

PORTFOLIO RECOVERY ASSOCIATES INC

Form 10-Q

October 30, 2006

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

FORM 10-Q

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

For the quarterly period ended September 30, 2006

**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)

Delaware

75-3078675

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

120 Corporate Boulevard, Norfolk, Virginia

23502

(Address of principal executive offices)

(zip code)

(888) 772-7326

(Registrant's telephone number, including area code)

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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.

| Class                          | Outstanding as of October 20, 2006 |
|--------------------------------|------------------------------------|
| Common Stock, \$0.01 par value | 15,921,482                         |

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**PORTFOLIO RECOVERY ASSOCIATES, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
**September 30, 2006 and December 31, 2005**  
**(unaudited)**

|  | <b>September 30,<br/>2006</b> | <b>December 31,<br/>2005</b> |
|--|-------------------------------|------------------------------|
| <b>Assets</b>  |                               |                              |
| Cash and cash equivalents  | \$ 26,661,564                 | \$ 15,984,855                |
| Finance receivables, net   | 211,763,470                   | 193,644,670                  |
| Property and equipment, net  | 7,729,693                     | 7,186,418                    |
| Income tax receivable  | 661,688                       |                              |
| Goodwill   | 18,287,511                    | 18,287,511                   |
| Intangible assets, net   | 7,321,177                     | 9,022,666                    |
| Other assets   | 2,845,491                     | 3,646,126                    |
| <br>   |                               |                              |
| Total assets   | \$ 275,270,594                | \$ 247,772,246               |
| <br><b>Liabilities and Stockholders Equity</b>   |                               |                              |
| Liabilities:   |                               |                              |
| Accounts payable   | \$ 2,763,306                  | \$ 2,332,685                 |
| Accrued expenses   | 2,639,252                     | 2,239,267                    |
| Income taxes payable   |                               | 3,054,883                    |
| Accrued payroll and bonuses  | 6,091,177                     | 5,942,618                    |
| Deferred tax liability   | 28,970,753                    | 22,345,995                   |
| Revolving lines of credit  |                               | 15,000,000                   |
| Long-term debt   | 806,498                       | 1,151,965                    |
| Obligations under capital lease  | 276,251                       | 382,658                      |
| <br>   |                               |                              |
| Total liabilities  | 41,547,237                    | 52,450,071                   |
| <br>Commitments and contingencies (Note 10)  |                               |                              |
| Stockholders equity:   |                               |                              |
| Preferred stock, par value \$0.01, authorized shares, 2,000,000, issued and outstanding shares - 0   |                               |                              |
| Common stock, par value \$0.01, authorized shares, 30,000,000, issued and outstanding shares - 15,921,482 at September 30, 2006, and 15,767,443 at December 31, 2005 | 159,215                       | 157,674                      |
| Additional paid in capital   | 113,387,363                   | 108,063,899                  |
| Retained earnings  | 120,176,779                   | 87,100,602                   |
| <br>   |                               |                              |
| Total stockholders equity  | 233,723,357                   | 195,322,175                  |
| <br>   |                               |                              |
| Total liabilities and stockholders equity  | \$ 275,270,594                | \$ 247,772,246               |

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

**PORTFOLIO RECOVERY ASSOCIATES, INC.**  
**CONSOLIDATED INCOME STATEMENTS**  
**For the Three and Nine Months Ended September 30, 2006 and 2005**  
**(unaudited)**

|  | <b>Three Months Ended<br/>September 30,</b> |               | <b>Nine Months Ended<br/>September 30,</b> |                |
|--|---|---------------|--|----------------|
|  | <b>2006</b>                                 | <b>2005</b>   | <b>2006</b>                                | <b>2005</b>    |
| <b>Revenues:</b>   |   |               |  |                |
| Income recognized on finance receivables                     | \$ 41,760,421                               | \$ 33,987,480 | \$ 121,527,560                             | \$ 100,060,121 |
| Commissions  | 6,076,231                                   | 3,517,617     | 17,835,053                                 | 9,139,288      |
| <br>   |   |               |  |                |
| Total revenue  | 47,836,652                                  | 37,505,097    | 139,362,613                                | 109,199,409    |
| <br><b>Operating expenses:</b>                               |   |               |  |                |
| Compensation and employee services                           | 14,550,391                                  | 11,215,665    | 42,981,680                                 | 32,491,172     |
| Outside legal and other fees and services                    | 10,582,130                                  | 7,417,463     | 29,382,631                                 | 22,153,943     |
| Communications   | 1,474,423                                   | 1,115,603     | 4,392,290                                  | 3,213,324      |
| Rent and occupancy   | 573,241                                     | 554,675       | 1,693,448                                  | 1,543,004      |
| Other operating expenses                                     | 1,212,134                                   | 833,815       | 3,493,562                                  | 2,315,722      |
| Depreciation and amortization                                | 1,278,500                                   | 1,288,649     | 3,770,940                                  | 3,268,654      |
| <br>   |   |               |  |                |
| Total operating expenses                                     | 29,670,819                                  | 22,425,870    | 85,714,551                                 | 64,985,819     |
| <br>   |   |               |  |                |
| Income from operations                                       | 18,165,833                                  | 15,079,227    | 53,648,062                                 | 44,213,590     |
| <br><b>Other income and (expense):</b>                       |   |               |  |                |
| Interest income  | 170,812                                     | 188,220       | 414,672                                    | 475,680        |
| Interest expense   | (66,036)                                    | (59,001)      | (308,733)                                  | (185,816)      |
| <br>   |   |               |  |                |
| Income before income taxes                                   | 18,270,609                                  | 15,208,446    | 53,754,001                                 | 44,503,454     |
| <br>   |   |               |  |                |
| Provision for income taxes                                   | 7,027,110                                   | 5,866,624     | 20,677,824                                 | 17,180,104     |
| <br>   |   |               |  |                |
| Net income   | \$ 11,243,499                               | \$ 9,341,822  | \$ 33,076,177                              | \$ 27,323,350  |
| <br><b>Net income per common share</b>                       |   |               |  |                |
| Basic  | \$ 0.71                                     | \$ 0.60       | \$ 2.08                                    | \$ 1.75        |
| Diluted  | \$ 0.70                                     | \$ 0.58       | \$ 2.06                                    | \$ 1.69        |
| <br><b>Weighted average number of shares<br/>outstanding</b> |   |               |  |                |
| Basic  | 15,915,495                                  | 15,692,417    | 15,894,548                                 | 15,607,596     |
| Diluted  | 16,071,292                                  | 16,172,657    | 16,073,860                                 | 16,132,869     |

