

***OCLC Online Computer  
Library Center, Inc. and  
Subsidiaries***

*Consolidated Financial Statements as of  
and for the Years Ended June 30, 2004 and  
2003 and Independent Auditors' Report*

# OCLC ONLINE COMPUTER LIBRARY CENTER, INC. AND SUBSIDIARIES

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## INDEPENDENT AUDITORS' REPORT

Board of Trustees  
OCLC Online Computer Library Center, Inc.

We have audited the accompanying consolidated balance sheets of OCLC Online Computer Library Center, Inc. and its subsidiaries (the "Corporation") as of June 30, 2004 and 2003, and the related consolidated statements of revenues, expenses and corporate equity and of cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Corporation and its subsidiaries at June 30, 2004 and 2003, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Deloitte + Touche LLP*

September 2, 2004

**OCLC ONLINE COMPUTER LIBRARY CENTER, INC.  
AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS  
JUNE 30, 2004 AND 2003**

<b>ASSETS</b>	<b>2004</b>	<b>2003</b>
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 26,480,300	\$ 17,577,000
Short-term investments	7,939,200	
Government securities	18,717,100	14,702,800
Corporate notes and bonds	19,410,300	17,427,800
Equity securities	69,316,500	62,470,900
Receivables—net	29,792,000	37,407,700
Prepaid expenses and other	<u>8,472,900</u>	<u>8,632,500</u>
Total current assets	180,128,300	158,218,700
<b>FIXED ASSETS—At cost, less accumulated depreciation and amortization</b>	125,420,200	125,334,100
<b>OTHER ASSETS</b>	<u>9,575,300</u>	<u>8,916,100</u>
<b>TOTAL</b>	<u>\$ 315,123,800</u>	<u>\$ 292,468,900</u>
 <b>LIABILITIES AND CORPORATE EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Current portion of long-term debt and capital leases	\$ 7,292,300	\$ 6,786,700
Accounts payable	5,409,300	10,953,400
Accrued liabilities	14,148,900	14,183,700
Advance subscription payments	14,281,100	11,699,400
Unearned revenue	<u>35,261,700</u>	<u>34,075,500</u>
Total current liabilities	76,393,300	77,698,700
<b>LONG-TERM DEBT AND CAPITAL LEASES— Less current portion</b>	68,325,300	60,259,100
<b>OTHER NONCURRENT LIABILITIES</b>	23,036,800	20,792,200
<b>MINORITY INTEREST</b>	9,190,200	8,383,200
<b>CORPORATE EQUITY</b>	<u>138,178,200</u>	<u>125,335,700</u>
<b>TOTAL</b>	<u>\$ 315,123,800</u>	<u>\$ 292,468,900</u>

See notes to consolidated financial statements.

**OCLC ONLINE COMPUTER LIBRARY CENTER, INC.  
AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF REVENUES,  
EXPENSES AND CORPORATE EQUITY  
YEARS ENDED JUNE 30, 2004 AND 2003**

	<b>2004</b>	<b>2003</b>
REVENUES	<u>\$ 190,649,300</u>	<u>\$ 191,806,300</u>
OPERATING EXPENSES:		
Salaries, wages and related fringe benefits	84,529,900	88,179,400
Telecommunications and computer support	45,094,400	44,043,200
Selling, general and administrative	32,867,300	34,512,400
Depreciation and amortization	19,299,900	15,475,900
Building and utilities	<u>5,892,900</u>	<u>5,326,900</u>
Total operating expenses	<u>187,684,400</u>	<u>187,537,800</u>
EXCESS OF NET REVENUES OVER OPERATING EXPENSES	<u>2,964,900</u>	<u>4,268,500</u>
OTHER INCOME (EXPENSE):		
Investment income (expense)	6,873,000	(1,645,800)
Interest expense	(3,078,300)	(3,104,100)
Minority interest in excess of revenues over expenses of majority-owned subsidiaries	(159,300)	(430,700)
Miscellaneous—net	<u>(186,500)</u>	<u>(40,600)</u>
Total other income (expense)	<u>3,448,900</u>	<u>(5,221,200)</u>
EXCESS (DEFICIT) OF REVENUES OVER EXPENSES	6,413,800	(952,700)
NET UNREALIZED GAIN ON INVESTMENTS	5,419,800	5,000,600
CHANGE IN VALUE OF INTEREST RATE SWAP AGREEMENT	361,000	(376,100)
FOREIGN CURRENCY TRANSLATION ADJUSTMENT	<u>647,900</u>	<u>1,950,500</u>
INCREASE IN NET EQUITY	12,842,500	5,622,300
CORPORATE EQUITY—Beginning of year	<u>125,335,700</u>	<u>119,713,400</u>
CORPORATE EQUITY—End of year	<u>\$ 138,178,200</u>	<u>\$ 125,335,700</u>

See notes to consolidated financial statements.

