HMH Holdings (Delaware), Inc.

Consolidated Financial Statements
December 31, 2011, 2010 and 2009

HMH Holdings (Delaware), Inc.
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Report of Independent Auditors

To the Board of Directors and Stockholders of
HMH Holdings (Delaware), Inc.

In our opinion, the accompanying consolidated balance sheets as of December 31, 2011 and 2010 and the related consolidated statements of operations, of stockholders' equity (deficit) and comprehensive income (loss), and of cash flows for the year ended December 31, 2011 and for the period from March 10, 2010 to December 31, 2010 present fairly, in all material respects, the financial position of HMH Holdings (Delaware), Inc. and its subsidiaries (Successor) at December 31, 2011 and 2010, and the results of their operations and their cash flows for the year ended December 31, 2011 and for the period from March 10, 2010 to December 31, 2010 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We have not audited any financial statements of the Company for any period subsequent to December 31, 2011. However, as described in Note 15 to the consolidated financial statements, on May 10, 2012 the Company entered into a restructuring support agreement with participating borrowers to restructure the Company's debt pursuant to a joint prepackaged plan of reorganization under Chapter 11 of the U.S Bankruptcy Code. This raises substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 15. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty and have been prepared assuming that the Company will continue as a going concern.

PricewaterhouseCoopers LLP

March 30, 2012, except with respect to our opinion on the consolidated financial statements insofar as it relates to Note 15, as to which the date is May 10, 2012

PricewaterhouseCoopers LLP, 125 High Street, Boston, MA 02110
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Report of Independent Auditors

To the Board of Directors and Stockholders of
HMH Holdings (Delaware), Inc.

In our opinion, the accompanying consolidated statements of operations, of stockholders' equity (deficit) and comprehensive income (loss), and of cash flows for the period from January 1, 2010 to March 9, 2010 and for the year ended December 31, 2009 present fairly, in all material respects, the results of operations and cash flows of HMH Publishing Company and its subsidiaries (Predecessor) for the period from January 1, 2010 to March 9, 2010 and for the year ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

March 30, 2011

PricewaterhouseCoopers LLP, 125 High Street, Boston, MA 02110
T: (617) 530 5000, F: (617) 530 5001, www.pwc.com/us

HMH Holdings (Delaware), Inc.
Consolidated Balance Sheets

(in thousands of dollars, except share information)	December 31, 2011	December 31, 2010
Assets		
Current assets		
Cash and cash equivalents	$ 413,610	$ 380,073
Restricted cash	26,495	43,246
Short-term investments	-	17,667
Accounts receivable, net of allowance for bad debts and book returns of $43.8 million and $30.4 million, respectively	256,271	252,065
Inventories	242,162	281,987
Deferred income taxes	14,152	-
Prepaid expenses and other assets	13,811	17,347
Total current assets	966,501	992,385
Property, plant, and equipment, net	152,212	144,139
Pre-publication costs, net	289,125	373,442
Royalty advances to authors, net of allowance of $12.3 million and $3.7 million, respectively	42,700	44,414
Goodwill	520,088	1,956,071
Other intangible assets, net	1,274,213	1,734,810
Other assets and long-term receivables	19,064	11,894
Total assets	$ 3,263,903	$ 5,257,155
Liabilities and Stockholders' Equity (Deficit)		
Current liabilities		
Current portion of long-term debt	$ 43,500	$ 193,064
Accounts payable	130,128	98,615
Royalties payable	52,294	47,468
Salaries, wages, and commissions payable	43,515	52,990
Deferred revenue	141,763	112,045
Interest payable	30,843	12,830
Severance and other charges	35,750	31,180
Accrued postretirement benefits	2,252	2,450
Other liabilities	45,612	61,065
Total current liabilities	525,657	611,707
Long-term debt	2,968,088	2,668,530
Royalties payable	1,313	2,075
Long-term deferred revenue	208,173	126,896
Accrued pension benefits	64,490	59,973
Accrued postretirement benefits	33,718	34,096
Deferred income taxes	32,072	135,536
Other liabilities	104,944	100,514
Total liabilities	3,938,455	3,739,327
Commitments and contingencies (Note 13)		
Stockholders' equity (deficit)		
Common stock, $0.001 par value: authorized 600,000,000 shares; issued and outstanding 283,636,235 shares	284	284
Capital in excess of par value	2,038,714	2,030,155
Accumulated deficit	(2,690,097)	(507,727)
Accumulated other comprehensive income (loss)	(23,453)	(4,884)
Total stockholders' equity (deficit)	(674,552)	1,517,828
Total liabilities and stockholders' equity (deficit)	$ 3,263,903	$ 5,257,155

The accompanying notes are an integral part of these consolidated financial statements.

HMH Holdings (Delaware), Inc.
Consolidated Statements of Operations

(in thousands of dollars)	Successor		Predecessor	
	For the Year Ended December 31, 2011	For the Period March 10, 2010 to December 31, 2010	For the Period January 1, 2010 to March 9, 2010	For the Year Ended December 31, 2009
Net sales	$ 1,295,295	$ 1,397,142	$ 109,905	$ 1,562,415
Costs and expenses				
Cost of sales, excluding pre-publication and publishing rights amortization	512,612	559,593	45,270	586,159
Publishing rights amortization	230,624	235,977	48,336	334,022
Pre-publication amortization	176,829	181,521	37,923	242,045
Cost of sales	920,065	977,091	131,529	1,162,226
Selling and administrative	640,023	598,807	119,039	740,068
Other intangible asset amortization	67,372	57,601	2,006	28,857
Impairment charge for goodwill, intangible assets, pre-publication costs and fixed assets	1,674,164	103,933	4,028	953,587
Severance and other charges	32,801	(11,243)	-	75,882
Gain on sale of assets	(2,000)	(1,179)	-	(5,937)
	3,332,425	1,725,010	256,602	2,954,683
Operating income (loss)	(2,037,130)	(327,868)	(146,697)	(1,392,268)
Other income (expense)				
Interest expense	(244,582)	(258,174)	(157,947)	(860,042)
Other (loss) income, net	-	(6)	9	(631)
Change in fair value of derivative instruments	(811)	90,250	(7,361)	46,401
	(245,393)	(167,930)	(165,299)	(814,272)
Loss before taxes	(2,282,523)	(495,798)	(311,996)	(2,206,540)
Income tax expense (benefit)	(100,153)	11,929	(220)	(61,393)
Net income (loss)	$ (2,182,370)	$ (507,727)	$ (311,776)	$ (2,145,147)

The accompanying notes are an integral part of these consolidated financial statements.

HMH Holdings (Delaware), Inc.

Consolidated Statements of Cash Flows

(in thousands of dollars)	Successor		Predecessor	
	For the Year Ended December 31, 2011	For the Period March 10, 2010 to December 31, 2010	For the Period January 1, 2010 to March 9, 2010	For the Year Ended December 31, 2009
Cash flows from operating activities				
Net loss	$ (2,182,370)	$ (507,727)	$ (311,776)	$ (2,145,147)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities				
Noncash interest expense	-	-	20,737	344,524
Gain on sale of assets	(2,000)	(1,179)	-	(5,937)
Depreciation and amortization expense	532,996	523,651	99,260	680,622
Amortization of debt discount and deferred financing costs	46,249	37,040	13,680	71,295
Deferred income taxes (benefit)	(117,616)	11,708	(220)	(63,728)
Noncash stock-based compensation expense	8,559	4,274	925	7,970
Impairment charge for goodwill, intangible assets, pre-publication costs and fixed assets	1,674,164	103,933	4,028	953,587
Allowance for loan receivable from officer	-	18,875	-	-
Change in fair value of derivative instruments	811	(90,250)	7,361	(15,163)
Changes in operating assets and liabilities, net of acquisitions				
Accounts receivable	(2,356)	(27,996)	86,787	17,433
Inventories	39,825	98,329	(22,741)	90,867
Accounts payable and accrued expenses	18,488	(13,145)	(30,990)	(34,799)
Royalties, net	5,778	11,653	(9,867)	(3,571)
Deferred revenue	110,993	130,683	(9,539)	34,697
Interest payable	18,013	(49,328)	118,423	(38,770)
Severance and other charges	4,570	(30,977)	(4,257)	42,142
Accrued pension and postretirement benefits	(10,568)	(19,003)	1,297	(11,053)
Other, net	(12,740)	(17,575)	(4,404)	(132,354)
Net cash provided by (used in) operating activities	132,796	182,966	(41,296)	(207,385)
Cash flows from investing activities				
Proceeds from (deposits into) restricted cash accounts	16,751	(42,745)	-	-
Proceeds from sale of short-term investments	17,800	-	-	-
Purchases of short-term investments	-	(17,978)	-	-
Additions to pre-publication costs	(122,592)	(96,613)	(22,057)	(138,440)
Additions to property, plant, and equipment	(71,817)	(64,139)	(3,559)	(30,659)
Proceeds from sale of assets	150	2,177	-	14,000
Acquisition of intangible asset	(30,000)	-	-	-
Acquisition of business, net of cash acquired	(5,592)	(12,824)	-	-
Net cash (used in) provided by investing activities	(195,300)	(232,122)	(25,616)	(155,099)
Cash flows from financing activities				
(Payments) borrowings under receivables funding agreement	-	(140,000)	2,350	87,650
Proceeds from revolving credit facility	-	-	-	258,539
Payments of long-term debt	(43,500)	(43,640)	-	(32,625)
Payments of short-term debt	(150,000)	-	-	-
Proceeds from secured notes offering	300,000	-	-	-
Payments of deferred financing fees	(10,459)	-	-	-
Dividend to affiliate	-	-	(2,500)	-
Proceeds from issuance of common stock, net	-	649,600	-	-
Loan advances to officer	-	(20,000)	-	-
Payment of restructuring costs	-	(43,671)	-	-
Payment to parent, net	-	-	-	(10,486)
Net cash provided by (used in) financing activities	96,041	402,289	(150)	303,078
Net increase (decrease) in cash and cash equivalents	33,537	353,133	(67,062)	(59,406)
Cash and cash equivalents				
Beginning of period	380,073	26,940	94,002	153,408
Net increase (decrease) in cash and cash equivalents	33,537	353,133	(67,062)	(59,406)
End of period	$ 413,610	$ 380,073	$ 26,940	$ 94,002
Supplementary disclosure of cash flow information				
Income taxes (refunded) paid	$ 2,825	$ (2,210)	$ 855	$ 3,702
Interest paid	180,647	268,925	4,847	421,735
Deferred/contingent consideration for acquisitions, net	4,695	(15,626)	-	-
Restructuring (See Note 1)				

The accompanying notes are an integral part of these consolidated financial statements.

HMH Holdings (Delaware), Inc.
Consolidated Statements of Stockholders' Equity (Deficit) and Comprehensive Income (Loss)

Predecessor Company

(in thousands of dollars, except share information)	Common Stock Shares	Common Stock $0.001 Par Value Amount	Capital in excess of Par Value	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total
Balance at January 1, 2009	3,100	$ -	$ 1,748,460	$ (2,586,960)	$ (17,560)	$ (856,060)
Comprehensive income (loss)						
Net loss	-	-	-	(2,145,147)	-	(2,145,147)
Net change in pension liability	-	-	-	-	1,275	1,275
Cumulative translation adjustment	-	-	-	-	193	193
Total comprehensive income (loss)						(2,143,679)
Recapitalization of amounts due to Parent	-	-	379,368	-	-	379,368
Stock compensation	-	-	7,970	-	-	7,970
Effects of adoption of accounting standard on uncertainties in income taxes	-	-	-	(2,335)	-	(2,335)
Balance at December 31, 2009	3,100	-	2,135,798	(4,734,442)	(16,092)	(2,614,736)
Comprehensive income (loss)						
Net loss	-	-	-	(311,776)	-	(311,776)
Net change in pension liability	-	-	-	-	(1,313)	(1,313)
Cumulative translation adjustment	-	-	-	-	392	392
Total comprehensive income (loss)						(312,697)
Stock compensation	-	-	925	-	-	925
Dividend to affiliate	-	-	(2,500)	-	-	(2,500)
Recapitalization of amounts due from Parent	-	-	(1,154)	-	-	(1,154)
Balance at March 9, 2010	3,100	$ -	$ 2,133,069	$ (5,046,218)	$ (17,013)	$ (2,930,162)

Successor Company

(in thousands of dollars, except share information)	Common Stock Shares	Common Stock $0.001 Par Value Amount	Capital in excess of Par Value	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total
Balance at March 10, 2010	129,999,970	$ 130	$ 1,376,435	$ -	$ -	$ 1,376,565
Comprehensive income (loss)						
Net loss	-	-	-	(507,727)	-	(507,727)
Net change in pension liability	-	-	-	-	(6,533)	(6,533)
Cumulative translation adjustment	-	-	-	-	1,829	1,829
Unrealized loss on short-term investments	-	-	-	-	(180)	(180)
Total comprehensive income (loss)						(512,611)
Issuance of common stock, net	153,636,265	154	649,446	-	-	649,600
Stock compensation	-	-	4,274	-	-	4,274
Balance at December 31, 2010	283,636,235	284	2,030,155	(507,727)	(4,884)	1,517,828
Comprehensive income (loss)						
Net loss	-	-	-	(2,182,370)	-	(2,182,370)
Net change in pension liability	-	-	-	-	(14,509)	(14,509)
Cumulative translation adjustment	-	-	-	-	(4,241)	(4,241)
Unrealized gain on short-term investments	-	-	-	-	181	181
Total comprehensive income (loss)						(2,200,939)
Stock compensation	-	-	8,559	-	-	8,559
Balance at December 31, 2011	283,636,235	$ 284	$ 2,038,714	$ (2,690,097)	$ (23,453)	$ (674,552)

The accompanying notes are an integral part of these consolidated financial statements.

