals from independent valuation firms to assist in the process of determining goodwill impairment, if any. Estimates of fair value are primarily determined using discounted cash flows, market comparisons and analysis of recent transactions. These approaches use significant estimates and assumptions including projected future cash flows (including timing), discount rate reflecting the risk inherent in future cash flows, perpetual growth rate, determination of appropriate market comparables and the determination of whether a premium or discount should be applied to comparables.

We test our goodwill and other indefinite lived intangible assets for impairment on an annual basis in the fourth quarter each fiscal year. We tested our goodwill and other indefinite lived intangible assets for impairment in the fourth fiscal quarter of 2007 and noted that no impairment occurred.

As of September 30, 2007, Warner Music Group has recorded goodwill in the amount of \$1.065 billion, primarily related to the Acquisition. See Note 9 to our audited financial statements included herein for a further discussion of Warner Music Group's goodwill.

## **Equity Method and Cost Method Investments**

For non-publicly traded investments, management's assessment of fair value is based on valuation methodologies including discounted cash flows, estimates of sales proceeds and external appraisals, as appropriate. The ability to accurately predict future cash flows, especially in developing and unstable markets, may impact the determination of fair value.

In the event a decline in fair value of an investment occurs, management may be required to determine if the decline in market value is other than temporary. Management's assessments as to the nature of a decline in fair value are based on the valuation methodologies discussed above and our ability and intent to hold the investment. We consider our equity method investees to be strategic long-term investments; therefore, we generally complete our assessments with a long-term viewpoint. If the fair value of any of our equity method or cost method investments is less than the carrying value and the decline in value is considered to be other than temporary, an impairment charge is recorded to write down the carrying value of the investment to its fair value. Management's assessments of fair value in accordance with these valuation methodologies represent our best estimates as of the time of the impairment review and are consistent with our internal planning. If different fair values were estimated, this could have a material impact on the financial statements.

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### **Revenue and Cost Recognition**

#### ***Sales Returns and Uncollectible Accounts***

In accordance with practice in the recorded music industry and as customary in many territories, certain products (such as compact discs and cassettes) are sold to customers with the right to return unsold items. Under Statement of Accounting Standards No. 48, Revenue When Right of Return Exists, revenues from such sales are recognized when the products are shipped based on gross sales less a provision for future estimated returns.

In determining the estimate of product sales that will be returned, management analyzes historical returns, current economic trends, changes in customer demand and commercial acceptance of our products. Based on this information, management reserves a percentage of each dollar of product sales to provide for the estimated customer returns.

Similarly, management evaluates accounts receivables to determine if they will ultimately be collected. In performing this evaluation, significant judgments and estimates are involved, including an analysis of specific risks on a customer-by-customer basis for larger accounts and customers, and a receivables aging analysis that determines the percent that has historically been uncollected by aged category. Based on this information, management provides a reserve for the estimated amounts believed to be uncollectible.

Based on management's analysis of sales returns and uncollectible accounts, reserves totaling \$192 million and \$207 million have been established at September 30, 2007 and September 30, 2006, respectively.

Comparability of gross dollar value of reserves is affected by the inherent seasonality in the music business. That is, the recorded music business historically has generated approximately 35% of its sales in the last three months of the calendar year due to increased consumer demand associated with the holiday season. As such, both gross receivables and related allowances would be at a naturally lower level at September 30, the end of our fiscal year, and at a naturally higher level at December 31, the end of our first fiscal quarter. The ratios of our receivable allowances to gross accounts receivables were approximately 26% at the end of September 30, 2007 and September 30, 2006.

#### ***Gross Versus Net Revenue Classification***

In the normal course of business, we act as an intermediary or agent with respect to certain payments received from third parties. For example, we distribute music product on behalf of third-party record labels.

The accounting issue encountered in these arrangements is whether we should report revenue based on the gross amount billed to the ultimate customer or on the net amount received from the customer after participation and other royalties paid to third parties. To the extent revenues are recorded gross (in the full amount billed), any participations and royalties paid to third parties are recorded as expenses so that the net amount (gross revenues, less expenses) flows through operating income. Accordingly, the impact on operating income is the same, whether we record the revenue on a gross basis or net basis (less related participations and royalties).

Determining whether revenue should be reported gross or net is based on an assessment of whether we are acting as the principal in a transaction or acting as an agent in the transaction. To the extent we are acting as a principal in a transaction, we report as revenue the payments received on a gross basis. To the extent we are acting as an agent in a transaction, we report as revenue the payments received less participations and royalties paid to third parties, i.e., on a net basis. The determination of whether we are serving as principal or agent in a transaction is judgmental in nature and based on an evaluation of the terms of an arrangement.



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In determining whether we serve as principal or agent in these arrangements, we follow the guidance in EITF 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent ( EITF 99-19 ). Pursuant to such guidance, we serve as the principal in transactions where we have the substantial risks and rewards of ownership. The indicators that we have substantial risks and rewards of ownership are as follows:

we are the supplier of the products or services to the customer;

we have general inventory risk for a product before it is sold;

we have latitude in establishing prices;

we have the contractual relationship with the ultimate customer;

we modify and service the product purchased to meet the ultimate customer specifications;

we have discretion in supplier selection; and

we have credit risk.

Conversely, pursuant to EITF 99-19, we serve as agent in arrangements where we do not have substantial risks and rewards of ownership. The indicators that we do not have substantial risks and rewards of ownership are as follows:

the supplier (not Warner Music Group) is responsible for providing the product or service to the customer;

the supplier (not Warner Music Group) has latitude in establishing prices;

the amount we earn is fixed; and

the supplier (not Warner Music Group) has credit risk.

Based on the above criteria and for the more significant transactions that we have evaluated, we record the distribution of product on behalf of third-party record labels on a gross basis, subject to the terms of the contract. However, recorded music compilations distributed by other record companies where we have a right to participate in the profits are recorded on a net basis.

## **Accounting for Royalty Advances**

We regularly commit to and pay advance royalties to our artists and songwriters in respect of future sales. We account for these advance royalty payments under the related guidance in Statement of Financial Accounting Standard No. 50, Financial Reporting in the Record and Music Industry ( FAS 50 ). Under FAS 50, we capitalize as assets certain advance royalty payments that management believes are recoverable from future royalties to be earned by the artist or songwriter.

## Edgar Filing: Warner Music Group Corp. - Form 10-K

Management's decision to capitalize an advance to an artist or songwriter as an asset requires significant judgment as to the recoverability of these advances. The recoverability of these assets is assessed upon initial commitment of the advance, based upon management's forecast of anticipated revenues from the sale of future and existing music and publishing-related products. In determining whether these amounts are recoverable, management evaluates the current and past popularity of the artist or songwriter, the initial or expected commercial acceptability of the product, the current and past popularity of the genre of music that the product is designed to appeal to, and other relevant factors. Based upon this information, management expenses the portion of such advances that it believes is not recoverable. In many cases, royalty advance payments to artists or publishers without history of successful commercial acceptability of the product and evidence of current or past popularity will be expensed immediately. All advances are assessed for recoverability continuously and at minimum on a quarterly basis.

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We had \$392 million and \$398 million of advances on our balance sheet as of September 30, 2007 and 2006, respectively. We believe such advances are recoverable through future royalties to be earned by the related artists and songwriters.

### **Stock-Based Compensation**

We account for stock-based compensation issued to employees in accordance with Statement of Financial Accounting Standard No. 148, Accounting for Stock-Based Compensation Transition and Disclosure ( FAS 148 ), which amends Statement of Financial Accounting Standard FASB Statement No. 123, Share Based Payment , FAS 123 ). This statement provides alternative methods of transition for a voluntary change to the fair value-based method of accounting for stock-based employee compensation. We adopted the expense recognition provision of FAS 123 as of March 1, 2004, the date of the Acquisition, and record stock-based compensation expense for grants on and after that date as provided by FAS 148, and will continue to provide pro forma information for all previous periods in the notes to financial statements to provide results as if FAS 123 had been adopted in those years. Effective October 1, 2005, we adopted FASB Statement No. 123(R), Share-Based Payment, ( FAS 123(R) ) which revises FAS 123, using the modified prospective method. There was no impact to our results of operations or financial position as a result of the adoption of FAS 123(R). Under this provision, we estimate the fair value of our stock-based awards on the grant date and expense the fair value over the service period.

As disclosed in the notes to financial statements, we previously estimated the fair value of options issued at the date of grant using a Black-Scholes option-pricing model, which includes assumptions related to volatility, expected life, dividend yield and risk-free interest rate. In January of 2005 we determined that a binomial method was a more accurate and appropriate method for determining fair value. We have estimated the fair value of our grants made subsequent to January 2005 using the binomial method, which includes assumptions related to volatility, expected life, dividend yield and risk factors. We also award or sell restricted shares to our employees. For restricted shares awarded or sold below market value, the accounting charge is measured at the grant date and amortized ratably as non-cash compensation over the vesting term.

### **Accounting for Income Taxes**

As part of the process of preparing its consolidated financial statements, we are required to estimate income taxes payable in each of the jurisdictions in which it operates. This process involves estimating the actual current tax expense together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheets. Statement of Financial Accounting Standard No. 109, Accounting for Income Taxes , ( FAS 109 ), requires a valuation allowance be established when it is more likely than not that all or a portion of deferred tax assets will not be realized. In circumstances where there is sufficient negative evidence, establishment of a valuation allowance must be considered. We believe that cumulative losses in the most recent three-year period represent sufficient negative evidence to consider a valuation allowance under the provisions of FAS 109. As a result, we determined that certain of our deferred tax assets required the establishment of a valuation allowance.

The realization of the remaining deferred tax assets is primarily dependent on forecasted future taxable income. Any reduction in estimated forecasted future taxable income may require that we record additional valuation allowances against our deferred tax assets on which a valuation allowance has not previously been established. The valuation allowance that has been established will be maintained until there is sufficient positive evidence to conclude that it is more likely than not that such assets will be realized. An ongoing pattern of profitability will generally be considered as sufficient positive evidence. Our income tax expense recorded in the future may be reduced to the extent of offsetting decreases in our valuation allowance if such valuation allowances were not established through goodwill at the time of the Acquisition. The establishment and reversal of valuation allowances could have a significant negative or positive impact on our future earnings.

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Tax assessments may arise several years after tax returns have been filed. Predicting the outcome of such tax assessments involves uncertainty; however, we believe that recorded tax liabilities adequately account for our analysis of probable outcomes.

### **Cash Flow Presentation**

In our consolidated statement of cash flows, we report repayments of principal amounts borrowed under our debt instruments as cash used in financing activities. This includes repayments of amounts due with respect to the redemption of our PIK notes in 2005, a portion of which was used to satisfy obligations for accrued interest that was deferred to be paid as additional principal. Pursuant to this policy, accrued interest of \$13 million in 2005 related to the repayment of our Holdings PIK Notes and Holdings Discount Notes is included in cash used in financing activities in our consolidated statement of cash flows. We classify interest paid as originally scheduled in our borrowing arrangements as operating cash outflows and interest deferred and subsequently paid as additional principal as financing cash outflows. There is diversity in practice, as some other companies present all interest payments, whether deferred or not, as operating cash flows. In this respect, our cumulative operating cash flows may not be comparable to other companies that differ from us only in respect to the repayment terms of their borrowings. If the Company were to alternatively present this amount as cash paid for operating activities rather than cash paid in financing activities, cash flows from operating activities would have decreased by \$13 million for the year ended September 30, 2005.

### **New Accounting Principles**

In addition to the critical accounting policies discussed above, we adopted several new accounting policies during the past two years. None of these new accounting principles had a material affect on our audited financial statements. See Note 3 to our audited financial statements included elsewhere herein for a more complete summary.

### **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As discussed in Note 20 to our audited consolidated financial statements for the twelve months ended September 30, 2007, the Company is exposed to market risk arising from changes in market rates and prices, including movements in foreign currency exchange rates and interest rates. As of September 30, 2007, other than as described below, there have been no material changes to the Company's exposure to market risk since September 30, 2006.

We have transactional exposure to changes in foreign currency exchange rates relative to the U.S. dollar due to the global scope of our operations. We use foreign exchange contracts, primarily to hedge the risk that unremitted or future royalties and license fees owed to our domestic companies for the sale, or anticipated sale, of U.S.-copyrighted products abroad may be adversely affected by changes in foreign currency exchange rates. We focus on managing the level of exposure to the risk of foreign current exchange rate fluctuations on our major currencies, which include the British pound sterling, euro, Japanese yen, Canadian dollar, Mexican peso, Swedish krona and Australian dollar. During the twelve months ended September 30, 2007, the Company entered into foreign exchange hedge contracts and, as of September 30, 2007, the Company has outstanding hedge contracts for the sale of \$472 million and the purchase of \$173 million of foreign currencies at fixed rates. As of November 27, 2007, the Company had not entered into any significant foreign exchange contracts subsequent to September 30, 2007.

The fair value of foreign exchange contracts is subject to changes in foreign currency exchange rates. For the purpose of assessing the specific risks, we use a sensitivity analysis to determine the effects that market risk exposures may have on the fair value of our financial instruments. For foreign exchange forward contracts outstanding at September 30, 2007, assuming a hypothetical 10% depreciation of the U.S. dollar against foreign currencies from prevailing foreign currency exchange rates and assuming no change in interest rates, the fair value of the foreign exchange forward contracts would have decreased by \$30 million. Because our foreign exchange contracts are entered into for hedging purposes, these losses would be largely offset by gains on the underlying transactions.

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We are exposed to foreign currency exchange rate risk with respect to our £100 million principal amount of sterling-denominated notes that were issued in April 2004. These sterling notes mature on April 15, 2014. As of September 30, 2007, these sterling notes had a fair value and carrying value of approximately \$202 million. Based on the principal amount of sterling-denominated notes outstanding as of September 30, 2007 and assuming that all other market variables are held constant (including the level of interest rates), a 10% weakening or strengthening of the U.S. dollar compared to the British pound sterling would not have an impact on the fair value of these sterling notes, since these notes are completely hedged as of September 30, 2007.

We are exposed to interest rate risk with respect to our floating rate debt. Based on the amount of our floating-rate debt and our interest rate swap agreements outstanding as of September 30, 2007, each 25 basis point increase or decrease in interest rates would increase or decrease our annual interest expense and cash outlay by approximately \$1 million. This potential increase or decrease is based on the simplified assumption that the level of floating-rate debt remains constant with an immediate across the board increase or decrease as of September 30, 2007 with no subsequent change in rates for the remainder of the period. This increase or decrease in rates would partially be mitigated by an increase or decrease in interest income earned on our cash balances, almost all of which are invested in short-term variable interest rate earning assets. During the twelve months ended September 30, 2007, the Company did not enter into any interest rate addition swaps or swap extensions. The total notional amount of debt hedged as of September 30, 2007 was \$897 million. As of November 27, 2007, the Company had not entered into any additional interest rate swap agreements subsequent to September 30, 2007.

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

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA  
WARNER MUSIC GROUP CORP.**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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**MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER**

**FINANCIAL REPORTING**

Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the U.S. Securities Exchange Act of 1934, as amended. Management designed our internal control systems in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Our internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (ii) 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 are being made only in accordance with authorizations of management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

Our internal control systems include the controls themselves, monitoring and internal auditing practices and actions taken to correct deficiencies as identified and are augmented by written policies, an organizational structure providing for division of responsibilities, careful selection and training of qualified financial personnel and a program of internal audits.

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.

Management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on its evaluation, our management concluded that our internal control over financial reporting was effective as of September 30, 2007. The Company's independent auditors have issued their report on the Company's internal control over financial reporting.

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders of Warner Music Group Corp.

We have audited Warner Music Group Corp. and subsidiaries' internal control over financial reporting as of September 30, 2007, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company'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 included in the accompanying Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on 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, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, 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, the Company maintained, in all material respects, effective internal control over financial reporting as of September 30, 2007, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Warner Music Group Corp. as of September 30, 2007 and 2006, and the related consolidated statement of operations, shareholders' equity, and cash flows for each of the three years in the period ended September 30, 2007 of the Company and our report dated November 26, 2007 expressed an unqualified opinion thereon.

New York, NY

November 26, 2007

/s/ Ernst & Young LLP



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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders of Warner Music Group Corp.

We have audited the accompanying consolidated balance sheets of Warner Music Group Corp. and subsidiaries as of September 30, 2007 and 2006, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended September 30, 2007. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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 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 consolidated financial position of Warner Music Group Corp. as of September 30, 2007 and 2006, and the consolidated results of its operations and its cash flows for each of the three years in the period ended September 30, 2007, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Warner Music Group Corp.'s internal control over financial reporting as of September 30, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated November 26, 2007 expressed an unqualified opinion thereon.

Our audits were conducted for the purpose of forming an opinion on the financial statements taken as a whole. The condensed and consolidating financial statements are presented for purposes of additional analysis and are not a required part of the financial statements. Such information has been subjected to the auditing procedures applied in our audits of the consolidated financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

New York, NY

November 26, 2007

/s/ Ernst & Young LLP

**Table of Contents****Warner Music Group Corp.****Consolidated Balance Sheets**

|  | September 30,<br>2007 | September 30,<br>2006 |
|--|-----------------------|-----------------------|
|  | (in millions)         |                       |
| <b>Assets</b>  |                       |                       |
| Current assets:  |                       |                       |
| Cash and equivalents   | \$ 333                | \$ 367                |
| Short-term investments   |                       | 18                    |
| Accounts receivable, less allowances of \$192 and \$207 million  | 555                   | 585                   |
| Inventories  | 58                    | 59                    |
| Royalty advances expected to be recouped within one year   | 176                   | 191                   |
| Deferred tax assets  | 40                    | 45                    |
| Other current assets   | 33                    | 35                    |
| <b>Total current assets</b>  | <b>1,195</b>          | <b>1,300</b>          |
| Royalty advances expected to be recouped after one year  | 216                   | 207                   |
| Investments  | 146                   | 25                    |
| Property, plant and equipment, net   | 133                   | 146                   |
| Goodwill   | 1,065                 | 929                   |
| Intangible assets subject to amortization, net   | 1,632                 | 1,711                 |
| Intangible assets not subject to amortization  | 100                   | 100                   |
| Other assets   | 85                    | 102                   |
| <b>Total assets</b>  | <b>\$ 4,572</b>       | <b>\$ 4,520</b>       |
| <b>Liabilities and Shareholders (Deficit) Equity</b>   |                       |                       |
| Current liabilities:   |                       |                       |
| Accounts payable   | \$ 225                | \$ 209                |
| Accrued royalties  | 1,226                 | 1,142                 |
| Taxes and other withholdings   | 33                    | 32                    |
| Dividends payable  | 23                    | 22                    |
| Current portion of long-term debt  | 17                    | 17                    |
| Other current liabilities  | 358                   | 377                   |
| <b>Total current liabilities</b>   | <b>1,882</b>          | <b>1,799</b>          |
| Long-term debt   | 2,256                 | 2,239                 |
| Dividends payable  | 1                     | 3                     |
| Deferred tax liabilities   | 244                   | 197                   |
| Other noncurrent liabilities   | 225                   | 224                   |
| <b>Total liabilities</b>   | <b>4,608</b>          | <b>4,462</b>          |
| <b>Commitments and Contingencies (See Note 19)</b>   |                       |                       |
| Shareholders (deficit) equity:   |                       |                       |
| Common stock (\$0.001 par value; 500,000,000 shares authorized; 149,524,737 and 149,156,028 shares issued and outstanding) |                       |                       |
| Additional paid-in capital   | 579                   | 567                   |
| Accumulated deficit  | (614)                 | (516)                 |
| Accumulated other comprehensive (loss) income, net   | (1)                   | 7                     |
| <b>Total shareholders (deficit) equity</b>   | <b>(36)</b>           | <b>58</b>             |

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|  |          |          |
|--|----------|----------|
| Total liabilities and shareholders' (deficit) equity | \$ 4,572 | \$ 4,520 |
|--|----------|----------|

See accompanying notes.

**Table of Contents****Warner Music Group Corp.****Consolidated Statements of Operations**

|   | Year Ended                           | Year Ended            | Year Ended            |
|---|--------------------------------------|-----------------------|-----------------------|
|   | September 30,<br>2007                | September 30,<br>2006 | September 30,<br>2005 |
|   | (in millions, except per share data) |                       |                       |
| Revenues (b)  | \$ 3,385                             | \$ 3,516              | \$ 3,502              |
| Costs and expenses:   |                                      |                       |                       |
| Cost of revenues (a)(b)   | (1,823)                              | (1,822)               | (1,850)               |
| Selling, general and administrative expenses (a)(b)   | (1,164)                              | (1,232)               | (1,305)               |
| Other income, net   | 73                                   | 14                    | 4                     |
| Amortization of intangible assets   | (206)                                | (193)                 | (187)                 |
| Loss on termination of management agreement   |                                      |                       | (73)                  |
| Restructuring costs   | (50)                                 |                       | (7)                   |
| <b>Total costs and expenses</b>   | <b>(3,170)</b>                       | <b>(3,233)</b>        | <b>(3,418)</b>        |
| Operating income  | 215                                  | 283                   | 84                    |
| Interest expense, net (b)   | (182)                                | (180)                 | (182)                 |
| Net investment-related gains  |                                      |                       | 1                     |
| Equity in the gains (losses) of equity-method investees, net  |                                      | 1                     | (1)                   |
| Loss on repayment of Holdings Notes   |                                      |                       | (35)                  |
| Unrealized gain on warrants   |                                      |                       | 17                    |
| Other income, net   |                                      | 3                     | 7                     |
| Minority interest expense   | (5)                                  |                       | (5)                   |
| Income (loss) before income taxes   | 28                                   | 107                   | (114)                 |
| Income tax expense  | (49)                                 | (47)                  | (55)                  |
| Net (loss) income   | \$ (21)                              | \$ 60                 | \$ (169)              |
| Net (loss) income per common share:   |                                      |                       |                       |
| Basic   | \$ (0.14)                            | \$ 0.42               | \$ (1.40)             |
| Diluted   | \$ (0.14)                            | \$ 0.40               | \$ (1.40)             |
| Average common shares:  |                                      |                       |                       |
| Basic   | 146.2                                | 142.8                 | 120.9                 |
| Diluted   | 146.2                                | 150.9                 | 120.9                 |
| (a) Includes depreciation expense of:   | \$ (40)                              | \$ (42)               | \$ (51)               |
| (b) Includes the following income (expenses) resulting from transactions with related companies (Note 17) |                                      |                       |                       |
| Revenues  | \$ 8                                 | \$ 6                  | \$ 9                  |
| Cost of revenues  | (1)                                  | (3)                   | (3)                   |
| Selling, general and administrative expenses  | (4)                                  | (16)                  | (7)                   |
| Minority interest expense   |                                      |                       | (5)                   |

See accompanying notes.



