Houghton Mifflin Harcourt Co
Form 424B3
November 06, 2014
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Prospectus Supplement No. 2
to Prospectus dated May 12, 2014

Filed pursuant to Rule 424(b)(3)
File No. 333-194862

115,972,361 SHARES

Houghton Mifflin Harcourt Company

COMMON STOCK

This prospectus supplement relates to the prospectus dated May 12, 2014, which permits the resale of up to an aggregate of 115,972,361 shares of common stock of Houghton Mifflin Harcourt Company by selling stockholders from time to time at prevailing market prices or at privately negotiated prices.

This prospectus supplement is being filed to update, amend and supplement the information previously included in the prospectus with the information contained in our Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on November 6, 2014 (the 10-Q). Accordingly, we have attached the 10-Q to this prospectus supplement. You should read this prospectus supplement together with the prospectus, which is to be delivered with this prospectus supplement.

Our common stock is listed on the NASDAQ Global Select Market (NASDAQ) under the symbol HMHC. On November 5, 2014, the last reported sale price of the shares of our common stock as reported on NASDAQ was $20.23 per share.

Investing in our common stock involves risks. See Risk Factors beginning on page 3 of the prospectus, and under similar headings in any amendments or supplements to the prospectus, or documents incorporated by reference into the prospectus, including under the heading Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2013 and in our Quarterly Reports on Form 10-Q, to read about risks you should consider before buying shares of our common stock.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if the prospectus or this prospectus supplement is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus supplement is November 6, 2014.

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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 September 30, 2014

OR

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

Commission file number 001-36166

Houghton Mifflin Harcourt Company

(Exact name of registrant as specified in its charter)

Delaware	**27-1566372**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**

222 Berkeley Street

Boston, MA 02116

(617) 351-5000

(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	x	Smaller reporting company	¨

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The number of shares of common stock, par value $0.01 per share, outstanding as of October 31, 2014 was 141,479,963.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained herein include forward-looking statements, which involve risks and uncertainties. These forward-looking statements can be identified by the use of forward-looking terminology, including the terms believes, estimates, projects, anticipates, expects, could, intends, may, will or should, forecast, intend, target or, in each case, their negative, or other variations or comparable terminology. These forward-looking statements include all matters that are not historical facts. They include statements regarding our intentions, beliefs or current expectations concerning, among other things, our results of operations, financial condition, liquidity, prospects, growth, strategies, the industry in which we operate and potential business decisions. We derive many of our forward-looking statements from our operating budgets and forecasts, which are based upon many detailed assumptions. While we believe that our assumptions are reasonable, we caution that it is very difficult to predict the impact of known factors, and, of course, it is impossible for us to anticipate all factors that could affect our actual results. All forward-looking statements are based upon information available to us on the date of this report.

By their nature, forward-looking statements involve risks and uncertainties because they relate to events and depend on circumstances that may or may not occur in the future. We caution you that forward-looking statements are not guarantees of future performance and that our actual results of operations, financial condition and liquidity, and the development of the industry in which we operate may differ materially from those made in or suggested by the forward-looking statements contained herein. In addition, even if our results of operations, financial condition and liquidity and the development of the industry in which we operate are consistent with the forward-looking statements contained herein, those results or developments may not be indicative of results or developments in subsequent periods.

Important factors that could cause our results to vary from expectations include, but are not limited to: changes in state and local education funding and/or related programs, legislation and procurement processes; adverse or worsening economic trends or the continuation of current economic conditions; changes in consumer demand for, and acceptance of, our products; changes in competitive factors; offerings by technology companies that compete with our products; industry cycles and trends; conditions and/or changes in the publishing industry; changes or the loss of our key third-party print vendors; restrictions under agreements governing our outstanding indebtedness; changes in laws or regulations governing our business and operations; changes or failures in the information technology systems we use; demographic trends; uncertainty surrounding our ability to enforce our intellectual property rights; inability to retain management or hire employees; impact of potential impairment of goodwill and other intangibles in a challenging economy; decline or volatility of our stock price regardless of our operating performance; and other factors discussed in the Risk Factors section of our Annual Report on Form 10-K for the year ended December 31, 2013. In light of these risks, uncertainties and assumptions, the forward-looking events described herein may not occur.

We undertake no obligation, and do not expect, to publicly update or publicly revise any forward-looking statement, whether as a result of new information, future events or otherwise, except as required by law. All subsequent written and oral forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by the cautionary statements contained herein.

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PART 1 FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements (Unaudited)

Houghton Mifflin Harcourt Company

Consolidated Balance Sheets (Unaudited)

(in thousands of dollars, except share information)	September 30, 2014	December 31, 2013
Assets		
Current assets		
Cash and cash equivalents	$ 296,840	$ 313,628
Short-term investments	291,637	111,721
Accounts receivable, net of allowance for bad debts and book returns of $46.1 million and $40.6 million, respectively	528,400	318,101
Inventories	190,426	182,194
Deferred income taxes	19,627	29,842
Prepaid expenses and other assets	14,485	16,130
Total current assets	1,341,415	971,616
Property, plant, and equipment, net	137,847	140,848
Pre-publication costs, net	249,081	269,488
Royalty advances to authors, net of allowance of $49.6 million and $41.2 million, respectively	49,713	46,881
Goodwill	532,921	531,786
Other intangible assets, net	830,607	919,994
Other assets	36,121	29,773
Total assets	$ 3,177,705	$ 2,910,386
Liabilities and Stockholders Equity		
Current liabilities		
Current portion of long-term debt	$ 2,500	$ 2,500
Accounts payable	100,050	105,012
Royalties payable	85,842	65,387
Salaries, wages, and commissions payable	61,711	29,945
Deferred revenue	162,372	107,905
Interest payable	48	55
Severance and other charges	5,648	8,184
Accrued postretirement benefits	2,141	2,141
Other liabilities	37,787	32,002
Total current liabilities	458,099	353,131
Long-term debt	241,250	243,125
Royalties payable		1,520

Long-term deferred revenue	379,685	189,258
Accrued pension benefits	16,066	24,405
Accrued postretirement benefits	21,963	23,860
Deferred income taxes	109,836	116,999
Other liabilities	102,582	107,812
Total liabilities	1,329,481	1,060,110
Commitments and contingencies (Note 12)		
Stockholders equity		
Preferred stock, $0.01 par value: 20,000,000 shares authorized; no shares issued and outstanding at September 30, 2014 and December 31, 2013		
Common stock, $0.01 par value: 380,000,000 shares authorized; 141,354,618 and 140,044,400 shares issued at September 30, 2014 and December 31, 2013, respectively; 141,272,596 and 139,962,378 shares outstanding at September 30, 2014 and December 31, 2013, respectively	1,400	1,400
Treasury stock, 82,022 shares as of September 30, 2014 and December 31, 2013		
Capital in excess of par value	4,774,089	4,750,589
Accumulated deficit	(2,916,179)	(2,888,422)
Accumulated other comprehensive income (loss)	(11,086)	(13,291)
Total stockholders equity	1,848,224	1,850,276
Total liabilities and stockholders equity	$ 3,177,705	$ 2,910,386

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

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Houghton Mifflin Harcourt Company

Consolidated Statements of Operations (Unaudited)

