RR Donnelley & Sons Co
Form 10-Q
August 08, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2006

OR

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

Commission File Number 1-4694

R.R. DONNELLEY & SONS COMPANY

(Exact name of registrant as specified in its charter)

Delaware	**36-1004130**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
111 South Wacker Drive, Chicago, Illinois	**60606**
(Address of principal executive offices)	**(Zip code)**

(312) 326-8000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

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

Large Accelerated Filer x Accelerated Filer ¨ Non-Accelerated Filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

As of July 31, 2006, 216.3 million shares of common stock were outstanding.

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R.R. DONNELLEY & SONS COMPANY

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

R.R. DONNELLEY & SONS COMPANY AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

As of June 30, 2006 and December 31, 2005

(In millions, except per share data)

(UNAUDITED)

	June 30, 2006	December 31, 2005
ASSETS		
Cash and cash equivalents	$ 138.5	$ 366.7
Receivables, less allowance for doubtful accounts of $72.2 (2005 $61.3)	1,570.9	1,529.1
Inventories net (Note 4)	522.6	481.4
Prepaid expenses and other current assets	91.4	67.5
Deferred income taxes	168.7	177.0
Total current assets	2,492.1	2,621.7
Property, plant and equipment net (Note 5)	2,138.9	2,138.6
Goodwill (Note 6)	2,974.5	2,750.7
Other intangible assets net (Note 6)	1,166.3	1,094.3
Prepaid pension costs	517.1	514.1
Other noncurrent assets	311.7	254.3
Total assets	$ 9,600.6	$ 9,373.7
LIABILITIES		
Accounts payable	$ 661.6	$ 718.1
Accrued liabilities	810.8	826.9
Short-term and current portion of long-term debt (Note 7)	330.2	269.1
Total current liabilities	1,802.6	1,814.1
Long-term debt (Note 7)	2,357.9	2,365.4
Postretirement benefit obligations	333.4	330.6
Deferred income taxes	586.7	596.8
Other noncurrent liabilities	627.3	541.2
Liabilities of discontinued operations (Note 3)	3.5	1.4

Total liabilities	5,711.4	5,649.5
SHAREHOLDERS EQUITY		
Preferred stock, $1.00 par value		
Authorized: 2.0 shares; Issued: None		
Common stock, $1.25 par value	303.7	303.7
Authorized: 500.0 shares; Issued: 243.0 shares in 2006 and 2005		
Additional paid-in capital	2,850.6	2,888.2
Retained earnings	1,564.1	1,439.4
Accumulated other comprehensive loss	(71.1)	(90.2)
Unearned compensation		(44.9)
Treasury stock, at cost, 25.1 shares in 2006 (2005 25.5 shares)	(758.1)	(772.0)
Total shareholders equity	3,889.2	3,724.2
Total liabilities and shareholders equity	$ 9,600.6	$ 9,373.7

(See Notes to Condensed Consolidated Financial Statements)

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R.R. DONNELLEY & SONS COMPANY AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

Three and Six Months Ended June 30, 2006 and 2005

(In millions, except per share data)

(UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net sales	$ 2,273.7	$ 1,932.1	$ 4,540.6	$ 3,858.6
Cost of sales (exclusive of depreciation and amortization shown below)	1,648.0	1,399.2	3,309.4	2,766.2
Selling, general and administrative expenses (exclusive of depreciation and amortization shown below)	275.2	233.2	537.3	484.7
Restructuring and impairment charges net (Note 8)	14.6	24.4	31.2	36.6
Depreciation and amortization	114.2	99.6	229.0	198.3
Total operating expenses	2,052.0	1,756.4	4,106.9	3,485.8
Income from continuing operations	221.7	175.7	433.7	372.8
Interest expense net	35.6	23.7	70.5	44.8
Investment and other income (expense) net	(3.7)	(3.8)	(4.5)	(4.4)
Earnings from continuing operations before income taxes and minority interest	182.4	148.2	358.7	323.6
Income tax expense	58.2	53.1	120.7	119.6
Minority interest	(0.2)	(0.2)	(0.6)	(0.5)
Net earnings from continuing operations	124.4	95.3	238.6	204.5
Income (loss) from discontinued operations, net of tax (Note 3)	0.8	(4.6)	(1.5)	(6.9)
Net earnings	$ 125.2	$ 90.7	$ 237.1	$ 197.6
Earnings per share (Note 11):				
Basic:				
Net earnings from continuing operations	$ 0.57	$ 0.44	$ 1.10	$ 0.95
Loss from discontinued operations, net of tax		(0.02)	(0.01)	(0.03)
Net earnings	$ 0.57	$ 0.42	$ 1.09	$ 0.92
Diluted:				
Net earnings from continuing operations	$ 0.57	$ 0.44	$ 1.09	$ 0.94
Loss from discontinued operations, net of tax		(0.02)	(0.01)	(0.03)