**Table of Contents****Warner Music Group Corp.****Consolidated Statements of Cash Flows**

|  | Year<br>Ended         | Year Ended                             | Year Ended            |
|--|-----------------------|--|-----------------------|
|  | September 30,<br>2007 | September 30,<br>2006<br>(in millions) | September 30,<br>2005 |
| <b>Cash flows from operating activities</b>  |                       |  |                       |
| Net (loss) income  | \$ (21)               | \$ 60                                  | \$ (169)              |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                       |  |                       |
| Depreciation and amortization  | 246                   | 235                                    | 238                   |
| Deferred taxes   | (2)                   | (11)                                   | (7)                   |
| Loss on debt repayment   |                       |  | 35                    |
| Non-cash interest expense  | 60                    | 52                                     | 68                    |
| Net investment-related gains   |                       |  | (1)                   |
| Equity in the (gains) losses of equity-method investees, including distributions         |                       | (1)                                    | 1                     |
| Non-cash, stock-based compensation expense   | 10                    | 16                                     | 25                    |
| Unrealized (gain) loss on warrants   |                       |  | (17)                  |
| Other non-cash adjustments   | (4)                   |  |                       |
| Minority interest expense  | 5                     |  | 5                     |
| Changes in operating assets and liabilities:   |                       |  |                       |
| Accounts receivable  | 73                    | 53                                     | (69)                  |
| Inventories  | 3                     |  | (3)                   |
| Royalty advances   | 18                    | (40)                                   | (2)                   |
| Accounts payable and accrued liabilities   | (78)                  | (60)                                   | 46                    |
| Other balance sheet changes  | (8)                   | 3                                      | 55                    |
| Net cash provided by operating activities (a)  | 302                   | 307                                    | 205                   |
| <b>Cash flows from investing activities</b>  |                       |  |                       |
| (Loans to third parties) or repayments of loans to third parties                         | (14)                  | 7                                      | (10)                  |
| Other investments and acquisitions   | (237)                 | (104)                                  | (78)                  |
| Sales (purchases) of short-term investments  | 18                    | (19)                                   |                       |
| Investment proceeds  | 7                     |  | 54                    |
| Capital expenditures   | (29)                  | (30)                                   | (30)                  |
| Net cash used in investing activities  | (255)                 | (146)                                  | (64)                  |
| <b>Cash flows from financing activities</b>  |                       |  |                       |
| Borrowings   |                       |  | 946                   |
| Financing costs  |                       |  | (20)                  |
| Debt repayments  | (17)                  | (17)                                   | (588)                 |
| Proceeds from the issuance of common stock   |                       |  | 554                   |
| Costs to issue common stock  |                       |  | (32)                  |
| Repurchase of subsidiary preferred stock   |                       |  | (200)                 |
| Dividends paid on subsidiary preferred stock   |                       |  | (9)                   |
| Proceeds from the issuance of restricted shares  |                       |  | 1                     |
| Cash paid to repurchase warrant  |                       |  | (138)                 |
| Returns of capital and dividends paid  | (79)                  | (74)                                   | (917)                 |
| Other  | 2                     | 3                                      | (3)                   |

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|  |        |        |        |
|--|--------|--------|--------|
| Net cash used in financing activities                    | (94)   | (88)   | (406)  |
| Effect of foreign currency exchange rate changes on cash | 13     | 6      | (2)    |
| Net (decrease) increase in cash and equivalents          | (34)   | 79     | (267)  |
| Cash and equivalents at beginning of period              | 367    | 288    | 555    |
| Cash and equivalents at end of period                    | \$ 333 | \$ 367 | \$ 288 |

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(a) Net cash used in operating activities for the twelve months ended September 30, 2007, 2006 and 2005 includes approximately \$50 million, \$10 million and \$80 million of acquisition-related restructuring payments, respectively.  
See accompanying notes.

**Table of Contents****Warner Music Group Corp.****Consolidated Statements of Shareholders' Equity**

|   | Common Stock       |                 | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total<br>Shareholders'<br>(Deficit)<br>Equity |
|---|--------------------|-----------------|----------------------------------|------------------------|---|---|
|   | Common<br>Shares   | Par             |                                  |                        |   |   |
| <b>Balance at September 30, 2004</b>                            | <b>114,115,176</b> |                 | <b>\$ 512</b>                    | <b>\$ (238)</b>        | <b>\$ 6</b>   | <b>\$ 280</b>                                 |
| Comprehensive loss:   |                    |                 |                                  |                        |   |   |
| Net loss  |                    |                 |                                  | (169)                  |   | (169)   |
| Foreign currency translation adjustment                         |                    |                 |                                  |                        | 3   | 3   |
| Deferred gains on derivative financial instruments              |                    |                 |                                  |                        | 12  | 12  |
| Total comprehensive loss  |                    |                 |                                  | (169)                  | 15  | (154)   |
| Return of capital   |                    |                 | (508)                            | (73)                   |   | (581)   |
| Issuance of common stock, net of issuance costs                 | 32,600,000         | \$ 0.001        | 522                              |                        |   | 522   |
| Issuance of stock options and restricted shares of common stock | 1,740,137          | \$ 0.001        | 25                               |                        |   | 25  |
| Other   |                    |                 | (3)                              |                        |   | (3)   |
| <b>Balance at September 30, 2005</b>                            | <b>148,455,313</b> | <b>\$ 0.001</b> | <b>\$ 548</b>                    | <b>\$ (480)</b>        | <b>\$ 21</b>  | <b>\$ 89</b>                                  |
| Comprehensive loss:   |                    |                 |                                  |                        |   |   |
| Net income  |                    |                 |                                  | 60                     |   | 60  |
| Foreign currency translation adjustment                         |                    |                 |                                  |                        | (8)   | (8)   |
| Minimum Pension Liability                                       |                    |                 |                                  |                        | (4)   | (4)   |
| Deferred gains on derivative financial instruments              |                    |                 |                                  |                        | (2)   | (2)   |
| Total comprehensive income                                      |                    |                 |                                  | 60                     | (14)  | 46  |
| Dividends   |                    |                 |                                  | (95)                   |   | (95)  |
| Issuance of stock options and restricted shares of common stock | 700,715            | \$ 0.001        | 16                               |                        |   | 16  |
| Exercises of stock options                                      |                    |                 | 3                                |                        |   | 3   |
| Other   |                    |                 |                                  | (1)                    |   | (1)   |
| <b>Balance at September 30, 2006</b>                            | <b>149,156,028</b> | <b>\$ 0.001</b> | <b>\$ 567</b>                    | <b>\$ (516)</b>        | <b>\$ 7</b>   | <b>\$ 58</b>                                  |
| Comprehensive loss:   |                    |                 |                                  |                        |   |   |
| Net loss  |                    |                 |                                  | (21)                   |   | (21)  |
| Foreign currency translation adjustment                         |                    |                 |                                  |                        | (2)   | (2)   |
| Minimum Pension Liability                                       |                    |                 |                                  |                        | 8   | 8   |
| Deferred gains on derivative financial instruments              |                    |                 |                                  |                        | (14)  | (14)  |
| Total comprehensive income                                      |                    |                 |                                  | (21)                   | (8)   | (29)  |
| Dividends   |                    |                 |                                  | (76)                   |   | (76)  |
| Issuance of stock options and restricted shares of common stock | (90,247)           | \$ 0.001        | 10                               |                        |   | 10  |
| Exercises of stock options                                      | 458,956            |                 | 2                                |                        |   | 2   |
| Other   |                    |                 |                                  | (1)                    |   | (1)   |
| <b>Balance at September 30, 2007</b>                            | <b>149,524,737</b> | <b>\$ 0.001</b> | <b>\$ 579</b>                    | <b>\$ (614)</b>        | <b>\$ (1)</b>   | <b>\$ (36)</b>                                |



See accompanying notes.

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements**

**1. Description of Business**

Warner Music Group Corp. was formed by a private equity consortium of Investors on November 21, 2003. The Company is the direct parent of WMG Holdings Corp., which is the direct parent of WMG Acquisition Corp. Acquisition Corp. is one of the world's major music-based content companies and the successor to substantially all of the interests of the recorded music and music publishing businesses of Time Warner. Effective March 1, 2004, Acquisition Corp. acquired such interests from Time Warner for approximately \$2.6 billion. The original Investor Group included Thomas H. Lee Partners, THL, Bain, Providence Equity Partners, Inc. and its affiliates ( Providence ) and Music Capital. Music Capital's partnership agreement required that the Music Capital partnership dissolve and commence winding up by the second anniversary of the Company's May 2005 initial public offering. As a result, on May 7, 2007, Music Capital made a pro rata distribution of all shares of common stock of the Company held by it to its partners. The shares held by Music Capital had been subject to a stockholders agreement among Music Capital, THL, Bain and Providence and certain other parties. As a result of the distribution, the shares distributed by Music Capital ceased to be subject to the voting and other provisions of the stockholders agreement and Music Capital was no longer part of the Investor Group subject to the stockholders agreement.

The Company classifies its business interests into two fundamental operations: Recorded Music and Music Publishing. A brief description of these operations is presented below.

*Recorded Music Operations*

The Company's Recorded Music business consists of the discovery and development of artists and the related marketing, distribution and licensing of recorded music produced by such artists. In addition to the more traditional methods of discovering and developing artists, the Company established ILG to discover artists earlier in the process and at lower cost by leveraging the Company's independent distribution network.

In the U.S., Recorded Music operations are conducted principally through the Company's major record labels Warner Bros. Records and The Atlantic Records Group. The Company's Recorded Music operations also include Rhino Entertainment ( Rhino ), a division that specializes in marketing the Company's music catalog through compilations and reissues of previously released music and video titles, as well as in the licensing of recordings to and from third parties for various uses, including film and television soundtracks.

On May 31, 2006, the Company completed the acquisition of Ryko, a leading independent, integrated music and entertainment company. In January 2007, the Company acquired a majority interest in Roadrunner, which includes Roadrunner Records, one of the leading hard rock and heavy metal labels. See Note 5.

Outside the U.S., Recorded Music activities are conducted in more than 50 countries through Warner Music International ( WMI ) and its various subsidiaries, affiliates and non-affiliated licensees. WMI engages in the same activities as the Company's U.S. labels: discovering and signing artists and distributing, marketing and selling their recorded music. In most cases, WMI also markets and distributes the records of those artists for whom the Company's domestic record labels have international rights. In certain smaller countries, WMI licenses to unaffiliated third-party record labels the right to distribute its records.

Recorded Music distribution operations include WEA Corp., which markets and sells music and DVD products to retailers and wholesale distributors in the U.S.; ADA, which distributes the products of independent labels to retail and wholesale distributors in the U.S.; Ryko Distribution, which distributes music and DVD releases from Rykodisc, Ryko's record music label, and third-party record and video labels; various distribution

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

centers and ventures operated internationally; an 80% interest in Word Entertainment, which specializes in the distribution of music products in the Christian retail marketplace; and ADA Global, which provides ADA's distribution services to independent labels outside of the U.S.

*Music Publishing Operations*

Where recorded music is focused on exploiting a particular recording of a song, music publishing is an intellectual property business focused on the exploitation of the song itself. In return for promoting, placing, marketing and administering the creative output of a songwriter, or engaging in those activities for other rightsholders, the Company's music publishing business garners a share of the revenues generated from use of the song.

The Company's music publishing operations include Warner/Chappell its global music publishing company headquartered in Los Angeles with operations in over 50 countries through various subsidiaries, affiliates and non-affiliated licensees. The Company owns or controls rights to more than one million musical compositions, including numerous pop hits, American standards, folk songs and motion picture and theatrical compositions. Assembled over decades, our award-winning catalog includes over 65,000 songwriters and composers and a diverse range of genres including pop, rock, jazz, country, R&B, hip-hop, rap, reggae, Latin, folk, blues, symphonic, soul, Broadway, techno, alternative, gospel and other Christian music. Warner/Chappell also administers the music and soundtracks of several third-party television and film producers and studios, including Lucasfilm, Ltd. and Hallmark Entertainment.

Warner/Chappell also previously owned WBP, which printed and distributed a broad selection of sheet music, books and educational materials, orchestrations, folios, personality books, and arrangements from the catalogs of Warner/Chappell and other music publishers. On May 31, 2005, the Company sold its printed sheet music business to Alfred Publishing. See Note 5.

Publishing revenues are derived from four main sources:

*Mechanical:* the licensor receives royalties with respect to compositions embodied in recordings sold in any format or configuration, including physical recordings (e.g., CDs, DVDs, video cassettes), online and wireless downloads and mobile phone ringtones.

*Performance:* the licensor receives royalties if the composition is performed publicly through broadcast of music on television, radio, cable and satellite, live performance at a concert or other venue (e.g., arena concerts, nightclubs), online and wireless streaming and performance of music in staged theatrical productions.

*Synchronization:* the licensor receives royalties or fees for the right to use the composition in combination with visual images such as in films or television programs, television commercials and videogames.

*Other:* the licensor receives royalties from other uses such as in toys or novelty items and for use in sheet music.

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

**2. Basis of Presentation**

**Recapitalization**

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

**Basis of Consolidation**

The accompanying financial statements present the *consolidated* accounts of such businesses for all periods. The consolidated accounts include 100% of the assets, liabilities, revenues, expenses, income, losses and cash flows of the Company and all entities in which the Company has a controlling voting interest and/or variable interest entities required to be consolidated in accordance with accounting principles generally accepted in the United States (U.S. GAAP). Significant inter-company balances and transactions have been eliminated in consolidation and combination.

**3. Summary of Significant Accounting Policies**

**Use of Estimates**

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ from those estimates due to, among other factors, the risks inherent in the recorded music and music publishing businesses, including continuing industry-wide piracy. Estimates are used when accounting for certain items such as allowances for doubtful accounts and sales returns, depreciation and amortization, asset recoverability and impairments (including royalty advances and intangible assets), contingencies, reserves (including certain royalty payables) and the value of stock-based compensation.

**Cash and Equivalents**

The Company considers all highly liquid investments with maturities of three months or less when purchased to be cash equivalents.

**Short-term Investments**

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

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

**Foreign Currency Translation**

The financial position and operating results of substantially all foreign operations are consolidated using the local currency as the functional currency. Local currency assets and liabilities are translated at the rates of exchange on the balance sheet date, and local currency revenues and expenses are translated at average rates of exchange during the period. Resulting translation gains or losses are included in the accompanying consolidated statement of shareholders' equity as a component of accumulated other comprehensive income (loss).

**Derivative and Financial Instruments**

The Company has adopted Financial Accounting Standards Board (FASB) Statement No. 133, as amended by FASB Statement No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities (FAS 133). FAS 133 requires that all derivative instruments be recognized on the balance sheet at fair value. In addition, FAS 133 provides that, for derivative instruments that qualify for hedge accounting, changes in the fair value are either (a) offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or (b) recognized in equity until the hedged item is recognized in earnings, depending on whether the derivative is being used to hedge changes in fair value or cash flows. The ineffective portion of a derivative's change in fair value is immediately recognized in earnings.

As further described in Note 16, the Company issued, and subsequently repurchased, stock warrants to Time Warner as part of the purchase price of the Acquisition. The stock warrants were derivative financial instruments which the Company accounted for in accordance with the provisions of FAS 133. Changes in the fair value of the warrants were reflected in the accompanying consolidated statement of operations of the Company for the year ended September 30, 2005.

The carrying value of the Company's financial instruments approximates fair value, except for certain differences relating to long-term, fixed-rate debt and other financial instruments that are not significant. The fair value of financial instruments is generally determined by reference to market values resulting from trading on a national securities exchange or an over-the-counter market. In cases where quoted market prices are not available, fair value is based on estimates using present value or other valuation techniques. See Note 12 for the fair value of the Company's debt.

**Revenues**

*Recorded Music*

In accordance with industry practice and as is customary in many territories, certain products (such as CDs and cassettes) are sold to customers with the right to return unsold items. Revenues from such sales are recognized when the products are shipped based on gross sales less a provision for future estimated returns. Revenues from the sale of recorded music products through digital distribution channels are recognized when the products are sold and related sales accounting reports are delivered by the providers.

*Music Publishing*

Revenues are earned from the receipt of royalties relating to the licensing of rights in musical compositions, and for the sale of published sheet music and songbooks. The receipt of royalties principally relates to amounts earned from the public performance of copyrighted material, the mechanical reproduction of copyrighted material on recorded media including digital formats, and the use of copyrighted material in synchronization with visual images. Consistent with industry practice, music-publishing royalties generally are recognized as revenue when received.

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

**Gross Versus Net Revenue Classification**

In the normal course of business, the Company acts as an intermediary or agent with respect to certain payments received from third parties. For example, the Company distributes music product on behalf of third-party record labels. Pursuant to Emerging Issues Task Force ( EITF ) No. 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent, such transactions are recorded on a gross or net basis depending on whether the Company is acting as the principal in the transaction or acting as an agent in the transaction. The Company serves as the principal in transactions in which it has substantial risks and rewards of ownership and, accordingly, revenues are recorded on a gross basis. For those transactions in which the Company does not have substantial risks and rewards of ownership, the Company is considered an agent in the transactions and, accordingly, revenues are recorded on a net basis.

To the extent revenues are recorded on a gross basis, any participations and royalties paid to third parties are recorded as expenses so that the net amount (gross revenues less expenses) flows through operating income. To the extent revenues are recorded on a net basis, revenues are reported based on the amounts received, less participations and royalties paid to third parties. Either way, the impact on operating income is the same whether the Company records the revenues on a gross or net basis.

Based on an evaluation of the individual terms of each contract and whether the Company is acting as principal or agent, the Company generally records revenues from the distribution of recorded music product on behalf of third-party record labels on a gross basis. However, revenues are recorded on a net basis for recorded music compilations distributed by other record companies where the Company has a right to participate in the profits.

**Royalty Advances and Royalty Costs**

The Company regularly commits to and pays advance royalties to its artists and songwriters in respect of future sales. The Company accounts for these advance royalty payments under the related guidance in FASB No. 50, Financial Reporting in the Record and Music Industry ( FAS 50 ). Under FAS 50, certain advance royalty payments that are believed to be recoverable from future royalties to be earned by the artist or songwriter are capitalized as assets. The decision to capitalize an advance to an artist or songwriter as an asset requires significant judgment as to the recoverability of these advances. The recoverability of these assets is assessed upon initial commitment of the advance, based upon the Company's forecast of anticipated revenues from the sale of future and existing music and publishing-related products. In determining whether these amounts are recoverable, the Company evaluates the current and past popularity of the artist or songwriter, the initial or expected commercial acceptability of the product, the current and past popularity of the genre of music that the product is designed to appeal to, and other relevant factors. Based upon this information, the portion of such advances that are believed not to be recoverable is expensed. All advances are assessed for recoverability continuously and at minimum on a quarterly basis.

Royalties earned by artists, songwriters, co-publishers, other copyright holders and trade unions are recognized as an expense in the period in which the sale of the product takes place, less an adjustment for future estimated returns, and are included in cost of revenue.

**Inventories**

Inventories consist of CDs, cassettes and related music products, as well as published sheet music and songbooks. Inventories are stated at the lower of cost or estimated realizable value. Cost is determined using first-in, first-out ( FIFO ) and average cost methods, which approximate cost under the FIFO method. Returned goods included in inventory are valued at estimated realizable value, but not in excess of cost.

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

**Advertising**

In accordance with American Institute of Certified Public Accountants ( AICPA ) Statement of Position ( SOP ) No. 93-7, Reporting on Advertising Costs, advertising costs, including costs to produce music videos used for promotional purposes, are expensed as incurred. Advertising expense amounted to approximately \$144 million, \$202 million, and \$192 million for the years ended 2007, 2006, and 2005, respectively. Deferred advertising costs, which principally relate to advertisements that have not been exhibited or services that have not been received, were approximately \$2 million at both September 30, 2007 and 2006.

**Concentration of Credit Risk**

The Company has 15 significant recorded music customers that individually represent from 1% to 7% of the Company's consolidated gross accounts receivable, and approximately 38% in the aggregate. Based on a history of cash collection, the Company does not believe there is any significant collection risk from such customers. Additionally, in the recorded music business, the Company has 15 key customers that generate significant sales volume. For the twelve months ended September 30, 2007, these customers comprised approximately 32% of recorded music revenues.

In the music publishing business, the Company collects a significant portion of its royalties from copyright collection societies around the world. Collection societies and associations generally are not-for-profit organizations that represent composers, songwriters and music publishers. These organizations seek to protect the rights of their members by licensing, collecting license fees and distributing royalties for the use of their works. Accordingly, the Company does not believe there is any significant collection risk from such societies.

**Shipping and Handling**

The costs associated with shipping goods to customers are recorded as cost of revenues. Shipping and handling charges billed to customers are included in revenues.

**Investments**

FASB Interpretation No. 46, Consolidation of Variable Interest Entities an Interpretation of ARB No. 51 ( FIN 46 ) requires that the Company first evaluate its investments to determine if any investments in companies in which the Company has significant influence, but less than a controlling voting interest, qualify as a variable interest entity ( VIE ). In determining if an entity is a VIE, FIN 46 requires one to evaluate whether the equity of the entity is sufficient to absorb its expected losses. The evaluation requires the consideration of qualitative factors and various assumptions, including expected future cash flows and funding needs. Even if the entity's equity is determined to be sufficient to absorb expected losses, the rules provide that in certain circumstances there needs to be a qualitative assessment as to whether substantially all the benefits of the entity are for the benefit of one of the variable interest holders. In such circumstances, the entity would be deemed a VIE. FIN 46 further provides that the primary beneficiary of a VIE is required to consolidate the VIE's operations.

For investments in companies in which the Company has significant influence, but less than a controlling voting interest, that do not qualify as VIE's under the provisions of FIN 46, the Company accounts for the investments using the equity method. This is generally presumed to exist when the Company owns between 20% and 50% of the investee. Should the Company had a greater than 50% ownership interest in an investee and the minority shareholders held certain rights that allowed them to participate in the day-to-day operations of the business, the Company would also use the equity method of accounting.

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

Under the equity method, only the Company's investment in and amounts due to and from the equity investee are included in the consolidated balance sheet; only the Company's share of the investee's earnings (losses) is included in the consolidated operating results; and only the dividends, cash distributions, loans or other cash received from the investee, additional cash investments, loan repayments or other cash paid to the investee are included in the consolidated cash flows.

