

Warner Music Group Corp.
Form 10-Q
May 05, 2006
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2006

OR

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

Commission File Number 001-32502

Warner Music Group Corp.

(Exact name of Registrant as specified in its charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

13-4271875
(I.R.S. Employer
Identification No.)

75 Rockefeller Plaza

New York, NY 10019

(Address of principal executive offices)

(212) 275-2000

(Registrant's telephone number, including area code)

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

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

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

As of May 1, 2006, the number of shares of the Registrant's common stock, par value \$0.001 per share, outstanding was 148,546,120.787.

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WARNER MUSIC GROUP CORP.

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Table of Contents**ITEM 1. FINANCIAL STATEMENTS****Warner Music Group Corp.****Consolidated Balance Sheets**

	March 31, 2006	September 30, 2005
	(unaudited)	(audited)
	(in millions)	
Assets		
Current assets:		
Cash and equivalents	\$ 359	\$ 288
Short-term investments	61	
Accounts receivable, less allowances of \$230 and \$218 million	530	637
Inventories	44	52
Royalty advances expected to be recouped within one year	196	190
Deferred tax assets	32	36
Other current assets	56	39
	<u> </u>	<u> </u>
Total current assets	1,278	1,242
Royalty advances expected to be recouped after one year	196	190
Investments	24	21
Property, plant and equipment, net	147	157
Goodwill	876	869
Intangible assets subject to amortization, net	1,737	1,815
Intangible assets not subject to amortization	100	100
Other assets	106	104
	<u> </u>	<u> </u>
Total assets	<u>\$ 4,464</u>	<u>\$ 4,498</u>
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	\$ 211	\$ 247
Accrued royalties	1,088	1,057
Taxes and other withholdings	43	23
Current portion of long-term debt	17	17
Dividends payable	20	
Other current liabilities	327	404
	<u> </u>	<u> </u>
Total current liabilities	1,706	1,748
Long-term debt	2,226	2,229
Dividends payable	6	5
Deferred tax liabilities, net	192	201
Other noncurrent liabilities	225	226
	<u> </u>	<u> </u>
Total liabilities	<u>4,355</u>	<u>4,409</u>

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Commitments and Contingencies (See Note 9)

Shareholders' equity:

Common stock (\$0.001 par value; 500,000,000 shares authorized; 148,496,538 and 148,455,313 shares issued and outstanding)

Additional paid-in capital	556	548
Accumulated deficit	(475)	(480)
Accumulated other comprehensive income, net	28	21
	<u>109</u>	<u>89</u>
Total shareholders' equity	109	89
	<u>\$ 4,464</u>	<u>\$ 4,498</u>
Total liabilities and shareholders' equity	\$ 4,464	\$ 4,498

See accompanying notes.

Table of Contents**Warner Music Group Corp.****Consolidated Statements of Operations (Unaudited)****Three Months Ended March 31, 2006 and 2005**

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
	(in millions, except per share amounts)	
Revenues (b)	\$ 796	\$ 767
Costs and expenses:		
Cost of revenues (a)	(409)	(400)
Selling, general and administrative expenses (a) (b)	(294)	(293)
Amortization of intangible assets	(48)	(47)
Total costs and expenses	(751)	(740)
Operating income	45	27
Interest expense, net	(45)	(52)
Equity in the gains of equity-method investees, net	1	
Unrealized gain on warrants		39
Other income, net	2	
Income before income taxes	3	14
Income tax expense	(10)	(10)
Net (loss) income	\$ (7)	\$ 4
Net (loss) income per common share:		
Basic	\$ (0.05)	\$ 0.04
Diluted	\$ (0.05)	\$ (0.28)
Weighted average common shares:		
Basic	141.9	107.7
Diluted	141.9	123.5
(a) Includes depreciation expense of	\$ (11)	\$ (14)
(b) Includes the following expenses resulting from transactions with related companies:		
Revenues	4	
Selling, general and administrative expense	(3)	(2)

See accompanying notes.