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

**PORTFOLIO RECOVERY ASSOCIATES, INC.**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY**  
**For the Nine Months Ended September 30, 2006**  
**(unaudited)**

|   | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid in<br/>Capital</b> | <b>Retained<br/>Earnings</b> | <b>Total<br/>Stockholders<br/>Equity</b> |
|---|-------------------------|---|------------------------------|--|
| Balance at December 31, 2005  | \$ 157,674              | \$ 108,063,899                            | \$ 87,100,602                | \$ 195,322,175                           |
| Net income  |                         |   | 33,076,177                   | 33,076,177                               |
| Exercise of stock options, warrants and vesting of restricted shares        | 1,541                   | 1,688,205                                 |                              | 1,689,746                                |
| Amortization of stock-based compensation                                    |                         | 1,543,670                                 |                              | 1,543,670                                |
| FAS123R adoption reclass of payroll liability to additional paid in capital |                         | 426,752                                   |                              | 426,752                                  |
| Income tax benefit from share based compensation                            |                         | 1,664,837                                 |                              | 1,664,837                                |
| Balance at September 30, 2006   | \$ 159,215              | \$ 113,387,363                            | \$ 120,176,779               | \$ 233,723,357                           |

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



**PORTFOLIO RECOVERY ASSOCIATES, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**For the Nine Months Ended September 30, 2006 and 2005**  
**(unaudited)**

|   | <b>Nine Months<br/>Ended<br/>September 30,<br/>2006</b> | <b>Nine Months<br/>Ended<br/>September 30,<br/>2005</b> |
|---|---|---|
| Operating activities:   |   |   |
| Net income  | \$ 33,076,177   | \$ 27,323,350   |
| Adjustments to reconcile net income to cash provided by operating activities: |   |   |
| Amortization of stock based compensation                                      | 1,543,670   | 718,942   |
| Income tax benefit from share based compensation                              |   | 1,788,148   |
| Depreciation and amortization   | 3,770,940   | 3,268,654   |
| Deferred tax expense  | 6,624,758   | 8,213,785   |
| Changes in operating assets and liabilities:                                  |   |   |
| Other assets  | 800,635   | 1,742,935   |
| Accounts payable  | 430,621   | 313,433   |
| Income taxes  | (3,716,571)   | 3,303,538   |
| Accrued expenses  | 399,985   | 241,765   |
| Accrued payroll and bonuses   | 575,311   | 1,059,141   |
| <br>Net cash provided by operating activities                                 | <br>43,505,526  | <br>47,973,691  |
| <br>Cash flows from investing activities:                                     |   |   |
| Purchases of property and equipment   | (2,612,726)   | (3,074,499)   |
| Acquisition of finance receivables, net of buybacks                           | (74,203,321)  | (56,133,504)  |
| Collections applied to principal on finance receivables                       | 56,084,521  | 44,075,939  |
| Acquisition of RDS, net of acquisition costs and cash received                |   | (14,983,332)  |
| Purchase of auction rate certificates and variable rate demand notes          |   | (84,475,000)  |
| Sale of auction rate certificates and variable rate demand notes              |   | 108,425,000   |
| <br>Net cash used in investing activities                                     | <br>(20,731,526)  | <br>(6,165,396)   |
| <br>Cash flows from financing activities:                                     |   |   |
| Proceeds from exercise of options and warrants                                | 1,689,746   | 1,880,981   |
| Income tax benefit from share based compensation                              | 1,664,837   |   |
| Payments on lines of credit   | (15,000,000)  |   |
| Payments on long-term debt  | (345,467)   | (655,091)   |
| Payments on capital lease obligations   | (106,407)   | (148,492)   |
| <br>Net cash (used in) provided by financing activities                       | <br>(12,097,291)  | <br>1,077,398   |

|  |               |               |
|--|---------------|---------------|
| Net increase in cash and cash equivalents      | 10,676,709    | 42,885,693    |
| Cash and cash equivalents, beginning of period | 15,984,855    | 24,512,575    |
| Cash and cash equivalents, end of period       | \$ 26,661,564 | \$ 67,398,268 |

Noncash investing and financing activities:

|   |            |              |
|---|------------|--------------|
| FAS123R adoption reclass of payroll liability to additional paid in capital | \$ 426,752 | \$           |
| Acquisition of RDS Common stock issued                                      | \$         | \$ 1,443,763 |

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

**PORTFOLIO RECOVERY ASSOCIATES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

**1. Organization and Business:**

Portfolio Recovery Associates, LLC ( PRA ) was formed on March 20, 1996. Portfolio Recovery Associates, Inc. ( PRA Inc ) was formed in August 2002. On November 8, 2002, PRA Inc completed its initial public offering ( IPO ) of common stock. As a result, all of the membership units and warrants of PRA were exchanged on a one to one basis for warrants and shares of a single class of common stock of PRA Inc. PRA Inc owns all outstanding membership units of PRA, PRA Holding I, LLC ( PRA Holding I ), PRA Receivables Management, LLC (d/b/a Anchor Receivables Management) ( Anchor ), PRA Location Services, LLC (d/b/a IGS Nevada) ( IGS ) and PRA Government Services, LLC (d/b/a Alatax and RDS) ( RDS ). One of PRA Inc 's wholly owned subsidiaries, Thomas West Associates, LLC ( TWA ), was dissolved as an entity on May 8, 2006. PRA Inc, a Delaware corporation, and its subsidiaries (collectively, the Company ) are full-service providers of outsourced receivables management and related services. The Company is engaged in the business of purchasing, managing and collecting portfolios of defaulted consumer receivables as well as offering a broad range of accounts receivable management services. The majority of the Company 's business activities involve the purchase, management and collection of defaulted consumer receivables. These are purchased from sellers of finance receivables and collected by a highly skilled staff whose purpose is to locate and contact customers and arrange payment or resolution of their debts. The Company, through its Legal Recovery Department, collects accounts judicially, either by using its own attorneys, or by contracting with independent attorneys throughout the country through whom the Company takes legal action to satisfy consumer debts. The Company also services receivables on behalf of clients on either a commission or transaction-fee basis. Clients include entities in the financial services, auto, retail, utility, health care and government sectors. Services provided to these clients include standard collection services on delinquent accounts, obtaining location information for clients in support of their collection activities (known as skip tracing), and the management of both delinquent and non-delinquent tax receivables for government entities.

The consolidated financial statements of the Company include the accounts of PRA Inc, PRA, PRA Holding I, Anchor, IGS and RDS.