Investments in companies in which the Company does not have a controlling interest or is unable to exert significant influence are accounted for at market value if the investments are publicly traded and there are no resale restrictions greater than one year (available-for-sale investments). If there are resale restrictions greater than one year, or if the investment is not publicly traded, then the investment is accounted for at cost.

**Property, Plant and Equipment**

Property, plant and equipment are recorded at historical cost. Depreciation is calculated using the straight-line method based upon the estimated useful lives of depreciable assets as follows: five to seven years for furniture and fixtures, periods of up to five years for computer equipment and periods of up to seven years for machinery and equipment. Buildings are depreciated over periods of up to forty years. Leasehold improvements are depreciated over periods up to the life of the lease.

**Accounting for Goodwill and Other Intangible Assets**

In July 2001, FASB Statement No. 141, Business Combinations (FAS 141) and FASB Statement No. 142, Goodwill and Other Intangible Assets (FAS 142) were issued. These standards changed the accounting for business combinations by, among other things, prohibiting the prospective use of pooling-of-interests accounting. In addition, FAS 142 required that goodwill, including the goodwill included in the carrying value of investments accounted for using the equity method of accounting, and certain other intangible assets deemed to have an indefinite useful life, should not be amortized. These new rules also require that goodwill and certain intangible assets be assessed for impairment using fair value measurement techniques.

**Internal-Use Software Development Costs**

In accordance with AICPA SOP No. 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, the Company capitalizes certain external and internal computer software costs incurred during the application development stage. The application development stage generally includes software design and configuration, coding, testing and installation activities. Training and maintenance costs are expensed as incurred, while upgrades and enhancements are capitalized if it is probable that such expenditures will result in additional functionality. Capitalized software costs are depreciated over the estimated useful life of the underlying project on a straight-line basis, generally not exceeding five years.

**Valuation of Long-Lived Assets**

The Company periodically reviews the carrying value of its long-lived assets, including property, plant and equipment, whenever events or changes in circumstances indicate that the carrying value may not be recoverable. To the extent the estimated future cash inflows attributable to the asset, less estimated future cash outflows, are less than the carrying amount, an impairment loss is recognized in an amount equal to the difference between the carrying value of such asset and its fair value. Assets to be disposed of and for which there is a committed plan to dispose of the assets, whether through sale or abandonment, are reported at the lower of carrying value or fair value less costs to sell.



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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

**Cash Flow Presentation**

The Company reports any repayments of principal amounts borrowed under our debt instruments as cash used in financing activities. We classify interest paid as originally scheduled in our borrowing arrangements as operating cash outflows and interest deferred and subsequently paid as additional principal as financing cash outflows. Our PIK notes allow for deferral of interest payments. SFAS 95 requires interest payments to be classified as operating cash outflows. However, because we believe deferred interest is legally converted to principal, our classification of such payments varies depending on whether we pay them as scheduled in our borrowing arrangements or defer them as permitted under the terms of our borrowing arrangements. A portion of the aggregate amount paid in connection with the redemption of the Holdings PIK Notes and the Holdings Discount Notes in 2005 related to accrued interest that was deferred to be paid as additional principal. Pursuant to this policy, accrued interest of \$13 million in 2005 related to the repayment of our Holdings PIK Notes and Holdings Discount Notes is included in cash used in financing activities in the consolidated statement of cash flows.

**Stock-Based Compensation**

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

**Income Taxes**

Income taxes are provided using the asset and liability method presented by FASB Statement No. 109, *Accounting for Income Taxes* ( FAS 109 ). Under this method, income taxes (i.e., deferred tax assets, deferred tax liabilities, taxes currently payable/refunds receivable and tax expense) are recorded based on amounts refundable or payable in the current year and include the results of any differences between U.S. GAAP and tax reporting. Deferred income taxes reflect the tax effect of net operating loss, capital loss and general business credit carryforwards and the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial statements and income tax purposes, as determined under enacted tax laws and rates. Valuation allowances are established when management determines that it is more likely than not that some portion or all of the deferred tax asset will not be realized. The financial effect of changes in tax laws or rates is accounted for in the period of enactment.

In June 2006, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement 109 ( FIN 48 ) was issued. FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and provides guidance on derecognition, classification, interest and penalties, accounting for interim periods, disclosures and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company will adopt the provisions of FIN 48 in the first quarter of fiscal 2008. The Company does not expect that the adoption of FIN 48 will have a material impact on its financial statements.

**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)****Comprehensive Income (Loss)**

Comprehensive income (loss), which is reported in the accompanying consolidated statements of shareholders' equity, consists of net income (loss) and other gains and losses affecting equity that, under U.S. GAAP, are excluded from net income (loss). For the Company, the components of other comprehensive income (loss) primarily consist of foreign currency translation gains and losses and deferred gains and losses on financial instruments designated as hedges under FAS 133, which include interest-rate swap and foreign exchange contracts. The following summary sets forth the components of other comprehensive income (loss), net of related taxes, that have been accumulated in shareholders' equity since September 30, 2004:

|                                      | Foreign<br>Currency<br>Translation<br>Gain (Losses) | Minimum<br>Pension<br>Liability<br>Adjustment | Derivative<br>Financial<br>Instruments<br>Gain (Losses)<br>(in millions) | Accumulated<br>Other<br>Comprehensive<br>Gain<br>(Losses) |
|--------------------------------------|---|---|--|---|
| <b>Balance at September 30, 2004</b> | <b>\$ 10</b>  |   | <b>\$ (4)</b>  | <b>\$ 6</b>   |
| Activity through September 30, 2005  | 3   |   | 12   | 15  |
| <b>Balance at September 30, 2005</b> | <b>\$ 13</b>  |   | <b>\$ 8</b>  | <b>\$ 21</b>  |
| Activity through September 30, 2006  | (8)   | (4)   | (2)  | (14)  |
| <b>Balance at September 30, 2006</b> | <b>\$ 5</b>   | <b>\$ (4)</b>                                 | <b>\$ 6</b>  | <b>\$ 7</b>   |
| Activity through September 30, 2007  | (2)   | 8   | (14)   | (8)   |
| <b>Balance at September 30, 2007</b> | <b>\$ 3</b>   | <b>\$ 4</b>                                   | <b>\$ (8)</b>  | <b>\$ (1)</b>   |

**4. Net Income (Loss) Per Common Share**

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

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

|   | Year ended<br>September 30,<br>2007 | Year ended<br>September 30,<br>2006 | Year ended<br>September 30,<br>2005 |
|---|-------------------------------------|-------------------------------------|-------------------------------------|
| Basic and diluted net (loss) income per common share: |                                     |                                     |                                     |
| Numerator:  |                                     |                                     |                                     |
| Net (loss) income                                     | \$ (21)                             | \$ 60                               | \$ (169)                            |

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Denominator:

|  |       |       |       |
|--|-------|-------|-------|
| Weighted average common shares outstanding for basic calculation | 146.2 | 142.8 | 120.9 |
| Dilutive effect of stock options and restricted stock            |       | 8.1   |       |

|  |       |       |       |
|--|-------|-------|-------|
| Weighted average common shares outstanding for diluted calculation | 146.2 | 150.9 | 120.9 |
|--|-------|-------|-------|

Net (loss) income per common share basic and diluted:

|  |           |         |           |
|--|-----------|---------|-----------|
| Net (loss) income per common share basic | \$ (0.14) | \$ 0.42 | \$ (1.40) |
|--|-----------|---------|-----------|

|  |           |         |           |
|--|-----------|---------|-----------|
| Net (loss) income per common share diluted | \$ (0.14) | \$ 0.40 | \$ (1.40) |
|--|-----------|---------|-----------|

**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)**

The calculation of diluted net loss per share excludes an adjustment to the weighted-average common shares outstanding for the potential dilution that would occur if the Company's stock options or warrants were exercised or the Company's restricted stock had vested. In the periods reported, the effect of the assumed exercise of stock options and warrants and the assumed vesting of restricted shares would have been antidilutive and accordingly, the following share amounts were excluded from the calculation of diluted net (loss) income per share:

|                  | Year ended<br>September 30,<br>2007 | Year ended<br>September 30,<br>2006 |
|------------------|-------------------------------------|-------------------------------------|
| Stock options    | 1.8                                 | 2.3                                 |
| Restricted stock | 3.0                                 | 6.1                                 |

See Note 15 for a summary of restricted stock and stock options outstanding during the period and Note 16 for information related to the warrants that were issued to Time Warner in connection with the Acquisition.

**5. Acquisitions and Dispositions****Acquisition of Roadrunner Music Group**

On January 29, 2007, the Company acquired 73.5% of Roadrunner, which includes Roadrunner Records, a leading hard rock and heavy metal label. The transaction was accounted for under the purchase method of accounting, and the results of operations of Roadrunner have been included in the Company's results of operations from the date of acquisition. The purchase price has been preliminarily allocated to the underlying net assets acquired in proportion to the estimated fair value, principally recorded music catalog, artist contracts and goodwill. The accompanying consolidated financial statements include the following allocation of the approximately \$83 million purchase price, consisting of a cash payment of \$59 million and estimated future payment obligations of \$24 million: recorded music catalog, \$15 million; artists' contracts, \$26 million; goodwill, \$39 million; tangible assets, \$36 million; and tangible liabilities, \$33 million.

In connection with the signing of the initial agreement in December 2006, the Company had loaned Roadrunner approximately \$52 million in the form of a promissory note. The note was repaid in connection with the close of the acquisition on January 29, 2007. In addition, in connection with the closing, the Company loaned the minority owner approximately \$14.3 million in the form of a promissory note, which bears an annual simple rate of interest of 4.73% and matures in six years and can be utilized to satisfy any of the Company's future payment obligations.

**Acquisition of Ryko Corporation**

On May 31, 2006, the Company completed the acquisition of Ryko, a leading independent, integrated music and entertainment company, for approximately \$67.5 million in cash. Ryko consists of a recorded music label, Rykodisc, which focuses on a range of contemporary music and comedy releases and numerous film and television soundtracks and Ryko Distribution, which distributes music and DVD releases from Rykodisc as well as from independent third-party record and video labels. Additionally, Ryko owns a catalog of more than 1,000 titles of rock, folk, jazz, world, blues and alternative albums including Restless Records' catalog of punk, new wave and soundtrack recordings. The catalog and roster includes artists such as Frank Zappa, Joe Jackson, Soul Asylum, The Flaming Lips and They Might Be Giants. The transaction was accounted for under the purchase method of accounting, and the results of operations of Ryko are included in the Company's results of operations from the acquisition date of Ryko. The purchase price was allocated to the underlying net assets acquired in proportion to the estimated fair value, principally recorded music catalog and goodwill. The accompanying consolidated financial statements include the following allocation of the approximately \$67.5 million purchase

**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)**

price: recorded music catalog, \$28 million; artists' contracts, \$1 million; tangible liabilities, \$13 million; and goodwill, \$52 million.

**Acquisition of Maverick Recording Company**

In November 2004, the Company acquired an additional 30% interest in Maverick Recording Company (Maverick) from its existing partner for approximately \$17 million and certain amounts previously owed by such partner to the Company, bringing its total interest in Maverick to 80%. The transaction was accounted for under the purchase method of accounting and the purchase price was allocated to the underlying net assets of Maverick in proportion to the estimated fair value, principally artist contracts and recorded music catalog.

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

**Sale of Warner Bros. Publications**

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

The sale has not had a material effect on the operating results and financial condition of the Company. For the year ended September 30, 2005 and the ten months ended September 30, 2004, the operations being sold generated revenues of approximately \$34 million and \$36 million, respectively; operating income (loss) of approximately \$1 million and \$(7) million, respectively; operating income (loss) before depreciation and amortization expense of \$1 million and \$(7) million, respectively; and net losses of approximately \$1 million and \$8 million, respectively.

**6. Investments**

The Company's investments consist of:

|                           | September 30,<br>2007 | September 30,<br>2006 |
|---------------------------|-----------------------|-----------------------|
|                           | (in millions)         |                       |
| Equity-method investments | \$ 138                | \$ 15                 |
| Cost-method investments   | 8                     | 10                    |
|                           | \$ 146                | \$ 25                 |

The Company's significant equity-method investment at September 30, 2007 relates to its minority interest in Frontline Management of approximately \$121 million. The Company has preliminarily allocated its purchase price to its share of the underlying net assets and will finalize the allocation in fiscal 2008. The Company's significant equity-method investment at September 30, 2006 relates to an investment in Royalty Services, L.P. (25% owned) to develop a shared royalty system platform with Universal Music Group, Exigen Group and Lightspeed Venture Partners. During 2007, the Company made additional capital contributions to its investment in Royalty Services, L.P., as required by the agreement.

**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)****Net Investment-Related Gains**

There were no significant investment-related gains or losses recognized in the twelve-month period ended September 30, 2007 and 2006. For the year ended September 30, 2005 the Company recognized \$1 million of net investment-related gains, primarily related to the disposition of an equity-method investment.

**7. Inventories**

Inventories consist of the following:

|   | September 30,<br>2007 | September 30,<br>2006 |
|---|-----------------------|-----------------------|
|   | (in millions)         |                       |
| Compact discs, cassettes and other music-related products | \$ 56                 | \$ 57                 |
| Published sheet music and song books                      | 2                     | 2                     |
|   | \$ 58                 | \$ 59                 |

**8. Property, Plant and Equipment**

Property, plant and equipment consist of the following:

|                                | September 30,<br>2007 | September 30,<br>2006 |
|--------------------------------|-----------------------|-----------------------|
|                                | (in millions)         |                       |
| Land                           | \$ 21                 | \$ 22                 |
| Buildings and improvements     | 108                   | 108                   |
| Furniture and fixtures         | 25                    | 21                    |
| Computer hardware and software | 133                   | 110                   |
| Construction in Progress       | 6                     | 4                     |
| Machinery and equipment        | 7                     | 3                     |
|                                | 300                   | 268                   |
| Less accumulated depreciation  | (167)                 | (122)                 |
|                                | \$ 133                | \$ 146                |

**9. Goodwill and Intangible Assets****Goodwill**

The following analysis details the changes in goodwill for each reportable segment during the year ended September 30, 2007 and September 30, 2006:

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|                                      | <b>Recorded</b> | <b>Music</b>                        |                 |
|--------------------------------------|-----------------|-------------------------------------|-----------------|
|                                      | <b>Music</b>    | <b>Publishing<br/>(in millions)</b> | <b>Total</b>    |
| <b>Balance at September 30, 2005</b> | <b>\$ 294</b>   | <b>\$ 575</b>                       | <b>\$ 869</b>   |
| Acquisitions                         | 80              |                                     | 80              |
| Other adjustments                    | (18)            | (2)                                 | (20)            |
| <b>Balance at September 30, 2006</b> | <b>\$ 356</b>   | <b>\$ 573</b>                       | <b>\$ 929</b>   |
| Acquisitions                         | 83              | 2                                   | 85              |
| Other adjustments                    | 35              | 16                                  | 51              |
| <b>Balance at September 30, 2007</b> | <b>\$ 474</b>   | <b>\$ 591</b>                       | <b>\$ 1,065</b> |

**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)**

The acquisitions of goodwill in 2007 primarily relate to the acquisition of Roadrunner for approximately \$83 million consisting of \$59 million in cash and an estimated future payment obligation of \$24 million, as described in Note 5. The allocation of the Roadrunner purchase price included \$39 million of goodwill acquired. The remaining \$44 million of goodwill additions relate to various acquisitions that are not individually material.

The acquisition of goodwill in 2006 primarily relates to the acquisition of Ryko for approximately \$68 million in cash as described in Note 5. The allocation of the Ryko purchase price included approximately \$52 million of goodwill acquired. The remaining \$28 million of goodwill additions relate to various acquisitions that are not individually material.

Other adjustments to goodwill in 2007 primarily reflect the finalization of deferred tax balances associated with various tax and book basis differences. Purchase accounting adjustments in 2006 relate to changes in the initial estimates of the restructuring costs that arose from the Acquisition and changes to the fair value of assets and liabilities recorded in connection with the Acquisition. These changes were determined in connection with the Company's finalization of the purchase price allocation related to the Acquisition and include the settlement of certain receivables from Time Warner for an amount that is \$12 million less than the original amount recorded. The remaining adjustments relate mainly to revisions of the costs to terminate artist contracts and other long-term agreements, and changes to pre-Acquisition deferred tax liability and taxes payable balances.

The Company performs its annual goodwill impairment test in accordance with FAS 142 during the fourth quarter of each fiscal year. The Company may conduct an earlier review if events or circumstances occur that would suggest the carrying value of the Company's goodwill may not be recoverable. The results of the test were that no impairment occurred in 2007.

**Other Intangible Assets**

Other intangible assets consist of the following:

|  | September 30,   |              |           | September 30,   |
|--|-----------------|--------------|-----------|-----------------|
|  | 2006            | Acquisitions | Other (a) | 2007            |
|  | (in millions)   |              |           |                 |
| <b>Intangible assets subject to amortization:</b>          |                 |              |           |                 |
| Recorded music catalog                                     | \$ 1,288        | \$ 17        | \$ 14     | \$ 1,319        |
| Music publishing copyrights                                | 852             | 25           | 39        | 916             |
| Artist contacts  | 39              | 26           | 1         | 66              |
| Trademarks   | 10              | 1            |           | 11              |
| Other intangible assets                                    | 4               | 2            |           | 6               |
|  | 2,193           | 71           | 54        | 2,318           |
| Accumulated amortization                                   | (482)           |              |           | (686)           |
| <b>Total net intangible assets subject to amortization</b> | <b>1,711</b>    |              |           | <b>1,632</b>    |
| <b>Intangible assets not subject to amortization:</b>      |                 |              |           |                 |
| Trademarks and brands                                      | 100             |              |           | 100             |
| <b>Total net other intangible assets</b>                   | <b>\$ 1,811</b> |              |           | <b>\$ 1,732</b> |

(a) Other represents foreign currency translation adjustments.



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The increase in the Company's gross intangible assets primarily reflects the acquisition of Roadrunner. Of the underlying net assets acquired of Roadrunner, it primarily relates to music catalog of approximately \$15 million and artist contracts of approximately \$26 million.

**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)****Amortization**

Based on the amount of intangible assets subject to amortization at the end of September 2007, the expected amortization for each of the next five fiscal years is as follows:

|            | <b>Years Ended</b>                           |
|------------|--|
|            | <b>September 30,</b><br><b>(in millions)</b> |
| 2008       | \$ 202                                       |
| 2009       | 202  |
| 2010       | 195  |
| 2011       | 194  |
| 2012       | 193  |
| Thereafter | 646  |
|            | <b>\$ 1,632</b>                              |

The life of all acquired intangible assets is evaluated based on the expected future cash flows associated with the asset. The expected amortization expense above reflects estimated useful lives assigned to the Company's identifiable, finite-lived intangible assets established in the accounting for the Acquisition effective as of March 1, 2004 as follows: ten years for recorded music catalog, fifteen years for music publishing copyrights and fifteen years for trademarks. Newly acquired recorded music catalog balances have estimated useful lives ranging from five to ten years. Newly acquired music publishing copyright balances have useful lives ranging from ten to fifteen years. Artist contracts acquired by the Company have variable estimated useful lives which do not exceed ten years.

**10. Restructuring Costs****Realignment Plan for Fiscal Year 2007**

In the second quarter of fiscal 2007, the Company announced plans to implement changes intended to better align the Company's workforce with the changing nature of the music industry. These changes are part of the Company's continued evolution from a traditional record and songs-based business to a music-based content company and its ongoing management of its cost structure. The changes include a continued redeployment of resources to focus on new business initiatives to help the Company diversify its revenue streams, including digital opportunities. The realignment plan is also designed to improve the operating effectiveness of our current businesses and to realign our management structure to, among other things, effectively address the continued development of digital distribution channels along with the decline of industry-wide CD sales.

The Company intends to enhance its effectiveness, flexibility, structure, and performance by reducing and realigning long-term costs. This will primarily consist of the reorganization of management structures to more adequately and carefully address regional needs and new business requirements, to reduce organizational complexity and to improve leadership channels. The Company also intends to continue to shift resources from our physical sales channels to efforts focused on digital distribution and emerging technologies and other new revenue streams. Part of the plan will also result in the outsourcing of some back-office functions as a cost-savings measure.

The changes described were implemented by the end of the fiscal year 2007. The Company incurred all of the costs associated with the realignment plan by the end of the current fiscal year. Approximately \$50 million of restructuring costs have been incurred since the realignment plan was implemented. The Company has also



**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)**

incurred approximately \$13 million of implementation charges. To implement such changes, the Company reduced headcount by approximately 400 employees. The Company expects the majority of any cost savings to be offset by new business initiatives such as digital distribution and video.

|   | <b>Employee<br/>Terminations</b> | <b>Other Exit<br/>Costs<br/>(in millions)</b> | <b>Total</b> |
|---|----------------------------------|---|--------------|
| <b>Liability as of September 30, 2006</b> | <b>\$</b>                        | <b>\$</b>                                     | <b>\$</b>    |
| Additions in 2007                         | 48                               | 2   | 50           |
| Cash paid in 2007                         | (32)                             | (1)   | (33)         |
| <b>Liability as of September 30, 2007</b> | <b>\$ 16</b>                     | <b>\$ 1</b>                                   | <b>\$ 17</b> |

**2005 Restructuring Activities**

In August of 2005, Jason Flom, the co-chairman of The Atlantic Records Group left the Company. In an effort to streamline the businesses, the Company merged the operations of Lava Records into the operations of The Atlantic Records Group in September 2005. As a result, certain employee positions at Lava were restructured. In addition to restructuring such employee positions, the Company evaluated its workforce at other affiliates and restructured certain other positions in order to maximize cost effectiveness. These employee terminations resulted in restructuring charges of \$4 million in the year ended September 30, 2005. Additionally, certain artists' contracts were terminated as part of the cost-saving initiative. Such artist contract terminations resulted in \$3 million restructuring charges in the year ended September 30, 2005, of which \$1 million was reversed in 2006.

**Acquisition-Related Restructuring Costs**

In connection with the Acquisition that was effective as of March 1, 2004, the Company reviewed its operations and implemented several plans to restructure its operations. As part of these restructuring plans, the Company recorded a restructuring liability of approximately \$307 million during 2004. This restructuring liability included costs to exit and consolidate certain activities of the Company, as well as costs to terminate employees and certain artist, songwriters and co-publisher contracts. Such liabilities were recognized as part of the cost of the Acquisition.