(in thousands of dollars, except share and per share information)	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Net sales	$ 551,008	$ 550,190	$ 1,106,831	$ 1,079,735
Costs and expenses				
Cost of sales, excluding pre-publication and publishing rights amortization	205,395	214,750	464,839	460,566
Publishing rights amortization	25,048	33,501	80,575	106,088
Pre-publication amortization	33,463	31,815	94,500	88,468
Cost of sales	263,906	280,066	639,914	655,122
Selling and administrative	167,741	156,592	457,034	420,295
Other intangible asset amortization	3,029	2,654	8,981	16,087
Impairment charge for investment in preferred stock, pre-publication costs and fixed assets			1,279	8,500
Severance and other charges	181	3,343	5,300	6,824
Operating income (loss)	116,151	107,535	(5,677)	(27,093)
Other income (expense)				
Interest expense	(4,662)	(5,041)	(13,354)	(16,626)
Change in fair value of derivative instruments	(1,252)	250	(1,560)	(229)
Loss on extinguishment of debt				(598)
Income (loss) before taxes	110,237	102,744	(20,591)	(44,546)
Income tax expense (benefit)	3,207	(2,368)	7,166	1,989
Net income (loss)	$ 107,030	$ 105,112	$ (27,757)	$ (46,535)
Net income (loss) per share attributable to common stockholders				
Basic	$ 0.76	$ 0.75	$ (0.20)	$ (0.33)
Diluted	$ 0.75	$ 0.75	$ (0.20)	$ (0.33)
Weighted average shares outstanding				
Basic	140,742,786	139,919,218	140,269,383	139,918,392

Diluted	143,583,901	140,357,220	140,269,383	139,918,392

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

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Houghton Mifflin Harcourt Company

Consolidated Statements of Comprehensive (Loss) Income (Unaudited)

(in thousands of dollars)	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Net income (loss)	$ 107,030	$ 105,112	$ (27,757)	$ (46,535)
Other comprehensive income (loss), net of taxes:				
Foreign currency translation adjustments	(485)	501	218	22
Net changes related to pension liabilities, reclassified from accumulated other comprehensive income				
Amortization of prior service cost			243	
Settlement loss recognized			1,740	
Change in pension liability, net			1,983	
Unrealized gain (loss) on short-term investments		7	4	(4)
Other comprehensive income (loss), net of taxes	(485)	508	2,205	18
Comprehensive income (loss)	$ 106,545	$ 105,620	$ (25,552)	$ (46,517)

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

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Houghton Mifflin Harcourt Company

Consolidated Statements of Cash Flows (Unaudited)

(in thousands of dollars)	Nine Months Ended September 30, 2014	2013
Cash flows from operating activities		
Net loss	$ (27,757)	$ (46,535)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities		
Gain on sale of assets		(2,720)
Depreciation and amortization expense	236,941	254,964
Amortization of deferred financing costs	3,563	3,609
Deferred income taxes	3,052	1,415
Noncash stock-based compensation expense	8,805	6,923
Change in fair value of derivative instruments	1,560	229
Loss on extinguishment of debt		598
Impairment charge for investment in preferred stock, pre-publication costs and fixed assets	1,279	8,500
Changes in operating assets and liabilities, net of acquisitions		
Accounts receivable	(207,212)	(246,156)
Inventories	(8,228)	(843)
Accounts payable and accrued expenses	47,409	92,384
Royalties, net	16,103	2,080
Deferred revenue	244,043	3,799
Interest payable	(7)	(18)
Severance and other charges	(4,988)	(1,916)
Accrued pension and postretirement benefits	(10,236)	(11,695)
Other, net	(3,601)	(18,325)
Net cash (used in) provided by operating activities	300,726	46,293
Cash flows from investing activities		
Proceeds from sales and maturities of short-term investments	94,190	193,632
Purchases of short-term investments	(274,599)	(174,672)
Additions to pre-publication costs	(90,280)	(112,597)
Additions to property, plant, and equipment	(49,779)	(46,232)
Proceeds from sale of assets		4,825
Acquisition of business, net of cash acquired	(9,091)	(5,276)
Investment in preferred stock		(1,500)
Net cash (used in) provided by investing activities	(329,559)	(141,820)
Cash flows from financing activities		
Payments of long-term debt	(1,875)	(1,875)
	(723)	

Tax withholding payments related to net share settlements of restricted stock units				
Proceeds from stock option exercises		14,643		
Net cash provided by (used in) financing activities		12,045		(1,875)
Net (decrease) increase in cash and cash equivalents		(16,788)		(97,402)
Cash and cash equivalents				
Beginning of period		313,628		329,078
Net (decrease) increase in cash and cash equivalents		(16,788)		(97,402)
End of period	$	296,840	$	231,676
Supplementary disclosure of cash flow information				
Pre-publication costs included in accounts payable (non cash)	$	8,534	$	11,239
Property, plant, and equipment included in accounts payable (non cash)		1,914		2,847
Property, plant, and equipment acquired under capital leases (non cash)		3,644		4,591

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

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Houghton Mifflin Harcourt Company

Notes to Consolidated Financial Statements (Unaudited)

(in thousands of dollars, except share and per share information)

1. Basis of Presentation

Houghton Mifflin Harcourt Company, formerly known as HMH Holdings (Delaware), Inc. (HMH , Houghton Mifflin Harcourt , we , us , our , or the Company), is a leading global provider of education solutions, delivering content, technology, services and media to over 50 million students in over 150 countries worldwide. We deliver our offerings to both educational institutions and consumers around the world. We believe our long-standing reputation and well-known brands enable us to capitalize on consumer and digital trends in the education market through our existing and developing channels. Furthermore, since 1832, we have published trade and reference materials, including adult and children s fiction and non-fiction books that have won industry awards such as the Pulitzer Prize, Newbery and Caldecott medals and National Book Award, all of which are generally known.

The consolidated financial statements of HMH include the accounts of all of our wholly-owned subsidiaries as of September 30, 2014 and December 31, 2013 and the three and nine month periods ended September 30, 2014 and September 30, 2013.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. Certain information and note disclosures normally included in our annual financial statements prepared in accordance with GAAP have been condensed or omitted consistent with Article 10 of Regulation S-X. In the opinion of management, our unaudited consolidated financial statements and accompanying notes include all adjustments (consisting of normal recurring adjustments) considered necessary by management to fairly state the results of operations, financial position and cash flows for the interim periods presented. Interim results of operations are not necessarily indicative of the results for the full year or for any future period. These financial statements should be read in conjunction with the annual financial statements and the notes thereto also included therein.

During the first quarter of 2014, we recorded an out of period correction of approximately $1.1 million reducing net sales and increasing deferred revenue that should have been deferred previously. In addition, during the first quarter of 2014, we recorded approximately $3.5 million of incremental expense, primarily commissions, related to the prior year. These out-of-period corrections had no impact on our debt covenant compliance. Management believes these out-of-period corrections are not material to the current period financial statements or any previously issued financial statements and does not expect them to be material for the full fiscal year 2014. Additionally, we revised previously reported December 31, 2013 balance sheet amounts to severance and other charges of $7.3 million, which has been reclassified as long term and to current deferred revenue of $5.2 million which has also been reclassified as long term. This revision was not material to the reported consolidated balance sheet for any previously filed periods.

Seasonality and Comparability

Our net sales, operating profit and operating cash flows are impacted by the inherent seasonality of the academic calendar. Consequently, the performance of our businesses may not be comparable quarter to consecutive quarter and should be considered on the basis of results for the whole year or by comparing results in a quarter with results in the same quarter for the previous year.

Approximately 88% of our net sales for the year ended December 31, 2013 were derived from our Education segment, which is a markedly seasonal business. Schools make most of their purchases in the second and third quarters of the calendar year in preparation for the beginning of the school year. Thus, over the past three years, approximately 67% of consolidated net sales have historically been realized in the second and third quarters. Sales of K-12 instructional materials and customized testing products are also cyclical, with some years offering more sales opportunities than others. The amount of funding available at the state level for educational materials also has a significant effect on year-to-year net sales. Although the loss of a single school customer would not have a material adverse effect on our business, schedules of school adoptions and market acceptance of our products can materially affect year-to-year net sales performance.