The accompanying unaudited 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 and, therefore, do not include all information and footnotes 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 balance sheet as of September 30, 2006, its income statements for the three and nine month periods ended September 30, 2006 and 2005, its statements of changes in stockholders ' equity for the nine month period ended September 30, 2006 and its statements of cash flows for the nine month periods ended September 30, 2006 and 2005, respectively. The income statements of the Company for the three and nine month periods ended September 30, 2006 and 2005 may not be indicative of future results. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company 's Annual Report on Form 10-K, as filed for the year ended December 31, 2005.

**2. Finance Receivables, net:**

The Company 's principal business consists of the acquisition and collection of accounts that have experienced deterioration of credit quality between origination and the Company 's acquisition of the accounts. The amount paid for an account reflects the Company 's determination that it is probable the Company will be unable to collect all amounts due according to the account 's contractual terms. At acquisition, the Company reviews each account 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 account 's contractual terms. If both conditions exist, the Company 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 for each acquired

portfolio and subsequently aggregated pools of accounts.

**PORTFOLIO RECOVERY ASSOCIATES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

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) based on the Company's proprietary acquisition models. The remaining amount, representing the excess of the account's cash flows expected to be collected over the amount paid, is accreted into income recognized on finance receivables over the remaining life of the account or pool (accretable yield).

Prior to January 1, 2005, the Company accounted for its investment in finance receivables using the interest method under the guidance of Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans. Effective January 1, 2005, the Company adopted and began to account for its investment in finance receivables using the interest method under the guidance of American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 03-3, Accounting for Loans or Certain Securities Acquired in a Transfer. For loans acquired in fiscal years beginning prior to December 15, 2004, Practice Bulletin 6 is still effective; however, Practice Bulletin 6 was amended by SOP 03-3 as described further in this note. For loans acquired in fiscal years beginning after December 15, 2004, SOP 03-3 is effective. Under the guidance of SOP 03-3 (and the amended Practice Bulletin 6), static pools of accounts are 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, principal payments and loss provision. Once a static pool is established for a 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). SOP 03-3 (and the amended Practice Bulletin 6) requires that the excess of the contractual cash flows over expected cash flows not be recognized as an adjustment of revenue or expense or on the balance sheet. The SOP initially freezes the internal rate of return, referred to as IRR, estimated when the accounts receivable are purchased as the basis for subsequent impairment testing. Significant increases in actual, or expected future cash flows may be recognized prospectively through an upward adjustment of the IRR over a portfolio's remaining life. Any increase to the IRR then becomes the new benchmark for impairment testing. Effective for fiscal years beginning after December 15, 2004 under SOP 03-3 (and the amended Practice Bulletin 6), rather than lowering the estimated IRR 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 IRR and is shown as a reduction in revenue in the consolidated income statements with a corresponding valuation allowance offsetting the finance receivables, net, on the balance sheet. Income on finance receivables is accrued quarterly based on each static pool's effective IRR. Quarterly cash flows greater than the interest accrual will reduce the carrying value of the static pool. Likewise, cash flows that are less than the accrual will accrete the carrying balance. The IRR is estimated and periodically recalculated based on the timing and amount of anticipated cash flows using the Company's proprietary collection models. 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 pools are not aggregated with other portfolios. Under the cost recovery method, no revenue is recognized until the Company has fully collected the cost of the portfolio, 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, 2006 and 2005, the Company had unamortized purchased principal (purchase price) in pools accounted for under the cost recovery method of \$1,429,416 and \$1,656,746, respectively.

The Company establishes valuation allowances for all acquired accounts subject to SOP 03-3 to reflect only those losses incurred after acquisition (that is, the present value of cash flows initially expected at acquisition that are no longer expected to be collected). Valuation allowances are established only subsequent to acquisition of the accounts. At September 30, 2006 and 2005, the Company had an allowance against its finance receivables of \$850,000 and \$0, respectively. Prior to January 1, 2005, in the event that a reduction of the yield to as low as zero in conjunction with estimated future cash collections that were inadequate to amortize the carrying balance, an allowance charge would be taken with a corresponding write-off of the receivable balance.



**PORTFOLIO RECOVERY ASSOCIATES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

The Company capitalizes certain fees paid to third parties related to the direct acquisition of a portfolio of accounts. These fees are added to the acquisition cost of the portfolio and accordingly are amortized over the life of the portfolio using the interest method. The balance of the unamortized capitalized fees at September 30, 2006 and 2005 was \$1,222,051 and \$998,192, respectively. During the three and nine months ended September 30, 2006 the Company capitalized \$130,398 and \$593,855, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2005 the Company capitalized \$228,150 and \$353,730, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2006 the Company amortized \$116,358 and \$399,873, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2005 the Company amortized \$138,193 and \$454,054, respectively, of these direct acquisition fees.

The agreements to purchase the aforementioned receivables include general representations and warranties from the sellers covering account holder death or bankruptcy and accounts settled or disputed prior to sale. The representation and warranty period permitting the return of these accounts from the Company to the seller is typically 90 to 180 days. Any funds received from the seller of finance receivables as a return of purchase price are referred to as buybacks. Buyback funds are simply applied against the finance receivable balance received and are not included in the Company's cash collections from operations. In some cases, the seller will replace the returned accounts with new accounts in lieu of returning the purchase price. In that case, the old account is removed from the pool and the new account is added.

As of September 30, 2006 and 2005, the Company had \$211,763,470 and \$117,246,471, respectively, remaining of finance receivables. Changes in finance receivables for the three and nine months ended September 30, 2006 and 2005 were as follows:

|  | <b>Three Months Ended</b> |                | <b>Nine Months Ended</b> |                |
|--|---------------------------|----------------|--------------------------|----------------|
|  | <b>September 30,</b>      |                | <b>September 30,</b>     |                |
|  | <b>2006</b>               | <b>2005</b>    | <b>2006</b>              | <b>2005</b>    |
| Balance at beginning of period                       | \$ 197,437,703            | \$ 114,837,794 | \$ 193,644,670           | \$ 105,188,906 |
| Acquisitions of finance receivables, net of buybacks | 32,249,112                | 15,916,690     | 74,203,321               | 56,133,504     |
| Cash collections                                     | (59,683,766)              | (47,495,493)   | (177,612,081)            | (144,136,060)  |
| Income recognized on finance receivables             | 41,760,421                | 33,987,480     | 121,527,560              | 100,060,121    |
| Cash collections applied to principal                | (17,923,345)              | (13,508,013)   | (56,084,521)             | (44,075,939)   |
| Balance at end of period                             | \$ 211,763,470            | \$ 117,246,471 | \$ 211,763,470           | \$ 117,246,471 |