**OCLC ONLINE COMPUTER LIBRARY CENTER, INC.  
AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS  
YEARS ENDED JUNE 30, 2004 AND 2003**

	<b>2004</b>	<b>2003</b>
<b>CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES:</b>		
Excess (deficit) of revenues over expenses	\$ 6,413,800	\$ (952,700)
Adjustments for non-cash items:		
Depreciation and amortization	19,299,900	15,475,900
Minority interest in earnings of majority-owned subsidiaries	159,300	430,700
Realized (gain) loss on sale of investments	(4,609,900)	4,194,100
Loss on sale of fixed assets	1,882,300	24,000
Loss on sale of MetaText		11,300
Changes in assets and liabilities:		
Decrease (increase) in receivables	7,726,500	(3,111,900)
Decrease (increase) in other assets	454,400	(2,171,000)
Increase (decrease) in accounts payable	(2,469,300)	1,890,900
Increase in accrued liabilities, unearned revenue and other	<u>4,170,700</u>	<u>5,658,300</u>
Cash provided by operating activities	<u>33,027,700</u>	<u>21,449,600</u>
<b>CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES:</b>		
Payments on revenue bonds and capital leases	(7,249,200)	(23,193,400)
Proceeds from revenue bonds and capital leases	14,000,000	25,000,000
Premium received on debt issuance		1,223,300
Proceeds from line of credit		2,700,000
Payments on line of credit		(2,700,000)
Debt issuance costs	(16,400)	(246,600)
Change in bond trust accounts—net	<u>12,000</u>	<u>(11,200)</u>
Cash provided by financing activities	<u>6,746,400</u>	<u>2,772,100</u>
<b>CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES:</b>		
Purchases of investments	(85,848,500)	(50,548,900)
Proceeds from sale of investments	75,168,200	47,311,000
Purchases of fixed assets	(10,246,800)	(11,859,000)
Capitalization of internal use software	(10,218,300)	(12,835,000)
Acquisition of Libpac Ltd. (excluding acquired cash of \$1,019,600)	(485,200)	
Acquisition of CAPCON (excluding acquired cash of \$315,000)	315,000	
Acquisition of Strata Preservation N.V. (excluding acquired cash of \$846,800)		304,500
Proceeds from sale of MetaText		2,504,400
Other—net	<u>(278,900)</u>	<u>(608,100)</u>
Cash used in investing activities	<u>(31,594,500)</u>	<u>(25,731,100)</u>
<b>EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS</b>		
	<u>723,700</u>	<u>1,646,700</u>

(Continued)

# OCLC ONLINE COMPUTER LIBRARY CENTER, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED JUNE 30, 2004 AND 2003

	2004	2003
INCREASE IN CASH AND CASH EQUIVALENTS	\$ 8,903,300	\$ 137,300
CASH AND CASH EQUIVALENTS—Beginning of year	<u>17,577,000</u>	<u>17,439,700</u>
CASH AND CASH EQUIVALENTS—End of year	<u>\$ 26,480,300</u>	<u>\$ 17,577,000</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the year for interest	<u>\$ 3,071,100</u>	<u>\$ 3,157,300</u>
Fixed asset additions financed by accounts payable	<u>\$ 230,200</u>	<u>\$ 3,307,900</u>
Property acquired by capital lease	<u>\$ 1,821,000</u>	<u>\$ 1,147,500</u>
Net unrealized gain on investments	<u>\$ 5,419,800</u>	<u>\$ 5,000,600</u>
Change in fair value of interest rate swap agreement	<u>\$ 361,000</u>	<u>\$ (376,100)</u>
Acquisitions:		
Fair value of assets acquired	\$ 1,556,900	\$ 1,388,300
Liabilities assumed	(1,485,000)	(966,600)
Minority interest		(168,700)
Excess of cost over fair value of assets acquired	<u>1,432,900</u>	<u>289,300</u>
Cash paid	<u>\$ 1,504,800</u>	<u>\$ 542,300</u>
Sale of MetaText:		
Assets disposed		\$ 2,664,600
Liabilities transferred		(148,900)
Loss on sale		<u>(11,300)</u>
Cash received		<u>\$ 2,504,400</u>

See notes to consolidated financial statements.