Of the total \$307 million restructuring costs recorded by the Company, approximately \$164 million related to work-force reductions, including employee termination benefits and relocation costs; approximately \$75 million related to costs to terminate certain artist, songwriters and co-publisher contracts; and the balance of approximately \$68 million related to other anticipated costs to exit certain leased facilities and operations, such as international distribution operations. The number of employees identified to be involuntarily terminated approximated 1,600.

Based on the restructuring plans already implemented, the Company revised its original estimates of restructuring costs during the years ended September 30, 2006 and 2005, resulting in an overall reduction in the restructuring costs of approximately \$4 million and \$32 million, respectively. As of September 30, 2007, the Company had approximately \$22 million of liabilities for Acquisition-related restructuring costs recorded in its balance sheet. These liabilities represent estimates of future cash obligations for all restructuring activities that had been implemented. The outstanding balance of these liabilities primarily relate to extended payment terms for long-term lease obligations for vacated facilities or long-term artist commitments. These remaining lease obligations are expected to be settled by 2019. We expect to pay a majority of the remaining costs in fiscal 2008.

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|   | Employee<br>Terminations | Other Exit<br>Costs<br>(in millions) | Total         |
|---|--------------------------|--------------------------------------|---------------|
| <b>Liability as of September 30, 2004</b> | <b>\$ 71</b>             | <b>\$ 108</b>                        | <b>\$ 179</b> |
| Cash paid in 2005                         | (53)                     | (27)                                 | (80)          |
| Non-cash reductions in 2005 (a)           |                          | (18)                                 | (18)          |
| Reversals of PPA liabilities in 2005      | (4)                      | (28)                                 | (32)          |
| <b>Liability as of September 30, 2005</b> | <b>\$ 14</b>             | <b>\$ 35</b>                         | <b>\$ 49</b>  |
| Cash paid in 2006                         | (9)                      | (1)                                  | (10)          |
| Non-cash reductions in 2006 (a)           |                          | (3)                                  | (3)           |
| Reversals of PPA liabilities in 2006 (b)  | (1)                      | (3)                                  | (4)           |
| <b>Liability as of September 30, 2006</b> | <b>\$ 4</b>              | <b>\$ 28</b>                         | <b>\$ 32</b>  |
| Cash paid in 2007                         |                          | (5)                                  | (5)           |
| Non-cash reductions in 2007 (a)           | (1)                      | (4)                                  | (5)           |
| <b>Liability as of September 30, 2007</b> | <b>\$ 3</b>              | <b>\$ 19</b>                         | <b>\$ 22</b>  |

- (a) Principally relates to changes in foreign currency exchange rates and the non-cash write-off of the carrying value of advances relating to terminating certain artist, songwriter, co-publisher and other contracts.
- (b) Excess liabilities during the twelve months ended September 30, 2006 and 2005 were either reversed through the statement of operations or were recorded as reduction of the initial purchase price of the Acquisition.

**11. Other Current and Noncurrent Liabilities**

Other current liabilities consist of the following (in millions):

|  | September 30,<br>2007 | September 30,<br>2006 |
|--|-----------------------|-----------------------|
| Accrued expenses   | \$ 171                | \$ 156                |
| Accrued restructuring                                    | 14                    |                       |
| Accrued compensation and benefits                        | 70                    | 107                   |
| Deferred income  | 57                    | 54                    |
| Acquisition and merger-related restructuring liabilities | 8                     | 18                    |
| Other contractual obligations                            | 2                     | 8                     |
| Accrued interest   | 36                    | 34                    |
|  | \$ 358                | \$ 377                |

Other noncurrent liabilities consist of the following (in millions):

| September 30,<br>2007 | September 30,<br>2006 |
|-----------------------|-----------------------|
|-----------------------|-----------------------|

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|  |    |     |    |     |
|--|----|-----|----|-----|
| Deferred income  | \$ | 6   | \$ | 9   |
| Accrued compensation and benefits                        |    | 27  |    | 29  |
| Minority interest  |    | 12  |    | 10  |
| Acquisition and merger-related restructuring liabilities |    | 14  |    | 14  |
| Unfavorable and other contractual obligations            |    | 126 |    | 122 |
| Other  |    | 40  |    | 40  |
|  | \$ | 225 | \$ | 224 |

**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)****12. Debt**

In connection with the Acquisition, the Company incurred \$1.650 billion of indebtedness consisting of (i) \$1.150 billion of borrowings under the term loan portion of a senior secured credit facility and (ii) \$500 million of borrowings under a senior subordinated bridge loan facility (the Bridge Loan). A portion of these borrowings was refinanced by WMG Acquisition Corp., a subsidiary of the Company, in April 2004 (the Acquisition Corp. Refinancing). In addition, in December 2004, Holdings incurred approximately \$700 million of debt to redeem its outstanding shares of cumulative preferred stock and pay a return of capital to the Investor Group (the Holdings Refinancing). A portion of this debt was redeemed in June 2005 (the Holdings Redemption). The following summarizes the Acquisition Corp. Refinancing, the Company's debt capitalization as of September 30, 2007 and 2006, the principal terms of the Company's financing arrangements and the Holdings Refinancing.

**The Acquisition Corp. Refinancing**

In April 2004, the Company incurred \$697 million of new indebtedness, consisting of the issuance by Acquisition Corp. of (i) \$465 million principal amount of 7.375% Senior Subordinated Notes due 2014, (ii) 100 million Sterling principal amount of 8.125% Senior Subordinated notes due 2014 (U.S. dollar equivalent of \$182 million as of April 2004) and (iii) \$50 million of additional borrowings under the term loan portion of the Company's senior secured credit facility.

Together with available cash on hand, such proceeds were used (i) to repay all \$500 million of borrowings under the Bridge Loan, (ii) to redeem a portion of the cumulative preferred stock of Holdings in the amount of \$202 million and (iii) to pay certain financing-related transaction costs.

**Debt Capitalization**

As of September 30, 2007 and 2006, the Company's long-term debt consisted of (in millions):

|   | September 30,<br>2007 | September 30,<br>2006 |
|---|-----------------------|-----------------------|
| Senior secured credit facility:                                 |                       |                       |
| Revolving credit facility                                       | \$                    | \$                    |
| Term loan (a)   | 1,396                 | 1,413                 |
|   | 1,396                 | 1,413                 |
| 7.375% U.S. dollar-denominated Notes due 2014 Acquisition Corp  | 465                   | 465                   |
| 8.125% Sterling-denominated Notes due 2014 Acquisition Corp (b) | 202                   | 187                   |
| 9.5% Senior Discount Notes due 2014 Holdings (c)                | 210                   | 191                   |
| Total debt  | 2,273                 | 2,256                 |
| Less current portion  | (17)                  | (17)                  |
| Total long term debt  | \$ 2,256              | \$ 2,239              |

(a) Decrease in term loan balance relates to quarterly repayments under our senior secured credit facility.

(b) Increase represents the impact of foreign currency exchange rates on the carrying value of the Sterling-denominated notes.

(c) Increase represents the accrual of interest on the discount notes in the form of an increase in the accreted value of the discount notes.





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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

**Senior Secured Credit Facility**

Holdings and Acquisition Corp. are party to a senior secured credit facility that was entered into in connection with the Acquisition. The senior secured credit facility, as amended, consists of a \$1.450 billion term loan portion and a \$250 million revolving credit portion. The term loan portion of the facility matures in February 2011. Acquisition Corp. is required to prepay outstanding term loans, subject to certain exceptions and conditions, with excess cash flow or in the event of certain asset sales, casualty and condemnation events and incurrence of debt. Acquisition Corp. is required to make minimum repayments under the term loan portion of the facility in quarterly principal amounts of \$4 million until November 2010, with a remaining balloon payment in February 2011.

The revolving credit portion of the senior secured facility matures in February 2010. There are no mandatory reductions in borrowing availability for the revolving credit portion of the facility through its term.

Borrowings under both the current term loan and revolving credit portion of the senior secured credit facility bear interest at a rate equal to an applicable margin plus, at the Company's option, either (a) a base rate determined by reference to the higher of (1) the prime rate of Bank of America, N.A. and (2) the federal funds rate plus  $\frac{1}{2}$  of 1% or (b) a LIBOR rate determined by reference to the costs of funds for deposits in the currency of such borrowing for the interest period relevant to such borrowing adjusted for certain additional costs. The applicable margins for borrowings under the senior secured credit facility are 1.00% with respect to base rate borrowings and 2.00% with respect to LIBOR borrowings, which reflects a reduction from the initial applicable margin rates of 1.75% and 2.75% for base rate borrowings and LIBOR borrowings, respectively, which occurred during the twelve months ended September 30, 2007.

In addition to paying interest on outstanding principal under the senior secured credit facility, Acquisition Corp. is required to pay a commitment fee to the lenders under the revolving credit facility in respect of the unutilized commitments. As of September 30, 2007, the commitment fee rate was 0.375%. The commitment fee rate may increase or be reduced subject to changes in Acquisition Corp. leverage ratios. Acquisition Corp. is also required to pay customary letter of credit fees, as necessary.

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

**Senior Subordinated Notes due 2014**

The Company has outstanding two tranches of Senior Subordinated notes of Acquisition Corp. due 2014: \$465 million principal amount of U.S. dollar-denominated notes (the "U.S. Notes") and 100 million principal amount of Sterling-denominated notes (the "Sterling Notes" and collectively, the "Subordinated Notes"). The Subordinated Notes mature on April 15, 2014. Interest is payable on the Subordinated Notes on a semi-annual basis at a fixed rate of 7.375% per annum for the U.S. Notes and 8.125% per annum for the Sterling Notes.

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

The Subordinated Notes are redeemable in whole or in part, at the option of Acquisition Corp., at any time at a redemption price defined under the indenture governing the Subordinated Notes that generally includes a premium. In addition, upon a change of control of Acquisition Corp. and upon certain asset sales as specified under the Indenture, Acquisition Corp. may be required to make an offer to redeem the Subordinated Notes from the holders at a redemption price defined under the Indenture that includes a premium.

The Subordinated Notes are unsecured and subordinated to all of Acquisition Corp.'s existing and future senior indebtedness, including Acquisition Corp.'s obligations under its senior secured credit facility. Each of Acquisition Corp.'s wholly owned domestic subsidiaries that have guaranteed the obligations under Acquisition Corp.'s senior secured credit facility also have guaranteed the Subordinated Notes on a joint, several and unconditional basis.

The indenture governing the Subordinated Notes limits Acquisition Corp.'s ability and the ability of its restricted subsidiaries to incur additional indebtedness or issue certain preferred shares; to pay dividends on or make other distributions in respect of its capital stock or make other restricted payments; to make certain investments; to sell certain assets; to create liens on certain debt without securing the notes; to consolidate, merge, sell or otherwise dispose off all or substantially all of its assets; to enter into certain transactions with affiliates; and to designate its subsidiaries as unrestricted subsidiaries.

Subject to certain exceptions, the Indenture permits Acquisition Corp. and its restricted subsidiaries to incur additional indebtedness, including secured indebtedness.

**The Holdings Refinancing**

In December 2004, Holdings issued \$847 million principal amount of debt consisting of (i) \$250 million principal amount of Floating Rate Senior Notes due 2011 (the Holdings Floating Rate Notes), (ii) \$397 million principal amount at maturity of 9.5% Senior Discount Notes due 2014, which had an initial issuance discount of \$147 million (the Holdings Discount Notes) and (iii) \$200 million principal amount of Floating Rate Senior PIK Notes due 2014 (the Holdings PIK Notes, and collectively, the Holdings Notes). The gross proceeds of \$696 million received from the issuance of the Holdings Notes were used to (i) redeem the remaining shares of cumulative preferred stock of Holdings at a redemption price of \$209 million, including \$9 million of accrued and unpaid dividends, (ii) pay a return of capital to Parent Corp. and its shareholders in the aggregate amount of \$472 million and (iii) pay debt-related issuance costs of approximately \$15 million.

**The Holdings Redemption**

In June 2005, using proceeds from the Company's Initial Common Stock Offering and approximately \$57 million of cash on hand, Holdings redeemed all of the Holdings Floating Rate Notes, all of the Holdings PIK Notes, and 35% of the aggregate outstanding principal at maturity of the Holdings Discount Notes.

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

The Holdings Discount Notes were issued at a discount and have an initial accreted value of \$630.02 per \$1,000 principal amount at maturity. Prior to December 15, 2009, no cash interest payments are required. However, interest accrues on the Holdings Discount Notes in the form of an increase in the accreted value of such notes such that the accreted value of the Holdings Discount Notes will equal the principal amount at

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

maturity on December 15, 2009. Thereafter, cash interest on the Holdings Discount Notes is payable semi-annually at a fixed rate of 9.5% per annum. The Holdings Discount Notes mature on December 15, 2014. The Company redeemed 35% of the Holdings Discount Notes on June 15, 2005, including amounts representing interest accreted on the notes redeemed through the date of redemption. The \$4 million of interest accreted through the date of redemption is included as cash paid in financing activities in our consolidated statement of cash flows for the year ended September 30, 2005.

The Holdings PIK Notes were redeemed in full on June 15, 2005. From the date of issuance through the date of redemption, the notes bore interest at a semi-annual, floating rate based on six-month LIBOR rates plus a margin equal to 7%. Interest was accrued in the form of additional PIK Notes at the election of the Company. Such amounts were also repaid in connection with the redemption. In connection with the redemption of the Holdings PIK Notes, we paid \$9 million representing interest accrued in the form of additional PIK notes through the date of redemption, which was classified as cash paid in financing activities in our consolidated statement of cash flows for the year ended September 30, 2005.

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

In connection with the redemption of certain of the Holdings Notes, the Company also wrote off the remaining balance of debt-issuance costs of \$12 million related to the notes redeemed and the remaining unamortized original issue discount of \$4 million related to the Holdings PIK Notes. Such amounts were recorded as a loss on the repayment of the notes in the consolidated statement of operations for the year ended September 30, 2005.

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

The indenture governing the Holdings Notes limits Holdings' ability and the ability of its restricted subsidiaries to incur additional indebtedness or issue certain preferred shares; to pay dividends on or make other distributions in respect of its capital stock or make other restricted payments; to make certain investments; to sell certain assets; to create liens on certain debt without securing the notes; to consolidate, merge, sell or otherwise dispose of all or substantially all of its assets; to enter into certain transactions with affiliates; and to designate its subsidiaries as unrestricted subsidiaries.

**Restricted Net Assets**

The Company is a holding company with no independent operations or assets other than through its interests in its subsidiaries, such as Holdings and Acquisition Corp. Accordingly, the ability of the Company to obtain funds from its subsidiaries is restricted by the senior secured credit facility of Acquisition Corp., the indenture for the Subordinated Notes issued by Acquisition Corp., and the indentures for the Holdings Notes.

**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)****Interest Expense and Maturities**

Total interest expense was \$199 million for the year ended September 30, 2007, \$194 million for the year ended September 30, 2006, and \$200 million for the year ended September 30, 2005. The weighted-average interest rate of the Company's total debt at September 30, 2007 and 2006 was 7.43% and 7.07%, respectively.

Based on the amount of debt outstanding as of September 30, 2007, annual repayments of long-term debt of \$17 million are required for 2008 2010, with an additional repayment of \$4 million and a balloon payment of \$1.341 billion in 2011.

**Fair Value of Debt**

Based on the level of interest rates prevailing at September 30, 2007, the carrying value of the Company's fixed-rate debt exceeded its fair value by approximately \$95 million. Unrealized gains or losses on debt do not result in the realization or expenditure of cash and generally are not recognized for financial reporting purposes unless the debt is retired prior to its maturity.

**13. Income Taxes**

For the years ended September 30, 2007, 2006, and 2005, the Company has been stand-alone tax filer.

Domestic and foreign pretax income (loss) are as follows (in millions):

|              | Year Ended<br>September 30,<br>2007 | Year Ended<br>September 30,<br>2006 | Year Ended<br>September 30,<br>2005 |
|--------------|-------------------------------------|-------------------------------------|-------------------------------------|
| Domestic     | \$ 7                                | \$ 16                               | \$ (194)                            |
| Foreign      | 21                                  | 91                                  | 80                                  |
| <b>Total</b> | <b>\$ 28</b>                        | <b>\$ 107</b>                       | <b>\$ (114)</b>                     |

Current and deferred income taxes (tax benefits) provided are as follows (in millions):

|              | Year Ended<br>September 30,<br>2007 | Year Ended<br>September 30,<br>2006 | Year Ended<br>September 30,<br>2005 |
|--------------|-------------------------------------|-------------------------------------|-------------------------------------|
| Federal:     |                                     |                                     |                                     |
| Current      | \$ 2                                | \$                                  | \$                                  |
| Deferred     | 5                                   |                                     |                                     |
| Foreign:     |                                     |                                     |                                     |
| Current (a)  | 46                                  | 52                                  | 53                                  |
| Deferred     | (7)                                 | (11)                                |                                     |
| U.S. State:  |                                     |                                     |                                     |
| Current      | 3                                   | 6                                   | 2                                   |
| Deferred     |                                     |                                     |                                     |
| <b>Total</b> | <b>\$ 49</b>                        | <b>\$ 47</b>                        | <b>\$ 55</b>                        |

- 
- (a) Includes cash withholding taxes of \$14 million, \$15 million and \$14 million for the years ended September 30, 2007, 2006, and 2005, respectively.

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The differences between the U.S. federal statutory income tax rate of 35% and income taxes provided are as follows (in millions):

|  | Year Ended<br>September 30,<br>2007 | Year Ended<br>September 30,<br>2006 | Ended<br>September 30,<br>2005 |
|--|-------------------------------------|-------------------------------------|--------------------------------|
| Taxes on income at the U.S. federal statutory rate                       | \$ 10                               | \$ 37                               | \$ (40)                        |
| U.S. state and local taxes   | 3                                   | 6                                   | 2                              |
| Foreign income taxed at different rates, including withholding taxes (a) | 20                                  | 26                                  | 14                             |
| Loss without benefit / (release of valuation allowance), net             | 17                                  | (20)                                | 86                             |
| Non-taxable gain on warrant  |                                     |                                     | (6)                            |
| Non-deductible loss on minority interest                                 |                                     |                                     | 2                              |
| Other  | (1)                                 | (2)                                 | (3)                            |
| Total income tax expense   | \$ 49                               | \$ 47                               | \$ 55                          |

(a) Includes residual U.S. tax on certain foreign income not permanently reinvested for the year ended September 30, 2006. During the year ended September 30, 2007, the Company incurred losses in certain foreign territories and have offset the tax benefit associated with these losses with a valuation allowance as the Company has determined that it is more likely than not that these losses will not be utilized. During the year ended September 30, 2006, the Company utilized a portion of its U.S. deferred tax assets for which no benefit has been previously recorded. The balance of the U.S. tax attributes remaining at the end of September 30, 2007 continues to be offset by a full valuation allowance as the Company has determined that it is more likely than not that these attributes will not be utilized. Significant components of the Company's net deferred tax assets/(liabilities) are summarized below (in millions):

|  | September 30, 2007 | September 30, 2006 |
|--|--------------------|--------------------|
| Deferred tax assets:                     |                    |                    |
| Allowances and reserves                  | \$ 58              | \$ 51              |
| Employee benefits and compensation       | 29                 | 34                 |
| Other accruals                           | 75                 | 88                 |
| Depreciation and amortization            | 4                  | 22                 |
| Tax attribute carryforwards              | 241                | 194                |
| Other                                    | 17                 | 9                  |
| Total deferred tax assets                | 424                | 398                |
| Valuation allowance                      | (349)              | (337)              |
| Net deferred tax assets                  | 75                 | 61                 |
| Deferred tax liabilities:                |                    |                    |
| Assets acquired in business combinations | (279)              | (213)              |
| Total deferred tax liabilities           | (279)              | (213)              |

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|                              |    |       |    |       |
|------------------------------|----|-------|----|-------|
| Net deferred tax liabilities | \$ | (204) | \$ | (152) |
|------------------------------|----|-------|----|-------|

At September 30, 2007, \$71 million of the total valuation allowance of \$349 million is related to deferred tax assets that were recorded in purchase accounting, which when released will be reversed through goodwill.

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

At September 30, 2007, the Company has U.S. federal tax net operating loss carryforwards of \$200 million, which will begin to expire in fiscal year 2024 and tax net operating losses in certain U.S. state and foreign jurisdictions expiring in various periods. In addition, the Company has foreign tax credit carryforwards for U.S. tax purposes of \$56 million, which will begin to expire in 2014.

U.S. income and foreign withholding taxes have not been recorded on permanently reinvested earnings of certain foreign subsidiaries of approximately \$650 million at September 30, 2007. As such, no federal income taxes have been provided for these undistributed earnings. Should these earnings be distributed, foreign tax credits, subject to various limitations, would be available to reduce the additional federal income tax that would be payable. Availability of these credits is subject to limitations which make it impracticable to estimate the amount of the ultimate deferred tax liability, if any, on these accumulated foreign earnings.

**14. Pensions**

Certain international employees, such as those in Germany and Japan, participate in locally sponsored defined benefit plans, which are not considered to be material in the aggregate and have a combined projected benefit obligation of approximately \$43 million and \$44 million as of September 30, 2007 and 2006, respectively. Pension benefits under the plans are based on formulas that reflect the employees' years of service and compensation levels during their employment period. The Company had an aggregate pension liability relating to these plans of approximately \$28 million recorded in its balance sheet as of September 30, 2007 and 2006.

The FASB recently issued FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (an amendment of FASB Statements No. 87, 88, 106 and 132(R)), (FAS 158), which the Company adopted in the first quarter of fiscal 2007. FAS 158 requires all companies to recognize the funded status of plans on the balance sheet. Under FAS 158, all underfunded plans are aggregated and recorded as a liability and all overfunded plans are aggregated and recorded as an asset. The company recorded an adjustment to reflect the implementation of FAS 158, which resulted in an other pension asset of \$1 million and additional pension liability of \$3 million, and an other comprehensive income of \$2 million. The Company also recorded related tax adjustments of approximately \$2 million.

FAS 158 also eliminates the early measurement date option previously permitted under the related guidance. The Company will be required to implement this change in the fiscal year ending September 30, 2008.

For each of the years ended September 30, 2007, 2006, and 2005, pension expense amounted to \$3 million.

Certain employees also participate in pre-tax defined contribution plans. The Company's contributions to the defined contribution plans are based upon a percentage of the employees' elected contributions. The Company's defined contribution plan expense amounted to approximately \$2 million for the year ended September 30, 2007, \$3 million for the year ended September 30, 2006, and \$4 million for the year ended September 30, 2005.



