

ENCORE CAPITAL GROUP INC

Form 10-Q

October 28, 2008

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2008

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

COMMISSION FILE NUMBER: 000-26489

**ENCORE CAPITAL GROUP, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**48-1090909**  
(IRS Employer  
Identification No.)

**8875 Aero Drive, Suite 200**

**San Diego, California**  
(Address of principal executive offices)

**92123**  
(Zip code)

**(877) 445 - 4581**

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(Registrant's telephone number, including area code)

(Not Applicable)

(Former name, former address and former fiscal year, if changed since last report)

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 last 90 days. Yes  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  Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class                          | Outstanding at October 20, 2008 |
|--------------------------------|---------------------------------|
| Common Stock, \$0.01 par value | 23,044,123 shares               |

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**ENCORE CAPITAL GROUP, INC.**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements (Unaudited)  
ENCORE CAPITAL GROUP, INC.****Condensed Consolidated Statements of Financial Condition**

(In Thousands, Except Par Value Amounts)

(Unaudited)

|   | September 30,<br>2008 | December 31,<br>2007 |
|---|-----------------------|----------------------|
| <b>Assets</b>   |                       |                      |
| Cash and cash equivalents   | \$ 5,403              | \$ 4,900             |
| Restricted cash   | 4,435                 | 3,776                |
| Accounts receivable, net  | 4,364                 | 4,136                |
| Investment in receivable portfolios, net  | 444,963               | 392,209              |
| Deferred court costs  | 27,207                | 20,533               |
| Property and equipment, net   | 5,182                 | 4,390                |
| Prepaid income tax  | 465                   | 10,346               |
| Forward flow asset  | 10,302                | 15,863               |
| Other assets  | 7,109                 | 8,800                |
| Goodwill  | 15,985                | 15,985               |
| Identifiable intangible assets, net   | 1,943                 | 2,557                |
| <b>Total assets</b>   | <b>\$ 527,358</b>     | <b>\$ 483,495</b>    |
| <b>Liabilities and stockholders equity</b>  |                       |                      |
| <b>Liabilities:</b>   |                       |                      |
| Accounts payable and accrued liabilities  | \$ 18,189             | \$ 20,346            |
| Deferred tax liabilities, net   | 14,431                | 13,669               |
| Deferred revenue and purchased servicing obligation   | 4,897                 | 3,898                |
| Debt  | 292,943               | 272,420              |
| Other liabilities   | 1,650                 | 1,642                |
| <b>Total liabilities</b>  | <b>332,110</b>        | <b>311,975</b>       |
| <b>Commitments and contingencies</b>  |                       |                      |
| <b>Stockholders equity:</b>   |                       |                      |
| Convertible preferred stock, \$.01 par value, 5,000 shares authorized, no shares issued and outstanding   |                       |                      |
| Common stock, \$.01 par value, 50,000 shares authorized, 23,044 shares and 22,992 shares issued and outstanding as of September 30, 2008, and December 31, 2007, respectively | 230                   | 230                  |
| Additional paid-in capital  | 78,441                | 73,310               |
| Accumulated earnings  | 117,578               | 98,975               |
| Accumulated other comprehensive loss  | (1,001)               | (995)                |
| <b>Total stockholders equity</b>  | <b>195,248</b>        | <b>171,520</b>       |
| <b>Total liabilities and stockholders equity</b>  | <b>\$ 527,358</b>     | <b>\$ 483,495</b>    |



**Table of Contents****ENCORE CAPITAL GROUP, INC.****Condensed Consolidated Statements of Operations**

(In Thousands, Except Per Share Amounts)

(Unaudited)

|   | <b>Three Months Ended</b> |                 | <b>Nine Months Ended</b> |                  |
|---|---------------------------|-----------------|--------------------------|------------------|
|   | <b>September 30,</b>      |                 | <b>September 30,</b>     |                  |
|   | <b>2008</b>               | <b>2007</b>     | <b>2008</b>              | <b>2007</b>      |
| <b>Revenues</b>   |                           |                 |                          |                  |
| Revenue from receivable portfolios, net                                     | \$ 62,557                 | \$ 59,415       | \$ 192,900               | \$ 185,589       |
| Servicing fees and other related revenue                                    | 3,816                     | 3,276           | 11,047                   | 9,705            |
| <b>Total revenues</b>   | <b>66,373</b>             | <b>62,691</b>   | <b>203,947</b>           | <b>195,294</b>   |
| <b>Operating expenses</b>   |                           |                 |                          |                  |
| Salaries and employee benefits (excluding stock-based compensation expense) | 14,963                    | 17,138          | 45,503                   | 50,388           |
| Stock-based compensation expense  | 860                       | 1,281           | 3,182                    | 3,286            |
| Cost of legal collections   | 25,390                    | 20,868          | 69,525                   | 59,649           |
| Other operating expenses  | 6,018                     | 4,987           | 17,656                   | 16,970           |
| Collection agency commissions   | 2,996                     | 2,478           | 10,808                   | 8,639            |
| General and administrative expenses   | 4,864                     | 4,462           | 13,905                   | 12,965           |
| Depreciation and amortization   | 674                       | 833             | 2,162                    | 2,541            |
| <b>Total operating expenses</b>   | <b>55,765</b>             | <b>52,047</b>   | <b>162,741</b>           | <b>154,438</b>   |
| <b>Income before other (expense) income and income taxes</b>                | <b>10,608</b>             | <b>10,644</b>   | <b>41,206</b>            | <b>40,856</b>    |
| <b>Other (expense) income</b>   |                           |                 |                          |                  |
| Interest expense  | (3,880)                   | (3,648)         | (11,409)                 | (9,904)          |
| Contingent interest expense   |                           |                 |                          | (4,123)          |
| Pay-off of future contingent interest                                       |                           |                 |                          | (11,733)         |
| Gain on repurchase of convertible notes, net                                |                           |                 | 1,417                    |                  |
| Other (expense) income  | (32)                      | 79              | 341                      | 153              |
| <b>Total other expense</b>  | <b>(3,912)</b>            | <b>(3,569)</b>  | <b>(9,651)</b>           | <b>(25,607)</b>  |
| <b>Income before income taxes</b>   | <b>6,696</b>              | <b>7,075</b>    | <b>31,555</b>            | <b>15,249</b>    |
| Provision for income taxes  | (2,923)                   | (1,717)         | (12,952)                 | (5,055)          |
| <b>Net income</b>   | <b>\$ 3,773</b>           | <b>\$ 5,358</b> | <b>\$ 18,603</b>         | <b>\$ 10,194</b> |
| <b>Weighted average shares outstanding:</b>                                 |                           |                 |                          |                  |
| Basic   | 23,029                    | 22,922          | 23,009                   | 22,837           |
| Diluted   | 23,675                    | 23,473          | 23,531                   | 23,420           |
| <b>Earnings per share:</b>  |                           |                 |                          |                  |
| Basic   | \$ 0.16                   | \$ 0.23         | \$ 0.81                  | \$ 0.45          |
| Diluted   | \$ 0.16                   | \$ 0.23         | \$ 0.79                  | \$ 0.44          |

*See accompanying notes to unaudited condensed consolidated financial statements*



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## ENCORE CAPITAL GROUP, INC.

## Condensed Consolidated Statement of Stockholders Equity

(Unaudited, In Thousands)

|   | Common Stock |        | Additional<br>Paid-In<br>Capital | Accumulated<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Equity | Comprehensive<br>Income (loss) |
|---|--------------|--------|----------------------------------|-------------------------|---|-----------------|--------------------------------|
|   | Shares       | Par    |                                  |                         |   |                 |                                |
| <b>Balance at December 31, 2007</b>                 | 22,992       | \$ 230 | \$ 73,310                        | \$ 98,975               | \$ (995)                                      | \$ 171,520      |                                |
| Net income  |              |        |                                  | 18,603                  |   | 18,603          | 18,603                         |
| Other comprehensive loss:                           |              |        |                                  |                         |   |                 |                                |
| Unrealized loss on cash flow hedge, net of tax      |              |        |                                  |                         | (6)   | (6)             | (6)                            |
| Exercise of stock options                           | 33           |        | 84                               |                         |   | 84              |                                |
| Issuance of share-based awards                      | 19           |        | (47)                             |                         |   | (47)            |                                |
| Stock-based compensation                            |              |        | 3,182                            |                         |   | 3,182           |                                |
| Tax provision related to stock option exercises     |              |        | (4)                              |                         |   | (4)             |                                |
| Tax benefit from convertible notes interest expense |              |        | 1,612                            |                         |   | 1,612           |                                |
| Tax benefit from repurchase of convertible notes    |              |        | 304                              |                         |   | 304             |                                |
| <b>Balance at September 30, 2008</b>                | 23,044       | \$ 230 | \$ 78,441                        | \$ 117,578              | \$ (1,001)                                    | \$ 195,248      | \$ 18,597                      |

*See accompanying notes to unaudited condensed consolidated financial statements*



**Table of Contents****ENCORE CAPITAL GROUP, INC.****Condensed Consolidated Statements of Cash Flows**

(Unaudited, In Thousands)

|   | <b>Nine Months Ended<br/>September 30,</b> |                 |
|---|--|-----------------|
|   | <b>2008</b>                                | <b>2007</b>     |
| <b>Operating activities:</b>  |  |                 |
| Net Income  | \$ 18,603                                  | \$ 10,194       |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |                 |
| Depreciation and amortization   | 2,162                                      | 2,541           |
| Amortization of loan costs  | 989  | 912             |
| Stock-based compensation expense  | 3,182                                      | 3,286           |
| Gain on repurchase of convertible notes, net                                      | (1,417)                                    |                 |
| Deferred income tax expense   | 762  | 195             |
| Other non-cash tax benefits, net  | 1,912                                      | 1,538           |
| Tax provision (benefit) from stock-based payment arrangements                     | 4  | (683)           |
| Provision for impairment on receivable portfolios, net                            | 15,993                                     | 2,558           |
| Changes in operating assets and liabilities                                       |  |                 |
| Restricted cash   | (659)                                      | 1,523           |
| Other assets  | 1,091                                      | (598)           |
| Deferred court costs  | (6,674)                                    | (6,110)         |
| Prepaid income tax  | 9,881                                      | (1,304)         |
| Accrued profit sharing arrangement  |  | (6,869)         |
| Deferred revenue and purchased service obligation                                 | 999  | 431             |
| Accounts payable and accrued liabilities  | (2,203)                                    | (4,771)         |
| Net cash provided by operating activities   | 44,625                                     | 2,843           |
| <b>Investing activities:</b>  |  |                 |
| Purchases of receivable portfolios, net of forward flow allocation                | (160,940)                                  | (125,224)       |
| Collections applied to investment in receivable portfolios                        | 95,144                                     | 81,267          |
| Proceeds from put-backs of receivable portfolios                                  | 2,610                                      | 2,097           |
| Purchases of property and equipment   | (2,139)                                    | (1,139)         |
| Net cash used in investing activities   | (65,325)                                   | (42,999)        |
| <b>Financing activities:</b>  |  |                 |
| Proceeds from notes payable and other borrowings                                  | 57,000                                     | 53,000          |
| Repayment of notes payable and other borrowings                                   | (32,169)                                   | (20,000)        |
| Repurchase of convertible notes   | (3,500)                                    |                 |
| Proceeds from exercise of stock options   | 84   | 344             |
| Tax (provision) benefit from stock-based payment arrangements                     | (4)  | 683             |
| Repayment of capital lease obligations  | (208)                                      | (184)           |
| Net cash provided by financing activities   | 21,203                                     | 33,843          |
| <b>Net increase (decrease) in cash</b>  | <b>503</b>                                 | <b>(6,313)</b>  |
| <b>Cash and cash equivalents, beginning of period</b>                             | <b>4,900</b>                               | <b>10,791</b>   |
| <b>Cash and cash equivalents, end of period</b>                                   | <b>\$ 5,403</b>                            | <b>\$ 4,478</b> |

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**Supplemental disclosures of cash flow information:**

|                            |           |           |
|----------------------------|-----------|-----------|
| Cash paid for interest     | \$ 10,928 | \$ 32,917 |
| Cash paid for income taxes | \$ 1,158  | \$ 7,398  |

**Supplemental schedule of non-cash investing and financing activities:**

|  |          |          |
|--|----------|----------|
| Fixed assets acquired through capital lease                        | \$ 201   | \$       |
| Allocation of forward flow asset to acquired receivable portfolios | \$ 5,561 | \$ 9,168 |

*See accompanying notes to unaudited condensed consolidated financial statements*

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**ENCORE CAPITAL GROUP, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**Note 1: Ownership, Description of Business and Summary of Significant Accounting Policies**

Encore Capital Group, Inc. ( *Encore* ), through its subsidiaries (collectively, the *Company* ), is a systems-driven purchaser and manager of charged-off consumer receivable portfolios and, through its wholly owned subsidiary Ascension Capital Group, Inc. ( *Ascension* ), a provider of bankruptcy services to the finance industry. The *Company* acquires its receivable portfolios at deep discounts from their face values using its proprietary valuation process that is based on the consumer attributes of the underlying accounts. Based upon the *Company*'s ongoing analysis of these accounts, it employs a dynamic mix of collection strategies to maximize its return on investment. The receivable portfolios the *Company* purchases consist primarily of unsecured, charged-off domestic consumer credit card, auto deficiency and telecom receivables purchased from national financial institutions, major retail credit corporations, telecom companies and resellers of such portfolios. Acquisitions of receivable portfolios are financed by operations and by borrowings from third parties. See Note 7 for further discussion of the *Company*'s debt.

***Financial Statement Preparation***

The accompanying interim condensed consolidated financial statements have been prepared by *Encore*, without audit, in accordance with the instructions to Form 10-Q, and Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission and, therefore, do not include all information and footnotes necessary for a fair presentation of its consolidated financial position, results of operations and cash flows in accordance with accounting principles generally accepted in the United States. The condensed consolidated statement of financial condition at December 31, 2007 was derived from the audited financial statements at that date but does not include all disclosures required by accounting principles generally accepted in the United States.

In the opinion of management, the unaudited financial information for the interim periods presented reflects all adjustments, consisting of only normal and recurring adjustments, necessary for a fair presentation of the *Company*'s consolidated results of operations, financial position and cash flows. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements included in the *Company*'s Annual Report on Form 10-K for the fiscal year ended December 31, 2007. Operating results for interim periods are not necessarily indicative of operating results for an entire fiscal year.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts and the disclosure of contingent amounts in the *Company*'s financial statements and the accompanying notes. Actual results could materially differ from those estimates.

***Principles of Consolidation***

The *Company*'s condensed consolidated financial statements include the assets, liabilities and operating results of its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

***Reclassification***

During the quarter ended September 30, 2008, the *Company* changed the presentation of its cash flows from the direct method to the indirect method, in order to conform to comparable industry presentations. As a result, the prior year consolidated statement of cash flows has been changed to the indirect method, to conform to the current year's presentation.

Certain reclassifications have been made to the 2007 condensed consolidated statement of operations to separately show contingent interest expense and to the condensed consolidated statement of cash flows to separately show provisions for impairment and to separately show the change in other assets and the change in deferred court costs.

***Changes in Accounting Estimate***

Effective January 1, 2008, the *Company* revised its Unified Collection Score ( *UCS* ) and Behavioral Liquidation Score ( *BLS* ) methodologies by extending the collection forecast from 72 months to 84 months. *UCS* is a proprietary forecasting tool that generates portfolio level expectations

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of liquidation for portfolios that the Company has owned and serviced for greater than six months. BLS forecasts portfolio level expectations based on credit characteristics for portfolios owned and serviced less than six months. The Company has observed that receivable portfolios purchased in 2001 and prior have consistently experienced cash collections beyond 72 months from the date of purchase. When the Company first developed its cash forecasting models in 2001, limited historical

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collection data was available with which to accurately model projected cash flows beyond 60 months. During the quarter ended June 30, 2006, the Company determined there was enough additional collection data accumulated over the previous several years, in addition to improvements in its forecasting tools, allowing it to extend the collection forecast to 72 months. During the quarter ended March 31, 2008, the Company determined that there was enough additional collection data to accurately extend the collection forecast in both the UCS and BLS models to 84 months.

The increase in the collection forecast from 72 to 84 months was applied effective January 1, 2008, to each portfolio for which the Company could accurately forecast through such term and resulted in an increase in the aggregate total estimated remaining collections for the receivable portfolios by \$67.3 million, or 7.5%, as of March 31, 2008. The Company did not extend the forecast on telecom portfolios, as it did not anticipate significant collections past 72 months on these portfolios. The extension of the collection forecast was treated as a change in estimate and, in accordance with Statement of Financial Accounting Standard No. 154, *Accounting Changes and Error Corrections*, was recognized prospectively in the consolidated financial statements, effective January 1, 2008. In the quarter ended March 31, 2008, this prospective treatment resulted in a reduction in the Company's net impairment provision of \$3.1 million and an increase in revenue of \$0.1 million. The impact of the change in estimate resulted in an increase in net income of \$1.9 million and an increase in fully diluted earnings per share of \$0.08 for the three months ended March 31, 2008. The impact of the change in estimate for the quarters ended June 30, 2008 and September 30, 2008 was not material to the Company's condensed consolidated financial statements.

***Earnings per Share***

Basic earnings per share (EPS) is calculated by dividing net earnings applicable to common stockholders by the weighted average number of shares of common stock outstanding. Common stock outstanding includes shares of common stock and restricted stock units for which no future service is required as a condition to the delivery of the underlying common stock. Diluted EPS includes the determinants of basic EPS and, in addition, reflects the dilutive effect of the common stock deliverable pursuant to stock options and to restricted stock units for which future service is required as a condition to the delivery of the underlying common stock. Employee stock options to purchase approximately 1,159,000 and 1,246,000 shares of common stock during the three months and nine months ended September 30, 2008, respectively, and employee stock options to purchase approximately 1,123,000 and 1,049,000 shares of common stock during the three months and nine months ended September 30, 2007, respectively, were outstanding but not included in the computation of diluted earnings per share because the effect on diluted earnings per share would be anti-dilutive.

***Effects of New Accounting Pronouncement***

In December 2007, the Financial Accounting Standard Board (the FASB) issued Statements No. 141 (revised 2007), *Business Combinations*. The new standard requires the acquiring entity in a business combination to recognize all (and only) the assets acquired and liabilities assumed in the transaction, establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. The Company will adopt this new standard for its fiscal year beginning January 1, 2009.

In December 2007, the FASB issued Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51*. This statement establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This statement is effective prospectively, except for certain retrospective disclosure requirements, for fiscal years beginning after December 15, 2008. The Company is currently analyzing the effects of the new standard and its potential impact, if any, on its consolidated financial statements.

In March 2008, the FASB issued Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*. This new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company expects to adopt this new standard and its required disclosures, in its consolidated financial statements for the fiscal year beginning January 1, 2009.

In May 2008, the FASB issued FASB Staff Position (FSP) No. APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*. This FSP requires that issuers of convertible debt instruments that, upon conversion, may be settled fully or partially in cash, must separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. This FSP is to be applied retrospectively to all past periods presented, even if the



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instrument has matured, converted, or otherwise been extinguished as of the FSP's effective date. The Company believes that this FSP will change the accounting treatment of its current outstanding convertible senior notes, and result in a reduction in the carrying value of debt, an increase in equity, an increase in interest expense and a reduction in earnings per share.