Net earnings	$ 0.57	$ 0.42	$ 1.08	$ 0.91
Dividends declared per common share	$ 0.26	$	$ 0.52	$ 0.52
Weighted average number of common shares outstanding (Note 11):				
Basic	216.9	213.5	216.4	214.4
Diluted	218.9	215.1	218.3	216.1

(See Notes to Condensed Consolidated Financial Statements)

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R.R. DONNELLEY & SONS COMPANY AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Six Months Ended June 30, 2006 and 2005

(In millions)

(UNAUDITED)

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
OPERATING ACTIVITIES		
Net earnings	$ 237.1	$ 197.6
Adjustments to reconcile net earnings to cash provided by operating activities:		
Loss from discontinued operations, net of tax	1.5	6.9
Impairment charges	2.3	3.5
Depreciation and amortization	229.0	198.3
Provision for doubtful accounts receivable	13.2	6.0
Deferred taxes	10.5	37.0
Loss on sale of investment and other assets net	3.4	1.5
Share-based compensation	17.8	22.4
Other	14.5	29.9
Changes in operating assets and liabilities of continuing operations net of acquisitions:		
Accounts receivable net	(24.9)	15.6
Inventories net	(38.9)	(44.4)
Prepaid expenses	(20.1)	(5.5)
Accounts payable	(65.8)	(32.6)
Accrued liabilities and other	(136.3)	(7.4)
Net cash provided by operating activities of continuing operations	243.3	428.8
Net cash used in operating activities of discontinued operations	(0.5)	(8.2)
Net cash provided by operating activities	242.8	420.6
INVESTING ACTIVITIES		
Capital expenditures	(177.7)	(224.2)
Acquisition of businesses net of cash acquired	(235.5)	(936.5)
Proceeds from sale of investment and other assets	0.9	18.2
Net cash used in investing activities of continuing operations	(412.3)	(1,142.5)
Net cash used in investing activities of discontinued operations		(0.5)
Net cash used in investing activities	(412.3)	(1,143.0)
FINANCING ACTIVITIES		
Net change in short-term debt	61.4	(86.1)
Payments of current maturities and long-term debt	(20.7)	(1.3)
Proceeds from issuance of long-term debt		997.8

Issuance of common stock	9.9	12.5
Acquisition of common stock	(1.1)	(268.7)
Dividends paid	(112.2)	(111.5)
Debt issuance costs		(6.6)
Net cash (used in) provided by financing activities of continuing operations	(62.7)	536.1
Net cash used in financing activities of discontinued operations		
Net cash (used in) provided by financing activities	(62.7)	536.1
Effect of exchange rate on cash and cash equivalents	4.0	(3.9)
Net decrease in cash and cash equivalents	(228.2)	(190.2)
Cash and cash equivalents at beginning of period	366.7	641.8
Cash and cash equivalents at end of period	$ 138.5	$ 451.6
Supplemental non-cash disclosure:		
Acquisition of business purchase price payable	$ 8.7	$
Acquisition of assets through direct financing	10.8	

(See Notes to Condensed Consolidated Financial Statements)

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R.R. DONNELLEY & SONS COMPANY AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Tabular amounts in millions, except per share data, unless otherwise indicated)

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated interim financial statements include the accounts of R.R. Donnelley & Sons Company and its subsidiaries (the Company or RR Donnelley) and have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and in accordance with the rules and regulations of the United States Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. These unaudited condensed consolidated interim financial statements reflect all normal and recurring adjustments which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods. These unaudited condensed consolidated interim financial statements should be read in conjunction with the consolidated financial statements and the related notes thereto included in the Company s latest Annual Report on Form 10-K for the year ended December 31, 2005 filed with the SEC on March 2, 2006. Operating results for the three and six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2006. All significant intercompany transactions have been eliminated in consolidation. These unaudited condensed consolidated interim financial statements include estimates and assumptions of management that affect the amounts reported in the condensed consolidated financial statements. Actual results could differ from these estimates. Certain prior year amounts have been reclassified to conform to the current presentation.

The accounts of businesses acquired during the six months ended June 30, 2006 and 2005 are included in the consolidated financial statements from the dates of acquisition (See Note 2).

2. ACQUISITIONS

2006 Acquisition

On April 27, 2006, the Company acquired OfficeTiger Holdings, Inc. (OfficeTiger), a leading provider of integrated business process outsourcing services through its operations in North America, Europe, India and Sri Lanka. OfficeTiger s transaction processing services are closely related and complementary to the Company s existing document-based business process outsourcing (DBPO) resources. The Company believes that the acquisition of OfficeTiger will enable the Company to further expand its service offerings with customers in both the U.S. and Europe. The purchase price for OfficeTiger was approximately $248.8 million, net of cash acquired of $5.6 million and including acquisition costs of $4.4 million. OfficeTiger is included in the Integrated Print Communications segment.