2. Significant Accounting Policies and Estimates

Our financial results are affected by the selection and application of accounting policies and methods. There were no material changes in the three and nine months ended September 30, 2014 to the application of significant accounting policies and estimates as described in our audited financial statements for the year ended December 31, 2013.

3. Recent Accounting Pronouncements

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

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In August 2014, the Financial Accounting Standards Board (FASB) issued new guidance related to the disclosures around going concern. The new standard provides guidance around management s responsibility to evaluate whether there is substantial doubt about an entity s ability to continue as a going concern and to provide related footnote disclosures. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. Early adoption is permitted. The adoption of this standard is not expected to have an impact on our consolidated financial statements or disclosures.

In June 2014, the FASB issued new guidance related to stock compensation. The new standard requires that a performance target that affects vesting, and that could be achieved after the requisite service period, be treated as a performance condition. As such, the performance target should not be reflected in estimating the grant date fair value of the award. This update further clarifies that compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the periods for which the requisite service has already been rendered. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015 and can be applied either prospectively or retrospectively to all awards outstanding as of the beginning of the earliest annual period presented as an adjustment to opening retained earnings. Early adoption is permitted. We do not believe the adoption of this new accounting standard will impact our consolidated financial statements.

In May 2014, the FASB issued new accounting guidance related to revenue recognition. This new standard will replace all current U.S. GAAP guidance on this topic and eliminate all industry-specific guidance. The new revenue recognition standard provides a unified model to determine when and how revenue is recognized. The core principle is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration for which the entity expects to be entitled in exchange for those goods or services. This guidance will be effective beginning January 1, 2017 and can be applied either retrospectively to each period presented or as a cumulative-effect adjustment as of the date of adoption. We are in the process of evaluating the impact of adopting this new accounting standard on our consolidated financial statements.

In April 2014, the FASB issued new guidance related to reporting discontinued operations. This new standard raises the threshold for a disposal to qualify as a discontinued operation and requires new disclosures of both discontinued operations and certain other disposals that do not meet the definition of a discontinued operation. The new standard is effective for fiscal years beginning on or after December 15, 2014. Early adoption is permitted but only for disposals that have not been reported in financial statements previously issued. We do not believe the adoption of this new accounting standard will impact our consolidated financial statements.

4. Acquisitions

On May 12, 2014, we completed the acquisition of certain assets and liabilities of Channel One News, which is a digital content provider dedicated to encouraging kids to be informed, digitally-savvy global citizens. The acquisition allows for continued development of high-quality digital content for students, teachers and parents across multiple modalities, and brings video and cross-media production capabilities to HMH.

On May 19, 2014, we completed the acquisition of 100% of the stock of Curiosityville, which is an online personalized learning environment that helps children ages 3-8 learn through playful exploration and discovery both at home and in pre-school settings. The acquisition also includes its proprietary data collection and analytics engine, the Learning Tree, which provides real-time information on individual learners and personalized recommendations for learning, both online and offline.

On June 30, 2014, we completed the acquisition of 100% of the stock of School Chapters, which is an educational solutions provider dedicated to standards-based education quality management, accreditation services and community-based resources for educators and learners across the pre-K-12 and college spectrum.

The total aggregate purchase price for the three acquisitions described above was approximately $9.5 million, which consisted of cash at closing of approximately $9.1 million, and amounts in accrued liabilities of approximately $0.4 million. Goodwill, other intangible assets, accounts receivable, property, plant, and equipment, other assets and other liabilities recorded as part of the acquisitions totaled approximately $1.1 million, $0.2 million, $3.1 million, $6.8 million, $0.4 million and $1.7 million, respectively.

The 2014 transactions were accounted for under the acquisition method of accounting. We allocated the purchase price to each of the assets and liabilities acquired at estimated fair values as of the acquisition date. The excess of the purchase price over the net amounts assigned to the fair value of the assets acquired and liabilities assumed was recorded as goodwill. The financial results of each company acquired were included within our financial statements from their respective dates of acquisition. The acquisitions were not considered to be material for purposes of additional disclosure.

In 2013, we made a $1.5 million investment in preferred stock. Based on impairment indicators, we were required to remeasure the fair value of our 2013 investment with any resulting gain or loss recognized in the statement of operations. Based on the implied fair value of the investment, we recorded an impairment charge of approximately $1.3 million during the nine months ended September 30, 2014 relating to the fair value remeasurement.

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5. Inventories

Inventories consisted of the following:

	September 30, 2014	December 31, 2013
Finished goods	$ 185,599	$ 177,017
Raw materials	4,827	5,177
Inventory	$ 190,426	$ 182,194

6. Goodwill and Other Intangible Assets

Goodwill and other intangible assets consisted of the following:

	September 30, 2014		December 31, 2013	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Goodwill	$ 532,921	$	$ 531,786	$
Trademarks and trade names	440,119		440,005	
Publishing rights	1,180,000	(864,512)	1,180,000	(783,937)
Customer related and other	283,227	(208,227)	283,172	(199,246)
	$ 2,436,267	$ (1,072,739)	$ 2,434,963	$ (983,183)

The changes in the carrying amount of goodwill for the periods ended September 30, 2014 and December 31, 2013 were as follows:

Goodwill	$ 1,974,286
Accumulated impairment losses	(1,442,500)
Balance at December 31, 2013	$ 531,786
Acquisitions	1,135
Balance at September 30, 2014	$ 532,921
Goodwill	1,975,421
Accumulated impairment losses	(1,442,500)
Balance at September 30, 2014	$ 532,921

Amortization expense for publishing rights and customer related and other intangibles were $28.1 million and $36.2 million for the three months ended September 30, 2014 and 2013, respectively, and $89.6 million and $122.2 million for the nine months ended September 30, 2014 and 2013, respectively.

7. Debt

Our debt consisted of the following:

	September 30, 2014	December 31, 2013
$250,000 term loan due May 21, 2018 interest payable monthly	$ 243,750	$ 245,625
Less: Current portion of long-term debt	2,500	2,500
Total long-term debt	$ 241,250	$ 243,125

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On January 15, 2014, we entered into Amendment No. 4 to our term loan facility, which reduced the interest rate applicable to outstanding borrowings by 1.0%. The transaction was accounted for under the accounting guidance for debt modifications and extinguishments. We recorded an expense of approximately $1.0 million relating to third party transaction fees which was included in the selling and administrative line item in its consolidated statements of operations for the nine months ended September 30, 2014.

Loan Covenants

We are required to meet certain restrictive financial covenants as defined under our term loan facility and revolving credit facility. We have financial covenants pertaining to interest coverage, maximum leverage, and fixed charge ratios. The interest coverage ratio is now 9.0 to 1.0 for all fiscal quarters ending through maturity. The maximum leverage ratio is now 2.0 to 1.0 for all fiscal quarters ending through maturity. The fixed charge ratio, which only pertains to the revolving credit facility and is only tested in limited situations, is 1.0 to 1.0 through the end of the facility. As of September 30, 2014, we were in compliance with all of our debt covenants.

Loan Guarantees

Under both the revolving credit facility and the term loan facility, Houghton Mifflin Harcourt Publishers Inc., HMH Publishers LLC and Houghton Mifflin Harcourt Publishing Company are the borrowers (collectively, the Borrowers), and Citibank, N.A. acts as both the administrative agent and the collateral agent.

