Warner Music Group Corp.
Form 10-Q
February 08, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 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)

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

75 Rockefeller Plaza

New York, NY 10019

(Address of principal executive offices)

(212) 275-2000

(Registrant s telephone number, including area code)

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

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

As of February 6, 2007, the number of shares of the Registrant s common stock, par value $0.001 per share, outstanding was 149,389,412.787.

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WARNER MUSIC GROUP CORP.

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ITEM 1. FINANCIAL STATEMENTS

Warner Music Group Corp.

Consolidated Balance Sheets

	December 31, 2006	September 30, 2006
	(unaudited)	(audited)
	(in millions)	
Assets		
Current assets:		
Cash and equivalents	$ 327	$ 367
Short-term investments	10	18
Accounts receivable, less allowances of $233 and $207 million, respectively	610	585
Inventories	63	59
Royalty advances expected to be recouped within one year	199	191
Deferred tax assets	53	45
Other current assets	84	35
Total current assets	1,346	1,300
Royalty advances expected to be recouped after one year	216	207
Investments	26	25
Property, plant and equipment, net	135	146
Goodwill	943	929
Intangible assets subject to amortization, net	1,679	1,711
Intangible assets not subject to amortization	100	100
Other assets	99	102
Total assets	$ 4,544	$ 4,520
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	$ 197	$ 209
Accrued royalties	1,225	1,142
Taxes and other withholdings	45	32
Current portion of long-term debt	17	17
Dividends payable	22	22
Other current liabilities	310	377
Total current liabilities	1,816	1,799
Long-term debt	2,249	2,239
Dividends payable	3	3
Deferred tax liabilities, net	196	197
Other noncurrent liabilities	225	224
Total liabilities	4,489	4,462

Commitments and Contingencies (See Note 12)		
Shareholders equity:		
Common stock ($0.001 par value; 500,000,000 shares authorized; 149,566,156 and 149,156,028 shares issued and outstanding, respectively)		
Additional paid-in capital	572	567
Accumulated deficit	(517)	(516)
Accumulated other comprehensive income, net		7
Total shareholders equity	55	58
Total liabilities and shareholders equity	$ 4,544	$ 4,520

See accompanying notes.

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Warner Music Group Corp.

Consolidated Statements of Operations (Unaudited)

Three Months Ended December 31, 2006 and 2005

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005
	(in millions, except per share amounts)	
Revenues (b)	$ 928	$ 1,044
Costs and expenses:		
Cost of revenues (a) (b)	(508)	(530)
Selling, general and administrative expenses (a) (b)	(290)	(323)
Amortization of intangible assets	(50)	(47)
Total costs and expenses	(848)	(900)
Operating income	80	144
Interest expense, net	(47)	(45)
Income before income taxes	33	99
Income tax expense	(15)	(30)
Net income	$ 18	$ 69
Net income per common share:		
Basic	$ 0.12	$ 0.49
Diluted	$ 0.12	$ 0.46
Weighted average common shares:		
Basic	144.9	141.4
Diluted	151.5	150.5
(a) Includes depreciation expense of	$ (10)	$ (11)
(b) Includes the following expenses resulting from transactions with related companies:		
Revenues	$ 1	$
Cost of revenues	$ (1)	$
Selling, general and administrative expenses	$ (4)	$ (5)

See accompanying notes.

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Warner Music Group Corp.

