

PORTFOLIO RECOVERY ASSOCIATES INC

Form 10-Q

November 07, 2012

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended September 30, 2012.

.. **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: 000-50058

**Portfolio Recovery Associates, Inc.**

(Exact name of registrant as specified in its charter)

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<p><b>Delaware</b> (State or other jurisdiction of incorporation or organization)</p>	<p><b>75-3078675</b> (I.R.S. Employer Identification No.)</p>
<p><b>120 Corporate Boulevard, Norfolk, Virginia</b> (Address of principal executive offices)</p>	<p><b>23502</b> (zip code)</p>
<p><b>(888) 772-7326</b> (Registrant's telephone number, including area code)</p>	

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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, non-accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES  NO

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

<u>Class</u>	<u>Outstanding as of November 1, 2012</u>
Common Stock, \$0.01 par value	16,882,070

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**Table of Contents****Part I. FINANCIAL INFORMATION****Item 1. Financial Statements****PORTFOLIO RECOVERY ASSOCIATES, INC.****CONSOLIDATED BALANCE SHEETS****September 30, 2012 and December 31, 2011****(unaudited)****(Amounts in thousands, except per share amounts)**

	<b>September 30, 2012</b>	<b>December 31, 2011</b>
<b>Assets</b>		
Cash and cash equivalents	\$ 31,488	\$ 26,697
Finance receivables, net	973,594	926,734
Accounts receivable, net	8,417	7,862
Property and equipment, net	25,506	25,727
Goodwill	100,456	61,678
Intangible assets, net	21,167	14,596
Other assets	9,070	7,829
<b>Total assets</b>	<b>\$ 1,169,698</b>	<b>\$ 1,071,123</b>
<b>Liabilities and Equity</b>		
<b>Liabilities:</b>		
Accounts payable	\$ 10,234	\$ 7,439
Accrued expenses and other liabilities	11,197	6,076
Income taxes payable	7,359	13,109
Accrued payroll and bonuses	13,241	16,036
Net deferred tax liability	186,506	193,898
Line of credit	250,000	220,000
Long-term debt	674	1,246
<b>Total liabilities</b>	<b>479,211</b>	<b>457,804</b>
<b>Commitments and contingencies (Note 13)</b>		
Redeemable noncontrolling interest	19,998	17,831
<b>Stockholders' equity:</b>		
Preferred stock, par value \$0.01, authorized shares, 2,000, issued and outstanding shares - 0		
Common stock, par value \$0.01, 60,000 authorized shares, 16,881 issued and outstanding shares at September 30, 2012, and 17,134 issued and outstanding shares at December 31, 2011	169	171
Additional paid-in capital	149,818	167,719
Retained earnings	518,389	427,598
Accumulated other comprehensive income	2,113	

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Total stockholders' equity	670,489	595,488
Total liabilities and equity	\$ 1,169,698	\$ 1,071,123

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

**Table of Contents****PORTFOLIO RECOVERY ASSOCIATES, INC.****CONSOLIDATED INCOME STATEMENTS**

For the three and nine months ended September 30, 2012 and 2011

(unaudited)

(Amounts in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>Revenues:</b>				
Income recognized on finance receivables, net	\$ 135,754	\$ 102,875	\$ 392,566	\$ 299,152
Fee income	14,765	11,401	45,983	41,696
Total revenues	150,519	114,276	438,549	340,848
<b>Operating expenses:</b>				
Compensation and employee services	41,334	33,475	123,508	102,443
Legal collection fees	8,635	5,962	25,241	17,681
Legal collection costs	15,810	9,731	57,705	28,949
Agent fees	1,545	1,643	4,495	6,005
Outside fees and services	10,131	6,222	21,575	13,702
Communications	6,777	5,865	22,037	17,884
Rent and occupancy	1,786	1,517	5,053	4,353
Depreciation and amortization	3,623	3,223	10,833	9,755
Other operating expenses	3,820	2,808	12,027	9,161
Total operating expenses	93,461	70,446	282,474	209,933
Gain on sale of property				1,157
Income from operations	57,058	43,830	156,075	132,072
<b>Other income and (expense):</b>				
Interest income		7	8	7
Interest expense	(2,189)	(2,555)	(7,223)	(8,057)
Income before income taxes	54,869	41,282	148,860	124,022
Provision for income taxes	21,742	16,089	58,493	49,544
Net income	\$ 33,127	\$ 25,193	\$ 90,367	\$ 74,478
Adjustment for (loss)/income attributable to redeemable noncontrolling interest	(187)	(313)	(424)	277
Net income attributable to Portfolio Recovery Associates, Inc.	\$ 33,314	\$ 25,506	\$ 90,791	\$ 74,201

Net income per common share attributable to Portfolio Recovery Associates, Inc:

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Basic	\$ 1.97	\$ 1.49	\$ 5.33	\$ 4.34
Diluted	\$ 1.96	\$ 1.48	\$ 5.30	\$ 4.31
Weighted average number of shares outstanding:				
Basic	16,881	17,117	17,034	17,106
Diluted	17,022	17,228	17,140	17,218

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

Table of Contents**PORTFOLIO RECOVERY ASSOCIATES, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****For the three and nine months ended September 30, 2012 and 2011****(unaudited)****(Amounts in thousands)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Net income	\$ 33,127	\$ 25,193	\$ 90,367	\$ 74,478
Other comprehensive income:				
Foreign currency translation adjustments	1,792		2,113	
Total other comprehensive income	1,792		2,113	
Comprehensive income	34,919	25,193	92,480	74,478
Comprehensive (loss)/income attributable to noncontrolling interest	(187)	(313)	(424)	277
Comprehensive income attributable to Portfolio Recovery Associates, Inc.	\$ 35,106	\$ 25,506	\$ 92,904	\$ 74,201

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



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	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders Equity
Balance at December 31, 2011	17,134	\$ 171	\$ 167,719	\$ 427,598	\$	\$ 595,488
Components of comprehensive income:						
Net income attributable to Portfolio Recovery Associates, Inc.				90,791		90,791
Foreign currency translation adjustment					2,113	2,113
Vesting of nonvested shares	79	1	(1)			
Repurchase and cancellation of common stock	(332)	(3)	(22,723)			(22,726)
Amortization of share-based compensation			8,361			8,361
Income tax benefit from share-based compensation			1,484			1,484
Employee stock relinquished for payment of taxes			(2,170)			(2,170)
Adjustment of the noncontrolling interest measurement amount			(2,852)			(2,852)
Balance at September 30, 2012	16,881	\$ 169	\$ 149,818	\$ 518,389	\$ 2,113	\$ 670,489

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

**Table of Contents****PORTFOLIO RECOVERY ASSOCIATES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****For the nine months ended September 30, 2012 and 2011****(unaudited)****(Amounts in thousands)**

	<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 90,367	\$ 74,478
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Amortization of share-based compensation	8,361	6,110
Depreciation and amortization	10,833	9,755
Deferred tax (benefit)/expense	(7,377)	27,327
Gain on sale of property		(1,157)
<b>Changes in operating assets and liabilities:</b>		
Other assets	(353)	(953)
Accounts receivable	1,579	2,470
Accounts payable	(856)	1,921
Income taxes	(7,024)	5,014
Accrued expenses	931	2,242
Accrued payroll and bonuses	(2,799)	(4,036)
<b>Net cash provided by operating activities</b>	<b>93,662</b>	<b>123,171</b>
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment	(5,362)	(4,851)
Proceeds from sale of property		1,267
Acquisition of finance receivables, net of buybacks	(329,444)	(314,162)
Collections applied to principal on finance receivables	286,907	226,014
Business acquisition, net of cash acquired	(48,653)	
<b>Net cash used in investing activities</b>	<b>(96,552)</b>	<b>(91,732)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of options		150
Income tax benefit from share-based compensation	1,484	503
Proceeds from line of credit	160,000	27,000
Principal payments on line of credit	(130,000)	(67,000)
Repurchases of common stock	(22,726)	
Distributions paid to noncontrolling interest		(2,308)
Principal payments on long-term debt	(572)	(843)
<b>Net cash provided by/(used in) financing activities</b>	<b>8,186</b>	<b>(42,498)</b>
Effect of exchange rate on cash	(505)	

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Net increase/(decrease) in cash and cash equivalents	4,791	(11,059)
Cash and cash equivalents, beginning of period	26,697	41,094
Cash and cash equivalents, end of period	\$ 31,488	\$ 30,035
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 7,577	\$ 7,771
Cash paid for income taxes	71,521	19,058
Noncash investing and financing activities:		
Adjustment of the noncontrolling interest measurement amount	\$ (2,852)	\$ (3,175)
Distributions payable relating to noncontrolling interest	261	
Employee stock relinquished for payment of taxes	(2,170)	

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

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Portfolio Recovery Associates, Inc., a Delaware corporation, and its subsidiaries (collectively, the Company) is a specialized financial and business service company. Its primary business is the purchase, collection and management of portfolios of defaulted consumer receivables. The Company also services receivables on behalf of clients on either a commission or transaction-fee basis and provides class action claims settlement recovery services and related payment processing to corporate clients.