The obligations under our senior secured credit facilities are guaranteed by the Company and each of its direct and indirect for-profit domestic subsidiaries (other than the Borrowers) (collectively, the Guarantors) and are secured by all capital stock and other equity interests of the Borrowers and the Guarantors and substantially all of the other tangible and intangible assets of the Borrowers and the Guarantors, including, without limitation, receivables, inventory, equipment, contract rights, securities, patents, trademarks, other intellectual property, cash, bank accounts and securities accounts and owned real estate. The revolving credit facility is secured by first priority liens on receivables, inventory, deposit accounts, securities accounts, instruments, chattel paper and other assets related to the foregoing (the Revolving First Lien Collateral), and second priority liens on the collateral which secures the term loan facility on a first priority basis. The term loan facility is secured by first priority liens on the capital stock and other equity interests of the Borrowers and the Guarantors, equipment, owned real estate, trademarks and other intellectual property, general intangibles that are not Revolving First Lien Collateral and other assets related to the foregoing, and second priority liens on the Revolving First Lien Collateral.

8. Severance and Other Charges
2014

During the nine months ended September 30, 2014, $6.8 million of severance payments were made to employees whose employment ended in 2014 and prior years and $3.5 million of net payments for office space no longer utilized by the Company. Further, we recorded an expense in the amount of $3.8 million to reflect additional costs for severance, which we expect to pay over the next twelve months, along with a $1.5 million accrual for additional space vacated.

2013

During the nine months ended September 30, 2013, $3.4 million of severance payments were made to employees whose employment ended in 2013 and prior years and $5.3 million of net payments for office space no longer utilized by the Company. Further, we recorded an expense in the amount of $5.6 million to reflect additional costs for severance, which have been substantially paid along with a $1.2 million accrual for additional space vacated.

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

	2014			
	Severance/ restructuring accrual at December 31, 2013	**Severance/ restructuring expense**	**Cash payments**	**Severance/ restructuring accrual at September 30, 2014**
Severance costs	$ 4,115	$ 3,824	$ (6,824)	$ 1,115
Other accruals	11,416	1,476	(3,464)	9,428
	$ 15,531	$ 5,300	$ (10,288)	$ 10,543

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	2013			
	Severance/ restructuring accrual at December 31, 2012	**Severance/ restructuring expense**	**Cash payments**	**Severance/ restructuring accrual at September 30, 2013**
Severance costs	$ 2,142	$ 5,617	$ (3,447)	$ 4,312
Other accruals	16,148	1,207	(5,293)	12,062
	$ 18,290	$ 6,824	$ (8,740)	$ 16,374

The current portion of the severance and other charges was $5.6 million and $8.2 million as of September 30, 2014 and December 31, 2013, respectively.

9. Income Taxes

The computation of the annual estimated effective tax rate at each interim period requires certain estimates and significant judgment, including, but not limited to, the expected operating income for the year, projections of the proportion of income earned and taxed in various jurisdictions, permanent and temporary differences and the likelihood of recovering deferred tax assets generated in the current year. The accounting estimates used to compute the provision for income taxes may change as new events occur, more experience is acquired, additional information is obtained or as the tax environment changes.

At the end of each interim period, we estimate the annual effective tax rate and apply that rate to our ordinary quarterly earnings. The amount of interim tax benefit recorded for the year-to-date ordinary loss is limited to the amount that is expected to be realized during the year or recognizable as a deferred tax asset at year end. The tax expense or benefit related to significant, unusual or extraordinary items that will be separately reported or reported net of their related tax effect, and are individually computed, are recognized in the interim period in which those items occur. In addition, the effect of changes in enacted tax laws or rates or tax status is recognized in the interim period in which the change occurs.

For the three months ended September 30, 2014 and 2013, we recorded an income tax expense (benefit) of approximately $3.2 million and $(2.4) million, respectively, and for the nine months ended September 30, 2014 and 2013, we recorded an income tax expense of approximately $7.2 million and $2.0 million, respectively. For both periods, the income tax expense was impacted by certain discrete tax items including the accrual of potential interest and penalties on uncertain tax positions. Including the tax effects of these discrete tax items, the effective rate was 2.9% and (2.3)% for the three months ended September 30, 2014 and 2013, respectively, and 34.8% and 4.5% for the nine months ended September 30, 2014 and 2013, respectively.

Reserves for unrecognized tax benefits, excluding accrued interest, were $63.2 million and $62.3 million at September 30, 2014 and December 31, 2013, respectively, and included in other long-term liabilities in the accompanying consolidated balance sheets.

10. Retirement and Postretirement Benefit Plans

We have a noncontributory, qualified defined benefit pension plan (the Retirement Plan), which covers certain employees. The Retirement Plan is a cash balance plan, which accrues benefits based on pay, length of service, and interest. We also have a nonqualified defined benefit plan, or nonqualified plan, that previously covered employees who earned over the qualified pay limit as determined by the U.S. Internal Revenue Service. The nonqualified plan accrues benefits for the participants based on the cash balance plan calculation. In 2007, both the qualified and nonqualified pension plans eliminated participation in the plans for new employees hired after October 31, 2007. We also had a foreign defined benefit plan. On July 20, 2011, we entered into a bulk annuity policy with a third party which effectively terminated the foreign defined benefit plan. This policy covered all known plan beneficiaries and liabilities and represents a full transfer of the plan s financial and longevity risk to the third party. At the time, this termination did not constitute a settlement of liability under applicable accounting guidance for pension plans. Following a full plan data cleansing, the bulk annuity policy was converted into individual annuity policies at which point the plan was discharged of all future liability with respect to the plan beneficiaries. On May 28, 2014, the conversion to individual annuity policies along with the liability discharge occurred, which resulted in a settlement charge of approximately $1.7 million. This amount has been recorded to the selling and administrative line in our consolidated statements of operations for the nine months ended September 30, 2014.

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

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Net periodic benefit cost for our pension and other postretirement benefits plans consisted of the following:

	Pension Benefits Nine Months Ended September 30, 2014	2013
Interest cost	$ 6,031	$ 5,569
Expected return on plan assets	(7,869)	(7,608)
Amortization of prior service cost	250	
Amortization of net loss	3	252
Settlement loss recognized	1,740	
Net periodic benefit cost (credit)	$ 155	$ (1,787)

	Other Post Retirement Benefits Nine Months Ended September 30, 2014	2013
Service cost	$ 134	$ 167
Interest cost	887	821
Amortization of prior service cost	(1,036)	(1,036)
Amortization of net loss		232
Net periodic benefit (credit) cost	$ (15)	$ 184

Contributions for the pension and post-retirement benefit plans for the nine months ended September 30, 2014 and September 30, 2013 were $6.6 million and $8.4 million, respectively.

We expect to contribute an additional $2.3 million during the remainder of 2014.

11. Fair Value Measurements

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

Level 1	Observable input such as quoted prices in active markets for identical assets or liabilities;
Level 2	Observable inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and
Level 3	Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

Assets and liabilities measured at fair value are based on one or more of three valuation techniques identified in the tables below. Where more than one technique is noted, individual assets or liabilities were valued using one or more of the noted techniques. The valuation techniques are as follows:

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

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

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

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

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The following tables present our financial assets and liabilities measured at fair value on a recurring basis at September 30, 2014 and December 31, 2013:

	September 30, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Valuation Technique
Financial assets				
Money market funds	$ 245,417	$ 245,417	$	(a)
U.S. treasury securities	101,031	101,031		(a)
U.S. agency securities	219,240		219,240	(a)
	$ 565,688	$ 346,448	$ 219,240	
Financial liabilities				
Foreign exchange derivatives	$ 1,337	$	$ 1,337	(a)
	$ 1,337	$	$ 1,337	

	December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Valuation Technique
Financial assets				
Money market funds	$ 259,031	$ 259,031	$	(a)
U.S. treasury securities	57,076	57,076		(a)
U.S. agency securities	54,645		54,645	(a)
Foreign exchange derivatives	222		222	(a)
	$ 370,974	$ 316,107	$ 54,867	

Our money market funds and U.S. treasury securities are classified within Level 1 of the fair value hierarchy because they are valued using quoted prices in active markets for identical instruments. Our U.S. agency securities are classified within level 2 of the fair value hierarchy because they are valued using other than quoted prices in active markets. In addition to $245.4 million and $259.0 million invested in money market funds as of September 30, 2014 and December 31, 2013, respectively, we had $22.8 million and $54.6 million of cash held in bank accounts as of September 30, 2014 and December 31, 2013, respectively.