As of September 30, 2006 the Company had \$211,763,470 in finance receivables. Based upon current projections, cash collections applied to principal are estimated to be as follows for the twelve months in the periods ending:

|                    |               |
|--------------------|---------------|
| September 30, 2007 | \$ 60,416,801 |
| September 30, 2008 | 50,296,729    |
| September 30, 2009 | 35,766,478    |
| September 30, 2010 | 29,462,760    |
| September 30, 2011 | 25,881,540    |
| September 30, 2012 | 9,916,887     |

September 30, 2013

22,275

\$ 211,763,470



**PORTFOLIO RECOVERY ASSOCIATES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

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 September 30, 2006 and 2005. Reclassifications from nonaccretable difference to accretable yield primarily result from the Company's increase in its estimate of future cash flows. Changes in accretable yield for the three and nine months ended September 30, 2006 and 2005 were as follows:

|   | <b>Three Months Ended</b> |                | <b>Nine Months Ended</b> |                |
|---|---------------------------|----------------|--------------------------|----------------|
|   | <b>September 30,</b>      |                | <b>September 30,</b>     |                |
|   | <b>2006</b>               | <b>2005</b>    | <b>2006</b>              | <b>2005</b>    |
| Balance at beginning of period                  | \$ 309,144,275            | \$ 224,453,203 | \$ 299,280,328           | \$ 202,841,339 |
| Income recognized on finance receivables        | (41,760,421)              | (33,987,480)   | (121,527,560)            | (100,060,121)  |
| Additions                                       | 42,156,860                | 20,054,019     | 91,190,556               | 60,482,154     |
| Reclassifications from nonaccretable difference | 11,887,947                | 22,268,147     | 52,485,337               | 69,524,517     |
| Balance at end of period                        | \$ 321,428,661            | \$ 232,787,889 | \$ 321,428,661           | \$ 232,787,889 |

During the three and nine months ended September 30, 2006, the Company recorded \$275,000 and \$650,000 in allowance charges on three pools that had recently underperformed expectations. There was no allowance charge during the three and nine months ended September 30, 2005. The change in the valuation allowance for the three and nine months ended September 30, 2006 is as follows:

|   | <b>Three Months Ended</b> | <b>Nine Months Ended</b>  |
|---|---------------------------|---------------------------|
|   | <b>September 30, 2006</b> | <b>September 30, 2006</b> |
| Balance at beginning of period                    | \$ 575,000                | \$ 200,000                |
| Allowance charges recorded                        | 275,000                   | 650,000                   |
| Reversal of previously recorded allowance charges |                           |                           |
| Change in allowance charge                        | 275,000                   | 650,000                   |
| Balance at end of period                          | \$ 850,000                | \$ 850,000                |

During the three and nine months ended September 30, 2006, the Company purchased \$1.19 billion and \$6.73 billion of face value of charged-off consumer receivables. During the three and nine months ended September 30, 2005, the Company purchased \$445.3 million and \$2.47 billion of face value of charged-off consumer receivables. At September 30, 2006, the estimated remaining collections on the receivables purchased in the three and nine months ended September 30, 2006 were \$73,548,376 and \$149,818,363, respectively. At September 30, 2006, the estimated remaining collections on the receivables purchased in the three and nine months ended September 30, 2005 were \$28,113,362 and \$79,385,100, respectively.

**3. Investments:**

The Company accounts for its investments under the guidance of SFAS 115, Accounting for Certain Investments in Debt and Equity Securities. The Company typically invests in variable rate auction rate certificates and variable rate demand notes which it classifies as available-for-sale securities. At September 30, 2006 and 2005, the Company did not have any investments on the Balance Sheet; however, it did purchase investments during the three and nine months ended September 30, 2005. No investments were purchased during 2006. These securities are recorded at cost, which approximates fair market value due to their variable interest rates, which typically reset every 7 to 35 days, and, despite the long term nature of their stated contractual maturities, the Company has the ability to quickly liquidate these investments. As a result, the Company had no cumulative gross unrealized holding gains (losses) or gross realized gains (losses) from these investments and all income generated was recorded as interest income. The Company may continue to invest in these types of securities within a given reporting period.

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**4. Revolving Lines of Credit:**

The Company maintained a \$25.0 million revolving line of credit pursuant to an agreement, which was entered into with RBC Centura Bank on November 28, 2003 and amended on November 22, 2004. This facility was terminated on November 28, 2005. The credit facility bore interest at a spread of 2.50% over LIBOR and extended through November 28, 2006. The agreement called for:

restrictions on monthly borrowings are limited to 20% of estimated remaining collections;

a debt coverage ratio of at least 8.0 to 1.0, calculated on a rolling twelve-month average;

a debt to tangible net worth ratio of less than 0.40 to 1.00;

net income per quarter of at least \$1.00, calculated on a consolidated basis; and

restrictions on change of control.

This facility had no amounts outstanding during 2005 through the time of its termination.

On November 29, 2005, the Company entered into a Loan and Security Agreement for a revolving line of credit jointly offered by Bank of America, N. A. and Wachovia Bank, National Association. This agreement was amended on May 9, 2006, to include RBC Centura Bank as an additional lender. The agreement is a revolving line of credit in an amount equal to the lesser of \$75,000,000 or 20% of the Company's estimated remaining collections of all its eligible asset pools. Borrowings under the new revolving credit facility will bear interest at a floating rate equal to the LIBOR Market Index Rate plus 1.75% and expires on November 29, 2008. The loan is collateralized by substantially all the tangible and intangible assets of the Company. The agreement provides for:

restrictions on monthly borrowings are limited to 20% of estimated remaining collections;

a funded debt to EBITDA ratio of less than 1.0 to 1.0 calculated on a rolling twelve-month average;

tangible net worth of at least 100% of prior quarter tangible net worth plus 25% of cumulative positive net income since the end of such fiscal quarter, plus 100% of the net proceeds from any equity offering; and

restrictions on change of control.

This facility had no amounts outstanding at September 30, 2006. As of September 30, 2006, the Company is in compliance with all of the covenants of this agreement.

**5. Long-Term Debt:**

In July 2000, the Company purchased a building in Hutchinson, Kansas. The building was financed with a commercial loan for \$550,000 with a variable interest rate based on LIBOR. This commercial loan was collateralized by the real estate in Kansas. Monthly principal payments on the loan were \$4,583 for an amortized term of 10 years. A balloon payment of \$275,000 was made on July 21, 2005 to pay this loan in full.

On February 9, 2001, the Company purchased a generator for its Norfolk location. The generator was financed with a commercial loan for \$107,000 with a fixed rate of 7.9%. This commercial loan was collateralized by the generator. Monthly payments on the loan were \$2,170 and the loan matured on February 1, 2006. The loan was paid in full at its maturity date of February 1, 2006.