Consolidated Statements of Cash Flows (Unaudited)

Three Months Ended December 31, 2006 and 2005

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005
	(in millions)	
Cash flows from operating activities		
Net income	$ 18	$ 69
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	60	58
Deferred taxes	(12)	(1)
Non-cash interest expense	16	13
Non-cash, stock-based compensation expense	3	6
Changes in operating assets and liabilities:		
Accounts receivable	(16)	(117)
Inventories	(3)	(2)
Royalty advances	(16)	(44)
Accounts payable and accrued liabilities	(11)	41
Other balance sheet changes	(2)	6
Net cash provided by operating activities	37	29
Cash flows from investing activities		
Loan to third party	(52)	
Investments and acquisitions	(8)	(11)
Proceeds from the sale of buildings	7	
Capital expenditures	(5)	(5)
Net cash used in investing activities	(58)	(16)
Cash flows from financing activities		
Quarterly debt repayments	(4)	(4)
Proceeds from the exercise of stock options	2	
Dividends paid	(19)	(18)
Net cash used in financing activities	(21)	(22)
Effect of foreign currency exchange rate changes on cash	2	(1)
Net decrease in cash and equivalents	(40)	(10)
Cash and equivalents at beginning of period	367	288
Cash and equivalents at end of period	$ 327	$ 278

See accompanying notes.

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Warner Music Group Corp.

Consolidated Statement of Shareholders Equity (Unaudited)

Three Months Ended December 31, 2006

	Common Stock Shares	Common Stock Value	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
	(in millions, except number of common shares)					
Balance at September 30, 2006	149,156,028		$ 567	$ (516)	$ 7	$ 58
Comprehensive income (loss):						
Net income				18		18
Foreign currency translation adjustment					(6)	(6)
Deferred losses on derivative financial instruments					(1)	(1)
Total comprehensive income (loss)				18	(7)	11
Dividends				(19)		(19)
Issuance of stock options and restricted shares of common stock	410,128		3			3
Exercises of stock options			2			2
Balance at December 31, 2006	149,566,156		$ 572	$ (517)	$	$ 55

See accompanying notes.

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-based content companies and the successor to substantially all of the interests of the recorded music and music publishing businesses of Time Warner Inc. (Time Warner). Effective March 1, 2004, Acquisition Corp. acquired such interests from Time Warner for approximately $2.6 billion (the Acquisition).

The Company s business is seasonal. Therefore, operating results for the three months ended December 31, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ended September 30, 2007.

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 the Independent Label Group (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. Recorded Music operations also include Rhino Entertainment (Rhino), a division that specializes in marketing the Company s music catalog through compilations and reissuances of previously released music and video titles, as well as in the licensing of 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 Corporation (Ryko), a leading independent, integrated music and entertainment company. See Note 5.

In January 2007, the Company acquired a majority interest in Roadrunner Music Group B.V. (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 Warner-Elektra-Atlantic Corporation (WEA Corp.), which markets and sells music products to retailers and wholesale distributors in the U.S.; Alternative Distribution Alliance (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

Warner Music Group Corp.

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

the Christian retail marketplace; and the newly created ADA U.K., which provides ADA s distribution services to independent labels in the U.K.

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. In addition to the more traditional methods, the Company has implemented new initiatives to promote and develop emerging songwriters, such as its label, Perfect Game Recording Co., which similar to ILG seeks to identify and nurture songwriters earlier in the development process.

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.

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 Company s financial position and the results of operations and cash flows for the periods presented in conformity with accounting principles generally accepted in the U.S. (U.S. GAAP) applicable to interim periods. The accompanying consolidated financial statements should be read in conjunction with the audited

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Warner Music Group Corp.

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

consolidated financial statements of the Company included in its Annual Report on Form 10-K for the fiscal year ended September 30, 2006 (Registration No. 001-32502).

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 inter-company balances and transactions have been eliminated in consolidation.

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).

Accounting for Pension and Post-retirement Plans

In September 2006, the FASB 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). FAS 158 requires all companies to recognize the funded status of all sponsored 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 is required to implement these provisions of FAS 158 in the fiscal year ended September 30, 2007. During the three months ended December 31, 2006, the Company recorded an adjustment to reflect the implementation of FAS 158, which resulted in an other pension asset of $1 million, an additional pension liability of $3 million and an other comprehensive loss of approximately $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 ended September 30, 2008.