R.R. DONNELLEY & SONS COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

(Tabular amounts in millions, except per share data unless otherwise indicated)

The OfficeTiger acquisition was recorded by allocating the cost to the assets acquired, including intangible assets and liabilities assumed, based on their estimated fair values at the acquisition date. The excess of the cost of the acquisition over the net amounts assigned to the fair value of the assets acquired and the liabilities assumed was recorded as goodwill. The allocation below is preliminary, as the final valuation of identifiable intangible assets has not been completed. The preliminary purchase price allocation is as follows:

Accounts receivable	$ 20.4
Other current assets	1.5
Property, plant and equipment and other long-term assets	7.2
Amortizable intangible assets	62.4
Goodwill	192.2
Accounts payable and accrued liabilities	(16.0)
Other long-term liabilities	(0.7)
Deferred taxes net	(18.2)
Total purchase price net of cash acquired	248.8
Accrued purchase price payable	(8.7)
Net cash paid	$ 240.1

2005 Acquisitions

On June 20, 2005, the Company acquired The Astron Group Limited (Astron), a leader in the DBPO market, providing transactional print and mail services, data and print management, document production and marketing support services primarily in the United Kingdom. Astron was acquired to extend the Company s services in the DBPO sector. Astron was acquired for approximately $954.5 million, net of $10.2 million of cash acquired, including $8.5 million in acquisition costs and the assumption of $449.4 million of Astron s debt. On the acquisition date, $434.5 million of the assumed debt was paid off.

Also during 2005, the Company completed several smaller acquisitions to build on the Company s scale advantages and extend its product offerings in key industry sectors and geographies. On July 7, 2005, the Company acquired Asia Printers Group Ltd. (Asia Printers), a book printer for customers in North America, Europe and Asia under the South China Printing brand and one of Hong Kong s leading financial printers under the Roman Financial Press brand. On August 18, 2005, the Company acquired the Charlestown, Indiana print operations of Adplex-Rhodes (Charlestown), a producer of tabloid-sized retail inserts. On September 5, 2005, the Company acquired Poligrafia S.A. (Poligrafia), the third-largest printer of magazines, catalogs, retail inserts and books in Poland. On November 9, 2005, the Company acquired Spencer Press, Inc. (Spencer), a Wells, Maine based printer serving the catalog, retail and direct mail segments of the printing industry. On December 6, 2005, Astron acquired Critical Mail Continuity Services, Limited (CMCS), a UK-based provider of disaster recovery, business continuity, digital printing, and print-and-mail services. The aggregate purchase price for these businesses was $273.1 million, net of cash acquired and including debt assumed of $23.0 million. Asia Printers (excluding Roman Financial Press), Charlestown, Poligrafia and Spencer are included in the Publishing and Retail Services segment. Astron, Roman Financial Press and CMCS are included in the Integrated Print

Communications segment.

The acquisitions were recorded by allocating the cost of the assets acquired, including intangible assets and liabilities assumed, based on their estimated fair values at the acquisition dates. The excess of the cost of each acquisition over the net amounts assigned to the fair value of the assets acquired and the liabilities assumed was recorded as goodwill. Although the purchase price allocation for Astron is finalized, the amounts below are

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R.R. DONNELLEY & SONS COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

(Tabular amounts in millions, except per share data unless otherwise indicated)

subject to further refinement as the final valuation of identifiable intangible assets and property, plant and equipment of Spencer is not finalized and the final purchase price for certain of the acquisitions is subject to adjustment based on certain provisions of the related purchase agreements. Based on these valuations, the preliminary purchase price allocation for all of the businesses acquired in 2005 is as follows:

Accounts receivable	$ 129.8
Inventories	42.2
Other current assets	29.4
Property, plant and equipment and other long-term assets	147.7
Amortizable intangible assets	536.1
Goodwill	679.1
Accounts payable and accrued liabilities	(180.5)
Postretirement and pension benefits and other long-term liabilities	(13.0)
Deferred taxes net	(143.2)
Total purchase price net of cash acquired	1,227.6
Debt assumed and not repaid	(37.9)
Net cash paid	$ 1,189.7

Pro forma results

The following unaudited pro forma financial information for the three and six months ended June 30, 2006 and 2005 presents the combined results of operations of the Company and OfficeTiger as if the acquisition had occurred at January 1, 2006 and 2005, respectively. The pro forma information for the three and six months ended June 30, 2005 also reflects the 2005 acquisitions as if they occurred on January 1, 2005.