(Concluded)

# OCLC ONLINE COMPUTER LIBRARY CENTER, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS YEARS ENDED JUNE 30, 2004 AND 2003

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### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND PROCEDURES

OCLC Online Computer Library Center, Inc. (“OCLC”) is a non-profit corporation organized to establish, maintain, and operate an international computerized network of bibliographic cataloging services for libraries and to promote the evolution of library use. The accumulated excess of revenues over expenses (corporate equity) cannot be distributed to the members. OCLC’s corporate equity is unrestricted. In the event of dissolution, the Board of Trustees is to adopt a plan for distribution of remaining assets that is consistent with the purpose of OCLC. OCLC generally provides services to its members on a contract basis. The significant accounting policies of OCLC and its subsidiaries are set forth below:

**Principles of Consolidation**—The consolidated financial statements include the accounts of OCLC and its wholly-owned for-profit subsidiaries, OCLC Educational Services, Inc. (“OESI”), and OCLC Information Distribution, Inc. (“OID”) as well as its majority-owned subsidiaries, OCLC PICA B.V. and Strata Preservation N.V. (“Strata”). OCLC’s wholly-owned for-profit subsidiaries were inactive for the year ended June 30, 2004 and OESI was dissolved on July 31, 2003. Operating revenues for OCLC’s wholly-owned for-profit subsidiaries were \$242,800, and expenses were \$539,100, for the year ended June 30, 2003. Intercompany transactions have been eliminated in consolidation. See Notes 7, 9, and 10 regarding the acquisition of CAPCON Library Network (“CAPCON”), Strata Preservation N.V., and Libpac, Ltd.

**Cash and Cash Equivalents**—All highly liquid debt investments with an original maturity of three months or less at the time of purchase are considered cash equivalents, and are stated at cost, which approximates market. Cash is primarily held in two banks.

**Investments**—Short-term investments consist of commercial paper and short-term government notes, and are stated at cost, which approximates market. Government securities, corporate notes and bonds and equity securities are stated at fair value. Fair values are based on market quotes.

**Revenue Recognition**—Member service revenues are recognized at the time services are provided, and include member system service revenues, telecommunication revenues, and miscellaneous member service revenues. Software license and consulting revenues are recognized at the time software is shipped and services are provided, or according to contract terms in the case of customized installations and system maintenance billings. Unearned revenue and advance subscription payments represent monies advanced to OCLC by members and Networks and are recognized as revenues when the service is provided. Member participation credits (2004—\$5,835,100; 2003—\$6,000,300) are issued to libraries for services provided to OCLC for the benefit of the cooperative and are recorded as an expense rather than a reduction of revenue.

**Minority Interest**—Minority interest represents the 40% of OCLC PICA B. V. owned by Stichting Pica and 40% of Strata Preservation N.V. owned by Koninklijke Bibliotheek, the National Library of the Netherlands (see Note 9).

**Use of Estimates**—The preparation of these financial statements in conformity with accounting principles generally accepted in the United States of America requires, in certain instances, the use of estimates. Actual results could differ from these estimates.

**Depreciation and Amortization**—Depreciation is provided using straight-line and accelerated methods at rates based on the estimated useful lives of the equipment and improvements (3 to 20 years) and buildings (30 to 40 years). Costs incurred and premiums received in connection with the issuance of revenue bonds are amortized and accreted, respectively, using the effective interest method over the terms of the respective bonds.

**Software and Goodwill**—The cost of purchased software is capitalized and amortized using the straight-line method over the estimated economic useful lives (3 to 15 years). OCLC capitalizes the costs associated with purchased databases, enhancements, and certain internal use software costs once certain criteria are met. These costs are amortized using the straight-line method (3 to 15 years). At each balance sheet date, management compares the carrying value of capitalized software to the net realizable value of the software, and the carrying value in excess of future discounted cash flows is expensed currently. Goodwill, which represents the excess of purchase price over the fair value of assets acquired, is amortized using the straight-line method (5 to 15 years). Net book value of goodwill was \$2,538,300 and \$2,498,200 at June 30, 2004 and 2003, respectively.

**Research and Development**—Research and development costs (principally salaries and related fringe benefits), approximating \$13,382,100 and \$14,048,400 for fiscal 2004 and 2003, respectively, are charged to operations as incurred.

