

Financial Statements

McGraw-Hill Ryerson Limited

December 31, 2006

AUDITORS' REPORT

To the Shareholders of
McGraw-Hill Ryerson Limited

We have audited the restated balance sheets of **McGraw-Hill Ryerson Limited** as at December 31, 2006 and 2005 and the restated statements of income and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these restated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

As discussed in note 2 to the financial statements, the financial statements as at December 31, 2006 and for the years ended December 31, 2006 and 2005 have been restated.

Toronto, Canada,
January 19, 2007 [except as to notes 2, 7, 10 and
13, which are as of July 26, 2007].

Ernst & Young LLP

Chartered Accountants
Licensed Public Accountants

McGraw-Hill Ryerson Limited

Incorporated under the laws of Ontario

BALANCE SHEETS

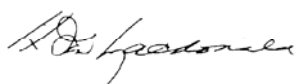
[in thousands of dollars]

As at December 31

	2006	2005
	\$	\$
	<i>[restated -</i>	<i>[restated -</i>
	<i>note 2]</i>	<i>note 2]</i>
ASSETS		
Current		
Cash and cash equivalents	33,511	27,206
Accounts receivable [net of allowance for book returns of \$7,013; 2005 - \$6,801] <i>[note 9]</i>	17,948	17,503
Due from parent and affiliated companies <i>[note 3]</i>	1,792	2,638
Inventories	8,066	8,006
Prepaid expenses and other	355	407
Income taxes receivable	—	190
Future tax assets <i>[note 7]</i>	2,485	2,535
Total current assets	64,157	58,485
Capital assets, net <i>[note 5]</i>	18,359	18,716
Other assets, net <i>[note 6]</i>	12,695	10,483
Future tax assets <i>[notes 2 and 7]</i>	1,336	801
	96,547	88,485
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued charges	10,697	9,966
Income taxes payable	511	—
Due to parent and affiliated companies <i>[note 3]</i>	7,291	6,181
Total current liabilities	18,499	16,147
Employee future benefits <i>[note 2]</i>	4,821	3,389
Total liabilities	23,320	19,536
Commitments <i>[note 8]</i>		
Shareholders' equity		
Share capital		
Authorized		
5,000,000 common shares		
Issued and outstanding		
1,996,638 common shares	1,997	1,997
Retained earnings	71,230	66,952
Total shareholders' equity	73,227	68,949
	96,547	88,485

See accompanying notes

On behalf of the Board:



H. Ian Macdonald, O.C., LL.D., Director



David L. Swail, Director

McGraw-Hill Ryerson Limited

STATEMENTS OF INCOME AND RETAINED EARNINGS

[in thousands of dollars, except per share data]

Years ended December 31

	2006 \$	2005 \$
	<i>[restated - note 2]</i>	<i>[restated - note 2]</i>
REVENUE		
Sales, less returns	90,343	85,557
Other	2,535	2,150
	92,878	87,707
EXPENSES		
Operating <i>[note 3]</i>	41,285	39,496
Editorial, selling, general and administrative <i>[notes 4 and 12]</i>	33,508	31,276
Amortization – Prepublication Costs	5,371	6,214
Amortization – Capital Assets	1,368	1,395
Employee future benefits <i>[note 2]</i>	1,470	1,110
Foreign exchange loss	176	89
	83,178	79,580
Income before income taxes	9,700	8,127
Provision for (recovery of) income taxes <i>[notes 2 and 7]</i>		
Current	4,260	3,951
Future <i>[note 2]</i>	(485)	(949)
	3,775	3,002
Net income for the year	5,925	5,125
Retained earnings, beginning of year - as previously reported	69,142	67,836
Adjustments to opening retained earnings <i>[note 2]</i>	(2,190)	(1,486)
Retained earnings, beginning of year - as restated	66,952	66,350
Dividends paid to shareholders [\$0.825 per share; 2005 - \$2.265 per share]	(1,647)	(4,523)
Retained earnings, end of year	71,230	66,952
Earnings per share <i>[note 2]</i>		
Basic	\$2.97	\$2.57
Diluted	\$2.97	\$2.57

See accompanying notes

McGraw-Hill Ryerson Limited

STATEMENTS OF CASH FLOWS

[in thousands of dollars]