In October 2008, the FASB issued FSP No. 157-3, *Determining the Fair Value of a Financial Instrument When the Market for That Asset Is Not Active*. This FSP illustrates key considerations in determining a fair value of a financial asset when the market for that financial asset is not active. This FSP also provides clarification, among other things, how the reporting entity's own assumptions should be considered when measuring fair value when relevant observable inputs do not exist. This FSP is effective upon issuance, including prior periods for which financial statements have not been issued. There was no impact to the Company's consolidated financial statements as a result of this FSP.

**Note 2: Fair Value Measurements**

On January 1, 2008, the Company adopted Statement of Financial Accounting Standard No. 157, *Fair Value Measurements* (FAS 157), for financial assets and liabilities. FAS 157 defines fair value, provides guidance for measuring fair value and requires certain disclosures. It does not require any new fair value measurements, but rather applies to all other accounting pronouncements that require or permit fair value measurements. The Company will adopt the provisions of FAS 157 for non-financial assets and non-financial liabilities that are recognized and disclosed at fair value on a nonrecurring basis for its fiscal year beginning January 1, 2009.

The fair values of the Company's financial instruments reflect the amounts 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 (*i.e.* the exit price). The statement utilizes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The following is a brief description of those three levels:

Level 1: Observable inputs such as quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3: Unobservable inputs that reflect the reporting entity's own assumptions.  
The Company's financial instruments consist of the following:

***Financial instruments with carrying value equal to fair value***

Cash and cash equivalents

Accounts receivable

Hedged derivative instruments

The fair value of cash and cash equivalents and accounts receivable approximates their respective carrying value. Cash flow hedging instruments, which are considered over-the-counter derivatives, are also carried at their fair values. The Company's fair value estimate for such derivative instruments incorporates quoted market prices at the balance sheet date from the counter party using significant observable inputs and is considered a level 2 fair value measurement.

***Financial instruments not required to be carried at fair value***

Investment in receivable portfolios, net

Deferred court costs

Forward flow asset

Long term debt

The Company has elected not to adopt the provisions of Statements of Financial Accounting Standard No. 159, *Fair Value Option*, for its fiscal year ended December 31, 2008. Therefore, the above instruments are not required to be recorded at their fair value. However, for disclosure purposes, in connection with the provisions of Statements of Financial Accounting Standard No. 107, *Disclosures about Fair Value of Financial Instruments*, the Company is required to estimate the fair value of financial instruments when it is practical to do so. Borrowings under the Company's revolving credit facility are carried at historical cost, adjusted for additional borrowings less principal repayments, which approximates fair value. The Company's convertible senior notes are carried at a principal amount of \$95.0 million at September 30, 2008. Their fair value estimate incorporates quoted market prices at the balance sheet date. However, the market for these securities is not active, and, therefore, results in a level 2 fair value measurement.



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As of September 30, 2008, the fair value estimate of the Company's convertible senior notes based on quoted market prices amounts to approximately \$75.8 million. For investment in receivable portfolios, deferred court costs and the forward flow asset, there is no active market or observable inputs for the fair value estimation. The Company considers it not practical to attempt to estimate the fair value of such financial instruments due to the excessive costs that would be incurred in doing so.

**Note 3: Stock-Based Compensation**

On March 30, 2005, the Board of Directors of the Company adopted the 2005 Stock Incentive Plan ( 2005 Plan ) for Board members, employees, officers, and executives of, and consultants and advisors to, the Company. The 2005 Plan provides for the granting of incentive stock options, nonqualified stock options, stock appreciation rights, restricted stock, performance shares, and performance-based awards to eligible individuals. Upon adoption, an aggregate of 1,500,000 shares of the Company's common stock were available for awards under the 2005 Plan, plus ungranted shares of stock that were available for future awards under the 1999 Equity Participation Plan ( 1999 Plan ). In addition, shares subject to options granted under either the 1999 Plan or the 2005 Plan that terminate or expire without being exercised are available for grant under the 2005 Plan. The benefits provided under these plans represent share-based compensation subject to the provisions of FAS 123R.

In accordance with FAS 123R, compensation expense is recognized only for those shares expected to vest, net of estimated forfeitures based on the Company's historical experience and future expectations. For the nine months ended September 30, 2008, \$3.2 million was recognized as stock-based compensation expense.

The Company's stock-based compensation arrangements are described below:

**Stock Options**

The 2005 Plan permits the granting of stock options to certain employees and directors of the Company. Option awards are generally granted with an exercise price equal to the market price of the Company's stock at the date of issuance. Options generally vest based on three to five years of continuous service and have ten-year contractual terms.

The Company uses the Black-Scholes option-pricing model to determine the fair-value of stock-based awards. All options are amortized ratably over the requisite service periods of the awards, which are generally the vesting periods.

The fair value of options granted is estimated at the date of grant using a Black-Scholes option-pricing model with the following weighted-average assumptions:

|   | Nine Months Ended<br>September 30, 2008 | Nine Months Ended<br>September 30, 2007 |
|---|---|---|
| Weighted average fair value of options granted                                  | \$ 5.37                                 | \$ 6.82                                 |
| Risk free interest rate   | 3.0%                                    | 4.5%                                    |
| Dividend yield  | 0.0%                                    | 0.0%                                    |
| Volatility factor of the expected market price of the Company's<br>common stock | 46.0%                                   | 70.7%                                   |
| Weighted-average expected life of options                                       | 5 Years                                 | 5 Years                                 |

Unrecognized estimated compensation cost related to stock options as of September 30, 2008, was \$2.4 million, which is expected to be recognized over a weighted-average period of approximately 2.5 years.

A summary of the Company's stock option activity and related information is as follows for the nine months ended September 30, 2008:

|                                  | Number of<br>Shares | Option Price<br>Per Share | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value<br>(in thousands) |
|----------------------------------|---------------------|---------------------------|--|---|
| Outstanding at December 31, 2007 | 2,126,852           | \$ 0.35                   | \$ 20.09                                 | \$ 9.30   |

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|  |                  |                |                |                |           |               |
|--|------------------|----------------|----------------|----------------|-----------|---------------|
| Granted                                  | 250,000          |                | 12.12          | 12.12          |           |               |
| Cancelled/forfeited                      | (158,566)        | 10.60          | 18.02          | 15.40          |           |               |
| Exercised                                | (32,760)         | 0.52           | 10.92          | 2.56           |           |               |
| <b>Outstanding at September 30, 2008</b> | <b>2,185,526</b> | <b>\$ 0.35</b> | <b>\$20.09</b> | <b>\$ 9.28</b> | <b>\$</b> | <b>11,186</b> |
| Exercisable at September 30, 2008        | 1,624,634        | \$ 0.35        | \$20.09        | \$ 8.33        | \$        | 10,124        |

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The total intrinsic value of options exercised during the nine months ended September 30, 2008 and 2007 was \$0.3 million and \$1.7 million, respectively. As of September 30, 2008, the weighted-average remaining contractual life of options outstanding and options exercisable was 6.06 years and 5.04 years, respectively.

**Restricted Stock Units**

Under the Company's 2005 Plan, certain employees and directors are eligible to receive restricted stock units. In accordance with FAS 123R, the fair value of restricted stock units is equal to the closing price of the Company's common stock on the date of issuance. The total number of restricted stock awards expected to vest is adjusted by estimated forfeiture rates. As of September 30, 2008, 117,600 of the non-vested shares are expected to vest over approximately three to five years based on certain performance goals ( Performance Shares ). The fair value of the Performance Shares is expensed over the expected vesting period based on the probability of performance goals being met. If performance goals are not expected to be met, the compensation expense previously recognized would be reversed. As of September 30, 2008, no reversals of compensation expense related to the Performance Shares have been made. The remaining 440,057 non-vested shares are not performance based, and will vest, and are being expensed over approximately two to five years.

For the nine months ended September 30, 2008, restricted stock unit activity and related information is as follows:

|                                  | Non-Vested<br>Shares | Weighted Average<br>Grant Date<br>Fair Value |
|----------------------------------|----------------------|--|
| <b>Restricted Stock Units</b>    |                      |  |
| Non-vested at December 31, 2007  | 671,900              | \$ 11.28                                     |
| Awarded                          | 34,390               | \$ 9.21                                      |
| Vested                           | (54,434)             | \$ 10.19                                     |
| Cancelled/forfeited              | (94,199)             | \$ 11.94                                     |
| Non-vested at September 30, 2008 | 557,657              | \$ 11.15                                     |

Unrecognized estimated compensation cost related to restricted stock units as of September 30, 2008, was \$3.1 million, which is expected to be recognized over a weighted-average period of approximately 2.6 years. The fair value of restricted stock units vested for the nine months ended September 30, 2008 and 2007 was \$0.2 million and less than \$0.1 million, respectively.

**Note 4: Investment in Receivable Portfolios, Net**

In accordance with the provisions of AICPA Statement of Position 03-3, *Accounting for Certain Debt Securities in a Transfer* ( SOP 03-3 ), discrete receivable portfolio purchases during a quarter are aggregated into pools based on common risk characteristics. Once a pool is established, the portfolios with common risk characteristics are permanently assigned to that pool. The discount (*i.e.*, the difference between the cost of each pool and the related aggregate contractual receivable balance) is not recorded because the Company expects to collect a relatively small percentage of each pool's contractual receivable balance. As a result, receivable portfolios are recorded at cost at the time of acquisition. All portfolios with common risk characteristics purchased prior to the adoption of SOP 03-3 in the first quarter of 2005 were aggregated by quarter of purchase.

In compliance with SOP 03-3, the Company accounts for its investments in consumer receivable portfolios using either the interest method or the cost recovery method. The interest method applies an effective interest rate, or IRR, to the cost basis of the pool, which remains unchanged throughout the life of the pool unless there is an increase or decrease in subsequent expected cash flows. Effective January 1, 2008, the IRR is based on the Company's collection forecast up to 84 months from the date a portfolio is purchased. (See Note 1 for discussion of the Company's extension of its collection forecast). Subsequent increases in cash flows expected to be collected are generally recognized prospectively through an upward adjustment of the pool's IRR over its remaining life. Subsequent decreases in expected cash flows do not change the IRR, but are recognized as an impairment of the cost basis of the pool, and are reflected in the consolidated statements of operations as a reduction in revenue with a corresponding valuation allowance offsetting the investment in receivable portfolios in the consolidated statements of financial condition.

The Company accounts for each pool as a unit for the economic life of the pool (similar to one loan) for recognition of revenue from receivable portfolios, for collections applied to the cost basis of receivable portfolios and for provision for loss or impairment. Revenue from receivable portfolios is accrued based on each pool's effective interest rate applied to each pool's adjusted cost basis. The cost basis of each pool is increased

by revenue earned and decreased by gross collections and impairments.

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If the amount and timing of future cash collections on a pool of receivables are not reasonably estimable, the Company accounts for such portfolios on the cost recovery method ( Cost Recovery Portfolios ). The accounts in these portfolios have different risk characteristics than those included in other portfolios acquired during the same quarter, or the necessary information was not available to estimate future cash flows and, accordingly, they were not aggregated with other portfolios. Under the cost recovery method of accounting, no income is recognized until the purchase price of a Cost Recovery Portfolio has been fully recovered. In September 2007, the Company decided to exit its healthcare purchasing and collection activities. At that time, the Company anticipated either selling these healthcare portfolios or placing the underlying accounts with external agencies for collections. The Company no longer anticipates a sale of these receivable portfolios and has placed them with external collection agencies. Since the Company is no longer actively collecting on these accounts internally, it has classified them as Cost Recovery Portfolios. As of September 30, 2008, there were six portfolios accounted for using the cost recovery method, consisting of \$1.2 million in net book value representing all of the healthcare portfolios that the Company had acquired. The \$1.2 million is included in investment in receivable portfolios, net, which reflects the value the Company expects to realize through the collection activities of the external agencies.

Accretable yield represents the amount of revenue the Company expects to generate over the remaining life of its existing investment in receivable portfolios based on estimated future cash flows. Total accretable yield is the difference between future estimated collections and the current carrying value of a portfolio. All estimated cash flows on portfolios where the cost basis has been fully recovered are classified as zero basis cash flows.

The following tables summarize the Company's accretable yield and an estimate of zero basis cash flows at the beginning and end of the current period (*in thousands*):

|   | <b>Nine Months Ended September 30, 2008</b> |  |              |
|---|---|--|--------------|
|   | <b>Accretable<br/>Yield</b>                 | <b>Estimate of<br/>Zero Basis<br/>Cash Flows</b> | <b>Total</b> |
| Beginning balance at December 31, 2007        | \$ 486,652                                  | \$ 13,002  | \$ 499,654   |
| Revenue recognized, net                       | (61,510)                                    | (2,558)  | (64,068)     |
| Reductions on existing portfolios             | (50,898)                                    | (1,015)  | (51,913)     |
| Additions for 12 months curve extension       | 67,287                                      |  | 67,287       |
| Additions for current purchases               | 112,780                                     |  | 112,780      |
| <br>  |   |  |              |
| Balance at March 31, 2008                     | \$ 554,311                                  | \$ 9,429   | \$ 563,740   |
| Revenue recognized, net                       | (63,652)                                    | (2,623)  | (66,275)     |
| (Reductions) additions on existing portfolios | (3,206)                                     | 1,598  | (1,608)      |
| Additions for current purchases               | 79,159                                      |  | 79,159       |
| <br>  |   |  |              |
| Balance at June 30, 2008                      | \$ 566,612                                  | \$ 8,404   | \$ 575,016   |
| Revenue recognized, net                       | (60,298)                                    | (2,259)  | (62,557)     |
| (Reductions) additions on existing portfolios | (11,736)                                    | 2,752  | (8,984)      |
| Additions for current purchases               | 106,525                                     |  | 106,525      |
| <br>  |   |  |              |
| Balance at September 30, 2008                 | \$ 601,103                                  | \$ 8,897   | \$ 610,000   |

|   | <b>Nine Months Ended September 30, 2007</b> |  |              |
|---|---|--|--------------|
|   | <b>Accretable<br/>Yield</b>                 | <b>Estimate of<br/>Zero Basis<br/>Cash Flows</b> | <b>Total</b> |
| Beginning balance at December 31, 2006        | \$ 417,981                                  | \$ 38,967  | \$ 456,948   |
| Revenue recognized, net                       | (57,045)                                    | (5,108)  | (62,153)     |
| Additions (reductions) on existing portfolios | 20,438                                      | (3,956)  | 16,482       |
| Additions for current purchases               | 52,980                                      |  | 52,980       |
| <br>  |   |  |              |
| Balance at March 31, 2007                     | \$ 434,354                                  | \$ 29,903  | \$ 464,257   |

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|                                   |            |           |            |
|-----------------------------------|------------|-----------|------------|
| Revenue recognized, net           | (59,974)   | (4,047)   | (64,021)   |
| Additions on existing portfolios  | 39,959     | 4,442     | 44,401     |
| Additions for current purchases   | 58,837     |           | 58,837     |
| Balance at June 30, 2007          | \$ 473,176 | \$ 30,298 | \$ 503,474 |
| Revenue recognized, net           | (56,099)   | (3,316)   | (59,415)   |
| Reductions on existing portfolios | (6,907)    | (2,613)   | (9,520)    |
| Additions for current purchases   | 58,936     |           | 58,936     |
| Balance at September 30, 2007     | \$ 469,106 | \$ 24,369 | \$ 493,475 |

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During the three months ended September 30, 2008, the Company purchased receivable portfolios with a face value of \$1.8 billion for \$66.1 million, or a purchase cost of 3.6% of face value. The estimated future collections at acquisition for these portfolios amounted to \$172.9 million. During the nine months ended September 30, 2008, the Company purchased receivable portfolios with a face value of \$4.8 billion for \$166.5 million, or a purchase cost of 3.4% of face value. The estimated future collections at acquisition for these portfolios amounted to \$419.6 million.

All collections realized after the net book value of a portfolio has been fully recovered ( Zero Basis Portfolios ) are recorded as revenue ( Zero Basis Revenue ). During the three months ended September 30, 2008 and 2007, approximately \$2.3 million and \$3.3 million were recognized as Zero Basis Revenue, respectively. During the nine months ended September 30, 2008 and 2007, approximately \$7.4 million and \$12.5 million were recognized as Zero Basis Revenue, respectively.

During the quarter ended March 31, 2008, the Company revised the forecasting methodology it uses to value a portfolio by extending the collection forecast from 72 months to 84 months. This change was made as a result of the Company's increased confidence in its ability to forecast future cash collections to 84 months. Extending the collection forecast from 72 months to 84 months resulted in an increase in the aggregate total estimated remaining collections for the receivable portfolios as of March 31, 2008, by \$67.3 million, or 7.5%.

The following tables summarize the changes in the balance of the investment in receivable portfolios during the nine months ended September 30, 2008 and 2007 (in thousands, except percentages):

|   | For the Nine Months Ended September 30, 2008 |                          |                       |            |
|---|--|--------------------------|-----------------------|------------|
|   | Accrual Basis Portfolios                     | Cost Recovery Portfolios | Zero Basis Portfolios | Total      |
| Balance, beginning of period                        | \$ 390,564                                   | \$ 1,645                 | \$                    | \$ 392,209 |
| Purchases of receivable portfolios                  | 166,501                                      |                          |                       | 166,501    |
| Gross collections <sup>1</sup>                      | (296,178)                                    | (419)                    | (7,440)               | (304,037)  |
| Put-backs and recalls <sup>2</sup>                  | (2,597)                                      | (13)                     |                       | (2,610)    |
| Revenue recognized <sup>3</sup>                     | 201,453                                      |                          | 7,440                 | 208,893    |
| Impairment, net <sup>3</sup>                        | (15,993)                                     |                          |                       | (15,993)   |
| Balance, end of period                              | \$ 443,750                                   | \$ 1,213                 | \$                    | \$ 444,963 |
| Revenue as a percentage of collections <sup>4</sup> | 68.0%  | 0.0%                     | 100.0%                | 68.7%      |

|   | For the Nine Months Ended September 30, 2007 |                          |                       |            |
|---|--|--------------------------|-----------------------|------------|
|   | Accrual Basis Portfolios                     | Cost Recovery Portfolios | Zero Basis Portfolios | Total      |
| Balance, beginning of period                        | \$ 300,348                                   | \$                       | \$                    | \$ 300,348 |
| Purchases of receivable portfolios                  | 134,392                                      |                          |                       | 134,392    |
| Transfer of healthcare receivables                  | (3,241)                                      | 3,241                    |                       |            |
| Gross collections <sup>1</sup>                      | (256,943)                                    |                          | (12,471)              | (269,414)  |
| Put-backs and recalls <sup>2</sup>                  | (2,097)                                      |                          |                       | (2,097)    |
| Revenue recognized                                  | 175,676                                      |                          | 12,471                | 188,147    |
| Impairment, net                                     | (1,167)                                      |                          |                       | (1,167)    |
| Write-down of healthcare receivables                |  | (1,391)                  |                       | (1,391)    |
| Balance, end of period                              | \$ 346,968                                   | \$ 1,850                 | \$                    | \$ 348,818 |
| Revenue as a percentage of collections <sup>4</sup> | 68.4%  | 0.0%                     | 100.0%                | 69.8%      |

<sup>1</sup> Does not include amounts collected on behalf of others.

<sup>2</sup>

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Put-backs represent accounts that are returned to the seller in accordance with the respective purchase agreement ( Put-Backs ). Recalls represents accounts that are recalled by the seller in accordance with the respective purchase agreement ( Recalls ).

<sup>3</sup> Reflects additional revenue of \$0.1 million and a lower net impairment of \$3.1 million, as a result of extending the collection curves from 72 to 84 months.

<sup>4</sup> Revenue as a percentage of collections excludes the effects of net impairment or net impairment reversals.