Table of Contents**Warner Music Group Corp.****Consolidated Statements of Operations (Unaudited)****Six Months Ended March 31, 2006 and 2005**

	Six Months Ended March 31, 2006	Six Months Ended March 31, 2005
	(in millions, except per share amounts)	
Revenues (b)	\$ 1,840	\$ 1,855
Costs and expenses:		
Cost of revenues (a)	(939)	(981)
Selling, general and administrative expenses (a) (b)	(617)	(624)
Amortization of intangible assets	(95)	(93)
Total costs and expenses	(1,651)	(1,698)
Operating income	189	157
Interest expense, net (b)	(90)	(90)
Equity in the gains (losses) of equity-method investees, net	1	(1)
Unrealized gain on warrants		17
Minority interest expense (b)		(5)
Other income, net	2	4
Income before income taxes	102	82
Income tax expense	(40)	(42)
Net income	\$ 62	\$ 40
Net income per common share:		
Basic	\$ 0.44	\$ 0.37
Diluted	\$ 0.41	\$ 0.19
Weighted average common shares:		
Basic	141.7	107.6
Diluted	150.6	119.6
(a) Includes depreciation expense of	\$ (22)	\$ (28)
(b) Includes the following expenses resulting from transactions with related companies:		
Revenues	4	
Selling, general and administrative expense	(8)	(5)
Interest expense		(1)
Minority interest expense		(5)

See accompanying notes.

Table of Contents**Warner Music Group Corp.****Consolidated Statements of Cash Flows (Unaudited)****Six Months Ended March 31, 2006 and 2005**

	Six Months Ended March 31, 2006	Six Months Ended March 31, 2005
	_____	_____
	(in millions)	
Cash flows from operating activities		
Net income	\$ 62	\$ 40
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	117	121
Non-cash interest expense	26	30
Non-cash, stock-based compensation expense	8	9
Deferred taxes	(2)	2
Equity in the (gains) losses of equity-method investees, including distributions	(1)	1
Unrealized gain on warrants		(17)
Minority interest expense		5
Changes in operating assets and liabilities:		
Accounts receivable	108	103
Inventories	8	1
Royalty advances	(29)	9
Accounts payable and accrued liabilities	(66)	(22)
Other balance sheet changes	(26)	10
	_____	_____
Net cash provided by operating activities	205	292
	_____	_____
Cash flows from investing activities		
Investments and acquisitions	(18)	(48)
Investments in short-term investments	(61)	
Investment proceeds		1
Capital expenditures	(12)	(14)
	_____	_____
Net cash used in investing activities	(91)	(61)
	_____	_____
Cash flows from financing activities		
Borrowings		696
Financing costs of borrowings		(17)
Quarterly debt repayments	(8)	(6)
Proceeds from the issuance of restricted shares		1
Repurchase of subsidiary preferred stock		(209)
Dividends and returns of capital paid	(37)	(807)
	_____	_____
Net cash used in financing activities	(45)	(342)
Effect of foreign currency exchange rate changes on cash	2	3
	_____	_____
Net increase (decrease) in cash and equivalents	71	(108)
Cash and equivalents at beginning of period	288	555

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Cash and equivalents at end of period	<u>\$ 359</u>	<u>\$ 447</u>
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See accompanying notes.

Table of Contents**Warner Music Group Corp.****Consolidated Statement of Shareholders Equity (Unaudited)****Six Months Ended March 31, 2006**

	<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Retained Earnings (Deficit)</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total Shareholders Equity</u>
	<u>Shares</u>	<u>Value</u>				
	(in millions, except number of common shares)					
Balance at September 30, 2005	148,455,313	\$	\$ 548	\$ (480)	\$ 21	\$ 89
Comprehensive income:						
Net income				62		62
Foreign currency translation adjustment					(2)	(2)
Deferred gains on derivative financial instruments					9	9
Total comprehensive income				62	7	69
Dividends				(57)		(57)
Issuance of stock options and restricted shares of common stock, net	41,225		8			8
Balance at March 31, 2006	148,496,538	\$	\$ 556	\$ (475)	\$ 28	\$ 109

See accompanying notes.

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Warner Music Group Corp.

Notes to Consolidated Interim Financial Statements (Unaudited)

1. Description of Business

Warner Music Group Corp. (the *Company* 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*). Effective March 1, 2004, Acquisition Corp. acquired such interests from Time Warner for approximately \$2.6 billion (the *Acquisition*). On May 10, 2005, the Company sold 32,600,000 shares of its common stock in an initial public offering (the *Initial Common Stock Offering*) and became a public company.

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

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

Recorded Music Operations

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

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

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

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operations specialize in the distribution of music products in the Christian retail marketplace.

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

The Company plays an integral role in virtually all aspects of the music value chain from discovering and developing talent, to producing albums and promoting artists and their product. After an artist has entered into a contract with one of the Company's record labels, a master recording of the artist's music is created. The recording is then replicated for sale to consumers primarily in CD and digital formats. In the U.S., WEA Corp.

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Warner Music Group Corp.