(in thousands of dollars, except share information)

1. Basis of Presentation

HMH Holdings (Delaware), Inc., ("HMH", "Houghton Mifflin Harcourt", "we", "us", "our", or the "Company"), is a leading global education and learning company providing innovative solutions and approaches to the challenges facing education today. We are the world's largest provider of educational products and solutions for pre-K–12 learning and we also develop and deliver interactive, results-driven learning solutions that advance teacher effectiveness and student achievement in the Education market. Furthermore, since 1832, we have published trade and reference materials including award-winning adult and children's books, fiction, and nonfiction.

The consolidated December 31, 2011 and 2010 financial statements of HMH include the accounts of all of our wholly-owned subsidiaries as of and for the periods ended December 31, 2011, December 31, 2010, March 9, 2010 and December 31, 2009. Prior to the Restructuring noted below, our operations were held by HMH Publishing Company ("HMH Publishing" or "Predecessor"), a wholly-owned subsidiary of Education Media and Publishing Group Limited ("EMPG" or "Former Parent") formed through the combination of Houghton Mifflin and Harcourt Education (both education learning companies) and Riverdeep Group Limited, a digital publishing business. Throughout the notes to the consolidated financial statements, both HMH and HMH Publishing are referred to collectively as the "Company".

The accompanying consolidated financial statements have been prepared in accordance with principles generally accepted in the United States of America ("GAAP"). All intercompany accounts and transactions have been eliminated.

March 2010 Restructuring

As a result of lower than expected operating results beginning in the latter half of 2008 and continuing through 2009, primarily due to a downturn in the economy and state budget deficits adversely affecting many of our customers, we failed several of our debt covenants and faced liquidity constraints. Waivers were obtained from our first lien lenders and mezzanine lenders for the covenant violations through March 9, 2010.

On March 9, 2010, the Company and its first lien and mezzanine lenders and its shareholders consummated a restructuring of the Company (the "Restructuring"). As part of the Restructuring, a new legal entity was formed, HMH Holdings (Delaware), Inc., to hold all of the assets of the operating companies. On March 9, 2010, the then-existing senior secured lenders in the first lien credit facility received 90% (pre-dilution from the rights offering noted below) of the equity in HMH, in exchange for converting $1,983.7 million of their senior secured position in the first lien credit agreement to equity in HMH. The then-existing mezzanine lenders received 10% of the equity of HMH (pre-dilution from the rights offering) and 40,519,431 warrants at a strike price of $12.26, in exchange for converting all of their $2,124.8 million subordinated secured position in the mezzanine credit agreement to equity. The former shareholder, EMPG, cancelled its equity ownership in the Company in exchange for 18,956,473 warrants with a strike price of $22.32. Upon conclusion of the Restructuring, EMPG no longer had an ownership interest in us.

Additionally, on March 9, 2010, HMH raised $650.0 million of new equity capital through a rights offering from the then-existing senior secured and mezzanine lenders who agreed to convert a portion of their first lien and mezzanine positions to equity. The proceeds were used to pay transaction fees, accrued interest and fund working capital needs.

(in thousands of dollars, except share information)

As a result of this change in control, we applied the acquisition method of accounting, as required by authoritative literature. Accordingly, the consolidated financial statements prior to the closing of the Restructuring reflect the historical accounting basis in the assets and liabilities and are labeled Predecessor Company, while such records subsequent to the Restructuring are labeled Successor Company and reflect the fair values determined as part of applying the acquisition method. This is presented in the consolidated financial statements by a vertical black line division which appears between the columns labeled Predecessor and Successor in the financial statements and the relevant notes. The black line signifies that the periods prior to the Restructuring are not comparable.

A valuation was performed to determine the acquisition price using the Income Approach employing a Discounted Cash Flow ("DCF") methodology. The DCF method explicitly recognizes that the value of a business enterprise is equal to the present value of the cash flows that are expected to be available for distribution to the equity and/or debt holders of a company. In the valuation of a business enterprise, indications of value are developed by discounting future net cash flows available for distribution to their present worth at a rate that reflects both the current return requirements of the market and the risk inherent in the specific investment.

We used a multi-year DCF model to derive a Total Invested Capital value which was adjusted for cash, non-operating assets, debt and any negative net working capital to calculate a Business Enterprise Value of approximately $5.0 billion which was then used to value our equity. In connection with the Income Approach portion of this exercise, we made the following assumptions: (1) the discount rate was based on an average of a range of scenarios with rates between 8.6% and 11.4%; (2) management's estimates of future performance of our operations; and (3) a terminal growth rate of 3.5%. The discount rate and market growth rate reflect the risks associated with the general economic pressure impacting both the economy in general and more specifically the publishing industry. Costs and professional fees incurred as part of the refinancing totaled $43.7 million and were recorded in other assets and long-term receivables in the Predecessor Company and were treated as a reduction to the equity value in the Successor Company.

(in thousands of dollars, except share information)

We finalized the valuation and completed the allocation of the business enterprise value. The allocation of the business enterprise value at March 10, 2010 was as follows:

Cash and cash equivalents	$ 22,995
Accounts receivable	222,213
Inventories	380,243
Note receivable - related party	73
Prepaid expenses and other assets	12,191
Property, plant, and equipment	128,282
Pre-publication costs	463,459
Royalty advances to authors	44,415
Goodwill	1,935,965
Other intangible assets	2,108,538
Other assets and long-term receivables	9,123
Accounts payable	(105,688)
Royalties payable	(34,621)
Salaries, wages, and commissions payable	(46,872)
Deferred revenue	(107,609)
Interest payable	(30,517)
Interest rate swap liability	(121,891)
Severance and other charges	(62,157)
Accrued postretirement benefits	(2,443)
Other liabilities	(124,761)
Debt	(3,009,212)
Royalties payable	(3,243)
Accrued pension benefits	(80,026)
Accrued postretirement benefits	(31,526)
Deferred income taxes	(153,003)
Other liabilities	(37,363)
Total net assets acquired	$ 1,376,565

Liquidity

Our liquidity and our ability to service our debt, as well as fund future acquisitions, other purchase commitments, operating leases, working capital and capital expenditure requirements, is dependent on our future financial performance, which is subject to general economic, financial and other factors certain of which are beyond our control. We expect our cash flows from operations, combined with our cash on hand and availability under our accounts receivable securitization facility, to provide sufficient liquidity to fund our current obligations, debt service requirements, projected working capital requirements, debt principal repayments, and capital spending over the next twelve months; however, there can be no assurance that our business will generate sufficient cash flow from operations, that anticipated net sales will be realized or that future borrowings will be available under our accounts receivable securitization facility, or any other facility, in an amount sufficient to enable us to service our indebtedness or to fund our other liquidity needs beyond such period. We anticipate that to the extent additional liquidity is necessary to fund our operations, it would be funded through an expansion of our accounts receivable securitization facility, the incurrence of other indebtedness, additional equity financings or a combination of these potential sources of liquidity, however, there can be no assurance that we will be able to raise additional debt or equity or whether such debt or equity could be obtained on commercially reasonable terms.

(in thousands of dollars, except share information)

All previous debt covenants were amended under the Restructuring described above and were further amended in December 2011 to provide for additional covenant expansion. We are in compliance with our amended debt covenant as of December 31, 2011. The economic downturn has resulted in a contraction of spending in the education market for 2011 materially beyond what we had forecasted and it appears that this will continue through 2012. As a direct result of the lower sales generated in 2011 and expected for 2012, we have enacted cost saving initiatives to help align our cost structure with anticipated revenues. With the financial covenant expansion and cost reductions, we expect to be in compliance with our financial covenant over the next twelve months. If we were to not comply with any of our financial covenants, we would expect to pursue an amendment of or waiver under our credit facilities, however, there can be no assurance that we would be able to obtain such amendment or waiver and thus have sufficient liquidity. The failure to comply with our financial covenants and to obtain a waiver or amendment of such covenants would cause an event of default under the senior secured credit facilities and the accounts receivable securitization facility which would allow the lenders to terminate their commitments under the credit facilities, and also, subject to certain cure periods, allow the lenders to accelerate the repayment of amounts outstanding under the credit facilities. Also, if the lenders were to accelerate indebtedness under the credit facilities, and such indebtedness were not discharged within a specific period of time, it would be the basis for an event of default under our Senior Notes, which would allow the holders of the Senior Notes to accelerate the maturity of the Senior Notes.

As of December 31, 2011, we had approximately $2.8 billion (face value) outstanding under our senior secured credit facility and $300.0 million outstanding under our Senior Notes. $235.8 million of the amount outstanding under the senior secured credit facility is due in December 2013 and $2.6 billion is due in June 2014. The $300.0 million outstanding under the Senior Notes is due in June 2019. We do not currently have sufficient funds to repay the debt upon maturity or an acceleration of maturity and we would need to raise additional funds to do so. We cannot assure you that any necessary additional financing would be available to us on commercially reasonable terms, or at all. If adequate funds were not available and we were unable to repay the amounts due and payable under our senior secured credit facilities, the lenders could proceed against the collateral granted to them to secure that indebtedness. Further, in the event we cannot repay such indebtedness, we may not be able to sustain our future operations and may be required to delay, reduce and/or cease our operations. Also, if lenders were to terminate their commitment under our accounts receivable securitization facility, our inability to draw on the facility would affect our working capital, would impact our ability to make capital improvements and may also impact our ability to acquire inventory and products because vendors may be unwilling to extend credit to us. Borrowings under the accounts receivable securitization facility are subject to meeting certain requirements and borrowing base availability. As of December 31, 2011, we have borrowing capacity of $250.0 million, of which $110.6 million is available to us. We also had approximately $26.2 million of outstanding letters of credit under our $50.0 million standby letter of credit facility, all of which were cash collateralized. We are currently assessing strategic alternatives to restructure our debt obligations. In the event we are unable to complete a consensual restructuring with our lenders, we may consider other actions, including the restructuring of the debt through an in-court process.

Subsequent Events

The Company has performed an evaluation of subsequent events through March 30, 2012, which is the date the financial statements were issued.

(in thousands of dollars, except share information)

2. Significant Accounting Policies

Principles of Consolidation

Our accompanying consolidated financial statements include the results of operations of the Company and our wholly-owned subsidiaries. All material intercompany accounts and transactions are eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires the use of estimates, assumptions and judgments by management that affect the reported amounts of assets, liabilities, revenues, expenses, and related disclosure of contingent assets and liabilities in the amounts reported in the financial statements and accompanying notes. On an ongoing basis, we evaluate our estimates andassumptions including, but not limited to, book returns, allowance for bad debts, recoverability of advances to authors, valuation of inventory, depreciation and amortization periods, recoverability of long-term assets such as property, plant, and equipment, capitalized pre-publication costs, other identified intangibles, goodwill, deferred revenue, income taxes, pensions and other postretirement benefits, contingencies, and litigation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from those estimates.

Revenue Recognition

We derive revenue primarily from the sale of print and digital textbooks and instructional materials, trade books, reference materials, multimedia instructional programs, license fees for book rights, content, software and services that include test development, test scoring, consulting and training. Revenue from print and digital textbooks and instructional materials, trade books, reference materials, assessment materials and multimedia instructional programs is recognized in the period when persuasive evidence of an arrangement with the customer exists, the products are shipped, title and risk of loss have transferred to the customer, all significant obligations have been performed and collection is reasonably assured.

We enter into certain contractual arrangements that have multiple elements, one or more of which may be delivered subsequent to the initial sale. These multiple deliverable arrangements may include print and digital media, professional development, training services, software, software as a service (SaaS), and various services related to the software including but not limited to hosting, maintenance and support, and implementation. At the inception of these arrangements, consideration is allocated using the Relative Sales Value (RSV) method. For each element, we determine whether the element falls under the accounting guidance within multiple element arrangements or software revenue recognition. For elements which fall under the accounting guidance for multiple element arrangements, we apply the highest applicable relative selling price guidance available, Vendor Specific Objective Evidence (VSOE), Third Party Evidence (TPE), or Best Estimate of Selling Price (BESP). For elements which fall under the accounting guidance for software revenue recognition, we apply VSOE and the residual method. If we are not able to establish VSOE, we estimate relative selling price based on TPE or BESP for purposes of allocation of total project discount, and defer until all such elements are fulfilled assuming all other revenue recognition criteria have been met. For multiple deliverable arrangements, fair value is determined for all elements and the relative sales value of revenue for items to be delivered after the initial sale is deferred until such time as the items are delivered. A significant component of revenue that is deferred relates to gratis items delivered in connection with sales to customers within adoption states. As our business model shifts to more digital and on-line learning components, additional revenue could be deferred. As products are shipped with right of return, a

(in thousands of dollars, except share information)

provision for estimated returns on these sales is made at the time of sale based on historical experience.

License fees for software products without future obligations are recognized upon delivery. Certain contracts include software and on-going fees for maintenance and other support. If vendor-specific objective evidence of the fair value of each element of the arrangement exists, the elements of the contract are unbundled and the revenue is recognized for each element when or as delivered. Revenue for test delivery, test scoring and training are recognized when the services have been completed, the fee is fixed or determinable and collection is reasonably assured. Revenue for test development is recognized as the services are provided. Differences between what has been billed and what has been recognized as revenue is recorded as deferred revenue. We enter into agreements to license certain book publishing rights and content. We recognize revenue on such arrangements when all materials have been delivered to the customer and collection is reasonably assured.

Advertising Costs and Sample Expenses
Advertising costs are charged to selling and administrative expenses as incurred. For the year ended December 31, 2011, advertising costs were $7.4 million. For the period January 1, 2010 to March 9, 2010, advertising costs were $1.1 million and for the period March 10, 2010 to December 31, 2010 advertising costs were $5.1 million. For the year ended December 31, 2009, advertising costs were $7.2 million. Sample expenses are charged to selling and administrative expenses when the samples are shipped.

Cash and Cash Equivalents
Cash and cash equivalents consist primarily of cash in banks and highly liquid investment securities that have maturities of three months or less when purchased. The carrying amount of cash equivalents approximates fair value because of the short term maturity of these investments.

Restricted Cash
Restricted cash consists primarily of cash collateral for irrevocable standby letters of credit in connection with property that we currently lease and performance and surety bonds.