On February 20, 2002, the Company completed the construction of a satellite parking lot at its Norfolk location. The parking lot was financed with a commercial loan for \$500,000 with a fixed rate of 6.47%. The loan is collateralized by the parking lot. The loan required only interest payments during the first six months. Beginning October 1, 2002, monthly payments on the loan are \$9,797 and the loan matures on September 1, 2007.

On May 1, 2003, the Company secured financing for its computer equipment purchases related to the Hampton, Virginia office opening. The computer equipment was financed with a commercial loan for \$975,000

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with a fixed rate of 4.25%. This loan is collateralized by computer equipment. Monthly payments are \$18,096 and the loan matures on May 1, 2008.

On January 9, 2004, the Company entered into a commercial loan agreement in the amount of \$750,000 to finance equipment purchases at its newly leased Norfolk facility. This loan bears interest at a fixed rate of 4.45% and is collateralized by the purchased equipment. Monthly payments are \$13,975 and the loan matures on January 1, 2009.

The three outstanding loans are collateralized by the related asset and are subject to the following covenants: net worth greater than \$20,000,000, and;

a cash flow coverage ratio of at least 1.5 to 1 calculated on a rolling twelve-month average.

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

Property and equipment, at cost, consist of the following as of the dates indicated:

|                               | <b>September 30,<br/>2006</b> | <b>December<br/>31,<br/>2005</b> |
|-------------------------------|-------------------------------|----------------------------------|
| Software                      | \$ 4,791,875                  | \$ 3,253,454                     |
| Computer equipment            | 4,159,707                     | 3,626,353                        |
| Furniture and fixtures        | 2,418,360                     | 2,182,388                        |
| Equipment                     | 2,995,103                     | 2,743,966                        |
| Leasehold improvements        | 1,683,003                     | 1,644,566                        |
| Building and improvements     | 1,718,195                     | 1,714,353                        |
| Land                          | 156,200                       | 150,922                          |
| Less accumulated depreciation | (10,192,750)                  | (8,129,584)                      |
| Property and equipment, net   | \$ 7,729,693                  | \$ 7,186,418                     |

Depreciation expense for the three and nine months ended September 30, 2006 was \$711,337 and \$2,069,451. Depreciation expense for the three and nine months ended September 30, 2005 was \$637,095 and \$1,727,384.

Beginning in July 2006 upon initiation of certain internally developed software projects, in accordance with the provisions of SOP 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, the Company began capitalizing qualifying computer software costs incurred during the application development stage and amortizing them over their estimated useful life of three 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, 2006, the Company has incurred and capitalized \$74,091 of these direct payroll costs related to software developed for internal use. These costs are for projects that are in the development stage and therefore are a component of Other Assets. Once the projects are completed the costs will be transferred to Software and amortized over their estimated useful life of three to five years.

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**7. Intangible Assets, net:**

With the acquisition of IGS on October 1, 2004 and RDS on July 29, 2005, the Company purchased certain tangible and intangible assets. Intangible assets purchased included client and customer relationships, non-compete agreements and goodwill. In accordance with the Financial Accounting Standards Board ( FASB ) Statement of Financial Accounting Standard No. 142, Goodwill and Other Intangible Assets ( SFAS 142 ), the Company is amortizing the IGS client relationships over seven years, the RDS customer relationships over ten years and the non-compete agreements over three years for both the IGS and RDS acquisitions. The Company reviews these relationships at least annually for impairment. Total amortization expense was \$567,163 and \$1,701,489 for the three and nine months ended September 30, 2006. Total amortization expense was \$651,554 and \$1,541,270 for the three and nine months ended September 30, 2005. In addition, goodwill, pursuant to SFAS 142, is not amortized but rather is reviewed at least annually for impairment. The annual review, which is conducted as of October 1, 2006, has not been completed at the time of the filing of this Form 10-Q.

**8. Stock-Based Compensation:**

The Company has a stock option and nonvested share plan. The Amended and Restated Portfolio Recovery Associates 2002 Stock Option Plan and 2004 Restricted Stock Plan was approved by the Company's shareholders at its Annual Meeting of Shareholders on May 12, 2004, enabling the Company to issue to its employees and directors nonvested shares of stock, as well as stock options. Also, in connection with the IPO, all existing PRA warrants that were owned by certain individuals and entities were exchanged for an equal number of PRA Inc warrants. Prior to 2002, the Company accounted for stock compensation issued under the recognition and measurement provisions of APB Opinion No. 25 ( APB 25 ), Accounting for Stock Issued to Employees, and related Interpretations.

Effective January 1, 2002, the Company adopted the fair value recognition provisions of FASB Statement No. 123 ( SFAS 123 ), Accounting for Stock-Based Compensation, prospectively to all employee awards granted, modified, or settled after January 1, 2002. All stock-based compensation measured under the provisions of APB 25 became fully vested during 2002. All stock-based compensation expense recognized thereafter was derived from stock-based compensation based on the fair value method prescribed in SFAS 123. Effective January 1, 2006, the Company adopted FASB Statement No. 123R ( SFAS 123R ), Share-Based Payment using the modified prospective approach. The adoption of SFAS 123R resulted in a reclassification which increased cash flows from financing activities and decreased cash flows from operating activities by \$1,664,837 relating to income tax benefits from share based compensation and increased equity by \$426,752 for the nine months ended September 30, 2006. The adoption of SFAS 123R had no material impact on the Company's Income Statement. The adoption of SFAS 123R had no impact on previously reported interim periods. As of September 30, 2006, total future compensation costs related to nonvested awards of stock options and nonvested shares are \$7,089,123 with a weighted average remaining life of 3.3 years for stock options and 4.0 years for nonvested shares. Based upon historical data, the Company used an annual forfeiture rate of 3.38% for stock options and 2.90% for nonvested shares for most of the employee grants. Grants made to key employee hires and directors of the Company were assumed to have no forfeiture rates associated with them due to the low turnover among this group. In addition, commensurate with the adoption of SFAS 123R, all previous references to restricted stock are now referred to as nonvested shares.

Total equity-based compensation expense was \$573,700 and \$1,543,670 for the three and nine months ended September 30, 2006, respectively. Total equity-based compensation expense was \$331,211 and \$808,684 for the three and nine months ended September 30, 2005, respectively.

***Stock Warrants***

Prior to the IPO, the PRA management committee was authorized to issue warrants to partners, employees or vendors to purchase membership units. Generally, warrants granted had a term between five and seven years and vested within three years. Warrants had been issued at or above the fair market value on the date of grant. Warrants vest and expire according to terms established at the grant date. All warrants became fully vested at the Company's IPO in 2002. During the three and nine months ended September 30, 2006 and 2005, no warrants were issued.