**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)****15. Stock-Based Compensation Plans***LTIP and Individual Stock Option and Restricted Stock Agreements*

In 2004, the Company's board of directors approved a form of LTIP stock option agreement for grants of options to eligible individuals. Eligible individuals include any employee, director or consultant of the Company or any of its affiliates, or any other entity designated by Warner Music Group's board of directors in which the Company has an interest, who is selected by the Company's compensation committee to receive an award. The board authorized the granting of options to purchase up to 1,355,066 shares of common stock pursuant to the LTIP program. The Company has granted options and may grant additional stock options under the LTIP stock option agreements to certain members of current or future management. The board also approved the sale of 5,676,300 restricted shares of the Company's stock, the awarding of 2,629,091 restricted shares of the Company's stock, and the granting of options to purchase 3,701,850 shares of the Company's common stock under stock option agreements with certain members of management. Individual option agreements and options granted under the LTIP program generally will have a 10-year term and the exercise price will equal at least 100% of the fair market value on the date of the grant. With respect to each option granted pursuant to individual option agreements or a LTIP stock option agreement, one-third of the shares covered by the option generally vest and become exercisable in four equal installments on the day prior to each of first through fourth anniversaries of the effective date of the LTIP stock option agreement, subject to the employee's continued employment. Two-thirds of the shares covered by the option generally vest and become exercisable based on the occurrence of both a service condition (which is the same as the service condition described with respect to the service-based portion of the option) and a performance condition. Under the original agreements, the performance condition would be met if, following an initial public offering or certain other events (including a change in control), a specified investment return was achieved by the investors (one-half of such shares require one return level and the other one-half of such shares require a different return level). The performance-based portion of the option would also vest, subject to the employee's continued employment, on the day prior to the seventh anniversary of the effective date of the individual or LTIP stock option agreement and the service condition applicable to the performance-based option will be deemed to have been attained upon certain terminations following or in anticipation of a change in control. All of the performance-based requirements have been achieved for all of these grants, therefore, only the service condition remains as a vesting requirement. The first performance-based requirement, which resulted in the vesting of approximately one-third of the awards for which service had already been provided, was met on the date of the Company's initial public offering in 2005. The second performance-based requirement, which resulted in the vesting of approximately one-third of the awards for which service had already been provided, was met in April of 2006. The remaining unvested awards vest over a four-year service period beginning on the grant date.

*2005 Omnibus Stock Plan*

In May 2005, the board adopted the 2005 Omnibus Stock Plan, or 2005 Plan, which authorized the granting of stock based awards to purchase up to 3,416,133 shares of the Company's common stock. The 2005 Plan was amended and restated as of February 23, 2007. Under the 2005 Plan, the board of directors or the compensation committee will administer the plan and has the power to make awards, to determine when and to whom awards will be granted, the form of each award, the amount of each award, and any other terms or conditions of each award consistent with the terms of the 2005 Plan. Awards may be made to employees, directors and others as set forth in the 2005 Plan. The types of awards that may be granted include restricted and unrestricted stock, incentive and non-statutory stock options, stock appreciation rights, performance units and other stock based awards. Each award agreement specifies the number and type of award, together with any other terms and conditions as determined by the board of directors or the compensation committee in their sole discretion. Eligible employees include any employee who does not already have any other equity participation in the

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Company. The Company has granted options and restricted stock and may grant additional awards under the 2005 Plan to certain members of our current or future management and directors. Options granted generally have a 10-year term, the exercise price will equal at least 100% of the fair market value on the date of the grant and generally vest in four equal installments on the day prior to each of first through fourth anniversaries of the effective date of the stock option agreement, subject to the employee's continued employment.

*Stock Options*

The following is a summary of the Company's stock option awards for the fiscal year ended September 30, 2007:

|  | Number of options<br>granted | Weighted-average<br>exercise price |
|--|------------------------------|------------------------------------|
| Shares options outstanding at September 30, 2006 | 4,737,390                    | \$ 9.41                            |
| Share options granted in 2007                    | 815,000                      | \$ 15.09                           |
| Share options exercised in 2007                  | (458,956)                    | \$ 4.40                            |
| Share options forfeited in 2007                  | (278,484)                    | \$ 8.31                            |
| Shares options outstanding at September 30, 2007 | 4,814,950                    | \$ 10.91                           |
| Share options exercisable at September 30, 2007  | 2,017,927                    | \$ 9.55                            |

The share options that were vested and exercisable as of September 30, 2007 have an aggregate intrinsic value of \$1.1 million and a weighted-average remaining contractual term of 7.19 years.

The Company granted its employees stock option awards as follows:

|  | Fiscal Year<br>Ended<br>September 30,<br>2007 | Fiscal Year<br>Ended<br>September 30,<br>2006 | Fiscal Year<br>Ended<br>September 30,<br>2005 |
|--|---|---|---|
| Share options granted                  | 815,000                                       | 340,000                                       | 5,183,690                                     |
| Weighted-average grant date fair value | \$ 7.13                                       | \$ 9.73                                       | \$ 7.24                                       |

*Assumptions*

For purposes of applying FAS 123(R), the fair value of each stock option grant was estimated on the date of grant using the Black-Scholes option-pricing model, if granted prior to January 2005 and the Binomial model subsequent to January 2005, both of which are based upon several assumptions estimated by the company. The following weighted-average assumptions were used for all grants to the Company's employees:

| Weighted average assumptions used to                 | Year ended<br>September 30,<br>2007 | Year ended<br>September 30,<br>2006 | Year ended<br>September 30,<br>2005 |
|--|-------------------------------------|-------------------------------------|-------------------------------------|
| <b>calculate fair market value of stock options:</b> |                                     |                                     |                                     |
| Dividend yield                                       | 3.9%                                | 2.2%                                | 0%                                  |
| Expected volatility                                  | 50.0%                               | 50.0%                               | 47.8%                               |
| Risk-free interest rate                              | 4.59%                               | 4.58%                               | 3.80%                               |

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Expected term

6.00 years

6.00 years

6.01 years

For periods prior to and subsequent to the Company's initial public offering, the Company has estimated its expected volatility using comparative company historical stock price volatility in order to appropriately estimate the volatility of the stock underlying its stock option awards. In periods where sufficient data is available, the Company will calculate its own historical volatility to estimate the volatility of its underlying stock price.

**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)**

The Company calculates the expected term of its stock options by considering employee attrition rates, employee exercise activity, the length of the vesting period for each award and the length of the expiration period for each award. The Company calculates the expected term by segmenting its employees between senior executives and other employees and analyzing the expected life fore each segment using historical expected exercise behavior.

*Option Exercises*

During the fiscal year ended September 30, 2007 and 2006, employees exercised 458,956 and 872,009 stock options with a total intrinsic value of \$2.6 million and \$17.1 million, respectively. There were no stock options exercised in the fiscal year ended September 30, 2005. Total cash received from stock option exercises in 2007 and 2006 was \$2.2 million and \$2.9 million, respectively.

*Restricted Stock*

The following is a summary of the Company's restricted stock awards for the fiscal year ended September 30, 2007:

|  | Number of<br>restricted shares | Weighted-average<br>grant date fair value |
|--|--------------------------------|---|
| Unvested restricted shares at September 30, 2006 | 4,466,418                      | \$ 4.07                                   |
| Restricted shares granted in 2007                | 193,210                        | \$ 18.08                                  |
| Restricted shares vested in 2007                 | (1,979,768)                    | \$ 2.99                                   |
| Restricted shares forfeited in 2007              | (238,990)                      | \$ 12.99                                  |
| Unvested restricted shares at September 30, 2007 | 2,440,870                      | \$ 5.18                                   |

The weighted-average grant date fair value of restricted shares awarded in the fiscal year ended September 30, 2005, 2006, and 2007 was \$15.47, \$24.71, and \$18.08, respectively.

The total fair value of the restricted shares that vested in the fiscal years ended September 30, 2007, 2006, and 2005 was \$5.9 million, \$7.4 million and \$1.5 million, respectively.

*Compensation Expense*

The Company recognized non-cash compensation expense related to its stock-based compensation plans of \$10 million, \$16 million and \$25 million for the fiscal years ended September 30, 2007, 2006, and 2005, respectively. In addition, as of September 30, 2007 and 2006, the Company had \$12.1 million and \$17.1 million, respectively, of unrecognized compensation costs related to its unvested stock option and restricted stock awards. The weighted average period over which total compensation related to non-vested awards is expected to be recognized in 2.7 years.

*Payments Relating to Executive Compensation*

Concurrent with the Initial Common Stock Offering, the Company determined that certain shares of restricted stock issued in 2004 and early 2005 may have been sold at prices below fair market value on the applicable date of sale and certain options to purchase shares of the Company's stock granted may have had exercise prices below fair market value on the applicable date of grant. As a result, certain U.S. employee holders of the restricted stock who made elections under Section 83(b) of the Internal Revenue Code would be subject to

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

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

*Restricted Stock*

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

*Options*

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

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

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

**16. Shareholders (Deficit) Equity**

**Warrants**

A portion of the consideration paid to Time Warner in connection with the Acquisition was in the form of two stock warrants that were issued to Time Warner. On May 16, 2005, in connection with the Company's Initial Common Stock Offering, the Company repurchased certain warrants from Time Warner for an aggregate purchase price of \$138 million, which approximated fair value at that date. The repurchase of these warrants had the effect of terminating all of Time Warner's warrants as of the date of repurchase. As a result, the warrants were no longer outstanding.

**Dividends**

In 2006 and 2007, the Company declared and paid regular quarterly dividends on its common stock of \$.13 per share. As of September 30, 2007 and 2006, the Company had accrued all unpaid dividends, including the portion of dividends with respect to unvested restricted stock, which will be paid at such time as such shares become vested.

During the twelve months ended September 30, 2007, 2,039,515 shares of restricted stock purchased by or awarded to certain employees vested, and employees of the Company exercised 458,456 stock options.

**17. Related Party Transactions**

*Arrangements with the Investor Group and its Affiliates*

The Company entered into publicity, advertising and promotional arrangements with a certain television corporation that is owned by a member of the Investor Group. This arrangement resulted in \$15 million of expenses during the twelve months ended September 30, 2006 and resulted from a negotiation that, in management's view, reflects market rates. The Company also entered into a consulting agreement with an affiliate of the Investor Group, which resulted in \$1 million of expense during the twelve months ended September 30, 2006.

*Distribution Arrangements with Related Parties*

In the normal course of business the Company enters into arrangements to distribute the products of third parties. In addition, the Company enters into joint ventures, and the Company distributes the products of certain companies that are its joint venture partners. During the twelve months ended September 30, 2007, 2006 and 2005 the Company recorded revenues of \$8 million, \$6 million and \$9 million, respectively, in the statement of operations related to these arrangements. Such distribution arrangements are negotiated on an arm's-length basis and reflect market rates.

*Management/Monitoring Agreement*

In connection with the Acquisition, the Company entered into a management agreement with the Investor Group for ongoing consulting and management advisory services. Pursuant to this agreement, the Company paid an aggregate of \$75 million to the Investor Group under the management agreement in connection with the Acquisition and related original financing. These fees were apportioned between direct costs of the Acquisition (and capitalized as part of the allocation of purchase price) and capitalized debt issuance costs. In consideration for ongoing consulting and management advisory services, the management agreement required the Company to pay (or to cause Holdings or Acquisition Corp. to pay) the Investor Group an aggregate annual fee of \$10 million per year (Periodic Fees), which was payable quarterly in advance. For the year ended September 30, 2005, the

**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)**

Company recorded expense of \$6 million related to this fee, and such amount has been included as a component of selling, general and administrative expenses in the accompanying statement of operations.

The Investor Group terminated the Management Agreement on May 10, 2005, and on May 16, 2005, the Company paid the Investor Group a \$73 million termination fee for the termination of the Management Agreement, which was reflected in the Company's statement of operations for the year ended September 30, 2005.

**18. Commitments and Contingencies****Leases**

The Company occupies various facilities and uses certain equipment under many operating leases. Net rent expense was approximately \$35 million, \$33 million, and \$37 million for the years ended September 30, 2007, 2006, and 2005, respectively.

At September 30, 2007, future minimum payments under non-cancelable operating leases (net of sublease income) are as follows:

|              | <b>September 30,<br/>2007</b> |
|--------------|-------------------------------|
|              | <b>(in millions)</b>          |
| 2008         | \$ 32                         |
| 2009         | 31                            |
| 2010         | 24                            |
| 2011         | 23                            |
| 2012         | 21                            |
| Thereafter   | 64                            |
| <b>Total</b> | <b>\$ 195</b>                 |

The future minimum payments reflect the amounts owed under lease arrangements and do not include any fair market value adjustments that may have been recorded as a result of the Acquisition.

**Guaranteed Minimum Talent Advances**

The Company routinely enters into long-term commitments with artists, songwriters and co-publishers for the future delivery of music product. Aggregate firm commitments to such talent approximated \$424 million and \$481 million as of September 30, 2007 and 2006, respectively. Such commitments are payable principally over a ten-year period, generally upon delivery of albums from the artists or future musical compositions by songwriters and co-publishers.

**Other**

Other off-balance sheet, firm commitments, which include letters of credit and minimum funding commitments to investees, amounted to approximately \$12 million and \$47 million at September 30, 2007 and 2006, respectively.

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

**Litigation**

*Radio Promotion Activities*

Two independent labels filed antitrust suits against the Company alleging that its radio promotion activities are anticompetitive. *Radikal Records, Inc. v. Warner Music Group, et al.* was filed on March 21, 2006 in U.S. District Court in the Central District of California, Western Division. *TSR Records, Inc. v. Warner Music Group, et al.* was filed on March 28, 2006 in U.S. District Court in the Central District of California, Western Division. The Company filed a Notice of Related Case and was successful in having both of these cases consolidated. On May 16, 2006, the Company filed a Motion to Dismiss in both cases. On October 11, 2006, the court denied the Company's Motion to Dismiss as to the antitrust claims but granted the motion, with leave to amend, as to the state tort claim for interference with prospective economic advantage. On October 24, 2006, the plaintiffs filed amended complaints, attempting to cure the defects in their tort claim. The Company again moved to dismiss the state court claims and on January 31, 2007, the court granted the Company's motion, but allowed the plaintiffs to replead. On June 5, 2007, the court again granted the Company's motion to dismiss the plaintiffs' claims for interference with prospective economic advantage, but granted the plaintiffs one final chance to amend their complaints.

On July 27, 2007, the parties filed a stipulation in the U.S. District Court in the Central District of California to dismiss both cases with prejudice after the Company reached a settlement with both plaintiffs wherein the Company admitted no wrongdoing. The Company paid each of the two plaintiffs \$43,500.00, inclusive of attorneys' fees and all other costs and expenses, to settle all claims arising from the allegations in both lawsuits. On August 9, 2007, the court approved the parties' stipulation and dismissed both cases with prejudice, thereby concluding these actions.

*Pricing of Digital Music Downloads*

On December 20, 2005 and February 3, 2006, the Attorney General of the State of New York served the Company with requests for information in connection with an industry-wide investigation as to whether the practices of industry participants concerning the pricing of digital music downloads violate Section 1 of the Sherman Act, New York State General Business Law §§ 340 et seq., New York Executive Law §63(12), and related statutes. On February 28, 2006, the Antitrust Division of the U.S. Department of Justice served the Company with a request for information in the form of a Civil Investigative Demand as to whether its activities relating to the pricing of digitally downloaded music violate Section 1 of the Sherman Act. The Company has provided documents and other information in response to these requests and intends to continue to fully cooperate with the New York Attorney General's and Department of Justice's industry-wide inquiries. Subsequent to the announcements of the above governmental investigations, more than thirty putative class action lawsuits concerning the pricing of digital music downloads have been filed. On August 15, 2006, the Judicial Panel on Multidistrict Litigation consolidated these actions for pre-trial proceedings in the Southern District of New York. The consolidated amended complaint, filed on April 13, 2007, alleges conspiracy among record companies to delay the release of their content for digital distribution, inflate their pricing of CDs and fix prices for digital downloads. The complaint seeks unspecified compensatory, statutory and treble damages. All defendants, including the Company, filed a motion to dismiss the consolidated amended complaint on July 30, 2007. That motion will likely be argued during the latter part of 2007. The Company intends to defend against these lawsuits vigorously, but is unable to predict the outcome of these suits. Any litigation the Company may become involved in as a result of the inquiries of the Attorney General and Department of Justice, regardless of the merits of the claim, could be costly and divert the time and resources of management.



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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

*Statement of Objections*

On March 30, 2007, the European Commission ( EC ) issued a Statement of Objections to Apple Inc., iTunes S.a.r.l. and one of our subsidiaries, WEA International Inc. ( WEA ). Similar Statements of Objections were also issued to Apple Inc. and each of the other major recorded music companies. The Statement of Objections targets Apple Inc.'s practice of applying certain territorial restrictions in relation to its iTunes stores in the European Economic Area ( EEA ). The EC alleges that these restrictions arise, among other ways, as a result of the agreement between Apple Inc. and WEA for the sale of downloaded music in the EEA. In the EC's preliminary view, these restrictions may lead to a distortion of competition, infringing Article 81 of the EC Treaty. In particular, the EC asserts that (i) consumers resident in a particular EEA country in which iTunes does not operate a dedicated online store are prevented from acquiring downloaded music from iTunes and (ii) consumers resident in a particular EEA country may be required to pay a higher price for the same download than consumers resident in another EEA country or may not have access to the same downloads as are available to consumers resident in another EEA country. The EC, if it finds an infringement, may require that the alleged restriction be eliminated and also has the authority to impose fines on the parties to any infringement. The Company is cooperating with the EC and, on June 29, 2007, submitted its response to the Statement of Objections to the Commission. It continues to believe that its practices have not infringed Article 81 of the EC Treaty and presented arguments to that effect in its response.

*Settlement with Bertelsmann AG Regarding Napster*

In April 2007, the Company entered into an agreement with Bertelsmann AG ( Bertelsmann ) related to a settlement of contingent claims held relating to Bertelsmann's relationship with Napster in 2000-2001. The settlement covers the resolution of the related legal claims against Bertelsmann by our Recorded Music and Music Publishing businesses. As part of the settlement, the Company has received \$110 million which it has shared with its artists and songwriters. The Company recorded \$64 million of other income in the twelve months ended September 30, 2007 related to the settlement, the Company allocated 90% of the settlement to our Recorded Music business and 10% of the settlement to our Music Publishing business. Of such amount, \$61 million was recorded as income to Recorded Music and \$3 million was recorded as income to Music Publishing. These amounts were recorded net of amounts payable to recording artists and songwriters.

*Other Matters*

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

**19. Derivative Financial Instruments**

The Company has exposure to changes in foreign currency exchange rates relating to the cash flows generated by its international operations and exposure to changes in interest rates relating to floating-rate borrowings under its senior secured credit facility. Consequently, the Company uses derivative financial instruments to manage such risks. The following is a summary of the Company's risk management strategies and the effect of those strategies on the Company's financial statements.

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

**Interest Rate Risk Management**

The Company uses interest rate swap agreements to manage the floating to fixed-rate proportion of its debt portfolio. In particular, under its senior secured credit facility, the Company is required to maintain a fixed-to-floating debt ratio of at least 50% of its actual funded debt through at least April 2007. The Company enters into interest rate swap agreements in order to hedge the variability of expected future cash interest payments. Under interest rate swap agreements, the Company agrees to receive floating-rate payments (based on three-month LIBOR rates) in exchange for fixed-rate payments for a fixed term through May 2009. As of September 30, 2007, the Company had total notional amounts hedged under these agreements of \$897 million.

The interest rate swap agreements have been designated as a cash flow hedge of the associated variability in future interest payments. As such, the agreements have been recorded at fair value in the accompanying consolidated balance sheet and the related gains or losses on the agreements are deferred in shareholder's (deficit) equity (as a component of comprehensive income (loss)). These deferred gains and losses are recognized as an adjustment to interest expense in the period in which the related interest payments being hedged are made and recognized in income. However, to the extent that any of these contracts are not considered to be perfectly effective in offsetting the change in the amount of the interest payments being hedged, any changes in fair value relating to the ineffective portion of these contracts would be immediately recognized in income. The Company has not had any ineffective amounts related to interest rate swaps.

For the years ended September 30, 2007 and 2006, the Company recognized approximately \$10 million and \$6 million, respectively, of income on its interest rate swap agreements, which have been classified as a component of interest expense in the accompanying statement of operations. For the year ended September 30, 2005, the Company recognized approximately \$4 million of expense on its interest rate swap agreements, which have been classified as a component of interest expense in the accompanying statement of operations. The Company has not recognized any material gains or losses relating to the ineffective portion of the agreements. At September 30, 2007 and 2006 the Company had deferred \$4 million of net losses and \$7 million, of net gains, respectively, on its interest rate swap agreements in shareholders' (deficit) equity. The \$4 million of net losses for 2007 is expected to be recognized in fiscal year 2008 and 2009 of approximately \$3 million and \$1 million, respectively.

The Company monitors its positions with, and the credit quality of, the financial institutions that are party to any of its financial transactions. Credit risk related to interest rate swaps is considered low because swaps are entered into with strong creditworthy counterparties and are limited to the net interest payments due/payable for the remaining life of the swap.

**Foreign Currency Risk Management**

Historically, the Company has used, and continues to use, foreign exchange contracts and foreign exchange options primarily to hedge the risk that unremitted or future royalties and license fees owed to its domestic companies for the sale, or anticipated sale, of U.S.-copyrighted products abroad may be adversely affected by changes in foreign currency exchange rates. The Company focuses on managing the level of exposure to the risk of foreign currency exchange rate fluctuations on its major currencies, which include the euro, British pound sterling, Japanese yen, Canadian dollar, Mexican peso, Swedish krona and Australian dollar. In addition, the Company currently hedges foreign currency risk associated with financing transactions such as third party and inter-company debt and other balance sheet items.

For royalty related hedges, the Company records foreign exchange contracts at fair value on its balance sheet and the related gains or losses on these contracts are deferred in shareholder's (deficit) equity (as a component of comprehensive income (loss)). These deferred gains and losses are recognized in income in the

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**Warner Music Group Corp.**

**Notes to Consolidated Audited Financial Statements (Continued)**

period in which the related royalties and license fees being hedged are received and recognized in income. However, to the extent that any of these contracts are not considered to be perfectly effective in offsetting the change in the value of the royalties and license fees being hedged, any changes in fair value relating to the ineffective portion of these contracts are immediately recognized in income, and have been immaterial. For hedges of financing transactions and other balance sheet items, hedge gains and losses are taken directly to the statement of operations since there is an equal and offsetting statement of operations entry related to the underlying exposure. Gains and losses on foreign exchange contracts generally are included as a component of other income (expense), net, in the Company's consolidated statement of operations.