Our foreign exchange derivatives consist of forward and option contracts and are classified within Level 2 of the fair value hierarchy because they are valued based on observable inputs and are available for substantially the full term of our derivative instruments. We use foreign exchange forward and option contracts to fix the functional currency value of forecasted commitments, payments and receipts. The aggregate notional amount of the outstanding foreign exchange forward and option contracts was $22.0 million and $24.1 million at September 30, 2014 and December 31, 2013, respectively. Our foreign exchange forward and option contracts contain netting provisions to mitigate credit risk in the event of counterparty default, including payment default and cross default. At September 30, 2014 and December 31, 2013, the fair value of our counterparty default exposure was less than $1.5 million and spread across several highly rated counterparties.

The following table presents our nonfinancial assets and liabilities measured at fair value on a nonrecurring basis during 2014 and 2013:

	September 30, 2014	**Significant Unobservable Inputs (Level 3)**	**Total Impairment**	**Valuation Technique**
Nonfinancial assets				
Investment in preferred stock	$	$	$ 1,279	(c)
Nonfinancial liabilities				
Contingent consideration liability associated with acquisitions	$ 1,970	$ 1,970	$	(c)

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	December 31, 2013	Significant Unobservable Inputs (Level 3)	Total Impairment	Valuation Technique
Nonfinancial assets				
Property, plant, and equipment	$	$	$ 7,439	(b)
Pre-publication costs			1,061	(b)
Other intangible assets	4,200	4,200	500	(a)(c)
	$ 4,200	$ 4,200	$ 9,000	
Nonfinancial liabilities				
Contingent consideration liability associated with acquisitions	$ 1,881	$ 1,881	$	(c)

Our nonfinancial assets, which include goodwill, other intangible assets, property, plant, and equipment, and pre-publication costs, are not required to be measured at fair value on a recurring basis. However, if certain trigger events occur, or if an annual impairment test is required, we evaluate the nonfinancial assets for impairment. If an impairment did occur, the asset is required to be recorded at the estimated fair value.

We review software development costs, included within property, plant, and equipment, for impairment. There was no impairment recorded for the nine months ended September 30, 2014. For the nine months ended September 30, 2013, software development costs of $7.4 million were impaired as the products will not be sold in the marketplace.

Pre-publication costs recorded on the balance sheet are periodically reviewed for impairment by comparing the unamortized capitalized costs of the assets to the fair value of those assets. There was no impairment recorded for the nine months ended September 30, 2014. For the nine months ended September 30, 2013, pre-publication costs of $1.1 million were impaired as the programs will not be sold in the marketplace.

In evaluating goodwill for impairment, we first compare our reporting unit s fair value to its carrying value. We estimate the fair values of our reporting units by considering market multiple and recent transaction values of peer companies, where available, and projected discounted cash flows, if reasonably estimable. There was no impairment recorded for goodwill for the nine months ended September 30, 2014 and September 30, 2013.

We perform an impairment test for our other intangible assets by comparing the assets fair value to their carrying value. Fair value is estimated based on recent market transactions, where available, and projected discounted cash flows, if reasonably estimable. There was no impairment recorded for the nine months ended September 30, 2014 and September 30, 2013. The fair value of goodwill and other intangible assets are estimates, which are inherently subject to significant uncertainties, and actual results could vary significantly from these estimates.

We reviewed our former investment in preferred stock, which was included in other assets, periodically, for impairment. In connection with an acquisition, we remeasured the fair value of the investment and recorded an impairment of $1.3 million for the nine months ended September 30, 2014.

The fair value of an acquisition-related contingent consideration liability is affected most significantly by changes in the estimated probabilities of the contingencies being achieved.

The following table presents a summary of changes in fair value of the Company s Level 3 liabilities measured on a recurring basis for September 30, 2014 and December 31, 2013:

	Level 3 Inputs Liabilities
Balance at December 31, 2013	$ 1,881
Change in fair value of contingent consideration liability, included in interest expense	89
Balance at September 30, 2014	$ 1,970

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Fair Value of Debt

The following table presents the carrying amounts and estimated fair market values of our debt at September 30, 2014 and December 31, 2013. The fair value of debt is deemed to be the amount at which the instrument could be exchanged in an orderly transaction between market participants at the measurement date.

	September 30, 2014		December 31, 2013	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Debt				
$250,000 term loan	$ 243,750	$ 243,445	$ 245,625	$ 247,774

The fair market values of our debt were estimated based on quoted market prices on a private exchange for those instruments that are traded and are classified as level 2 within the fair value hierarchy, at September 30, 2014 and December 31, 2013. The fair market values require varying degrees of management judgment. The factors used to estimate these values may not be valid on any subsequent date. Accordingly, the fair market values of the debt presented may not be indicative of their future values.

12. Commitments and Contingencies

Contingencies

We are involved in ordinary and routine litigation and matters incidental to our business. Litigation alleging infringement of copyrights and other intellectual property rights has become extensive in the educational publishing industry. Specifically, there have been various settled, pending and threatened litigation that allege we exceeded the print run limitation or other restrictions in licenses granted to us to reproduce photographs in our textbooks. While management believes that there is a reasonable possibility we may incur a loss associated with the pending and threatened litigation, we are not able to estimate such amount, but we do not expect any of these matters to have a material adverse effect on our results of operations, financial position or cash flows. We have insurance over such amounts and with coverage and deductibles as management believes is reasonable. There can be no assurance that our liability insurance will cover all events or that the limits of coverage will be sufficient to fully cover all liabilities. We were contingently liable for $16.3 million and $23.0 million of performance-related surety bonds for our operating activities as of September 30, 2014 and December 31, 2013, respectively. An aggregate of $21.3 million and $19.7 million of letters of credit existed as of September 30, 2014 and December 31, 2013, respectively, of which $2.4 million backed the aforementioned performance-related surety bonds as of September 30, 2014 and December 31, 2013, respectively.

We routinely enter into standard indemnification provisions as part of license agreements involving use of our intellectual property. These provisions typically require us to indemnify and hold harmless licensees in connection with any infringement claim by a third party relating to the intellectual property covered by the license agreement. The assessment business routinely enters into contracts with customers that contain provisions requiring us to indemnify the customer against a broad array of potential liabilities resulting from any breach of the contract or the invalidity of the test. Although the term of these provisions and the maximum potential amounts of future payments we could be required to make is not limited, we have never incurred any costs to defend or settle claims related to these types of indemnification provisions. We therefore believe the estimated fair value of these provisions is inconsequential, and have no liabilities recorded for them as of September 30, 2014 and December 31, 2013.

Concentration of Credit Risk and Significant Customers

As of September 30, 2014, there were no individual customers that comprised more than 10% of our accounts receivable balance. There were two customers that represented approximately $55.8 million, or 10.6%, of our accounts receivable, net balance. We believe that our accounts receivable credit risk exposure is limited and we have not experienced significant write-downs in our accounts receivable balances. There are payables by the Company to the same customers in the amount of $29.5 million and there are legal or contractual rights to offset such customers.