The consolidated financial statements of the Company are prepared in accordance with U.S. generally accepted accounting principles and include the accounts of all of its subsidiaries. All significant intercompany accounts and transactions have been eliminated. Under the guidance of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 280 Segment Reporting (ASC 280), the Company has determined that it has several operating segments that meet the aggregation criteria of ASC 280, and therefore, it has one reportable segment, accounts receivable management, based on similarities among the operating units including homogeneity of services, service delivery methods and use of technology.

With the acquisition of Mackenzie Hall Holdings Limited, a limited company organized under the laws of England and Wales, and its subsidiaries (MHH) on January 16, 2012, the Company began doing business in the United Kingdom. The assets, liabilities and operations of the Company's foreign subsidiary are recorded based on the functional currency of the entity. For MHH, the functional currency is the local currency, which is the Pound Sterling. Accordingly, the assets, liabilities and operations are translated, for consolidation purposes, from the local currency to the U.S. dollar reporting currency at period-end rates for assets and liabilities and generally at average rates for results of operations and cash flows. The resulting unrealized gains or losses are reported as a component of accumulated other comprehensive income. Realized gains and losses resulting from foreign currency transactions are recorded in Other operating expenses in the consolidated income statements.

The following table shows the amount of revenue generated for the three and nine months ended September 30, 2012 and long-lived assets held at September 30, 2012 by geographical location (amounts in thousands):

	As Of And For The Three Months Ended September 30, 2012		As Of And For The Nine Months Ended September 30, 2012	
	Revenues	Long-Lived Assets	Revenues	Long-Lived Assets
United States	\$ 145,585	\$ 23,596	\$ 424,434	\$ 23,596
United Kingdom	4,934	1,910	14,115	1,910
<b>Total</b>	<b>\$ 150,519</b>	<b>\$ 25,506</b>	<b>\$ 438,549</b>	<b>\$ 25,506</b>

Revenues are attributed to countries based on the location of the related operations and long-lived assets consist of net property and equipment. Prior to the acquisition of MHH on January 16, 2012, all revenue generated and long-lived assets held related to the Company's United States operations.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (SEC) and, therefore, do not include all information and disclosures required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of the Company, however, the accompanying unaudited consolidated financial statements contain all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the Company's consolidated balance sheet as of September 30, 2012, its consolidated income statements and statements of comprehensive income for the three and nine months ended September 30, 2012 and 2011, its consolidated statement of changes in stockholders' equity for the nine months ended September 30, 2012, and its consolidated statements of cash flows for the nine months ended September 30, 2012 and 2011. The consolidated income statements of the Company for the three and nine months ended



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**PORTFOLIO RECOVERY ASSOCIATES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

September 30, 2012 may not be indicative of future results. Certain reclassifications have been made to prior year amounts to conform to the current year presentation. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's 2011 Annual Report on Form 10-K, filed on February 28, 2012.

**2. Finance Receivables, net:**

The Company accounts for its investment in finance receivables under the guidance of ASC Topic 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality (ASC 310-30). The Company acquires portfolios of accounts that have experienced deterioration of credit quality between origination and the Company's acquisition of the accounts. The amount paid for a portfolio reflects the Company's determination that it is probable the Company will be unable to collect all amounts due according to an account's contractual terms. At acquisition, the Company reviews the accounts to determine whether there is evidence of deterioration of credit quality since origination, and if it is probable that the Company will be unable to collect all amounts due according to the loan's contractual terms. If both conditions exist, the Company then determines whether each such account is to be accounted for individually or whether such accounts will be assembled into pools based on common risk characteristics. The Company considers expected prepayments and estimates the amount and timing of undiscounted expected principal, interest and other cash flows (expected at acquisition) for each acquired portfolio based on the Company's proprietary models, and the Company subsequently aggregates portfolios of accounts into pools. The Company determines the excess of the pool's scheduled contractual principal and contractual interest payments over all cash flows expected at acquisition as an amount that should not be accreted (nonaccretable difference). The remaining amount, representing the excess of the pool's cash flows expected to be collected over the amount paid, is accreted into income recognized on finance receivables over the remaining estimated life of the pool (accretable yield). ASC 310-30 requires that the excess of the contractual cash flows over expected cash flows, based on the Company's estimates derived from its proprietary collection models, not be recognized as an adjustment of revenue or expense or on the balance sheet.

Under ASC 310-30 static pools of accounts may be established. These pools are aggregated based on certain common risk criteria. Each static pool is recorded at cost, which includes certain direct costs of acquisition paid to third parties, and is accounted for as a single unit for the recognition of income, payments applied to principal and loss provision. Once a static pool is established for a calendar quarter, individual receivable accounts are not added to the pool (unless replaced by the seller) or removed from the pool (unless sold or returned to the seller). ASC 310-30, utilizing the interest method, initially freezes the yield, estimated when the accounts are purchased as the basis for subsequent impairment testing. The yield is estimated and periodically recalculated based on the timing and amount of anticipated cash flows using the Company's proprietary collection models. Income on finance receivables is accrued quarterly based on each static pool's effective yield. Significant increases in expected future cash flows may be recognized prospectively, through an upward adjustment of the yield, over a pool's remaining life. Any increase to the yield then becomes the new benchmark for impairment testing. Under ASC 310-30, rather than lowering the estimated yield if the collection estimates are not received or projected to be received, the carrying value of a pool would be written down to maintain the then current yield and is shown as a reduction in revenue in the consolidated income statements with a corresponding valuation allowance offsetting finance receivables, net, on the consolidated balance sheets. Cash flows greater than the interest accrual will reduce the carrying value of the static pool. This reduction in carrying value is defined as payments applied to principal (also referred to as principal amortization). Likewise, cash flows that are less than the interest accrual will accrete the carrying balance. Generally, the Company does not record accretion in the first six to twelve months of the life of the pool; accordingly, the Company utilizes either the cost recovery method or cash method when necessary to prevent accretion as permitted by ASC 310-30. Under the cash method, revenue is recognized as it would be under the interest method up to the amount of cash collections. Under the cost recovery method, no revenue is recognized until the Company has fully collected the cost of

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the pool. A pool can become fully amortized (zero carrying balance on the balance sheet) while still generating cash collections. In this case, all cash collections are recognized as revenue when received. Additionally, the Company uses the cost recovery method when collections on a particular pool of accounts cannot be reasonably predicted. These cost recovery pools are not aggregated with other pools. Under the cost recovery method, no revenue is recognized until the Company has fully collected the cost of the pool, or until such time that the Company considers the collections to be probable and estimable and begins to recognize income based on the interest method as described above. At September 30, 2012 and 2011, the Company had unamortized purchased principal (purchase price) in pools accounted for under the cost recovery method of \$4.5 million and \$12.8 million, respectively; at December 31, 2011, the amount was \$7.4 million.

The Company establishes valuation allowances, if necessary, for acquired accounts subject to ASC 310-10. Valuation allowances are established only subsequent to acquisition of the accounts. At September 30, 2012 and 2011, the Company had a valuation allowance against its finance receivables of \$90.8 million and \$83.5 million, respectively; at December 31, 2011, the valuation allowance was \$86.6 million.