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

and ADA market, sell and deliver products, either directly or through sub-distributors and wholesalers, to thousands of record stores, mass merchants and other retailers throughout the country. Recorded music products are also sold in physical form to Internet physical retailers. In addition, the Internet and wireless networks have become increasingly important sales channels for records in non-physical forms.

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

Music Publishing Operations

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

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

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

Music publishing revenues are derived from four main sources:

Mechanical: the licensor receives royalties with respect to compositions embodied in recordings sold in any format or configuration, including singles, albums, CDs, digital downloads and mobile phone ringtones.

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Performance: the licensor receives royalties when the composition is performed publicly (*e.g.*, broadcast radio and television, movie theater, concert, nightclub or Internet and wireless streaming).

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

Other: the licensor receives royalties from other uses such as stage productions.

2. Basis of Presentation

Interim Financial Statements

The accompanying consolidated financial statements are unaudited but, in the opinion of management, contain all the adjustments (consisting of those of a normal recurring nature) considered necessary to present fairly the financial position and the results of operations and cash flows for the periods presented in conformity

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Warner Music Group Corp.

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

with accounting principles generally accepted in the U.S. (U.S. GAAP) applicable to interim periods. The accompanying consolidated financial statements should be read in conjunction with the audited consolidated financial statements of the Company included in its Annual Report on Form 10-K (Registration No. 001-32502).

Recapitalization

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

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

Reclassifications

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

Basis of Consolidation

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

Short-term Investments

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

Stock-Based Compensation

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

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

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

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005	Six Months Ended March 31, 2006	Six Months Ended March 31, 2005
Net (loss) income	\$ (7)	\$ 4	\$ 62	\$ 40
Foreign currency translation gains (losses)		13	(2)	(12)
Derivative financial instruments gains	2	7	9	10
Comprehensive (loss) income	\$ (5)	\$ 24	\$ 69	\$ 38

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):

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005	Six Months Ended March 31, 2006	Six Months Ended March 31, 2005
Basic and diluted net income (loss) per common share:				

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Numerator:

Net income (loss) for basic calculation	\$ (7)	\$ 4	\$ 62	\$ 40
Less: Unrealized gain on warrants		(39)		(17)
Net income (loss) for diluted calculation	\$ (7)	\$ (35)	\$ 62	\$ 23

Denominator:

Weighted average common shares outstanding for basic calculation (a)	141.9	107.7	141.7	107.6
Weighted average common outstanding shares for diluted calculation	141.9	123.5	150.6	119.6
Net income (loss) per common share basic	\$ (0.05)	\$ 0.04	\$ 0.44	\$ 0.37
Net income (loss) per common share diluted	\$ (0.05)	\$ (0.28)	\$ 0.41	\$ 0.19

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

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

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

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005	Six Months Ended March 31, 2006	Six Months Ended March 31, 2005
Stock options	2.7	3.2	2.6	2.7
Restricted stock	6.2	6.9	6.3	6.8
Warrants		5.7		2.5
	8.9	15.8	8.9	12.0

The Company recognized a net loss for the three months ended March 31, 2006. Therefore, the effects from the assumed exercise of any outstanding stock options or warrants, or the assumed vesting of shares of restricted stock, during such period would be antidilutive. Accordingly, they have not been included in the presentation of diluted net income (loss) per share for the three months ended March 31, 2006.

See Note 19 in the Company's audited consolidated financial statements for the year ended September 30, 2005 for a summary of the terms of the warrants that were issued to Time Warner in connection with the Acquisition. The Company repurchased the warrants from Time Warner in May 2005 for approximately \$138 million.

3. Significant Acquisitions and Dispositions**Acquisition of Ryko Corporation**

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

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allocated to the underlying net assets based on their fair values, including identifiable intangible assets such as music catalog and artist contracts. The excess of the purchase price over the estimated fair value of the net assets acquired, if any, will be recorded primarily as goodwill.

Bad Boy Records LLC Joint Venture

On April 8, 2005, the Company entered into an agreement with an affiliate of Sean "Diddy" Combs to form Bad Boy Records LLC ("Bad Boy"), a joint venture, owned 50% by the Company and 50% by the affiliate. The Company purchased its 50% membership interest in Bad Boy Records LLC for approximately \$30 million in cash. Mr. Combs is the CEO of the joint venture and supervises its staff and day-to-day operations. The Company provides funding, marketing, promotion and certain back-office services for the joint venture. The

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Warner Music Group Corp.

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

transaction was accounted for under the purchase method of accounting, and the results of operations of Bad Boy are included in the Company's results of operations from its acquisition date.