As of December 31, 2013, two customers represented approximately $104.8 million, or 32.9%, of our accounts receivable, net balance and there existed a payable by the Company to one of the same customers in the amount of $4.6 million and there is a contractual right to offset with such customer.

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13. Net Income (Loss) Per Share

The following table sets forth the computation of basic and diluted earnings per share (EPS):

	For the Three Months Ended September 30, 2014	For the Three Months Ended September 30, 2013	For the Nine Months Ended September 30, 2014	For the Nine Months Ended September 30, 2013
Numerator				
Net income (loss) attributable to common stockholders	$ 107,030	$ 105,112	$ (27,757)	$ (46,535)
Denominator				
Weighted average shares outstanding				
Basic	140,742,786	139,919,218	140,269,383	139,918,392
Diluted	143,583,901	140,357,220	140,269,383	139,918,392
Net income (loss) per share attributable to common stockholders				
Basic	$ 0.76	$ 0.75	$ (0.20)	$ (0.33)
Diluted	$ 0.75	$ 0.75	$ (0.20)	$ (0.33)

As we incurred a net loss in the nine month periods ended September 30, 2014 and 2013, presented above, the outstanding stock options and restricted stock units for those periods have an anti-dilutive effect and therefore are excluded from the computation of diluted weighted average shares outstanding. Accordingly, basic and diluted weighted average shares outstanding are equal for such periods.

The following table summarizes our weighted average outstanding common stock equivalents that were anti-dilutive and therefore excluded from the computation of diluted EPS:

	For the Three Months Ended September 30, 2014	For the Three Months Ended September 30, 2013	For the Nine Months Ended September 30, 2014	For the Nine Months Ended September 30, 2013
Stock options	306,861	2,863,663	10,886,685	10,446,461
Restricted stock units		86,196	147,063	96,611

14. Segment Reporting

As of September 30, 2014, we had two reportable segments (Education and Trade Publishing). Our Education segment provides educational products, technology platforms and services to meet the diverse needs of today s classrooms. These products and services include print and digital content in the form of textbooks, digital courseware, instructional aids, educational assessment and intervention solutions, which are aimed at improving achievement and supporting learning for students that are not keeping pace with peers, professional development and school reform services. Our Trade Publishing segment primarily develops, markets and sells consumer books in print and digital formats and licenses book rights to other publishers and electronic businesses in the United States and abroad. The principal markets for Trade Publishing products are retail stores, both physical and online, and wholesalers. Reference materials are also sold to schools, colleges, libraries, office supply distributors and other businesses.

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We measure and evaluate our reportable segments based on net sales and segment Adjusted EBITDA. We exclude from segment Adjusted EBITDA certain corporate-related expenses, as our corporate functions do not meet the definition of a segment, as defined in the accounting guidance relating to segment reporting. In addition, certain transactions or adjustments that our Chief Operating Decision Maker considers to be non-operational, such as amounts related to goodwill and other intangible asset impairment charges and restructuring-related charges, as well as amortization expenses, are excluded from segment Adjusted EBITDA. Although we exclude these amounts from segment Adjusted EBITDA, they are included in reported consolidated net income (loss) and are included in the reconciliation below.

(in thousands)	Three Months Ended September 30,			Total
	Education	Trade Publishing	Corporate/ Other	
2014				
Net sales	$ 504,724	$ 46,284	$	$ 551,088
Segment Adjusted EBITDA	206,257	7,222	(13,192)	200,287
2013				
Net sales	$ 504,585	$ 45,605	$	$ 550,190
Segment Adjusted EBITDA	202,613	8,619	(5,738)	205,494

(in thousands)	Nine Months Ended September 30,			Total
	Education	Trade Publishing	Corporate/ Other	
2014				
Net sales	$ 991,216	$ 115,615	$	$ 1,106,831
Segment Adjusted EBITDA	285,346	7,844	(36,859)	256,331
2013				
Net sales	$ 955,145	$ 124,590	$	$ 1,079,735
Segment Adjusted EBITDA	276,060	19,927	(25,786)	270,201

Reconciliation of Segment Adjusted EBITDA to the consolidated statements of operations is as follows:

(in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Total Segment Adjusted EBITDA	$ 200,287	$ 205,494	$ 256,331	$ 270,201
Interest expense	(4,662)	(5,041)	(13,354)	(16,626)
Depreciation expense	(17,564)	(14,094)	(52,885)	(44,319)
Amortization expense	(61,540)	(67,970)	(184,056)	(210,643)
Stock compensation	(2,861)	(3,648)	(8,805)	(6,923)
Gain (loss) on derivative instruments	(1,252)	250	(1,560)	(229)
Asset impairment charges			(1,279)	(8,500)
Purchase accounting adjustments	(1,434)	(3,637)	(3,025)	(8,515)

Fees, expenses or charges for equity offerings, debt or acquisitions	(461)	(4,055)	(4,151)	(5,819)
Restructuring	(95)	(171)	(2,507)	(1,710)
Severance, separation costs and facility closures	(181)	(4,384)	(5,300)	(10,865)
Debt extinguishment loss				(598)
Net income (loss) from continuing operations before taxes	110,237	102,744	(20,591)	(44,546)
Provision for income taxes	(3,207)	2,368	(7,166)	(1,989)
Net income (loss)	$ 107,030	$ 105,112	$ (27,757)	$ (46,535)

15. Subsequent Events

On November 3, 2014, the Company s Board of Directors authorized the repurchase of up to $100.0 million in aggregate value of the Company s Common Stock over a period of two years. Repurchases under the program may be made from time to time in open market or privately negotiated transactions. The extent and timing of any such repurchases would be at the Company s discretion and subject to market conditions, applicable legal requirements and other considerations.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of the financial condition and results of operations of HMH should be read in conjunction with the interim unaudited consolidated financial statements and the related notes thereto included elsewhere in this Quarterly Report on Form 10-Q and the audited financial statements and the related notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2013, which was filed with the Securities Exchange Commission (the SEC) on March 27, 2014. This Management s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934, as amended. See Special Note Regarding Forward-Looking Statements included elsewhere in this Quarterly Report on Form 10-Q.

Overview

We are a leading global provider of education solutions, delivering content, technology, services and media to over 50 million students in over 150 countries worldwide. We deliver our offerings to both educational institutions and consumers around the world. We believe our long-standing reputation and well-known brands enable us to capitalize on consumer and digital trends in the education market through our existing and developing channels. Furthermore, since 1832, we have published trade and reference materials, including adult and children s fiction and non-fiction books that have won industry awards such as the Pulitzer Prize, Newbery and Caldecott medals and National Book Award, all of which are generally known.

Corporate History

Houghton Mifflin Harcourt Company was incorporated as a Delaware corporation on March 5, 2010, and was established as the holding company of the current operating group. The Company changed its name from HMH Holdings (Delaware), Inc. on October 22, 2013. Houghton Mifflin Harcourt was formed in December 2007 with the acquisition of Harcourt Education Group, then the second-largest K-12 U.S. publisher, by Houghton Mifflin Group. We are headquartered in Boston, Massachusetts.

Key Aspects and Trends of Our Operations

Business Segments

We are organized along two business segments: Education and Trade Publishing. Our Education segment is our largest segment and represented approximately 88%, 88% and 90% of our total net sales for the years ended December 31, 2013, 2012 and 2011, respectively. Our Trade Publishing segment represented approximately 12%, 12% and 10% of our total net sales for the years ended December 31, 2013, 2012 and 2011, respectively. The Corporate and Other category represents certain general overhead costs not fully allocated to the business segments, such as legal, accounting, treasury, human resources and executive functions.