The Company implements the accounting for income recognized on finance receivables under ASC 310-30 as follows. The Company creates each accounting pool using its projections of estimated cash flows and expected economic life. The Company then computes the effective yield that fully amortizes the pool to the end of its expected economic life based on the current projections of estimated cash flows. As actual cash flow results are recorded, the Company balances those results to the data contained in its proprietary models to ensure accuracy, then reviews each pool watching for trends, actual performance versus projections and curve shape (a graphical depiction of the timing of cash flows), sometimes re-forecasting future cash flows utilizing the Company's statistical models. The review process is primarily performed by the Company's finance staff; however, the Company's operational and statistical staffs are also involved, providing updated statistical input and cash projections to the finance staff. To the extent there is overperformance, the Company will either increase the yield or release the allowance and consider increasing future cash projections, if persuasive evidence indicates that the overperformance is considered to be a significant betterment. If the over performance is considered more of an acceleration of cash flows (a timing difference), the Company will: a) adjust estimated future cash flows downward which effectively extends the amortization period to fall within a reasonable expectation of the pool's economic life, b) introduce some level of future cash adjustment as noted previously coupled with an increase in yield in order for the amortization period to fall within a reasonable expectation of the pool's economic life, or c) take no action at all if the amortization period falls within a reasonable expectation of the pool's expected economic life. To the extent there is underperformance, the Company will record an allowance if the underperformance is significant and will also consider revising estimated future cash flows based on current period information, or take no action if the pool's amortization period is reasonable and falls within the currently projected economic life.

Changes in finance receivables, net for the three and nine months ended September 30, 2012 and 2011 were as follows (amounts in thousands):

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Balance at beginning of period	\$ 966,508	\$ 879,515	\$ 926,734	\$ 831,330
Acquisitions of finance receivables, net of buybacks	100,063	119,256	333,402	314,162
Foreign currency translation adjustment	321		365	
Cash collections	(229,052)	(182,168)	(679,473)	(525,166)
Income recognized on finance receivables, net	135,754	102,875	392,566	299,152
Cash collections applied to principal	(93,298)	(79,293)	(286,907)	(226,014)
Balance at end of period	\$ 973,594	\$ 919,478	\$ 973,594	\$ 919,478





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At the time of acquisition, the life of each pool is generally estimated to be between 60 to 96 months based on projected amounts and timing of future cash collections using the proprietary models of the Company. Based upon current projections, cash collections applied to principal on finance receivables as of September 30, 2012 are estimated to be as follows for the twelve months in the periods ending (amounts in thousands):

September 30, 2013	\$ 352,374
September 30, 2014	273,710
September 30, 2015	204,808
September 30, 2016	105,186
September 30, 2017	37,516
	\$ 973,594

During the three and nine months ended September 30, 2012, the Company purchased approximately \$1.26 billion and \$4.24 billion, respectively, in face value of charged-off consumer receivables. During the three and nine months ended September 30, 2011, the Company purchased approximately \$5.68 billion and \$8.59 billion, respectively, in face value of charged-off consumer receivables. At September 30, 2012, the estimated remaining collections (ERC) on the receivables purchased in the three and nine months ended September 30, 2012, were \$195.7 million and \$594.8 million, respectively. At September 30, 2012, ERC on the receivables purchased in the three and nine months ended September 30, 2011, were \$195.3 million and \$468.9 million, respectively.

Accretable yield represents the amount of income recognized on finance receivables the Company can expect to generate over the remaining life of its existing portfolios based on estimated future cash flows as of the balance sheet date. Additions represent the original expected accretable yield to be earned by the Company based on its proprietary buying models. Reclassifications from nonaccretable difference to accretable yield primarily result from increases in the Company's estimates of future cash flows. Reclassifications to nonaccretable difference from accretable yield result from decreases in the Company's estimates of future cash flows and allowance charges that exceed any increases in the Company's estimates of future cash flows. Changes in accretable yield for the three and nine months ended September 30, 2012 and 2011 were as follows (amounts in thousands):

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Balance at beginning of period	\$ 1,151,653	\$ 936,490	\$ 1,026,614	\$ 892,188
Income recognized on finance receivables, net	(135,754)	(102,875)	(392,566)	(299,152)
Additions	102,997	155,680	325,165	356,848
Reclassifications from nonaccretable difference	45,182	16,519	205,997	55,930
Foreign currency translation adjustment	(104)		(1,236)	
Balance at end of period	\$ 1,163,974	\$ 1,005,814	\$ 1,163,974	\$ 1,005,814

A valuation allowance is recorded for significant decreases in expected cash flows or change in timing of cash flows which would otherwise require a reduction in the stated yield on a pool of accounts. In any given period, the Company may be required to record valuation allowances due to pools of receivables underperforming expectations. Factors that may contribute to the recording of valuation allowances may include both internal as well as external factors. External factors which may have an impact on the collectability, and subsequently to the overall profitability of purchased pools of defaulted consumer receivables would include: new laws or regulations relating to collections, new interpretations of

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existing laws or regulations, and the overall condition of the economy. Internal factors which may have an impact on the collectability, and subsequently the overall profitability of purchased pools of defaulted consumer receivables would include necessary revisions to initial and post-acquisition scoring and modeling estimates, non-optimal operational activities (which relate to the collection and movement of accounts on both the collection floor of the Company and external channels), and decreases in productivity related to turnover and tenure of the Company's collection staff.

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The following is a summary of activity within the Company's valuation allowance account, all of which relates to loans acquired with deteriorated credit quality, for the three and nine months ended September 30, 2012 and 2011 (amounts in thousands):

	Three Months Ended September 30,					
	2012			2011		
	Core Portfolio <sup>(1)</sup>	Purchased Bankruptcy Portfolio <sup>(2)</sup>	Total	Core Portfolio <sup>(1)</sup>	Purchased Bankruptcy Portfolio <sup>(2)</sup>	Total
Valuation allowance - finance receivables:						
Beginning balance	\$ 75,850	\$ 13,419	\$ 89,269	\$ 73,630	\$ 9,100	\$ 82,730
Allowance charges	1,850	945	2,795	1,400	1	1,401
Reversal of previous recorded allowance charges	(1,150)	(82)	(1,232)	(500)	(160)	(660)
Net allowance charge	700	863	1,563	900	(159)	741
Ending balance	\$ 76,550	\$ 14,282	\$ 90,832	\$ 74,530	\$ 8,941	\$ 83,471
Finance receivables, net <sup>(3)</sup> :	\$ 479,558	\$ 480,402	\$ 959,960	\$ 453,168	\$ 466,310	\$ 919,478

	Nine Months Ended September 30,					
	2012			2011		
	Core Portfolio <sup>(1)</sup>	Purchased Bankruptcy Portfolio <sup>(2)</sup>	Total	Core Portfolio <sup>(1)</sup>	Purchased Bankruptcy Portfolio <sup>(2)</sup>	Total
Valuation allowance - finance receivables:						
Beginning balance	\$ 76,580	\$ 9,991	\$ 86,571	\$ 70,030	\$ 6,377	\$ 76,407
Allowance charges	4,000	4,620	8,620	6,250	2,951	9,201
Reversal of previous recorded allowance charges	(4,030)	(329)	(4,359)	(1,750)	(387)	(2,137)
Net allowance charge	(30)	4,291	4,261	4,500	2,564	7,064
Ending balance	\$ 76,550	\$ 14,282	\$ 90,832	\$ 74,530	\$ 8,941	\$ 83,471
Finance receivables, net <sup>(3)</sup> :	\$ 479,558	\$ 480,402	\$ 959,960	\$ 453,168	\$ 466,310	\$ 919,478

(1) Core accounts or portfolios refer to accounts or portfolios that are defaulted consumer receivables and are not in a bankrupt status upon purchase. These accounts are aggregated separately from purchased bankruptcy accounts.

