

(Convenience Translation into English from the Original Previously Issued in Portuguese)

LIVRARIA E PAPELARIA SARAIVA S.A.

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004
(Amounts in thousands of Brazilian reais - R\$, unless otherwise stated)

1. OPERATIONS

Livraria e Papelaria Saraiva S.A. (the “Company”) is primarily engaged in the sale of books, stationery, audio and video products, periodicals and multimedia products. Sales and distribution are made through the Internet and 31 stores, of which 15 are megastores and 16 are conventional stores.

2. PRESENTATION OF FINANCIAL STATEMENTS

The financial statements have been prepared in accordance with Brazilian accounting practices and standards established by the Brazilian Securities Commission (CVM), in accordance with the procedures adopted by the Parent Company, Saraiva S.A. Livreiros Editores.

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

3. SIGNIFICANT ACCOUNTING PRACTICES

a) Current and long-term assets

- Temporary cash investments

Stated at cost plus income earned through the balance sheet dates.

- Allowance for doubtful accounts

Recorded in an amount considered sufficient to cover potential losses on the realization of trade accounts receivable. Uncollectible receivables are charged directly to income.

- Inventories

Stated at the lower of average acquisition cost or market.

- Other current and long-term assets

Stated at net realizable value.

b) Permanent assets

- Investments

Stated at cost, less a valuation allowance.

- Property and equipment

Recorded at acquisition or construction cost, plus monetary restatement through December 31, 1995. Depreciation and amortization are computed under the straight-line method based on the useful lives of the assets.

- Deferred charges

Stated at cost, less amortization, and include preoperating expenses associated with commercial assignment and expenses incurred prior to the start-up of new stores. Preoperating expenses are amortized over five years or over the terms of the lease contracts, beginning upon the start-up of the stores.

c) Current and long-term liabilities

Stated at known or estimated amounts plus charges, monetary and/or exchange variations incurred through the balance sheet dates, if applicable.

d) Income and social contribution taxes

Taxes on net income (loss) include current and deferred amounts.

Income tax is calculated at the rate of 15% on taxable income plus a 10% surtax, and social contribution tax is calculated at the rate of 9% on taxable income.

Deferred income and social contribution taxes are recorded in current and long-term assets, as stated in Note 10, to reflect future tax effects on temporary differences between the reported amounts of assets and liabilities and their tax bases, and tax loss carryforwards.

Deferred tax assets are based on expected future taxable income at the tax rates in effect at yearend, and are reviewed annually and adjusted to reflect any substantial change in expected profits.

e) Earnings (loss) per share

Computed based on the number of shares at the balance sheet dates.

4. TRADE ACCOUNTS RECEIVABLE

	<u>2005</u>	<u>2004</u>
Credit cards	31,101	20,736
Checks receivable	932	1,335
Other	230	190
Allowance for doubtful accounts	<u>(391)</u>	<u>(490)</u>
	<u>31,872</u>	<u>21,771</u>

5. PROPERTY AND EQUIPMENT

	Annual depreciation rate - %	2005		2004	
		Cost	Accumulated depreciation	Net book value	Net book value
Land	-	3	-	3	3
Buildings	4	1,441	(572)	869	1,160
Furniture, fixtures and installations	10	47,864	(35,099)	12,765	11,959
Vehicles	20	157	(119)	38	63
Software and IT equipment	20	11,713	(7,810)	3,903	4,067
Advances to suppliers	-	230	-	230	101
Other	-	614	-	614	624
		<u>62,022</u>	<u>(43,600)</u>	<u>18,422</u>	<u>17,977</u>

6. DEFERRED CHARGES

	2005	2004
Commercial assignment and preoperating expenses	22,713	22,713
Accumulated amortization	(20,285)	(19,555)
	<u>2,428</u>	<u>3,158</u>

7. LOANS AND FINANCING

	2005	2004
Current-		
Financing in local currency-		
BNDES - FINEM	<u>2,324</u>	<u>3,112</u>
Long term-		
Financing in local currency-		
BNDES - FINEM	<u>1,081</u>	<u>3,273</u>

BNDES - National Bank for Economic and Social Development

FINEM - Enterprises Financing

Maturities of long-term debt are as follows:

	2007	2008	Total
Financing	<u>838</u>	<u>243</u>	<u>1,081</u>

Financing from the BNDES - FINEM was used for investment in megastores and modernization of conventional stores, and is 100% guaranteed by the Parent Company. The

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principal of the financing is subject to annual interest of 3% to 3.5%, plus TJLP (long-term interest rate).

8. RELATED PARTIES

Transactions with related parties include purchase and sale operations and loan agreements. Loans due from the Parent Company, Saraiva S.A. Livreiros Editores, are subject to interest calculated at 100% of the CDI (interbank deposit rate) variation, and will be repaid in 2006, as stated in the loan agreement.