Years ended December 31

	2006	2005
	\$	\$
	<i>[restated - note 2]</i>	<i>[restated - note 2]</i>
OPERATING ACTIVITIES		
Net income for the year	5,925	5,125
Add (deduct) non-cash items		
Amortization – Prepublication Costs	5,371	6,214
Amortization – Capital Assets	1,368	1,395
Employee future benefits	1,432	1,090
Future income taxes	(485)	(1,054)
	13,611	12,770
Net change in non-cash working capital balances related to operations <i>[note 11]</i>	2,935	2,684
Cash provided by operating activities	16,546	15,454
INVESTING ACTIVITIES		
Pre-publication costs	(7,583)	(4,844)
Additions to capital assets	(1,011)	(377)
Cash used in investing activities	(8,594)	(5,221)
FINANCING ACTIVITIES		
Dividends paid to shareholders	(1,647)	(4,523)
Cash used in financing activities	(1,647)	(4,523)
Net increase in cash during the year	6,305	5,710
Cash and cash equivalents, beginning of year	27,206	21,496
Cash and cash equivalents, end of year	33,511	27,206

See accompanying notes

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements of McGraw-Hill Ryerson Limited [the "Company"] have been prepared in accordance with Canadian generally accepted accounting principles. The most significant accounting policies are summarized as follows:

Cash and cash equivalents

The Company considers all highly liquid instruments with a maturity date of ninety days or less at the date of acquisition to be cash equivalents.

Allowance for doubtful accounts and sales returns

The accounts receivable reserve methodology is based on historical analysis and a review of outstanding balances. A significant estimate for the Company is the allowance for sales returns, which is based on the historical rate of return and current market conditions.

Inventories

Inventories are stated at the lower of cost, on a first-in, first-out basis, and net realizable value. A significant estimate for the Company is the reserve for inventory obsolescence. The reserve is based upon management's assessment of the marketplace of products on demand as compared to the number of units currently on hand.

Capital assets

Capital assets are recorded at cost less accumulated amortization. Amortization is provided on a straight-line basis at the following annual rates:

Building	40 years
Computer equipment	3 to 7 years
Furniture, fixtures and equipment	5 to 10 years

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

Pre-publication costs

Pre-publication costs include third party services, preparation, and plate costs, which are amortized from the year of publication over the lesser of five years and the expected sales life of the related publication using either an accelerated or straight-line method. The Company periodically evaluates the remaining lives and recoverability of such costs, which is sometimes dependent upon program acceptance by provincial authorities, based on expected undiscounted cash flows.

Goodwill

Effective January 1, 2002, goodwill is no longer amortized but is subject to an annual review for impairment, which consists of a comparison of the fair value of the assets to their carrying value. Based on the annual impairment review for 2006, the Company determined that no provision for impairment was required.

Foreign exchange translation

Foreign cash balances and amounts receivable from or payable to foreign affiliates are translated into Canadian dollars at the rates of exchange prevailing at year end. Transactions denominated in foreign currencies are translated into Canadian dollars at the exchange rates at the date of the transactions. Any resulting gains or losses are included in net income for the year.

Revenue recognition

The Company recognizes revenue for product sales, net of estimated returns, when the products are shipped to customers, which is also when title passes to the customer.

Other revenue is comprised mainly of rental income, interest, and other miscellaneous income, and is recognized as earned on a monthly basis.

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

Pension costs

The Company has a defined contribution pension plan for all employees for which the Company's contributions are expensed as incurred. Total pension expense for this plan during the year is \$725 [2005 - \$703].

The Company also has a supplemental employee retirement plan ["SERP"] for certain executives. They are entitled to additional pension payments upon retirement or end of services to the Company determined primarily based on the executives' salaries and years of service. Total SERP expense during the year is \$98 [2005 - \$171] and the SERP liability as at December 31, 2006 is \$783 [2005 - \$546]. The SERP obligation is unfunded and is included in accrued charges on the Company's balance sheet.

Income taxes

The Company uses the liability method of accounting for income taxes. Under the liability method, future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities, and are measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse.

Earnings per share

The weighted average number of common shares used in the computation of both basic and diluted earnings per share for 2006 is 1,996,638 [2005 - 1,996,638].

Use of estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results may differ from those estimates.