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- (2) Purchased bankruptcy accounts or portfolios refer to accounts or portfolios that are in bankruptcy status when purchased, and as such, are purchased as a pool of bankrupt accounts.
- (3) At September 30, 2012, the MHH finance receivables balance was \$13.6 million against which there was no valuation allowance recorded; therefore it is not included in this roll-forward.

### **3. Accounts Receivable, net:**

Accounts receivable are recorded at the invoiced amount and do not bear interest. Amounts collected on accounts receivable are included in net cash provided by operating activities in the consolidated statements of cash flows. The Company maintains an allowance for doubtful accounts for estimated losses inherent in its accounts receivable portfolio. In establishing the required allowance, management considers historical losses adjusted to take into account current market conditions and its customers' financial condition, the amount of receivables in dispute, the current receivables aging, and current payment patterns. The Company reviews its allowance for doubtful accounts monthly. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The balance of the allowance for doubtful accounts at September 30, 2012 and December 31, 2011 was \$2.3 million and \$2.1 million, respectively. The Company does not have any off balance sheet credit exposure related to its customers.

### **4. Line of Credit:**

On December 20, 2010, the Company entered into a credit agreement with Bank of America, N.A., as administrative agent, and a syndicate of lenders named therein (the Credit Agreement). Under the terms of the Credit Agreement, the credit facility includes an aggregate principal amount available of \$407.5 million (subject to the borrowing base and applicable debt covenants) that consists of a \$50 million fixed rate loan that matured on May 4, 2012, which was transferred from the Company's then existing credit agreement, and a \$357.5 million revolving credit facility that matures on December 20, 2014. The revolving credit facility automatically increased by \$50 million upon the maturity and repayment of the fixed rate loan. The fixed rate loan bore interest at a rate of 6.8% per annum, payable monthly in arrears. The revolving loans accrue interest, at the option of the Company, at either

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**PORTFOLIO RECOVERY ASSOCIATES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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the base rate plus 1.75% per annum or the Eurodollar rate (as defined in the Credit Agreement) for the applicable term plus 2.75% per annum. The base rate is the highest of (a) the Federal Funds Rate plus 0.50%, (b) Bank of America's prime rate, and (c) the Eurodollar rate plus 1.00%. Interest is payable on base rate loans quarterly in arrears and on Eurodollar loans in arrears on the last day of each interest period or, if such interest period exceeds three months, every three months. The Company's revolving credit facility includes a \$20 million swingline loan sublimit, a \$20 million letter of credit sublimit and an accordion loan feature that allows the Company to request an increase of up to \$142.5 million in the amount available for borrowing under the revolving credit facility, whether from existing or new lenders, subject to terms of the Credit Agreement. Through September 30, 2012, the Company closed a series of transactions to exercise a portion of the accordion loan feature of its existing credit facility with its administrative agent and its syndicate of lenders, thereby increasing the lenders' commitments by \$57.0 million, resulting in \$464.5 million aggregate principal amount available under the Company's line of credit. The Company's existing lenders under the Credit Agreement provided \$41.0 million of this increase, and \$16.0 million was provided by a new lender, which is now a party to the Credit Agreement. The Company may request additional increases of up to \$85.6 million under its credit facility. The Credit Agreement is secured by a first priority lien on substantially all of the Company's assets. The Credit Agreement contains restrictive covenants and events of default including the following:

borrowings may not exceed 30% of the ERC of all its domestic eligible asset pools plus 75% of its eligible accounts receivable;

the consolidated leverage ratio (as defined in the Credit Agreement) cannot exceed 2.0 to 1.0 as of the end of any fiscal quarter;

consolidated Tangible Net Worth (as defined in the Credit Agreement) must equal or exceed \$309.5 million plus 50% of positive consolidated net income for each fiscal quarter beginning December 31, 2010, plus 50% of the net proceeds of any equity offering;

capital expenditures during any fiscal year cannot exceed \$20 million;

cash dividends and distributions during any fiscal year cannot exceed \$20 million;

stock repurchases during the term of the agreement cannot exceed \$100 million;

permitted acquisitions (as defined in the Credit Agreement) during any fiscal year cannot exceed \$100 million;

the Company must maintain positive consolidated income from operations (as defined in the Credit Agreement) during any fiscal quarter; and

restrictions on changes in control.

The revolving credit facility also bears an unused commitment fee of 0.375% per annum, payable quarterly in arrears.

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The Company had \$250.0 million and \$220.0 million of borrowings outstanding under its credit facility as of September 30, 2012 and December 31, 2011, respectively, of which \$50 million represented borrowing under the non-revolving fixed rate loan at December 31, 2011. At September 30, 2012, the Company's borrowings under its revolving credit facility consisted of 30-day Eurodollar rate loans and base rate loans with a weighted average annual interest rate equal to 2.97%.

The Company was in compliance with all covenants of its credit facility as of September 30, 2012 and December 31, 2011.

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On February 6, 2009, the Company entered into a commercial loan agreement to finance computer software and equipment purchases in the amount of approximately \$2.0 million. The loan was collateralized by the related computer software and equipment. The loan was a three year loan with a fixed rate of 4.78% with monthly installments, including interest, of \$60,823 beginning on June 30, 2009, and it matured on February 28, 2012.

On December 15, 2010, the Company entered into a commercial loan agreement to finance computer software and equipment purchases in the amount of approximately \$1.6 million. The loan is collateralized by the related computer software and equipment. The loan is a three year loan with a fixed rate of 3.69% with monthly installments, including interest, of \$46,108 beginning on January 15, 2011, and it matures on December 15, 2013.

**6. Property and Equipment, net:**

Property and equipment, at cost, consisted of the following as of the dates indicated (amounts in thousands):

	September 30, 2012	December 31, 2011
Software	\$ 29,004	\$ 25,252
Computer equipment	13,728	12,221
Furniture and fixtures	6,924	6,501
Equipment	8,268	7,798
Leasehold improvements	6,833	6,117
Building and improvements	7,014	6,987
Land	1,269	1,269
Accumulated depreciation and amortization	(47,534)	(40,418)
<b>Property and equipment, net</b>	<b>\$ 25,506</b>	<b>\$ 25,727</b>

Depreciation and amortization expense relating to property and equipment, for the three and nine months ended September 30, 2012, was \$2.2 million and \$6.5 million, respectively. Depreciation and amortization expense relating to property and equipment, for the three and nine months ended September 30, 2011, was \$2.1 million and \$6.0 million, respectively.

The Company, in accordance with the guidance of FASB ASC Topic 350-40 Internal-Use Software (ASC 350-40), capitalizes qualifying computer software costs incurred during the application development stage and amortizes them over their estimated useful life of three to seven years on a straight-line basis beginning when the project is completed. Costs associated with preliminary project stage activities, training, maintenance and all other post implementation stage activities are expensed as incurred. The Company's policy provides for the capitalization of certain direct payroll costs for employees who are directly associated with internal use computer software projects, as well as external direct costs of services associated with developing or obtaining internal use software. Capitalizable personnel costs are limited to the time directly spent on such projects. As of September 30, 2012 and December 31, 2011, the Company has incurred and capitalized approximately \$7.2 million and \$6.1 million, respectively, of these direct payroll costs and external direct costs related to software developed for internal use. Of these costs, at September 30, 2012 and December 31, 2011, approximately \$0.8 million and \$1.3 million, respectively, is for projects that were in the development stage and, therefore are a component of Other Assets. Once the projects are completed, the costs are transferred to Software and amortized over their estimated useful life of three to seven years. Amortization expense for the three and nine months ended September 30, 2012, was approximately \$0.3 million and \$0.9 million, respectively. Amortization expense for the three and nine months ended September 30, 2011, was approximately \$0.2 million and \$0.6 million, respectively. The remaining unamortized costs relating to internally developed software

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at September 30, 2012 and December 31, 2011 were approximately \$4.0 million and \$3.3 million, respectively.



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In accordance with ASC 810, the Company has consolidated all financial statement accounts of Claims Compensation Bureau, LLC ( CCB ) in its consolidated balance sheets and its consolidated income statements. The redeemable noncontrolling interest amount is separately stated on the consolidated balance sheets and represents the 38% interest in CCB not owned by the Company. In addition, net income/loss attributable to the noncontrolling interest is stated separately in the consolidated income statements.