As of September 30, 2007, the Company had outstanding hedge contracts for the sale of \$472 million and the purchase of \$173 million of foreign currencies at fixed rates. Further, as of September 30, 2007, the Company had approximately \$3 million of deferred net losses in comprehensive income (loss) related to foreign exchange hedging. As of September 30, 2006, the Company had outstanding hedge contracts for the sale of \$419 million and the purchase of \$163 million of foreign currencies at fixed rates. Further, as of September 30, 2006, the Company had approximately \$0.2 million of deferred net gains in comprehensive income (loss) related to foreign exchange hedging.

**Warrants**

The Company recorded unrealized gains related to the warrants issued to Historic TW as part of the purchase price of the Acquisition of \$17 million in its consolidated statement of operations for the year ended September 30, 2005.

**20. Segment Information**

As discussed more fully in Note 1, based on the nature of its products and services, the Company classifies its business interests into two fundamental operations: recorded music and music publishing. Information as to each of these operations is set forth below. The Company evaluates performance based on several factors, of which the primary financial measure is operating income (loss) before non-cash depreciation of tangible assets, non-cash amortization of intangible assets and non-cash impairment charges to reduce the carrying value of goodwill and intangible assets ( OIBDA ). The Company has supplemented its analysis of OIBDA results by segment with an analysis of operating income (loss) by segment.

**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)**

The accounting policies of the Company's business segments are the same as those described in the summary of significant accounting policies included elsewhere herein. The Company accounts for intersegment sales at fair value as if the sales were to third parties. While intercompany transactions are treated like third-party transactions to determine segment performance, the revenues (and corresponding expenses recognized by the segment that is counterparty to the transaction) are eliminated in consolidation, therefore, do not themselves impact consolidated results.

|   | Recorded<br>music | Music<br>publishing | Corporate<br>expenses and<br>eliminations | Total           |
|---|-------------------|---------------------|---|-----------------|
|   | (in millions)     |                     |   |                 |
| <b>2007</b>                                   |                   |                     |   |                 |
| Revenues                                      | \$ 2,837          | \$ 570              | \$ (22)                                   | <b>\$ 3,385</b> |
| OIBDA (a)                                     | 409               | 160                 | (108)                                     | <b>461</b>      |
| Depreciation of property, plant and equipment | (26)              | (3)                 | (11)                                      | <b>(40)</b>     |
| Amortization of intangible assets             | (146)             | (59)                | (1)                                       | <b>(206)</b>    |
| Operating income (loss) (a)                   | 237               | 98                  | (120)                                     | <b>215</b>      |
| Assets  | 2,573             | 1,679               | 320                                       | <b>4,572</b>    |
| Capital expenditures                          | 25                | 2                   | 2   | <b>29</b>       |
| <b>2006</b>                                   |                   |                     |   |                 |
| Revenues                                      | \$ 3,005          | \$ 538              | \$ (27)                                   | <b>\$ 3,516</b> |
| OIBDA   | 480               | 144                 | (106)                                     | <b>518</b>      |
| Depreciation of property, plant and equipment | (27)              | (3)                 | (12)                                      | <b>(42)</b>     |
| Amortization of intangible assets             | (136)             | (57)                |   | <b>(193)</b>    |
| Operating income (loss)                       | 317               | 84                  | (118)                                     | <b>283</b>      |
| Assets  | 2,664             | 1,621               | 235                                       | <b>4,520</b>    |
| Capital expenditures                          | 23                | 2                   | 5   | <b>30</b>       |
| <b>2005</b>                                   |                   |                     |   |                 |
| Revenues                                      | \$ 2,924          | \$ 607              | \$ (29)                                   | <b>3,502</b>    |
| OIBDA (b)                                     | 380               | 141                 | (199)                                     | <b>322</b>      |
| Depreciation of property, plant and equipment | (32)              | (5)                 | (14)                                      | <b>(51)</b>     |
| Amortization of intangible assets             | (133)             | (54)                |   | <b>(187)</b>    |
| Operating income (loss) (b)                   | 215               | 82                  | (213)                                     | <b>84</b>       |
| Assets  | 2,517             | 1,645               | 336                                       | <b>4,498</b>    |
| Capital expenditures                          | 22                | 2                   | 6   | <b>30</b>       |

The comparability of OIBDA and of operating income (loss) by business segment for all periods presented has been affected by the following transactions which occurred in each of the respective fiscal years as follows:

- (a) Fiscal 2007 OIBDA and operating income (loss) have been reduced by restructuring costs of \$50 million. Of such amounts, \$46 million related to Recorded Music, \$2 million related to Music Publishing and \$2 million related to Corporate expenses and eliminations.
- (b) Fiscal 2005 OIBDA and operating income (loss) have been reduced by \$7 million of restructuring costs related to Recorded Music and a loss on the termination of the management agreement of \$73 million recorded in Corporate expenses and eliminations.



**Table of Contents****Warner Music Group Corp.****Notes to Consolidated Audited Financial Statements (Continued)**

Revenues and total assets relating to operations in different geographical areas are set forth below. (Note that Revenues are attributed to countries based on the location of customer)

|                       | 2007            |                   | 2006            |                   | 2005            |                   |
|-----------------------|-----------------|-------------------|-----------------|-------------------|-----------------|-------------------|
|                       | Revenue         | Long-lived Assets | Revenue         | Long-lived Assets | Revenue         | Long-lived Assets |
|                       | (in millions)   |                   |                 |                   |                 |                   |
| United States         | \$ 1,673        | \$1,993           | \$ 1,703        | \$ 1,939          | \$ 1,677        | \$ 1,868          |
| United Kingdom        | 346             | 274               | 431             | 254               | 387             | 339               |
| All other territories | 1,366           | 1,110             | 1,382           | 1,027             | 1,438           | 1,048             |
| <b>Total</b>          | <b>\$ 3,385</b> | <b>\$ 3,377</b>   | <b>\$ 3,516</b> | <b>\$ 3,220</b>   | <b>\$ 3,502</b> | <b>\$ 3,255</b>   |

**21. Additional Financial Information****Cash Interest and Taxes**

The Company made interest payments of approximately \$136 million, \$141 million, and \$151 million during the years ended September 30, 2007, 2006, and 2005, respectively. The Company paid approximately \$59 million, \$66 million, and \$51 million of foreign income and withholding taxes in the years ended September 30, 2007, 2006, and 2005, respectively. The Company received \$15 million, \$11 million, and \$6 million of foreign income tax refunds in the years ended September 30, 2007, 2006, and 2005, respectively.

**Non-cash Transactions**

There were no significant non-cash activities for the years ended September 30, 2007 or September 30, 2006.

**Table of Contents****WARNER MUSIC GROUP****2007 QUARTERLY FINANCIAL INFORMATION**

(unaudited)

The following table sets forth the quarterly information for Warner Music Group (in millions, except per share data).

|  | September 30, | Three months ended<br>March 31, |           | December 31, |
|--|---------------|---------------------------------|-----------|--------------|
|  | 2007(a)       | June 30,<br>2007(a)             | 2007(a)   | 2006(a)      |
| Revenues                                       | \$ 869        | \$ 804                          | \$ 784    | \$ 928       |
| Costs and expenses                             |               |                                 |           |              |
| Cost of revenues                               | (459)         | (429)                           | (427)     | (508)        |
| Selling, general and administrative expenses   | (301)         | (298)                           | (275)     | (290)        |
| Other income (c)                               | 21            | 52                              |           |              |
| Restructuring costs (b)                        | (6)           | (32)                            | (12)      |              |
| Amortization of intangible assets              | (53)          | (52)                            | (51)      | (50)         |
| Total costs and expenses                       | (798)         | (759)                           | (765)     | (848)        |
| Operating income                               | 71            | 45                              | 19        | 80           |
| Interest expense, net                          | (45)          | (45)                            | (45)      | (47)         |
| Equity in the gains of equity-method investees | (1)           | 1                               |           |              |
| Minority interest                              | (3)           | (2)                             |           |              |
| Other income (loss), net                       | 5             | (5)                             |           |              |
| Income (loss) before income taxes              | 27            | (6)                             | (26)      | 33           |
| Income tax (expense) benefit                   | (22)          | (11)                            | (1)       | (15)         |
| Net income (loss)                              | \$ 5          | \$ (17)                         | \$ (27)   | \$ 18        |
| Net income (loss) per common share             |               |                                 |           |              |
| Basic  | \$ 0.03       | \$ (0.12)                       | \$ (0.19) | \$ 0.12      |
| Diluted  | \$ 0.03       | \$ (0.12)                       | \$ (0.19) | \$ 0.12      |
| Average common shares:                         |               |                                 |           |              |
| Basic  | 147.0         | 146.9                           | 145.9     | 144.9        |
| Diluted  | 150.5         | 146.9                           | 145.9     | 151.5        |

- (a) The Company's business is seasonal. Therefore quarterly operating results are not necessarily indicative of the results that may be expected for the full fiscal year.
- (b) The three months ended September 30, 2007, June 30, 2007, and March 31, 2007 include certain restructuring costs mainly related to severance costs incurred with our realignment plan.
- (c) The year ended September 30, 2007 include \$64 million related to the settlement of contingent claims held by us relating to Bertelsmann's relationship with Napster in 2000 through 2001.





**Table of Contents****WARNER MUSIC GROUP****2006 QUARTERLY FINANCIAL INFORMATION**

(unaudited)

The following table sets forth the quarterly information for Warner Music Group (in millions, except per share data).

|  | September 30, |                     | Three months ended<br>March 31, |                         |
|--|---------------|---------------------|---------------------------------|-------------------------|
|  | 2006(a)       | June 30,<br>2006(a) | 2006(a)                         | December 31,<br>2005(a) |
| Revenues                                       | \$ 854        | \$ 822              | \$ 796                          | \$ 1,044                |
| Costs and expenses                             |               |                     |                                 |                         |
| Cost of revenues                               | (438)         | (445)               | (409)                           | (530)                   |
| Selling, general and administrative expenses   | (314)         | (301)               | (294)                           | (323)                   |
| Other income, net (b)                          | 14            |                     |                                 |                         |
| Amortization of intangible assets              | (50)          | (48)                | (48)                            | (47)                    |
| Total costs and expenses                       | (788)         | (794)               | (751)                           | (900)                   |
| Operating income                               | 66            | 28                  | 45                              | 144                     |
| Interest expense, net                          | (45)          | (45)                | (45)                            | (45)                    |
| Equity in the gains of equity-method investees |               |                     | 1                               |                         |
| Other income, net                              |               | 1                   | 2                               |                         |
| Income (loss) before income taxes              | 21            | (16)                | 3                               | 99                      |
| Income tax (expense) benefit                   | (9)           | 2                   | (10)                            | (30)                    |
| Net income (loss)                              | \$ 12         | \$ (14)             | \$ (7)                          | \$ 69                   |
| Net income (loss) per common share             |               |                     |                                 |                         |
| Basic  | \$ 0.08       | \$ (0.10)           | \$ (0.05)                       | \$ 0.49                 |
| Diluted  | \$ 0.08       | \$ (0.10)           | \$ (0.05)                       | \$ 0.46                 |
| Average common shares:                         |               |                     |                                 |                         |
| Basic  | 144.3         | 143.7               | 141.9                           | 141.4                   |
| Diluted  | 151.3         | 143.7               | 141.9                           | 150.5                   |

- (a) The Company's business is seasonal. Therefore quarterly operating results are not necessarily indicative of the results that may be expected for the full fiscal year.
- (b) The three months ended September 30, 2006 include certain non-recurring recorded income of \$13 million, related to management's estimate of the amount that will be paid to us, net of amounts owed to artists in respect of royalties, as a result of the settlement of international copyright litigation claim against the operators of the KaZaA peer-to-peer network.

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**WARNER MUSIC GROUP CORP.**

**Supplementary Information**

**Consolidating Financial Statements**

Warner Music Group Corp. (the Company or Parent ) was formed by a private equity consortium of Investors (the Investor Group ) on November 21, 2003. The Company is the direct parent of WMG Holdings Corp. ( Holdings ), which is the direct parent of WMG Acquisition Corp. ( New WMG or Acquisition Corp. ). New WMG is the successor to substantially all of the interests of the recorded music and music publishing businesses of Time Warner Inc. ( Time Warner ). Such predecessor interests formerly owned by Time Warner are hereinafter referred to as Old WMG or the Predecessor . Effective March 1, 2004, Old WMG was acquired from Time Warner by a private consortium of investors for approximately \$2.6 billion.

Holdings issued (i) \$250 million principal amount of Floating Rate Senior Notes due 2011 (the Holdings Floating Rate Notes ), (ii) \$397 million principal amount at maturity of 9.5% Senior Discount Notes due 2014, which had an initial issuance discount of \$147 million (the Holdings Discount Notes ) and (iii) \$200 million principal amount of Floating Rate Senior PIK Notes due 2014 (the Holdings PIK Notes, and collectively, the Holdings Notes ), which had an initial discount of \$4 million. In June 2005, using proceeds from the Company s Initial Common Stock Offering and approximately \$57 million of cash on hand, Holdings redeemed all of the Holdings Floating Rate Notes, all of the Holdings PIK Notes and 35% of the aggregate outstanding principal of the Holdings Discount Notes. The remaining Holdings Discount Notes are guaranteed by the Company. These guarantees are full, unconditional, joint and several. The following condensed consolidating financial statements are presented for the information of the holders of the remaining Holdings Discount Notes and present the results of operations, financial position and cash flows of (i) the Company, which is the guarantor of the remaining Holdings Discount Notes, (ii) Holdings, which is the issuer of the remaining Holdings Discount Notes, (ii) the subsidiaries of Holdings and (iii) the eliminations necessary to arrive at the information for the Company on a consolidated basis. Investments in consolidated or combined subsidiaries are presented under the equity method of accounting.

The Company is a holding company with no independent operations or assets other than through its interests in its subsidiaries, such as Holdings and Acquisition Corp. Accordingly, the ability of the Company to obtain funds from its subsidiaries is restricted by the senior secured credit facility of Acquisition Corp., the indenture for the Subordinated Notes issued by Acquisition Corp., and the indenture for the Holdings Notes.

**Table of Contents****Consolidating Balance Sheet**

September 30, 2007

|   | Warner<br>Music<br>Group Corp. | WMG<br>Holdings<br>Corp. (issuer) | WMG<br>Acquisition<br>Corp.<br>(in millions) | Eliminations   | Warner Music<br>Group<br>Corp.<br>Consolidated |
|---|--------------------------------|-----------------------------------|--|----------------|--|
| <b>Assets:</b>  |                                |                                   |  |                |  |
| Current assets:   |                                |                                   |  |                |  |
| Cash and equivalents  | \$ 74                          | \$                                | \$ 259                                       | \$             | \$ 333   |
| Due from (to) affiliates  | (2)                            |                                   | 2  |                |  |
| Accounts receivable, net  |                                |                                   | 555  |                | 555  |
| Inventories   |                                |                                   | 58   |                | 58   |
| Royalty advances expected to be recouped within one year        |                                |                                   | 176  |                | 176  |
| Deferred tax assets   |                                |                                   | 40   |                | 40   |
| Other current assets  |                                |                                   | 33   |                | 33   |
| <b>Total current assets</b>                                     | <b>72</b>                      |                                   | <b>1,123</b>                                 |                | <b>1,195</b>                                   |
| Royalty advances expected to be recouped after one year         |                                |                                   | 216  |                | 216  |
| Investments in and advances to (from) consolidated subsidiaries | (85)                           | 121                               |  | (36)           |  |
| Investments   |                                |                                   | 146  |                | 146  |
| Property, plant and equipment                                   |                                |                                   | 133  |                | 133  |
| Goodwill  |                                |                                   | 1,065  |                | 1,065  |
| Intangible assets subject to amortization                       |                                |                                   | 1,632  |                | 1,632  |
| Intangible assets not subject to amortization                   |                                |                                   | 100  |                | 100  |
| Other assets  |                                | 4                                 | 81   |                | 85   |
| <b>Total assets</b>   | <b>\$ (13)</b>                 | <b>\$ 125</b>                     | <b>\$ 4,496</b>                              | <b>\$ (36)</b> | <b>\$ 4,572</b>                                |
| <b>Liabilities and Shareholders (Deficit) Equity:</b>           |                                |                                   |  |                |  |
| Current liabilities:  |                                |                                   |  |                |  |
| Accounts payable  | \$                             | \$                                | \$ 225                                       | \$             | \$ 225   |
| Accrued royalties   |                                |                                   | 1,226  |                | 1,226  |
| Taxes and other withholdings                                    | 2                              |                                   | 31   |                | 33   |
| Current portion of long-term debt                               |                                |                                   | 17   |                | 17   |
| Dividends payable   | 23                             |                                   |  |                | 23   |
| Other current liabilities                                       |                                |                                   | 358  |                | 358  |
| <b>Total current liabilities</b>                                | <b>25</b>                      |                                   | <b>1,857</b>                                 |                | <b>1,882</b>                                   |
| Long-term debt  |                                | 210                               | 2,046  |                | 2,256  |
| Deferred tax liabilities, net                                   |                                |                                   | 244  |                | 244  |
| Dividends payable   | 1                              |                                   |  |                | 1  |
| Other noncurrent liabilities                                    | (3)                            |                                   | 228  |                | 225  |
| <b>Total liabilities</b>  | <b>23</b>                      | <b>210</b>                        | <b>4,375</b>                                 |                | <b>4,608</b>                                   |
| Shareholders (deficit) equity                                   | (36)                           | (85)                              | 121  | (36)           | (36)   |

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|  |         |        |          |         |          |
|--|---------|--------|----------|---------|----------|
| <b>Total liabilities and shareholders (deficit) equity</b> | \$ (13) | \$ 125 | \$ 4,496 | \$ (36) | \$ 4,572 |
|--|---------|--------|----------|---------|----------|

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**Table of Contents****Consolidating Balance Sheet**

September 30, 2006

|   | Warner<br>Music<br>Group Corp. | WMG<br>Holdings<br>Corp. (issuer) | WMG<br>Acquisition<br>Corp.<br>(in millions) | Eliminations    | Warner Music<br>Group<br>Corp.<br>Consolidated |
|---|--------------------------------|-----------------------------------|--|-----------------|--|
| <b>Assets:</b>  |                                |                                   |  |                 |  |
| Current assets:   |                                |                                   |  |                 |  |
| Cash and equivalents  | \$ 41                          | \$                                | \$ 326                                       | \$              | \$ 367   |
| Short-term investments  | 18                             |                                   |  |                 | 18   |
| Due from (to) affiliates  | (4)                            |                                   | 4  |                 |  |
| Accounts receivable, net  |                                |                                   | 585  |                 | 585  |
| Inventories   |                                |                                   | 59   |                 | 59   |
| Royalty advances expected to be recouped within one year        |                                |                                   | 191  |                 | 191  |
| Deferred tax assets   |                                |                                   | 45   |                 | 45   |
| Other current assets  |                                |                                   | 35   |                 | 35   |
| <b>Total current assets</b>                                     | <b>55</b>                      |                                   | <b>1,245</b>                                 |                 | <b>1,300</b>                                   |
| Royalty advances expected to be recouped after one year         |                                |                                   | 207  |                 | 207  |
| Investments in and advances to (from) consolidated subsidiaries | 28                             | 215                               |  | (243)           |  |
| Investments   |                                |                                   | 25   |                 | 25   |
| Property, plant and equipment                                   |                                |                                   | 146  |                 | 146  |
| Goodwill  |                                |                                   | 929  |                 | 929  |
| Intangible assets subject to amortization                       |                                |                                   | 1,711  |                 | 1,711  |
| Intangible assets not subject to amortization                   |                                |                                   | 100  |                 | 100  |
| Other assets  |                                | 4                                 | 98   |                 | 102  |
| <b>Total assets</b>   | <b>\$ 83</b>                   | <b>\$ 219</b>                     | <b>\$ 4,461</b>                              | <b>\$ (243)</b> | <b>\$ 4,520</b>                                |
| <b>Liabilities and Shareholders Equity:</b>                     |                                |                                   |  |                 |  |
| Current liabilities:  |                                |                                   |  |                 |  |
| Accounts payable  | \$                             | \$                                | \$ 209                                       | \$              | \$ 209   |
| Accrued royalties   |                                |                                   | 1,142  |                 | 1,142  |
| Taxes and other withholdings                                    |                                |                                   | 32   |                 | 32   |
| Current portion of long-term debt                               |                                |                                   | 17   |                 | 17   |
| Dividends payable   | 22                             |                                   |  |                 | 22   |
| Other current liabilities                                       |                                |                                   | 377  |                 | 377  |
| <b>Total current liabilities</b>                                | <b>22</b>                      |                                   | <b>1,777</b>                                 |                 | <b>1,799</b>                                   |
| Long-term debt  |                                | 191                               | 2,048  |                 | 2,239  |
| Deferred tax liabilities, net                                   |                                |                                   | 197  |                 | 197  |
| Dividends payable   | 3                              |                                   |  |                 | 3  |
| Other noncurrent liabilities                                    |                                |                                   | 224  |                 | 224  |
| <b>Total liabilities</b>  | <b>25</b>                      | <b>191</b>                        | <b>4,246</b>                                 |                 | <b>4,462</b>                                   |
| Shareholders equity   | 58                             | 28                                | 215  | (243)           | 58   |

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|  |       |        |          |          |          |
|--|-------|--------|----------|----------|----------|
| <b>Total liabilities and shareholders equity</b> | \$ 83 | \$ 219 | \$ 4,461 | \$ (243) | \$ 4,520 |
|--|-------|--------|----------|----------|----------|

