Houghton Mifflin Harcourt Co
Form 10-Q
November 05, 2015
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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, 2015

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 incorporation or organization)	**(I.R.S. Employer 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	x	Accelerated filer	¨
Non-accelerated filer	¨	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 30, 2015 was 134,299,959.

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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, our recent acquisition and its impact, 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; ability to obtain debt financing on favorable terms or at all; ability to integrate acquired businesses; and other factors discussed in the Risk Factors sections of our Annual Report on Form 10-K for the year ended December 31, 2014 and our Quarterly Report on Form 10-Q for the three months ended March 31, 2015. 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, 2015**	**December 31, 2014**
Assets		
Current assets		
Cash and cash equivalents	$ 377,043	$ 456,581
Short-term investments	146,492	286,764
Accounts receivable, net of allowance for bad debts and book returns of $33.1 million and $27.8 million, respectively	478,733	255,669
Inventories	185,600	183,961
Deferred income taxes	17,264	20,459
Prepaid expenses and other assets	29,052	18,665
Total current assets	1,234,184	1,222,099
Property, plant, and equipment, net	134,643	138,362
Pre-publication costs, net	326,975	236,995
Royalty advances to authors, net	45,779	46,777
Goodwill	783,923	532,921
Other intangible assets, net	939,617	801,969
Deferred income taxes	3,705	3,705
Other assets	37,009	28,279
Total assets	$ 3,505,835	$ 3,011,107
Liabilities and Stockholders Equity		
Current liabilities		
Current portion of long-term debt	$ 8,000	$ 67,500
Accounts payable	80,155	51,266
Royalties payable	96,289	80,089
Salaries, wages, and commissions payable	65,936	59,733
Deferred revenue	234,940	157,016
Interest payable	106	47
Severance and other charges	5,026	5,928
Accrued postretirement benefits	2,037	2,037
Other liabilities	37,679	27,015
Total current liabilities	530,168	450,631
Long-term debt, net of discount	786,222	175,625

Long-term deferred revenue		459,951		370,103
Accrued pension benefits		16,424		18,525
Accrued postretirement benefits		24,548		26,500
Deferred income taxes		151,218		112,220
Other liabilities		22,388		97,823
Total liabilities		1,990,919		1,251,427
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, 2015 and December 31, 2014				
Common stock, $0.01 par value: 380,000,000 shares authorized; 144,931,777 and 142,000,019 shares issued at September 30, 2015 and December 31, 2014, respectively; 134,707,975 and 141,917,997 shares outstanding at September 30, 2015 and December 31, 2014, respectively		1,348		1,420
Treasury stock, 10,223,802 and 82,022 shares at September 30, 2015 and December 31, 2014, respectively, at cost		(239,408)		
Capital in excess of par value		4,822,524		4,784,962
Accumulated deficit		(3,036,515)		(2,999,913)
Accumulated other comprehensive loss		(33,033)		(26,789)
Total stockholders equity		1,514,916		1,759,680
Total liabilities and stockholders equity	$	3,505,835	$	3,011,107

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, 2015	Three Months Ended September 30, 2014	Nine Months Ended September 30, 2015	Nine Months Ended September 30, 2014
Net sales	$ 575,507	$ 551,008	$ 1,118,059	$ 1,106,831
Costs and expenses				
Cost of sales, excluding pre-publication and publishing rights amortization	220,492	205,395	485,137	464,839
Publishing rights amortization	19,358	25,048	61,649	80,575
Pre-publication amortization	32,437	33,463	86,809	94,500
Cost of sales	272,287	263,906	633,595	639,914
Selling and administrative	191,843	167,741	505,539	457,034
Other intangible assets amortization	7,255	3,029	14,734	8,981
Impairment charge for investment in preferred stock				1,279
Severance and other charges	1,563	181	3,605	5,300
Operating income (loss)	102,559	116,151	(39,414)	(5,677)
Other income (expense)				
Interest expense	(10,196)	(4,662)	(22,310)	(13,354)
Change in fair value of derivative instruments	(42)	(1,252)	(1,893)	(1,560)
Loss on extinguishment of debt	(878)		(3,051)	
Income (loss) before taxes	91,443	110,237	(66,668)	(20,591)
Income tax expense (benefit)	(39,638)	3,207	(30,066)	7,166
Net income (loss)	$ 131,081	$ 107,030	$ (36,602)	$ (27,757)
Net income (loss) per share attributable to common stockholders				
Basic	$ 0.97	$ 0.76	$ (0.26)	$ (0.20)
Diluted	$ 0.94	$ 0.75	$ (0.26)	$ (0.20)
Weighted average shares outstanding				
Basic	135,169,318	140,742,786	138,978,746	140,269,383
Diluted	139,813,309	143,583,901	138,978,746	140,269,383