The Company has the right through February 28, 2015 to purchase the remaining 38% of CCB at certain multiples of earnings before interest, taxes, depreciation and amortization ( EBITDA ). In addition, beginning March 1, 2012 and ending February 28, 2018, the noncontrolling interest can require the Company to purchase its membership units in CCB at pre-defined multiples of EBITDA.

The Company applies the provisions of FASB ASC Topic 480-10-S99 Distinguishing Liabilities from Equity ( ASC 480-10-S99 ), which provides guidance on the accounting for equity securities that are subject to mandatory redemption requirements or whose redemption is outside the control of the issuer. The noncontrolling interest put arrangement is accounted for under ASC 480-10-S99, as redemption under the put arrangement is outside the control of the Company. As such, the redeemable noncontrolling interest is recorded outside of permanent equity. The Company measures the redeemable noncontrolling interest at the greater of its ASC 480-10-S99 measurement amount (estimated redemption value of the put option embedded in the noncontrolling interest) or its measurement amount under the guidance of ASC 810. The ASC 810 measurement amount includes adjustments for the noncontrolling interest's pro-rata share of earnings, losses and distributions, pursuant to the limited liability company agreement of CCB. Adjustments to the measurement amount are recorded to stockholders' equity. The Company used a present value calculation to estimate the redemption value of the put option as of the reporting date. As such, for the three and nine months ended September 30, 2012, the Company increased the redeemable noncontrolling interest by \$0.8 million and \$2.8 million, respectively, with a corresponding reduction of stockholders' equity. For the three and nine months ended September 30, 2011, the Company increased the redeemable noncontrolling interest by \$1.1 million and \$3.2 million, respectively, with a corresponding reduction of stockholders' equity. If material, the Company adjusts the numerator of earnings per share calculations for the current period change in the excess of the noncontrolling interest's ASC 480-10-S99 measurement amount over the greater of its ASC 810 measurement amount or the estimated fair value of the noncontrolling interest. The maximum estimated redemption value of the noncontrolling interest under the terms of the put arrangement, was \$22.8 million as of September 30, 2012 and December 31, 2011.

The following table represents the changes in the redeemable noncontrolling interest for the three and nine months ended September 30, 2012 and 2011 (amounts in thousands):

	<b>Three Months Ended September 30, 2012</b>	<b>Three Months Ended September 30, 2011</b>	<b>Nine Months Ended September 30, 2012</b>	<b>Nine Months Ended September 30, 2011</b>
Balance at beginning of period	\$ 19,381	\$ 16,068	\$ 17,831	\$ 14,449
Net (loss)/income attributable to redeemable noncontrolling interest	(187)	(313)	(424)	277
Distributions paid or payable			(261)	(1,017)
Adjustment of the noncontrolling interest measurement amount	804	1,129	2,852	3,175
Balance at end of period	\$ 19,998	\$ 16,884	\$ 19,998	\$ 16,884

In accordance with the limited liability company agreement of CCB, distributions due to the members of CCB are accrued each quarter and are payable as soon as reasonably possible subsequent to each quarter end.



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In connection with the Company's previous business acquisitions, the Company purchased certain tangible and intangible assets. Intangible assets purchased included client and customer relationships, non-compete agreements, trademarks and goodwill. Pursuant to ASC 350, goodwill is not amortized but rather is reviewed at least annually for impairment. During the fourth quarter of 2011, the Company underwent its annual review of goodwill. Based upon the results of this review, which was conducted as of October 1, 2011, no impairment charges to goodwill or the other intangible assets were necessary as of the date of this review. The Company believes that nothing has occurred since the review was performed through September 30, 2012 that would indicate a triggering event and thereby necessitate testing goodwill or the other intangible assets between annual tests. Accordingly, there were no impairment losses during the three or nine months ended September 30, 2012 and 2011. The Company expects to perform its next annual goodwill review during the fourth quarter of 2012. At September 30, 2012 and December 31, 2011, the carrying value of goodwill was \$100.5 million and \$61.7 million, respectively. Refer to Note 9 Business Acquisitions for more information. The following table represents the changes in goodwill for the three and nine months ended September 30, 2012 and 2011 (amounts in thousands):

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Balance at beginning of period	\$ 99,384	\$ 61,678	\$ 61,678	\$ 61,678
Acquisition of MHH			34,270	
Adjustment to provisional amount	(549)		2,511	
Foreign currency translation adjustment	1,621		1,997	
Balance at end of period	\$ 100,456	\$ 61,678	\$ 100,456	\$ 61,678

Intangible assets, excluding goodwill, consist of the following at September 30, 2012 and December 31, 2011 (amounts in thousands):

	September 30, 2012		December 31, 2011	
	Gross Amount	Accumulated Amortization	Gross Amount	Accumulated Amortization
Client and customer relationships	\$ 40,134	\$ 21,337	\$ 30,777	\$ 17,950
Non-compete agreements	3,747	3,374	3,103	2,771
Trademarks	3,469	1,472	2,500	1,063
Total	\$ 47,350	\$ 26,183	\$ 36,380	\$ 21,784

Increases in the gross amounts of intangible assets during the nine months ended September 30, 2012 relate to the purchase of MHH on January 16, 2012. The combined original weighted average amortization period related to the acquired intangible assets of MHH is approximately 13 years. In accordance with ASC 350, the Company is amortizing the intangible assets over the estimated useful lives as indicated:

Acquisition Date	Customer Relationships	Non-Compete Agreements	Trademarks
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MHH	January 16, 2012	15 years	1 year	3 years
Total intangible amortization expense for the three and nine months ended September 30, 2012 was \$1.5 million and \$4.4 million, respectively.				
Total intangible amortization expense for the three and nine months ended September 30, 2011 was \$1.2 million and \$3.7 million, respectively.				
The Company reviews intangible assets at least annually for impairment.				

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On January 16, 2012, the Company acquired 100% of the equity interest in MHH. The transaction was completed in cash at a price of £33.5 million (approximately \$51.3 million). The Company financed the acquisition with borrowings under its existing line of credit. Based in Kilmarnock, Scotland, MHH employs approximately 250 people and offers outsourced and contingent consumer debt recovery on behalf of banks, credit providers and debt purchasers, as well as distressed and dormant niche portfolio purchasing. The acquisition of MHH expands the Company's presence into new geographical markets outside the United States, further diversifying its revenues and available service offerings.

The Company accounted for this purchase in accordance with ASC Topic 805, Business Combinations. Under this guidance, an entity is required to recognize the assets acquired, liabilities assumed and the consideration given at their fair value on the acquisition date. The following tables summarize the fair value of the consideration given for MHH, as well as the preliminary fair value of the assets acquired and liabilities assumed related to the acquisition.

Recognized amounts of identifiable assets and liabilities are as follows (amounts in thousands):

Purchase price	\$ 51,258
Cash	(2,605)
Finance receivables, net	(3,906)
Accounts receivable	(2,038)
Prepaid expenses (included in other assets)	(330)
Customer relationships	(8,875)
Non-compete agreements	(612)
Trademarks	(918)
Property and equipment	(814)
Accounts payable	3,500
Accrued expenses	912
Income tax payable	1,209
Goodwill	 \$ 36,781

The Company is evaluating the purchase price allocations and at the time of the filing of this Form 10-Q, the valuation has not been completed. However, the Company has recorded provisional amounts for the assets acquired in its consolidated financial statements and will adjust the allocations relative to the fair value of the assets, if necessary, during the remainder of the one-year measurement period.

**10. Share-Based Compensation:**

The Company follows the provisions of FASB ASC Topic 718 Compensation-Stock Compensation (ASC 718) with respect to its stock plan. As of September 30, 2012, total future compensation costs related to nonvested awards of nonvested shares (not including nonvested shares granted under the Long-Term Incentive Programs (LTI)) is estimated to be \$4.0 million with a weighted average remaining life for all nonvested shares of 2.0 years (not including nonvested shares granted under the LTI Programs). As of September 30, 2012, there are no future compensation costs related to stock options and there are no remaining vested stock options to be exercised.