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**Table of Contents****Consolidating Statement of Operations****For The Year Ended September 30, 2007**

|  | Warner Music<br>Group<br>Corp. | WMG Holdings<br>Corp.<br>(issuer) | WMG<br>Acquisition<br>Corp.<br>(in millions) | Eliminations | Warner Music<br>Group Corp.<br>Consolidated |
|--|--------------------------------|-----------------------------------|--|--------------|---|
| Revenues                                     | \$                             | \$                                | \$ 3,385                                     | \$           | \$ 3,385                                    |
| Costs and expenses:                          |                                |                                   |  |              |   |
| Cost of revenues                             |                                |                                   | (1,823)                                      |              | (1,823)                                     |
| Selling, general and administrative expenses |                                |                                   | (1,164)                                      |              | (1,164)                                     |
| Other income, net                            |                                |                                   | 73   |              | 73  |
| Amortization of intangible assets            |                                |                                   | (206)  |              | (206)                                       |
| Restructuring costs                          |                                |                                   | (50)   |              | (50)  |
| Total costs and expenses                     |                                |                                   | (3,170)                                      |              | (3,170)                                     |
| Operating income                             |                                |                                   | 215  |              | 215   |
| Interest income (expense), net               | 4                              | (19)                              | (167)  |              | (182)                                       |
| Minority interest                            |                                |                                   | (5)  |              | (5)   |
| Income (loss) before income taxes            | 4                              | (19)                              | 43   |              | 28  |
| Income tax expense                           |                                |                                   | (49)   |              | (49)  |
| Net income (loss)                            | \$ 4                           | \$ (19)                           | \$ (6)                                       | \$           | \$ (21)                                     |

**Table of Contents****Consolidating Statement of Operations****For The Year Ended September 30, 2006**

|  | <b>Warner Music<br/>Group<br/>Corp.</b> | <b>WMG Holdings<br/>Corp.<br/>(issuer)</b> | <b>WMG<br/>Acquisition<br/>Corp.<br/>(in millions)</b> | <b>Eliminations</b> | <b>Warner Music<br/>Group Corp.<br/>Consolidated</b> |
|--|---|--|--|---------------------|--|
| Revenues   | \$                                      | \$   | \$ 3,516   | \$                  | \$ 3,516   |
| Costs and expenses:  |   |  |  |                     |  |
| Cost of revenues   |   |  | (1,822)  |                     | (1,822)  |
| Selling, general and administrative expenses                 |   |  | (1,232)  |                     | (1,232)  |
| Other income, net  |   |  | 14   |                     | 14   |
| Amortization of intangible assets                            |   |  | (193)  |                     | (193)  |
| Total costs and expenses                                     |   |  | (3,233)  |                     | (3,233)  |
| Operating income   |   |  | 283  |                     | 283  |
| Interest income (expense), net                               | 2                                       | (17)                                       | (165)  |                     | (180)  |
| Equity in the gains (losses) of equity-method investees, net | 58                                      | 75   | 1  | (133)               | 1  |
| Other expense, net   |   |  | 3  |                     | 3  |
| Income (loss) before income taxes                            | 60                                      | 58   | 122  | (133)               | 107  |
| Income tax expense   |   |  | (47)   |                     | (47)   |
| Net income (loss)  | \$ 60                                   | \$ 58                                      | \$ 75  | \$ (133)            | \$ 60  |



**Table of Contents****Consolidating Statement of Operations****For The Year Ended September 30, 2005**

|   | Warner Music<br>Group<br>Corp. | WMG Holdings<br>Corp.<br>(issuer) | WMG<br>Acquisition<br>Corp.<br>(in millions) | Eliminations | Warner Music<br>Group<br>Corp.<br>Consolidated |
|---|--------------------------------|-----------------------------------|--|--------------|--|
| Revenues  | \$                             | \$                                | \$ 3,502                                     | \$           | \$ 3,502                                       |
| Costs and expenses:                                     |                                |                                   |  |              |  |
| Cost of revenues  |                                |                                   | (1,850)                                      |              | (1,850)  |
| Selling, general and administrative expenses            |                                |                                   | (1,305)                                      |              | (1,305)  |
| Other income, net                                       |                                |                                   | 4  |              | 4  |
| Amortization of intangible assets                       |                                |                                   | (187)  |              | (187)  |
| Loss on termination of management agreement             |                                |                                   | (73)   |              | (73)   |
| Restructuring costs, net                                |                                |                                   | (7)  |              | (7)  |
| Total costs and expenses                                |                                |                                   | (3,418)                                      |              | (3,418)  |
| Operating income  |                                |                                   | 84   |              | 84   |
| Interest expense, net                                   | (1)                            | (35)                              | (146)  |              | (182)  |
| Equity in the losses of equity-method investees,<br>net | (185)                          | (110)                             | (1)  | 295          | (1)  |
| Net investment-related gains                            |                                |                                   | 1  |              | 1  |
| Loss on repayment of Holdings Notes                     |                                | (35)                              |  |              | (35)   |
| Unrealized gain on warrant                              | 17                             |                                   |  |              | 17   |
| Other expense, net                                      |                                |                                   | 7  |              | 7  |
| Minority interest expense                               |                                | (5)                               |  |              | (5)  |
| (Loss) income before income taxes                       | (169)                          | (185)                             | (55)   | 295          | (114)  |
| Income tax expense                                      |                                |                                   | (55)   |              | (55)   |
| Net (loss) income                                       | \$ (169)                       | \$ (185)                          | \$ (110)                                     | \$ 295       | \$ (169)                                       |

**Table of Contents****Consolidating Statement of Cash Flows****For The Year Ended September 30, 2007**

|   | <b>Warner Music<br/>Group<br/>Corp.</b> | <b>WMG Holdings<br/>Corp.<br/>(issuer)</b> | <b>WMG Acquisition<br/>Corp.<br/>(in millions)</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|---|--|--|---------------------|---------------------|
| <b>Cash flows from operating activities:</b>  |   |  |  |                     |                     |
| Net income (loss)   | \$ 4                                    | \$ (19)                                    | \$ (6)   | \$                  | \$ (21)             |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |   |  |  |                     |                     |
| Depreciation and amortization   |   |  | 246  |                     | 246                 |
| Deferred taxes  |   |  | (2)  |                     | (2)                 |
| Non-cash interest expense   |   | 19   | 41   |                     | 60                  |
| Non-cash stock-based compensation expense   |   |  | 10   |                     | 10                  |
| Unrealized (gain) loss on warrants  |   |  |  |                     |                     |
| Other non-cash items  |   |  | (4)  |                     | (4)                 |
| Minority Interest/Dividends on preferred shares   |   |  | 5  |                     | 5                   |
| Changes in operating assets and liabilities:  |   |  |  |                     |                     |
| Accounts receivable   |   |  | 73   |                     | 73                  |
| Inventories   |   |  | 3  |                     | 3                   |
| Royalty advances  |   |  | 18   |                     | 18                  |
| Accounts payable and accrued liabilities  |   |  | (78)   |                     | (78)                |
| Other balance sheet changes   | (1)                                     |  | (7)  |                     | (8)                 |
| Net cash provided by (used in) operating activities                                       | 3                                       |  | 299  |                     | 302                 |
| <b>Cash flows from investing activities:</b>  |   |  |  |                     |                     |
| Loan to third party   |   |  | (14)   |                     | (14)                |
| Other investments and acquisitions  |   |  | (237)  |                     | (237)               |
| Sales (purchases) of short-term investments   | 18                                      |  |  |                     | 18                  |
| Investment proceeds   |   |  | 7  |                     | 7                   |
| Capital expenditures  |   |  | (29)   |                     | (29)                |
| Net cash used in investing activities   | 18                                      |  | (273)  |                     | (255)               |
| <b>Cash flows from financing activities:</b>  |   |  |  |                     |                     |
| Debt repayments   |   |  | (17)   |                     | (17)                |
| Returns of capital and dividends paid   | (79)                                    | (90)                                       | (90)   | 180                 | (79)                |
| Return of capital received  | 90                                      | 90   |  | (180)               |                     |
| Change in intercompany  | (1)                                     |  | 1  |                     |                     |
| Other   | 2                                       |  |  |                     | 2                   |
| Net cash provided by (used in) financing activities                                       | 12                                      |  | (106)  |                     | (94)                |
| Effect of foreign currency on cash  |   |  | 13   |                     | 13                  |
| Net decrease (increase) in cash   | 33                                      |  | (67)   |                     | (34)                |
| Cash and equivalents at beginning of period   | 41                                      |  | 326  |                     | 367                 |
| Cash and equivalents at end of period   | \$ 74                                   | \$   | \$ 259   | \$                  | \$ 333              |



**Table of Contents****Consolidating Statement of Cash Flows****For The Year Ended September 30, 2006**

|   | <b>Warner Music<br/>Group<br/>Corp.</b> | <b>WMG Holdings<br/>Corp.<br/>(issuer)</b> | <b>WMG Acquisition<br/>Corp.<br/>(in millions)</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|---|--|--|---------------------|---------------------|
| <b>Cash flows from operating activities:</b>  |   |  |  |                     |                     |
| Net income (loss)   | \$ 60                                   | \$ 58                                      | \$ 75  | \$ (133)            | \$ 60               |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |   |  |  |                     |                     |
| Depreciation and amortization   |   |  | 235  |                     | 235                 |
| Deferred taxes  |   |  | (11)   |                     | (11)                |
| Non-cash interest expense   |   | 17   | 35   |                     | 52                  |
| Non-cash stock-based compensation expense   |   |  | 16   |                     | 16                  |
| Equity in the (gains) losses of equity-method investees                                   |   |  | (1)  |                     | (1)                 |
| Equity in the (gains) losses of consolidated subsidiaries                                 | (58)                                    | (75)                                       |  | 133                 |                     |
| Changes in operating assets and liabilities:  |   |  |  |                     |                     |
| Accounts receivable   |   |  | 53   |                     | 53                  |
| Royalty advances  |   |  | (40)   |                     | (40)                |
| Accounts payable and accrued liabilities  |   |  | (60)   |                     | (60)                |
| Other balance sheet changes   | (5)                                     |  | 8  |                     | 3                   |
| Net cash provided by (used in) operating activities                                       | (3)                                     |  | 310  |                     | 307                 |
| <b>Cash flows from investing activities:</b>  |   |  |  |                     |                     |
| Repayment of loans to third party   |   |  | 7  |                     | 7                   |
| Other investments and acquisitions  | (18)                                    |  | (105)  |                     | (123)               |
| Capital expenditures  |   |  | (30)   |                     | (30)                |
| Net cash used in investing activities   | (18)                                    |  | (128)  |                     | (146)               |
| <b>Cash flows from financing activities:</b>  |   |  |  |                     |                     |
| Debt repayments   |   |  | (17)   |                     | (17)                |
| Capital contributions received (paid)   | (3)                                     | 3  |  |                     |                     |
| Change in intercompany  | 4                                       | (8)  | 4  |                     |                     |
| Return of capital and dividends paid  | (74)                                    | (92)                                       |  | 92                  | (74)                |
| Return of capital received  | 92                                      | 96   | (96)   | (92)                |                     |
| Other   | 3                                       |  |  |                     | 3                   |
| Net cash provided by (used in) financing activities                                       | 22                                      | (1)  | (109)  |                     | (88)                |
| Effect of foreign currency on cash  |   |  | 6  |                     | 6                   |
| Net decrease (increase) in cash   | 1                                       | (1)  | 79   |                     | 79                  |
| Cash and equivalents at beginning of period   | 40                                      | 1  | 247  |                     | 288                 |
| Cash and equivalents at end of period   | \$ 41                                   | \$   | \$ 326   | \$                  | \$ 367              |

**Table of Contents****Consolidating Statement of Cash Flows****For The Year Ended September 30, 2005**

|   | Warner Music<br>Group<br>Corp. | WMG Holdings<br>Corp.<br>(issuer) | WMG Acquisition<br>Corp.<br>(in millions) | Eliminations | Consolidated |
|---|--------------------------------|-----------------------------------|---|--------------|--------------|
| <b>Cash flows from operating activities:</b>  |                                |                                   |   |              |              |
| Net loss  | \$ (169)                       | \$ (185)                          | \$ (110)                                  | \$ 295       | \$ (169)     |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |                                |                                   |   |              |              |
| Depreciation and amortization   |                                |                                   | 238                                       |              | 238          |
| Deferred taxes  |                                |                                   | (7)                                       |              | (7)          |
| Loss on repayment of Holdings Notes   |                                | 35                                |   |              | 35           |
| Non-cash interest expense   |                                | 31                                | 37  |              | 68           |
| Non-cash stock-based compensation expense   |                                |                                   | 25  |              | 25           |
| Net investment-related losses   |                                |                                   | (1)                                       |              | (1)          |
| Minority interest   |                                | 5                                 |   |              | 5            |
| Equity in the losses of equity-method investees   |                                |                                   | 1   |              | 1            |
| Equity in the gains (losses) of consolidated subsidiaries                                 | 185                            | 110                               |   | (295)        |              |
| Unrealized gain on warrant  | (17)                           |                                   |   |              | (17)         |
| Changes in operating assets and liabilities:  |                                |                                   |   |              |              |
| Accounts receivable   |                                |                                   | (69)                                      |              | (69)         |
| Inventories   |                                |                                   | (3)                                       |              | (3)          |
| Royalty advances  |                                |                                   | (2)                                       |              | (2)          |
| Accounts payable and accrued liabilities  | 1                              |                                   | 45  |              | 46           |
| Other balance sheet changes   |                                | 1                                 | 54  |              | 55           |
| Net cash provided by (used in) operating activities                                       |                                | (3)                               | 208                                       |              | 205          |
| <b>Cash flows from investing activities:</b>  |                                |                                   |   |              |              |
| Loans to third party  |                                |                                   | (10)                                      |              | (10)         |
| Investments and acquisitions  |                                |                                   | (78)                                      |              | (78)         |
| Investment proceeds   |                                |                                   | 54  |              | 54           |
| Capital expenditures  |                                |                                   | (30)                                      |              | (30)         |
| Net cash used in investing activities   |                                |                                   | (64)                                      |              | (64)         |
| <b>Cash flows from financing activities:</b>  |                                |                                   |   |              |              |
| Issuance of Holdings debt   |                                | 696                               |   |              | 696          |
| Repayment of Holdings debt  |                                | (574)                             |   |              | (574)        |
| Additional term loan borrowings   |                                |                                   | 250                                       |              | 250          |
| Financing costs of borrowings   |                                | (17)                              | (3)                                       |              | (20)         |
| Debt repayments   |                                |                                   | (14)                                      |              | (14)         |
| Capital contributions received (paid)   | (590)                          | 517                               | 73  |              |              |
| Proceeds on the issuance of common stock  | 554                            |                                   |   |              | 554          |
| Costs of issuing common stock   | (32)                           |                                   |   |              | (32)         |
| Repurchase of subsidiary preferred stock  |                                | (200)                             |   |              | (200)        |
| Change in intercompany  | (7)                            | 18                                | (11)                                      |              |              |
| Cash paid to repurchase warrant   | (126)                          | (12)                              |   |              | (138)        |
| Return of capital   | (917)                          | (1,157)                           | (742)                                     | 1,899        | (917)        |
| Return of capital received  | 1,157                          | 742                               |   | (1,899)      |              |
| Dividends paid on preferred capital   |                                | (9)                               |   |              | (9)          |
| Proceeds on the issuance of restricted shares   | 1                              |                                   |   |              | 1            |

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|   |       |      |        |    |        |
|---|-------|------|--------|----|--------|
| Other   |       |      | (3)    |    | (3)    |
| Net cash provided by (used in) financing activities | 40    | 4    | (450)  |    | (406)  |
| Effect of foreign currency on cash                  |       |      | (2)    |    | (2)    |
| Net increase (decrease) in cash                     | 40    | 1    | (308)  |    | (267)  |
| Cash and equivalents at beginning of period         |       |      | 555    |    | 555    |
| Cash and equivalents at end of period               | \$ 40 | \$ 1 | \$ 247 | \$ | \$ 288 |

**Table of Contents****WARNER MUSIC GROUP CORP.****Schedule II Valuation and Qualifying Accounts**

| Description                                  | Balance<br>at<br>Beginning<br>of<br>Period | Additions                             |            | Balance<br>at<br>End of<br>Period |
|--|--|---------------------------------------|------------|-----------------------------------|
|  |  | Charged<br>to<br>Cost and<br>Expenses | Deductions |                                   |
| (in millions)                                |  |                                       |            |                                   |
| <b>Year Ended September 30, 2007</b>         |  |                                       |            |                                   |
| Allowance for doubtful accounts              | \$ 38                                      | \$ (2)                                | \$ (16)    | \$ 20                             |
| Reserves for sales returns and allowances    | 165  | 489                                   | (485)      | 169                               |
| Allowance for deferred tax asset             | 337  | 41                                    | (29)       | 349                               |
| <b>Year Ended September 30, 2006</b>         |  |                                       |            |                                   |
| Allowance for doubtful accounts              | \$ 50                                      | \$ 11                                 | \$ (23)    | \$ 38                             |
| Reserves for sales returns and allowances    | 168  | 491                                   | (494)      | 165                               |
| Allowance for deferred tax asset             | 323  | 37                                    | (23)       | 337                               |
| <b>Seven Months Ended September 30, 2005</b> |  |                                       |            |                                   |
| Allowance for doubtful accounts              | \$ 58                                      | \$ 1                                  | \$ (9)     | \$ 50                             |
| Reserves for sales returns and allowances    | 164  | 493                                   | (489)      | 168                               |
| Allowance for deferred tax asset             | 293  | 86                                    | (56)       | 323                               |

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### **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCE DISCLOSURE**

None.

### **ITEM 9A. CONTROLS AND PROCEDURES**

#### *Certification*

The certifications of the principal executive officer and the principal financial officer (or persons performing similar functions) required by Rules 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended (the "Certifications") are filed as exhibits to this report. This section of the report contains the information concerning the evaluation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) ("Disclosure Controls") and changes to internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) ("Internal Controls") referred to in the Certifications and this information should be read in conjunction with the Certifications for a more complete understanding of the topics presented.

#### *Introduction*

The Securities and Exchange Commission's rules define "disclosure controls and procedures" as controls and procedures that are designed to ensure that information required to be disclosed by public companies in the reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by public companies in the reports that they file or submit under the Exchange Act is accumulated and communicated to a company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

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

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



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*Evaluation of Disclosure Controls and Procedures*

Based on our management's evaluation (with the participation of our principal executive officer and principal financial officer), as of the end of the period covered by this report, our principal executive officer and principal financial officer have concluded that our Disclosure Controls provided reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act will be recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, including that such information is accumulated and communicated to management, including the principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

*Changes in Internal Control over Financial Reporting*

There have been no other changes in our Internal Controls over financial reporting or other factors during the period ended September 30, 2007 that have materially affected, or are reasonably likely to materially affect, our Internal Controls.

*Management's Report on Internal Control Over Financial Reporting*

Management's report on internal control over financial reporting is located on page 83 of this report and Ernst & Young LLP's Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting is located on page 84 of this report.

**ITEM 9B. OTHER INFORMATION**

Item 9B is not applicable and has been omitted.

**Table of Contents****PART III****ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

In addition to the information set forth under the caption "Executive Officers" in Part I of this Form 10-K, the information required by this Item is incorporated by reference to our Proxy Statement for the fiscal 2007 Annual Meeting of Stockholders.

**ITEM 11. EXECUTIVE COMPENSATION**

The information called for by this item is hereby incorporated by reference to our Proxy Statement for the fiscal 2007 Annual Meeting of Stockholders.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS****Equity Compensation Plan Information**

The following table provides information as of September 30, 2007 with respect to shares of our common stock that may be issued under our existing equity compensation plans.

| Plan Category                | Number of Securities to be Issued upon Exercise of Outstanding Options | Weighted Exercise Price of Outstanding Options | Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (excluding securities reflected in first column) |
|------------------------------|--|--|---|
| Equity Compensation Plans    |  |  |   |
| Approved by Stockholders (1) | 4,814,950  | \$ 10.91                                       | 820,929   |

(1) Consists of the 2005 Omnibus Stock Plan, as well as individual LTIP and individual stock option agreements.  
*LTIP and Individual Stock Option Agreements*

In 2004, the Company's board of directors approved a form of LTIP stock option agreement for grants of options to eligible individuals. Eligible individuals include any employee, director or consultant of the Company or any of its affiliates, or any other entity designated by Warner Music Group's board of directors in which the Company has an interest, who is selected by the Company's compensation committee to receive an award. The board authorized the granting of options to purchase up to 1,355,066 shares of our common stock pursuant to the LTIP program. The Company has granted options and may grant additional stock options under the LTIP stock option agreements to certain members of our current or future management. The board also approved the granting of options to purchase 3,701,850 shares of our common stock under stock option agreements with certain members of our management. Individual option agreements and options granted under the LTIP program generally will have a 10-year term and the exercise price will equal at least 100% of the fair market value on the date of the grant. With respect to each option granted pursuant to individual option agreements or a LTIP stock option agreement, one-third of the shares covered by the option generally vest and become exercisable in four equal installments on the day prior to each of first through fourth anniversaries of the effective date of the LTIP stock option agreement, subject to the employee's continued employment. Two-thirds of the shares covered by the option generally vest and become exercisable based on the occurrence of both a service condition (which is the same as the service condition described with respect to the service-based portion of the option) and a performance condition. The performance condition is met if, following an initial public offering or certain other events (including a change in control), a specified investment return is achieved by the investors (one-half of such shares require one return level and the other one-half of such shares require a different return level). The performance-based portion of the option also vests, subject to the employee's continued employment, on the day prior to the seventh anniversary of the effective date of the individual or LTIP stock option agreement and the

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service condition applicable to the performance-based option will be deemed to have been attained upon certain terminations following or in anticipation of a change in control. All of the performance-based requirements have been achieved for all of these grants, therefore, only the service condition remains as a vesting requirement.

### *2005 Omnibus Stock Plan*

In May 2005, we adopted the 2005 Omnibus Stock Plan, or 2005 Plan, which authorized the granting of stock based awards to purchase up to 3,416,133 shares of our common stock. The 2005 Plan was amended and restated as of February 23, 2007. Under the 2005 Plan, our board of directors or the compensation committee will administer the plan and has the power to make awards, to determine when and to whom awards will be granted, the form of each award, the amount of each award, and any other terms or conditions of each award consistent with the terms of the 2005 Plan. Awards may be made to employees, directors and others as set forth in the 2005 Plan. The types of awards that may be granted include restricted and unrestricted stock, incentive and non-statutory stock options, stock appreciation rights, performance units and other stock based awards. Each award agreement specifies the number and type of award, together with any other terms and conditions as determined by the board of directors or the compensation committee in their sole discretion. Eligible employees include any employee who does not already have any other equity participation in our company. The Company has granted options and restricted stock and may grant additional awards under the 2005 Plan to certain members of our current or future management and directors. Options granted generally have a 10-year term, the exercise price will equal at least 100% of the fair market value on the date of the grant and generally vest in four equal installments on the day prior to each of first through fourth anniversaries of the effective date of the stock option agreement, subject to the employee's continued employment.