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

2. RESTATEMENT OF ACCOUNTING FOR EMPLOYEE FUTURE BENEFITS

The Company has a post-retirement benefit plan for certain retirees covering extended health, dental and basic life insurance. This plan was introduced in 2002 and premiums for this plan are paid by the Company.

The Company accounted for the cost of this program since its inception in 2002 on a pay-as-you-go basis and did not correctly follow the guidance as required by The Canadian Institute of Chartered Accountants ["CICA"] Section 3461 "Employee Future Benefits". Under CICA 3461, the Company is required to recognize in its financial statements an annual cost and benefit obligation related to estimated future benefit payments to be made to its current and retired employees. Accordingly, the Company has restated the December 31, 2006 financial statements and recorded an increase in expenses for the years ended December 31, 2006 and 2005 of \$1.4 million and \$1.1 million, respectively, a decrease in future tax expense of \$0.3 million and \$0.4 million, respectively and a decrease in net income of \$1.1 million and \$0.7 million, respectively. Long-term liabilities increased as at December 31, 2006 and 2005 in the amount of \$4.8 million and \$3.4 million, respectively and future tax assets increased by \$1.5 million and \$1.2 million, respectively, to give effect to the proper accounting for this plan. An adjustment to decrease opening retained earnings by \$1.5 million was recorded in 2005 for the correction of errors prior to 2005. On July 26, 2007, the Company amended this plan and will report a curtailment gain of approximately \$3.5 million pre-tax in its results for the third quarter of 2007 [note 13].

Earnings Per Share Impact	As Previously Reported	Restated
	\$	\$
Year ended December 31, 2005	2.92	2.57
Year ended December 31, 2006	3.51	2.97

The actuarial determination of the accrued benefit obligation for this benefit plan uses the projected benefit method [which incorporates management's best estimate of cost escalations, retirement ages and other actuarial factors]. Actuarial gains (losses) can arise from changes in actuarial assumptions used to determine the accrued benefit obligation. When the unamortized net actuarial gain (loss) exceeds 10% of the accrued benefit obligation, the excess amount is amortized over the expected average remaining service lifetime of the Company's employees. Past service costs are amortized over the expected remaining service life of employees until retirement eligibility [12.7 years]. The most recent actuarial valuation was completed as of December 31, 2006.

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

The significant assumptions used to calculate the accrued benefit obligation are as follows:

	2006	2005
	%	%
Discount rate	5.4	5.2
Dental cost increase	5.0	5.0

The weighted average health care cost rates for 2006 and 2005 were 9.0%. The weighted average health care cost trend rate will decrease ratably from 9.0% in 2006 to 5.0% over the next six years.

Changes to the accrued benefit obligation during the year are shown in the table below:

	2006	2005
	\$	\$
Accrued benefit obligation, beginning of year	7,380	5,036
Current service cost	776	561
Interest cost	423	346
Benefits paid	(38)	(20)
Actuarial loss (gain)	(372)	1,457
Accrued benefit obligation, end of year	8,169	7,380

The reconciliation of accrued benefit obligation to the liability recognized on the balance sheets is as follows:

	2006	2005
	\$	\$
Accrued benefit obligation, end of year	(8,169)	(7,380)
Unamortized past service costs	1,389	1,563
Unamortized net actuarial loss	1,959	2,428
Net liability recognized on balance sheets	(4,821)	(3,389)

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NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

Expenses resulting from this plan during the year are \$1.5 million [2005 - \$1.1 million] and expense components are summarized below:

	2006	2005
	\$	\$
Current service cost	776	561
Interest cost	423	346
Amortization of past service costs	175	175
Amortization of net actuarial loss	96	28
	1,470	1,110

Assumed health care cost trend rates have a significant effect on the amounts reported for this plan. A one-percentage-point change in assumed health care cost trend rates would have the following effects for 2006:

	Increase	Decrease
	\$	\$
Total Annual Service Cost and Interest Cost	340	(254)
Accrued Benefit Obligations	1,959	(1,506)

Subsequent to December 31, 2006, the Company has amended the plan [note 13]. Expected annual expenses going forward are \$0.1 million.

3. RELATED PARTY TRANSACTIONS

The Company is a subsidiary of The McGraw-Hill Companies, Inc. which owns 70.1% of the outstanding common shares. Transactions with related parties are as follows:

Under long-standing arrangements, the Company, in the normal course of business, purchases books and educational materials from the parent company and various international subsidiaries of The McGraw-Hill Companies, Inc.