**Income and Other Taxes**—OCLC is tax exempt under the appropriate sections of the Internal Revenue Code and various sections of state and local tax statutes and, accordingly, no provision for federal, state, or local income taxes is currently required for its operations. OCLC PICA B.V., Strata Preservation N.V., OID and OESI are not exempt from federal, state, local, or foreign income taxes.

The asset and liability method is used for financial accounting and reporting of income taxes. Deferred income tax assets and liabilities are computed annually for differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted laws and rates applicable to the periods in which differences are expected to affect taxable income. Income tax expense is the tax payable or refundable for the period plus or minus the change during the period in deferred tax assets and liabilities. Income tax expense for the years ended June 30, 2004 and 2003 was \$838,800 and \$660,500 respectively, and is included in selling, general, and administrative expense.

**Foreign Currency Translation**—Branch offices, foreign subsidiaries and equity interests are based in Canada, United Kingdom, France and the Netherlands. The local currency has been designated as the functional currency for such operations. Income and expense items are translated at the average monthly rate of exchange. Assets and liabilities are translated at the rate of exchange on the balance sheet dates with the resultant translation gains or losses included as a separate component of corporate equity. Corporate equity includes net cumulative translation gains of \$3,006,600 and \$2,358,700 at June 30, 2004 and 2003, respectively.

**Self-Insurance Programs**—OCLC uses various self-insurance plans for certain of its medical insurance programs. The associated liability has been recorded in the consolidated financial statements based on information currently available as to the estimated ultimate cost for incidents prior to the balance sheet dates. Losses in excess of certain limits are insured with third-party insurance companies.

## 2. INVESTMENTS

In accordance with Statement of Financial Accounting Standards (“SFAS”) No. 124, *Accounting for Certain Investments Held by Not-For-Profit Organizations*, debt and equity investments are carried at their fair value with related unrealized gains and losses on the portfolio reflected in the change in net equity. Realized gains and losses are included in investment income.

OCLC invests available cash in major banks, federal, state, and local government obligations and investment grade debt and equity securities. Market risk is reduced by investing funds in maturities that match anticipated short and long-term cash needs and by investing in diversified industries and markets, both domestic and international. All investments are held in safekeeping by a trustee and are reflected in the balance sheets as cash equivalents, short-term investments, government securities, corporate notes and bonds, and equity securities.

In fiscal year 2001, OCLC adopted the provisions of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to establish accounting and reporting requirements for derivative instruments. See Note 4 for the impact on OCLC’s financial position.

Realized gains and losses related to investments are recorded using the specific identification method. Net unrealized gains on the portfolio totaled \$7,044,000 and \$1,624,200 at June 30, 2004 and 2003, respectively. The following schedule details investment returns for the years ended June 30:

	2004	2003
Dividends and interest income	\$ 2,263,100	\$ 2,548,300
Net realized gains (losses)	<u>4,609,900</u>	<u>(4,194,100)</u>
Investment income (expense)	6,873,000	(1,645,800)
Net unrealized gain on investments	<u>5,419,800</u>	<u>5,000,600</u>
Total net investment return	<u>\$ 12,292,800</u>	<u>\$ 3,354,800</u>

In November 2003, the FASB issued EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. This guidance requires additional disclosures of investments having unrealized losses. The following table shows the gross unrealized losses and fair value, aggregated by investment category and length of time those securities have been in a continuous unrealized loss position, at June 30, 2004.

Description of Temporarily Impaired Securities	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
US Treasury obligations	\$ 5,010,800	\$ (76,800)	\$1,649,100	\$ (114,200)	\$ 6,659,900	\$ (191,000)
Mortgage backed securities	1,777,800	(66,000)	170,700	(6,700)	1,948,500	(72,700)
Corporate bonds	9,854,600	(231,100)	748,100	(234,000)	10,602,700	(465,100)
Total debt securities	<u>16,643,200</u>	<u>(373,900)</u>	<u>2,567,900</u>	<u>(354,900)</u>	<u>19,211,100</u>	<u>(728,800)</u>
Common stock	13,728,200	(1,038,700)	2,070,800	(690,500)	15,799,000	(1,729,200)
Preferred stock	803,800	(35,700)			803,800	(35,700)
Total equity securities	<u>14,532,000</u>	<u>(1,074,400)</u>	<u>2,070,800</u>	<u>(690,500)</u>	<u>16,602,800</u>	<u>(1,764,900)</u>
Total temporarily impaired securities	<u>\$31,175,200</u>	<u>\$ (1,448,300)</u>	<u>\$4,638,700</u>	<u>\$ (1,045,400)</u>	<u>\$35,813,900</u>	<u>\$(2,493,700)</u>