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The following table summarizes the change in the valuation allowance for investment in receivable portfolios during the nine months ended September 30, 2008 (*in thousands*):

|                                 | <b>Valuation<br/>Allowance</b> |
|---------------------------------|--------------------------------|
| Balance at December 31, 2007    | \$ 15,752                      |
| Provision for impairment losses | 5,335                          |
| Reversal of prior allowance     |                                |
| Balance at March 31, 2008       | \$ 21,087                      |
| Provision for impairment losses | 3,557                          |
| Reversal of prior allowance     | (167)                          |
| Balance at June 30, 2008        | \$ 24,477                      |
| Provision for impairment losses | 8,065                          |
| Reversal of prior allowance     | (797)                          |
| Balance at September 30, 2008   | \$ 31,745                      |

The Company utilizes various business channels for the collection of its receivable portfolios. The following table summarizes collections by collection channel (*in thousands*):

|                                  | <b>Three Months<br/>Ended</b> |             | <b>Nine Months Ended</b>      |             |
|----------------------------------|-------------------------------|-------------|-------------------------------|-------------|
|                                  | <b>September 30,<br/>2008</b> | <b>2007</b> | <b>September 30,<br/>2008</b> | <b>2007</b> |
| Collection sites                 | \$ 36,858                     | \$ 30,571   | \$ 119,076                    | \$ 97,082   |
| Legal collections                | 49,765                        | 42,546      | 144,241                       | 126,706     |
| Collection agencies              | 7,881                         | 6,894       | 28,851                        | 23,397      |
| Sales                            | 3,166                         | 4,992       | 11,013                        | 20,261      |
| Other                            | 107                           | 627         | 1,081                         | 2,336       |
| Gross collections for the period | \$ 97,777                     | \$ 85,630   | \$ 304,262                    | \$ 269,782  |

**Note 5: Deferred Court Costs**

The Company contracts with a nationwide network of attorneys that specialize in collection matters. The Company generally refers charged-off accounts to its contracted attorneys when it believes the related debtor has sufficient assets to repay the indebtedness and has, to date, been unwilling to pay. In connection with the Company's agreement with the contracted attorneys, it advances certain out-of-pocket court costs ( Deferred Court Costs ). The Company capitalizes Deferred Court Costs in its consolidated financial statements and provides a reserve for those costs that it believes will ultimately be uncollectible. The Company determines the reserve based on its analysis of court costs that have been advanced and those that have been recovered. Deferred court costs not recovered within three years of placement are fully written off. Collections received from these debtors are first applied against related court costs with the balance applied to the debtors' account.

Deferred Court Costs consist of the following as of the dates presented (*in thousands*):

|                      | <b>September 30,<br/>2008</b> | <b>December 31,<br/>2007</b> |
|----------------------|-------------------------------|------------------------------|
| Court costs advanced | \$ 132,636                    | \$ 88,385                    |

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|                           |           |           |
|---------------------------|-----------|-----------|
| Court costs recovered     | (34,262)  | (21,749)  |
| Court costs reserve       | (71,167)  | (46,103)  |
| Deferred court costs, net | \$ 27,207 | \$ 20,533 |

**Table of Contents****Note 6: Other Assets**

Other assets consist of the following (*in thousands*):

|                              | September 30,<br>2008 | December 31,<br>2007 |
|------------------------------|-----------------------|----------------------|
| Debt issuance costs          | \$ 2,846              | \$ 3,177             |
| Deferred compensation assets | 1,407                 | 3,158                |
| Prepaid expenses             | 1,082                 | 785                  |
| Other                        | 1,774                 | 1,680                |
|                              | \$ 7,109              | \$ 8,800             |

**Note 7: Debt**

The Company is obligated under borrowings as follows (*in thousands*):

|  | September 30,<br>2008 | December 31,<br>2007 |
|--|-----------------------|----------------------|
| Convertible senior notes                 | \$ 95,000             | \$ 100,000           |
| Revolving credit facility                | 197,000               | 172,169              |
| Capital lease obligations and other debt | 943                   | 251                  |
|  | \$ 292,943            | \$ 272,420           |

**Convertible Senior Notes**

In 2005, the Company issued \$100.0 million of 3.375% convertible senior notes due September 19, 2010 (the *Convertible Notes*). Interest on the *Convertible Notes* is payable semi-annually, in arrears, on March 19 and September 19 of each year. The *Convertible Notes* rank equally with the Company's existing and future senior indebtedness and are senior to the Company's potential future subordinated indebtedness. Prior to the implementation of the net-share settlement feature discussed below, the *Convertible Notes* were convertible, prior to maturity, subject to certain conditions described below, into shares of the Company's common stock at an initial conversion rate of 44.7678 per \$1,000 principal amount of notes, which represented an initial conversion price of approximately \$22.34 per share, subject to adjustment.

In April 2008, the Company repurchased \$5.0 million principal amount of its outstanding *Convertible Notes*, for a total price of \$3.5 million, plus accrued interest. This transaction left \$95.0 million principal amount of the Company's *Convertible Notes* outstanding, and resulted in a net gain of \$1.4 million in the second quarter of 2008. As of September 30, 2008, the Company is making the required interest payments on the *Convertible Notes* and no other changes in the balance or structure of the *Convertible Notes* has occurred.

In October 2005, the Company obtained stockholder approval of a net-share settlement feature that allows the Company to settle conversion of the *Convertible Notes* through a combination of cash and stock. Based on the provisions of Emerging Issues Task Force No. 90-19, *Convertible Bonds with Issuer Option to Settle for Cash upon Conversion* (EITF 90-19), and Emerging Issues Task Force No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled In, a Company's Own Stock* (EITF 00-19), the net-settlement feature is accounted for as convertible debt and is not subject to the provisions of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133). As a result of the net-settlement feature, the Company will be able to substantially reduce the number of shares issuable in the event of conversion of the *Convertible Notes* by repaying principal in cash instead of issuing shares of common stock for that amount. Additionally, the Company will not be required to include the underlying shares of common stock in the calculation of the Company's diluted weighted average shares outstanding for earnings per share until the Company's common stock price exceeds \$22.34.

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The aggregate underwriting commissions and other debt issuance costs incurred with respect to the issuance of the Convertible Notes were \$3.4 million, which have been capitalized as debt issuance costs on the Company's consolidated statements of financial condition and are being amortized using the effective interest rate method over the term of the Convertible Notes.

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The Convertible Notes also contain a restricted convertibility feature that does not affect the conversion price of the Convertible Notes but, instead, places restrictions on a holder's ability to convert their Convertible Notes into shares of the Company's common stock. A holder may convert the Convertible Notes prior to March 19, 2010, only if one or more of the following conditions are satisfied:

the average of the trading prices of the Convertible Notes for any five consecutive trading day period is less than 103% of the average of the conversion values of the Convertible Notes during that period;

the Company makes certain significant distributions to holders of the Company's common stock;

the Company enters into specified corporate transactions; or

the Company's common stock ceases to be approved for listing on the NASDAQ National Market and is not listed for trading on a U.S. national securities exchange or any similar U.S. system of automated securities price dissemination.

Holders may also surrender their Convertible Notes for conversion anytime on or after March 19, 2010, until the close of business on the trading day immediately preceding September 19, 2010, regardless of whether any of the foregoing conditions have been satisfied. Upon the satisfaction of any of the foregoing conditions, on the last day of a reporting period, or during the twelve months prior to September 19, 2010, the Company would write off to expense all remaining unamortized debt issuance costs in that period.

If the Convertible Notes are converted in connection with certain fundamental changes that occur prior to March 19, 2010, the Company may be obligated to pay an additional make-whole premium with respect to the Convertible Notes converted.

*Convertible Notes Hedge Strategy.* Concurrent with the sale of the Convertible Notes, the Company purchased call options to purchase from the counterparties an aggregate of 4,476,780 shares of the Company's common stock at a price of \$22.34 per share. The cost of the call options totaled \$27.4 million. The Company also sold warrants to the same counterparties to purchase from the Company an aggregate of 3,984,334 shares of the Company's common stock at a price of \$29.04 per share and received net proceeds from the sale of these warrants of \$11.6 million. Taken together, the call option and warrant agreements have the effect of increasing the effective conversion price of the Convertible Notes to \$29.04 per share. The call options and warrants must be settled in net shares, except in connection with certain termination events, in which case they would be settled in cash based on the fair market value of the instruments. On the date of settlement, if the market price per share of the Company's common stock is above \$29.04 per share, the Company will be required to deliver shares of its common stock representing the value of the call options and warrants in excess of \$29.04 per share.

The warrants have a strike price of \$29.04 and are generally exercisable at any time. The Company issued and sold the warrants in a transaction exempt from the registration requirements of the Securities Act of 1933, as amended, because the offer and sale did not involve a public offering. There were no underwriting commissions or discounts in connection with the sale of the warrants. In accordance with EITF No. 00-19 and Statement of Financial Accounting Standards No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, the Company recorded the net call options and warrants as a reduction in additional paid in capital as of December 31, 2005, and will not recognize subsequent changes in fair value of the call options and warrants in its consolidated financial statements.

### ***Revolving Credit Facility***

During 2005, the Company entered into a three-year revolving credit facility ( *Revolving Credit Facility* ), to be used for the purposes of purchasing receivable portfolios and for general working capital needs. This Revolving Credit Facility has been amended several times to meet the needs of the Company, and is due to expire in May 2010.

Effective February 27, 2007 and May 9, 2008, the Company amended the Revolving Credit Facility to allow for the Company to repurchase up to \$50 million of a combination of its common stock and Convertible Notes, subject to compliance with certain covenants and available borrowing capacity.

Effective May 7, 2007, the Company amended the Revolving Credit Facility in connection with an agreement reached with the lender under the Company's Secured Financing Facility. This amendment allows the Company to exclude the expense associated with a one-time payment of

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\$16.9 million in connection with its termination of all future obligations under its Secured Financing Facility as further discussed below.

Effective October 19, 2007, the Company amended the Revolving Credit Facility to change the definition of "change of control" to exclude from that definition acquisitions of stock by Red Mountain Capital Partners LLC ( "Red Mountain" ), JCF FPK I LP ( "JCF FPK" ) and their respective affiliates. The amendment was entered into in contemplation of a shareholders' agreement between Red Mountain affiliates and JCF FPK. That shareholders' agreement was subsequently executed between Red Mountain affiliates and JCF FPK.

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Effective July 3, 2008, the Company amended the Revolving Credit Facility to expand the capacity from \$230.0 million to \$335.0 million. This amendment added three additional lenders and increased the applicable margin under certain circumstances between 25 and 75 basis points.

Other provisions of the amended Revolving Credit Facility include:

Interest at a floating rate equal to, at the Company's option, either: (a) reserve adjusted LIBOR plus a spread that ranges from 225 to 275 basis points, depending on the Company's leverage; or (b) the higher of the federal funds rate then in effect plus a spread of 50 basis points or the prime rate plus a spread that ranges from 25 to 75 basis points.

\$5.0 million sub-limits for swingline loans and letters of credit.

A borrowing base that provides for an 85.0% initial advance rate for the purchase of qualified receivable portfolios. The borrowing base reduces for each qualifying portfolio by 3% per month beginning after the third complete month subsequent to the initial purchase. The aggregate borrowing base is equal to the lesser of (a) the sum of all of the borrowing bases of all qualified receivable portfolios under this facility, as defined above, or (b) 95% of the net book value of all receivable portfolios acquired on or after January 1, 2005.

Restrictions and covenants, which limit, among other things, the payment of dividends and the incurrence of additional indebtedness and liens.

Events of default which, upon occurrence, may permit the lenders to terminate the Revolving Credit Facility and declare all amounts outstanding to be immediately due and payable.

Collateralization by all assets of the Company.

At September 30, 2008, the outstanding balance on the Revolving Credit Facility was \$197.0 million, which bore a weighted average interest rate of 5.84%. The aggregate borrowing base was \$258.1 million, of which \$61.1 million was available for future borrowings.

### ***Secured Financing Facility***

The Company repaid in full the principal balance of the Secured Financing Facility at the end of 2006 and will make no further borrowings under that facility. Prior to May 7, 2007, the Company and the lender shared the residual collections, net of servicing fees paid to the Company. The residual collections paid to the lender were classified as contingent interest ( Contingent Interest ).

On May 7, 2007, the Company entered into an agreement with the lender under its Secured Financing Facility to eliminate all future Contingent Interest payments, for a one-time payment of \$16.9 million. This agreement released the lender's security interests in the remaining receivables originally financed under the Secured Financing Facility. Subsequent to the second quarter of 2007, the Company is no longer obligated to make any Contingent Interest payments under the Secured Financing Facility and, as a result, no longer records such interest in its statements of operations.

### ***Derivative Instruments***

On April 11, 2007, the Company entered into two separate interest rate swap agreements intended to more effectively manage interest rates by establishing a set level of fixed rates associated with a portion of the borrowings under its Revolving Credit Facility. The first agreement is for a notional amount of \$25.0 million, a term of three years and a fixed interest rate of 4.99%. The second agreement is for a notional amount of \$25.0 million, a term of four years and a fixed interest rate of 5.01%. Giving effect to these hedges, the interest rate the Company will pay on \$50.0 million of the outstanding balance under the Revolving Credit Facility will be the fixed interest rates mentioned above plus the required credit spread. In accordance with FAS 133, the Company designates its interest rate swap instruments as cash flow hedges.

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FAS 133 requires companies to recognize derivative instruments as either an asset or liability measured at fair value in the statement of financial position. The effective portion of the change in fair value of the derivative is recorded in other comprehensive income. The ineffective portion of the change in fair value of the derivative, if any, is recognized in interest expense in the period of change. From the inception of the hedging program, the Company has determined that the hedging instruments are highly effective. Accordingly, no gain or loss has been recognized in earnings for the three and nine months ended September 30, 2008. The change in fair value recognized in accumulated other comprehensive loss was a gain of less than \$0.1 million and a loss of less than \$0.1 million for the three and nine months ended September 30, 2008, respectively. As of September 30, 2008, the fair value of the hedges represented a liability of \$1.7 million.



**Table of Contents*****Capital Lease Obligations and Other Debt***

The Company has capital lease obligations for certain computer equipment. These lease obligations require monthly payments aggregating approximately \$21,000 through November 2008 and have implicit interest rates ranging from 2.9% to 3.1%.

The Company finances certain leasehold improvement projects with its lessors in its Phoenix and St. Cloud facilities. These projects are currently under construction and, as of September 30, 2008, the Company's obligation was approximately \$0.9 million. Commencing in October 2008, these financing agreements require monthly principal and interest payments, accrue interest at 8% to 9% per annum and will mature in June and September 2013.

**Note 8: Income Taxes**

The Company recorded an income tax provision of \$2.9 million, reflecting an effective rate of 43.7% of pretax income during the three months ended September 30, 2008. The effective tax rate for the three months ended September 30, 2008, consists primarily of a provision for Federal income taxes of 31.9% (which is net of a benefit for state taxes of 3.1%), a provision for state taxes of 8.8% and a provision for the effect of permanent book versus tax differences of 3.0%. For the three months ended September 30, 2007, the Company recorded an income tax provision of \$1.7 million, reflecting an effective rate of 24.3% of pretax income. The effective tax rate for the three months ended September 30, 2007, primarily consisted of an expense for Federal income taxes of 32.6% (which is net of a provision for state taxes of 2.4%), an expense for state taxes of 6.8%, a provision for the effect of permanent book versus tax differences of 0.1%, and a one-time benefit of 15.2% related to state taxes. The 15.2% benefit was primarily due to a new effective state tax rate resulting from the receipt of a favorable ruling from a state tax authority granting the Company the right to a more favorable filing methodology, a net beneficial adjustment to the state and Federal tax payables resulting from the completion of the Company's 1999-2006 state tax returns, a beneficial adjustment to the Company's deferred taxes and the recognition of the benefit of certain state net operating losses generated in 2006.

The Company recorded an income tax provision of \$13.0 million, reflecting an effective rate of 41.0% of pretax income during the nine months ended September 30, 2008. The effective tax rate for the nine months ended September 30, 2008, consists primarily of a provision for Federal income taxes of 31.9% (which is net of a benefit for state taxes of 2.1%), a provision for state taxes of 8.8% and a provision for the effect of permanent book versus tax differences of 0.3%. For the nine months ended September 30, 2007, the Company recorded an income tax provision of \$5.1 million, reflecting an effective rate of 33.1% of pretax income. The effective tax rate for the nine months ended September 30, 2007, primarily consisted of a provision for Federal income taxes of 32.6% (which is net of a benefit for state taxes of 2.4%), a provision for state taxes of 6.8%, a provision for the effect of permanent book versus tax differences of 0.1%, and a one-time benefit of 6.4% related to state taxes. The 6.4% benefit was primarily due to a new effective state tax rate resulting from the receipt of a favorable ruling from a state tax authority granting the Company the right to a more favorable filing methodology, a net beneficial adjustment to the state and Federal tax payables resulting from the completion of the Company's 1999-2006 state tax returns, a beneficial adjustment to the Company's deferred taxes and the recognition of the benefit of certain state net operating losses generated in 2006.

Effective January 1, 2007, the Company adopted the provisions of Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). As of December 31, 2007, the Company had a gross unrecognized tax benefit of \$1.3 million that, if recognized, would result in a net tax benefit of approximately \$1.0 million and would have a positive effect on the Company's effective tax rate. During the three and nine months ended September 30, 2008, there were no material changes to the unrecognized tax benefit.

For the three months ended September 30, 2008, the Company has not provided for the United States income taxes or foreign withholding taxes on the quarterly undistributed earnings from continuing operations of its subsidiary operating outside of the United States. Undistributed earnings of the subsidiary for the three and nine months ended September 30, 2008, were approximately \$0.1 million and \$0.4 million, respectively. Such undistributed earnings are considered permanently reinvested.

The Company's subsidiary operating outside of the United States is currently operating under a tax holiday in India. The tax holiday is due to expire on March 31, 2010. The impact of the tax holiday on the Company's consolidated financial statements is immaterial.

**Table of Contents****Note 9: Purchase Concentrations**

The following table summarizes the concentration of the Company's purchases by seller sorted by total aggregate costs for the nine months ended September 30, 2008 (in thousands, except percentages):

|                          | Concentration of Initial Purchase<br>Cost by Seller for the Nine Months<br>Ended September 30, 2008 |        |
|--------------------------|---|--------|
|                          | Cost  | %      |
| Seller 1                 | \$ 41,414   | 24.9%  |
| Seller 2                 | 36,182  | 21.7%  |
| Seller 3                 | 33,334  | 20.0%  |
| Seller 4                 | 18,377  | 11.1%  |
| Seller 5                 | 9,695   | 5.8%   |
| Other                    | 27,499  | 16.5%  |
|                          | \$ 166,501  | 100.0% |
| Adjustments <sup>1</sup> | (355)   |        |
| Purchases, net           | \$ 166,146  |        |

<sup>1</sup> Adjusted for Put-backs and Recalls.