The Company pays royalties to the parent company for any U.S. titles that have been adapted to the Canadian market.

The Company also, in the normal course of business, sells books and educational materials to various international subsidiaries of The McGraw Hill Companies, Inc.

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

The Company reimburses [and is reimbursed] for common expenses shared with other McGraw-Hill entities [note 4].

Terms of payment vary from 50 to 90 days [2005 - 50 to 90 days], net from the transaction date and all amounts are non-interest bearing.

Amounts due from parent and affiliated companies consist of the following:

	2006	2005
	\$	\$
Parent	784	1,228
Common-controlled enterprises	1,008	1,410
	1,792	2,638

Amounts due to parent and affiliated companies consist of the following:

	2006	2005
	\$	\$
Parent	7,243	6,127
Common-controlled enterprises	48	54
	7,291	6,181

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

Related party transactions with parent and affiliated companies consist of the following:

	2006	2005
	\$	\$
Inventory purchases from		
Parent	31,767	32,905
Common-controlled enterprises	210	181
Royalties paid to parent		
Parent	1,435	1,129
Common-controlled enterprises	62	50
Common expenses paid to parent	625	243
Common expenses reimbursed from parent	242	246

4. STOCK-BASED COMPENSATION

The parent company has granted certain employees of the Company stock options to purchase common stock of the parent and/or restricted stock of the parent, collectively referred to as awards [note 3]. The fair values of these awards are charged to the Company by the parent and are recorded as compensation expense by the Company over their respective vesting periods with a corresponding increase in due to parent company. For the year ended December 31, 2006, editorial, selling, general, and administrative expenses include stock-based compensation of \$172 [2005 - nil].

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

5. CAPITAL ASSETS

Capital assets consist of the following:

	2006		
	Cost	Accumulated	Net
	\$	amortization	book value
	\$	\$	\$
Land	3,598	—	3,598
Building	18,017	6,819	11,198
Computer equipment	5,839	4,785	1,054
Furniture, fixtures and equipment	5,146	2,637	2,509
	32,600	14,241	18,359

	2005		
	Cost	Accumulated	Net
	\$	amortization	book value
	\$	\$	\$
Land	3,598	—	3,598
Building	17,967	6,366	11,601
Computer equipment	5,710	4,293	1,417
Furniture, fixtures and equipment	4,314	2,214	2,100
	31,589	12,873	18,716

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

6. OTHER ASSETS

Other assets consist of the following:

	2006	2005
	\$	\$
Net book value, prepublication costs	12,332	10,120
Goodwill	363	363
	12,695	10,483

Prepublication costs consist of the following:

	Prepublication Costs	Accumulated Amortization	Net Book Value
	\$	\$	\$
Beginning balance	41,967	31,847	10,120
Additions	7,583	—	7,583
Amortization	—	5,371	5,371
Write off of fully amortized titles	(74)	(74)	—
Ending balance	49,476	37,144	12,332

There is \$3,842 of prepublication costs on unpublished titles not being amortized as of December 31, 2006.

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

7. INCOME TAXES

Under the liability method, future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities. Significant components of the Company's future tax assets and liabilities are as follows:

	2006	2005
	\$	\$
Current future tax assets		
Allowance for book returns and other items	2,474	2,406
Other	11	129
	2,485	2,535
Non-current future tax assets (liabilities)		
Capital assets	(2,546)	(2,906)
Prepublication costs	2,198	2,366
Employee future benefits	1,550	1,199
Other	134	142
	1,336	801

The reconciliation of the provision for income taxes computed at the statutory tax rates is as follows:

	2006	2005
	\$	\$
Tax at combined federal and provincial rates	3,503	2,935
Manufacturing and processing profits reduction	(102)	(80)
Decrease in future income taxes resulting from statutory tax rate change	217	—
Other	157	147
	3,775	3,002

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

8. COMMITMENTS

The Company has entered into operating leases, primarily for automobiles, for which the estimated future minimum annual lease payments are as follows:

	\$
2007	299
2008	109
Thereafter	17
	<u>425</u>

The Company has future purchase commitments with a vendor for printing/copying costs and as a result of an agency relationship. The future minimum annual commitments are as follows:

	\$
2007	447
2008	48
2009	32
	<u>527</u>

The Company has a \$22 [2005 - \$22] contingent letter of credit to secure the release of goods from customs prior to payment of duties at the Canadian border.