Accounts Receivable
Accounts receivable are recorded net of allowances for doubtful accounts and reserves for book returns. In the normal course of business, we extend credit to customers that satisfy predefined criteria. We estimate the collectability of our receivables. Allowances for doubtful accounts are established through the evaluation of accounts receivable aging and prior collection experience to estimate the ultimate collectability of these receivables. Reserves for book returns are based on historical return rates and sales patterns.

Inventories
Inventories are stated at the lower of weighted average cost or net realizable value. The level of obsolete and excess inventory is estimated on a program or title level-basis by comparing the number of units in stock with the expected future demand. The expected future demand of a program or title is determined by the copyright year, the previous years' sales history, the subsequent year's sales forecast, known forward-looking trends including our development cycle to replace the title or program and competing titles or programs.

Property, Plant, and Equipment
Property, plant, and equipment are stated at cost, or in the case of assets acquired in business combinations, at fair value as of the acquisition date, less accumulated depreciation. Equipment

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under capital lease is stated at fair value at inception of the lease, less accumulated depreciation. Maintenance and repair costs are charged to expense as incurred, and renewals and improvements that extend the useful life of the assets are capitalized.

Depreciation on property, plant, and equipment is calculated using the straight-line method over the estimated useful lives of the assets or, in the case of assets acquired in business combinations, over their remaining lives. Equipment held under capital leases and leasehold improvements are amortized using the straight-line method over the shorter of the lease term or estimated useful life of the asset. Estimated useful lives of property, plant, and equipment are as follows:

Capitalized Internal-Use and External-Use Software
Capitalized internal-use and external-use software is included in property, plant and equipment on the consolidated balance sheets.

We capitalize certain costs related to obtaining or developing computer software for internal use. Costs incurred during the application development stage, including external direct costs of materials and services, and payroll and payroll related costs for employees who are directly associated with the internal-use software project, are capitalized and amortized on a straight-line basis over the expected useful life of the related software. The application development stage includes design, software configuration and integration, coding, hardware installation and testing. Costs incurred during the preliminary stage, as well as maintenance, training and upgrades that do not result in additional functionality are expensed as incurred.

Certain computer software development costs for software that is to be sold or marketed are capitalized in the consolidated balance sheets. Capitalization of computer software development costs begins upon the establishment of technological feasibility. We define the establishment of technological feasibility as a working model. Amortization of capitalized computer software development costs is provided on a product-by-product basis using the straight-line method, beginning upon commercial release of the product, and continuing over the remaining estimated economic life of the product. The carrying amounts of computer software development costs are periodically compared to net realizable value and impairment charges are recorded, as appropriate, when amounts expected to be realized are lower.

We review internal and external software development costs for impairment. For the year ended December 31, 2011 and for the period January 1, 2010 to March 9, 2010, software development costs of $5.6 million and $4.0 million, respectively, were deemed impaired and included as a charge to the statement of operations in the impairment charge for pre-publication costs and fixed assets caption. There were no software development cost impairments for the period March 10, 2010 to September 30, 2010 and for the year ended December 31, 2009.

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Pre-publication costs
We capitalize the art, prepress, manuscript and other costs incurred in the creation of the master copy of a book or other media (the "pre-publication costs"). Pre-publication costs are primarily amortized from the year of copyright, or sale if earlier, over five years using the sum-of-the years-digits method. This policy is used throughout the Company, except for the Trade and Reference division's consumer trade books, which expenses such costs as incurred, and the assessment products, which uses the straight-line amortization method. The amortization methods and periods chosen best reflect the pattern of expected sales generated from individual titles or programs. We periodically evaluate the remaining lives and recoverability of capitalized pre-publication costs, which are often dependent upon program acceptance by state adoption authorities.

Amortization expense related to pre-publication costs was $176.8 million for the year ended December 31, 2011. For the period January 1, 2010 to March 9, 2010 amortization expense related to pre-publication costs was $37.9 million and for the period March 10, 2010 to December 31, 2010 amortization expense related to pre-publication costs was $181.5 million. For the year ended December 31, 2009, amortization expense related to pre-publication costs was $242.0 million.

Pre-publication costs recorded on the balance sheet are periodically reviewed for impairment by comparing the unamortized capitalized costs of the assets to the net realizable value of those assets. The net realizable value approximates the fair value of the assets. For the year ended December 31, 2011, the period January 1, 2010 to March 9, 2010, and the period March 10, 2010 to December 31, 2010, pre-publication costs of $33.5 million, zero and $16.9 million, respectively, were deemed to be impaired. For the year ended December 31, 2009, pre-publication costs of $20.3 million were deemed to be impaired. The impairment was included as a charge to the statement of operations in the impairment charge for goodwill, intangible assets, pre-publication costs and fixed assets caption by comparing the unamortized capital costs of the assets to the net realizable value of those assets.

Goodwill and indefinite-lived intangible assets
Goodwill is the excess of the purchase price paid over the fair value of the net assets of the business acquired. Other intangible assets principally consist of branded trademarks and trade names, acquired publishing rights and customer relationships. Goodwill and indefinite-lived intangible assets (certain trade names) are not amortized but are reviewed at least annually for impairment or earlier, if an indication of impairment exists. Recoverability of goodwill and indefinite lived intangibles is evaluated using a two-step process. In the first step, the fair value of a reporting unit is compared to its carrying value. If the fair value of a reporting unit exceeds the carrying value of the net assets assigned to a reporting unit, goodwill is considered not impaired and no further testing is required. If the carrying value of the net assets assigned to a reporting unit exceeds the fair value of a reporting unit, the second step of the impairment test is performed in order to determine the implied fair value of a reporting unit's goodwill. Determining the implied fair value of goodwill requires valuation of a reporting unit's tangible and intangible assets and liabilities in a manner similar to the allocation of purchase price in a business combination. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, goodwill is deemed impaired and is written down to the extent of the difference. We estimate total fair value of each reporting unit using discounted cash flow analysis, and make assumptions regarding future revenue, gross margins, working capital levels, investments in new products, capital spending, tax, cash flows and the terminal value of the reporting unit. With regard to other intangibles with indefinite lives, we determine the fair value by asset, which is then compared to its carrying value to determine if the assets are impaired.

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Goodwill is allocated entirely to our Education reporting unit. Determining the fair value of a reporting unit is judgmental in nature, and involves the use of significant estimates and assumptions. These estimates and assumptions may include revenue growth rates sand operating margins used to calculate projected future cash flows, risk-adjusted discount rates, future economic and market conditions, the determination of appropriate market comparables as well as the fair value of individual assets and liabilities. Consistent with prior years, we used an income approach to establish the fair value of the reporting unit as of October 1, 2011. As in prior years, we used the most recent five year strategic plan as the initial basis of our analysis. We also assessed the fair values of the assets and liabilities attributed to our education business. Under this approach, the fair value of each asset and liability were determined based on the methodology we believe is most appropriate for each. Significant estimates and judgments were involved in this assessment. Those estimates and judgments include the use of valuation methods for determining the fair value of the intangible assets and the applicable assumptions utilized to arrive at the market values of the fixed assets and the realizability of other assets within the Education business.

We completed our annual goodwill and indefinite-lived intangible asset impairment tests as of October 1, 2011, 2010 and 2009 and recorded a noncash impairment charge of $1,635.1 million for the year ended December 31, 2011 and $87.0 million for the period March 10, 2010 to December 31, 2010. There was no impairment for the period January 1, 2010 to March 9, 2010. For the year ended December 31, 2009, impairment charges were $933.3 million. The impairments principally related to goodwill and tradenames within the Education business in 2011, and related to tradenames within the Education business and Trade Division in 2010, and principally related to tradenames and goodwill within the Education business in 2009. The impairment charges resulted primarily from a decline in revenue from previously projected amounts as a result of the economic downturn and reduced educational spending by states and school districts. All impairment charges are included in operating income.

Publishing Rights

A publishing right allows us to publish and republish existing and future works as well as create new works based on previously published materials. We determine the fair market value of the publishing rights arising from business combinations by discounting the after-tax cash flows projected to be derived from the publishing rights and titles to their net present value using a rate of return that accounts for the time value of money and the appropriate degree of risk. The useful life of the publishing rights is based on the lives of the various copyrights involved. We calculate amortization using the percentage of the projected operating income before taxes derived from the titles in the current year as a percentage of the total estimated operating income before taxes over the remaining useful life. Acquired publication rights, as well as customer-related intangibles with definitive lives, are primarily amortized on an accelerated basis over periods ranging from three to 20 years.

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Impairment of other long-lived assets

We review our other long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. If the future undiscounted cash flows are less than their book value, impairment exists. The impairment is measured as the difference between the book value and the fair value of the underlying asset. Fair value is normally determined using a discounted cash flow model.

Severance

We accrue postemployment benefits if the obligation is attributable to services already rendered, rights to those benefits accumulate, payment of benefits is probable, and amount of benefit is reasonably estimated. Postemployment benefits include severance benefits.

Subsequent to recording such accrued severance liabilities, changes in market or other conditions may result in changes to assumptions upon which the original liabilities were recorded that could result in an adjustment to the liabilities.

Royalty advances

Royalty advances to authors are capitalized and represent amounts paid in advance of the sale of an author's product and are recovered as earned. As advances are recorded, a partial reserve may be recorded immediately based primarily upon historical sales experience. Advances are evaluated periodically to determine if they are expected to be recovered. Any portion of a royalty advance that is not expected to be recovered is fully reserved.

Income taxes

We record income taxes using the asset and liability method. Deferred income tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective income tax basis, and operating loss and tax credit carryforwards. Our consolidated financial statements contain certain deferred tax assets which have arisen primarily as a result of operating losses, as well as other temporary differences between financial and tax accounting. We establish a valuation allowance if the likelihood of realization of the deferred tax assets is reduced based on an evaluation of objective verifiable evidence. Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against those net deferred tax assets. We evaluate the weight of all available evidence to determine whether it is more likely than not that some portion or all of the net deferred income tax assets will not be realized.

We also evaluate any uncertain tax positions and only recognize the tax benefit from an uncertain tax position if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such positions are then measured based on the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement. We record a liability for unrecognized tax benefits resulting from uncertain tax positions taken or expected to be taken in a tax return. Any change in judgment related to the expected ultimate resolution of uncertain tax positions is recognized in earnings in the period in which such change occurs. Interest and penalties, if any, related to unrecognized tax benefits are recorded in income tax expense.

Share-Based Compensation

Certain employees and or directors have been granted stock options and restricted stock awards in both the predecessor and successor companys' common stock. Stock based compensation

expense reflects the fair value of stock-based awards measured at the grant date and recognized over the relevant service period. We estimate the fair value of each stock-based award on the measurement date using either the current market price or the Black-Scholes option valuation model. The Black-Scholes option valuation model incorporates assumptions as to stock volatility, the expected life of the options, risk-free interest rate and dividend yield for time-vested stock options and restricted stock. We recognize compensation cost on a straight-line basis over the awards' vesting periods.

Comprehensive Income (Loss)
Comprehensive income (loss) is defined as changes in the equity of an enterprise except those resulting from stockholder transactions. The amounts shown on the consolidated statements of stockholders' equity (deficit) and comprehensive income (loss) relate to the cumulative effect of minimum pension liabilities and translation gain and loss adjustments.

Foreign Currency Translation
The functional currency for each of our subsidiaries is the currency of the primary economic environment in which the subsidiary operates, generally defined as the currency in which the entity generates and expends cash. Foreign currency denominated assets and liabilities are translated into United States dollars at current rates as of the balance sheet date and the revenue, costs and expenses are translated at the average rates established during each reporting period. Cumulative translation gains or losses are recorded in equity as an element of accumulated other comprehensive income.

Financial instruments
Derivative financial instruments are employed to manage risks associated with interest rate exposures and are not used for trading or speculative purposes. We recognize all derivative instruments, such as interest rate swap agreements, in our consolidated balance sheets at fair value. Changes in the fair value of derivatives are recognized periodically either in earnings or in stockholders' equity (deficit) as a component of other comprehensive income (loss), depending on whether the derivative financial instrument qualifies for hedge accounting and, if so, whether it qualifies as a fair value hedge or a cash flow hedge. Gains and losses on derivatives designated as hedges, to the extent they are effective, are recorded in other comprehensive income, and subsequently reclassified to earnings to offset the impact of the hedged items when they occur. Changes in the fair value of derivatives not qualifying as hedges are reported in earnings. Our interest rate swap agreements that existed during 2010 and terminated upon expiration did not qualify for hedge accounting because we did not contemporaneously document our hedging strategy upon entering into the hedging arrangements. The net interest paid or received on interest rate swaps is recognized within net interest expense in the consolidated statement of operations. There were no derivative instruments that qualified for hedge accounting during 2011.

Reclassifications
Certain 2011 amounts have been reclassified to conform to the 2010 presentation.

Recent Accounting Pronouncements
Recent accounting pronouncements, not included below, are not expected to have a material impact on our consolidated financial position and results of operations.

On January 1, 2011, we adopted guidance issued by the Financial Accounting Standards Board ("FASB") on revenue recognition. Under the new guidance, when vendor specific objective evidence or third party evidence of the selling price for a deliverable in a multiple element

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arrangement cannot be determined, a best estimate of the selling price is required to allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing of when revenue is recognized. Adoption of the new guidance did not have a material impact to our financial position, results of operations or cash flows

In May 2011, the FASB issued new guidance for fair value measurements intended to achieve common fair value measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards. The amended guidance provides a consistent definition of fair value to ensure that the fair value measurement and disclosure requirements are similar between U.S. GAAP and International Financial Reporting Standards. The amended guidance changes certain fair value measurement principles and enhances the disclosure requirements, particularly for Level 3 fair value measurements. The amended guidance will be effective for us beginning January 1, 2012. We do not anticipate that these changes will have a significant impact on our financial position, results of operations or cash flows. We have elected not to early adopt this new guidance and we do not anticipate that these changes will have a material impact on our financial statements.