**Note 10: Commitments and Contingencies****Litigation**

On October 18, 2004, Timothy W. Moser, one of the Company's former officers, filed an action in the United States District Court for the Southern District of California against the Company, and certain individuals, including several of the Company's officers and directors. On February 14, 2005, the Company was served with an amended complaint in this action alleging defamation, intentional interference with contractual relations, breach of contract, breach of the covenant of good faith and fair dealing, intentional and negligent infliction of emotional distress and civil conspiracy arising out of certain statements in the Company's Registration Statement on Form S-1 originally filed in September 2003 and alleged to be included in the Company's Registration Statement on Form S-3 originally filed in May 2004. The amended complaint seeks injunctive relief, economic and punitive damages in an unspecified amount plus an award of profits allegedly earned by the defendants and alleged co-conspirators as a result of the alleged conduct, in addition to attorney's fees and costs. On May 2, 2006, the court denied the Company's special motion to strike pursuant to California's anti-SLAPP statute, denied in part and granted in part the Company's motion to dismiss, denied a variety of *ex parte* motions and applications filed by the plaintiff and denied the plaintiff's motion for leave to conduct discovery or file supplemental briefing. The court granted the plaintiff 30 days in which to further amend his complaint, and on June 1, 2006, the plaintiff filed a second amended complaint in which he amended his claim for negligent infliction of emotional distress. On May 25, 2006, the Company filed a notice of appeal of the court's order denying the anti-SLAPP motion and on June 16, 2006, the Company filed a motion to stay the case pending the outcome of the appeal, which was granted. Oral argument on the appeal was heard on July 17, 2008, and on July 28, 2008, the appellate court affirmed the trial court's denial of the Company's anti-SLAPP motion. The appellate court denied the Company's request for a rehearing and the case has been returned to the district court where it will proceed from the point at which it was stayed. Management of the Company believes the claims are without merit and intends to vigorously defend the action. Although the outcome of this matter cannot be predicted with certainty, management does not currently believe that this matter will have a material adverse effect on the Company's consolidated financial position or results of operations.

On September 7, 2005, Mr. Moser filed a related action in the United States District Court for the Southern District of California against Triarc Companies, Inc. (Triarc), which at the time was a significant stockholder of the Company, alleging intentional interference with contractual relations and intentional infliction of emotional distress. The case arises out of the same statements made or alleged to have been made in the Company's Registration Statements mentioned above. On January 7, 2006, Triarc was served with an amended complaint seeking injunctive relief, an order directing Triarc to issue a statement of retraction or correction of the allegedly false statements, economic and punitive damages in an unspecified amount and attorney's fees and costs. Triarc tendered the defense of this action to the Company, and the Company accepted the

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defense and will indemnify Triarc, pursuant to the indemnification provisions of the Registration Rights Agreements dated as of October 31, 2000 and February 21, 2002, and the Underwriting Agreements dated September 25, 2004 and January 20, 2005 to which Triarc is a party. Although the outcome of this matter cannot be predicted with certainty, management does not currently believe that this matter will have a material adverse effect on the Company's consolidated financial position or results of operations.

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Claims based on the Fair Debt Collection Practices Act ( FDCPA ) and comparable state statutes may result in class action lawsuits, which can be material to the Company due to the remedies available under these statutes, including punitive damages. A number of cases styled as class actions have been filed against the Company. A class has been certified in several of these cases. Several of these cases present novel issues on which there is no legal precedent. As a result, the Company is unable to predict the range of possible outcomes. There are a number of other lawsuits, claims and counterclaims pending or threatened against the Company. In general, these lawsuits, claims or counterclaims have arisen in the ordinary course of business and involve claims for actual damages arising from alleged misconduct or improper reporting of credit information by the Company or its employees or agents. Although litigation is inherently uncertain, based on past experience, the information currently available and the possible availability of insurance and/or indemnification in some cases, management of the Company does not believe that the currently pending and threatened litigation or claims will have a material adverse effect on the Company's consolidated financial position or results of operations. However, future events or circumstances, currently unknown to management, will determine whether the resolution of pending or threatened litigation or claims will ultimately have a material effect on the Company's consolidated financial position, liquidity or results of operations in any future reporting periods.

***Purchase Commitments***

In the normal course of business, the Company enters into forward flow purchase agreements and other purchase commitment agreements. As of September 30, 2008, the Company has entered into agreements to purchase receivable portfolios with a face value of approximately \$1.0 billion for a purchase price of approximately \$58.0 million. Certain of these agreements allow the Company to terminate the commitment with 60 days notice or by paying a one-time cancellation fee. The Company has no purchase commitments extending past one year, except as discussed below.

In connection with the Company's acquisition of certain assets of Jefferson Capital Group in June 2005, the Company entered into a forward flow agreement to purchase a minimum of \$3.0 billion in face value of credit card charge-offs over a five-year period at a fixed price. As of June 30, 2008, future purchase commitments under this agreement were approximately \$51.3 million.

On July 15, 2008, the Company gave Jefferson Capital Group and its parent Company, CompuCredit Corporation, notice of breach by Jefferson Capital and CompuCredit of the Asset Purchase and Forward Flow Agreement dated June 2, 2005, as amended, as well as a related Collection Agreement dated the same date. On July 16, 2008, the Company initiated arbitration as a result of the breach, pursuant to the arbitration provisions of the Agreements. The Company asserts that the litigation initiated by the Federal Trade Commission (the FTC) on June 11, 2008, wherein the FTC alleges that Jefferson Capital and CompuCredit have violated the FTC Act with deceptive marketing practices when issuing credit cards, among other allegations, violates the Asset Purchase and Forward Flow Agreement and Collection Agreement. The Company seeks an arbitral award that (i) Jefferson Capital and CompuCredit are in material breach of the Agreements, (ii) declares the Company's obligations to purchase forward flow accounts under the Agreements is thereby excused or discharged, (iii) confirms the Company's rights to cause Jefferson Capital to repurchase certain accounts previously sold to the Company under the Agreements, and other appropriate relief, including return of prepaid amounts relating to forward flow purchases, (iv) confirms the Company's rights to indemnity by Jefferson Capital and CompuCredit and (v) awards compensatory damages, attorney fees, interest, arbitration costs and other appropriate relief.

The Company has commenced Arbitration proceedings and the Arbitrators have just been identified. The Company has ceased forward flow purchases of accounts from Jefferson Capital, the sale of bankrupt accounts to Jefferson Capital and participation in a balance transfer program with CompuCredit. In response to the Notice of Breach from the Company, Jefferson Capital and CompuCredit delivered its own Notice of Default to the Company alleging the breach by the Company of the Company's forward flow purchase, bankruptcy sale and balance transfer obligations and initiated a separate arbitration of the Company's alleged breach of its bankruptcy sale obligations.

This matter is in the early stages of development and any impact on the recoverability of the Company's forward flow asset, currently stated at \$10.3 million, is uncertain. The consolidated financial statements do not include any adjustment that might result from the outcome of this uncertainty.

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**Note 11: Securities Repurchase Program**

On February 27, 2007, the Company's board of directors authorized a securities repurchase program under which the Company may buy back up to \$50 million of a combination of its common stock and Convertible Notes. The purchases may be made from time to time in the open market or through privately negotiated transactions and will be dependent upon various business and financial considerations. Securities repurchases are subject to compliance with applicable legal requirements and other factors. During April 2008, the Company repurchased \$5.0 million principal amount of its outstanding Convertible Notes, for a total of \$3.5 million, plus accrued interest. No repurchases were made during the three months ended September 30, 2008.

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

This information should be read in conjunction with the condensed consolidated financial statements and the notes thereto included in Item 1 of Part I of this Quarterly Report on Form 10-Q and the audited consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 31, 2007 contained in our 2007 Annual Report on Form 10-K. The Form 10-K contains a general description of our industry and a discussion of recent trends affecting the industry. Certain statements herein may constitute forward-looking statements under the Private Securities Litigation Reform Act of 1995 (the Reform Act), for which we claim the protection of the safe harbor of the Reform Act. See Part II, Item 1A Risk Factors for more discussion on our forward-looking statements.

### **Introduction**

We are a systems-driven purchaser and manager of charged-off consumer receivable portfolios and a provider of bankruptcy services to the finance industry. We acquire receivable portfolios at deep discounts from their face values using our proprietary valuation process that is based on the consumer attributes of the underlying accounts. Based upon the ongoing analysis of these accounts, we employ a dynamic mix of collection strategies to maximize our return on investment.

### **Purchases and Collections**

#### *Purchases by Paper Type*

The following table summarizes the types of charged-off consumer receivable portfolios we purchased for the three and nine months ended September 30, 2008 and 2007 (in thousands):

|             | Three Months                   |           | Nine Months Ended     |            |
|-------------|--------------------------------|-----------|-----------------------|------------|
|             | Ended<br>September 30,<br>2008 | 2007      | September 30,<br>2008 | 2007       |
| Credit card | \$ 57,107                      | \$ 40,971 | \$ 142,552            | \$ 121,232 |
| Other       | 9,000                          | 6,898     | 23,949                | 13,160     |
|             | \$ 66,107                      | \$ 47,869 | \$ 166,501            | \$ 134,392 |

During the three months ended September 30, 2008, we invested \$66.1 million for portfolios with face values aggregating \$1.8 billion for an average purchase price of 3.6% of face value. This is an increase of \$18.2 million, or 38.1%, in the amount invested, compared with the \$47.9 million invested during the three months ended September 30, 2007, to acquire portfolios with a face value aggregating \$1.3 billion, for an average purchase price of 3.7% of face value.

During the nine months ended September 30, 2008, we invested \$166.5 million for portfolios with face values aggregating \$4.8 billion for an average purchase price of 3.4% of face value. This is an increase of \$32.1 million, or 23.9%, in the amount invested, compared with the \$134.4 million invested during the nine months ended September 30, 2007, to acquire portfolios with a face value aggregating \$5.1 billion, for an average purchase price of 2.6% of face value.

During the twelve months ended September 30, 2008, we invested \$241.1 million for portfolios with face values aggregating \$6.6 billion for an average purchase price of 3.7% of face value. This is an increase of \$43.1 million, or 21.8%, in the amount invested, compared with the \$198.0 million invested during the twelve months ended September 30, 2007, to acquire portfolios with a face value aggregating \$6.6 billion, for an average purchase price of 3.0% of face value.

Subsequent to July 2008, we ceased forward flow purchases of accounts from Jefferson Capital Group. Management believes that the supply of available credit card receivable portfolios for purchase in the markets will provide us with opportunities to purchase other portfolios that will generate returns at least comparable to that which we have been purchasing under the agreement with Jefferson Capital.



**Table of Contents****Collections by Channel**

During the three and nine months ended September 30, 2008 and 2007, we utilized several business channels for the collection of charged-off credit card receivables and other charged-off receivables. The following table summarizes gross collections by collection channel (*in thousands*):

|                                  | Three Months                   |           | Nine Months Ended     |            |
|----------------------------------|--------------------------------|-----------|-----------------------|------------|
|                                  | Ended<br>September 30,<br>2008 | 2007      | September 30,<br>2008 | 2007       |
| Collection sites                 | \$ 36,858                      | \$ 30,571 | \$ 119,076            | \$ 97,082  |
| Legal collections                | 49,765                         | 42,546    | 144,241               | 126,706    |
| Collection agencies              | 7,881                          | 6,894     | 28,851                | 23,397     |
| Sales                            | 3,166                          | 4,992     | 11,013                | 20,261     |
| Other                            | 107                            | 627       | 1,081                 | 2,336      |
| Gross collections for the period | \$ 97,777                      | \$ 85,630 | \$ 304,262            | \$ 269,782 |

Gross collections increased \$12.1 million, or 14.2%, to \$97.8 million during the three months ended September 30, 2008, from \$85.6 million during the three months ended September 30, 2007.

Gross collections increased \$34.5 million, or 12.8%, to \$304.3 million during the nine months ended September 30, 2008, from \$269.8 million during the nine months ended September 30, 2007.

**Results of Operations**

Results of operations in dollars and as a percentage of revenue were as follows (*in thousands, except percentages*):

|  | Three Months Ended September 30, |        |           |        |
|--|----------------------------------|--------|-----------|--------|
|  | 2008                             | 2007   |           |        |
| <b>Revenue</b>   |                                  |        |           |        |
| Revenue from receivable portfolios, net                      | \$ 62,557                        | 94.3%  | \$ 59,415 | 94.8%  |
| Servicing fees and other related revenue                     | 3,816                            | 5.7%   | 3,276     | 5.2%   |
| <b>Total revenue</b>   | 66,373                           | 100.0% | 62,691    | 100.0% |
| <b>Operating expenses</b>                                    |                                  |        |           |        |
| Salaries and employee benefits                               | 14,963                           | 22.5%  | 17,138    | 27.3%  |
| Stock-based compensation expense                             | 860                              | 1.3%   | 1,281     | 2.0%   |
| Cost of legal collections                                    | 25,390                           | 38.3%  | 20,868    | 33.3%  |
| Other operating expenses                                     | 6,018                            | 9.1%   | 4,987     | 8.0%   |
| Collection agency commissions                                | 2,996                            | 4.5%   | 2,478     | 4.0%   |
| General and administrative expenses                          | 4,864                            | 7.3%   | 4,462     | 7.1%   |
| Depreciation and amortization                                | 674                              | 1.0%   | 833       | 1.3%   |
| <b>Total operating expenses</b>                              | 55,765                           | 84.0%  | 52,047    | 83.0%  |
| <b>Income before other (expense) income and income taxes</b> | 10,608                           | 16.0%  | 10,644    | 17.0%  |
| <b>Other (expense) income</b>                                |                                  |        |           |        |
| Interest expense   | (3,880)                          | (5.9)% | (3,648)   | (5.8)% |
| Other (expense) income                                       | (32)                             | (0.0)% | 79        | 0.1%   |



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|                                   |                 |              |                 |              |
|-----------------------------------|-----------------|--------------|-----------------|--------------|
| Total other expense               | (3,912)         | (5.9)%       | (3,569)         | (5.7)%       |
| <b>Income before income taxes</b> | <b>6,696</b>    | <b>10.1%</b> | <b>7,075</b>    | <b>11.3%</b> |
| Provision for income taxes        | (2,923)         | (4.4)%       | (1,717)         | (2.7)%       |
| <b>Net income</b>                 | <b>\$ 3,773</b> | <b>5.7%</b>  | <b>\$ 5,358</b> | <b>8.6%</b>  |

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|  | <b>Nine Months Ended September 30,</b> |               |                  |                |
|--|--|---------------|------------------|----------------|
|  | <b>2008</b>                            |               | <b>2007</b>      |                |
| <b>Revenue</b>   |  |               |                  |                |
| Revenue from receivable portfolios, net                      | \$ 192,900                             | 94.6%         | \$ 185,589       | 95.0%          |
| Servicing fees and other related revenue                     | 11,047                                 | 5.4%          | 9,705            | 5.0%           |
| <b>Total revenue</b>   | <b>203,947</b>                         | <b>100.0%</b> | <b>195,294</b>   | <b>100.0%</b>  |
| <b>Operating expenses</b>                                    |  |               |                  |                |
| Salaries and employee benefits                               | 45,503                                 | 22.3%         | 50,388           | 25.8%          |
| Stock-based compensation expense                             | 3,182                                  | 1.6%          | 3,286            | 1.7%           |
| Cost of legal collections                                    | 69,525                                 | 34.1%         | 59,649           | 30.6%          |
| Other operating expenses                                     | 17,656                                 | 8.7%          | 16,970           | 8.7%           |
| Collection agency commissions                                | 10,808                                 | 5.3%          | 8,639            | 4.4%           |
| General and administrative expenses                          | 13,905                                 | 6.8%          | 12,965           | 6.6%           |
| Depreciation and amortization                                | 2,162                                  | 1.0%          | 2,541            | 1.3%           |
| <b>Total operating expenses</b>                              | <b>162,741</b>                         | <b>79.8%</b>  | <b>154,438</b>   | <b>79.1%</b>   |
| <b>Income before other (expense) income and income taxes</b> | <b>41,206</b>                          | <b>20.2%</b>  | <b>40,856</b>    | <b>20.9%</b>   |
| <b>Other (expense) income</b>                                |  |               |                  |                |
| Interest expense   | (11,409)                               | (5.6)%        | (9,904)          | (5.1)%         |
| Contingent interest expense                                  |  | 0.0%          | (4,123)          | (2.1)%         |
| Pay-off of contingent interest                               |  | 0.0%          | (11,733)         | (6.0)%         |
| Gain on repurchase of debt, net                              | 1,417                                  | 0.7%          |                  | 0.0%           |
| Other income   | 341                                    | 0.2%          | 153              | 0.1%           |
| <b>Total other expense</b>                                   | <b>(9,651)</b>                         | <b>(4.7)%</b> | <b>(25,607)</b>  | <b>(13.1)%</b> |
| <b>Income before income taxes</b>                            | <b>31,555</b>                          | <b>15.5%</b>  | <b>15,249</b>    | <b>7.8%</b>    |
| Provision for income taxes                                   | (12,952)                               | (6.4)%        | (5,055)          | (2.6)%         |
| <b>Net income</b>  | <b>\$ 18,603</b>                       | <b>9.1%</b>   | <b>\$ 10,194</b> | <b>5.2%</b>    |

**Comparison of Results of Operations****Revenue**

Our revenue consists primarily of portfolio revenue and bankruptcy servicing revenue. Portfolio revenue consists of accretion revenue and zero basis revenue. Accretion revenue represents revenue derived from pools (quarterly groupings of purchased receivable portfolios) with a cost basis that has not been fully amortized. Revenue from pools with a remaining unamortized cost basis is accrued based on each pool's effective interest rate applied to each pool's remaining unamortized cost basis. The cost basis of each pool is increased by revenue earned and decreased by gross collections and impairments. The effective interest rate is the internal rate of return derived from the timing and amounts of actual cash received and anticipated future cash flow projections for each pool. All collections realized after the net book value of a portfolio has been fully recovered ( Zero Basis Portfolios ) are recorded as revenue ( Zero Basis Revenue ). We account for our investment in receivable portfolios utilizing the interest method in accordance with the provisions of the AICPA's Statement of Position 03-3, *Accounting for Certain Debt Securities Acquired in a Transfer* ( SOP 03-3 ). Servicing fee revenue is revenue primarily associated with bankruptcy servicing fees earned from our wholly-owned subsidiary, Ascension Capital Group, Inc. ( Ascension ), a provider of bankruptcy services to the finance industry.

Effective January 1, 2008, we revised our Unified Collection Score ( UCS ) and Behavioral Liquidation Score ( BLS ) methodologies by extending our collection forecast from 72 months to 84 months. UCS is a proprietary forecasting tool that generates portfolio level expectations of liquidation for portfolios that we have owned and serviced for more than six months. BLS forecasts portfolio level expectations based on credit characteristics for portfolios owned and serviced less than six months. We have observed that receivable portfolios purchased in 2001 and prior have consistently experienced cash collections beyond 72 months from the date of purchase. When we first developed our cash forecasting models in 2001, limited historical collection data was available with which to accurately model projected cash flows beyond 60 months. During

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the quarter ended June 30, 2006, we determined there was enough additional collection data accumulated over the previous several years, in addition to improvements in our forecasting tools,

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allowing us to extend the collection forecast to 72 months. During the quarter ended March 31, 2008, we determined that there was enough additional collection data to accurately extend the collection forecast in both our UCS and BLS models to 84 months. The increase in the collection forecast from 72 to 84 months was applied effective January 1, 2008, to each portfolio for which we could accurately forecast through such term and resulted in an increase in the aggregate total estimated remaining collections for the receivable portfolios by \$67.3 million, or 7.5%, as of March 31, 2008. We did not extend the forecast on telecom portfolios as we do not anticipate significant collections past 72 months on these portfolios. The extension of the collection forecast was treated as a change in estimate and, in accordance with Statement of Financial Accounting Standard No. 154, *Accounting Changes and Error Corrections*, was recognized prospectively in our consolidated financial statements, effective January 1, 2008. In the quarter ended March 31, 2008, this prospective treatment resulted in a reduction in our net impairment provision of \$3.1 million and an increase in revenue of \$0.1 million. The impact of the change in estimate resulted in an increase in net income of \$1.9 million and an increase in fully diluted earnings per share of \$0.08 for the three months ended March 31, 2008. The impact of the change in estimate for the quarters ended June 30, 2008, and September 30, 2008, was not material to our condensed consolidated financial statements.