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The following summarizes all warrant related transactions from December 31, 2002 through September 30, 2006:

|                    | Warrants<br>Outstanding | Weighted<br>Average<br>Exercise Price |
|--------------------|-------------------------|---------------------------------------|
| December 31, 2002  | 2,185,000               | \$ 4.30                               |
| Exercised          | (2,026,000)             | 4.17                                  |
| Cancelled          | (51,500)                | 9.72                                  |
| December 31, 2003  | 107,500                 | 4.20                                  |
| Exercised          | (67,500)                | 4.20                                  |
| December 31, 2004  | 40,000                  | 4.20                                  |
| Exercised          | (36,250)                | 4.20                                  |
| December 31, 2005  | 3,750                   | 4.20                                  |
| Exercised          | (3,750)                 | 4.20                                  |
| September 30, 2006 |                         | \$                                    |

As of September 30, 2006, all warrants have been exercised and/or cancelled and there are no warrants outstanding.

***Stock Options***

The Company created the 2002 Stock Option Plan (the Plan) on November 7, 2002. The Plan was amended in 2004 (the Amended Plan) to enable the Company to issue nonvested shares of stock to its employees and directors. The Amended Plan was approved by the Company's shareholders at its Annual Meeting on May 12, 2004. Up to 2,000,000 shares of common stock may be issued under the Amended Plan. The Amended Plan expires November 7, 2012. All options and nonvested shares issued under the Amended Plan vest ratably over five years. Granted options expire seven years from grant date. Expiration dates range between November 7, 2009 and January 16, 2011. Options granted to a single person cannot exceed 200,000 in a single year. As of September 30, 2006, 895,000 options have been granted under the Amended Plan, of which 107,575 have been cancelled.

Prior to January 1, 2006, options were expensed under SFAS 123 and were included in operating expenses as a component of compensation. Effective January 1, 2006, the Company adopted and began expensing options under SFAS 123R. The expense is included in operating expenses as a component of compensation. The Company issued no options during the three and nine months ended September 30, 2006 and 2005. All of the stock options which have been issued under the Amended Plan were issued to employees of the Company except for 40,000 which were issued to non-employee directors.



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The following summarizes all option related transactions from December 31, 2002 through September 30, 2006:

|                    | Options<br>Outstanding | Weighted<br>Average<br>Exercise Price |
|--------------------|------------------------|---------------------------------------|
| December 31, 2002  | 807,850                | \$ 13.06                              |
| Granted            | 55,000                 | 27.88                                 |
| Exercised          | (50,915)               | 13.00                                 |
| Cancelled          | (14,025)               | 13.00                                 |
| December 31, 2003  | 797,910                | 14.09                                 |
| Granted            | 20,000                 | 28.79                                 |
| Exercised          | (63,511)               | 13.30                                 |
| Cancelled          | (47,940)               | 13.00                                 |
| December 31, 2004  | 706,459                | 14.65                                 |
| Exercised          | (181,910)              | 13.22                                 |
| Cancelled          | (20,040)               | 15.63                                 |
| December 31, 2005  | 504,509                | 15.12                                 |
| Exercised          | (127,175)              | 13.16                                 |
| Cancelled          | (13,420)               | 13.00                                 |
| September 30, 2006 | 363,914                | \$ 15.88                              |

The following information is as of September 30, 2006:

| Exercise<br>Prices             | Number<br>Outstanding | Options Outstanding                                      |   | Options Exercisable   |   |
|--------------------------------|-----------------------|--|---|-----------------------|---|
|                                |                       | Weighted-<br>Average<br>Remaining<br>Contractual<br>Life | Weighted-<br>Average<br>Exercise<br>Price | Number<br>Exercisable | Weighted-<br>Average<br>Exercise<br>Price |
| \$13.00                        | 288,414               | 3.1  | \$ 13.00                                  | 26,274                | \$ 13.00                                  |
| \$16.16                        | 7,500                 | 3.1  | 16.16                                     | 3,500                 | 16.16                                     |
| \$27.77 - \$29.79              | 68,000                | 3.9  | 28.07                                     | 37,000                | 27.99                                     |
| Total at September<br>30, 2006 | 363,914               | 3.3  | \$ 15.88                                  | 66,774                | \$ 21.47                                  |

The Company utilizes the Black-Scholes option pricing model to calculate the value of the stock options when granted. This model was developed to estimate the fair value of traded options, which have different characteristics than employee stock options. In addition, changes to the subjective input assumptions can result in materially different fair market value estimates. Therefore, the Black-Scholes model may not necessarily provide a reliable single measure of the fair value of employee stock options.

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|  |                 |
|--|-----------------|
| Options issue year:                            | 2004            |
| Weighted average fair value of options granted | \$2.85          |
| Expected volatility                            | 13.26% - 13.55% |
| Risk-free interest rate                        | 3.16% - 3.37%   |
| Expected dividend yield                        | 0.00%           |
| Expected life (in years)                       | 5.00            |

Utilizing these assumptions, each non-employee director stock option granted in 2004 was valued between \$2.62 and \$2.92. There were no options granted during 2005 or 2006.

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**Nonvested Shares**

Prior to the approval of the Amended Plan, nonvested shares were permitted to be issued as an incentive to attract new employees and, effective commensurate with the adoption of the Amended Plan at the meeting of shareholders held on May 12, 2004, are permitted to be issued to directors and existing employees. The terms of the nonvested share awards are similar to those of the stock option awards, wherein the shares are issued at or above market values and vest ratably over five years. Nonvested share grants are expensed over their vesting period.

The following summarizes all nonvested stock transactions from December 31, 2002 through September 30, 2006:

|                              | Nonvested<br>Shares<br>Outstanding | Weighted<br>Average<br>Price at<br>Grant Date<br>\$ |
|------------------------------|------------------------------------|---|
| December 31, 2002<br>Granted | 13,045                             | 27.57   |
| December 31, 2003<br>Granted | 13,045<br>84,350                   | 27.57<br>26.94                                      |
| Vested                       | (2,609)                            | 27.57   |
| Cancelled                    | (4,900)                            | 26.08   |
| December 31, 2004<br>Granted | 89,886<br>74,600                   | 27.06<br>41.92                                      |
| Vested                       | (17,389)                           | 27.10   |
| Cancelled                    | (11,760)                           | 30.40   |
| December 31, 2005<br>Granted | 135,337<br>77,500                  | 34.96<br>46.99                                      |
| Vested                       | (23,114)                           | 34.15   |
| Cancelled                    | (16,255)                           | 36.60   |
| September 30, 2006           | 173,468                            | \$ 40.29  |