Total share-based compensation expense was approximately \$2.8 million and \$8.4 million for the three and nine months ended September 30, 2012, respectively. Total share-based compensation expense was approximately \$1.5 million and \$6.1 million for the three and nine months ended September 30, 2011, respectively. Tax benefits resulting from tax deductions in excess of share-based compensation expense recognized

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under the provisions of ASC 718 (windfall tax benefits) are credited to additional paid-in capital in the Company's Consolidated Balance Sheets. Realized tax shortfalls, if any, are first offset against the cumulative balance of windfall tax benefits, if any,

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and then charged directly to income tax expense. The total tax benefit realized from share-based compensation was approximately \$0.2 million and \$3.0 million for the three and nine months ended September 30, 2012, respectively. The total tax benefit realized from share-based compensation was approximately \$0.1 million and \$1.6 million for the three and nine months ended September 30, 2011, respectively.

***Nonvested Shares***

With the exception of the awards made pursuant to the LTI Programs and a few employee and director grants, the nonvested shares generally vest ratably over three to five years and are expensed over their vesting period. These grants were made to key employees and directors of the Company and, therefore, were assumed to have no forfeiture rates associated with them due to the historically low turnover among this group.

The following summarizes all nonvested share transactions (excluding shares granted under the LTI Programs) from December 31, 2010 through September 30, 2012 (amounts in thousands, except per share amounts):

	Nonvested Shares Outstanding	Weighted-Average Price at Grant Date
December 31, 2010	91	\$ 47.89
Granted	48	76.59
Vested	(53)	55.97
Cancelled	(5)	50.34
December 31, 2011	81	59.31
Granted	49	63.18
Vested	(31)	59.75
September 30, 2012	99	\$ 61.08

The total grant date fair value of shares vested during the three and nine months ended September 30, 2012 was approximately \$0.2 million and \$1.8 million, respectively. The total grant date fair value of shares vested during the three and nine months ended September 30, 2011 was approximately \$0.2 million and \$2.8 million, respectively.

***Long-Term Incentive Programs***

Pursuant to the Company's stock plan, on January 14, 2010 and 2011 and January 9, 2012, the Compensation Committee approved the grant of 53,656, 73,914 and 65,647 performance and market based nonvested shares, respectively. All shares granted under the LTI Programs were granted to key employees of the Company. The 2009 grant was performance based and cliff vested after the requisite service period if certain financial goals were met. The goals were based upon diluted earnings per share (EPS) totals for 2009, the return on stockholders' equity for the three year period beginning on January 1, 2009 and ending December 31, 2011, and the relative total stockholder return as compared to a peer group for the same three year period. The Company expensed the nonvested share grant over the requisite service period of two to three years beginning on January 1, 2009. The EPS component of the 2009 plan was not achieved and therefore no compensation expense was recognized relative to this component. The return on owners' equity and relative total stockholder return components have been achieved at 98% and 145%, respectively, and the awards were paid to participants during the first quarter of 2012.

The 2010 grant is performance based and cliff vests after the requisite service period of two to three years if certain financial goals are met. The goals are based upon diluted EPS totals for 2010, the return on stockholders' equity for the three year period beginning on January 1, 2010 and ending December 31, 2012, and the relative total stockholder return as compared to a peer group for the same three year period. For each

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component, the number of shares vested can double if the financial goals are exceeded and no shares will vest if the financial goals are not met. The EPS component of the 2010 plan was achieved at 190% and these shares vested at 50% on December 31, 2011



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and the remaining 50% will vest on December 31, 2012. The Company is expensing the nonvested share grant over the requisite service period of two to three years beginning on January 1, 2010. If the Company believes that the number of shares granted will be more or less than originally projected, an adjustment to the expense will be made at that time based on the probable outcome.

The 2011 grant is performance based and cliff vests after the requisite service period of two to three years if certain financial goals are met. The goals are based upon the Company's EBITDA for 2011, the return on stockholders' equity for the three year period beginning on January 1, 2011 and ending December 31, 2013, and the relative total stockholder return as compared to a peer group for the same three year period. For each component, the number of shares vested can double if the financial goals are exceeded and no shares will vest if the financial goals are not met. The Company is expensing the nonvested share grant over the requisite service period of two to three years beginning on January 1, 2011. If the Company believes that the number of shares granted will be more or less than originally projected, an adjustment to the expense will be made at that time based on the probable outcome. The EBITDA component of the 2011 plan was achieved at 200% and these shares will vest 50% on December 31, 2012 and 50% on December 31, 2013.

The 2012 grant is performance based and cliff vests after the requisite service period of two to three years if certain financial goals are met. The goals are based upon the Company's EBITDA for 2012, the return on stockholders' equity for the three year period beginning on January 1, 2012 and ending December 31, 2014, and the relative total stockholder return as compared to a peer group for the same three year period. For each component, the number of shares vested can double if the financial goals are exceeded and no shares will vest if the financial goals are not met. The Company is expensing the nonvested share grant over the requisite service period of two to three years beginning on January 1, 2012. If the Company believes that the number of shares granted will be more or less than originally projected, an adjustment to the expense will be made at that time based on the probable outcome.

At September 30, 2012, total future compensation costs, assuming the current estimated levels are achieved, related to nonvested share awards granted under the 2010, 2011 and 2012 LTI Programs are estimated to be approximately \$8.6 million. The Company assumed a 7.5% forfeiture rate for this grant and the remaining shares have a weighted average life of 1.29 years at September 30, 2012.

**11. Income Taxes:**

The Company follows the guidance of FASB ASC Topic 740 Income Taxes (ASC 740) as it relates to the provision for income taxes and uncertainty in income taxes. The guidance prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. There were no unrecognized tax benefits at both September 30, 2012 and 2011.

The IRS examined the Company's tax returns for the 2005 calendar year. The IRS concluded the audit and on March 19, 2009 issued Form 4549-A, Income Tax Examination Changes, for tax years ended December 31, 2007, 2006 and 2005. The IRS has asserted that cost recovery for tax revenue recognition does not clearly reflect taxable income and that unused line fees paid on credit facilities should be capitalized and amortized rather than taken as a current deduction. The Company believes it has sufficient support for the technical merits of its positions and that it is more likely than not these positions will ultimately be sustained; therefore, a reserve for uncertain tax positions is not necessary. On April 22, 2009, the Company filed a formal protest of the findings contained in the examination report prepared by the IRS. On August 26, 2011, the IRS issued a Notice of Deficiency for the tax years ended December 31, 2007, 2006, and 2005. The Company subsequently filed a petition in United States Tax Court to which the IRS responded on January 12, 2012. If the Company is unsuccessful in United States Tax Court, it can appeal to the federal Circuit Court of Appeals. Payment of the assessed taxes and interest could have an adverse affect on the Company's financial condition, be material to the Company's results of operations, and possibly require additional financing from other sources. In accordance with the U.S. Internal Revenue Code of 1986, as amended (the Internal Revenue Code), underpayments of federal tax accrue interest, compounded daily, at the applicable federal short term rate plus three percentage points. An additional two percentage points applies to large



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corporate underpayments of \$100,000 or more to periods after the applicable date as defined in the Internal Revenue Code. The Company files taxes in multiple state jurisdictions; therefore, any underpayment of state tax will accrue interest in accordance with the respective state statute. In 2011, the IRS expanded the audit to include the tax years ended December 31, 2010, 2009 and 2008.

At September 30, 2012, the tax years subject to examination by the major taxing jurisdictions, including the IRS, are 2003, 2005 and subsequent years. The 2003 tax year remains open to examination because of a net operating loss that originated in that year but was not fully utilized until the 2005 tax year. The examination periods for the 2007, 2006 and 2005 tax years were extended through December 31, 2011; however, because the IRS issued the Notice of Deficiency for those tax periods prior to December 31, 2011, the period for assessment is suspended until a decision of the Tax Court becomes final. The examination period for the 2008 tax year has been extended through April 20, 2013.