In June 2011, the FASB issued guidance that modified how comprehensive income is presented in an entity's financial statements. The guidance issued requires an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements and eliminates the option to present the components of other comprehensive income as part of the statement of equity. The revised financial statement presentation for comprehensive income will be effective for us beginning January 1, 2012, with early adoption permitted.

In September 2011, the FASB issued new guidance to simplify how entities test goodwill for impairment. The amended guidance permits an entity to first assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount. If this is the case, companies will need to perform a more detailed two-step goodwill impairment test which is used to identify potential goodwill impairments and to measure the amount of goodwill impairment losses to be recognized, if any. The amended guidance will be effective for us beginning January 1, 2012. We believe the adoption of this update will not have a material impact on our financial statements.

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3. Acquisitions

During the period March 10, 2010 to December 31, 2010, we completed the acquisitions of two companies (the "Acquired Companies") for a total purchase price of approximately $28.3 million, which is net of cash acquired. The purchase price consisted of approximately $12.9 million of cash at closing, installment payments due over 5 years with a net present value of approximately $4.1 million, and approximately $11.6 million of accrued contingent consideration. The Acquired Companies provided us with a suite of educational technology software for students along with consulting services to school districts throughout the United States.

During 2011, we reduced the accrued contingent consideration in total for the Acquired Companies by $5.6 million, as we have not been able to achieve certain growth targets and the projections for future growth are lower than originally anticipated. In accordance with the accounting guidance relating to the subsequent remeasurement of contingent consideration, the amount was recorded as a decrease to the selling and administrative expenses caption in our statement of operations for the year ended December 31, 2011.

During the year ended December 31, 2011, we completed two acquisitions for a total purchase price of approximately $6.5 million, which is net of cash acquired. The purchase price consisted of approximately $5.6 million of cash at closing and $0.9 million of accrued contingent consideration. The acquisitions provide us with English as a second language course material for the international markets.

The aforementioned transactions were accounted for under the acquisition method of accounting. We allocated the purchase price to each company's assets and liabilities assumed at estimated fair values as of the acquisition dates. The excess of the purchase price over the net amounts assigned to the fair value of the assets acquired and liabilities assumed was recorded as goodwill. Goodwill and intangible assets recorded as part of the acquisitions totaled approximately $6.5 million and $0 in 2011 and $20.1 million and $6.9 million in 2010, respectively. The financial results of each company acquired were included within our financial statements from their respective dates of acquisition. These acquisitions were not considered to be material for purposes of additional disclosure.

(in thousands of dollars, except share information)

4. Balance Sheet Information

Inventories

Inventories at December 31, 2011 and 2010 consisted of the following:

	2011	2010
Finished goods	$ 236,350	$ 277,192
Raw materials	5,812	4,795
Inventory	$ 242,162	$ 281,987

Property, Plant, and Equipment

Balances of major classes of assets and accumulated depreciation and amortization at December 31, 2011 and 2010 were as follows:

	2011	2010
Land and land improvements	$ 6,629	$ 6,629
Building and building equipment	16,322	15,708
Machinery and equipment	37,452	30,501
Capitalized software	176,276	126,363
Leasehold improvements	22,131	13,495
	258,810	192,696
Less: Accumulated depreciation and amortization	(106,598)	(48,557)
Property, plant, and equipment, net	$ 152,212	$ 144,139

For the year ended December 31, 2011, depreciation and amortization expense were $58.0 million. Depreciation and amortization expense for the period January 1, 2010 to March 9, 2010 was $10.9 million and for the period March 10, 2010 to December 31, 2010 was $48.6 million. For the year ended December 31, 2009, depreciation and amortization expense were $75.7 million.

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5. Goodwill and Other Intangible Assets

Goodwill and other intangible assets consisted of the following:

	December 31, 2011		December 31, 2010	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Goodwill	$ 520,088	$ -	$ 1,956,071	$ -
Trademarks and tradenames	440,805	-	601,805	-
Publishing rights	1,180,000	(466,601)	1,180,000	(235,977)
Customer related and other	245,470	(125,461)	247,071	(58,089)
	$ 2,386,363	$ (592,062)	$ 3,984,947	$ (294,066)

The changes in the carrying amount of goodwill for the years ended December 31, 2011 and 2010 are as follows:

	Predecessor Company
Balance at December 31, 2009	
Goodwill	$ 3,253,384
Accumulated impairment losses	(895,800)
	2,357,584
Acquisitions	-
Impairment losses	-
Balance at March 9, 2010	2,357,584
Goodwill	3,253,384
Accumulated impairment losses	(895,800)
Balance at March 9, 2010	$ 2,357,584

	Successor Company
Balance at March 10, 2010	
Goodwill	$ 1,935,965
Accumulated impairment losses	-
	1,935,965
Acquisitions	20,106
Impairment losses	-
Balance at December 31, 2010	1,956,071
Goodwill	1,956,071
Accumulated impairment losses	-
Balance at December 31, 2010	1,956,071
Acquisitions	6,517
Impairment losses	(1,442,500)
Balance at December 31, 2011	520,088
Goodwill	1,962,588
Accumulated impairment losses	(1,442,500)
Balance at December 31, 2011	$ 520,088

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We had goodwill of $520.1 million and $1,956.1 million at December 31, 2011 and 2010, respectively. The adjustments to goodwill relate to our acquisitions described in Note 3 of approximately $6.5 million and $20.1 million for the years ended December 31, 2011 and 2010, respectively. The decrease in goodwill of $1,442.5 million for the year ended December 31, 2011 was due to goodwill impairment charges. There was no goodwill impairment charge for the period January 1, 2010 to March 9, 2010, or for the period March 10, 2010 to December 31, 2010.

In accordance with the provisions of the accounting standard for goodwill and other intangible assets, goodwill and certain indefinite-lived tradenames are not amortized. We recorded an impairment charge of approximately $192.6 million, $87.0 million and $291.0 million for certain of our intangible assets at October 1, 2011, 2010 and 2009, respectively. Amortization expense for publishing rights and customer related and other intangibles were $298.0 million for the year ended December 31, 2011, $50.3 million for the period January 1, 2010 to March 9, 2010, $293.6 million for the period March 10, 2010 to December 31, 2010, and $362.9 million for the year ended December 31, 2009.

On October 5, 2011, we entered into an agreement with EMPG International Limited (“EMPGI”), a former related party, to terminate the 2008 license agreement between us and EMPGI. The license agreement had provided EMPGI the rights to translate and prepare localized versions of substantially all of our products, as well as change or create derivative versions and redistribute such products in territories outside of our current presence. As a result of entering into the agreement, certain international intellectual property rights were obtained for consideration of a one-time payment of $30.0 million. This amount has been capitalized within other intangible assets and is being amortized over a 20 year life.

Estimated aggregate amortization expense expected for each of the next five years related to intangibles subject to amortization is as follows:

	Publishing Rights	Other Intangible Assets
2012	$ 177,747	$ 52,243
2013	139,588	16,978
2014	105,624	8,255
2015	81,007	7,434
2016	61,350	5,873
Thereafter	148,083	29,226

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6. Long-Term Debt and Receivables Funding Agreement

As described in Note 1, we completed our Restructuring on March 9, 2010 converting $1,983.7 million of our Term Loan and the entire balance of our Mezzanine Loan to equity.

Long-term debt at December 31, 2011 and 2010 consisted of the following:

	2011	2010
$150,000 7.2% Secured Notes due March 15, 2011, interest payable semiannually	$ -	$ 149,564
$2,668,690 Term Loan due June 12, 2014	2,475,837	2,476,279
$235,751 Revolving Loan due December 12, 2013	235,751	235,751
$300,000 10.5% Secured Notes due June 1, 2019, interest payable semiannually	300,000	-
	3,011,588	2,861,594
Less: Current portion of long-term debt	43,500	193,064
Total long-term debt, net of discount	$ 2,968,088	$ 2,668,530

Long-term debt repayments due (at face value) in each of the next five years and thereafter is as follows:

Year	
2012	$ 43,500
2013	279,251
2014	2,494,690
2015	-
2016	-
Thereafter	300,000
	$ 3,117,441

On March 19, 2001, we issued $150.0 million of 10-year 7.2% notes through a public offering ("7.2% Notes") that were priced at 99.847% to yield an effective annual interest rate of 7.22%. The notes are secured obligations, ranking equally with our First Lien indebtedness and matured on March 15, 2011, at which time they were paid in full.

On March 9, 2010, in connection with the Restructuring, we entered into Amendment No. 3 to our first lien credit agreement (the "First Lien Credit Agreement") in connection with the conversion of $1,983.7 million of the senior secured position in the First Lien Credit Agreement to equity in HMH and converting all amounts owed under the Mezzanine Credit Agreement (the "Mezzanine Credit Agreement"), $2,124.8 million, to equity in HMH. Subsequent to the Restructuring, the face value of the First Lien indebtedness was $2,904.6 million.

The amendment modified certain financial covenants, definitions and provisions of the agreement, modified the interest rate to LIBOR plus an applicable percentage of 5.0% (while retaining the 25 basis point increase every six month up to a maximum applicable percentage of 7.5%), eliminated interest paid in kind, eliminated restrictions on transfer of funds with foreign loan parties, reinstated

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the excess cash prepayments beginning at the end of 2011, eliminated the ability to transfer funds to EMPG, and modified certain asset sales and disposition covenants.

Prior to the Restructuring, our debt consisted of a First Lien Credit Agreement in the amount of $4,350.0 million (the "Term Loan"), and a $500.0 million revolving loan (the "Revolving Loan"). A related entity of Lehman Brothers, Inc. ("Lehman") was a party to our Revolving Loan. We had the option of paying the following floating interest rates: (i) a rate equal to the higher of (A) the rate announced from time to time as the prime rate of Credit Suisse's New York City branch, or (B) the Federal Funds Effective Rate in effect on such day plus .50% plus an applicable percentage plus an applicable percentage of 7.5% or (ii) a rate based on the London Interbank Offered Rate (LIBOR) plus an applicable percentage of 4.0% for the Term Loan and a range of 2.0% to 3.5%, depending on our consolidated leverage ratio, for the Revolving Loan. The Term Loan matures on June 12, 2014 and the Revolving Loan on December 12, 2013, the terms of which were not modified with the Restructuring.

Along with the First Lien Credit Agreement, we were a party to a mezzanine credit agreement in an aggregate amount of $1,700.0 million, comprised of a seven-year loan (the "Mezzanine Loan"). We had the option of paying the following floating interest rates: (i) a rate equal to the higher of (A) the rate announced from time to time as the prime rate of Credit Suisse's New York City branch, or (B) the Federal Funds Effective Rate in effect on such day plus .50% plus an applicable percentage plus an applicable percentage of 7.5% or (ii) a rate based on the London Interbank Offered Rate (LIBOR) plus an applicable percentage of 9.5%. A portion of the interest on the Mezzanine Loan (550 basis points) was to be paid in kind and added to principal unless an election was made in advance to pay this interest in cash. The remaining portion of the interest is to be paid in cash.

On March 12, 2009, we entered into Amendment No. 1 to our First Lien Credit Agreement, which provided us greater near-term financial flexibility, primarily through changes to certain restrictive financial covenants, definitions and provisions of the agreements. The amendment also had the effect of increasing the interest rate margin on the Term Loan by 300 basis points to be paid in kind. The amendment provided for the incremental interest rate margin to be decreased 100 basis points for each $600.0 million of debt repaid prior to the maturity date. The cost of the amendment was approximately $7.8 million and was being amortized over the remaining term of the debt using the effective interest method.

On August 13, 2009, we entered into Amendment No. 2 to our First Lien Credit Agreement, providing us a widening of leverage and interest coverage covenants, increase in permitted indebtedness to allow for an increase in the accounts receivable facility, eliminated excess cash flow prepayments, amending the inter-creditor agreement to reflect the terms of the Mezzanine Loan. In exchange for the amendment, we agreed to the following: (i) to pay an amendment fee of approximately $11.6 million which was being amortized over the remaining term of the debt using the effective interest method, (ii) an additional 100 basis points of payable in kind interest per annum beginning on the amendment effective date, increasing by an additional 25 basis points per annum on the date six months after the amendment effective date and each six month anniversary thereafter up to 250 basis points, (iii) a shortening of the maturity on the Revolving Loan and the Term Loan to June 12, 2013 if by March 12, 2011 indebtedness under the First Lien Credit Agreement had not been reduced by $700.0 million (which was achieved), and (iv) a limit on capital expenditures, permitted acquisitions and certain other transactions. We incurred approximately $7.9 million of professional fees in connection with the amendment which were expensed in accordance with the applicable accounting guidance for debt modifications.

On March 16, 2009 through August 11, 2009, we entered into Amendment No. 2 through Amendment No. 12 to the Mezzanine Credit Agreement. These amendments principally deferred

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the interest payments due along with certain other modifications. The cost of the amendment was approximately $8.5 million, all of which was payable in kind, and was being amortized over the remaining term of the debt.

On August 13, 2009, we entered into Amendment No. 13 to the Mezzanine Credit Agreement. This agreement amended the Mezzanine Loan at 100% of its accreted value into an all payable in kind facility, deferred interest payments that were due on May 27, 2009 and June 30, 2009 which were converted to payable in kind rather than cash payments, amended the definition of Receivables Facility to allow for increases in the accounts receivable facility from $275.0 million to $400.0 million, and amended leverage and interest coverage covenants. In exchange for the amendment, we agreed to the following: (i) an increase to the interest rate of the Mezzanine Loan to 17.5% payable in kind, (ii) a shortening of the maturity to December 12, 2013 if by March 12, 2011 indebtedness under the First Lien Credit Agreement has not been reduced by $700.0 million, (iii) a limit on capital expenditures, permitted acquisitions and certain other transactions, and (iv) to provide for additional sale rights as set forth in the Sale Rights Agreement. We incurred approximately $12.6 million of professional fees in connection with the amendment which were expensed in accordance with the applicable accounting guidance for debt modifications.