**9. Earnings per Share:**

Basic earnings per share ( EPS ) are computed by dividing income available to common shareholders 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 warrants, stock options and nonvested stock awards. The following tables provide a reconciliation between the computation of basic EPS and diluted EPS for the three and nine months ended September 30, 2006 and 2005:

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|   | <b>For the three months ended September 30,</b> |   |         |              |   |         |
|---|---|---|---------|--------------|---|---------|
|   | <b>2006</b>                                     |   |         | <b>2005</b>  |   |         |
|   | Net Income                                      | Weighted<br>Average<br>Common<br>Shares | EPS     | Net Income   | Weighted<br>Average<br>Common<br>Shares | EPS     |
| Basic EPS   | \$ 11,243,499                                   | 15,915,495                              | \$ 0.71 | \$ 9,341,822 | 15,692,417                              | \$ 0.60 |
| Dilutive effect of<br>stock warrants,<br>options and restricted<br>stock awards |   | 155,797                                 |         |              | 480,240                                 |         |
| Diluted EPS   | \$ 11,243,499                                   | 16,071,292                              | \$ 0.70 | \$ 9,341,822 | 16,172,657                              | \$ 0.58 |

|   | <b>For the nine months ended September 30,</b> |   |         |               |   |         |
|---|--|---|---------|---------------|---|---------|
|   | <b>2006</b>                                    |   |         | <b>2005</b>   |   |         |
|   | Net Income                                     | Weighted<br>Average<br>Common<br>Shares | EPS     | Net Income    | Weighted<br>Average<br>Common<br>Shares | EPS     |
| Basic EPS   | \$ 33,076,178                                  | 15,894,548                              | \$ 2.08 | \$ 27,323,350 | 15,607,596                              | \$ 1.75 |
| Dilutive effect of<br>stock warrants,<br>options and restricted<br>stock awards |  | 179,312                                 |         |               | 525,273                                 |         |
| Diluted EPS   | \$ 33,076,178                                  | 16,073,860                              | \$ 2.06 | \$ 27,323,350 | 16,132,869                              | \$ 1.69 |

There were no antidilutive options outstanding as of September 30, 2006 or 2005.

**10. Commitments and Contingencies:**

*Employment Agreements:*

The Company has employment agreements with all of its executive officers and with several members of its senior management group, the terms of which expire on December 31, 2008, or, in the case of the senior managers of IGS, on December 31, 2007. Such agreements provide for base salary payments as well as bonus entitlement, based on the attainment of specific personal and Company goals. Estimated future compensation under these agreements is approximately \$9,591,700 and is expected to be paid through December 31, 2008. The agreements also contain confidentiality and non-compete provisions.

*Leases:*

The Company is party to various operating and capital leases with respect to its facilities and equipment. Please refer to the Company's consolidated financial statements and notes thereto in the Company's Annual Report on Form 10-K, as filed with the Securities and Exchange Commission for discussion of these leases.

*Litigation:*

The Company is from time to time subject to routine litigation incidental to its business. The Company believes that the results of any pending legal proceedings will not have a material adverse effect on the financial condition, results of operations or liquidity of the Company.

**11. Recent Accounting Pronouncements:**

On December 16, 2004, the Financial Accounting Standards Board ( FASB ) issued FASB statement No. 123(R), Share-Based Payment, ( SFAS 123R ). SFAS 123R revises FASB statement No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ) and requires companies to expense the fair value of employee stock options and other forms of stock-based compensation. In addition to revising SFAS 123, SFAS 123R supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and amends FASB Statement No. 95, Statement of Cash Flows. SFAS 123R applies to all stock-based compensation transactions in which a company acquires services by (1) issuing its stock or other equity instruments, except through arrangements resulting from employee stock-ownership plans (ESOPs) or (2) incurring liabilities that are based on the company's stock price. SFAS 123R is effective for annual periods that begin after June 15, 2005; however, early adoption is encouraged. The Company has determined that all of its existing stock-based awards are equity instruments. The Company previously adopted SFAS 123 on January 1, 2002 and has been expensing equity based compensation since that time. The Company adopted SFAS 123R on January 1, 2006. The adoption of SFAS 123R had no material impact on its financial statements.

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On July 13, 2006, The FASB issued Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes, which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with FASB Statement 109, Accounting for Income Taxes. FIN 48 provides guidance on the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting for interim periods, disclosures, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact FIN 48 will have on its financial statements.

On September 13, 2006, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin No. 108 Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 ). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in a misstatement that, when all relevant quantitative and qualitative factors are considered, is material and therefore must be quantified. SAB 108 is effective for fiscal years ending on or after November 15, 2006. The Company is currently evaluating the impact SAB 108 will have on its financial statements.

On September 15, 2006, the FASB issued SFAS No. 157, Fair Value Measurements , ( SFAS 157 ). SFAS 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. The changes to current practice resulting from the application of SFAS 157 relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently evaluating the impact SFAS 157 will have on its financial statements.

**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:

our ability to purchase defaulted consumer receivables at appropriate prices;

changes in the business practices of credit originators in terms of selling defaulted consumer receivables or outsourcing defaulted consumer receivables to third-party contingent fee collection agencies;

changes in government regulations that affect our ability to collect sufficient amounts on our acquired or serviced receivables;

our ability to employ and retain qualified employees, especially collection personnel;

changes in the credit or capital markets, which affect our ability to borrow money or raise capital to purchase or service defaulted consumer receivables;

the degree and nature of our competition;

our future ability to comply with the provisions of the Sarbanes-Oxley Act of 2002 and the rules and regulations promulgated thereunder;

our ability to successfully integrate IGS and RDS into our business operations;

our ability to secure sufficient levels of placements for our fee-for-service businesses;

the sufficiency of our funds generated from operations, existing cash and available borrowings to finance our current operations; and

the risk factors listed from time to time in our filings with the Securities and Exchange Commission.

You should assume that the information appearing in this quarterly report is accurate only as of the date it was issued. Our business, financial condition, results of operations and prospects may have changed since that date.

For a discussion of the risks, uncertainties and assumptions that could affect our future events, developments or results, you should carefully review the following Management's Discussion and Analysis of Financial Condition and Results of Operations as well as the discussion of Risk Factors beginning on page 36 and described in our Annual Report on Form 10-K, filed on March 3, 2006.

Our forward-looking statements could be wrong in light of these and other risks, uncertainties and assumptions. The future events, developments or results described in this report could turn out to be materially different. We have no obligation to publicly update or revise our forward-looking statements after the date of this annual report and you should not expect us to do so.

Investors should also be aware that while we do, from time to time, communicate with securities analysts and others, we do not, by policy, selectively disclose to them any material nonpublic information or other confidential commercial information. Accordingly, stockholders should not assume that we agree with any statement or report

issued by any analyst regardless of the content of the statement or report. We do not, by policy, confirm forecasts or projections issued by others. Thus, to the extent that reports issued by securities analysts contain any projections, forecasts or opinions, such reports are not our responsibility.