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

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Houghton Mifflin Harcourt Company

Consolidated Statements of Comprehensive Income (Loss) (Unaudited)

(in thousands of dollars, except share and per share information)	**Three Months Ended September 30, 2015**	**Three Months Ended September 30, 2014**	**Nine Months Ended September 30, 2015**	**Nine Months Ended September 30, 2014**
Net income (loss)	$ 131,081	$ 107,030	$ (36,602)	$ (27,757)
Other comprehensive income (loss), net of taxes:				
Foreign currency translation adjustments	637	(485)	(1,828)	218
Net change in unrealized loss on derivative financial instruments	(4,461)		(4,461)	
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 on short-term investments	45		45	4
Other comprehensive income (loss), net of taxes	(3,779)	(485)	(6,244)	2,205
Comprehensive income (loss)	$ 127,302	$ 106,545	$ (42,846)	$ (25,552)

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, 2015	Nine Months Ended September 30, 2014
Cash flows from operating activities		
Net loss	$ (36,602)	$ (27,757)
Adjustments to reconcile net loss to net cash provided by operating activities		
Depreciation and amortization expense	216,542	236,941
Amortization of debt discount and deferred financing costs	5,807	3,563
Deferred income taxes	42,193	3,052
Stock-based compensation expense	9,928	8,805
Loss on extinguishment of debt	3,051	
Change in fair value of derivative instruments	1,893	1,560
Impairment charge for investment in preferred stock		1,279
Changes in operating assets and liabilities, net of acquisitions		
Accounts receivable	(191,826)	(207,212)
Inventories	12,074	(8,228)
Accounts payable and accrued expenses	25,693	47,409
Royalties, net	15,718	16,103
Deferred revenue	147,583	244,043
Interest payable	59	(7)
Severance and other charges	(2,670)	(4,988)
Accrued pension and postretirement benefits	(4,053)	(10,236)
Other, net	(82,012)	(3,601)
Net cash provided by operating activities	163,378	300,726
Cash flows from investing activities		
Proceeds from sales and maturities of short-term investments	286,732	94,190
Purchases of short-term investments	(146,518)	(274,599)
Additions to pre-publication costs	(78,978)	(90,280)
Additions to property, plant, and equipment	(49,642)	(49,779)
Acquisition of business, net of cash acquired	(578,190)	(9,091)
Net cash used in investing activities	(566,596)	(329,559)
Cash flows from financing activities		
Proceeds from term loan	796,000	
Payments of long-term debt	(245,125)	(1,875)
Payments of deferred financing fees	(15,255)	
Repurchases of common stock	(239,408)	
Tax withholding payments related to net share settlements of restricted stock units	(658)	(723)
Proceeds from stock option exercises	28,126	14,643

Net cash provided by financing activities	323,680	12,045
Net decrease in cash and cash equivalents	(79,538)	(16,788)
Cash and cash equivalents		
Beginning of period	456,581	313,628
Net decrease in cash and cash equivalents	(79,538)	(16,788)
End of period	$ 377,043	$ 296,840
Supplementary disclosure of cash flow information		
Amounts due from seller for acquisition (noncash)	$ 2,034	$
Issuance of common stock upon exercise of warrants (noncash)	1,815	
Pre-publication costs included in accounts payable (noncash)	10,545	8,534
Property, plant, and equipment included in accounts payable (noncash)	4,028	1,914
Property, plant, and equipment acquired under capital leases (noncash)	1,912	3,644

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 (HMH , Houghton Mifflin Harcourt , we , us , our , or the Company) is a g learning company, specializing in education solutions across a variety of media, delivering content, services and technology to over 50 million students in over 150 countries worldwide. We deliver our offerings to both educational institutions and consumers around the world. In the United States, we are the leading provider of Kindergarten through twelfth grade (K-12) educational content by market share. We believe that nearly every current K-12 student in the United States has utilized our content during the course of his or her education. As a result, we believe that we have an established reputation with students and educators that is difficult for others to replicate and positions us to also provide broader content and services to serve their learning needs beyond the classroom. 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 widely known.