The following tables summarize collections, revenue, end of period receivable balance and other related supplemental data by year of purchase (in thousands, except percentages):

|       | For the Three Months Ended<br>September 30, 2008 |                               |   |                                 | As of<br>September 30, 2008         |                         |                |
|-------|--|-------------------------------|---|---------------------------------|-------------------------------------|-------------------------|----------------|
|       | Collections <sup>1</sup>                         | Gross<br>Revenue <sup>2</sup> | Revenue<br>Recognition<br>Rate <sup>3</sup> | Net<br>(Impairment)<br>Reversal | Revenue<br>% of<br>Total<br>Revenue | Unamortized<br>Balances | Monthly<br>IRR |
| ZBA   | \$ 2,259   | \$ 2,259                      | 100.0%                                      | \$                              | 3.2%                                | \$                      |                |
| 2002  | 1,276  | 872                           | 68.3%                                       | 220                             | 1.2%                                | 895                     | 29.1%          |
| 2003  | 3,327  | 2,730                         | 82.1%                                       | 440                             | 3.9%                                | 2,808                   | 30.7%          |
| 2004  | 4,310  | 3,584                         | 83.2%                                       | (1,426)                         | 5.1%                                | 14,420                  | 7.9%           |
| 2005  | 15,048   | 10,805                        | 71.8%                                       | (4,235)                         | 15.5%                               | 61,044                  | 5.6%           |
| 2006  | 16,268   | 11,418                        | 70.2%                                       | (1,932)                         | 16.4%                               | 72,214                  | 5.1%           |
| 2007  | 36,020   | 22,798                        | 63.3%                                       | (335)                           | 32.7%                               | 138,876                 | 5.2%           |
| 2008  | 19,189   | 15,359                        | 80.0%                                       |                                 | 22.0%                               | 154,706                 | 4.8%           |
| Total | \$ 97,697  | \$ 69,825                     | 71.5%                                       | \$ (7,268)                      | 100.0%                              | \$ 444,963              | 5.4%           |

|       | For the Three Months Ended<br>September 30, 2007 |                               |   |                                 | As of<br>September 30, 2007         |                         |                |
|-------|--|-------------------------------|---|---------------------------------|-------------------------------------|-------------------------|----------------|
|       | Collections <sup>1</sup>                         | Gross<br>Revenue <sup>2</sup> | Revenue<br>Recognition<br>Rate <sup>3</sup> | Net<br>(Impairment)<br>Reversal | Revenue<br>% of<br>Total<br>Revenue | Unamortized<br>Balances | Monthly<br>IRR |
| ZBA   | \$ 3,316   | \$ 3,316                      | 100.0%                                      | \$                              | 5.2%                                | \$                      |                |
| 2002  | 2,140  | 2,127                         | 99.4%                                       | (368)                           | 3.4%                                | 2,649                   | 25.7%          |
| 2003  | 5,717  | 5,754                         | 100.6%                                      | (834)                           | 9.1%                                | 5,958                   | 30.6%          |
| 2004  | 7,863  | 6,194                         | 78.8%                                       | (1,131)                         | 9.8%                                | 24,311                  | 8.0%           |
| 2005  | 25,373   | 17,287                        | 68.1%                                       | (1,362)                         | 27.3%                               | 96,531                  | 5.6%           |
| 2006  | 22,096   | 15,269                        | 69.1%                                       | 30                              | 24.2%                               | 102,959                 | 4.7%           |
| 2007  | 19,023   | 13,289                        | 69.9%                                       | (156)                           | 21.0%                               | 116,410                 | 4.2%           |
| Total | \$ 85,528  | \$ 63,236                     | 73.9%                                       | \$ (3,821)                      | 100.0%                              | \$ 348,818              | 5.6%           |

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- <sup>1</sup> Does not include amounts collected on behalf of others.
- <sup>2</sup> Gross revenue excludes the effects of net impairment or net impairment reversals.
- <sup>3</sup> Revenue recognition rate excludes the effects of net impairment or net impairment reversals.

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|       | For the Nine Months Ended<br>September 30, 2008 |                               |   |                                 |                                     | As of<br>September 30, 2008 |                |
|-------|---|-------------------------------|---|---------------------------------|-------------------------------------|-----------------------------|----------------|
|       | Collections <sup>1</sup>                        | Gross<br>Revenue <sup>2</sup> | Revenue<br>Recognition<br>Rate <sup>3</sup> | Net<br>(Impairment)<br>Reversal | Revenue<br>% of<br>Total<br>Revenue | Unamortized<br>Balances     | Monthly<br>IRR |
| ZBA   | \$ 7,440  | \$ 7,440                      | 100.0%                                      | \$                              | 3.6%                                | \$                          |                |
| 2002  | 4,544   | 3,331                         | 73.3%                                       | 291                             | 1.6%                                | 895                         | 29.1%          |
| 2003  | 11,396  | 9,681                         | 85.0%                                       | 127                             | 4.6%                                | 2,808                       | 30.7%          |
| 2004  | 15,663  | 12,376                        | 79.0%                                       | (3,003)                         | 5.9%                                | 14,420                      | 7.9%           |
| 2005  | 54,560  | 37,164                        | 68.1%                                       | (8,880)                         | 17.8%                               | 61,044                      | 5.6%           |
| 2006  | 57,340  | 37,966                        | 66.2%                                       | (4,086)                         | 18.2%                               | 72,214                      | 5.1%           |
| 2007  | 113,111   | 72,392                        | 64.0%                                       | (442)                           | 34.6%                               | 138,876                     | 5.2%           |
| 2008  | 39,983  | 28,543                        | 71.4%                                       |                                 | 13.7%                               | 154,706                     | 4.8%           |
| Total | \$ 304,037                                      | \$ 208,893                    | 68.7%                                       | \$ (15,993)                     | 100.0%                              | \$ 444,963                  | 5.4%           |

|       | For the Nine Months Ended<br>September 30, 2007 |                               |   |                                 |                                     | As of<br>September 30, 2007 |                |
|-------|---|-------------------------------|---|---------------------------------|-------------------------------------|-----------------------------|----------------|
|       | Collections <sup>1</sup>                        | Gross<br>Revenue <sup>2</sup> | Revenue<br>Recognition<br>Rate <sup>3</sup> | Net<br>(Impairment)<br>Reversal | Revenue<br>% of<br>Total<br>Revenue | Unamortized<br>Balances     | Monthly<br>IRR |
| ZBA   | \$ 12,471                                       | \$ 12,471                     | 100.0%                                      | \$                              | 6.6%                                | \$                          |                |
| 2002  | 8,338   | 7,460                         | 89.5%                                       | (36)                            | 4.0%                                | 2,649                       | 25.7%          |
| 2003  | 22,013  | 20,011                        | 90.9%                                       | (936)                           | 10.6%                               | 5,958                       | 30.6%          |
| 2004  | 28,199  | 20,773                        | 73.7%                                       | (1,381)                         | 11.0%                               | 24,311                      | 8.0%           |
| 2005  | 86,447  | 54,800                        | 63.4%                                       | 760                             | 29.1%                               | 96,531                      | 5.6%           |
| 2006  | 71,320  | 49,070                        | 68.8%                                       | (809)                           | 26.1%                               | 102,959                     | 4.7%           |
| 2007  | 40,626  | 23,562                        | 58.0%                                       | (156)                           | 12.6%                               | 116,410                     | 4.2%           |
| Total | \$ 269,414                                      | \$ 188,147                    | 69.8%                                       | \$ (2,558)                      | 100.0%                              | \$ 348,818                  | 5.6%           |

<sup>1</sup> Does not include amounts collected on behalf of others.

<sup>2</sup> Gross revenue excludes the effects of net impairment or net impairment reversals.

<sup>3</sup> Revenue recognition rate excludes the effects of net impairment or net impairment reversals.

Total revenue was \$66.4 million for the three months ended September 30, 2008, an increase of \$3.7 million, or 5.9%, compared to total revenue of \$62.7 million for the three months ended September 30, 2007. Portfolio revenue was \$62.6 million for the three months ended September 30, 2008, an increase of \$3.2 million, or 5.3%, compared to portfolio revenue of \$59.4 million for the three months ended September 30, 2007.

Total revenue was \$203.9 million for the nine months ended September 30, 2008, an increase of \$8.6 million, or 4.4%, compared to total revenue of \$195.3 million for the nine months ended September 30, 2007. Portfolio revenue was \$192.9 million for the nine months ended September 30, 2008, an increase of \$7.3 million, or 3.9%, compared to portfolio revenue of \$185.6 million for the nine months ended September 30, 2007.

The increase of portfolio revenue for the three and nine months ended September 30, 2008, was primarily the result of additional accretion revenue associated with higher purchasing volumes and, as discussed above, from the extension of our collection forecast from 72 to 84 months. The increase was partially offset by a greater portion of our revenues coming from our 2004 to 2008 portfolio purchases that have lower effective accretion rates than our 2003 and prior purchases, due to a more competitive pricing environment since 2004, and the recording of a larger impairment provision on certain portfolios during the quarter. During the three months ended September 30, 2008, we recorded a net impairment provision of \$7.3 million, compared to a net impairment provision of \$2.4 million and a write-down of our healthcare receivable portfolios of \$1.4 million associated with exiting our healthcare purchasing and collection activities during the three months ended

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September 30, 2007. During the nine months ended September 30, 2008, we recorded a net impairment provision of \$16.0 million, compared to a net impairment provision of \$1.2 million and a write-down of our healthcare receivable portfolios of \$1.4 million associated with exiting our healthcare purchasing and collection activities during the same period in the prior year.

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The increase in impairment for the three and nine months ended September 30, 2008, was primarily due to a shortfall in collections in certain pool groups against our forecast, primarily our 2004, 2005 and 2006 vintages. We believe that this is the result of the broadening pressure on our consumers due to a weakening economy. Economic and financial market conditions have deteriorated in the last two months, which, we believe, have resulted in a decrease in our collections and a corresponding increase in our impairment provision. Until economic conditions improve, we may continue to experience a shortfall in collections against our UCS forecast which, depending on the magnitude of the shortfall and the pool groups that experience such shortfall, may result in future provisions for impairment. In accordance with SOP 03-3, an impairment provision to reduce the book value and therefore, maintain a level yield on a pool group's internal rate of return, is only recorded when current information and events indicate that it is probable that an entity will be unable to collect all of its expected future cash flows, or when the timing of such cash flows is delayed. Since we cannot presently determine the future impact of the current economic conditions on our collections, we cannot conclude that further reductions in cash flows are probable or that the timing of cash flows has changed in a manner that would significantly impact any pool groups' internal rate of return and, therefore, have not recorded a related additional impairment.

Revenue associated with bankruptcy servicing fees earned from Ascension was \$3.8 million for the three months ended September 30, 2008, an increase of \$0.5 million, or 16.8%, compared to revenue of \$3.3 million for the three months ended September 30, 2007. Revenue associated with bankruptcy servicing fees earned from Ascension was \$11.0 million for the nine months ended September 30, 2008, an increase of \$1.3 million, or 14.1%, compared to revenue of \$9.7 million for the nine months ended September 30, 2007. The increase in Ascension revenue for the three and nine months ended September 30, 2008 was due to the slightly higher volume of bankruptcy placements.

**Operating Expenses**

Total operating expenses were \$55.8 million for the three months ended September 30, 2008, an increase of \$3.8 million, or 7.1%, compared to total operating expenses of \$52.0 million for the three months ended September 30, 2007.

Total operating expenses were \$162.7 million for the nine months ended September 30, 2008, an increase of \$8.3 million, or 5.4%, compared to total operating expenses of \$154.4 million for the nine months ended September 30, 2007.

Operating expenses are explained in more detail as follows:

***Salaries and employee benefits***

Total salaries and employee benefits decreased by \$2.1 million, or 12.7%, to \$15.0 million during the three months ended September 30, 2008, from \$17.1 million during the three months ended September 30, 2007. The decrease was the result of a decrease of \$0.4 million in health and life insurance costs and a decrease of \$2.1 million in salaries and related payroll taxes and benefits, resulting from the reduction in our workforce, associated with our cost savings initiatives implemented in September 2007, when we recorded a one-time restructuring charge of \$1.4 million. The decrease was partially offset by an increase of \$0.4 million in other employee benefits.

Total salaries and employee benefits decreased by \$4.9 million, or 9.7%, to \$45.5 million during the nine months ended September 30, 2008, from \$50.4 million during the nine months ended September 30, 2007. The decrease was the result of a decrease of \$0.2 million in health and life insurance costs and a decrease of \$5.4 million in salaries and related payroll taxes and benefits, resulting from the reduction in our workforce, associated with our cost savings initiatives implemented in September 2007, when we recorded a one-time restructuring charge of \$1.4 million. The decrease was partially offset by a net increase of \$0.7 million in other employee benefits.

***Stock-based compensation expenses***

Stock-based compensation expense decreased by \$0.4 million, or 32.9%, to \$0.9 million during the three months ended September 30, 2008, from \$1.3 million for the three months ended September 30, 2007. The decrease was primarily attributable to certain grants becoming fully vested prior to the quarter and a decrease in the fair value of stock options granted in recent years.

Stock-based compensation expense decreased by \$0.1 million, or 3.2%, to \$3.2 million during the nine months ended September 30, 2008, from \$3.3 million for the nine months ended September 30, 2007. The decrease was a result of a reduction in expenses as a result of fewer grants and the decreased fair value of stock options granted in recent years. The decrease was partially offset by a



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one-time reduction in expense in the nine months ended September 30, 2007, due to a change in assumptions used during that period. This change in assumptions resulted in a cumulative adjustment reducing stock-based compensation expense by \$0.4 million for the nine months ended September 30, 2007.

***Cost of legal collections***

The cost of legal collections increased \$4.5 million, or 21.7%, to \$25.4 million during the three months ended September 30, 2008, compared to \$20.9 million during the three months ended September 30, 2007. These costs represent contingent fees paid to our nationwide network of attorneys and costs of litigation. The increase in the cost of legal collections was primarily the result of an increase of \$7.3 million, or 17.0%, in gross collections through our legal channel and upfront litigation costs. Gross legal collections amounted to \$49.8 million during the three months ended September 30, 2008, compared to \$42.5 million collected during the three months ended September 30, 2007. The cost of legal collections as a percent of gross collections through this channel, increased to 51.0% during the three months ended September 30, 2008, from 49.0% during the three months ended September 30, 2007. This increase is primarily attributable to an increase in upfront litigation costs.

The cost of legal collections increased \$9.9 million, or 16.6%, to \$69.5 million during the nine months ended September 30, 2008, compared to \$59.6 million during the nine months ended September 30, 2007. These costs represent contingent fees paid to our nationwide network of attorneys and costs of litigation. The increase in the cost of legal collections was primarily the result of an increase of \$17.5 million, or 13.8%, in gross collections through our legal channel and upfront litigation costs. Gross legal collections amounted to \$144.2 million during the nine months ended September 30, 2008, compared to \$126.7 million collected during the nine months ended September 30, 2007. The cost of legal collections as a percent of gross collections through this channel increased to 48.2% during the nine months ended September 30, 2008, from 47.1% during the nine months ended September 30, 2007. This increase is primarily attributable to an increase in upfront litigation costs.

***Other operating expenses***

Other operating expenses increased \$1.0 million, or 20.7%, to \$6.0 million during the three months ended September 30, 2008, from \$5.0 million during the three months ended September 30, 2007. The increase was primarily the result of an increase of \$0.5 million related to direct mail campaign expenses, an increase of \$0.3 million in Ascension legal expenses due to the addition of litigation only clients, and a net increase of \$0.6 million in various other operating expenses. The increase was partially offset by a decrease of \$0.2 million in skip tracing expenses and a decrease of \$0.2 million in the amortization of a previously acquired deferred revenue asset.

Other operating expenses increased \$0.7 million, or 4.0%, to \$17.7 million during the nine months ended September 30, 2008, from \$17.0 million during the nine months ended September 30, 2007. The increase was primarily the result of an increase of \$1.3 million related to direct mail campaign expenses, an increase of \$0.5 million in Ascension legal expenses due to the addition of litigation only clients, and a net increase of \$0.3 million in various other operating expenses. The increase was partially offset by a decrease of \$0.7 million in skip tracing expenses and a decrease of \$0.7 million in the amortization of a previously acquired deferred revenue asset.

***Collection agency commissions***

During the three months ended September 30, 2008, we incurred \$3.0 million in commissions to third party collection agencies, or 38.0% of the related gross collections of \$7.9 million compared to \$2.5 million in commissions, or 35.9% of the related gross collections of \$6.9 million, during the three months ended September 30, 2007. The increase in commissions was consistent with the increase in collections through this channel. The increase in the commission rate as a percentage of the related gross collections is primarily due to the mix of accounts placed with the agencies. Commissions, as a percentage of collections in this channel, vary from period to period depending on, among other things, the time from charge-off of the accounts placed with an agency. Generally, freshly charged-off accounts have a lower commission rate than accounts that have been charged off for a longer period of time.

During the nine months ended September 30, 2008, we incurred \$10.8 million in commissions to third party collection agencies, or 37.5% of the related gross collections of \$28.9 million, compared to \$8.6 million in commissions, or 36.9% of the related gross collections of \$23.4 million, during the nine months ended September 30, 2007. The increase in commissions was consistent with the increase in collections through this channel. The increase in the commission rate as a percentage of the related gross collections is primarily due to the mix of accounts placed with the agencies. Commissions, as a percentage of collections in this channel, vary from period to period depending on, among other things, the time from charge-off of the accounts placed with an agency. Generally, freshly charged-off accounts have a lower commission rate than accounts that have been charged off for a longer period of time.



**Table of Contents****General and administrative expenses**

General and administrative expenses increased \$0.4 million, or 9.0%, to \$4.9 million during the three months ended September 30, 2008, from \$4.5 million during the three months ended September 30, 2007. The increase was primarily the result of an increase of \$0.4 million in corporate legal expenses.

General and administrative expenses increased \$0.9 million, or 7.3%, to \$13.9 million during the nine months ended September 30, 2008, from \$13.0 million during the nine months ended September 30, 2007. The increase was primarily the result of an increase of \$1.1 million in corporate legal expenses and litigation settlement costs and an increase of \$0.3 million in various corporate insurance costs compared to the same period of the prior year, which included a \$0.6 million release of reserves in the previously self insured workers compensation plan. The increase was partially offset by a decrease of \$0.5 million in accounting and consulting service fees incurred in the prior year related to the filing of our 1999-2005 state tax returns.

**Depreciation and amortization**

Depreciation and amortization expense decreased \$0.1 million, or 19.1%, to \$0.7 million during the three months ended September 30, 2008, from \$0.8 million during the three months ended September 30, 2007. Depreciation expense was \$0.5 million for the three months ended September 30, 2008, compared to \$0.6 million for the three months ended September 30, 2007. Amortization expense relating to intangible assets acquired in conjunction with the acquisition of Ascension, remained consistent at \$0.2 million during the three months ended September 30, 2008 and 2007.