3. Comprehensive Income

Comprehensive income consists of net 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, as well as adjustments to correctly

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

state pension obligations. The following summary sets forth the components of comprehensive income, net of related taxes, for the three months ended December 31, 2006 and 2005 (in millions):

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005
Net income	$ 18	$ 69
Foreign currency translation losses (a)	(6)	(2)
Derivative financial instruments (losses) gains	(1)	7
Pension adjustments		
Comprehensive income	$ 11	$ 74

(a) The foreign currency translation adjustments are not adjusted for income taxes as they relate to permanent investments in international subsidiaries.

4. Net Income Per Common Share

The Company computes net income per common share in accordance with FASB Statement No. 128, Earnings per Share (FAS 128). Under the provisions of FAS 128, basic net income per common share is computed by dividing the net income applicable to common shares after preferred dividend requirements, if any, by the weighted average of common shares outstanding during the period. Diluted net income per common share adjusts basic net income 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 per common share (in millions, except per share amounts):

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005

Basic and diluted net income per common share:		
Numerator:		
Net income for basic calculation	$ 18	$ 69
Net income for diluted calculation	$ 18	$ 69
Denominator:		
Weighted average common shares outstanding for basic calculation (a)	144.9	141.4
Weighted average common outstanding shares for diluted calculation	151.5	150.5
Net income per common share basic	$ 0.12	$ 0.49
Net income per common share diluted	$ 0.12	$ 0.46

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

The calculation of diluted net income per common share for each of the periods includes the effects of the assumed exercise of any outstanding stock options or warrants and the assumed vesting of shares of restricted

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Warner Music Group Corp.

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

stock where dilutive. The assumed exercise of outstanding stock options and warrants and the assumed vesting of restricted stock represent the following dilutive effect (in millions of shares):

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005
Stock options	2.5	2.6
Restricted stock	4.1	6.5
	6.6	9.1

5. Significant Acquisitions and Dispositions

Acquisition of Roadrunner Music Group

In December 2006, the Company entered into a definitive agreement to acquire 73.5% of Roadrunner, which includes Roadrunner Records, a leading hard rock and heavy metal label. The transaction will be accounted for under the purchase method of accounting, and the results of operations of Roadrunner will be included in the Company s results of operations from the date of acquisition. The purchase price will be allocated to the underlying net assets acquired in proportion to the estimated fair value, principally recorded music catalog, artist contracts and goodwill.

In connection with the agreement, in December 2006, the Company loaned Roadrunner approximately $52 million in the form of a promissory note, which bears interest at the prime rate and matures in one year. The note was repaid in connection with the close of the acquisition in January 2007.

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 preliminary allocation of the approximately $67.5 million purchase 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.

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

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.

6. Inventories

Inventories consist of the following (in millions):

	December 31, 2006	September 30, 2006
	(unaudited)	(audited)
Compact discs, cassettes and other music-related products	$ 109	$ 100
Published sheet music and song books	2	2
	111	102
Less reserve for obsolescence	(48)	(43)
	$ 63	$ 59

7. Intangible Assets

Intangible assets consist of the following (in millions):

	September 30, 2006	Acquisitions	Other (a)	December 31, 2006
	(audited)			(unaudited)
Intangible assets subject to amortization:				
Record music catalog	$ 1,288	$	$ 5	$ 1,293
Music publishing copyrights	852	1	11	864
Artist contracts	39			39
Trademarks	10			10
Other intangible assets	4			4

	2,193	1	16	2,210
Accumulated amortization	(482)			(531)
Total net intangible assets subject to amortization	1,711			1,679
Intangible assets not subject to amortization:				
Trademarks and brands	100			100
Total net other intangible assets	$ 1,811			$ 1,779

(a) Other represents foreign currency translation adjustments.

8. Restructuring Costs

Acquisition-Related Restructuring Costs

As of December 31, 2006, the Company had approximately $27 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

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Warner Music Group Corp.

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

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 2007.