The unaudited pro forma financial information is not intended to represent or be indicative of the Company s consolidated results of operations or financial condition that would have been reported had these acquisitions been completed as of the beginning of the periods presented and should not be taken as indicative of the Company s future consolidated results of operations or financial condition. Pro forma adjustments are tax-effected at the applicable statutory tax rates.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005

Net sales	$ 2,282.4	$ 2,137.8	$ 4,575.8	$ 4,278.8
Net earnings	124.2	84.4	234.2	186.1
Earnings per share:				
Net earnings				
Basic	0.57	0.40	1.08	0.87
Diluted	0.57	0.39	1.07	0.86

The three months ended June 30, 2006 and 2005 include $19.1 million and $23.3 million, respectively, for amortization of purchased intangibles. The six months ended June 30, 2006 and 2005 include $37.9 million and $46.7 million, respectively, for amortization of purchased intangibles. Also included for the three and six months ended June 30, 2006 are net restructuring and impairment charges of $14.6 million and $31.2 million, respectively, and for the three and six months ended June 30, 2005, $24.4 million and $36.6 million, respectively (see Note 8).

R.R. DONNELLEY & SONS COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

(Tabular amounts in millions, except per share data unless otherwise indicated)

3. DISCONTINUED OPERATIONS AND DIVESTITURES

On December 22, 2005, the Company sold its Peak Technologies business (Peak), which was formerly reported in the Forms and Labels segment. On October 29, 2004, the Company sold its package logistics business. Both Peak and the package logistics business have been reported as discontinued operations for all periods presented. As of June 30, 2006 and December 31, 2005, the Company had remaining liabilities for contractual obligations related to these discontinued businesses of $3.5 million and $1.4 million, respectively. These liabilities have been classified separately in the Condensed Consolidated Balance Sheets as liabilities of discontinued operations.

Included in the net loss from discontinued operations in the Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2006 and 2005 are the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net sales	$	$ 53.5	$	$ 104.8
Income tax expense (benefit)	0.2	(2.8)	(1.0)	(4.0)
Income (loss) from discontinued operations, net of tax	0.8	(4.6)	(1.5)	(6.9)

4. INVENTORIES

	June 30, 2006	December 31, 2005
Raw materials and manufacturing supplies	$ 217.8	$ 212.3
Work-in-process	149.7	131.9
Finished goods	216.5	196.2
LIFO reserves	(61.4)	(59.0)
	$ 522.6	$ 481.4

5. PROPERTY, PLANT AND EQUIPMENT

	June 30, 2006	December 31, 2005
Land	$ 79.3	$ 76.5
Buildings	959.0	948.0
Machinery and equipment	5,051.3	4,935.3
	6,089.6	5,959.8
Less: Accumulated depreciation	(3,950.7)	(3,821.2)
	$ 2,138.9	$ 2,138.6

Assets Held for Sale

As a result of restructuring actions, certain facilities and equipment are considered held for sale. The net book value of assets held for sale was $6.5 million at June 30, 2006 and $7.6 million at December 31, 2005. These assets are included in other non-current assets in the Condensed Consolidated Balance Sheets at the lower of their historical net book value or their estimated fair value less estimated costs to sell.

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R.R. DONNELLEY & SONS COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

(Tabular amounts in millions, except per share data unless otherwise indicated)

6. GOODWILL AND OTHER INTANGIBLES

Goodwill	December 31, 2005	Acquisitions	Foreign Exchange and Other Adjustments	June 30, 2006
Publishing and Retail Services	$ 388.4	$	$ (3.7)	$ 384.7
Integrated Print Communications	1,634.7	192.2	36.1	1,863.0
Forms and Labels	727.6		(0.8)	726.8
	$ 2,750.7	$ 192.2	$ 31.6	$ 2,974.5

Other Intangibles	Gross Carrying Amount at January 1, 2006	Additions During the Year	Accumulated Amortization and Foreign Exchange	June 30, 2006	Amortization Period
Trademarks, licenses and agreements	$ 21.9	$	$ (21.3)	$ 0.6	1.5-16 years
Patents	98.3		(28.5)	69.8	8 years
Customer relationship intangibles	795.6	48.6	(119.8)	724.4	5-15 years
Trade names	347.2	26.8	(2.5)	371.5	10 years indefinite
	$ 1,263.0	$ 75.4	$ (172.1)	$ 1,166.3	

Amortization expense for other intangibles was $18.5 million and $12.0 million for the three months ended June 30, 2006 and 2005, respectively, and $35.5 million and $23.2 million for the six months ended June 30, 2006 and 2005, respectively. Annual amortization expense related to these intangibles for each of the next five years, from 2007 to 2011, is estimated to be approximately $75 million. Included in trade names at June 30, 2006 and December 31, 2005 was $304.7 million for indefinite-lived trade names that are not subject to amortization.