	<u>2005</u>	<u>2004</u>
Balance:		
Current assets-		
Loans	11,446	11,736
Current liabilities-		
Accounts payable	1,041	16
Transactions:		
Sales of products	25	22
Purchases of products	9,174	8,212
Financial income	629	-

9. LOYALTY PROGRAM - SARAIVA PLUS

The Company has a customer loyalty program (“Saraiva Plus”) whereby purchases made by customers in stores and at the Company’s website earn points that can be discounted in future purchases. Accumulated points, net of redemptions, are accrued considering redemption estimates. As of December 31, 2005, the subsidiary has a provision for the loyalty program in the amount of R\$1,108, recorded under the caption “Other payables”.

10. DEFERRED INCOME AND SOCIAL CONTRIBUTION TAXES

Deferred income and social contribution taxes arise from:

	<u>2005</u>	<u>2004</u>
Current assets-		
Temporary differences (provision for trade accounts payable)	<u>4,853</u>	<u>1,199</u>
Long-term assets:		
Reserve for contingencies (including lawsuits involving income and social contribution taxes)	5,009	4,876
Tax loss carryforwards	<u>1,023</u>	<u>3,182</u>
	<u>6,032</u>	<u>8,058</u>

In conformity with the procedures adopted by the Parent Company regarding CVM requirements and based on the expectation of future taxable income and positive cash flows discounted to present value, the Company maintained in its financial statements the deferred tax asset.

Considering the final resolution of the lawsuits, the estimate of realization of the deferred tax asset is as follows:

	<u>Realization of deferred tax asset</u>	<u>Deferred tax asset</u>
Balance of deferred tax asset as of December 31, 2005	-	10,885
December 31, 2006	3,472	7,413
December 31, 2007	6,529	884
December 31, 2008	884	-

Reconciliation of the tax expense calculated by applying the combined tax rate and the tax expense charged to income is as follows:

	<u>2005</u>	<u>2004</u>
Income (loss) before taxes on income	10,045	(4,202)
Combined tax rate	<u>34%</u>	<u>34%</u>
Credits (taxes) computed at the combined tax rate	(3,415)	1,429
Permanent add-backs-		
Nondeductible expenses	(57)	(84)
Permanent deductions	61	-
Other items	<u>112</u>	<u>(1)</u>
	<u>(3,299)</u>	<u>1,344</u>
Income and social contribution taxes:		
Current	(4,927)	-
Deferred	<u>1,628</u>	<u>1,344</u>
	<u>(3,299)</u>	<u>1,344</u>
Effective tax rate	<u>32.8%</u>	<u>32.0%</u>

11. RESERVE FOR CONTINGENCIES

The Company is challenging in court the constitutionality of federal taxes, such as PIS and COFINS (taxes on revenue), IR (income tax) and CSLL (social contribution tax). Escrow deposits were made for the PIS/COFINS lawsuit, which are recorded in a specific account in long-term assets.

The contingent liability is composed of:

	<u>2005</u>	<u>2004</u>
PIS/COFINS - expansion of tax basis and rate increase	8,992	8,885
IR/CSLL - "Plano Real" (economic plan) - Law No. 8,880/94	<u>1,533</u>	<u>9,376</u>
	<u>10,525</u>	<u>18,261</u>

In October 2005, the Company transferred to the caption "Taxes payable" part of the provision related to lawsuits that discuss the IR/CSLL - "Plano Real", in the amount of R\$8,381 (R\$1,968 and R\$6,413, in current and long-term liabilities, respectively), on account of a petition for the payment in installments of the amounts due, filed with the Office of the National Treasury Attorney-General, and is awaiting the granting of the request for paying part of the debt at issue in installments.

12. SHAREHOLDERS' EQUITY

Fully paid-up capital as of December 31, 2005 is R\$51,210, represented by 57,539,843 common shares with par value of R\$0.89.

All shares are entitled to a minimum dividend equivalent to 25% of adjusted net income for each year.

13. FINANCIAL INSTRUMENTS

The carrying amounts and fair values of the financial instruments recorded in the balance sheet as of December 31, 2005 are as follows:

	<u>Carrying amount</u>	<u>Fair value</u>
Cash and cash equivalents	11,553	11,553
Financing in local currency	3,405	3,397

Criteria, assumptions and limitations used in calculating fair values:

a) Cash and cash equivalents

Represented by bank deposits and temporary cash investments.

b) Loans and financing

The carrying amounts of loans and financing refer to financing from BNDES. The fair values of such financing do not differ significantly from the carrying amounts as of December 31, 2005.

c) Limitations

The fair values were estimated at a specific time, based on relevant market information. Changes in assumptions may significantly affect those estimates.

d) Derivatives

The Company has not conducted derivative transactions in 2005.

e) Market risks

Risk of inventory obsolescence - product discontinuity and new technologies may lead to excess and obsolete inventories. In order to minimize these conditions, the Company periodically monitors inventory levels and takes the necessary action for its realization.

14. INSURANCE

As of December 31, 2005, the Company had insurance coverage against fire and sundry risks for fixed assets and inventories, in amounts considered sufficient to cover potential losses.