The other information called for by this item is hereby incorporated by reference to our Proxy Statement for the fiscal 2007 Annual Meeting of Stockholders.

### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The information called for by this item is hereby incorporated by reference to our Proxy Statement for the fiscal 2007 Annual Meeting of Stockholders.

### **ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

The information called for by this item is hereby incorporated by reference to our Proxy Statement for the fiscal 2007 Annual Meeting of Stockholders.

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**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

**(a)(1) Financial Statements**

The Financial Statements listed in the Index to Consolidated Financial Statements, filed as part of this Annual Report on Form 10-K.

**(a)(2) Financial Statement Schedule**

The Financial Statements Schedule listed in the Index to Consolidated Financial Statements, filed as part of this Annual Report on Form 10-K.

**(a)(3) Exhibits**

See Item 15(b) below.

**(b) Exhibits**

| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
| 2.1(1)             | Purchase Agreement, dated as of November 24, 2003 as amended, between Time Warner Inc. and WMG Acquisition Corp.  |
| 2.2(12)            | Settlement Agreement, dated as of July 13, 2005, between Time Warner Inc. and WMG Acquisition Corp.   |
| 3.1(2)             | Amended and Restated Certificate of Incorporation of Warner Music Group Corp.   |
| 3.2(2)             | Amended and Restated By-laws of Warner Music Group Corp.  |
| 4.1(3)             | Indenture, dated as of April 8, 2004, among WMG Acquisition Corp., the Guarantors named therein and Wells Fargo Bank, National Association, as Trustee  |
| 4.2(3)             | First Supplemental Indenture, dated as of November 16, 2004, among WMG Acquisition Corp., Wells Fargo Bank, National Association, as Trustee, WEA Urban LLC and WEA Rock LLC                              |
| 4.3(7)             | Second Supplemental Indenture, dated as of May 17, 2005, among WMG Acquisition Corp., Wells Fargo Bank, National Association, as Trustee, NonZero (since renamed Cordless Recordings LLC) and The Biz LLC |
| 4.4(13)            | Third Supplemental Indenture, dated as of September 28, 2005, among WMG Acquisition Corp., Wells Fargo Bank, National Association, as Trustee, and Lava Records LLC                                       |
| 4.5(14)            | Fourth Supplemental Indenture, dated as of October 26, 2005, among WMG Acquisition Corp., Wells Fargo Bank, National Association, as Trustee, and BB Investments LLC                                      |
| 4.6(15)            | Fifth Supplemental Indenture, dated as of November 29, 2005, among WMG Acquisition Corp., Wells Fargo Bank, National Association, as Trustee, and Perfect Game Recording Company LLC                      |
| 4.7(19)            | Sixth Supplemental Indenture, dated as of June 30, 2006, among WMG Acquisition Corp., the additional subsidiary guarantors party thereto and Wells Fargo Bank, National Association, as Trustee           |
| 4.8(20)            | Seventh Supplemental Indenture, dated as of September 29, 2006, among WMG Acquisition Corp., the additional subsidiary guarantors party thereto and Wells Fargo Bank, National Association, as Trustee    |

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| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
| 4.9(24)            | Eighth Supplemental Indenture, dated as of November 29, 2006, among WMG Acquisition Corp., the additional subsidiary guarantors party thereto and Wells Fargo Bank, National Association as Trustee.  |
| 4.10(27)           | Ninth Supplemental Indenture, dated as of August 3, 2007, to the Indenture dated April 8, 2004, as amended, among WMG Acquisition Corp., the additional subsidiary guarantors party thereto and Wells Fargo Bank, National Association, as Trustee  |
| 4.11**             | Tenth Supplemental Indenture, dated as of November 28, 2007 to the Indenture dated April 8, 2004, as amended among WMG Acquisition Corp., the additional subsidiary guarantors party there to and Wells Fargo Bank, Nation Association, as Trustee  |
| 4.12(4)            | Indenture, dated as of December 23, 2004, between WMG Holdings Corp. and Wells Fargo Bank, National Association, as Trustee   |
| 4.13(12)           | Guarantee of Warner Music Group Corp.   |
| 10.1(5)            | Amended and Restated Credit Agreement, dated as of April 8, 2004, among WMG Acquisition Corp., the Overseas Borrowers from time to time party thereto, WMG Holdings Corp., each lender from time to time party thereto Banc of America Securities LLC and Deutsche Bank Securities Inc., as joint lead arrangers and joint book managers, Lehman Brothers Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, as co-arrangers and joint book managers, Deutsche Bank Securities Inc. and Lehman Commercial Paper Inc., as co-syndication agents, Merrill Lynch, Pierce, Fenner & Smith Incorporated, as documentation agent, and Bank of America, N.A., as administrative agent, Swing Line Lender and L/C Issuer. |
| 10.2(5)            | Amendment No. 1 to the Credit Agreement, dated as of September 30, 2004, among WMG Acquisition Corp., the Overseas Borrowers party thereto, WMG Holdings Corp., the lenders party thereto, Banc of America Securities LLC and Deutsche Bank Securities Inc., as joint lead arrangers and joint book managers and various other parties  |
| 10.3(5)            | Amendment No. 2 to the Credit Agreement, dated as of December 6, 2004, among WMG Acquisition Corp., the Overseas Borrowers party thereto, WMG Holdings Corp., the lenders party thereto, Banc of America Securities LLC and Deutsche Bank Securities Inc., as joint lead arrangers and joint book managers and various other parties  |
| 10.4(6)            | Amendment No. 3 to the Credit Agreement, dated as of April 29, 2005 among WMG Acquisition Corp., the Overseas Borrowers parties thereto, WMG Holdings Corp., the lenders party thereto, Banc of America Securities LLC and Deutsche Bank Securities Inc., as joint lead arrangers and joint book managers and various other parties   |
| 10.5(5)            | Security Agreement, dated as of February 27, 2004, from the Grantors named to therein to Bank of America, N.A.  |
| 10.6(5)            | Subsidiary Guaranty, dated as of February 27, 2004, from the Guarantors named therein and the Additional Guarantors named therein in favor of the Secured Parties named in the Credit Agreement referred to therein   |
| 10.7(5)            | Parent Guaranty, dated as of February 27, 2004, from WMG Holdings Corp. in favor of the Secured Parties named in the Credit Agreement referred to therein   |
| 10.8(5)            | Company Guaranty, dated as of February 27, 2004, from WMG Acquisition Corp. in favor of the Secured Parties named in the Credit Agreement referred to therein   |
| 10.9(5)            | Deed of Trust, Security Agreement, Assignment of Rents and Leases and Fixture Filing (Tennessee) by and from Warner Bros. Records, Inc. to Kay B. Housch in favor of Bank of America, N.A., dated as of February 29, 2004 (20, 24, 26 Music Square East)  |

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| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
| 10.10(5)           | Deed of Trust, Security Agreement, Assignment of Rents and Leases and Fixture Filing (Tennessee) by and from Warner Bros. Records, Inc. to Kay B. Housch in favor of Bank of America, N.A., dated as of February 29, 2004 (21 Music Square East)  |
| 10.11(5)           | Deed of Trust, Security Agreement, Assignment of Rents and Leases and Fixture Filing (California) by and from Warner Bros. Records, Inc. to MTC Financial Inc. in favor of Bank of America, N.A., dated as of February 29, 2004   |
| 10.12(5)           | Trademark Security Agreement, dated as of February 29, 2004, made by the Grantors listed on the signature pages thereto in favor of the Bank of America, N.A.   |
| 10.13(5)           | Copyright Security Agreement, dated as of February 29, 2004, made by the Grantors listed on the signature pages thereto in favor of the Bank of America, N.A.   |
| 10.14(5)           | Stockholders Agreement, dated as of February 29, 2004, among WMG Parent Corp., WMG Holdings Corp., WMG Acquisition Corp. and Certain Stockholders of Warner Music Group Corp. (formerly known as WMG Parent Corp.) and WMG Holdings Corp.   |
| 10.15(5)           | Amendment No. 1 to Stockholders Agreement, dated as of July 30, 2004, among WMG Parent Corp., WMG Holdings Corp., WMG Acquisition Corp., each Person executing this Agreement and listed as an Investor on the signature pages hereto, each Person executing this Agreement and listed as a Seller on the signature pages hereto, each Person executing this Agreement and listed as a Manager on the signature pages hereto and such other Persons, if any, that from time to time become party hereto as holders of Other Holder Shares solely in the capacity of permitted assignees with respect to certain registration rights hereunder |
| 10.16(7)           | Amended and Restated Stockholders Agreement dated as of May 10, 2005 between Warner Music Group Corp., WMG Holdings Corp., WMG Acquisition Corp. and certain stockholders of Warner Music Group Corp.   |
| 10.17(5)           | Seller Administrative Services Agreement, dated as of February 29, 2004, between Time Warner Inc. and WMG Acquisition Corp.   |
| 10.18(5)           | Amendment No. 1 to Seller Administrative Services Agreement, dated as of July 1, 2004, between Time Warner Inc. and WMG Acquisition Corp.   |
| 10.19(5)           | Purchaser Administrative Services Agreement, dated as of February 29, 2004, between Time Warner Inc. and WMG Acquisition Corp.  |
| 10.20(5)           | Management Agreement, dated as of February 29, 2004, among WMG Parent Corp., WMG Holdings Corp., WMG Acquisition Corp., THL Managers V, L.L.C., Bain Capital Partners, LLC, Providence Equity Partners IV Inc. and Music Partners Management, LLC   |
| 10.21(7)           | Termination Agreement of the Management Agreement dated as of May 10, 2005, between Warner Music Group Corp., WMG Holdings Corp., WMG Acquisition Corp., THL Managers V, L.L.C., Bain Capital Partners, LLC, Providence Equity Partners IV Inc. and Music Partners Management, LLC  |
| 10.22(5)           | Warrant Agreement (MMT Warrants), February 29, 2004, WMG Parent Corp., WMG Holdings Corp. and Historic TW Inc.  |
| 10.23(5)           | Warrant Agreement (Three-Year Warrants), February 29, 2004, WMG Parent Corp., WMG Holdings Corp. and Historic TW Inc.   |
| 10.24(10)          | Warrant Repurchase Agreement, dated as of April 21, 2005, between Warner Music Group Corp. and Historic TW Inc.   |

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| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 10.25(5)           | Employment Agreement, dated as of March 1, 2004, between WMG Acquisition Corp. and Edgar Bronfman, Jr.   |
| 10.26(5)           | Employment Agreement, dated as of January 25, 2004, between WMG Acquisition Corp. and Lyor Cohen   |
| 10.27(5)           | Employment Agreement, dated as of December 15, 1998, between Warner Music Inc. and David H. Johnson, as amended, assumed by WMG Acquisition Corp. on March 1, 2004 |
| 10.28(26)          | Employment Agreement Amendment, dated as of May 4, 2007, between Warner Music Inc. and David H. Johnson  |
| 10.29(9)           | Employment Agreement, dated as of December 21, 2004 between Warner Music Inc and Michael D. Fleisher.  |
| 10.30(24)          | Employment Agreement, dated as of November 4, 2005, between Warner Music Group Corp. and Alex Zubillaga  |
| 10.31(25)          | Employment Agreement Amendment, dated as of February 7, 2007, between Warner Music Inc. and Alex Zubillaga   |
| 10.32(5)           | Restricted Stock Award Agreement, dated as of March 1, 2004, between Warner Music Group Corp. (formerly known as WMG Parent Corp.) and Edgar Bronfman, Jr.         |
| 10.33(5)           | Restricted Stock Award Agreement, dated as of March 1, 2004, between Warner Music Group Corp. (formerly known as WMG Parent Corp.) and Lyor Cohen                  |
| 10.34(5)           | Restricted Stock Award Agreement, dated as of January 28, 2005, between Warner Music Group Corp. (formerly known as WMG Parent Corp.) and David H. Johnson         |
| 10.35(5)           | Restricted Stock Award Agreement, dated as of December 31, 2004, between Warner Music Group Corp. (formerly known as WMG Parent Corp.) and Michael D. Fleisher     |
| 10.36(24)          | Restricted Stock Award Agreement, dated as of October 1, 2004, between Warner Music Group Corp. (formerly known as WMG Parent Corp.) and Alex Zubillaga            |
| 10.37(5)           | Form of WMG Parent Corp. LTIP Stock Option Agreement   |
| 10.38(6)           | Warner Music Group Corp. Amended and Restated 2005 Omnibus Award Plan  |
| 10.39(24)          | Form of Restricted Stock Award Agreement   |
| 10.40(24)          | Form of Director Restricted Stock Award Agreement  |
| 10.41(24)          | Form of Option Agreement   |
| 10.42(24)          | Form of Stock Appreciation Rights Agreement  |
| 10.43(5)           | Office Lease, June 27, 2002, by and between Media Center Development, LLC and Warner Music Group Inc., as amended  |
| 10.44(5)           | Lease, dated as of February 1, 1996, between 1290 Associates, L.L.C. and Warner Communications Inc.  |
| 10.45(5)           | Consent to Assignment of Sublease, dated as of October 5, 2001, between 1290 Partners, L.P. and Warner Music Group   |
| 10.46(5)           | Lease, dated as of February 29, 2004, between Historical TW Inc. and Warner Music Group Inc. regarding 75 Rockefeller Plaza  |
| 10.47*(5)          | U.S. Pick, Pack and Shipping Services Agreement, dated as of October 24, 2003, between Warner-Elektra-Atlantic Corporation and Cinram Distribution LLC             |

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| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 10.48*(5)          | U.S. Manufacturing and Packaging Agreement, dated as of October 24, 2003, between Warner-Elektra-Atlantic Corporation and Cinram Manufacturing Inc.  |
| 10.49*(5)          | International Pick, Pack and Shipping Services Agreement, dated as of October 24, 2003, between WEA International Inc. and Warner Music Manufacturing Europe GmbH Company  |
| 10.50*(5)          | International Manufacturing and Packaging Agreement, dated as of October 24, 2003, between WEA International Inc. and Warner Music Manufacturing Europe GmbH Company   |
| 10.51*(26)         | Amendment dated March 13, 2007 to U.S. Manufacturing and Packaging Agreement, dated as of October 24, 2003, between Warner-Elektra-Atlantic Corporation and Cinram Manufacturing LLC, formerly known as Cinram Manufacturing Inc., and International Manufacturing and Packaging Agreement, dated as of October 24, 2003, between WEA International Inc. and Cinram GmbH |
| 10.52*(26)         | Amendment dated March 13, 2007 to U.S. Pick, Pack and Shipping Services Agreement, dated as of October 24, 2003, between Warner-Elektra-Atlantic Corporation and Cinram Distribution LLC and International Pick, Pack and Shipping Services Agreement, dated as of October 24, 2003, between WEA International Inc. and Cinram GmbH                                      |
| 10.53(16)          | Assurance of Discontinuance dated November 22, 2005  |
| 12.1**             | Computation of Ratio of Earnings to Fixed Charges  |
| 14(15)             | Code of Ethics   |
| 21.1**             | List of Subsidiaries   |
| 23.1**             | Consent of Ernst & Young LLP   |
| 24.1**             | Power of Attorney (see signature page)   |
| 31.1**             | Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended   |
| 31.2**             | Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended   |
| 32.1***            | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 32.2***            | Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| (c)                | Financial Statement Schedules  |
|                    | Schedule II Valuation and Qualifying Accounts  |

- \* Exhibit omits certain information that has been filed separately with the Securities and Exchange Commission pursuant to a confidential treatment request pursuant to Rule 406 promulgated under the Securities Act of 1933, as amended.
- \*\* Filed herewith.
- \*\*\* Pursuant to SEC Release No. 33-8212, this certification will be treated as accompanying this Annual Report on Form 10-K and not filed as part of such report for purposes of Section 18 of the Securities Exchange Act, as amended, or otherwise subject to the liability of Section 18 of the Securities Exchange Act, as amended, and this certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, except to the extent that the registrant specifically incorporates it by reference.
- (1) Incorporated by reference to WMG Acquisition Corp. s Amendment No. 1 to the Registration Statement on Form S-4 (File No. 333-121322).



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- (2) Incorporated by reference to Warner Music Group Corp. s Quarterly Report on Form 10-Q for the period ended March 31, 2005 (File No. 001-32502).
- (3) Incorporated by reference to WMG Acquisition Corp. s Registration Statement on Form S-4 (File No. 333-121322).
- (4) Incorporated by reference to Warner Music Group Corp. s Amendment No. 2 to the Registration Statement on Form S-1 (File No. 333-123249).
- (5) Incorporated by reference to WMG Acquisition Corp. s Amendment No. 2 to the Registration Statement on Form S-4 (File No. 333-121322).
- (6) Incorporated by reference to Warner Music Group Corp. s Amendment No. 4 to the Registration Statement on Form S-1 (File No. 333-123249).
- (7) Incorporated by reference to Warner Music Group Corp. s Current Report on Form 8-K filed May 19, 2005 (File No. 001-32502).
- (8) Incorporated by reference to WMG Acquisition Corp. s Current Report on form 8-K filed April 1, 2005 (File No. 333-121322).
- (9) Incorporated by reference to WMG Acquisition Corp. s Current Report on form 8-K filed April 11, 2005 (File No. 333-121322).
- (10) Incorporated by reference to Warner Music Group Corp. s Amendment No. 3 to the Registration Statement on Form S-1 (File No. 333-123249).
- (11) Incorporated by reference to WMG Acquisition Corp. s Amendment No. 3 to the Registration Statement on Form S-4 (File No. 333-121322).
- (12) Incorporated by reference to Warner Music Group Corp. s Registration Statement on Form S-4 (File No. 333-126786-01).
- (13) Incorporated by reference to Warner Music Group Corp. s Current Report on Form 8-K filed October 3, 2005 (File No. 001-32502).
- (14) Incorporated by reference to Warner Music Group Corp. s Current Report on Form 8-K filed October 27, 2005 (File No. 001-32502).
- (15) Incorporated by reference to Warner Music Group Corp. s Annual Report on Form 10-K for the Fiscal year ended September 30, 2005 (File No. 001-32502).
- (16) Incorporated by reference to Warner Music Group Corp. s Current Report on Form 8-K filed November 7, 2005 (File No. 001-32502).
- (17) Incorporated by reference to Warner Music Group Corp. s Current Report on Form 8-K filed February 13, 2005 (File No. 001-32502).
- (18) Incorporated by reference to Warner Music Group Corp. s Quarterly Report on Form 10-Q for the period ended March 31, 2006 (File No. 001-32502).
- (19) Incorporated by reference to Warner Music Group Corp. s Current Report on Form 8-K filed June 30, 2006 (File No. 001-32502).
- (20) Incorporated by reference to Warner Music Group Corp. s Current Report on Form 8-K filed on September 29, 2006 (File No. 001-32502).
- (21) Incorporated by reference to Warner Music Group Corp. s Current Report on Form 8-K filed on November 7, 2005 (File No. 001-32502)
- (22) Incorporated by reference to Warner Music Group Corp. s Current Report on Form 8-K filed on March 6, 2006 (File No. 001-32502)
- (23) Incorporated by reference to Warner Music Group Corp. s Current Report on Form 8-K filed on July 27, 2006 (File No. 001-32502)
- (24) Incorporated by reference to Warner Music Group Corp. s Annual Report on Form 10-K for the Fiscal year ended September 30, 2006 (File No. 001-32502)
- (25) Incorporated by reference to Warner Music Group Corp. s Quarterly Report on Form 10-Q for the period ended December 31, 2006 (File No. 001-32502).
- (26) Incorporated by reference to Warner Music Group Corp. s Quarterly Report on Form 10-Q for the period ended March 31, 2007 (File No. 001-32502).
- (27) Incorporated by reference to Warner Music Group Corp. s Quarterly Report on Form 10-Q for the period ended June 30, 2007 (File No. 001-32502).

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**SIGNATURE**

Pursuant to the requirements of Section 13 or 15(d) 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, on November 29, 2007.

WARNER MUSIC GROUP CORP.

By: /s/ EDGAR BRONFMAN, JR.  
**Name: Edgar Bronfman, Jr.**  
**Title: Chief Executive Officer and Chairman of the**  
**Board of Directors (Principal Executive Officer)**

By: /s/ MICHAEL D. FLEISHER  
**Name: Michael D. Fleisher**  
**Title: Chief Financial Officer (Principal Financial**  
**Officer and Principal Accounting Officer)**

**POWER OF ATTORNEY**

KNOW BY ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints jointly and severally, Paul M. Robinson and Trent N. Tappe, and each of them, his attorneys-in-fact, each with the power of substitution, for him in any and all capacities, to sign any and all amendments to the this Annual Report on Form 10-K and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each said attorneys-in-fact, or his substitute or substitutes, may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons in the capacities indicated on November 29, 2007.

| Signature   | Title   |
|---|---|
| /s/ EDGAR BRONFMAN, JR.<br><b>Edgar Bronfman, Jr.</b> | Chief Executive Officer and Chairman of the Board of Directors<br>(Principal Executive Officer) |
| /s/ MICHAEL D. FLEISHER<br><b>Michael D. Fleisher</b> | Chief Financial Officer (Principal Financial Officer and Principal<br>Accounting Officer)       |
| /s/ LEN BLAVATNIK<br><b>Len Blavatnik</b>             | Director  |
| /s/ SHELBY W. BONNIE<br><b>Shelby W. Bonnie</b>       | Director  |
| /s/ RICHARD BRESSLER<br><b>Richard Bressler</b>       | Director  |
| /s/ JOHN P. CONNAUGHTON<br><b>John P. Connaughton</b> | Director  |
| /s/ PHYLLIS E. GRANN<br><b>Phyllis E. Grann</b>       | Director  |
| /s/ MICHELE J. HOOPER<br><b>Michele J. Hooper</b>     | Director  |



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|     | <b>Signature</b>                                | <b>Title</b> |
|-----|---|--------------|
| /s/ | SCOTT L. JAECKEL<br><b>Scott L. Jaeckel</b>     | Director     |
| /s/ | SETH W. LAWRY<br><b>Seth W. Lawry</b>           | Director     |
| /s/ | THOMAS H. LEE<br><b>Thomas H. Lee</b>           | Director     |
| /s/ | IAN LORING<br><b>Ian Loring</b>                 | Director     |
| /s/ | JONATHAN M. NELSON<br><b>Jonathan M. Nelson</b> | Director     |
| /s/ | MARK NUNNELLY<br><b>Mark Nunnely</b>            | Director     |
| /s/ | SCOTT M. SPERLING<br><b>Scott M. Sperling</b>   | Director     |