7. DEBT

The Company s debt consists of the following:

	June 30, 2006	December 31, 2005
Commercial paper	$ 92.7	$
5.0% debentures due November 15, 2006 (1)	224.0	223.6
3.75% senior notes due April 1, 2009	399.7	399.6
4.95% senior notes due May 15, 2010	499.0	498.9
4.95% senior notes due April 1, 2014	598.2	598.0
5.50% senior notes due May 15, 2015	499.3	499.2
8.875% debentures due April 15, 2021	80.9	80.9
6.625% debentures due April 15, 2029	199.1	199.1
8.820% debentures due April 15, 2031	68.9	68.9
Other, including capital leases	26.3	66.3
Total debt	2,688.1	2,634.5
Less: current portion (1)	(330.2)	(269.1)
Long-term debt	$ 2,357.9	$ 2,365.4

R.R. DONNELLEY & SONS COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

(Tabular amounts in millions, except per share data unless otherwise indicated)

(1) Includes a $0.9 million reduction and $1.2 million reduction in debt related to the fair market value of interest rate swaps at June 30, 2006 and December 31, 2005, respectively.

8. RESTRUCTURING AND IMPAIRMENT CHARGES

Restructuring and Impairment Costs Charged to Results of Operations

For the three months ended June 30, 2006 and 2005, the Company recorded the following net restructuring and impairment charges:

	Three Months Ended June 30, 2006				Three Months Ended June 30, 2005			
	Employee Terminations	Other Charges	Impairment	Total	Employee Terminations	Other Charges	Impairment	Total
Publishing and Retail Services	$ 2.8	$ 0.4	$	$ 3.2	$ 3.2	$ 3.0	$ 1.1	$ 7.3
Integrated Print Communications	5.8	1.3	1.4	8.5	1.5	1.1	0.2	2.8
Forms and Labels	1.1	0.6	0.5	2.2	0.3	0.6	0.9	1.8
Corporate	0.5	0.2		0.7		12.5		12.5
	$ 10.2	$ 2.5	$ 1.9	$ 14.6	$ 5.0	$ 17.2	$ 2.2	$ 24.4

For the six months ended June 30, 2006 and 2005, the Company recorded the following net restructuring and impairment charges:

	Six Months Ended June 30, 2006				Six Months Ended June 30, 2005			
	Employee Terminations	Other Charges	Impairment	Total	Employee Terminations	Other Charges	Impairment	Total
Publishing and Retail Services	$ 9.4	$ 0.4	$	$ 9.8	$ 4.1	$ 3.4	$ 1.1	$ 8.6

Integrated Print Communications	8.4	1.3	1.8	11.5	1.3	5.5	0.3	7.1
Forms and Labels	1.4	1.3	0.5	3.2	1.8	1.8	2.1	5.7
Corporate	4.5	2.2		6.7	1.0	14.2		15.2
	$ 23.7	$ 5.2	$ 2.3	$ 31.2	$ 8.2	$ 24.9	$ 3.5	$ 36.6

For the three and six months ended June 30, 2006, the Company recorded net restructuring charges of $10.2 million and $23.7 million, respectively, for employee termination costs for 499 and 796 employees, respectively, 571 of whom were terminated as of June 30, 2006. These charges were associated with actions resulting from the reorganization of certain operations and the exiting of certain business activities. In addition, the Company incurred other restructuring charges, primarily lease termination costs, of $2.5 million and $5.2 million for the three and six months ended June 30, 2006 and impairment charges of $1.9 million and $2.3 million, respectively.

For the three and six months ended June 30, 2005, the Company recorded net restructuring charges of $5.0 million and $8.2 million, respectively, for employee termination costs for 229 and 336 employees, respectively, all of whom were terminated as of June 30, 2006. These workforce reductions resulted from the elimination of

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R.R. DONNELLEY & SONS COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

(Tabular amounts in millions, except per share data unless otherwise indicated)

duplicative administrative functions due to the acquisition of Moore Wallace Incorporated in 2004 and other actions to restructure operations. In addition, the Company recorded other restructuring charges for the three and six months ended June 30, 2005 of $17.2 million and $24.9 million, respectively, including lease termination charges associated with the relocation of the Company s corporate headquarters within Chicago, the relocation of a Logistics business facility, employee and equipment relocation costs associated with the Moore Wallace acquisition restructuring plans and the exiting of a U.K. financial print facility in the Integrated Print Communications segment.

Restructuring Reserve

The reconciliation of the restructuring reserve as of June 30, 2006 is as follows:

		Restructuring Cost, Net			
	December 31, 2005	Charged to Results of Operations	Capitalized as a Cost of Acquisitions	Cash Paid	June 30, 2006
Employee terminations	$ 14.6	$ 23.7	$ 0.7	$ (15.8)	$ 23.2
Other	21.2	5.2	0.8	(11.3)	15.9
	$ 35.8	$ 28.9	$ 1.5	$ (27.1)	$ 39.1

The restructuring reserve classified as other primarily consists of the estimated remaining payments related to lease terminations and facility closing costs. Payments on certain of these lease obligations are scheduled to continue until 2011. Market conditions and the Company s ability to sublease these properties may affect the ultimate charge related to these lease obligations. Any potential recoveries or additional charges may affect amounts reported in the consolidated financial statements of future periods. The Company anticipates that payments associated with employee terminations relating to the aforementioned restructuring actions will be substantially completed by June 2007.