	Employee Terminations	Other Exit Costs	Total
		(in millions)	
Liability as of September 30, 2006	**$ 4**	**$ 28**	**$ 32**
Cash paid during the three months ended December 31, 2006		(4)	(4)
Non-cash reductions during the three months ended December 31, 2006 (a)		(1)	(1)
Liability as of December 31, 2006	**$ 4**	**$ 23**	**$ 27**

(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.

9. Debt

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

	December 31, 2006	September 30, 2006
	(unaudited)	(audited)
Senior secured credit facility:		
Revolving credit facility	$	$
Term loan	1,409	1,413
	1,409	1,413
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	196	187
9.5% Senior Discount Notes due 2014 Holdings	196	191
Total debt	2,266	2,256
Less current portion	(17)	(17)
Total long-term debt	$ 2,249	$ 2,239

Restricted Net Assets

The Company is a holding company that conducts substantially all its business operations through its subsidiary, Acquisition Corp. and its subsidiaries. Accordingly, the ability of the Company to obtain funds from its subsidiaries is restricted by the senior secured credit facility of Acquisition Corp., the indenture for the 7.375% U.S. dollar-denominated Senior Subordinated Notes due 2014 and 8.125% Sterling-denominated Senior Subordinated Notes due 2014 (collectively the Acquisition Corp. Senior Subordinated Notes) and the indenture for the 9.5% Senior Discount Notes due 2014 issued by Holdings (Holdings Discount Notes).

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Warner Music Group Corp.

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

10. Stock-based Compensation

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

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005
Recorded Music	$ 1.8	$ 3.1
Music Publishing	0.3	0.6
Corporate expenses	1.0	1.9
Total	$ 3.1	$ 5.6

During the three months ended December 31, 2006, employees of the Company exercised 420,969 stock options and the Company received cash payments in respect of those exercises in the amount of approximately $2 million.

11. Shareholders   Equity

Return of Capital and Dividends Paid

On August 31, 2006, the Company declared a dividend on its outstanding common stock at a rate of $0.13 per share, or approximately $19 million in the aggregate, which was paid to the Company   s shareholders on October 20, 2006, 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.

On December 29, 2006, the Company declared a dividend on its outstanding common stock at a rate of $0.13 per share, or approximately $19 million in the aggregate. The dividend is payable on February 16, 2007 to the Company   s shareholders of record as of the close of business on January 18, 2007.

During the three months ended December 31, 2006, 315,229 shares of restricted stock purchased by or awarded to certain employees vested.

12. Commitments and Contingencies

Radio Promotion Activities

Two independent labels have 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, 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

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Warner Music Group Corp.

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

allowed plaintiffs to replead. The Company intends to defend against these lawsuits vigorously, but is unable to predict the outcome of these suits.

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 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 (15 U.S.C. Section 1). The Company has provided documents in response to these requests and intends to continue to fully cooperate with the Attorney General s and Department of Justice s industry-wide inquiries. Subsequent to the announcements of the above governmental investigations, a total of 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 lawsuits are all based on the same general subject matter as the Attorney General s request for information alleging conspiracy among record companies to fix prices for downloads and, according to some of the complaints, protect allegedly inflated prices for compact discs. The complaints 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 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.

13. Derivative Financial Instruments

During the three months ended December 31, 2006, the Company did not enter into additional interest rate swap agreements to hedge the variability of its expected future cash interest payments. However, the Company entered into additional foreign exchange contracts to hedge its foreign currency royalty payments for the first quarter of fiscal 2008. As of December 31, 2006, the Company had interest rate swap agreements to hedge a total notional debt amount of $897 million and recorded deferred gains in comprehensive income of $7 million. Additionally, as of December 31, 2006, the Company had less than $1 million of deferred net losses in comprehensive income related to foreign currency hedging.

14. 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.

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Warner Music Group Corp.

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

The Company evaluates performance based on several factors, of which the primary financial measure is operating income 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 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 December 31, 2006	Three Months