Net Sales

We derive revenue primarily from the sale of print and digital textbooks and instructional materials, trade books, reference materials, multimedia instructional programs, license fees for book rights, content, software and services, test scoring, consulting and training. We primarily sell to customers in the United States. Our net sales are driven primarily as a function of volume and, to a certain extent, changes in price. Our net sales consist of our billings for products and services, less revenue that will be deferred until future recognition and a provision for product returns.

Deferred revenues primarily derive from of work-texts, workbooks, online interactive digital content, digital and on-line learning components. The work-texts and workbooks are deferred until delivered, which often extends over the life of the contract and the online and digital content is typically recognized ratably over the life of the contract. The digitalization of education content and delivery is driving a substantial shift in the education market. An increasing number of schools are utilizing digital content in their classrooms and implementing online or blended learning environments, which is altering the historical mix of print and digital educational materials in the classroom. As a result, our business model has shifted to more digital and on-line learning components to address the needs of the education marketplace; thus, resulting in an increase in the percentage of our net sales being deferred.

Basal programs, which represent the most significant portion of our Education segment net sales, cover curriculum standards in a particular K-12 academic subject and include a comprehensive offering of teacher and student materials required to conduct the class throughout the school year. Products and services in basal programs include print and digital offerings for students and a variety of supporting materials such as teacher s editions, formative assessments, whole group instruction materials, practice aids, educational games and services. The process through which materials and curricula are selected and procured for classroom use varies throughout the United States. Twenty states, known as adoption states, approve and procure new basal programs usually every five to seven years

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on a state-wide basis, before individual schools or school districts are permitted to schedule the purchase of materials. In all remaining states, known as open states or open territories, each individual school or school district can procure materials at any time, though usually according to a five to nine year cycle. The student population in adoption states represents over 50% of the U.S. elementary and secondary school-age population. Many adoption states provide categorical funding for instructional materials, which means that state funds cannot be used for any other purpose. Our basal programs, primarily in adoption states, typically have the higher deferred sales than other parts of the business. The higher deferred sales are primarily due to the length of time that our programs are being delivered along with greater component and digital product offerings.

A significant portion of our Education segment net sales is dependent upon our ability to maintain residual sales, which are subsequent sales after the year of the original adoption, and our ability to continue to generate new business. In addition, our market is affected by changes in state curriculum standards, which drive instruction, assessment and accountability in each state. Changes in state curriculum standards require that instructional materials be revised or replaced to align to the new standards, which historically has driven demand for basal programs.

We also derive our Education segment net sales from the sale of summative, formative or in-classroom and diagnostic assessments to districts and schools in all 50 states. Summative assessments are concluding or final exams that measure students proficiency in a particular academic subject or group of subjects on an aggregate level or against state standards. Formative assessments are on-going, in-classroom tests that occur throughout the school year and monitor progress in certain subjects or curriculum units. Additionally, our offerings include supplemental products that target struggling learners through comprehensive intervention solutions along with products targeted at assisting English language learners.

In international markets, our Education segment predominantly exports and sells K-12 books to premium private schools that utilize the U.S. curriculum, which are located primarily in Asia, the Pacific, the Middle East, Latin America and the Caribbean. Our international sales team utilizes a global network of distributors in local markets around the world.

Our Trade Publishing segment sells works of fiction and non-fiction for adults and children, dictionaries and other reference works through physical and online retail outlets and book distributors, as well as through our e-commerce platform.

Factors affecting our net sales include:

Education

- state or district per student funding levels;
- the cyclicality of the purchasing schedule for adoption states;
- student enrollments;
- adoption of new education standards;

- technological advancement and the introduction of new content and products that meet the needs of students, teachers and consumers, including through strategic agreements pertaining to content development and distribution; and

- the amount of net sales subject to deferrals which is impacted by the mix of product offering between digital and non-digital products along with the mix of product delivered immediately or over time.

Trade Publishing

- consumer spending levels as influenced by various factors, including the U.S. economy and consumer confidence;

- the transition to e-books and any resulting impact on market growth;

- the publishing of bestsellers along with obtaining recognized authors; and

- movie tie-ins to our titles that spur sales of current and backlist titles, which are titles that have been on sale for more than a year.

State or district per-student funding levels, which closely correlate with state and local receipts from income, sales and property taxes, impact our sales as institutional customers are affected by funding cycles. Most public school districts, the primary customers for K-12 products and services, are largely dependent on state and local funding to purchase materials. Recently, total educational materials expenditures by institutions in the United States is rebounding in the wake of the economic recovery. Globally, education expenditures are projected to grow at 7% through 2018, according to GSV Asset Management.

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We monitor the purchasing cycles for specific disciplines in the adoption states in order to manage our product development and to plan sales campaigns. Our sales may be materially impacted during the years that major adoption states, such as Florida, California and Texas, are or are not scheduled to make significant purchases. Florida implemented a language arts adoption in 2014 and is scheduled to adopt social studies materials in 2015, for purchase in 2016. Texas school districts are purchasing mathematics and science materials in 2014, and this fall the State adopted social studies and high school math materials for purchase in 2015. California adopted math materials in 2013, with purchases expected to be spread over 2014-15, and is scheduled to adopt English language arts materials in 2015 for purchase beginning in 2016. Both Florida and Texas, along with several other adoption states, provide dedicated state funding for instructional materials and classroom technology, with funding typically appropriated by the legislature in the first half of the year in which materials are to be purchased. Texas has a two-year budget cycle and in the 2015 legislative session will appropriate funds for purchases in 2015 and 2016. California funds instructional materials in part with a dedicated portion of state lottery proceeds and in part out of general formula funds, with the minimum overall level of school funding determined according to the Proposition 98 funding guarantee. Nationally, total state funding for public schools has been trending upward as state revenues recover from the lows of the 2008-2009 economic recession. While we do not currently have contracts with these states for future instructional materials adoptions and there is no guarantee that we will continue to capture the same market share in the future, we have historically captured over 50% of the market share in these states in the years that they adopt educational materials for various subjects.

Longer-term growth in the U.S. K-12 market is positively correlated with student enrollments, which is a driver of growth in the educational publishing industry. Although economic cycles may affect short-term buying patterns, school enrollments are highly predictable and are expected to trend upward over the longer term. According to the U.S. Department of Education s National Center for Education Statistics (NCES), student enrollments are expected to increase from 54.7 million in 2010, to over 58.0 million by the 2020 school year. Outside of the United States, the global education market continues to demonstrate strong macroeconomic growth characteristics. Population growth is a leading indicator for pre-primary school enrollments, which have a subsequent impact on secondary and higher education enrollments. Globally, according to United Nations Educational, Scientific and Cultural Organization (UNESCO), rapid population growth has caused pre-primary enrollments to grow by 16.2% worldwide from 2007 to 2011. The global population is expected to be approximately 9.0 billion by 2050, as countries develop and improvements in medical conditions increase the birth rate.

The digitalization of education content and delivery is also driving a substantial shift in the education market. As the K-12 educational market transitions to purchasing more digital solutions, our ability to offer embedded assessments, adaptive learning, real-time interaction and student-specific personalization in addition to our core educational content in a platform- and device-agnostic manner provide new opportunities for growth.

Our Trade Publishing segment is heavily influenced by the U.S. and broader global economy, consumer confidence and consumer spending. As the economy continues to recover, both consumer confidence and consumer spending have increased and are at their highest level since 2008.