Depreciation and amortization expense decreased \$0.3 million, or 14.9%, to \$2.2 million during the nine months ended September 30, 2008, from \$2.5 million during the nine months ended September 30, 2007. Depreciation expense was \$1.6 million for the nine months ended September 30, 2008, compared to \$1.7 million for the nine months ended September 30, 2007. Amortization expense relating to intangible assets acquired in conjunction with the acquisition of Ascension was \$0.6 million for the nine months ended September 30, 2008, compared to \$0.8 million for the nine months ended September 30, 2007.

**Interest expense**

Total interest expense increased \$0.2 million, or 6.4%, to \$3.9 million during the three months ended September 30, 2008, from \$3.6 million during the three months ended September 30, 2007.

Total interest expense decreased \$14.4 million, or 55.7%, to \$11.4 million during the nine months ended September 30, 2008, from \$25.8 million during the nine months ended September 30, 2007.

The following tables summarize our interest expense (*in thousands, except percentages*):

|  | <b>For the Three Months Ended September 30,</b> |                 |                  |                 |
|--|---|-----------------|------------------|-----------------|
|  | <b>2008</b>                                     | <b>2007</b>     | <b>\$ Change</b> | <b>% Change</b> |
| Stated interest on debt obligations            | \$ 3,345  | \$ 3,277        | \$ 68            | 2.1%            |
| Amortization of loan fees and other loan costs | 535   | 371             | 164              | 44.2%           |
| <b>Total interest expense</b>                  | <b>\$ 3,880</b>                                 | <b>\$ 3,648</b> | <b>\$ 232</b>    | <b>6.4%</b>     |

|  | <b>For the Nine Months Ended September 30,</b> |              |                  |                 |
|--|--|--------------|------------------|-----------------|
|  | <b>2008</b>                                    | <b>2007</b>  | <b>\$ Change</b> | <b>% Change</b> |
| Stated interest on debt obligations            | \$ 10,151                                      | \$ 8,752     | \$ 1,399         | 16.0%           |
| Amortization of loan fees and other loan costs | 1,258  | 1,152        | 106              | 9.2%            |
| <b>Subtotal</b>                                | <b>11,409</b>                                  | <b>9,904</b> | <b>1,505</b>     | <b>15.2%</b>    |
| Contingent interest                            |  | 4,123        | (4,123)          | (100.0)%        |
| Pay-off of future contingent interest          |  | 11,733       | (11,733)         | (100.0)%        |

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|                        |           |           |             |         |
|------------------------|-----------|-----------|-------------|---------|
| Total interest expense | \$ 11,409 | \$ 25,760 | \$ (14,351) | (55.7)% |
|------------------------|-----------|-----------|-------------|---------|

As of December 31, 2004, we no longer made borrowings under our Secured Financing Facility. As of December 31, 2006, we repaid in full the principal balance of our Secured Financing Facility. Prior to May 7, 2007, we shared with the lender the residual collections on purchases made under this facility, net of servicing fees paid to us. The residual collections paid to the lender were

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classified as contingent interest. On May 7, 2007, we entered into an agreement with the lender under our Secured Financing Facility to eliminate all future Contingent Interest payments for a one-time payment of \$16.9 million. This agreement effectively eliminated all future Contingent Interest payments and released our lender's security interests in the remaining receivables originally financed under our Secured Financing Facility. Subsequent to the second quarter of 2007, we no longer are required to pay any Contingent Interest expense under the Secured Financing Facility.

We have financed portfolio purchases subsequent to December 31, 2004 using our Revolving Credit Facility, which does not require the sharing of residual collections with the lender. See Note 7 to the unaudited condensed consolidated financial statements for a further discussion of our Revolving Credit Facility.

**Gain on repurchase of debt, net**

In April 2008, we repurchased \$5.0 million principal amount of our outstanding convertible senior notes, for a total price of \$3.5 million, plus accrued interest. This transaction left \$95.0 million principal amount of our convertible senior notes outstanding. This repurchase also resulted in a pre-tax gain of \$1.5 million, which was partially offset by a \$0.1 million write-off of the debt issuance costs related to the portions of the senior convertible notes repurchased. The net gain of \$1.4 million was recognized in our consolidated statement of operations for the nine months ended September 30, 2008.

**Other income and expense**

During the three months ended September 30, 2008, total other expense was less than \$0.1 million, compared to other income of less than \$0.1 million for the three months ended September 30, 2007.

During the nine months ended September 30, 2008, total other income was \$0.3 million, compared to other income of \$0.2 million for the nine months ended September 30, 2007.

**Provision for income taxes**

During the three months ending September 30, 2008, we recorded an income tax provision of \$2.9 million, reflecting an effective rate of 43.7% of pretax income. Our effective tax rate for the three months ended September 30, 2008, differed from the Federal statutory rate primarily due to the net effect of state taxes and the effect of permanent book versus tax differences. For the three months ended September 30, 2007, we recorded an income tax provision of \$1.7 million, reflecting an effective rate of 24.3% of pretax income. Our effective tax rate for the three months ended September 30, 2007, primarily consisted of an expense for Federal income taxes of 32.6% (which is net of a provision for state taxes of 2.4%), an expense for state taxes of 6.8%, a provision for the effect of permanent book versus tax differences of 0.1%, and a one-time benefit of 15.2% related to state taxes. The 15.2% benefit was primarily due to a new effective state tax rate resulting from the receipt of a favorable ruling from a state tax authority granting us the right to a more favorable filing methodology, a net beneficial adjustment to the state and Federal tax payables resulting from the completion of our 1999-2006 state tax returns, a beneficial adjustment to our deferred taxes and the recognition of the benefit of certain state net operating losses generated in 2006.

During the nine months ended September 30, 2008, we recorded an income tax provision of \$13.0 million, reflecting an effective rate of 41.0% of pretax income. Our effective tax rate for the nine months ended September 30, 2008, differed from the Federal statutory rate primarily due to the net effect of state taxes. For the nine months ended September 30, 2007, we recorded an income tax provision of \$5.1 million, reflecting an effective rate of 33.1% of pretax income. Our effective tax rate for the nine months ended September 30, 2007, primarily consisted of a provision for Federal income taxes of 32.6% (which is net of a benefit for state taxes of 2.4%), a provision for state taxes of 6.8%, a provision for the effect of permanent book versus tax differences of 0.1%, and a one-time benefit of 6.4% related to state taxes. The 6.4% benefit was primarily due to a new effective state tax rate resulting from the receipt of a favorable ruling from a state tax authority granting us the right to a more favorable filing methodology, a net beneficial adjustment to the state and Federal tax payables resulting from the completion of our 1999-2006 state tax returns, a beneficial adjustment to our deferred taxes and the recognition of the benefit of certain state net operating losses generated in 2006.

**Table of Contents****Supplemental Performance Data****Cumulative Collections to Purchase Price Multiple**

The following table summarizes our purchases and related gross collections by year of purchase (*in thousands, except multiples*):

| Cumulative Collections through September 30, 2008 |                             |            |           |            |            |            |            |            |            |            |                    |                  |
|---|-----------------------------|------------|-----------|------------|------------|------------|------------|------------|------------|------------|--------------------|------------------|
| Year of Purchase                                  | Purchase Price <sup>1</sup> | <2001      | 2001      | 2002       | 2003       | 2004       | 2005       | 2006       | 2007       | 2008       | Total <sup>2</sup> | CCM <sup>3</sup> |
| <1999   | \$ 41,117 <sub>4</sub>      | \$ 88,629  | \$ 22,545 | \$ 15,007  | \$ 7,546   | \$ 4,202   | \$ 2,042   | \$ 1,513   | \$ 989     | \$ 410     | \$ 142,883         | 3.5              |
| 1999  | 48,805                      | 29,163     | 19,174    | 16,259     | 11,508     | 8,654      | 5,157      | 3,513      | 1,954      | 924        | 96,306             | 2.0              |
| 2000  | 6,153                       | 5,489      | 7,172     | 4,542      | 4,377      | 2,293      | 1,323      | 1,007      | 566        | 274        | 27,043             | 4.4              |
| 2001  | 38,186                      |            | 21,197    | 54,184     | 33,072     | 28,551     | 20,622     | 14,521     | 5,644      | 2,448      | 180,239            | 4.7              |
| 2002  | 61,495                      |            |           | 48,322     | 70,227     | 62,282     | 45,699     | 33,694     | 14,902     | 6,505      | 281,631            | 4.6              |
| 2003  | 88,513                      |            |           |            | 59,038     | 86,958     | 69,932     | 55,131     | 26,653     | 11,415     | 309,127            | 3.5              |
| 2004  | 101,337                     |            |           |            |            | 39,400     | 79,845     | 54,832     | 34,625     | 15,662     | 224,364            | 2.2              |
| 2005  | 192,850                     |            |           |            |            |            | 66,491     | 129,809    | 109,078    | 55,119     | 360,497            | 1.9              |
| 2006  | 142,043                     |            |           |            |            |            |            | 42,354     | 92,265     | 57,340     | 191,959            | 1.4              |
| 2007  | 204,430                     |            |           |            |            |            |            |            | 68,048     | 113,111    | 181,159            | 0.9              |
| 2008  | 166,146                     |            |           |            |            |            |            |            |            | 40,829     | 40,829             | 0.2              |
| Total   | \$ 1,091,075                | \$ 123,281 | \$ 70,088 | \$ 138,314 | \$ 185,768 | \$ 232,340 | \$ 291,111 | \$ 336,374 | \$ 354,724 | \$ 304,037 | \$ 2,036,037       | 1.9              |

<sup>1</sup> Adjusted for put-backs, account recalls, purchase price rescissions, and the impact of an acquisition in 2000. Put-backs represent accounts that are returned to the seller in accordance with the respective purchase agreement ( Put-Backs ). Recalls represents accounts that are recalled by the seller in accordance with the respective purchase agreement ( Recalls ).

<sup>2</sup> Cumulative collections from inception through September 30, 2008.

<sup>3</sup> Cumulative Collections Multiple ( CCM ) through September 30, 2008 collections as a multiple of purchase price.

<sup>4</sup> From inception through December 31, 1998.

**Total Estimated Collections to Purchase Price Multiple**

The following table summarizes our purchases, resulting historical gross collections, and estimated remaining gross collections by year of purchase (*in thousands, except multiples*):

|       | Purchase Price <sup>1</sup> | Historical Gross Collections <sup>2</sup> | Estimated Remaining Collections <sup>3,4</sup> | Total Estimated Gross Collections | Total Estimated Gross Collections to Purchase Price |
|-------|-----------------------------|---|--|-----------------------------------|---|
| <1999 | \$ 41,117 <sub>5</sub>      | \$ 142,883                                | \$ 211   | \$ 143,094                        | 3.5   |
| 1999  | 48,805                      | 96,306                                    | 560  | 96,866                            | 2.0   |
| 2000  | 6,153                       | 27,043                                    | 228  | 27,271                            | 4.4   |
| 2001  | 38,186                      | 180,239                                   | 1,653  | 181,892                           | 4.8   |
| 2002  | 61,495                      | 281,631                                   | 5,042  | 286,673                           | 4.7   |
| 2003  | 88,513                      | 309,127                                   | 13,849   | 322,976                           | 3.6   |
| 2004  | 101,337                     | 224,364                                   | 34,973   | 259,337                           | 2.6   |
| 2005  | 192,850                     | 360,497                                   | 135,052  | 495,549                           | 2.6   |
| 2006  | 142,043                     | 191,959                                   | 170,334  | 362,293                           | 2.6   |
| 2007  | 204,430                     | 181,159                                   | 309,290  | 490,449                           | 2.4   |
| 2008  | 166,146                     | 40,829                                    | 383,771  | 424,600                           | 2.6   |

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|       |              |              |              |              |     |
|-------|--------------|--------------|--------------|--------------|-----|
| Total | \$ 1,091,075 | \$ 2,036,037 | \$ 1,054,963 | \$ 3,091,000 | 2.8 |
|-------|--------------|--------------|--------------|--------------|-----|

<sup>1</sup> Adjusted for Put-Backs, Recalls, purchase price rescissions, and the impact of an acquisition in 2000.

<sup>2</sup> Cumulative collections from inception through September 30, 2008.

<sup>3</sup> Includes \$1.2 million in expected collections for the healthcare portfolios on cost recovery.

<sup>4</sup> Effective January 1, 2008, we revised our UCS and BLS methodologies by extending our collection forecast from 72 months to 84 months.

<sup>5</sup> From inception through December 31, 1998.

**Table of Contents****Estimated Remaining Gross Collections by Year of Purchase**

The following table summarizes our estimated remaining gross collections by year of purchase (*in thousands*):

|                    | Estimated Remaining Gross Collections by Year of Purchase |            |            |            |            |           |           |          | Total        |
|--------------------|---|------------|------------|------------|------------|-----------|-----------|----------|--------------|
|                    | 2008 <sup>2</sup>   | 2009       | 2010       | 2011       | 2012       | 2013      | 2014      | 2015     |              |
| <1999 <sup>1</sup> | \$ 67   | \$ 144     | \$         | \$         | \$         | \$        | \$        | \$       | \$ 211       |
| 1999 <sup>1</sup>  | 228   | 253        | 79         |            |            |           |           |          | 560          |
| 2000 <sup>1</sup>  | 70  | 158        |            |            |            |           |           |          | 228          |
| 2001 <sup>1</sup>  | 413   | 1,134      | 106        |            |            |           |           |          | 1,653        |
| 2002 <sup>1</sup>  | 1,448   | 3,460      | 134        |            |            |           |           |          | 5,042        |
| 2003               | 2,660   | 8,593      | 2,596      |            |            |           |           |          | 13,849       |
| 2004               | 3,787   | 15,948     | 10,426     | 4,812      |            |           |           |          | 34,973       |
| 2005               | 14,636  | 51,757     | 35,380     | 24,209     | 9,070      |           |           |          | 135,052      |
| 2006               | 15,489  | 54,446     | 39,328     | 29,526     | 21,479     | 10,066    |           |          | 170,334      |
| 2007               | 32,786  | 111,685    | 68,716     | 44,363     | 29,872     | 17,359    | 4,509     |          | 309,290      |
| 2008               | 25,181  | 121,258    | 89,286     | 59,605     | 40,842     | 27,100    | 15,903    | 4,596    | 383,771      |
| Total              | \$ 96,765   | \$ 368,836 | \$ 246,051 | \$ 162,515 | \$ 101,263 | \$ 54,525 | \$ 20,412 | \$ 4,596 | \$ 1,054,963 |

<sup>1</sup> Estimated remaining collections for Zero Basis Portfolios can extend beyond the 84-month accrual basis collection forecast.

<sup>2</sup> 2008 amount consists of three months data, from October 1, 2008 to December 2008.

**Unamortized Balances of Portfolios**

The following table summarizes the remaining unamortized balances of our purchased receivable portfolios by year of purchase as of September 30, 2008 (*in thousands, except percentages*):

|       | Unamortized Balance<br>as of<br>September 30, 2008 <sup>1</sup> |            | Purchase Price <sup>2</sup> | Unamortized Balance<br>as a Percentage of<br>Purchase Price |  |
|-------|---|------------|-----------------------------|---|--|
|       |   |            |                             |   | Unamortized Balance<br>as a Percentage of<br>Total |
| 2002  | \$ 895  | \$ 61,495  |                             | 1.5%  | 0.2%   |
| 2003  | 2,808   | 88,513     |                             | 3.2%  | 0.6%   |
| 2004  | 14,420  | 101,337    |                             | 14.2%   | 3.3%   |
| 2005  | 61,044  | 192,850    |                             | 31.7%   | 13.7%  |
| 2006  | 72,214  | 142,043    |                             | 50.8%   | 16.2%  |
| 2007  | 138,876   | 204,430    |                             | 67.9%   | 31.2%  |
| 2008  | 154,706   | 166,146    |                             | 93.1%   | 34.8%  |
| Total | \$ 444,963  | \$ 956,814 |                             | 46.5%   | 100.0%   |

<sup>1</sup> Includes \$1.2 million for healthcare portfolios being accounted for on the cost recovery method.

<sup>2</sup> Purchase price refers to the cash paid to a seller to acquire a portfolio less Put- Backs, plus allocation of our forward flow asset (if applicable), and less the purchase price for accounts that were sold at the time of purchase to another debt purchaser.

**Collections by Channel**

During the three and nine months ended September 30, 2008 and 2007, we utilized several business channels for the collection of charged-off credit card receivables and other charged-off receivables. The following table summarizes gross collections by collection channel (*in thousands*):



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|                                  | <b>Three Months Ended</b> |                           | <b>Nine Months Ended</b>  |                           |
|----------------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
|                                  | <b>September 30, 2008</b> | <b>September 30, 2007</b> | <b>September 30, 2008</b> | <b>September 30, 2007</b> |
| Collection sites                 | \$ 36,858                 | \$ 30,571                 | \$ 119,076                | \$ 97,082                 |
| Legal collections                | 49,765                    | 42,546                    | 144,241                   | 126,706                   |
| Collection agencies              | 7,881                     | 6,894                     | 28,851                    | 23,397                    |
| Sales                            | 3,166                     | 4,992                     | 11,013                    | 20,261                    |
| Other                            | 107                       | 627                       | 1,081                     | 2,336                     |
| Gross collections for the period | \$ 97,777                 | \$ 85,630                 | \$ 304,262                | \$ 269,782                |

**Table of Contents****External Collection Channels and Related Direct Costs**

The following tables summarize our external collection channel performance and related direct costs (*in thousands, except percentages*):

|                                 | Legal Collections                     |              |                                       |              | Collection Agencies                   |              |                                       |              |
|---------------------------------|---------------------------------------|--------------|---------------------------------------|--------------|---------------------------------------|--------------|---------------------------------------|--------------|
|                                 | Three Months Ended September 30, 2008 |              | Three Months Ended September 30, 2007 |              | Three Months Ended September 30, 2008 |              | Three Months Ended September 30, 2007 |              |
| Collections                     | \$ 49,765                             | 100.0%       | \$ 42,546                             | 100.0%       | \$ 7,881                              | 100.0%       | \$ 6,894                              | 100.0%       |
| Commissions                     | \$ 14,452                             | 29.0%        | \$ 12,072                             | 28.4%        | \$ 2,996                              | 38.0%        | \$ 2,478                              | 35.9%        |
| Court cost expense <sup>1</sup> | 10,361                                | 20.8%        | 8,285                                 | 19.4%        |                                       |              |                                       |              |
| Other <sup>2</sup>              | 577                                   | 1.2%         | 511                                   | 1.2%         |                                       |              |                                       |              |
| <b>Total Costs</b>              | <b>\$ 25,390</b>                      | <b>51.0%</b> | <b>\$ 20,868</b>                      | <b>49.0%</b> | <b>\$ 2,996</b>                       | <b>38.0%</b> | <b>\$ 2,478</b>                       | <b>35.9%</b> |

|                                 | Legal Collections                    |              |                                      |              | Collection Agencies                  |              |                                      |              |
|---------------------------------|--------------------------------------|--------------|--------------------------------------|--------------|--------------------------------------|--------------|--------------------------------------|--------------|
|                                 | Nine Months Ended September 30, 2008 |              | Nine Months Ended September 30, 2007 |              | Nine Months Ended September 30, 2008 |              | Nine Months Ended September 30, 2007 |              |
| Collections                     | \$ 144,241                           | 100.0%       | \$ 126,706                           | 100.0%       | \$ 28,851                            | 100.0%       | \$ 23,397                            | 100.0%       |
| Commissions                     | \$ 41,437                            | 28.7%        | \$ 36,366                            | 28.7%        | \$ 10,808                            | 37.5%        | \$ 8,639                             | 36.9%        |
| Court cost expense <sup>1</sup> | 26,377                               | 18.3%        | 21,848                               | 17.3%        |                                      |              |                                      |              |
| Other <sup>2</sup>              | 1,711                                | 1.2%         | 1,435                                | 1.1%         |                                      |              |                                      |              |
| <b>Total Costs</b>              | <b>\$ 69,525</b>                     | <b>48.2%</b> | <b>\$ 59,649</b>                     | <b>47.1%</b> | <b>\$ 10,808</b>                     | <b>37.5%</b> | <b>\$ 8,639</b>                      | <b>36.9%</b> |

<sup>1</sup> In connection with our agreement with contracted attorneys, we advance certain out-of-pocket court costs. We capitalize these costs in our consolidated financial statements and provide a reserve and corresponding court cost expense for the costs that we believe will be ultimately uncollectible. This amount includes changes in our anticipated recovery rate of court costs expensed.