9. EMPLOYEE BENEFITS

The components of the estimated net pension and postretirement benefits expense for the three and six months ended June 30, 2006 and 2005 are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
PENSION EXPENSE				
Service cost	$ 19.9	$ 20.2	$ 39.9	$ 40.4
Interest cost	32.4	32.2	64.8	64.4
Expected return on assets	(51.3)	(49.4)	(102.7)	(98.8)
Amortization, net	0.7	(1.8)	1.5	(3.6)
Settlement				0.7
Curtailment				(0.7)
Net pension expense	$ 1.7	$ 1.2	$ 3.5	$ 2.4

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
POSTRETIREMENT BENEFITS EXPENSE				
Service cost	$ 2.9	$ 2.8	$ 6.0	$ 5.6
Interest cost	6.6	7.6	14.1	15.2
Expected return on assets	(3.9)	(4.6)	(8.0)	(9.2)
Amortization, net	(3.3)	(3.2)	(5.3)	(6.4)
Net postretirement expense	$ 2.3	$ 2.6	$ 6.8	$ 5.2

10. SHARE-BASED COMPENSATION

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment, (SFAS No. 123(R))which requires the measurement and recognition of compensation expense, based on estimated fair values, for all share-based awards made to employees and directors, including stock options, restricted stock, restricted stock units and performance share units. In March 2005, the SEC issued Staff Accounting Bulletin (SAB) No. 107 relating to SFAS 123(R). The Company has applied the provisions of SAB No. 107 in its adoption of SFAS No. 123(R).

The Company adopted SFAS No. 123(R) using the modified prospective application transition method as of January 1, 2006. The condensed consolidated financial statements as of June 30, 2006 and for the three and six months then ended reflect the impact of SFAS No. 123(R). In accordance with the modified prospective application transition method, the Company s consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R).

Prior to the adoption of SFAS No. 123(R), the Company accounted for share-based awards to employees and directors using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees . Additionally, prior to January 1, 2006, the Company provided pro forma disclosure amounts in accordance with SFAS No. 148, Accounting for Share-based Compensation Transition and Disclosure, as if the fair value method defined by SFAS No. 123 had been applied to share-based compensation. Under APB Opinion No. 25, because the exercise price of the Company s stock options granted to employees and directors equaled the fair market value of the underlying stock at the grant date, no share-based compensation expense was recognized in the Company s consolidated statement of operations related to stock options.

SFAS No. 123(R) requires companies to estimate the fair value of share-based awards on the date of grant using an option-pricing model, where applicable. Share-based compensation expense recognized in the Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2006 included compensation expense for share-based awards granted (i) prior to, but not yet vested as of, December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (ii) subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). The Company recognizes these compensation costs for only those awards expected to vest, on a straight-line basis over the requisite service period of the award, which is generally the vesting term of three to four years for restricted stock awards, performance share units and stock options. The Company estimated the number of awards expected to vest based, in part, on historical forfeiture rates and also based on management s expectations of employee turnover within the specific employee groups receiving each type of award. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company s pro forma

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information required under SFAS No. 123 for periods prior to fiscal 2006, the Company accounted for forfeitures of stock options as they occurred.

The Company will continue to follow the nominal vesting period approach for awards granted prior to its January 1, 2006 adoption of SFAS No. 123(R). For awards granted subsequent to its adoption of SFAS No. 123(R), compensation cost will be recognized over the shorter of the nominal vesting period or the period until the employee s award becomes non-forfeitable upon reaching eligible retirement age under the terms of the award.

Share-Based Compensation under SFAS No. 123(R) for the three and six months ended June 30, 2006 and under APB Opinion No. 25 for the three and six months ended June 30, 2005

As a result of the adoption of SFAS No. 123(R), the Company recorded $0.9 million and $1.8 million of compensation expense associated with stock options for the three and six months ended June 30, 2006, respectively. In addition, prior to the adoption of SFAS No. 123(R), the Company presented the tax benefit of stock option exercises as operating cash flows. As a result, excess tax benefits of $0.7 million are shown as financing cash inflows in the Condensed Consolidated Statement of Cash Flows for the six months ended June 30, 2006.

The total compensation expense related to all share-based compensation plans was $9.0 million and $17.9 million for the three and six months ended June 30, 2006, respectively. Prior to January 1, 2006, the Company accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25 (APB 25). Income from continuing operations for the three and six months ending June 30, 2006 was $0.6 million and $1.2 million lower, respectively, than if the Company had continued to account for share-based compensation under APB 25. Under SFAS No. 123(R), compensation expense is recognized ratably over the associated service period, which is generally the vesting term. The income tax benefit related to share-based compensation expense was $3.6 million and $7.2 million for the three and six months ended June 30, 2006, respectively. As of June 30, 2006, $60.5 million of total unrecognized compensation cost related to share-based compensation is expected to be recognized over a weighted-average period of 2.1 years. The total unrecognized share-based compensation cost to be recognized in future periods as of June 30, 2006 does not consider the effect of share-based awards that may be issued in subsequent periods. Also as a result of the adoption of SFAS No. 123(R), $44.9 million of unearned compensation recorded in shareholders equity as of January 1, 2006 was reclassified to and reduced the balance of additional paid-in capital.