The consolidated financial statements of HMH include the accounts of all of our wholly-owned subsidiaries as of September 30, 2015 and December 31, 2014 and the three and nine month periods ended September 30, 2015 and September 30, 2014.

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.

During the quarter, an error was identified in certain disclosures within the Income Taxes footnote, as contained in our 2014 annual report on Form 10-K. This error had no effect on income tax expense or net income. The error also had no effect on the consolidated balance sheet as there is no change to the deferred tax assets or deferred tax liabilities accounts. The correction of the error impacts certain deferred tax components within the Income Taxes footnote.

Deferred tax assets related to net operating loss and other carryforwards will decrease by approximately $15.1 million and deferred interest will increase by approximately $15.1 million, however, net deferred tax assets will be unchanged. Management believes the out-of-period correction is not material to any previously issued financial statements. The 2014 amounts will be revised in connection with the filing of our 2015 annual report on Form 10-K.

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.

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.

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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, 2015 to the application of significant accounting policies and estimates as described in our audited financial statements for the year ended December 31, 2014.

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.

In September 2015, the Financial Accounting Standards Board (FASB) issued new accounting guidance which replaces the requirement that an acquirer in a business combination account for measurement period adjustments retrospectively with a requirement that an acquirer recognize adjustments to the provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The accounting guidance requires that an acquirer record, in the same period s financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. This guidance will be effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. The guidance is to be applied prospectively to adjustments to provisional amounts that occur after the effective date of the guidance, with earlier application permitted for financial statements that have not been issued. Our early adoption of the accounting guidance in the third quarter of 2015 did not have a material impact on our consolidated financial statements and footnote disclosures.

In August 2015, the FASB issued guidance to defer the effective date of the new accounting guidance related to revenue recognition by one year to December 15, 2017 for annual reporting periods beginning after that date and permitted early adoption of the standard, but not before fiscal years beginning after the original effective date of December 15, 2016. This new accounting 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, 2018 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 that the adoption of this new revenue recognition standard will have on our consolidated financial statements and footnote disclosures.

In April 2015, the FASB issued new accounting guidance related to simplifying the presentation of debt issuance costs. This standard amends existing guidance to require the presentation of debt issuance costs in the balance sheet as a deduction from the carrying amount of the related debt liability instead of a deferred charge, consistent with debt discounts. The FASB later issued guidance in August 2015 stating that debt issuance costs related to line-of-credit arrangements may be presented as an asset and subsequently amortized ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The recognition and measurement guidance for debt issuance costs are not affected by the new accounting guidance. The new guidance will be effective for annual reporting periods beginning after December 15, 2015, but early adoption is permitted. We evaluated the impact of adopting this standard and do not expect it to have a material impact on our consolidated financial statements and footnote disclosures.

4. Acquisitions

On April 23, 2015, we entered into a stock and asset purchase agreement with Scholastic Corporation (Scholastic) to acquire certain assets (including the stock of two of Scholastic s subsidiaries) comprising its Educational Technology and Services (EdTech) business. On May 29, 2015, we completed the acquisition and paid an aggregate purchase price of $575.0 million in cash to Scholastic, subject to adjustments for working capital. $34.5 million of the purchase price was deposited into an escrow account to be held for 18 months as security for potential indemnification obligations of Scholastic. Portions of such escrow is released periodically during the 18-month period.

The acquisition provided us with a leading position in intervention curriculum and services and extends our product offerings in key growth areas, including educational technology, early learning, and education services, creating a more comprehensive offering for students, teachers and schools.