<sup>2</sup> Other costs consist primarily of costs related to counter claims.

**Legal Outsourcing Collections and Related Costs**

The following tables summarize our legal outsourcing collection channel performance and related direct costs (*in thousands, except percentages*):

| Placement Year    | Gross Collections by Year of Collection <sup>1</sup> |           |           |           |           |           | Total Collections |
|-------------------|--|-----------|-----------|-----------|-----------|-----------|-------------------|
|                   | 2003   | 2004      | 2005      | 2006      | 2007      | 2008      |                   |
| 2003              | \$ 10,750  | \$ 27,192 | \$ 17,212 | \$ 9,566  | \$ 5,561  | \$ 2,524  | \$ 72,805         |
| 2004              |  | \$ 23,455 | \$ 37,674 | \$ 21,676 | \$ 12,029 | \$ 4,856  | \$ 99,690         |
| 2005              |  |           | \$ 21,694 | \$ 40,762 | \$ 22,152 | \$ 8,763  | \$ 93,371         |
| 2006              |  |           |           | \$ 39,395 | \$ 82,740 | \$ 35,713 | \$ 157,848        |
| 2007              |  |           |           |           | \$ 41,958 | \$ 64,600 | \$ 106,558        |
| 2008 <sup>2</sup> |  |           |           |           |           | \$ 25,566 | \$ 25,566         |

<sup>1</sup> Includes collections for accounts placed in our legal channel beginning January 1, 2003. We continue to collect on accounts placed in this channel prior to that date.

<sup>2</sup> 2008 amount consists of nine months data, from January 1, 2008, to September 30, 2008.



**Table of Contents****Court Costs by Year of Collection<sup>1</sup>**

| Placement Year    | 2003   | 2004     | 2005     | 2006      | 2007      | 2008      | Total<br>Court Costs |
|-------------------|--------|----------|----------|-----------|-----------|-----------|----------------------|
| 2003              | \$ 908 | \$ 2,046 | \$ 571   | \$ 300    | \$ 147    | \$ 75     | \$ 4,047             |
| 2004              |        | \$ 2,509 | \$ 2,937 | \$ 1,087  | \$ 406    | \$ 164    | \$ 7,103             |
| 2005              |        |          | \$ 3,271 | \$ 4,426  | \$ 859    | \$ 264    | \$ 8,820             |
| 2006              |        |          |          | \$ 10,158 | \$ 10,291 | \$ 1,458  | \$ 21,907            |
| 2007              |        |          |          |           | \$ 15,357 | \$ 10,429 | \$ 25,786            |
| 2008 <sup>2</sup> |        |          |          |           |           | \$ 11,318 | \$ 11,318            |

<sup>1</sup> Includes court cost expense for accounts placed in our legal channel beginning January 1, 2003. We continue to incur court cost expense on accounts placed in this channel prior to that date. Court cost expense in this table is calculated based on our blended court cost expense rate.

<sup>2</sup> 2008 amount consists of nine months data, from January 1, 2008, to September 30, 2008.

**Commissions by Year of Collection<sup>1</sup>**

| Placement Year    | 2003     | 2004     | 2005      | 2006      | 2007      | 2008      | Total<br>Commissions |
|-------------------|----------|----------|-----------|-----------|-----------|-----------|----------------------|
| 2003              | \$ 3,574 | \$ 8,606 | \$ 5,496  | \$ 2,898  | \$ 1,574  | \$ 721    | \$ 22,869            |
| 2004              |          | \$ 7,273 | \$ 12,060 | \$ 6,653  | \$ 3,498  | \$ 1,405  | \$ 30,889            |
| 2005              |          |          | \$ 6,725  | \$ 12,108 | \$ 6,364  | \$ 2,516  | \$ 27,713            |
| 2006              |          |          |           | \$ 11,451 | \$ 23,659 | \$ 10,200 | \$ 45,310            |
| 2007              |          |          |           |           | \$ 11,845 | \$ 18,472 | \$ 30,317            |
| 2008 <sup>2</sup> |          |          |           |           |           | \$ 7,359  | \$ 7,359             |

<sup>1</sup> Includes commissions for accounts placed in our legal channel beginning January 1, 2003. We continue to incur commissions on collections for accounts placed in this channel prior to that date.

<sup>2</sup> 2008 amount consists of nine months data, from January 1, 2008, to September 30, 2008.

**Court Cost Expense and Commissions as a % of Gross Collections  
by Year of Collection**

| Placement Year    | 2003  | 2004  | 2005  | 2006  | 2007  | 2008  | Cumulative<br>Average |
|-------------------|-------|-------|-------|-------|-------|-------|-----------------------|
| 2003              | 41.7% | 39.2% | 35.2% | 33.4% | 31.0% | 31.6% | 37.0%                 |
| 2004              |       | 41.7% | 39.8% | 35.7% | 32.4% | 32.3% | 38.1%                 |
| 2005              |       |       | 46.1% | 40.6% | 32.6% | 31.7% | 39.1%                 |
| 2006              |       |       |       | 54.9% | 41.0% | 32.6% | 42.6%                 |
| 2007              |       |       |       |       | 64.8% | 44.7% | 52.7%                 |
| 2008 <sup>1</sup> |       |       |       |       |       | 73.1% | 73.1%                 |

<sup>1</sup> 2008 amount consists of nine months data, from January 1, 2008, to September 30, 2008.

| Placement Year <sup>2</sup> | Lawsuits Filed by Year <sup>1</sup> |      |      |      |      |      | Total |
|-----------------------------|-------------------------------------|------|------|------|------|------|-------|
|                             | 2003                                | 2004 | 2005 | 2006 | 2007 | 2008 |       |
| 2003                        | 23                                  | 29   | 5    | 2    |      |      | 59    |
| 2004                        |                                     | 59   | 39   | 11   | 2    |      | 111   |
| 2005                        |                                     |      | 76   | 46   | 3    |      | 125   |
| 2006                        |                                     |      |      | 205  | 105  | 4    | 314   |
| 2007                        |                                     |      |      |      | 269  | 102  | 371   |
| 2008 <sup>3</sup>           |                                     |      |      |      |      | 235  | 235   |

<sup>1</sup> Represents the year the account was placed into litigation.

<sup>2</sup> Represents the year the account was placed into our legal channel.

<sup>3</sup> 2008 amount consists of nine months data, from January 1, 2008, to September 30, 2008.

***Changes in Investment in Receivable Portfolios***

Revenue related to our investment in receivable portfolios comprises two groups: first, revenue from those portfolios that have a remaining book value and are accounted for on the accrual basis ( Accrual Basis Portfolios ), and second, revenue from those portfolios that have fully recovered their book value Zero Basis Portfolios and, therefore, every dollar of gross collections is recorded entirely as Zero Basis Revenue. If the amount and timing of future cash collections on a pool of receivables are not reasonably estimable, we account for such portfolios on the cost recovery method ( Cost Recovery Portfolios ). No revenue is recognized on Cost Recovery Portfolios until the cost basis has been fully recovered, at which time they become Zero Basis Portfolios.

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The following tables summarize the changes in the balance of the investment in receivable portfolios and the proportion of revenue recognized as a percentage of collections (*in thousands, except percentages*):

|   | <b>For the Three Months Ended September 30, 2008</b> |                                     |                                  |                   |
|---|--|-------------------------------------|----------------------------------|-------------------|
|   | <b>Accrual Basis<br/>Portfolios</b>                  | <b>Cost Recovery<br/>Portfolios</b> | <b>Zero Basis<br/>Portfolios</b> | <b>Total</b>      |
| Balance, beginning of period                        | \$ 413,256   | \$ 1,303                            | \$                               | \$ 414,559        |
| Purchases of receivable portfolios                  | 66,107   |                                     |                                  | 66,107            |
| Gross collections <sup>1</sup>                      | (95,349)   | (89)                                | (2,259)                          | (97,697)          |
| Put-backs and recalls                               | (562)  | (1)                                 |                                  | (563)             |
| Revenue recognized                                  | 67,566   |                                     | 2,259                            | 69,825            |
| Impairment, net                                     | (7,268)  |                                     |                                  | (7,268)           |
| <b>Balance, end of period</b>                       | <b>\$ 443,750</b>                                    | <b>\$ 1,213</b>                     | <b>\$</b>                        | <b>\$ 444,963</b> |
| Revenue as a percentage of collections <sup>3</sup> | 70.9%  | 0.0%                                | 100.0%                           | 71.5%             |

|   | <b>For the Three Months Ended September 30, 2007</b> |                                     |                                  |                   |
|---|--|-------------------------------------|----------------------------------|-------------------|
|   | <b>Accrual Basis<br/>Portfolios</b>                  | <b>Cost Recovery<br/>Portfolios</b> | <b>Zero Basis<br/>Portfolios</b> | <b>Total</b>      |
| Balance, beginning of period                        | \$ 327,586   | \$                                  | \$                               | \$ 327,586        |
| Purchases of receivable portfolios                  | 47,869   |                                     |                                  | 47,869            |
| Transfer of healthcare receivables                  | (3,241)  | 3,241                               |                                  |                   |
| Gross collections <sup>1</sup>                      | (82,213)   |                                     | (3,316)                          | (85,529)          |
| Put-backs and recalls                               | (523)  |                                     |                                  | (523)             |
| Revenue recognized                                  | 59,920   |                                     | 3,316                            | 63,236            |
| Impairment, net                                     | (2,430)  |                                     |                                  | (2,430)           |
| Write-down of healthcare receivables                |  | (1,391)                             |                                  | (1,391)           |
| <b>Balance, end of period</b>                       | <b>\$ 346,968</b>                                    | <b>\$ 1,850</b>                     | <b>\$</b>                        | <b>\$ 348,818</b> |
| Revenue as a percentage of collections <sup>3</sup> | 72.9%  | 0.0%                                | 100.0%                           | 73.9%             |

|   | <b>For the Nine Months Ended September 30, 2008</b> |                                     |                                  |                   |
|---|---|-------------------------------------|----------------------------------|-------------------|
|   | <b>Accrual Basis<br/>Portfolios</b>                 | <b>Cost Recovery<br/>Portfolios</b> | <b>Zero Basis<br/>Portfolios</b> | <b>Total</b>      |
| Balance, beginning of period                        | \$ 390,564  | \$ 1,645                            | \$                               | \$ 392,209        |
| Purchases of receivable portfolios                  | 166,501   |                                     |                                  | 166,501           |
| Gross collections <sup>1</sup>                      | (296,178)   | (419)                               | (7,440)                          | (304,037)         |
| Put-backs and recalls                               | (2,597)   | (13)                                |                                  | (2,610)           |
| Revenue recognized <sup>2</sup>                     | 201,453   |                                     | 7,440                            | 208,893           |
| Impairment, net <sup>2</sup>                        | (15,993)  |                                     |                                  | (15,993)          |
| <b>Balance, end of period</b>                       | <b>\$ 443,750</b>                                   | <b>\$ 1,213</b>                     | <b>\$</b>                        | <b>\$ 444,963</b> |
| Revenue as a percentage of collections <sup>3</sup> | 68.0%   | 0.0%                                | 100.0%                           | 68.7%             |

|                                    | <b>For the Nine Months Ended September 30, 2007</b> |                                     |                                  |              |
|------------------------------------|---|-------------------------------------|----------------------------------|--------------|
|                                    | <b>Accrual Basis<br/>Portfolios</b>                 | <b>Cost Recovery<br/>Portfolios</b> | <b>Zero Basis<br/>Portfolios</b> | <b>Total</b> |
| Balance, beginning of period       | \$ 300,348  | \$                                  | \$                               | \$ 300,348   |
| Purchases of receivable portfolios | 134,392   |                                     |                                  | 134,392      |

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|   |            |          |          |            |
|---|------------|----------|----------|------------|
| Transfer of healthcare receivables                  | (3,241)    | 3,241    |          |            |
| Gross collections <sup>1</sup>                      | (256,943)  |          | (12,471) | (269,414)  |
| Put-backs and recalls                               | (2,097)    |          |          | (2,097)    |
| Revenue recognized                                  | 175,676    |          | 12,471   | 188,147    |
| Impairment, net                                     | (1,167)    |          |          | (1,167)    |
| Write-down of healthcare receivables                |            | (1,391)  |          | (1,391)    |
| Balance, end of period                              | \$ 346,968 | \$ 1,850 | \$       | \$ 348,818 |
| Revenue as a percentage of collections <sup>3</sup> | 68.4%      | 0.0%     | 100.0%   | 69.8%      |

<sup>1</sup> Does not include amounts collected on behalf of others.

<sup>2</sup> Reflects additional revenue of \$0.1 million and a lower net impairment of \$3.1 million, as a result of extending the collection curves from 72 to 84 months.

<sup>3</sup> Revenue as a percentage of collections excludes the effects of net impairment or net impairment reversals.

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As of September 30, 2008, we had \$445.0 million in investment in receivable portfolios. This balance will be amortized based upon current projections of cash collections in excess of revenue applied to the principal balance. The estimated amortization of the investment in receivable portfolio balance is as follows (*in thousands*):

| <b>For the Years Ended December 31,</b> | <b>Amortization</b> |
|---|---------------------|
| 2008 <sup>1</sup>                       | \$ 24,290           |
| 2009                                    | 139,317             |
| 2010                                    | 101,314             |
| 2011                                    | 74,378              |
| 2012                                    | 53,735              |
| 2013                                    | 33,791              |
| 2014                                    | 14,298              |
| 2015                                    | 3,840               |
| <b>Total</b>                            | <b>\$ 444,963</b>   |

<sup>1</sup> 2008 amount consists of three months data from October 1, 2008 to December 31, 2008.

**Analysis of Changes in Revenue**

The following tables analyze the components of the increase in revenue from our receivable portfolios for the three and nine months ended September 30, 2008, compared to the three and nine months ended September 30, 2007 (*in thousands, except percentages*):

| <b>For The Three Months Ended September 30,</b>       |             |             |               |                         |
|---|-------------|-------------|---------------|-------------------------|
| <b>Variance Component</b>                             | <b>2008</b> | <b>2007</b> | <b>Change</b> | <b>Revenue Variance</b> |
| Average portfolio balance                             | \$ 407,153  | \$ 331,113  | \$ 76,040     | \$ 13,761               |
| Weighted average effective interest rate <sup>1</sup> | 66.4%       | 72.4%       | (6.0)%        | \$ (6,115)              |
| Zero basis revenue                                    | \$ 2,259    | \$ 3,316    |               | \$ (1,057)              |
| Net impairment  | \$ (7,268)  | \$ (3,821)  |               | \$ (3,447)              |
| <b>Total variance</b>                                 |             |             |               | <b>\$ 3,142</b>         |

| <b>For The Nine Months Ended September 30,</b>        |             |             |               |                         |
|---|-------------|-------------|---------------|-------------------------|
| <b>Variance Component</b>                             | <b>2008</b> | <b>2007</b> | <b>Change</b> | <b>Revenue Variance</b> |
| Average portfolio balance                             | \$ 400,030  | \$ 314,481  | \$ 85,549     | \$ 47,789               |
| Weighted average effective interest rate <sup>1</sup> | 67.2%       | 74.5%       | (7.3)%        | \$ (22,012)             |
| Zero basis revenue                                    | \$ 7,440    | \$ 12,471   |               | \$ (5,031)              |
| Net impairment  | \$ (15,993) | \$ (2,558)  |               | \$ (13,435)             |
| <b>Total variance</b>                                 |             |             |               | <b>\$ 7,311</b>         |

<sup>1</sup> For accrual basis portfolios, the weighted average annualized effective interest rate is the accrual rate utilized in recognizing revenue on our accrual basis portfolios. This rate represents the monthly internal rate of return, which has been annualized utilizing the simple interest method. The monthly internal rate of return is determined based on the timing and amounts of actual cash received to date and the anticipated future cash flow projections for each pool.





**Table of Contents****Purchases by Quarter**

The following table summarizes the purchases we made by quarter, and the respective purchase prices (*in thousands*):

| Quarter              | # of<br>Accounts | Face<br>Value | Purchase<br>Price | Forward Flow<br>Allocation <sup>2</sup> |
|----------------------|------------------|---------------|-------------------|---|
| Q1 2005              | 513              | 530,047       | 19,523            |   |
| Q2 2005 <sup>1</sup> | 2,773            | 3,675,277     | 121,939           |   |
| Q3 2005              | 434              | 381,508       | 14,151            | 2,330                                   |
| Q4 2005              | 1,568            | 1,326,216     | 39,941            | 1,935                                   |
| Q1 2006              | 673              | 558,574       | 27,091            | 2,403                                   |
| Q2 2006              | 837              | 594,190       | 21,262            | 2,118                                   |
| Q3 2006              | 1,469            | 1,081,892     | 32,334            | 2,939                                   |
| Q4 2006              | 814              | 1,439,826     | 63,600            | 3,184                                   |
| Q1 2007              | 1,434            | 2,510,347     | 45,386            | 3,539                                   |
| Q2 2007              | 1,042            | 1,341,148     | 41,137            | 2,949                                   |
| Q3 2007              | 659              | 1,281,468     | 47,869            | 2,680                                   |
| Q4 2007              | 1,204            | 1,768,111     | 74,561            | 2,536                                   |
| Q1 2008              | 647              | 1,199,703     | 47,902            | 2,926                                   |
| Q2 2008              | 676              | 1,801,902     | 52,492            | 2,635                                   |
| Q3 2008              | 795              | 1,830,292     | 66,107            |   |

<sup>1</sup> Purchase price for Q2 2005 includes a \$0.9 million cost adjustment associated with the finalization of the Jefferson Capital purchase price allocation.

<sup>2</sup> Allocation of the forward flow asset to the cost basis of receivable portfolio purchases. In July 2008, we ceased forward flow purchases from Jefferson Capital Group due to a breach by Jefferson Capital and its parent, CompuCredit Corporation, of certain agreements. See Note 10 to our unaudited condensed consolidated financial statements for further information about our dispute with Jefferson Capital and CompuCredit.

**Purchases by Paper Type**

The following table summarizes the types of charged-off consumer receivable portfolios we purchased for the three and nine months ended September 30, 2008 and 2007 (*in thousands*):

|             | Three Months<br>Ended |                       | Nine Months Ended     |                       |
|-------------|-----------------------|-----------------------|-----------------------|-----------------------|
|             | September 30,<br>2008 | September 30,<br>2007 | September 30,<br>2008 | September 30,<br>2007 |
| Credit card | \$ 57,107             | \$ 40,971             | \$ 142,552            | \$ 121,232            |
| Other       | 9,000                 | 6,898                 | 23,949                | 13,160                |
|             | \$ 66,107             | \$ 47,869             | \$ 166,501            | \$ 134,392            |

**Table of Contents****Liquidity and Capital Resources****Overview**

Historically, we have met our cash requirements by utilizing our cash flows from operations, bank borrowings and equity offerings. Our primary cash requirements have included the purchase of receivable portfolios, operational expenses, the payment of interest and principal on bank borrowings and tax payments.