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The pro forma table below reflects net earnings and basic and diluted net earnings per share for the three and six months ended June 30, 2005, had the Company applied the fair value recognition provisions of SFAS No. 123, as follows:

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net earnings, as reported	$ 90.7	$ 197.6
Add: Share-based compensation included in reported net earnings, net of related tax effects	7.4	13.7
Less: Share-based compensation expense determined under the fair value-based method for all awards, net of related tax effects	(8.8)	(16.5)
Pro forma net earnings	$ 89.3	$ 194.8
Basic net earnings per share:		
As reported	$ 0.42	$ 0.92
Pro forma	$ 0.42	$ 0.91
Diluted net earnings per share:		
As reported	$ 0.42	$ 0.91
Pro forma	$ 0.42	$ 0.90

Share-Based Compensation Plans

The Company has two share-based compensation plans available under which it may grant future awards, as described below, and eight terminated or expired share-based compensation plans under which awards remain outstanding.

RR Donnelley 2004 Performance Incentive Plan

The 2004 Performance Incentive Plan (the 2004 PIP) was approved by stockholders to provide incentives to key employees of the Company and its subsidiaries. Awards under the 2004 PIP are generally not restricted to any specific form or structure and could include, without limitation, stock options, stock units, restricted stock awards, cash or stock bonuses and stock appreciation rights. There are 7.0 million shares of common stock of the Company reserved and authorized for issuance under the 2004 PIP.

Moore Wallace 2003 Long-Term Incentive Plan

Upon acquiring Moore Wallace, the Company assumed the Moore Wallace 2003 Long-Term Incentive Plan (the 2003 LTIP), which had been approved by the stockholders of Moore Wallace, under which all employees of Moore Wallace and its subsidiaries are eligible to participate. Awards under the 2003 LTIP may consist of restricted stock or restricted stock units. The time period during which these shares will be available for issuance will not be extended beyond the period when they would have been available under the 2003 LTIP absent the acquisition of Moore Wallace. No awards may be granted under the 2003 LTIP to any legacy RR Donnelley or RR Donnelley subsidiary employees.

General Terms of Awards

Under various incentive plans, the Company has granted certain employees cash, non-qualified stock options, restricted stock awards, restricted stock units and performance share units. The human resources committee of the board of directors has discretion to establish the terms and conditions for grants, including the

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number of shares, vesting and required service or other performance criteria. The maximum term of any award under the 2004 PIP is ten years. At June 30, 2006, there were 2.5 million shares of common stock authorized and available for grant under the 2004 PIP and 5.1 million shares of common stock authorized and available for grant under the 2003 LTIP.

For all of the Company s stock options outstanding at June 30, 2006, the exercise price of the stock option equals the fair market value of the Company s common stock on the option grant date. Options generally vest over four years or less from the date of grant, upon retirement or upon a change in control of the Company. Options granted prior to November 2004 expire ten years from the date of grant or five years after the date of retirement, whichever is earlier, while options granted after November 2004 expire five years from the date of grant.

The rights granted to the recipient of restricted stock and restricted stock unit awards accrue ratably over the restriction or vesting period, which is generally four years or less. These awards are subject to forfeiture upon termination of employment prior to vesting, subject in some cases to early vesting upon specified events, including death or permanent disability of the grantee, termination of the grantee s employment under certain circumstances or a change in control of the Company. The Company expenses the cost of restricted stock and restricted stock unit awards, based on the fair market value of the shares at the date of grant, ratably over the period during which the restrictions lapse.

The Company also issues restricted stock units as share-based compensation for members of the board of directors. One-third of these restricted stock units vest on the third anniversary of the grant date, and the remaining two-thirds of these restricted stock units vest upon termination of the holder s service on the board of directors. The holder may elect to defer delivery of the initial one-third of the restricted stock units until termination of service on the board of directors. In the event of termination of service on the board of directors prior to the third anniversary of the grant date, all restricted stock units will vest. The restricted stock units are payable in shares of the Company s common stock or cash, at the discretion of the Company. These awards are classified as liability awards due to their expected settlement in cash and are included in accrued liabilities in the Condensed Consolidated Balance Sheets. Compensation expense for these awards is measured based upon the fair market value of the awards at the end of each reporting period.