While print remains the primary format in which trade books are produced and distributed, the market for trade titles in digital format, primarily e-books, has developed rapidly over the past several years, as the industry evolves to embrace new technologies for developing, producing, marketing and distributing trade works. We continue to focus on the development of innovative new digital products which capitalize on our strong content, our digital expertise and the growing consumer demand for these products.

In the Trade Publishing segment, annual results can be driven by bestselling trade titles. Furthermore, backlist titles can experience resurgence in sales when made into films. Over the past several years, a number of our backlist titles such as *The Hobbit*, *The Lord of the Rings*, *Life of Pi*, *Extremely Loud and Incredibly Close* and *The Time Traveler s Wife* have benefited in popularity due to movie releases and have subsequently resulted in increased trade sales. The second part of *The Hobbit* trilogy was released in December 2013 and the third part is scheduled to be released in December 2014.

We employ several pricing models to serve various customer segments, including institutions, consumers, other government agencies (*e.g.*, penal institutions, community centers, etc.) and other third parties. In addition to traditional pricing models where a customer receives a product in return for a payment at the time of product receipt, we currently use the following pricing models:

Pay-up-front: Customer makes a fixed payment at time of purchase and we provide a specific product/service in return;

Pre-pay Subscription: Customer makes a one-time payment at time of purchase, but receives a stream of goods/services over a defined time horizon; for example, we currently provide customers the option to purchase a multi-year subscription to textbooks where for a one-time charge, a new copy of the textbook is delivered to the customer each year for a defined time period. Pre-pay subscriptions to online textbooks are another example where the customer receives access to an online book for a specific period of time; and

Pay-as-you-go Subscription: Similar to the Pre-pay subscription, except that the customer makes periodic payments in a pre-described manner.

Cost of sales, excluding pre-publication and publishing rights

Cost of sales, excluding pre-publication and publishing rights, include expenses directly attributable to the production of our products and services, including the non-capitalizable costs associated with our content operations department. The expenses within cost of sales include variable costs such as paper, printing and binding costs of our print materials, royalty expenses paid to our authors, gratis costs or products provided at no charge as part of the sales transaction, and inventory obsolescence. Also included in cost of sales are labor costs related to professional services and the non-capitalized costs associated with our content and platform operations department. We also include depreciation expense associated with our software platforms. Certain products such as trade books and those products associated with our renowned authors carry higher royalty costs; conversely, digital offerings usually have a lower cost of sales due to lower costs associated with their production. Also, sales to adoption states usually contain higher gratis expense. A change in the sales mix of these products can impact consolidated profitability.

Pre-publication amortization and publishing rights amortization

A publishing right is an acquired right which allows us to publish and republish existing and future works as well as create new works based on previously published materials. As part of our March 9, 2010 restructuring, we recorded an intangible asset for publishing rights and amortize such asset on an accelerated basis over the useful lives of the various copyrights involved. See Note 1 to our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2013. Our publishing rights amortization is expected to decline from the 2013 amount of $139.6 million, to approximately $105.6 million, $81.0 million and $61.4 million in 2014, 2015 and 2016, respectively.

We capitalize the art, prepress, manuscript and other costs incurred in the creation of the master copy of a book or other media, known as the pre-publication costs. Pre-publication costs are primarily amortized from the year of sale over five years using the sum-of-the-years-digits method, which is an accelerated method for calculating an asset s amortization. Under this method, the amortization expense recorded for a pre-publication cost asset is approximately 33% (year 1), 27% (year 2), 20% (year 3), 13% (year 4) and 7% (year 5). We utilize this policy for all pre-publication costs, except with respect to our Trade Publishing consumer books, for which we generally expense such costs as incurred, and our assessment products, for which we use the straight-line amortization method. The amortization methods and periods chosen best reflect the pattern of expected sales generated from individual titles or programs. We periodically evaluate the remaining lives and recoverability of capitalized pre-publication costs, which are often dependent upon program acceptance by state adoption authorities.

Selling and administrative expenses

Our selling and administrative expenses include the salaries, benefits and related costs of employees engaged in sales and marketing, fulfillment and administrative functions. Also included within selling and administrative costs are variable costs such as commission expense, outbound transportation costs, sampling and depository fees, which are fees paid to state-mandated depositories that fulfill centralized ordering and warehousing functions for specific states. Additionally, significant fixed and discretionary costs include facilities, telecommunications, professional fees, promotions and advertising. We expect our selling and administrative costs in dollars to increase as we invest in new growth initiatives.

Other intangible asset amortization

Our other intangible asset amortization expense primarily includes the amortization of acquired intangible assets consisting of customer relationships, content rights and licenses. Our customer relationships, which constituted the largest component of the amortization expense over the past two years, pertained to our assessment customers and was fully amortized as of September 30, 2014. The existing software, content rights and licenses will be amortized over varying periods of 6 to 25 years.

Interest expense

Our interest expense includes interest accrued on our term loan facility, along with, to a lesser extent, our revolving credit facility, capital leases and the amortization of any deferred financing fees and loan discounts.

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Results of Operations

Consolidated Operating Results for the Three Months Ended September 30, 2014 and 2013

(dollars in thousands)	For the Three Months Ended September 30, 2014	For the Three Months Ended September 30, 2013	Dollar change	Percent Change
Net sales	$ 551,008	$ 550,190	$ 818	0.1%
Costs and expenses:				
Cost of sales, excluding pre-publication and publishing rights amortization	205,395	214,750	(9,355)	(4.4)%
Publishing rights amortization	25,048	33,501	(8,453)	(25.2)%
Pre-publication amortization	33,463	31,815	1,648	5.2%
Cost of sales	263,906	280,066	(16,160)	(5.8)%
Selling and administrative	167,741	156,592	11,149	7.1%
Other intangible asset amortization	3,029	2,654	375	14.1%
Severance and other charges	181	3,343	(3,162)	(94.6)%
Operating income	116,151	107,535	8,616	8.0%
Other income (expense):				
Interest expense	(4,662)	(5,041)	379	7.5%
Change in fair value of derivative instruments	(1,252)	250	(1,502)	NM
Income before taxes	110,237	102,744	7,493	7.3%
Income tax expense (benefit)	3,207	(2,368)	5,575	NM
Net income	$ 107,030	$ 105,112	$ 1,918	1.8%

NM = not meaningful

Net sales for the three months ended September 30, 2014 increased $0.8 million, or 0.1%, from $550.2 million for the same period in 2013, to $551.0 million. The net sales increase was largely driven by assessment sales, which increased by $7.0 million on the strength of our new addition to the Woodcock Johnson product line. There were also higher net sales of $4.0 million of the Heinemann products, due primarily to the Leveled Literacy Invention product line. Offsetting the aforementioned increases were lower net sales of $5.0 million of traditional print supplemental products due to an aging product base and a $4.0 million decline in international sales due to a decline in licensing revenue. We also had strong adoption sales in Texas, California and South Carolina; however, these sales were offset by increased deferred revenue which increased $140.6 million during the quarter. Our billings for the three months ended September 30, 2014 increased approximately $143.0 million, or 26%, from the same period in 2013. The increase in the amount of net sales that have been deferred is attributed to our change in product mix and the increase in our digital offerings.

Operating income for the three months ended September 30, 2014 increased $8.6 million from $107.5 million for the same period in 2013 to $116.2 million, due primarily to the following:

Our cost of sales, excluding pre-publication and publishing rights amortization, decreased $9.4 million. As a percent of net sales, our cost of sales, excluding pre-publication and publishing rights amortization, decreased to 37.3% from 39.0%, resulting in an approximate $9.7 million of improved net profitability. The increase in product profitability was primarily the result of a reduction of our product cost of $16.7 million, partially offset by a 0.6% increase in royalties as a percent of net sales, which had a ne