Sale of Warner Bros. Publications

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

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

Maverick

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

4. Inventories

Inventories consist of the following (in millions):

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

Table of Contents**Warner Music Group Corp.****Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)****5. Intangible Assets**

Intangible assets consist of the following (in millions):

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

(a) Other represents foreign currency translation adjustments.

6. Restructuring Costs**Acquisition-Related Restructuring Costs**

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

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

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

Table of Contents**Warner Music Group Corp.****Notes to Consolidated Interim Financial Statements (Unaudited) (Continued)****7. Debt**

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

	March 31, 2006	September 30, 2005
	(unaudited)	(audited)
Senior secured credit facility:		
Revolving credit facility	\$	\$
Term loan	1,422	1,430
	<u>1,422</u>	<u>1,430</u>
7.375% U.S. dollar-denominated Senior Subordinated Notes due 2014 Acquisition Corp	465	465
8.125% Sterling-denominated Senior Subordinated Notes due 2014 Acquisition Corp	174	177
9.5% Senior Discount Notes due 2014 Holdings	182	174
	<u>2,243</u>	<u>2,246</u>
Total debt	2,243	2,246
Less current portion	(17)	(17)
	<u>2,226</u>	<u>2,229</u>
Total long term debt	<u>\$ 2,226</u>	<u>\$ 2,229</u>

The Holdings Refinancing

In December 2004, Holdings issued \$847 million principal amount at maturity of debt consisting of (i) \$250 million principal amount of Floating Rate Senior Notes due 2011 (the Holdings Floating Rate Notes), (ii) \$397 million principal amount at maturity of 9.5% Senior Discount Notes due 2014, which had an initial issuance discount of \$147 million (the Holdings Discount Notes), and (iii) \$200 million principal amount of Floating Rate Senior PIK Notes due 2014 (the Holdings PIK Notes), and collectively, the Holdings Notes, which had an initial discount of \$4 million. The gross proceeds of \$696 million received from the issuance of the Holdings Notes were used to (i) redeem the remaining shares of cumulative preferred stock of Holdings at a redemption price of \$209 million, including \$9 million of accrued and unpaid dividends, (ii) pay a return of capital to the Company's shareholders in the aggregate amount of \$472 million, and (iii) pay debt-related issuance costs of approximately \$15 million.

The Holdings Redemption

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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 Holdings Discount Notes.

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

Parent has fully and unconditionally guaranteed the remaining Holdings Discount Notes. The Holdings Discount Notes are unsecured and subordinated to all of Holdings' existing and future secured debt, including

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Warner Music Group Corp.

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

Holdings' guarantee of borrowings by Acquisition Corp. under the Company's senior secured credit facility. In addition, the Holdings Discount Notes are structurally subordinated to the Senior Subordinated Notes of Acquisition Corp.

The indentures limit Holdings' ability and the ability of its restricted subsidiaries to (i) incur additional indebtedness or issue certain preferred shares; (ii) pay dividends on or make other distributions in respect of its capital stock or make other restricted payments; (iii) make certain investments; (iv) sell certain assets; (v) create liens on certain debt without securing the notes; (vi) consolidate, merge, sell or otherwise dispose of all or substantially all of its assets; (vii) enter into certain transactions with affiliates; and (viii) designate its subsidiaries as unrestricted subsidiaries.

Restricted Net Assets

The Company is a holding company 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 facility of Acquisition Corp., the indenture for the Acquisition Corp. Senior Subordinated Notes and the indenture for the Holdings Notes.

8. Shareholders' Equity

Return of Capital and Dividends Paid

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

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

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

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

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

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

9. Commitments and Contingencies

Radio Promotion Activities

In 2004 and 2005, the Attorney General of the State of New York served the Company with requests for information in connection with an industry-wide investigation of the relationship between music companies and

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Warner Music Group Corp.

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

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

Pricing of Digital Music Downloads

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

Other Matters

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

10. Derivative Financial Instruments

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During the six months ended March 31, 2006, the Company did not enter into additional interest rate swap agreements to hedge the variability of its expected future cash interest payments or any new foreign currency hedge programs. As of March 31, 2006, the Company had interest rate swap agreements to hedge a total notional

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

debt amount of \$897 million and recorded deferred gains in comprehensive income of \$16 million. Additionally, as of March 31, 2006 the Company had approximately \$1 million of deferred net gains in comprehensive income related to foreign currency hedging.