OCLC reviews its portfolio for impairment and has reached the conclusion, in consultation with OCLC's investment advisors, that these impairments are temporary due to the current market conditions and interest rates. The government securities are backed by the full faith of the US government and the corporate notes and bonds are investment grade (Standard & Poor rated triple B or better) and OCLC knows of no individual holdings that are permanently impaired or have fallen below investment grade. At June 30, 2004, the Corporation owns the following securities that had unrealized losses: 25 U.S. Treasury obligations, nine mortgage securities, 171 corporate bonds, 90 common stock, and 18 preferred stock.

### 3. FIXED ASSETS

Fixed assets include the following:

	June 30	
	2004	2003
Land and improvements	\$ 10,279,400	\$ 10,279,400
Buildings and improvements	60,111,700	59,513,200
Computer and telecommunications equipment	35,315,300	35,269,700
Databases	55,281,800	50,982,500
Intangibles including software and goodwill	55,674,000	45,722,600
Office furniture and equipment	<u>23,428,000</u>	<u>23,679,600</u>
 Total	 240,090,200	 225,447,000
 Less accumulated depreciation and amortization	 <u>114,670,000</u>	 <u>100,112,900</u>
 Fixed assets—net	 <u>\$125,420,200</u>	 <u>\$125,334,100</u>

Software development costs, related to internal use software, of \$10,218,300 and \$12,835,000 were capitalized in 2004 and 2003, respectively.

**Operating Leases**—Certain buildings and equipment are rented under operating leases. Rental expense for all leases was \$1,698,500 and \$1,324,700 for fiscal years 2004 and 2003, respectively. Future minimum lease payments under existing non-cancelable lease commitments are as follows:

Fiscal Year Ended June 30	
2005	\$ 1,339,400
2006	1,297,400
2007	1,168,200
2008	348,000
2009	224,400
Thereafter	<u>45,700</u>
 Total	 <u>\$4,423,100</u>

#### 4. LONG-TERM DEBT

In April 2003, OCLC issued \$25,000,000 of Franklin County Revenue Bonds (“2003 bonds”). The proceeds were used to refund the remaining portion of the 1993 Franklin County Revenue Bonds (“1993 bonds”), and to improve real property, acquire office systems, software, computers and other equipment, and bibliographic and other databases. The bonds were issued at a premium of \$1,223,000 which is being accreted over the life of the bonds using the effective interest method.

In December 1998, OCLC issued \$32,515,000 of Franklin County Revenue Bonds (“1998 bonds”). The proceeds were used to advance refund and defease a portion of the 1991 Franklin County Revenue Bonds (“1991 bonds”), and to improve real property, acquire office systems, software, computers and other equipment, and bibliographic and other databases. The total 1991 bonds refunded were \$6,675,000.

**Revenue Bonds**—Revenue bonds outstanding are as follows:

	June 30	
	2004	2003
Serial bonds:		
1998 bonds, 4.00% to 4.70%, maturing annually through October 1, 2012	\$ 14,865,000	\$ 17,165,000
2003 bonds, 3.00% to 5.00%, maturing annually through April 15, 2013	<u>19,730,000</u>	<u>21,545,000</u>
Total serial bonds	<u>34,595,000</u>	<u>38,710,000</u>
Term bonds:		
1998 bonds, 5.00% and 5.20%, maturing October 1, 2016 and October 1, 2020	11,975,000	11,975,000
2003 bonds, 5.25%, maturing April 15, 2018	<u>3,455,000</u>	<u>3,455,000</u>
Total term bonds	<u>15,430,000</u>	<u>15,430,000</u>
Total revenue bonds outstanding	<u>\$ 50,025,000</u>	<u>\$ 54,140,000</u>

Bond fund deposits for the 1998 serial bonds sufficient to cover the next principal payment will be made annually to the trustee. Annual sinking fund deposits for redemption of the principal balance of the 1998 term bonds commence October 1, 2013, in amounts ranging from \$1,375,000 in 2013 to \$1,575,000 in 2020. Interest on the 1998 bonds is payable semi-annually to the trustee. The 1998 bonds are callable at 101% of par if redeemed between October 2008 and September 2009, and at par beginning October 2009.