The transaction was accounted for under the acquisition method of accounting. Accordingly, the results of operations of the purchased assets of EdTech are included in our consolidated financial statements from the date of acquisition.

We have allocated the purchase price to the EdTech assets acquired and liabilities assumed at estimated fair values as of May 29, 2015. The excess of the purchase price over the net of amounts assigned to the fair value of the assets acquired and the liabilities assumed has been recorded as goodwill, which is allocated to our Education segment. The goodwill recognized is primarily the result of expected synergies. All of the goodwill and identifiable intangibles associated with the acquisition will be

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deductible for tax purposes. We are currently finalizing the assumed liabilities in connection with certain working capital adjustments; therefore the fair values set forth below are subject to adjustment as additional information is obtained. We expect to be completed during the fourth quarter of 2015.

The preliminary valuation of assets and liabilities has been determined and the purchase price has been allocated as follows:

Accounts receivable, net of allowance for bad debts and book returns of $2.2 million	$ 31,237
Inventories	13,714
Prepaid expenses and other assets	803
Property, plant, and equipment	1,725
Pre-publication costs	98,610
Royalty advances to authors	1,093
Goodwill	251,002
Other intangible assets	214,030
Other assets	28
Accounts payable	(8,117)
Royalties payable	(2,573)
Deferred revenue	(20,189)
Other accruals	(5,680)
Total purchase price	$ 575,683

The $214.0 million of other intangible assets included $54.7 million of tradenames amortizable over 20 years, and $159.3 million of customer relationships amortizable over 25 years. The tradenames are being amortized on a straight-line basis and the customer relationships over the pattern in which the economic benefits of the intangible is expected to be realized. The fair value of the other intangible assets was primarily derived using the income approach. The rate used to discount the net cash flows to their present value was based upon the weighted average cost of capital of 9.6%. This discount rate was determined based on the Capital Asset Pricing Model, which looks at the risk free rate and applies a market risk premium, business risk premium and size risk premium to the risk free rate to calculate the cost of equity. The weighted average cost of capital considers the cost of equity and a market participant cost of debt and capital structure. The tradenames were valued using a relief from royalty method and the customer relationships were valued using a multi-period excess earning method.

Transaction costs related to the acquisition were approximately $5.2 million during the nine months ended September 30, 2015 and are included in the selling and administrative line item in our consolidated statements of operations.

The unaudited pro forma information presented in the following table summarizes the consolidated results of operations for the periods presented as if the acquisition of EdTech had occurred on January 1, 2014. The pro forma financial information is presented for comparative purposes only and is not necessarily indicative of the results of operations that actually would have been achieved if the acquisition had occurred at the beginning of the periods, nor is it intended to be a projection of future results. For each period presented, the pro forma results include estimates of the interest expense on debt used to finance the acquisition, the amortization of the other intangible assets recorded in connection with the acquisition, the impact of the write-down of acquired deferred revenue to fair value and the

related tax effects of the adjustments.

	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2015	Three Months Ended September 30, 2014	Nine Months Ended September 30, 2014
Net sales	$ 578,464	$ 1,186,956	$ 638,043	$ 1,291,863
Net income (loss)	135,387	(50,693)	125,434	(16,899)

Since the date of acquisition, May 29, 2015, we recorded approximately $100.4 million of net sales and $30.1 million of operating income attributable to EdTech within our consolidated statements of operations.

On July 31, 2015, we acquired select ebook and technology assets of MeeGenius, which is an ebook subscription service for children up to eight years of age. The aggregate purchase price was approximately $0.5 million. The acquisition provided us with digital content for parents and young learners and supports our strategic focus on the direct to consumer market. There was no goodwill recorded and the aggregate purchase price was recorded to pre-publication costs.