On May 26, 2011, we issued $300.0 million aggregate principal amount of our 10.5% Senior Secured Notes due 2019 (“Senior Notes”), which mature on June 1, 2019. The Senior Notes accrue interest at 10.5% and interest is paid semi-annually on June 1 and December 1. The Senior Notes are pari passu to our existing Term Loan. The proceeds from the Senior Notes were used to provide for working capital needs and to repay borrowings under the accounts receivable securitization facility. We incurred approximately $8.2 million of professional fees to issue the Senior Notes which were capitalized in accordance with the applicable accounting guidance for debt issuance costs, and are being amortized over the term of the debt.

On May 26, 2011, we entered into Amendment No. 5 to our First Lien Credit Agreement, which modified certain financial covenants, definitions and provisions of the agreement. The amendment was required for the issuance of the 10.5% Senior Secured Notes as well as Amendment No.1 to our Receivables Funding and Administration Agreement (see below). We did not incur material professional fees in connection with the amendment. The professional fees incurred were expensed in accordance with the applicable accounting guidance for debt modifications.

On October 27, 2011, we entered into Amendment No. 6 to our First Lien Credit Agreement, in order to align our quarterly and annual financial reporting requirements under our First Lien Credit Agreement and the 10.5% Senior Secured Notes. We did not incur material professional fees in connection with the amendment. The professional fees incurred were expensed in accordance with the applicable accounting guidance for debt modifications.

On December 22, 2011, we entered into Amendment No. 7 to our First Lien Credit Agreement. Amendment No. 7 modified certain financial covenants, definitions and provisions of the agreement. The interest coverage ratio and maximum leverage ratio were suspended until June 30, 2013 and replaced with a minimum consolidated EBITDA requirement. We did not incur material professional fees in connection with the amendment. The professional fees incurred were expensed in accordance with the applicable accounting guidance for debt modifications.

The Term Loan and Revolving Loan were all issued with a discount equal to 4% of the borrowing commitment of each instrument. As of December 31, 2011, the effective interest rates were 8.1% and 6.4% for the Term Loan and Revolving Loan, respectively. As of December 31, 2010, the effective interest rates were 7.40% and 5.75% for the Term Loan and Revolving Loan, respectively.

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As of December 31, 2009, the effective interest rates were 6.36%, 6.77% and 17.91% for the Term Loan, Revolving Loan and Mezzanine Loan, respectively. We have written off the remaining balance of deferred financing fees as of March 10, 2010 relating to the issuance of the Term Loan, Mezzanine Loan and Revolving Loan. The discounts were being amortized over the life of each debt arrangement as additional interest expense.
Substantially all of our assets and the assets of the guarantors are also pledged as collateral pursuant to the terms of our senior secured credit facilities on a pari passu basis with the Senior Notes.

Loan Covenants
The Company is currently required to meet certain restrictive financial covenants as defined under the First Lien Credit Agreement.

The First Lien Credit Agreement covenants require us to maintain certain minimum consolidated EBITDA levels or quarterly ratios related to interest coverage and total leverage. The minimum consolidated EBITDA covenant is as follows.

Four consecutive fiscal quarters ending:	
December 31, 2011	$276.0 million
March 31, 2012	267.0 million
June 30, 2012	262.0 million
September 30, 2012	228.0 million
December 31, 2012	276.0 million
March 31, 2013	276.0 million

The covenants were established based on trailing twelve month EBITDA, as defined in the Credit Agreement. The leverage ratio covenant is set at 7.25x at Q2 2013, and 6.75x thereafter. The interest coverage ratio is set at 1.5x from Q2 2013 to the maturity of the debt.

We are also subject to restrictions on certain transactions that can be entered into by us. The First Lien Credit Agreement is guaranteed by HMH and secured by the assets of the operating companies. In the event of default, the collateral would be split on a pro rata basis with the holders of the 10.5% Notes. The Term Loan contains mandatory prepayments of principal in the event that cash proceeds from certain asset sales, debt and equity transactions are not reinvested in the business within 365 days.

A breach of any of these covenants, ratios, tests or restrictions, as applicable, for which a waiver is not obtained could result in an event of default, in which case our lenders could elect to declare all amounts outstanding to be immediately due and payable and result in a cross-default under other arrangements containing such provisions. A default would permit lenders to accelerate the maturity for the debt under these agreements and to foreclose upon any collateral securing the debt owed to these lenders and to terminate any commitments of these lenders to lend to us. If the lenders accelerate the payment of the indebtedness, our assets may not be sufficient to repay in full the indebtedness and any other indebtedness that would become due as a result of any acceleration. Further, in such an event, the lenders would not be required to make further loans to us, and assuming similar facilities were not established and we are unable to obtain replacement financing, it would materially affect our liquidity and results of operations.

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Receivables Funding Agreement

HM Receivables Co., LLC ("HMRC"), a subsidiary of HMH, entered into the Receivables Funding Agreement and Administration Agreement (the "Funding Agreement"), which established a $250.0 million revolving credit facility, with a maturity date of May 31, 2011. The LIBOR rate advance was LIBOR plus 1.4% per annum for the first $100.0 million of borrowing and LIBOR plus 1.7% for borrowings in excess of $100.0 million. The index rate advance was a base rate, as defined, plus 1.0% per annum for the first $100.0 million of borrowing and base rate plus 0.7% for borrowings in excess of $100.0 million.

On May 22, 2009, the Funding Agreement was amended primarily to allow HMRC to enter into a Second Lien Receivables Funding and Administration Agreement in order to increase the revolving loan commitments. This amendment allowed for up to $50.0 million in second lien obligations. Simultaneously with the execution of the amendment, on May 22, 2009, HMRC entered into a Second Lien Receivables Funding and Administration Agreement with Lehman Commercial Paper, Inc., whereby allowing the facility to increase to $50.0 million.

On February 23, 2010, HMRC entered into an Amended and Restated Receivables Funding and Administration Agreement, in the amount of a $140.0 million term loan (collectively “Tranche A1-3 Term Loans”). The proceeds of the term loan were used to repay the Funding Agreement which was terminated. The Tranche A1-3 Term Loans were secured by our accounts receivables. We have the option of paying the following interest rates: (i) a rate equal to the lower of (A) the rate announced from time to time as the prime rate plus an applicable percentage of 7.5%, or B) 10.0% or (ii) a rate based on the London Interbank Offered Rate (subject to a floor between 2.0%-2.25%) plus an applicable percentage ranging between 7.75% and 8.0%. Our effective interest rate for the Tranche A1-3 Term Loans was 10%. The maturity date was December 31, 2010 although the Tranche A1-3 Term Loans had a call feature at 104% from February 23, 2010 to April 24, 2010, 102% from April 25, 2010 to June 23, 2010, and 101% from June 24, 2010 to July 23, 2010. The Tranche A1-3 Term Loans were paid in full on August 4, 2010 in conjunction with obtaining the new receivables funding agreement.

On August 4, 2010, HM Receivables Co. II, LLC (“HMRC II”), a subsidiary of us, entered into a Receivables Funding and Administration Agreement (the “New Funding Agreement’), which established a $250.0 million revolving credit facility, with a maturity date of August 4, 2013. The interest rate is LIBOR based.

On May 26, 2011, HMRC II entered into Amendment No. 1 to its Receivables Funding and Administration Agreement (“RFAA”). The RFAA was amended primarily to extend the maturity of the existing facility by one additional year to August 4, 2014 and to allow a second lien debt of up to an additional $100.0 million. The amendment modified certain financial covenants, definitions and provisions of the agreement to conform to those defined in the amended First Lien Credit Agreement. Further, the amendment relaxed the borrowing base calculations to provide greater liquidity. We did not incur material professional fees in connection with the amendment. The professional fees incurred were capitalized in accordance with the applicable accounting guidance for revolving loan modifications.

On December 29, 2011, HMRC II entered into Amendment No. 2 to its RFAA. The RFAA was amended in connection with Amendment No. 7 to the First Lien Credit Agreement. The amendment aligned certain definitions, financial covenants, reporting requirements and provisions with those of the First Lien Credit Agreement Amendment No. 6 and No. 7.
The amendment no longer allows for a second lien facility. Further, there were changes to the borrowing base calculation to tighten the requirement. We incurred approximately $1.6 million of

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professional fees in connection with the amendment which were capitalized in accordance with the applicable accounting guidance for revolving loan modifications.

All accounts receivables are held in a subsidiary of HMH, HMRC II, which has entered into the aforementioned New Funding Agreement and amendments thereto. Total HMRCII receivables on December 31, 2011 and 2010 were $302.1 million and $248.3 million, respectively. As of December 31, 2011 and 2010, $156.3 million and $124.4 million, respectively, of eligible receivables were pledged as collateral on the revolving credit facility, and the receivables have been sold by originating subsidiaries to HMRC II. The assets of HMRC II are not available to satisfy the obligations of our other subsidiaries. No LIBOR based rate was elected as of December 31, 2011 and 2010 insofar as the HMRCII facility had no borrowings.

7. Interest Swap Arrangements

We entered into interest rate swap agreements to manage our exposure to interest rate changes as required under our First Lien Credit Agreement which had required, prior to the March 9, 2010 amendment, that at least 50% of the aggregate principal amount of our debt being effectively subject to a fixed or maximum interest. The swaps effectively converted a portion of our variable rate debt to a fixed rate, without exchanging the notional principal amounts.

We had entered into the following interest rate swap agreements with various financial institutions.

Effective date of swap	Expiration Date	Notional Amount	Interest Rates
3/30/2007	3/31/2010	$ 814,370	4.999%–5.12%
12/31/2007	12/31/2010	1,875,000	3.00%–4.715%

Our interest rate swaps were not designated as hedges and therefore did not qualify for hedge accounting under the accounting standards for derivative instruments and hedging activities. Our interest rate swaps expired in 2010. We had no other interest rate swaps outstanding as of December 31, 2011. We recorded an unrealized loss of $7.4 million for the period January 1, 2010 to March 9, 2010, and a gain of $90.3 million for the period March 10, 2010 to December 31, 2010 in our statement of operations to account for the changes in fair value of the derivatives. Interest rate swap arrangements expensed and recorded in interest expense for the period January 1, 2010 to March 9, 2010 were $23.3 million and for the period March 10, 2010 to December 31, 2010 were $69.8 million. Further, we recorded an unrealized gain of $46.4 million for the year ended December 31, 2009. Interest rate swap arrangements expensed and recorded in interest expense were $117.8 million for the year ended December 31, 2009.

8. Severance and Other Charges

2011

On November 8, 2011, our Board of Directors approved a restructuring plan that was substantially implemented in the fourth quarter of 2011 and with the remainder to be executed in the first two quarters of 2012. The plan includes workforce reductions of up to approximately 10% of the current workforce as part of an organizational realignment and a reduction of operating costs. Accordingly, a severance charge of $28.8 million was recorded in 2011 to reflect the workforce reductions due to our organizational realignment. For the year ended December 31, 2011, $18.3

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million of severance payments were made to employees whose employment ended in 2011 and prior years. We expect substantially all of the $16.1 million severance reserve at December 31, 2011 to be paid during 2012.

In the year ended December 31, 2011, the vacant space accrual was increased $4.0 million primarily as a result of our exiting certain space. Additionally, during 2011, we paid $9.9 million of payments for excess space where our committed payment obligations exceeded the sublease income received. The lease obligations anticipated to be paid in future years, on a discounted basis, are $6.7 million, $3.7 million, $3.2 million, $3.1 million, $2.3 million, $0.5 million, and $0.3 million in 2012, 2013, 2014, 2015, 2016, 2017 and thereafter, respectively.

2010

We recorded a reduction in severance expense for the period March 10, 2010 to December 31, 2010 of approximately $0.3 million in connection with revised cost estimates in relation to workforce reductions of employees. These reductions were part of our continuing strategic integration of the former Houghton and Harcourt businesses. During 2010, approximately $11.1 million of severance payments were made to employees whose employment ended in 2010 and prior years.

As part of purchase accounting, we established a $48.0 million accrual for ongoing obligations to pay rent for vacant space that could not be sublet or space that is expected to be sublet at rates lower than the committed lease arrangements. The length of these obligations varies by lease with the longest extending through 2019. Subsequently, we sublet vacant space more quickly and at higher rates than previously estimated. Accordingly, the reserve initially established was reduced by $11.5 million in the period ended December 31, 2010 to reflect the more recent positive sublet experience.

2009

During 2009, we recorded a severance charge of approximately $25.9 million in connection with workforce reductions of 499 employees. These reductions were part of our continuing strategic integration of the former Houghton and Harcourt businesses. During 2009, $33.7 million of severance payments were made to employees whose employment ended in 2009 and prior years.

In connection with the workforce reductions that occurred in 2007, 2008, and 2009, we were able to vacate various office spaces throughout the country. Accordingly, we established a $50.0 million accrual for ongoing obligations to pay rent for vacant space that could not be sublet or space that is expected to be sublet at rates lower than the committed lease arrangements. The length of these obligations varies by lease with the longest extending through 2019.