The following table summarizes our cash flows by category for the periods presented (*in thousands*):

|   | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|--|-------------|
|   | <b>2008</b>                                | <b>2007</b> |
| Net cash provided by operating activities | \$ 44,625                                  | \$ 2,843    |
| Net cash used in investing activities     | \$ (65,325)                                | \$ (42,999) |
| Net cash provided by financing activities | \$ 21,203                                  | \$ 33,843   |

On December 31, 2004, our Secured Financing Facility expired. All of our portfolio purchases are now funded with cash or financed under our Revolving Credit Facility. Unlike our Secured Financing Facility, the Revolving Credit Facility does not require us to share with the lender the residual collections on the portfolios financed. Effective July 3, 2008, we expanded our Revolving Credit Facility from \$230.0 million to \$335.0 million. See Note 7 to the unaudited condensed consolidated financial statements for a further discussion on our Revolving Credit Facility, Secured Financing Facility and Contingent Interest.

On May 7, 2007, we entered into an agreement with the lender under our Secured Financing Facility to eliminate all future Contingent Interest payments, for the one-time payment of \$16.9 million. As a result, beginning in May 2007, we are no longer obligated to make Contingent Interest payments under this facility. See Note 7 to the unaudited condensed consolidated financial statements for a further discussion of this one-time payment.

**Operating Cash Flows**

Net cash provided by operating activities was \$44.6 million and \$2.8 million for the nine months ended September 30, 2008 and 2007, respectively. The increase in cash provided by operating activities was primarily attributable to an increase of \$8.4 million in net income, an increase of \$13.4 million in a non-cash add back related to the net impairment of our receivable portfolios, and a decrease of \$9.9 million in prepaid income tax. The remaining change was due to adjustments in other non-cash operating activities and changes in other operating assets and liabilities.

**Investing Cash Flows**

Net cash used in investing activities was \$65.3 million for the nine months ended September 30, 2008 and \$43.0 million for the nine months ended September 30, 2007.

The cash flows used in investing activities for the nine months ended September 30, 2008, are primarily related to receivable portfolio purchases of \$160.9 million (\$166.5 million of gross purchases less our forward flow allocation of \$5.6 million), offset by gross collection proceeds applied to the principal of our receivable portfolios in the amount of \$95.1 million. The cash flows used in investing activities for the nine months ended September 30, 2007, primarily related to receivable portfolio purchases of \$125.2 million offset by gross collection proceeds applied to the principal of our receivable portfolios in the amount of \$81.3 million.

Capital expenditures for fixed assets acquired with internal cash flow were \$2.1 million and \$1.1 million for the nine months ended September 30, 2008 and 2007, respectively.

**Financing Cash Flows**

Net cash provided by financing activities was \$21.2 million and \$33.8 million for the nine months ended September 30, 2008 and 2007, respectively.

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The cash provided by financing activities during the nine months ended September 30, 2008, reflects \$57.0 million in borrowings under our Revolving Credit Facility, offset by \$32.2 million in repayments of principal, and \$3.5 million used to repurchase \$5.0 million principal amount of our outstanding convertible senior notes. The cash provided by financing activities during the nine months ended September 30, 2007, reflects \$53.0 million in borrowings, offset by \$20.0 million in repayments under our Revolving Credit Facility.

**Table of Contents****Future Contractual Cash Obligations**

The following table summarizes our future contractual cash obligations as of September 30, 2008, (*in thousands*):

|  | Total             | Payments Due by Period |                   |                 | More Than 5 Years |
|--|-------------------|------------------------|-------------------|-----------------|-------------------|
|  |                   | Less Than 1 Year       | 1 3 Years         | 3 5 Years       |                   |
| Revolving credit facility                                  | \$ 197,000        | \$                     | \$ 197,000        | \$              | \$                |
| 3.375% convertible senior notes                            | 95,000            |                        | 95,000            |                 |                   |
| Estimated interest payments <sup>1</sup>                   | 26,022            | 13,556                 | 12,466            |                 |                   |
| Accrued income taxes <sup>2</sup>                          | 3,055             | 3,055                  |                   |                 |                   |
| Purchase commitments on receivable portfolios <sup>3</sup> | 57,982            | 57,982                 |                   |                 |                   |
| Lease obligations  | 14,421            | 3,442                  | 5,531             | 3,710           | 1,738             |
| Employee agreements  | 211               | 211                    |                   |                 |                   |
| <b>Total contractual cash obligations</b>                  | <b>\$ 393,691</b> | <b>\$ 78,246</b>       | <b>\$ 309,997</b> | <b>\$ 3,710</b> | <b>\$ 1,738</b>   |

<sup>1</sup> We calculated estimated interest payments for long-term debt as follows: for the 3.375% convertible senior notes we calculated interest based on the applicable rates and payment dates. For our revolving credit facility, we calculated the interest for the hedged portion using fixed interest rates plus the required spread. For the remaining balance which is subject to a variable interest rate, we estimated interest rates based on our determination of the most likely scenario. We expect to settle such interest payments with cash flows from operating activities.

<sup>2</sup> As of September 30, 2008, the non-current portion of our income tax liability was approximately \$14.4 million, which was not included in the total above. At this time, the settlement period for the non-current portion of our income tax liability cannot be determined. In addition, any payments related to unrecognized tax benefits would be partially offset by reductions in payments in other jurisdictions. Refer to Note 8 to the unaudited consolidated financial statements for further information on our income taxes. We expect to settle cash income tax payments with cash flows from operating activities.

<sup>3</sup> Certain of these purchase commitments allow us to cancel the commitment with a 60-day notice or a one-time cancellation fee. We do not anticipate cancelling any of these commitments at this time and, as a result, have included the entire anticipated future commitment.

Our Revolving Credit Facility has a remaining term of 1.6 years and, to the extent that a balance is outstanding on our Revolving Credit Facility, it would be due in May 2010. The outstanding balance on our Revolving Credit Facility as of September 30, 2008, was \$197.0 million. Effective July 3, 2008, we expanded the capacity of our Revolving Credit Facility from \$230.0 million to \$335.0 million, which provides us with a significant amount of additional capital to fund our growth. For additional information on our debt, see Note 7 to our unaudited condensed consolidated financial statements.

We are in compliance with all covenants under our financing arrangements and, excluding the effects of the one-time payment of \$16.9 million to eliminate all future Contingent Interest payments in the second quarter of 2007 (this payment, less amounts accrued on our balance sheet, resulted in a charge of our statement of operations of \$6.9 million after the effect of income taxes), we have achieved 27 consecutive quarters of positive net income. We believe that we have sufficient liquidity to fund our operations for at least the next twelve months, given our expectation of continued positive cash flows from operations, our cash and cash equivalents of \$5.4 million as of September 30, 2008, and our expanded borrowing capacity and borrowing base availability under our Revolving Credit Facility.

**Off Balance Sheet Arrangements**

We do not have any off balance sheet arrangements as defined by Item 303(a)(4) of Regulation S-K.

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**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

For quantitative and qualitative disclosures about market risk affecting Encore, see Item 7A, Quantitative and Qualitative Disclosures About Market Risk, of our Annual Report on Form 10-K for the fiscal year ended December 31, 2007, which is incorporated herein by reference. Our exposure to market risk has not changed materially since December 31, 2007.

**Item 4. Controls and Procedures**

***Evaluation of Disclosure Controls and Procedures***

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our periodic reports filed with the Securities and Exchange Commission ( SEC ) is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC and that such information is accumulated and communicated to our management as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and management accordingly is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Based on their most recent evaluation, as of the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 ( Exchange Act ), as amended, are effective.

***Changes in Internal Control over Financial Reporting***

There was no change in our internal control over financial reporting during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings**

On October 18, 2004, Timothy W. Moser, one of our former officers, filed an action in the United States District Court for the Southern District of California against us, and certain individuals, including several of our officers and directors. On February 14, 2005, we were served with an amended complaint in this action alleging defamation, intentional interference with contractual relations, breach of contract, breach of the covenant of good faith and fair dealing, intentional and negligent infliction of emotional distress and civil conspiracy arising out of certain statements in our Registration Statement on Form S-1 originally filed in September 2003 and alleged to be included in our Registration Statement on Form S-3 originally filed in May 2004. The amended complaint seeks injunctive relief, economic and punitive damages in an unspecified amount plus an award of profits allegedly earned by the defendants and alleged co-conspirators as a result of the alleged conduct, in addition to attorney's fees and costs. On May 2, 2006, the court denied our special motion to strike pursuant to California's anti-SLAPP statute, denied in part and granted in part our motion to dismiss, denied a variety of *ex parte* motions and applications filed by the plaintiff and denied the plaintiff's motion for leave to conduct discovery or file supplemental briefing. The court granted the plaintiff 30 days in which to further amend his complaint, and on June 1, 2006, the plaintiff filed a second amended complaint in which he amended his claim for negligent infliction of emotional distress. On May 25, 2006, we filed a notice of appeal of the court's order denying the anti-SLAPP motion and on June 16, 2006, we filed a motion to stay the case pending the outcome of the appeal, which was granted. Oral argument on the appeal was heard on July 17, 2008, and on July 28, 2008, the appellate court affirmed the trial court's denial of our anti-SLAAP motion. The appellate court denied our request for a rehearing and the case has been returned to the district court where it will proceed from the point at which it was stayed. We believe the claims are without merit and intend to vigorously defend the action. Although the outcome of this matter cannot be predicted with certainty, we do not currently believe that this matter will have a material adverse effect on our consolidated financial position or results of operations.

On September 7, 2005, Mr. Moser filed a related action in the United States District Court for the Southern District of California against Triarc Companies, Inc. (Triarc), which at the time, was a significant stockholder of ours, alleging intentional interference with contractual relations and intentional infliction of emotional distress. The case arises out of the same statements made or alleged to have been made in our Registration Statements mentioned above. On January 7, 2006, Triarc was served with an amended complaint seeking injunctive relief, an order directing Triarc to issue a statement of retraction or correction of the allegedly false statements, economic and punitive damages in an unspecified amount and attorney's fees and costs. Triarc tendered the defense of this action to us, and we accepted the defense and will indemnify Triarc, pursuant to the indemnification provisions of the Registration Rights Agreements dated as of October 31, 2000 and February 21, 2002, and the Underwriting Agreements dated September 25, 2004 and January 20, 2005 to which Triarc is a party. Although the outcome of this matter cannot be predicted with certainty, we do not currently believe that this matter will have a material adverse effect on our consolidated financial position or results of operations.

Claims based on the Fair Debt Collection Practices Act (FDCPA) and comparable state statutes may result in class action lawsuits, which can be material to us due to the remedies available under these statutes, including punitive damages. A number of cases styled as class actions have been filed against us. A class has been certified in several of these cases. Several of these cases present novel issues on which there is no legal precedent. As a result, we are unable to predict the range of possible outcomes. There are a number of other lawsuits, claims and counterclaims pending or threatened against us. In general, these lawsuits, claims or counterclaims have arisen in the ordinary course of business and involve claims for actual damages arising from alleged misconduct or improper reporting of credit information by us or our employees or agents. Although litigation is inherently uncertain, based on past experience, the information currently available and the possible availability of insurance and/or indemnification in some cases, we do not believe that the currently pending and threatened litigation or claims will have a material adverse effect on our consolidated financial position or results of operations. However, future events or circumstances, currently unknown to management, will determine whether the resolution of pending or threatened litigation or claims will ultimately have a material effect on our consolidated financial position, liquidity or results of operations in any future reporting periods.

On July 15, 2008, we gave Jefferson Capital Group and its parent Company, CompuCredit Corporation, notice of breach by Jefferson Capital and CompuCredit of the Asset Purchase and Forward Flow Agreement dated June 2, 2005, as amended, as well as a related Collection Agreement dated the same date. On July 16, 2008, we initiated arbitration as a result of the breach, pursuant to the arbitration provisions of the Agreements. We assert that the litigation initiated by the Federal Trade Commission (the FTC) on June 11, 2008, wherein the FTC alleges that Jefferson Capital and CompuCredit have violated the FTC Act with deceptive marketing practices in selling credit cards, among other allegations, violates the Asset Purchase and Forward Flow Agreement and Collection Agreement. We seek an arbitral award that (i) Jefferson Capital and CompuCredit are in material breach of the Agreements, (ii) declares our obligations to purchase forward flow accounts under the Agreements is thereby excused or discharged, (iii) confirms





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our rights to cause Jefferson Capital to repurchase certain accounts previously sold to us under the Agreements, and other appropriate relief, including return of prepaid amounts relating to forward flow purchases, (iv) confirms our rights to indemnity by Jefferson Capital and CompuCredit and (v) awards compensatory damages, attorney fees, interest, arbitration costs and other appropriate relief.

We have commenced Arbitration proceedings and the Arbitrators have just been identified. We have ceased forward flow purchases of accounts from Jefferson Capital, the sale of bankrupt accounts to Jefferson Capital and participation in a balance transfer program with CompuCredit. In response to our Notice of Breach, Jefferson Capital and CompuCredit delivered its own Notice of Default to us alleging our breach of forward flow purchase, bankruptcy sale and balance transfer obligations and initiated a separate arbitration of our alleged breach of our bankruptcy sale obligations.

This matter is in the early stages of development and any impact on the recoverability of our forward flow asset, currently stated at \$10.3 million, is uncertain. Our consolidated financial statements do not include any adjustment that might result from the outcome of this uncertainty.

**Item 1A. Risk Factors**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), which we believe are subject to certain safe harbors. Many statements, other than statements of historical facts, included or incorporated into this Quarterly Report on Form 10-Q are forward-looking statements. The words believe, expect, anticipate, estimate, project, intend, plan, will, may, and other similar expressions often characterize forward-looking statements. These statements may include, but are not limited to, projections of collections, revenues, income or loss, estimates of capital expenditures, plans for future operations, products or services, and financing needs or plans, as well as assumptions relating to these matters. In particular, these statements may be found, among other places, under the Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors sections.

Although we believe that the expectations reflected in these forward-looking statements are reasonable, we caution you that these expectations or predictions may not prove to be correct or we may not achieve the financial results, savings or other benefits anticipated in the forward-looking statements. These forward-looking statements are necessarily estimates reflecting the best judgment of our senior management and involve a number of risks and uncertainties, some of which may be beyond our control or cannot be predicted or quantified, that could cause actual results to differ materially from those suggested by the forward-looking statements. Many factors, including but not limited to those set forth below, could cause our actual results, performance, achievements, or industry results to be very different from the results, performance or achievements expressed or implied by these forward-looking statements. Our business, financial condition or results of operations could also be materially and adversely affected by other factors besides those listed. These factors include, but are not limited to, the following:

Recent instability in the financial markets may affect our access to capital, our ability to purchase accounts, and the success of our collection efforts;

Our quarterly operating results may fluctuate and cause the prices of our common stock and convertible notes to decrease;

We may not be able to purchase receivables at sufficiently favorable prices or terms, or at all;

We may not be successful in acquiring and collecting on portfolios consisting of new types of receivables;

We may not be able to collect sufficient amounts on our receivable portfolios to recover our costs and fund our operations;

Collections on our receivable portfolios purchased from Jefferson Capital may be adversely affected by litigation brought against Jefferson Capital and its parent, CompuCredit, by the Federal Trade Commission and Federal Deposit Insurance Corporation;

We may purchase portfolios that contain unprofitable accounts;

The statistical model we use to project remaining cash flows from our receivable portfolios may prove to be inaccurate, which could result in reduced revenues or the recording of an impairment charge if we do not achieve the collections forecasted by our model;

We may not be successful in recovering court costs we anticipate recovering;

Our industry is highly competitive, and we may be unable to continue to compete successfully with businesses that may have greater resources than we have;

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Our failure to purchase sufficient quantities of receivable portfolios may necessitate workforce reductions, which may harm our business;

A significant portion of our portfolio purchases during any period may be concentrated with a small number of sellers;

We may be unable to meet our future liquidity requirements;

We may not be able to continue to satisfy the restrictive covenants in our debt agreements;

We use estimates in our revenue recognition and our earnings will be reduced if actual results are less than estimated;

We may incur impairment charges based on the provisions of American Institute of Certified Public Accountants Statement of Position 03-3;

Government regulation may limit our ability to recover and enforce the collection of receivables;

Failure to comply with government regulation could result in the suspension or termination of our ability to conduct business;

A significant portion of our collections relies upon our success in individual lawsuits brought against consumers and ability to collect on judgments in our favor;

We are subject to ongoing risks of litigation, including individual and class actions under consumer credit, collections, employment, securities and other laws, as well as our dispute with Jefferson Capital Group and CompuCredit Corporation;

We may make acquisitions that prove unsuccessful or strain or divert our resources;

We are dependent on our management team for the adoption and implementation of our strategies, and the loss of their services could have a material adverse effect on our business;

We may not be able to hire and retain enough sufficiently trained employees to support our operations, and/or we may experience high rates of personnel turnover;

Exposure to regulatory and economic conditions in India exposes us to risks or loss of business;

We may not be able to manage our growth effectively;

The failure of our technology and telecommunications systems could have an adverse effect on our operations;

We may not be able to successfully anticipate, invest in or adopt technological advances within our industry;

We may not be able to adequately protect the intellectual property rights upon which we rely; and

Our results of operations may be materially adversely affected if bankruptcy filings increase or if bankruptcy or other debt collection laws change.

For more information about these risks, see the discussion under Part I, Item 1A Risk Factors of our Annual Report on Form 10-K for the fiscal year ended December 31, 2007, filed with the Securities and Exchange Commission, which is incorporated herein by reference.

Forward-looking statements speak only as of the date the statements were made. We do not undertake any obligation to update or revise any forward-looking statements to reflect new information or future events, or for any other reason even if experience or future events make it clear that any expected results expressed or implied by these forward-looking statements will not be realized.

In addition, it is our policy generally not to make any specific projections as to future earnings and we do not endorse projections regarding future performance that may be made by third parties.

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**Item 6. Exhibits**

**Exhibit**

| <b>Number</b> | <b>Description</b>  |
|---------------|---|
| 10.1          | Amendment No. 8, dated as of July 3, 2008, to the Credit Agreement dated as of June 7, 2005, by and among Encore Capital Group, Inc., the lenders identified on the signature pages thereto, as Lenders, and JPMorgan Chase Bank, National Association, as Administrative Agent (incorporated by reference to Exhibit 10.1 to Form 8-K filed July 7, 2008). |
| 10.2          | Form of Restricted Stock Unit Grant Notice and Agreement (filed herewith).  |
| 18.1          | Letter from independent registered public accounting firm BDO Seidman, LLP, dated as of October 24, 2008, regarding change in presentation method of the statement of cash flows (filed herewith).  |
| 31.1          | Certification of the Principal Executive Officer pursuant to rule 13-14(a) under the Securities Exchange Act of 1934 (filed herewith).  |
| 31.2          | Certification of the Principal Financial Officer pursuant to rule 13-14(a) under the Securities Exchange Act of 1934 (filed herewith).  |
| 32.1          | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley act of 2002 (filed herewith).   |

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**ENCORE CAPITAL GROUP, INC.**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**ENCORE CAPITAL GROUP, INC.**

By: /s/ Paul Grinberg  
Paul Grinberg  
Executive Vice President,  
Chief Financial Officer and Treasurer

Date: October 28, 2008

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**EXHIBIT INDEX**

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