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5. Inventories

Inventories consisted of the following:

	September 30, 2015	December 31, 2014
Finished goods	$ 179,864	$ 178,812
Raw materials	5,736	5,149
Inventory	$ 185,600	$ 183,961

6. Goodwill and Other Intangible Assets

Goodwill and other intangible assets consisted of the following:

	September 30, 2015		December 31, 2014	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Goodwill	$ 783,923	$	$ 532,921	$
Trademarks and trade names	494,335	(912)	439,605	
Publishing rights	1,180,000	(951,209)	1,180,000	(889,560)
Customer related and other	442,640	(225,237)	283,340	(211,416)
	$ 2,900,898	$ (1,177,358)	$ 2,435,866	$ (1,100,976)

The changes in the carrying amount of goodwill for the periods ended September 30, 2015 and December 31, 2014 were as follows:

Balance at December 31, 2014	$ 532,921
Acquisitions	251,002
Balance at September 30, 2015	$ 783,923

Goodwill	$ 2,226,423
Accumulated impairment losses	(1,442,500)
Balance at September 30, 2015	$ 783,923

Amortization expense for trademarks and tradenames, publishing rights, and customer related and other intangibles were $26.6 million and $28.1 million for the three months ended September 30, 2015 and 2014, respectively, and

$76.4 million and $89.6 million for the nine months ended September 30, 2015 and 2014, respectively.

7. Debt

Our debt consisted of the following:

	September 30, 2015	December 31, 2014
$250,000 term loan due May 21, 2018 interest payable monthly	$	$ 243,125
$800,000 term loan due May 29, 2021 interest payable quarterly	794,222	
Total debt, net of discount	$ 794,222	$ 243,125
Less: Current portion of long-term debt	8,000	67,500
Total long-term debt, net of discount	$ 786,222	$ 175,625

Term Loan Facility

In connection with our closing of the EdTech acquisition referred to in Note 4, we entered into an amended and restated term loan credit facility (the New Term Loan Facility) dated as of May 29, 2015 to increase our outstanding term loan credit facility from $178.9 million to $800.0 million, all of which was drawn at closing. The New Term Loan Facility matures on May 29, 2021 and the interest rate is based on LIBOR plus 3.0% or an alternative base rate plus applicable margins. LIBOR is subject to a floor of 1.0% with the length of the LIBOR contracts ranging up to six months at the option of the Company.

The New Term Loan Facility may be prepaid, in whole or in part, at any time, without premium, except in the case of a re-pricing event within the first 6 months of the New Term Loan Facility, in which case, a 1.00% premium shall be paid. The New Term Loan Facility is required to be repaid in quarterly installments equal to 0.25%, or $2.0 million, of the aggregate principal amount outstanding under the New Term Loan Facility immediately prior to the first quarterly payment date.

The New Term Loan Facility was issued at a discount equal to 0.5% of the outstanding borrowing commitment. As of September 30, 2015, the interest rate of the New Term Loan Facility was 4.0%.

The New Term Loan Facility does not require us to comply with financial covenants. The New Term Loan Facility is subject to usual and customary conditions, representations, warranties and covenants, including restrictions on additional indebtedness, liens, investments, mergers, acquisitions, asset dispositions, dividends to stockholders, repurchase or redemption of our stock, transactions with affiliates and other matters. The New Term Loan Facility is subject to customary events of default. If an event of default occurs and is continuing, the administrative agent may, or at the request of certain required lenders shall, accelerate the obligations outstanding under the New Term Loan Facility.

We are subject to Excess Cash Flow provisions under our New Term Loan Facility which is predicated upon our leverage ratio and cash flow. The Excess Cash Flow provision does not apply in 2015.

On May 29, 2015, in connection with the New Term Loan Facility described above, we paid off the remaining outstanding balance of our previous $250.0 million Term Loan Facility (the Term Loan Facility) of approximately $179.6 million. The transaction was accounted for under the guidance for debt modifications and extinguishments. We incurred a loss on extinguishment of debt of approximately $2.2 million related to the write off of the portion of the unamortized deferred financing fees associated with the portion of the Term Loan accounted for as extinguishment associated with the Term Loan Facility. We incurred approximately $15.6 million of third-party fees for the transaction, of which approximately $13.6 million were capitalized as deferred financing fees and approximately $2.0 million was recorded to expense and included in the selling and administrative line item in our consolidated statements of operations for the nine months ended September 30, 2015.