A summary of the significant components of the severance/restructuring and other charges is as follows:

(in thousands of dollars, except share information)

	Successor Company 2011			
	Severance/ restructuring accrual at December 31, 2010	Severance/ restructuring expense	Cash payments	Severance/ restructuring accrual at December 31, 2011
Severance costs	$ 5,587	$ 28,801	$ (18,317)	$ 16,071
Other accruals	25,593	4,000	(9,914)	19,679
	$ 31,180	$ 32,801	$ (28,231)	$ 35,750

	Successor Company 2010			
	Severance/ restructuring accrual at March 10, 2010	Severance/ restructuring expense	Cash payments	Severance/ restructuring accrual at December 31, 2010
Severance costs	$ 14,392	$ 282	$ (9,087)	$ 5,587
Other accruals	47,765	(11,525)	(10,647)	25,593
	$ 62,157	$ (11,243)	$ (19,734)	$ 31,180

	Predecessor Company 2010			
	Severance/ restructuring accrual at December 31, 2009	Severance/ restructuring expense	Cash payments	Severance/ restructuring accrual at March 9, 2010
Severance costs	$ 16,414	$ -	$ (2,022)	$ 14,392
Other accruals	50,000	-	(2,235)	47,765
	$ 66,414	$ -	$ (4,257)	$ 62,157

	Predecessor Company 2009			
	Severance/ restructuring accrual at December 31, 2008	Severance/ restructuring expense	Cash payments	Severance/ restructuring accrual at December 31, 2009
Severance costs	$ 24,272	$ 25,882	$ (33,740)	$ 16,414
Other accruals	-	50,000	-	50,000
	$ 24,272	$ 75,882	$ (33,740)	$ 66,414

(in thousands of dollars, except share information)

9. Income Taxes

Total income taxes are as follows:

	Successor Company		Predecessor Company	
	For the Year Ended December 31, 2011	For the Period March 10, 2010 December 31, 2010	For the Period January 1, 2010 to March 9, 2010	For the Year Ended December 31, 2009
Income tax expense (benefit)	$ (100,153)	$ 11,929	$ (220)	$ (61,393)
	$ (100,153)	$ 11,929	$ (220)	$ (61,393)

Significant components of the expense (benefit) for income taxes attributable to loss from continuing operations consist of the following:

	Successor Company		Predecessor Company	
	For the Year Ended December 31, 2011	For the Period March 10, 2010 to December 31, 2010	For the Period January 1, 2010 to March 9, 2010	For the Year Ended December 31, 2009
Current				
Foreign	$ 3,958	$ -	$ -	$ -
U.S. - Federal	-	(2,775)	-	-
U.S. - State and other	13,506	4,207	499	25,340
Total current	17,464	1,432	499	25,340
Deferred				
Foreign	(2,413)	(6,548)	(719)	719
U.S. - Federal	(98,655)	15,465	-	(74,688)
U.S. - State and other	(16,549)	1,580	-	(12,764)
Total deferred	(117,617)	10,497	(719)	(86,733)
Income tax expense (benefit)	$ (100,153)	$ 11,929	$ (220)	$ (61,393)

The reconciliation of the income tax rate computed at the statutory tax rate to the reported income tax expense (benefit) attributable to continuing operations is as follows:

(in thousands of dollars, except share information)

	Successor Company		Predecessor Company	
	For the Year Ended December 31, 2011	For the Period March 10, 2010 to December 31, 2010	For the Period January 1, 2010 to March 9, 2010	For the Year Ended December 31, 2009
Statutory rate	(35.0)%	(35.0)%	(12.5)%	(12.5)%
Permanent items	0.1	0.1	0.1	3.3
Goodwill impairment	12.0	-	-	-
Foreign rate differential	1.0	2.4	(21.8)	(21.0)
State and local taxes	(0.4)	(2.5)	-	-
Alternative Minimum Tax Credit	-	(0.6)	-	-
Increase in valuation allowance	17.9	38.0	34.1	27.4
Effective tax rate	(4.4)%	2.4 %	(0.1)%	(2.8)%

The significant components of the net deferred tax assets and liabilities are shown in the following table:

	2011	2010
Tax asset related to		
Net operating loss and other carryforwards	$ 111,185	$ 200,190
Returns reserve/inventory expense	86,235	80,374
Pension and postretirement benefits	26,291	23,077
Interest	507,741	416,780
Deferred revenue	130,803	47,072
Deferred compensation	30,392	14,142
Other, net	17,943	9,736
Valuation allowance	(822,485)	(434,471)
	88,105	356,900
Tax liability related to		
Intangible assets	(34,330)	(216,032)
Depreciation and amortization expense	(70,667)	(276,404)
Other, net	(1,028)	-
	(106,025)	(492,436)
Net deferred tax liabilities	$ (17,920)	$ (135,536)

The net deferred tax liability balance is stated at prevailing statutory income tax rates. Deferred tax assets and liabilities are reflected on our consolidated balance sheets as follows:

(in thousands of dollars, except share information)

	2011	2010
Current deferred tax assets	$ 14,152	$ -
Noncurrent deferred tax liability	(32,072)	(135,536)
	$ (17,920)	$ (135,536)

A reconciliation of the gross amount of unrecognized tax benefits, excluding accrued interest and penalties, is as follows:

Predecessor Company	
Balance at January 1, 2009	$ 16,836
Additions based on tax positions related to the prior year	-
Additions based on tax positions related to the current year	48,338
Reductions based on tax positions related to the prior year	(519)
Balance at January 1, 2010	64,655
Additions based on tax positions related to the prior year	-
Additions based on tax positions related to the current year	-
Balance at March 9, 2010	$ 64,655

Successor Company	
Balance at March 10, 2010	$ 64,655
Additions based on tax positions related to the prior year	-
Additions based on tax positions related to the current year	-
Reductions based on tax positions related to the prior year	(243)
Balance at December 31, 2010	$ 64,412
Additions based on tax positions related to the prior year	-
Additions based on tax positions related to the current year	-
Balance at December 31, 2011	$ 64,412

At December 31, 2011, we had $64.4 million of gross unrecognized tax benefits (excluding interest and penalties), of which $52.1 million, if recognized, would reduce our effective tax rate. We expect the amount of unrecognized tax benefit disclosed above not to change significantly over the next 12 months.

With a few exceptions, we are currently open for audit under the statute of limitation for federal, state, and foreign jurisdictions for years 2008 through 2011. However, carryforward attributes from prior years may still be adjusted upon examination by tax authorities if they are used in a future period.

We report penalties and tax-related interest expense as a component of the provision for income taxes in the accompanying consolidated statement of operations. At December 31, 2011 and 2010, we had $3.7 million and $1.7 million, respectively, of accrued interest and penalties in the accompanying consolidated balance sheet.

(in thousands of dollars, except share information)

As part of the Restructuring discussed in Note 1, we realized approximately $2.3 billion of cancellation of debt income. We recognized approximately $200.0 million of income from cancellation of debt and were able to exclude approximately $2.1 billion from taxable income since we were insolvent (liabilities exceeded the fair market value of assets) by this amount at the time of the exchange. Although we will not have to pay current cash taxes from this transaction, it will reduce our tax attributes, such as net operating loss carryovers and tax credit carryovers, and also reduce the tax basis of our assets to offset the $2.1 billion of taxable income that did not have to be recognized due to the insolvency. As a result, the net operating losses and credit carryforwards have been reduced on January 1, 2011 and a portion of the tax basis in our assets were also reduced at that time.

As of December 31, 2011, we have approximately $206.0 million of federal tax loss carryforwards, which expire through 2031. In addition, we have foreign tax credit carryforwards of $4.6 million, which will expire through 2021.

Based on our assessment of historical pretax losses and the fact that we did not anticipate sufficient future taxable income in the near term to assure utilization of certain deferred tax assets, we recorded a valuation allowance at December 31, 2011 and 2010 of $822.5 million and $434.5 million, respectively. We increased our valuation allowance by $388.0 million for the year ended December 31, 2011, $188.3 million in the period from March 10, 2010 to December 31, 2010, $129.6 million in the period from January 1, 2010 to March 9, 2010 and by $629.2 million for the year ended December 31, 2009.

Tax Indemnification

Vivendi Universal, S.A. (former parent of Houghton Mifflin) agreed to indemnify Houghton Mifflin Company for all income taxes of Houghton Mifflin Company and its subsidiaries due with respect to tax periods, or any portion of a tax period, ending on or before September 30, 2002. Reed Elsevier Plc has agreed to indemnify the Company for all taxes for any of the Harcourt businesses with respect to periods prior to the date of acquisition.

10. Retirement and Postretirement Benefit Plans

Retirement Plan

We have a noncontributory, qualified defined benefit pension plan (the "Retirement Plan"), which covers certain employees. The Retirement Plan is a cash balance plan, which accrues benefits based on pay, length of service, and interest. The funding policy is to contribute amounts subject to minimum funding standards set forth by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code. The Retirement Plan's assets consist principally of common stocks, fixed income securities, investments in registered investment companies, and cash and cash equivalents. We also have a nonqualified defined benefit plan, or nonqualified plan, that covers employees who earn over the qualified pay limit as determined by the Internal Revenue Service. The nonqualified plan accrues benefits for the executive officers based on service and pay. Benefits for all other employees accrue based on the cash balance plan calculation. The nonqualified plan is not funded. We use a December 31 date to measure the pension and postretirement liabilities. In 2007, both the qualified and nonqualified pension plans eliminated participation in the plans for new employees hired after October 31, 2007.

Houghton Mifflin Plc, our subsidiary, has a defined benefit pension plan (the "Kingfisher Pension Plan") which has been approved by Inland Revenue. Prior to the elimination of participation in the plan in 2007, all permanent employees between ages 21 and 64 were eligible to join the plan. On

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July 20, 2011, we entered into a bulk annuity policy with a third party which effectively terminated the Kingfisher Pension Plan. This policy covers all known plan beneficiaries and liabilities and represents a full transfer of the plan's financial and longevity risk to the third party. The policy is held in the name of the plan trustees. This termination did not constitute a settlement of liability under applicable accounting guidance for pension plans. Following a full plan data cleansing, the bulk annuity policy is expected to be converted into individual annuity policies at which point the plan will be discharged of all future liability with respect to the plan beneficiaries. The Kingfisher Pension Plan had benefit obligations of $14.3 million and $12.7 million as of December 31, 2011 and 2010, respectively. The plan had assets of $14.6 million and $13.3 million December 31, 2011 and 2010, respectively. Further, the plan had a pension benefit asset of $0.2 million and $0.6 million, at December 31, 2011 and 2010, respectively. Kingfisher's Pension Plan is included in the accompanying table for all years presented.

We are required to recognize the funded status of defined benefit pension and other postretirement plans as an asset or liability in the balance sheet and are required to recognize actuarial gains and losses and prior service costs and credits in other comprehensive income and subsequently amortize those items in the statement of operations. Further, we are required to use a measurement date equal to the fiscal year end.

The following table summarizes the Accumulated Benefit Obligations ("ABO"), the change in Projected Benefit Obligation ("PBO"), and the funded status of our plans as of and for the financial statement period ended December 31, 2011 and 2010:

		2011		2010
ABO at end of period	$	196,898	$	186,169
Change in PBO				
PBO at beginning of period	$	186,169	$	175,421
Service cost		-		-
Interest cost on PBO		9,120		7,816
Actuarial (gain) loss		10,497		9,995
Benefits paid		(9,045)		(7,165)
Exchange rates		157		102
PBO at end of period	$	196,898	$	186,169
Change in plan assets				
Fair market value at beginning of period	$	126,196	$	95,395
Actual return (loss)		3,628		11,493
Company contribution		11,460		26,366
Benefits paid		(9,045)		(7,165)
Exchange rates		169		107
Fair market value at end of period	$	132,408	$	126,196
Funded status	$	(64,490)	$	(59,973)

(in thousands of dollars, except share information)

Amounts recognized in the consolidated balance sheets at December 31, 2011 and 2010 consist of:

	2011	2010
Noncurrent liabilities	$ (64,490)	$ (59,973)

Additional year-end information for pension plans with ABO in excess of plan assets at December 31, 2011 and 2010 consist of:

	2011	2010
PBO	$ 182,549	$ 173,483
ABO	182,549	173,483
Fair value of plan assets	117,843	112,865

Amounts not yet reflected in net periodic benefit cost and recognized in accumulated other comprehensive income at December 31, 2011 and 2010 consist of:

	2011	2010
Net gain (loss)	$ (14,954)	$ (3,945)
Accumulated other comprehensive income (loss)	$ (14,954)	$ (3,945)

Weighted average assumptions used to determine the benefit obligations (both PBO and ABO) at December 31, 2011 and 2010 are:

	2011	2010
Discount rate	4.4%	5.1%
Increase in future compensation	N/A	N/A

(in thousands of dollars, except share information)

Net periodic pension cost includes the following components:

	Sucessor Company		Predecessor Company	
	For the Year Ended December 31, 2011	For the Period March 10, 2010 to December 31, 2010	For the Period January 1, 2010 to March 9, 2010	For the Year Ended December 31, 2009
Service cost	$ -	$ -	$ -	$ -
Interest cost on projected benefit obligation	9,120	7,816	1,580	10,881
Expected return on plan assets	(8,175)	(5,443)	(1,318)	(9,866)
Amortization of net (gain) loss	-	-	2	30
Net pension expense	945	2,373	264	1,045
Loss (gain) due to settlement	20	-	-	5,343
Net cost (gain) recognized for the period	$ 965	$ 2,373	$ 264	$ 6,388

Significant actuarial assumptions used to determine net periodic pension cost at December 31, 2011 and 2010 are:

	2011	2010
Discount rate	5.1 %	5.6 %
Increase in future compensation	N/A	N/A
Expected long-term rate of return on assets	6.7 %	7.0 %

Assumptions on Expected Long-Term Rate of Return as Investment Strategies

We employ a building block approach in determining the long-term rate of return for plan assets. Historical markets are studied and long-term relationships between equities and fixed income are preserved congruent with the widely accepted capital market principle that assets with higher volatility generate a greater return over the long run. Current market factors such as inflation and interest rates are evaluated before long-term capital market assumptions are determined. The long-term portfolio return is established via a building block approach and proper consideration of diversification and rebalancing. Peer data and historical returns are reviewed for reasonability and appropriateness. We regularly review the actual asset allocation and periodically rebalances investments to a targeted allocation when appropriate. The current targeted asset allocation is 50% with equity managers and 50% with fixed income managers. For 2012, we will use a 7.0% long-term rate of return for the Retirement Plan. We will continue to evaluate the expected rate of return assumption, at least annually, and will adjust as necessary.

Plan Assets

Plan assets for the U.S. tax qualified plans consist of a diversified portfolio of fixed income securities, equity securities, real estate, and cash equivalents. Plan assets do not include any of our securities. The U.S. pension plan assets are invested in a variety of funds within a Collective Trust (“Trust”). The Trust is a group trust designed to permit qualified trusts to comingle their assts for investment purposes on tax-exempt basis. The U.K pension plan assets are invested in a single bulk annuity policy with a third party.