The Company has granted performance share unit awards to executive officers and other key employees. Distributions under these awards are payable at the end of the performance period in common stock or cash at the Company s discretion. Should certain performance targets be achieved, the amount payable under these awards could reach three hundred percent of the initial award. These awards are subject to forfeiture upon termination of employment prior to vesting, subject in some cases to early vesting upon specified events, including death or permanent disability of the grantee, termination of the grantee s employment under certain circumstances or a change in control of the Company. Prior to January 1, 2006, compensation expense for these awards was measured based upon the intrinsic value of the awards at the end of the reporting period and accrued over the performance period. Upon adoption of SFAS No. 123(R), the Company expenses the cost of the performance share unit awards, based on the fair market value of the awards at the date of grant, ratably over the performance period.

Stock Options

The fair value of each non-qualified stock option award is estimated on the date of grant using the Black-Scholes option pricing model. The Company did not grant stock options during the six months ended June 30, 2006. The Company granted 7,000 stock options during the six months ended June 30, 2005, none of which were

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granted in the three months ended June 30, 2005. The fair value of these stock options was determined using the following weighted average assumptions under SFAS No. 123:

	Six Months Ended June 30, 2005
Expected volatility	25.96%
Risk-free interest rate	3.52%
Expected life (years)	3.75
Expected dividend yield	3.1%

The per-option weighted average grant date fair value of options granted was $6.07 for the six months ended June 30, 2005. For future grants of stock options, the fair value will be estimated using the Black-Scholes option pricing model utilizing weighted average assumptions in accordance with SFAS No. 123(R) and SAB No. 107.

The following table is a summary of the Company s stock option activity:

	Shares (Thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at December 31, 2005	10,229	$ 28.75	4.9	
Granted				
Exercised	(411)	23.33	5.8	
Cancelled/forfeited/expired	(965)	36.86		
Outstanding at June 30, 2006	8,853	$ 28.41	4.8	$ 31.3
Exercisable at June 30, 2006	7,514	$ 27.97		$ 29.9

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the difference between the Company s closing stock price on June 30, 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on June 30, 2006. This amount will change in future periods based on the fair market value of the Company s common stock. Total intrinsic value of options exercised for the three and six months ended June 30, 2006 was $2.3 million and $4.4 million, respectively.

As of June 30, 2006, $6.0 million of total unrecognized compensation cost related to stock options is expected to be recognized over a weighted average period of 1.7 years.

Cash received from the option exercises for the three and six months ended June 30, 2006 was $5.4 million and $9.4 million, respectively. The actual tax benefit realized for the tax deduction from option exercises totaled $0.9 million and $1.7 million for the three and six months ended June 30, 2006.

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Restricted Stock and Restricted Stock Units

Nonvested restricted stock and restricted stock unit awards as of June 30, 2006 and December 31, 2005 and changes during the six months ended June 30, 2006 were as follows:

	Shares (Thousands)	Weighted-Average Grant Date Fair Value
Nonvested at December 31, 2005	1,937	$ 31.90
Granted	363	32.86
Vested	(593)	31.24
Forfeited	(126)	32.41
Nonvested at June 30, 2006	1,581	$ 32.32

Compensation expense recognized related to restricted stock awards and restricted stock units for the three and six months ended June 30, 2006 was $4.6 million and $9.1 million, respectively. For the three and six months ended June 30, 2005, compensation expense related to restricted stock awards and restricted stock units was $4.1 million and $8.3 million, respectively. As of June 30, 2006, there was $44.7 million of unrecognized share-based compensation expense related to nonvested restricted stock and restricted stock unit awards. That cost is expected to be recognized over a weighted-average period of 2.5 years.

Performance Share Unit Awards

A total of 460,000 nonvested performance share unit awards were outstanding as of June 30, 2006 and December 31, 2005, with a potential payout of 1,380,000 shares should all performance targets be met. Compensation expense recognized related to performance share unit awards for the three and six months ended June 30, 2006 was $3.5 million and $7.0 million, respectively. For the three and six months ended June 30, 2005, compensation expense related to performance share unit awards was $8.0 million and $14.2 million, respectively. As of June 30, 2006, there was $9.8 million of unrecognized share-based compensation expense related to nonvested performance share unit awards. That cost is expected to be recognized over a weighted-average period of 0.7 years.

Other Information

Authorized unissued shares or treasury shares may be used for issuance under the share-based compensation plans. The Company intends to use treasury shares of its common stock to meet the stock requirements of its awards in the future. As of June 30, 2006, the Company is authorized, under the terms of share repurchase programs approved by the Board of Directors, to repurchase up to approximately 11.0 million shares (based on the Company s closing share price on August 1, 2006).

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11. EARNINGS PER SHARE

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Net earnings	$ 125.2	$ 90.7	$ 237.1	$ 197.6
Basic:				
Weighted average number of common shares outstanding	216.9	213.5	216.4	214.4
Net earnings per share basic	$ 0.57	$ 0.42	$ 1.09	$ 0.92