ASC 740 requires the recognition of interest if the tax law would require interest to be paid on the underpayment of taxes, and recognition of penalties if a tax position does not meet the minimum statutory threshold to avoid payment of penalties. No interest or penalties were accrued or reversed in the three or nine month periods ended September 30, 2012 or 2011.

**12. Earnings per Share:**

Basic EPS are computed by dividing net income available to common stockholders of Portfolio Recovery Associates, Inc. by weighted average common shares outstanding. Diluted EPS are computed using the same components as basic EPS with the denominator adjusted for the dilutive effect of stock options and nonvested share awards. Share-based awards that are contingent upon the attainment of performance goals are not included in the computation of diluted EPS until the performance goals have been attained. The dilutive effect of stock options and nonvested shares is computed using the treasury stock method, which assumes any proceeds that could be obtained upon the exercise of stock options and vesting of nonvested shares would be used to purchase common shares at the average market price for the period. The assumed proceeds include the windfall tax benefit that would be received upon assumed exercise. The following tables provide reconciliation between the computation of basic EPS and diluted EPS for the three and nine months ended September 30, 2012 and 2011 (amounts in thousands, except per share amounts):

	For the Three Months Ended September 30, 2012		For the Three Months Ended September 30, 2011		EPS	
	Net Income attributable to Portfolio Recovery Associates, Inc.	Weighted Average Common Shares	Net Income attributable to Portfolio Recovery Associates, Inc.	Weighted Average Common Shares		
Basic EPS	\$ 33,314	16,881	\$ 1.97	\$ 25,506	17,117	\$ 1.49
Dilutive effect of nonvested share awards		141			111	
Diluted EPS	\$ 33,314	17,022	\$ 1.96	\$ 25,506	17,228	\$ 1.48

	For the Nine Months Ended September 30, 2012		For the Nine Months Ended September 30, 2011		EPS	
	Net Income attributable to Portfolio Recovery Associates, Inc.	Weighted Average Common Shares	Net Income attributable to Portfolio Recovery Associates, Inc.	Weighted Average Common Shares		
Basic EPS	\$ 90,791	17,034	\$ 5.33	\$ 74,201	17,106	\$ 4.34
Dilutive effect of nonvested share awards		106			112	

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Diluted EPS	\$ 90,791	17,140	\$ 5.30	\$ 74,201	17,218	\$ 4.31
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There were no antidilutive options outstanding for the three or nine months ended September 30, 2012 and 2011.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**13. Commitments and Contingencies:**

*Employment Agreements:*

The Company has employment agreements, most of which expire on December 31, 2014, with all of its executive officers and with several members of its senior management group. Such agreements provide for base salary payments as well as bonuses which are based on the attainment of specific management goals. Future compensation under these agreements is approximately \$13.3 million. The agreements also contain confidentiality and non-compete provisions.

*Leases:*

The Company is party to various operating leases with respect to its facilities and equipment. The future minimum lease payments at September 30, 2012 is approximately \$22.0 million.

*Forward Flow Agreements:*

The Company is party to several forward flow agreements that allow for the purchase of defaulted consumer receivables at pre-established prices. The maximum remaining amount to be purchased under forward flow agreements at September 30, 2012 is approximately \$166.3 million.

*Redeemable Noncontrolling Interest:*

In connection with the Company's acquisition of 62% of the membership units of CCB on March 15, 2010, the Company acquired the right through February 28, 2015 to purchase, at a predetermined price, the remaining 38% of the membership units of CCB not held by the Company. Also, the owners of the noncontrolling interest can require the Company to purchase their respective interest during the period beginning on March 1, 2012 and ending on February 28, 2018. While the actual amount or timing of any future payment is unknown at this time, the maximum amount of consideration to be paid for the 38% interest is \$22.8 million.

*Finance Receivables:*

Certain agreements for the purchase of finance receivables portfolios contain provisions that may, in limited circumstances, require the Company to refund a portion or all of the collections subsequently received by the Company on particular accounts. The potential refunds as of the balance sheet date are not considered to be significant.

*Litigation:*

The Company is from time to time subject to routine legal claims and proceedings, most of which are incidental to the ordinary course of its business. The Company initiates lawsuits against customers and is occasionally countersued by them in such actions. Also, customers, either individually, as members of a class action, or through a governmental entity on behalf of customers, may initiate litigation against the Company in which they allege that the Company has violated a state or federal law in the process of collecting on an account. From time to time, other types of lawsuits are brought against the Company. Additionally, the Company receives subpoenas and other requests for information from regulators or governmental authorities who are investigating the Company's debt collection activities. The Company makes every effort to respond appropriately to such requests. From time to time, other types of lawsuits are brought against the Company.

The Company accrues for potential liability arising from legal proceedings when it is probable that such liability has been incurred and the amount of the loss can be reasonably estimated. This determination is based upon currently available information for those proceedings in which the Company is involved, taking into account the Company's best estimate of such losses for those cases for which such estimates can be made. The Company's estimate involves significant judgment, given the varying stages of the proceedings (including the fact that many of them are

currently in preliminary stages), the number of unresolved issues in many of the proceedings (including

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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issues regarding class certification and the scope of many of the claims), and the related uncertainty of the potential outcomes of these proceedings. In making determinations of the likely outcome of pending litigation, the Company considers many factors, including, but not limited to, the nature of the claims, the Company's experience with similar types of claims, the jurisdiction in which the matter is filed, input from outside legal counsel, the likelihood of resolving the matter through alternative mechanisms, the matter's current status and the damages sought or demands made. Accordingly, the Company's estimate will change from time to time, and actual losses may be more than the current estimate.

Subject to the inherent uncertainties involved in such proceedings, the Company believes, based upon its current knowledge and after consultation with counsel, that the legal proceedings currently pending against it, including those that fall outside of the Company's routine legal proceedings, should not, either individually or in the aggregate, have a material adverse impact on the Company's financial condition. However, it is possible, in light of the uncertainties involved in such proceedings or due to unexpected future developments, that an unfavorable resolution of a legal proceeding or claim could occur which may be material to the Company's financial condition, results of operations, or cash flows for a particular period.

Excluding the matters described below and other putative class action suits which the Company believes are not material, the high end of the range of potential litigation losses in excess of the amount accrued is estimated by management to be less than \$1,000,000 as of September 30, 2012. Notwithstanding our attempt to estimate a range of possible losses in excess of the amount accrued based on current information, actual future losses may exceed both the Company's accrual and the range of potential litigation losses disclosed above.

In certain legal proceedings, the Company may have recourse to insurance or third party contractual indemnities to cover all or portions of its litigation expenses, judgments, or settlements. Loss estimates and accruals for potential liability related to legal proceedings are exclusive of potential recoveries, if any, under the Company's insurance policies or third party indemnities. The Company has not recorded any potential recoveries under the Company's insurance policies or third party indemnities.

The matters described below fall outside of the normal parameters of the Company's routine legal proceedings.

*Telephone Consumer Protection Act Litigation*

As previously disclosed, the Company has been named as defendant in a number of putative class action cases, each alleging that the Company violated the Telephone Consumer Protection Act ( TCPA ) by calling consumers' cellular telephones without their prior express consent. On December 21, 2011, the United States Judicial Panel on Multi-District Litigation entered an order transferring these matters into one consolidated proceeding in the United States District Court for the Southern District of California. On June 22, 2012, the putative class plaintiffs filed their consolidated complaint in the matter, now styled as *In re Portfolio Recovery Associates, LLC Telephone Consumer Protection Act Litigation*, case No. 11-md-02295 ( MDL action ). The Company filed a motion to dismiss the consolidated complaint. On October 9, 2012, the plaintiffs filed a motion requesting leave to file an amended consolidated complaint. A hearing on both motions is scheduled for November 26, 2012.

On October 12, 2012, the United States Court of Appeals for the Ninth Circuit, affirmed the decision of the United States District Court for the Southern District of California in the matter of *Meyer v. Portfolio Recovery Associates, LLC*, Case No. 11-cv-01008, which imposed a preliminary injunction prohibiting the Company from using its Avaya Proactive Contact Dialer to place calls to cellular telephones with California area codes that were obtained through skip-tracing. On October 26, 2012, the Company filed a petition seeking a rehearing *en banc* before the United States Court of Appeals for the Ninth Circuit. *Meyer* is one of the cases included in the MDL action listed above. Both *Meyer* and the MDL action are ongoing and no final determination on the merits in either has been made.