The Company recorded unrealized gains of \$39 million and \$17 million on the stock warrants issued to Historic Time Warner in connection with the Acquisition for the three-months and six-months ended March 31, 2005. On May 16, 2005, the Company repurchased the three-year warrants from Time Warner at a cost of approximately \$138 million, which approximated fair value at that date.

11. Segment Information

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

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

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

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

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

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

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

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

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

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

12. Additional Financial Information**Cash Interest and Taxes**

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

Non-cash Transactions

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

13. Subsequent Event

Certain of the stock options and restricted shares of common stock awarded by the Company vest upon the occurrence of a 3x liquidity event, which is defined with respect to the awards as the occurrence of an event that implies an aggregate value for the equity held by the Investor Group of 3x its initial value, as adjusted for prior dividends or other returns of capital received. In April 2006, the 3x liquidity event, as defined, occurred, which resulted in the vesting of 1,169,932 shares of restricted common stock awarded to or purchased by employees of the Company and 516,719 stock options awarded to employees of the Company. In addition, the Company paid out accrued dividends owed to restricted stockholders of \$1.3 million upon the occurrence of the 3x liquidity event and the subsequent vesting of their restricted shares. In accordance with the requirements of FAS 123(R), the Company recognizes the compensation for these awards over the employee's requisite service period. Accordingly, there is no impact of this event to the Company's statement of operations.

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WARNER MUSIC GROUP CORP.

Supplementary Information

Condensed Consolidating Financial Statements of Registrant

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

Holdings has issued and outstanding the Holdings Discount Notes. The Holdings Discount Notes are guaranteed by the Company. These guarantees are full, unconditional, joint and several. The following condensed consolidating financial statements are presented for the information of the holders of the Holdings Discount Notes and present the results of operations, financial position and cash flows of (i) the Company, which is the guarantor of the Holdings Discount Notes, (ii) Holdings, which is the issuer of the Holdings Discount Notes, (iii) the subsidiaries of Holdings and (iv) the eliminations necessary to arrive at the information for the Company on a consolidated basis. Investments in consolidated subsidiaries are presented under the equity method of accounting.

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

Table of Contents**WARNER MUSIC GROUP CORP.****Supplementary Information****Condensed Consolidating Balance Sheet (unaudited)**

March 31, 2006

	Warner Music Group Corp.	WMG Holdings Corp. (issuer)	WMG Acquisition Corp.	Eliminations	Warner Music Group Corp. Consolidated
	_____	_____	_____	_____	_____
	(in millions)				
Assets:					
Current assets:					
Cash and equivalents	\$ 48	\$	\$ 311	\$	\$ 359
Short-term investments	34		27		61
Accounts receivable, net			530		530
Due from (to) affiliates	(1)		1		
Inventories			44		44
Royalty advances expected to be recouped within one year			196		196
Deferred tax assets			32		32
Other current assets			56		56
	_____	_____	_____	_____	_____
Total current assets	81		1,197		1,278
Royalty advances expected to be recouped after one year			196		196
Investments in and advances to (from) consolidated subsidiaries	56	234	24	(290)	24
Property, plant and equipment			147		147
Goodwill			876		876
Intangible assets subject to amortization			1,737		1,737
Intangible assets not subject to amortization			100		100
Other assets		4	102		106
	_____	_____	_____	_____	_____
Total assets	\$ 137	\$ 238	\$ 4,379	\$ (290)	\$ 4,464
	_____	_____	_____	_____	_____
Liabilities and Shareholders Equity:					
Current liabilities:					
Accounts payable	\$	\$	\$ 211	\$	\$ 211
Accrued royalties			1,088		1,088
Taxes and other withholdings			43		43
Current portion of long-term debt			17		17
Dividends payable	20				20
Other current liabilities			327		327
	_____	_____	_____	_____	_____
Total current liabilities	20		1,686		1,706
Long-term debt		182	2,044		2,226
Dividends payable	6				6
Deferred tax liabilities, net			192		192
Other noncurrent liabilities	2		223		225
	_____	_____	_____	_____	_____

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Total liabilities	28	182	4,145		4,355
Total shareholders' equity	109	56	234	(290)	109
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total liabilities and shareholders' equity	\$ 137	\$ 238	\$ 4,379	\$ (290)	\$ 4,464
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>

Table of Contents**WARNER MUSIC GROUP CORP.****Supplementary Information****Condensed Consolidating Balance Sheet (audited)****September 30, 2005**

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

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

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WARNER MUSIC GROUP CORP.

Supplementary Information

Condensed Consolidating Statements of Operations (unaudited)

For The Three Months Ended March 31, 2006 and March 31, 2005

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