Bond fund deposits for the 2003 serial bonds sufficient to cover the next principal payment are made annually to the trustee. Annual sinking fund deposits for redemption of the principal balance of the 2003 term bonds commence April 15, 2014, in amounts ranging from \$620,000 in 2014 to \$765,000 in 2018. Interest on the 2003 bonds is payable semi-annually to the trustee. The 2003 bonds are callable at par beginning April 15, 2013.

All bond issues are unsecured. The indenture agreement and its supplements restrict, among other things, the issuance of additional debt and the granting of security interests.

**Capitalized Leases**—OCLC leases office and computer equipment and autos with an option to purchase the equipment at a nominal cost at the termination of the lease. The outstanding balance was \$1,497,400 and \$715,300 at June 30, 2004 and 2003, respectively.

On October 26, 2001, the Corporation entered into a seven-year tax-exempt lease agreement through Franklin County, Ohio for \$16,000,000 with an effective interest rate of 4.11%. The lease is due monthly in equal principal installments of \$190,500 (plus interest) and has a balance outstanding of \$10,095,200 and \$12,190,500 at June 30, 2004 and 2003, respectively. The proceeds were used to finance the acquisition and installation of office systems and equipment, computers, servers, related peripheral equipment and software and bibliographic and other information databases.

The Corporation also simultaneously entered into a \$16,000,000 interest rate swap agreement to manage its exposure to the variability of cash flows primarily related to the interest rate changes on its borrowing costs. The agreement is designated as a cash flow hedge at inception with a remaining maturity of seven years. The Corporation adjusts the swap to market value through equity as the contract is effective in offsetting the interest rate exposure of the forecasted interest rate payments hedged. Hedging effectiveness is assessed periodically by comparing the fair market value of the agreement to similar agreements maintained by the lending facility. The swap agreement had a total negative fair market value of \$177,900 and \$538,900 at June 30, 2004 and 2003, respectively, which is reflected as a long-term liability and charge to equity. As the interest rate protection agreement is with a major bank, the Corporation does not expect to be subject to credit risk exposures.

On June 14, 2004, the Corporation entered into a seven-year tax-exempt lease agreement through Franklin County, Ohio for \$14,000,000 with an effective interest rate equal to the LIBOR Rate plus 1.75%, multiplied by 0.65 (1.86% at June 30, 2004). The lease is due monthly in equal principal installments of \$233,300 (plus interest) starting July 2006 and has a balance outstanding of \$14,000,000 at June 30, 2004. Interest only is due July 1, 2004 to July 1, 2006. The proceeds were used to finance the acquisition and installation of office systems and equipment, computers, servers, related peripheral equipment and software and bibliographic and other information databases.

Cost and accumulated depreciation of the leased equipment included in 2004 and 2003 fixed assets were as follows:

	<b>2004</b>	<b>2003</b>
Equipment, software and databases	\$ 32,694,300	\$ 17,225,200
Less accumulated depreciation	<u>5,824,000</u>	<u>3,241,300</u>
Capitalized leased assets—net	<u>\$ 26,870,300</u>	<u>\$ 13,983,900</u>

The aggregate maturities of the revenue bonds and the capital lease obligations are as follows:

<b>Fiscal Year Ending June 30</b>	
2005	\$ 7,292,300
2006	7,329,500
2007	9,749,000
2008	8,285,700
2009	7,080,900
2010 and later	<u>35,880,200</u>
Total	<u>\$75,617,600</u>

## **5. BANK LINE OF CREDIT**

An unsecured revolving line of credit with a bank provided for total borrowings of up to \$6,000,000 during fiscal years 2004 and 2003. Under the terms of the agreement, interest on amounts borrowed is payable at the bank's prime rate of interest. The line of credit expires in December 2004. During fiscal 2004, no borrowings were made under such line of credit. During fiscal 2003, a total of \$2.7 million was borrowed and subsequently repaid within a week of the borrowings.

## **6. EMPLOYEE BENEFIT PLANS**

A noncontributory, defined contribution retirement plan covers all domestic OCLC employees who have completed two years of service, except for employees of OCLC's netLibrary division. Voluntary contributory, defined contribution employee savings plans cover all full-time domestic OCLC employees who have completed ninety days of service. In 2003, OCLC established a 457(b) non-qualified voluntary contributory, defined contribution savings plan for key domestic employees with no defined waiting period. The cost of these plans (included in salaries, wages, and related fringe benefits) was \$4,427,400 and \$4,474,700 for fiscal 2004 and 2003, respectively.