**Table of Contents****PORTFOLIO RECOVERY ASSOCIATES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)***Internal Revenue Service Audit*

The U.S. Internal Revenue Service (the "IRS") examined the Company's tax returns for the 2005 calendar year. The IRS concluded the audit and on March 19, 2009 issued Form 4549-A, Income Tax Examination Changes, for tax years ended December 31, 2007, 2006 and 2005. The IRS has asserted that cost recovery for tax revenue recognition does not clearly reflect taxable income and that unused line fees paid on credit facilities should be capitalized and amortized rather than taken as a current deduction. The Company believes it has sufficient support for the technical merits of its positions and that it is more likely than not these positions will ultimately be sustained; therefore, a reserve for uncertain tax positions is not necessary. On April 22, 2009, the Company filed a formal protest of the findings contained in the examination report prepared by the IRS. On August 26, 2011, the IRS issued a Notice of Deficiency for the tax years ended December 31, 2007, 2006, and 2005. The Company subsequently filed a petition in United States Tax Court to which the IRS responded on January 12, 2012. If the Company is unsuccessful in tax court, it can appeal to the federal Circuit Court of Appeals. Refer to Note 11 "Income Taxes" for additional information.

**14. Fair Value Measurements and Disclosures:**

In accordance with the disclosure requirements of FASB ASC Topic 825, "Financial Instruments" (ASC 825), the table below summarizes fair value estimates for the Company's financial instruments. The total of the fair value calculations presented does not represent, and should not be construed to represent, the underlying value of the Company. The carrying amounts in the table are recorded in the consolidated balance sheet under the indicated captions (amounts in thousands):

	September 30, 2012		December 31, 2011	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Financial assets:</b>				
Cash and cash equivalents	\$ 31,488	\$ 31,488	\$ 26,697	\$ 26,697
Finance receivables, net	973,594	1,602,245	926,734	1,269,277
<b>Financial liabilities:</b>				
Line of credit	\$ 250,000	\$ 250,000	\$ 220,000	\$ 220,000
Long-term debt	674	674	1,246	1,246

As of September 30, 2012, and December 31, 2011, the Company did not account for any financial assets or financial liabilities at fair value. As defined by FASB ASC Topic 820, "Fair Value Measurements and Disclosures" (ASC 820), fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 also requires the consideration of differing levels of inputs in the determination of fair values. Those levels of input are summarized as follows:

Level 1 Quoted prices in active markets for identical assets and liabilities.

Level 2 Observable inputs other than Level 1 quoted prices, such as quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.



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Level 3 Unobservable inputs that are supported by little or no market activity. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques as well as instruments for which the determination of fair value requires significant management judgment or estimation.

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The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

Disclosure of the estimated fair values of financial instruments often requires the use of estimates. The Company uses the following methods and assumptions to estimate the fair value of financial instruments:

**Cash and cash equivalents:** The carrying amount approximates fair value and quoted prices for identical assets can be found in active markets. Accordingly, the Company estimates the fair value of cash and cash equivalents using level 1 inputs.

**Finance receivables, net:** The Company records purchased receivables at cost, which represents a significant discount from the contractual receivable balances due. The Company computed the estimated fair value of these receivables using proprietary pricing models that the Company utilizes to make portfolio purchase decisions. Accordingly, the Company's fair value estimates use level 3 inputs as there is little observable market data available and management is required to use significant judgment in its estimates.

**Line of credit:** The carrying amount approximates fair value due to the short-term nature of the interest rate periods and the observable quoted prices for similar instruments in active markets. Accordingly, the Company uses level 2 inputs for its fair value estimates.

**Long-term debt:** The carrying amount approximates fair value, as the interest rates approximate the rate currently offered to the Company for similar debt instruments of comparable maturities by the Company's bankers. Accordingly, the Company uses level 2 inputs for its fair value estimates.

**15. Stockholders' Equity:**

On February 2, 2012, the Board of Directors of the Company authorized a share repurchase program of up to \$100 million of the Company's outstanding shares of common stock. The program is administered by a special committee of the Company's Board of Directors. Repurchases would depend on prevailing market conditions and other factors. The repurchase program may be suspended or discontinued at any time. During the first nine months of 2012, the Company repurchased and retired 331,449 shares at an average price of \$68.56 (including acquisition costs).

**16. Recent Accounting Pronouncements:**

In May 2011, the FASB issued ASU No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS. The amendments in ASU 2011-04 generally represent clarification of Topic 820, but also include instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. This update results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. generally accepted accounting principles and International Financial Reporting Standards. The provisions of ASU 2011-04 are effective prospectively for interim and annual periods beginning after December 15, 2011. Early adoption is prohibited. The Company adopted ASU 2011-04 on January 1, 2012, and has included the required disclosures in its notes to its consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income (Topic 220) to amend its accounting guidance on the presentation of other comprehensive income (OCI) in an entity's financial statements. The amended guidance eliminates the option to present the components of OCI as part of the statement of changes in stockholders' equity and provides two options for presenting OCI: in a statement included in the statements of comprehensive income or in a separate statement immediately following the statements of comprehensive income. The amendments do not change the guidance for the items that have to be reported in OCI or when an item of OCI has to be moved into net income. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15,

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2011. The Company adopted ASU 2011-05 on January 1, 2012, and has included the required disclosures in its consolidated financial statements.

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In September 2011, the FASB issued ASU 2011-08, *Intangibles-Goodwill and Other (Topic 350): Testing Goodwill for Impairment* to amend the accounting guidance on goodwill impairment testing. The amended guidance reduces the complexity and costs of goodwill impairment testing by allowing an entity the option to make a qualitative evaluation about the likelihood of goodwill impairment to determine whether it should calculate the fair value of a reporting unit. The amended guidance also improves previous guidance by expanding upon the examples of events and circumstances that an entity should consider between annual impairment tests in determining whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. The amendments are effective for interim and annual goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted. The Company adopted ASU 2011-08 on January 1, 2012 which had no material impact on its consolidated financial statements.

In July 2012, the FASB issued ASU 2012-02, *Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment* to amend the accounting guidance on intangible asset impairment testing. The ASU permits entities to perform an optional qualitative assessment for determining whether it is more likely than not that an indefinite-lived intangible asset is impaired. The guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. The Company is evaluating the impact of the ASU; however, it is not expected to have a significant impact on its consolidated financial statements.

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations  
Cautionary Statements Pursuant to Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995:**

This report contains forward-looking statements within the meaning of the federal securities laws. These forward-looking statements involve risks, uncertainties and assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. All statements, other than statements of historical fact, are forward-looking statements, including statements regarding overall trends, gross margin trends, operating cost trends, liquidity and capital needs and other statements of expectations, beliefs, future plans and strategies, anticipated events or trends, and similar expressions concerning matters that are not historical facts. The risks, uncertainties and assumptions referred to above may include the following:

a prolonged economic recovery or a deterioration in the economic or inflationary environment in the United States or the United Kingdom, including the interest rate environment, that may have an adverse effect on our collections, results of operations, revenue and stock price or on the stability of the financial system as a whole;

our ability to purchase defaulted consumer receivables at appropriate prices;

our ability to replace our defaulted consumer receivables with additional receivables portfolios;

our ability to obtain accurate and authentic account documents relating to accounts that we acquire and the possibility that documents that we provide could contain errors;

our ability to successfully acquire receivables of new asset types;

changes in the business practices of credit originators in terms of selling defaulted consumer receivables;

changes in government regulations that affect our ability to collect sufficient amounts on our defaulted consumer receivables;

changes in or interpretation of tax laws or adverse results of tax audits;

changes in bankruptcy or collection laws that could negatively affect our business, including by causing an increase in certain types of bankruptcy filings involving liquidations, which may cause our collections to decrease;