(in thousands of dollars, except share information)

Investment Policy and Investment Targets

The tax qualified plans consist of the U.S. pension plan and the U.K. pension scheme. It is our practice to fund amounts for our qualified pension plans at least sufficient to meet minimum requirements of local benefit and tax laws. The investment objectives of our pension plan asset investments is to provide long-term total growth and return, which includes capital appreciation and current income. The nonqualified noncontributory defined benefit pension plan is generally not funded. Assets were invested among several asset classes.

The percentage of assets invested in each asset class at December 31, 2011 and 2010 is shown below.

2011 **Asset Class**	**Percentage in Each Asset Class**
Equity	44.0 %
Fixed income	43.0
Annuity policies	10.8
Other	2.2
	100.0 %

2010 **Asset Class**	**Percentage in Each Asset Class**
Equity	51.1 %
Fixed income	46.2
Real estate investment trust	0.1
Other	2.6
	100.0 %

(in thousands of dollars, except share information)

Fair Value Measurements

The fair value of our pension plan assets by asset category and by level (as described in Note 12) at December 31 were as follows:

	For the Year ended December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Cash and cash equivalents	$ 1,005	$ 1,005	$ -
Equity securities			
U.S. large cap growth	8,944	-	8,944
U.S. large cap value	9,333	-	9,333
U.S. large cap passive	13,034	-	13,034
U.S. small / mid cap growth	3,877	-	3,877
U.S. small / mid cap value	3,983	-	3,983
Non-U.S. equities	19,102	-	19,102
Government bonds	17,535	-	17,535
Corporate bonds	29,249	-	29,249
Mortgage-backed securities	9,239	-	9,239
Asset-backed securities	472	-	472
Commercial Mortgage-Backed Securities	424	-	424
Annuity policies	14,349		14,349
Other	1,862	-	1,862
	$ 132,408	$ 1,005	$ 131,403

	For the Year Ended December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Cash and cash equivalents	$ 1,012	$ 1,012	$ -
Equity securities			
U.S. large cap growth	9,424	-	9,424
U.S. large cap value	9,458	-	9,458
U.S. large cap passive	11,027	-	11,027
U.S. small / mid cap growth	4,908	-	4,908
U.S. small / mid cap value	3,905	-	3,905
Non-U.S. equities	25,704	-	25,704
Government bonds	17,731	-	17,731
Corporate bonds	30,819	-	30,819
Mortgage-backed securities	8,724	-	8,724
Asset-backed securities	406	-	406
Commercial Mortgage-Backed Securities	665	-	665
Other	2,413	-	2,413
	$ 126,196	$ 1,012	$ 125,184

(in thousands of dollars, except share information)

We recognize that risk and volatility are present to some degree with all types of investments. However, high levels of risk are minimized through diversification by asset class, by style of each fund.

Estimated Future Benefit Payments
The following benefit payments are expected to be paid.

Fiscal Year Ended	Total Pension
2012	$ 13,719
2013	18,415
2014	19,471
2015	18,920
2016	10,645
2017–2021	58,073

Expected Contributions
We expect to contribute approximately $17.2 million in 2012; however, the actual funding decision will be made after the 2012 valuation is completed.

Postretirement Benefit Plan
We also provide postretirement medical benefits to retired full-time, nonunion employees hired before April 1, 1992, who have provided a minimum of five years of service and attained age 55.

(in thousands of dollars, except share information)

The following table summarizes the Accumulated Postretirement Benefit Obligation ("APBO"), the changes in plan assets, and the funded status of our plan as of and for the financial statement periods ended December 31, 2011 and 2010.

	2011	2010
Change in APBO		
APBO at beginning of period	$ 36,546	$ 33,967
Service cost (benefits earned during the period)	372	300
Interest cost on APBO	1,840	1,583
Plan curtailment	-	-
Employee contributions	716	1,198
Actuarial (gain) loss	(540)	2,796
Net transfer in (out) (including any business combination)	-	-
Benefits paid	(2,964)	(3,298)
APBO at end of period	$ 35,970	$ 36,546
Change in plan assets		
Fair market value at beginning of period	$ -	$ -
Company contributions	2,248	2,100
Employee contributions	716	1,198
Benefits paid	(2,964)	(3,298)
Fair market value at end of period	$ -	$ -
Funded status	$ 35,970	$ 36,546

Amounts for postretirement benefits accrued in the consolidated balance sheets at December 31, 2011 and 2010 consist of:

	2011	2010
Current liabilities	$ (2,252)	$ (2,450)
Noncurrent liabilities	(33,718)	(34,096)
Net amount recognized	$ (35,970)	$ (36,546)

Amounts not yet reflected in net periodic benefit cost and recognized in accumulated other comprehensive income at December 31, 2011and 2010 consist of:

	2011	2010
Net gain (loss)	$ (2,256)	$ (2,796)
Prior service cost	-	-
Accumulated other comprehensive income (loss)	$ (2,256)	$ (2,796)

(in thousands of dollars, except share information)

Weighted average actuarial assumptions used to determine APBO at year-end December 31, 2011 and 2010 are:

	2011	2010
Discount rate	4.5 %	5.2 %
Health care cost trend rate assumed for next year	7.6 %	7.8 %
Rate to which the cost trend rate is assumed to decline (ultimate trend rate)	4.5 %	4.5 %
Year that the rate reaches the ultimate trend rate	2027	2027

Net periodic postretirement benefit cost included the following components:

	Successor Company		Predecessor Company	
	For the Year Ended December 31, 2011	For the Period March 10, 2010 to December 31, 2010	For the Period January 1, 2010 to March 9, 2010	For the Year Ended December 31, 2009
Service cost	$ 372	$ 300	$ 57	$ 408
Interest cost on APBO	1,840	1,583	319	2,281
Amortization of unrecognized prior service cost	-	-	(15)	(92)
Amortization of net (gain) loss	-	-	(226)	(1,101)
Net periodic postretirement benefit expense	$ 2,212	$ 1,883	$ 135	$ 1,496

Significant actuarial assumptions used to determine postretirement benefit cost at December 31, 2011 and 2010 are:

	2011	2010
Discount rate	5.2 %	5.8 %
Health care cost trend rate assumed for next year	7.8%	8.1 %
Rate to which the cost trend rate is assumed to decline (ultimate trend rate)	4.5%	4.5 %
Year that the rate reaches the ultimate trend rate	2027	2027

(in thousands of dollars, except share information)

Assumed health care trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects on the expense recorded in 2011 and 2010 for the postretirement medical plan:

	2011	2010
One-percentage-point increase		
Effect on total of service and interest cost components	$ 47	$ 48
Effect on postretirement benefit obligation	1,076	880
One-percentage-point decrease		
Effect on total of service and interest cost components	(55)	(53)
Effect on postretirement benefit obligation	(1,278)	(996)

The following table presents the change in other comprehensive income for the year ended December 31, 2011 related to our pension and postretirement obligations.

	Pension Plans	Postretirement Benefit Plan	Total
Sources of change in accumulated other comprehensive income (loss)			
Net loss (gain) arising during the period	$ 15,049	$ (540)	$ 14,509
Total accumulated other comprehensive income (loss) recognized during the period	$ 15,049	$ (540)	$ 14,509

Estimated amounts that will be amortized from accumulated other comprehensive income (loss) over the next fiscal year.

	Total Pension Plans	Total Postretirement Plan
Prior service credit (cost)	$ -	$ -
Net gain (loss)	(12,839)	-
	$ (12,839)	$ -

(in thousands of dollars, except share information)

Estimated Future Benefit Payments

The following benefit payments, which reflect expected future service, are expected to be paid:

Fiscal Year Ended		Total Postretirement Plan
2012	$	2,252
2013		2,257
2014		2,305
2015		2,311
2016		2,308
2017-2021		15,812

Expected Contribution
We expect to contribute approximately $2.3 million in 2012.

Defined Contribution Retirement Plan
We maintain a defined contribution retirement plan, the Houghton Mifflin 401(k) Savings Plan, which conforms to Section 401(k) of the Internal Revenue Code, and covers substantially all of our eligible employees. Participants may elect to contribute up to 50.0% of their compensation subject to an annual limit. We provided a matching contribution in amounts up to 4.5% of employee compensation until March 1, 2009 when the employer contribution was suspended. The contribution was reinstated on July 1, 2010, where we provide a matching contribution in amounts up to 1.5% of employee compensation and further increased to 3.0% of employee contribution effective May 2011. The 401(k) contribution expense amounted to $4.0 million for the year ended December 31, 2011 and $1.0 million for the period March 10, 2010 through December 31, 2010. For the year ended December 31, 2009 the 401(k) contribution expense was $1.8 million. We did not make any discretionary contribution in 2011 and 2010.

11. Share-Based Compensation

Certain employees participate in various equity plans of the Predecessor and Successor Company which provide for the grant of stock options, some with performance conditions, and restricted stock to certain executive and management level employees. The stocks underlying such plans for the Predecessor Company were held in trust for the equity recipients. The stock related to award forfeitures remains outstanding and may be reallocated to new recipients. After the date of the Restructuring, the equity awards pertaining to the Predecessor Company were no longer charged to our financial results as the employees were no longer related to the Predecessor Company. The vesting terms for equity awards generally range from 1 to 5 years over equal annual installments and generally expire seven years after the date of grant. Restricted stock is common stock that is subject to a risk of forfeiture only upon voluntary termination or termination for cause, as defined. Total compensation expense related to stock option grants and restricted stock issuances recorded in the year ended December 31, 2011 was approximately $8.6 million and was recorded in selling and administrative expense. Total compensation expense related to stock option grants and

(in thousands of dollars, except share information)

restricted stock issuances for the period January 1, 2010 to March 9, 2010 was approximately $0.9 million and for the period March 10, 2010 to December 31, 2010 was approximately $4.3 million. Total compensation expense related to stock option grants and restricted stock issuances recorded in the year ended December 31, 2009 was approximately $12.4 million.

Stock Options

The following tables summarize option activity for HMH employees in stock options for the periods ended December 31, 2011, December 31, 2010, March 9, 2010, and December 31, 2009:

	Successor Company	
	Number of Shares	Weighted Average Exercise Price
Balance at March 10, 2010	-	$ -
Granted	26,976,957	9.54
Forfeited	-	-
Balance at December 31, 2010	26,976,957	$ 9.54
Granted	468,224	5.37
Forfeited	(14,522,175)	8.58
Cancelled	(9,213,225)	8.67
Balance at December 31, 2011	3,709,781	$ 5.90
Options Exercisable at end of year	648,311	$ 5.97

	Predecessor Company	
	Number of Shares	Weighted Average Exercise Price
Balance at December 31, 2008	7,310,125	$ 9.25
Granted	-	-
Forfeited	(2,133,332)	10.00
Balance at December 31, 2009	5,176,793	$ 8.94
Granted	-	-
Forfeited	-	-
Balance at March 9, 2010	5,176,793	$ 8.94
Options Exercisable at end of period	2,269,760	$ 7.59

The intrinsic value of a stock option is the amount by which the current market value of the underlying stock exceeds the exercise price of the option as of the balance sheet date. There was no intrinsic value of options outstanding and exercisable at December 31, 2011, 2010 and 2009.

We estimate the fair value of stock options using the Black-Scholes valuation model. Key input assumptions used to estimate the fair value of stock options include the exercise price of the

(in thousands of dollars, except share information)

award, the expected volatility of our stock over the option's expected term, the risk-free interest rate over the option's expected term, and our expected annual dividend yield.

The fair value of each option granted was estimated on the grant date using the Black-Scholes valuation model with the following assumptions:

	Successor Company		Predecessor Company	
	For the Year Ended December 31, 2011	For the Period March 10 2010 to December 31, 2010	For the period January 1 2010 to March 9, 2010	For the Year Ended December 31, 2009
Expected term (years) [a]	7.0	7.0	3.92-4.17	3.92-4.17
Expected dividend yield	0.00%	0.00%	0.00%	0.00%
Expected volatility [b]	25.88%	22.68%-24.12%	27.25%-28.01%	27.25%-28.01%
Risk-free interest rate [c]	2.40%	1.77%-3.11%	2.7%-2.95%	2.7%-2.95%

[a] The expected term is the number of years that we estimate that options will be outstanding prior to exercise.

[b] We have estimated volatility for options granted based on the historical volatility for a group of companies believed to be a representative peer group, selected based on industry and market capitalization.

[c] The risk-free interest rate is based on the U.S. Treasury yield for a period commensurate with the expected life of the option.

The accounting standard for stock-based compensation requires companies to estimate forfeitures at the time of grant and periodically revise those estimates in subsequent periods if actual forfeitures differ from those estimates. Stock-based compensation expense is recorded only for those awards expected to vest using an estimated forfeiture rate based on historical forfeiture data coupled with and estimated derived forfeiture rate of peers.

As of December 31, 2011, there remained approximately $2.4 million of unearned compensation expense related to unvested stock options to be recognized over a weighted average term of 3.3 years.

The weighted average grant date fair value was $4.54 and $7.01 for options granted in 2011 and 2010, respectively.