In 1998, OCLC established a non-qualified voluntary contributory savings plan for key domestic employees and Board of Trustee members. OCLC purchases and holds (reflected in other assets) investment assets, recorded at fair value, equal to the participants' voluntary contributions. Due to a change in federal tax regulations, the plan was frozen effective May 1, 2002. In 2003, OCLC established a 457(f) non-qualified deferred compensation plan for key domestic employees. The liability under these plans was \$5,591,900 and \$4,526,600 (reflected in Other Noncurrent Liabilities) at June 30, 2004 and 2003, respectively.

Foreign operations, including OCLC PICA B.V. and Strata Preservation N.V., maintain or participate in separate retirement and defined contribution pension plans. Total contributions recorded under these plans were \$583,300 and \$564,700 in fiscal years 2004 and 2003, respectively.

OCLC maintains a voluntary contributory plan providing postretirement health care and non-contributory postretirement life insurance coverage for domestic employees. OCLC's domestic employees meeting certain age and service requirements at the time of their retirement are eligible to participate. OCLC recognizes the cost of postretirement medical and life benefits as the employees render service. These benefits are funded by OCLC when incurred.

As of June 30, 2004 and 2003, relevant postretirement benefit information is summarized as follows:

	<b>2004</b>	<b>2003</b>
Accumulated postretirement benefit obligation:		
Retired participants	\$ 2,610,200	\$ 1,370,900
Fully eligible active plan participants	850,000	2,382,400
Other active plan participants	<u>8,078,400</u>	<u>8,636,000</u>
Postretirement benefit obligation	11,538,600	12,389,300
Unrecognized net gain (loss) from actuarial experience different than that assumed and changes in assumptions	2,624,800	(127,200)
Unrecognized prior service cost	<u>(45,500)</u>	<u>(50,000)</u>
Accrued postretirement benefit obligation (reflected in other noncurrent liabilities)	<u>\$ 14,117,900</u>	<u>\$ 12,212,100</u>
Net postretirement benefit cost:		
Service cost	\$ 1,332,800	\$ 1,215,400
Interest cost	708,400	729,500
Net amortization	<u>4,500</u>	<u>4,500</u>
Total	<u>\$ 2,045,700</u>	<u>\$ 1,949,400</u>
Contributions and benefits paid under the plan:		
Benefits paid by OCLC	\$ 139,800	\$ 47,200
Participant contributions	<u>151,500</u>	<u>93,300</u>
Total benefits paid	<u>\$ 291,300</u>	<u>\$ 140,500</u>

Actuarial assumptions used in determining these amounts included a weighted average discount rate of 5.75% at June 30, 2004 and 2003, and an annual increase in medical and dental expense of 8.75% and 9.0%, respectively, declining to 6.25% and 6%, respectively, in 2009 and thereafter.

OCLC's expected payment of benefits for its postretirement benefit plan in fiscal 2005 is \$150,000. The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

<b>Fiscal Year Ending June 30</b>	
2005	\$ 270,500
2006	300,600
2007	333,800
2008	369,500
2009	407,800
2010 - 2014	2,781,100

An agreement with a former officer provides for certain benefit payments, which commenced upon retirement. At June 30, 2004 and 2003, OCLC has a liability accrued of \$1,119,200 and \$1,164,100, respectively, for the present value of the estimated future payments under this agreement.

## **7. ACQUISITION OF CAPCON**

On November 12, 2003, the Corporation entered into an agreement to purchase certain assets and assume certain liabilities of CAPCON, a District of Columbia non-profit corporation. The purchase was accounted for by the purchase method of accounting. Assets acquired and liabilities assumed were based on their fair values at the date of acquisition. Goodwill, representing the excess of the fair value of the liabilities assumed over the fair value of assets acquired, of \$425,000 was recorded and subsequently deemed fully impaired and expensed prior to June 30, 2004. CAPCON's operations subsequent to the date of the sale are included in the consolidated financial statements for the year ended June 30, 2004. Its revenues for the seven and a half months ended June 30, 2004 were \$1,980,200. The pro-forma consolidated results for the fiscal year 2004, assuming the purchase had been made at the beginning of the fiscal year, would not have been materially different from reported results.

## **8. SALE OF METATEXT**

On August 9, 2002, OCLC sold the assets of its MetaText division to XanEdu, a division of Pro Quest Information & Learning, for \$2,504,400 in cash and recognized a loss of \$11,300.