In accordance with the Excess Cash Flow provisions of the Term Loan Facility, which were predicated upon our leverage ratio and cash flow, we made a $63.6 million principal payment on March 5, 2015. In connection with this principal payment, we recorded a $2.0 million write off of deferred financing costs, which was recognized as interest expense in the consolidated statements of operations for the nine months ended September 30, 2015. In connection with the Excess Cash Flow payment, $1.5 million was reclassified from current portion of long-term debt to long-term debt as of March 31, 2015.

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 our consolidated statements of operations for the nine months ended September 30, 2014.

Interest Rate Hedging

On August 17, 2015, we entered into interest rate derivative contracts with various financial institutions having an aggregate notional amount of $400.0 million to convert floating rate debt into fixed rate debt, which we designated as cash flow hedges, and had $400.0 million outstanding as of September 30, 2015. We assessed at inception, and re-assess on an ongoing basis, whether the interest rate derivative contracts are highly effective in offsetting changes in the fair value of the hedged variable rate debt.

These interest rate swaps were designated as hedges and qualify for hedge accounting under the accounting guidance related to derivatives and hedging. Accordingly, we recorded an unrealized loss of $4.5 million in our statements of comprehensive income to account for the changes in fair value of these derivatives during the period. The corresponding $4.5 million hedge liability is included within long-term other liabilities in our consolidated balance sheet as of September 30, 2015. We had no interest rate derivative contracts outstanding as of December 31, 2014.

Revolving Credit Facility

On July 22, 2015, we entered into an amended and restated revolving credit facility (the New Revolving Credit Facility). The New Revolving Credit Facility provides borrowing availability in an amount equal to the lesser of either $250.0 million or a

borrowing base that is computed monthly and comprised of the borrowers and the guarantors eligible inventory and receivables. The New Revolving Credit Facility includes a letter of credit subfacility of $50.0 million, a swingline subfacility of $20.0 million and the option to expand the facility by up to $100.0 million in the aggregate under certain specified conditions. The New Revolving Credit Facility may be prepaid, in whole or in part, at any time, without premium. The transaction was accounted for under the accounting guidance for modifications to or exchanges of revolving debt arrangements. We incurred a loss on extinguishment of debt of approximately $0.9 million related to the write off of the portion of the unamortized deferred financing fees associated with the portion of the revolving credit facility accounted for as an extinguishment. We incurred approximately $1.6 million of third-party fees which were capitalized as deferred financing fees.

The New Revolving Credit Facility requires the Company to maintain a minimum fixed charge coverage ratio of 1.0 to 1.0 on a trailing four-quarter basis only during certain periods commencing when excess availability under the New Revolving Credit Facility is less than certain limits prescribed by the terms of the New Revolving Credit Facility. The New Revolving Credit Facility is subject to usual and customary conditions, representations, warranties and covenants, including restrictions on additional indebtedness, liens, investments, mergers, acquisitions, asset dispositions, dividends to stockholders, repurchase or redemption of our stock, transactions with affiliates and other matters. The New Revolving Credit Facility is subject to customary events of default. No amounts have been drawn on the New Revolving Credit Facility as of September 30, 2015.

As of September 30, 2015, the minimum fixed charge coverage ratio covenant under our New Revolving Credit Facility was not applicable, due to our level of borrowing availability. The minimum fixed charge coverage ratio, which is only tested in limited situations, is 1.0 to 1.0 through the end of the facility.

The following amendments relate to our previously existing revolving credit facility:

On May 19, 2015, we entered into Amendment No. 4 to our revolving credit facility. Amendment No. 4 permits us to increase the aggregate amount of indebtedness we may incur under our term loan agreement to $800.0 million, plus the aggregate amount of any incremental facilities provided for therein.

On April 23, 2015, we entered into Amendment No. 3 to our revolving credit facility. Amendment No. 3 permits us to increase the aggregate amount of indebtedness we may incur under our term loan agreement to $500.0 million, plus the aggregate amount of any incremental facilities provided for therein.

Guarantees

Under both the revolving credit facility and the New 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.

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8. Severance and Other Charges

2015

During the nine months ended September 30, 2015, $3.0 million of severance payments were made to employees whose employment ended in 2015 and prior years and $3.3 million of net payments for office space no longer utilized by the Company. Further, we recorded an expense in the amount of $3.2 million to reflect additional costs for severance, which we expect to be paid over the next twelve months, along with a $0.4 million accrual for vacated space.