9. FINANCIAL INSTRUMENTS

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, due from/to parent and affiliated companies, accounts payable and accrued charges, and income taxes payable/receivable. At December 31, 2006 and 2005, the fair value of the Company's financial instruments approximates their carrying values due to the short-term maturity of these instruments.

The Company's five largest customers make up approximately 29% [2005 - 30%] of the accounts receivable balance and approximately 14% [2005 - 15%] of net sales.

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

10. SEGMENTED DISCLOSURE

The Company is structured on a market-focus basis and operates in three primary market areas: post-secondary education, including universities and community colleges, and proprietary colleges ["Higher Education"]; secondary and elementary schools ["School"] and trade, professional and medical, including retailers, distributors, libraries, non-traditional booksellers, direct marketing, and the medical sector ["Professional"]. Included in Warehouse, Support and Other sales are freight charged to customers and sales to French institutions mostly in Quebec. The accounting policies of these operating segments are the same as those described in the summary of significant accounting policies.

	2006				
	Higher Education	School	Professional	Warehouse, Support & Other	Total
	\$	\$	\$	\$	\$
Sales, less returns	54,209	23,551	10,821	1,762	90,343
Amortization – Prepublication Costs	2,679	2,692	—	—	5,371
Amortization – Capital Assets	83	42	14	1,229	1,368
Income (loss) before income taxes	14,140	6,069	2,183	(12,692)	9,700
Provision for income taxes	—	—	—	3,775	3,775
Total expenditures for additions to capital assets	59	42	5	905	1,011
Segment assets	21,293	12,307	5,519	18,079	57,198

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

	2005				
	Higher Education	School	Professional	Warehouse, Support & Other	Total
	\$	\$	\$	\$	\$
Sales, less returns	52,913	21,779	9,899	966	85,557
Amortization – Prepublication Costs	2,848	3,366	—	—	6,214
Amortization – Capital Assets	116	44	19	1,216	1,395
Income (loss) before income taxes	13,196	4,840	1,965	(11,874)	8,127
Provision for income taxes	—	—	—	3,002	3,002
Total expenditures for additions to capital assets	32	27	26	292	377
Segment assets	20,214	11,349	4,908	18,406	54,877

Reconciliations

	2006	2005
	\$	\$
Segment assets	57,198	54,877
Unallocated assets		
Cash and cash equivalents	33,511	27,206
Due from parent and affiliated companies	1,792	2,638
Income taxes receivable	—	190
Prepaid expenses and other	225	238
Future tax assets	2,485	2,535
Non-current future tax assets	1,336	801
Total Assets	96,547	88,485
Segment sales, less returns	90,343	85,557
Other revenue	2,535	2,150
Total Revenue	92,878	87,707

McGraw-Hill Ryerson Limited

NOTES TO FINANCIAL STATEMENTS

[in thousands of dollars]

December 31, 2006

11. STATEMENTS OF CASH FLOWS

The net change in non-cash working capital balances related to operations consists of the following:

	2006	2005
	\$	\$
Accounts receivable	(445)	(272)
Due from parent and affiliated companies	846	138
Inventories	(60)	3,537
Prepaid expenses and other	52	(79)
Income taxes receivable/payable	701	(643)
Accounts payable and accrued charges	731	2,557
Due to parent and affiliated companies	1,110	(2,554)
	<u>2,935</u>	<u>2,684</u>
Supplemental cash flow information		
Income taxes refunded	(478)	(87)
Income taxes paid	3,990	4,832

12. EDITORIAL, SELLING, GENERAL, AND ADMINISTRATIVE EXPENSES

In 2005, the Company restructured some business operations to enhance the Company's long-term growth prospects. The realignment cost of \$900 consisted of employee termination and severance costs and is included in the editorial, selling, general, and administrative expenses. No further costs related to the realignment are anticipated. There was no restructuring charge in 2006.

13. SUBSEQUENT EVENT

The Company implemented an amendment to its post-retirement benefit plan on July 26, 2007. The effect of this amendment is to reduce the reported liability as at June 30, 2007 by approximately \$3.5 million to \$2.0 million, and to recognize a pre-tax curtailment gain of approximately \$3.5 million [\$2.3 million after taxes] in 2007.