## **9. ACQUISITION OF STRATA PRESERVATION N.V.**

On August 21, 2002, OCLC purchased 60% interest in Strata, a for-profit organization founded by the Royal Library of the Netherlands for \$542,300, to provide preservation microfilming for the European Market. OCLC accounts for the majority ownership of Strata under the purchase method of accounting. The results of Strata's operations have been consolidated with those of OCLC since September 1, 2002. The purchase price was allocated to the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition with a minority interest of \$168,700. Goodwill, representing the excess of cost over fair value of assets acquired, of \$289,300 was recorded and is included in fixed assets. Strata's operations subsequent to the date of the sale are included in the consolidated financial statements for the year ended June 30, 2003, and its revenues for the ten months ended June 30, 2003 were \$817,500. The pro-forma consolidated results for the fiscal year 2003, assuming the acquisition had been made at the beginning of the fiscal year, would not have been materially different from reported results.

## **10 ACQUISITION OF LIBPAC, LTD.**

On July 4, 2003, OCLC PICA B.V. acquired Libpac, Ltd. ("Libpac"), an interlibrary loan requesting and management system, to enhance their services in public libraries in the United Kingdom for \$1,504,800. OCLC PICA B.V. accounted for the purchase under the purchase method of accounting; accordingly, the results of Libpac's operations have been consolidated with those of OCLC PICA since July 4, 2003. The purchase price was allocated to the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. Goodwill, representing the excess of cost over fair value of assets acquired, of \$1,007,900 was recorded and is included in fixed assets. Libpac's operations subsequent to the date of the sale are included in the consolidated financial statements for the year ended June 30, 2004, and its revenues for the twelve months ended June 30, 2004 were \$471,200. The pro-forma consolidated results for the fiscal year 2004, assuming the acquisition had been made at the beginning of the fiscal year, would not have been materially different from reported results.

## 11. INCOME TAXES

OCLC has a net deferred tax asset of \$12,500,000 for domestic operating loss carryforwards. The net deferred tax asset is fully offset by a valuation allowance due to the uncertainty of recoverability of these items.

At June 30, 2004, domestic net operating loss carryforwards for income tax reporting purposes are approximately \$36,886,400. The domestic carryforwards expire through the fiscal year 2024.

## 12. FAIR VALUE OF FINANCIAL INSTRUMENTS

SFAS No. 107, *Disclosures About Fair Value of Financial Instruments*, requires fair value disclosures about substantially all balance sheet financial instruments. Certain assets and liabilities, the most significant being fixed assets, do not meet the Statement's definition of financial instruments and are excluded from this disclosure. Similarly, corporate equity is not considered a financial instrument and is also excluded from this disclosure. Many of the assets and liabilities subject to the disclosure requirements are not actively traded, requiring fair values to be estimated by management. These estimations necessarily involve the use of judgment about a variety of factors, including but not limited to, materiality, relevancy of market prices of comparable instruments and appropriate discount rates. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The following table summarizes financial instruments at fair value that differ from carrying amounts as of June 30, 2004 and 2003, but it is not intended to, and does not, represent the Corporation's underlying value nor is it indicative of the amounts that could be realized in a current market exchange of these instruments:

	2004		2003	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Liabilities:				
Long-term debt	\$ 50,025,000	\$ 51,650,400	\$ 54,140,000	\$ 58,051,800
Interest rate swap	177,900	177,900	538,900	538,900

The following methods and assumptions were used to estimate the fair value of each material class of financial instruments:

***Cash and Cash Equivalents, Investments, Receivables, Accrued and Other Liabilities (excluding postretirement benefit obligations and deferred compensation) and Accounts Payable***—The carrying amounts of these items are a reasonable estimate of their fair value.

***Long-Term Debt and Interest Rate Swap***—Fair values for these instruments have been calculated with pricing models using current rate assumptions for debt with similar yields and maturities.

## 13. CONTINGENCIES

The Corporation is involved in various claims and legal actions in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Corporation's consolidated financial statements.

#### **14. SUBSEQUENT EVENT**

On August 10, 2004, OCLC acquired the assets (approximately \$125,000) and assumed the liabilities (approximately \$125,000) of 24/7 Reference service from the Metropolitan Cooperative Library System, a library cooperative located in Los Angeles, California. The 24/7 Reference Service will be combined with OCLC's QuestionPoint service to create a more powerful suite of virtual reference tools.

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