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 have been substantially paid along with a $1.5 million accrual for additional space vacated.

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

	2015			
	Severance/ restructuring accrual at December 31, 2014	Severance/ restructuring expense	Cash payments	Severance/ restructuring accrual at September 30, 2015
Severance costs	$ 1,271	$ 3,176	$ (2,949)	$ 1,498
Other accruals	9,050	429	(3,326)	6,153
	$ 10,321	$ 3,605	$ (6,275)	$ 7,651

	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

The current portion of the severance and other charges was $5.0 million and $5.9 million as of September 30, 2015 and December 31, 2014, 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, are individually computed, and 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, 2015 and 2014, we recorded an income tax expense (benefit) of approximately $(39.6) million and $3.2 million, respectively, and for the nine months ended September 30, 2015 and 2014, we recorded an income tax expense (benefit) of approximately $(30.1) million and $7.2 million, respectively. The 2015 benefit was impacted by approximately $34.9 million attributed to a release of an accrual for uncertain tax positions as the statutory period expired. The effects of this reversal in uncertain tax positions is shown in the Other, net line item in the operating activities section of the statement of cash flows. For both periods, the income tax expense (benefit) 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 (43.3)% and 2.9% for the three months ended September 30, 2015 and 2014, respectively, and (45.1)% and 34.8% for the nine months ended September 30, 2015 and 2014, respectively.

Reserves for unrecognized tax benefits, excluding accrued interest and penalties, were $16.3 million and $63.2 million at September 30, 2015 and December 31, 2014, respectively, and included in other long-term liabilities in the accompanying consolidated balance sheets. The Company recognized approximately $74.3 million of uncertain tax benefits including interest and penalties in the three months ended September 30, 2015 due to the expiration of the statute of limitations. Approximately $34.9 million was recognized as a component of income tax expense (benefit) and $39.4 million was recognized through the consolidated balance sheet as additional deferred tax assets with a corresponding increase to the valuation allowance.

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

We also had a foreign defined benefit plan. On May 28, 2014, the plan was converted to individual annuity policies and the liability discharge occurred.

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

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

	Pension Plans Nine Months Ended September 30,	
	2015	**2014**
Interest cost	$ 5,039	$ 6,031
Expected return on plan assets	(7,317)	(7,869)
Amortization of prior service costs		250
Amortization of net loss	248	3
Settlement loss recognized		1,740
Net periodic benefit (credit) cost	$ (2,030)	$ 155

	Other Post Retirement Plans Nine Months Ended September 30,	
	2015	**2014**
Service cost	$ 154	$ 134
Interest cost	811	887
Amortization of prior service cost	(1,036)	(1,036)
Amortization of net loss	165	
Net periodic benefit (credit) cost	$ 94	$ (15)

There were no contributions to the pension plans for the nine months ended September 30, 2015. Contributions to the pension plans for the nine months ended September 30, 2014 were $6.6 million.

We do not expect to make a contribution to the pension plans during 2015.

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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, foreign exchange forward and option contracts, and interest rate derivatives 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.

Financial Assets and Liabilities

The following tables present our financial assets and liabilities measured at fair value on a recurring basis at September 30, 2015 and December 31, 2014:

	September 30, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Valuation Technique
Financial assets				
Money market funds	$ 256,375	$ 256,375	$	(a)
U.S. treasury securities	9,028	9,028		(a)
U.S. agency securities	137,464		137,464	(a)
	$ 402,867	$ 265,403	$ 137,464	
Financial liabilities				
Foreign exchange derivatives	$ 92	$	$ 92	(a)
Interest rate derivatives	4,461		4,461	(a)
	$ 4,553	$	$ 4,553	

	December 31, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Valuation Technique
Financial assets				
Money market funds	$ 438,907	$ 438,907	$	(a)
U.S. treasury securities	93,004	93,004		(a)
U.S. agency securities	194,028		194,028	(a)
	$ 725,939	$ 531,911	$ 194,028	