(in thousands of dollars, except share information)

The following tables summarize information about stock options outstanding and exercisable under the plan at December 31, 2011:

Successor Company					
Options Outstanding				Options Exercisable	
Range of Exercise Price	Options Outstanding at December 31, 2011	Weighted Average Remaining Contractual life	Weighted Average Exercise Price	Options Exercisable at December 31, 2011	Weighted Average Exercise Price
$ 4.725	2,269,090	3.3	$ 4.725	388,267	$ 4.725
$ 6.88	1,112,934	3.3	6.88	194,493	6.88
$ 8.57	140,467	3.3	8.57	28,093	8.57
$ 12.26	187,290	3.3	12.26	37,458	12.26
	3,709,781	3.3	$ 5.90	648,311	$ 5.97

Restricted Stock (Successor Company)
The following table summarizes restricted stock activity for grants to HMH employees in our restricted stock units from March 10, 2010 to December 31, 2011:

	Numbers of Shares	Weighted Average Grant Date Fair Value
Balance at March 10, 2010	-	-
Granted	-	-
Vested	-	-
Forfeited	-	-
Balance at December 31, 2010	-	$ -
Granted	138,354	4.54
Vested	-	-
Forfeited	-	-
Balance at December 31, 2011	138,354	$ 4.54

(in thousands of dollars, except share information)

Restricted Stock (Predecessor Company)
The following table summarizes restricted stock activity for grants to HMH employees in EMPG restricted stock through March 9, 2010:

	Numbers of Shares	Weighted Average Grant Date Fair Value
Balance at December 31, 2008	1,850,000	$ 10.00
Granted	-	-
Vested	(750,000)	10.00
Forfeited	-	-
Balance at December 31, 2009	1,100,000	$ 10.00
Granted	-	-
Vested	(666,667)	10.00
Forfeited	-	-
Balance at March 9, 2010	433,333	$ 10.00

The total intrinsic value of EMPG restricted stock that vested in 2009 was zero. The EMPG restricted stock awards had various vesting terms generally over 2 to 3 years, including pro rata vesting over one and three years.

As of March 9, 2010 and December 31, 2009, 0.4 million and 1.1 million shares, respectively, of EMPG restricted stock were outstanding and unvested, with an aggregate intrinsic value of zero and a weighted average remaining contractual life of less than one year.

12. Fair Value Measurements

The accounting standard for fair value measurements among other things, defines fair value, establishes a consistent framework for measuring fair value and expands disclosure for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis. The accounting standard establishes a three-tier fair value hierarchy which prioritizes the inputs used in measuring fair value as follows:

Level 1 Observable input such as quoted prices in active markets for identical assets or liabilities;

Level 2 Observable inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and

Level 3 Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

Assets and liabilities measured at fair value are based on one or more of three valuation techniques identified in the tables below. Where more than one technique is noted, individual

(in thousands of dollars, except share information)

assets or liabilities were valued using one or more of the noted techniques. The valuation techniques are as follows:

(a) Market approach: Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities;

(b) Cost approach: Amount that would be currently required to replace the service capacity of an asset (current replacement cost); and

(c) Income approach: Valuation techniques to convert future amounts to a single present amount based on market expectations (including present value techniques).

On a recurring basis, we measure certain financial assets and liabilities at fair value, including our money market funds, foreign exchange forward contracts and interest rate swaps. The accounting standard for fair value measurements defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. In determining fair value, we utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible as well as considers counterparty and its credit risk in its assessment of fair value.

(in thousands of dollars, except share information)

The following tables present our financial assets and liabilities measured at fair value on a recurring basis at December 31, 2011 and December 31, 2010:

	Successor Company 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Valuation Technique
Financial assets				
Money market funds	$ 368,701	$ 368,701	$ -	(a)
	$ 368,701	$ 368,701	$ -	
Financial liabilities				
Foreign exchange forward contracts	$ 1,113	$ -	$ 1,113	(a)
	$ 1,113	$ -	$ 1,113	

	Successor Company 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Valuation Technique
Financial assets				
Money market funds	$ 307,612	$ 307,612	$ -	(a)
US treasury bills and notes	45,337	-	45,337	(a)
Short-term investments	17,667	17,667	-	(a)
	$ 370,616	$ 325,279	$ 45,337	
Financial liabilities				
Foreign exchange forward contracts	$ 413	-	$ 413	(a)
	$ 413	$ -	$ 413	

Our investments in U.S. treasury bills and notes are classified within Level 2 of the fair value hierarchy because they are valued using quoted market prices but are not traded actively on an exchange. In addition to $368.7 million and $352.9 million invested in money market funds and U.S. treasury bills and notes as of December 31, 2011 and December 31, 2010, respectively, we had $44.9 million and $27.0 million of cash invested in bank accounts as of December 31, 2011 and December 31, 2010, respectively.

Our short-term investments were investments in debt instruments which matured on March 15, 2011. These short-term investments are classified within Level 1 of the fair value hierarchy because they are valued based on quoted prices.

Our foreign exchange forward contracts consist of Euro forward contracts and are classified within Level 2 of the fair value hierarchy because they are valued based on observable inputs and are available for substantially the full term of our derivative instruments.

(in thousands of dollars, except share information)

We classified our derivative liabilities within Level 2 of the fair value hierarchy because these observable inputs are available for substantially the full term of our derivative instruments.

We determined there were no nonfinancial liabilities requiring disclosure under the accounting standard for fair value measurements. The following table presents our nonfinancial assets measured at fair value on a nonrecurring basis at December 31, 2011 and 2010:

	Successor Company 2011	Significant Unobservable Inputs (Level 3)	Total Impairment	Valuation Technique
Nonfinancial assets				
Goodwill	$ 520,088	$ 520,088	$ 1,442,500	(a) (c)
Other intangible assets	1,274,213	1,274,213	192,600	(a) (c)
	$ 1,794,301	$ 1,794,301	$ 1,635,100	

	Successor Company 2010	Significant Unobservable Inputs (Level 3)	Total Impairment	Valuation Technique
Nonfinancial assets				
Other intangible assets	$ 1,734,810	$ 1,734,810	$ 87,000	(a) (c)
	$ 1,734,810	$ 1,734,810	$ 87,000	

In evaluating goodwill for impairment, we first compare our reporting unit's fair value to its carrying value. We estimate the fair values of our reporting units by considering market multiple and recent transaction values of peer companies, where available, and projected discounted cash flows, if reasonably estimable. Impairment recorded for goodwill for the year ended December 31, 2011 was $1,442.5 million. There was no impairment recorded for the periods January 1, 2010 to March 9, 2010, and March 10, 2010 to December 31, 2010.

We perform an impairment test for our other intangible assets by comparing the assets fair value to its carrying value. Fair value is estimated based on recent market transactions, where available, and projected discounted cash flows, if reasonably estimable. Other intangible assets were written down to their fair value of $1,274.2 million resulting in an impairment charge of $192.6 million which was included in earnings for the year ended December 31, 2011. There was no impairment recorded for the period January 1, 2010 to March 9, 2010. Impairment charges were $87.0 million for the period March 10, 2010 to December 31, 2010. The fair value of goodwill and other intangible assets are estimates, which are inherently subject to significant uncertainties, and actual results could vary significantly from these estimates.

(in thousands of dollars, except share information)

Fair Value of Debt
The following table presents the carrying amounts and estimated fair market values of our debt at December 31, 2011 and December 31, 2010. The fair value of debt is deemed to be the amount at which the instrument could be exchanged in an orderly transaction between market participants at the measurement date.

	Successor Company December 31, 2011		Successor Company December 31, 2010	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Debt				
7.2% notes	$ -	$ -	$ 149,564	$ 150,750
Term loan	2,581,690	1,484,472	2,476,279	2,434,864
Revolving loan	235,751	135,557	235,751	218,659
10.5% notes	300,000	189,000	-	-

The fair market values of the debt were estimated based on quoted restricted market prices for those instruments that are traded or estimated based on publicly traded debt using current discount rates for similar instruments with equivalent credit quality at December 31, 2011 and December 31, 2010. The fair market values require varying degrees of management judgment. The factors used to estimate these values may not be valid on any subsequent date. Accordingly, the fair market values of the debt presented may not be indicative of their future values.

13. Commitments and Contingencies

Lease Obligations
We have operating leases for various real property, office facilities, and warehouse equipment that expire at various dates through 2019. Certain leases contain renewal and escalation clauses for a proportionate share of operating expenses.

The future minimum rental commitments under all noncancelable leases (with initial or remaining lease terms in excess of one year) for real estate and equipment are payable as follows:

	Operating Leases
2012	$ 46,040
2013	44,229
2014	42,773
2015	42,395
2016	34,606
Thereafter	50,869
Total minimum lease payments	$ 260,912
Total future minimal rentals under subleases	$ 35,334

For the year ended December 31, 2011 rent expense, net of sublease income, was $39.3 million. The rent expense, net of sublease income, for the period January 1, 2010 to March 9, 2010 was $6.3 million and for the period March 10, 2010 to December 31, 2010 was $18.4 million. In the

(in thousands of dollars, except share information)

year ended December 31, 2009 rent expense, net of sublease income, was $100.5 million. The 2009 rent expense included a $50.0 million charge for ongoing obligations to pay rent for vacant space that could not be sublet or space that is expected to be sublet at rates lower than the committed lease arrangements. On March 10, 2010, in connection with purchase accounting, the accrual estimate was revised and the estimate was adjusted to fair value. In the period March 10, 2010 to December 31, 2010, the accrual for the vacant space was reduced by $11.5 million; thus, lowering rent expense, to reflect the subleasing of space sooner and at higher rates than originally assumed. For the year ended December 31, 2011, the rent expenses included a $3.5 million charge as additional real estate was vacated.

Purchase Commitments

During 2008, we entered into a print services agreement with a third party for a term of five years commencing January 1, 2009 whereby the third party will provide platemaking, printing, binding and disposition services for the Company. The agreement expands the previous relationship between the two companies. We are obligated to purchase $175.0 million per contract year for a total of $875.0 million over the five-year term. Effective January 1, 2012, the print service agreement was amended to extend the agreement for two years and modify some of the aggregate spend and savings covenants.

Contingencies

We are involved in ordinary and routine litigation and matters incidental to our business. Litigation alleging infringement of copyrights and other intellectual property rights has become extensive in the educational publishing industry. Specifically, there have been various settled, pending and threatened litigation that allege we exceeded the print run limitation or other restrictions in licenses granted to us to reproduce photographs in our textbooks. While management believes that there is a reasonable possibility we may incur a loss associated with the pending and threatened litigation, we are not able to estimate such amount, and we do not expect any of these matters to have a material adverse effect on our results of operations, financial position or cash flows. We have insurance over such amounts and with coverage and deductibles as management believes is reasonable. There can be no assurance that our liability insurance will cover all events or that the limits of coverage will be sufficient to fully cover all liabilities. We were contingently liable for $11.6 million and $12.7 million of performance related surety bonds for our operating activities as of December 31, 2011 and 2010, respectively. An aggregate of $26.2 million and $31.8 million of letters of credit existed at December 31, 2011 and December 31, 2010, respectively, of which $6.4 million and $8.7 million backed the aforementioned performance related surety bonds in 2011 and 2010, respectively.

We routinely enter into standard indemnification provisions as part of license agreements involving use of our intellectual property. These provisions typically require us to indemnify and hold harmless licensees in connection with any infringement claim by a third party relating to the intellectual property covered by the license agreement. The assessment business routinely enters into contracts with customers that contain provisions requiring us to indemnify the customer against a broad array of potential liabilities resulting from any breach of the contract or the invalidity of the test. Although the term of these provisions and the maximum potential amounts of future payments we could be required to make is not limited, we have never incurred any costs to defend or settle claims related to these types of indemnification provisions. We therefore believe the estimated fair value of these provisions is minimal, and have no liabilities recorded for them as of December 31, 2011 and December 31, 2010.

(in thousands of dollars, except share information)

14. Related Party Transactions

Officer Loan

On March 9, 2010, we entered into a credit agreement with an entity controlled by an executive of the Company at that time, whereby the entity was granted a loan in the aggregate principal amount of $20.0 million for the sole purpose of satisfying certain obligations of that officer with regards to the acquisition of equity of the Predecessor Company. The loan bore interest at a rate per annum equal to 2.69% and had a maturity date of March 9, 2015.

On November 16, 2010, we entered into an amended and restated credit agreement whereby the loan of $20.0 million was divided into a tranche A loan with an aggregate principal amount of $12.2 million and a tranche B loan with an aggregate principal amount of $7.8 million. Both tranches of the loan continued to bear interest at a rate per annum equal to 2.69%. The tranche A loan had a maturity date of March 9, 2015 and the tranche B loan has a maturity date of September 30, 2030. There are no required principal or interest payments during the term of the loan with the interest accruing to the outstanding balance. While the officer was employed by the Company, the loan entity earned a fee equal to approximately $0.1 million per month (“Earned Fee”) that was used to repay the amount outstanding under the loan. The Earned Fee was approximately $1.1 million which was recorded as professional fees which is a component of administrative expenses in our statement of operations for the period March 10, 2010 to December 31, 2010.

We fully reserved the remaining balance of the loan due to the long term nature of the maturity date and uncertainty of collectability. The total amount of $18.9 million was recorded in selling and administrative expenses in our statement of operations for the period March 10, 2010 to December 31, 2010.

Officer Separation Agreement

On May 7, 2011, the Company entered into a separation agreement with an executive of the Company. Under the terms on the agreement, the former executive agreed to act as a senior advisor to the Company for a year. For these services, the former executive received a consulting fee of $2.0 million and the potential to receive an additional $3.0 million in success fees predicated upon certain criteria. The success fee was fully earned and paid in October 2011.

Other Transactions

We paid $10.0 million to an entity controlled by a former executive of the Company at that time for consulting services rendered in connection with the March 9, 2010 financial restructuring. The $10.0 million payment has been recorded as professional fees, which is a component of administrative expenses, in our statement of operations for the period March 10, 2010 to December 31, 2010.

15. Subsequent Events

Further to our discussions in Note 1, after considering various strategic alternatives to restructure our debt obligations, on May 10, 2012 we entered into a Restructuring Support Agreement with our participating borrowers to restructure our debt pursuant to a joint prepackaged plan of reorganization under Chapter 11 of the U.S. Bankruptcy Code. In conjunction with this agreement, we will seek approval for debtor-in-possession financing which we anticipate will become permanent financing upon completion of the restructuring. In connection with the reorganization, our existing long term debt will be converted to equity and our current equity will be eliminated. Although it is management’s expectation that the Company will emerge from bankruptcy as a

(in thousands of dollars, except share information)

viable entity, there can be no assurance that the prepackaged bankruptcy will proceed according to the prepackaged plan. These actions raise substantial doubt about the Company's ability to continue as a going concern. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty and have been prepared assuming that the Company will continue as a going concern.