**Results of Operations**

The following table sets forth certain operating data as a percentage of total revenue for the periods indicated:

|   | <b>For the Three Months</b>     |             | <b>For the Nine Months Ended September</b> |             |
|---|---------------------------------|-------------|--|-------------|
|   | <b>Ended September 30, 2006</b> | <b>2005</b> | <b>30, 2006</b>                            | <b>2005</b> |
| Revenues:                                 |                                 |             |  |             |
| Income recognized on finance receivables  | 87.3%                           | 90.6%       | 87.2%                                      | 91.6%       |
| Commissions                               | 12.7%                           | 9.4%        | 12.8%                                      | 8.4%        |
| Total revenue                             | 100.0%                          | 100.0%      | 100.0%                                     | 100.0%      |
| Operating expenses:                       |                                 |             |  |             |
| Compensation and employee services        | 30.4%                           | 29.9%       | 30.8%                                      | 29.8%       |
| Outside legal and other fees and services | 22.1%                           | 19.8%       | 21.1%                                      | 20.3%       |
| Communications                            | 3.1%                            | 3.0%        | 3.2%                                       | 2.9%        |
| Rent and occupancy                        | 1.2%                            | 1.5%        | 1.2%                                       | 1.4%        |
| Other operating expenses                  | 2.5%                            | 2.2%        | 2.5%                                       | 2.1%        |
| Depreciation and amortization             | 2.7%                            | 3.4%        | 2.7%                                       | 3.0%        |
| Total operating expenses                  | 62.0%                           | 59.8%       | 61.5%                                      | 59.5%       |
| Income from operations                    | 38.0%                           | 40.2%       | 38.5%                                      | 40.5%       |
| Other income and (expense):               |                                 |             |  |             |
| Interest income                           | 0.4%                            | 0.5%        | 0.3%                                       | 0.4%        |
| Interest expense                          | (0.1%)                          | (0.2%)      | (0.2%)                                     | (0.2%)      |
| Income before income taxes                | 38.3%                           | 40.5%       | 38.6%                                      | 40.7%       |
| Provision for income taxes                | 14.7%                           | 15.6%       | 14.8%                                      | 15.7%       |
| Net income                                | 23.6%                           | 24.9%       | 23.8%                                      | 25.0%       |

We use the following terminology throughout our reports. **Cash Receipts** refers to all collections of cash, regardless of the source. **Cash Collections** refers to collections on our owned portfolios only, exclusive of commission income and sales of finance receivables. **Cash Sales of Finance Receivables** refers to the sales of our owned portfolios.

**Commissions** refers to fee income generated from our wholly-owned contingent fee and fee-for-service subsidiaries.

***Three Months Ended September 30, 2006 Compared To Three Months Ended September 30, 2005***

**Revenue**

Total revenue was \$47.8 million for the three months ended September 30, 2006, an increase of \$10.3 million or 27.5% compared to total revenue of \$37.5 million for the three months ended September 30, 2005.

***Income Recognized on Finance Receivables***

Income recognized on finance receivables was \$41.8 million for the three months ended September 30, 2006, an increase of \$7.8 million or 23.0% compared to income recognized on finance receivables of \$34.0 million for the three months ended September 30, 2005. The majority of the increase was due to an increase in our cash collections on our owned defaulted consumer receivables to \$59.7 million from \$47.5 million, an increase of 25.7%. Our amortization rate, including the allowance charge, on our owned portfolio for the three months ended September 30, 2006 was 30.0% while for the three months ended September 30, 2005 it was 28.4%. During the three months ended

September 30, 2006, we acquired defaulted consumer receivables portfolios with an aggregate face value amount of \$1.19 billion at a cost of \$35.6 million. During the three months ended September 30, 2005, we acquired defaulted consumer receivable portfolios with an aggregate face value of \$445.3 million at a cost of \$16.5 million. In any period, we acquire defaulted consumer receivables that can vary dramatically in their age, type and ultimate collectibility. We may pay significantly different purchase rates for purchased receivables within any period as a result of this quality fluctuation. In addition, market forces can drive pricing rates up or down in any period, irrespective of other quality fluctuations. As a result, the average purchase rate paid for any given period can fluctuate dramatically based on our particular buying activity in that period. However, regardless of the average purchase price, we intend to target a similar internal rate of return in pricing our portfolio acquisitions; therefore, the absolute rate paid is not necessarily relevant to estimated profitability of a period's buying.

Income recognized on finance receivables is shown net of valuation allowances recognized under SOP 03-3, which requires that a valuation allowance be taken for 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. For the three months ended September 30, 2006 and 2005 we recorded allowance charges of \$275,000 and \$0, respectively.

*Commissions*

Commissions were \$6.1 million for the three months ended September 30, 2006, an increase of \$2.6 million or 74.3% compared to commissions of \$3.5 million for the three months ended September 30, 2005. Commissions increased as a result of the addition of our RDS government processing and collection business, as well as increases in revenue generated by our Anchor contingent fee business and IGS fee-for-service business compared to the prior year period.

**Operating Expenses**

Total operating expenses were \$29.7 million for the three months ended September 30, 2006, an increase of \$7.3 million or 32.6% compared to total operating expenses of \$22.4 million for the three months ended September 30, 2005. Total operating expenses, including compensation and employee services expenses, were 45.1% of cash receipts excluding sales for the three months ended September 30, 2006 compared to 44.0% for the same period in 2005.

*Compensation and Employee Services*

Compensation and employee services expenses were \$14.6 million for the three months ended September 30, 2006, an increase of \$3.4 million or 30.4% compared to compensation and employee services expenses of \$11.2 million for the three months ended September 30, 2005. Compensation and employee services expenses increased as total employees grew 27.8% to 1,284 at September 30, 2006 from 1,005 at September 30, 2005. Compensation and employee services expenses as a percentage of cash receipts excluding sales increased to 22.1% for the three months ended September 30, 2006 from 22.0% of cash receipts excluding sales for the same period in 2005 as a result of increased collector headcount as well as increases in salaries related to the hiring of non-collection personnel including several key new employees in our Information Technology department.

*Outside Legal and Other Fees and Services*

Outside legal and other fees and services expenses were \$10.6 million for the three months ended September 30, 2006, an increase of \$3.2 million or 43.3% compared to outside legal and other fees and services expenses of \$7.4 million for the three months ended September 30, 2005. Of the \$3.2 million increase, \$0.4 million was attributable to increases in outside fees and services, \$0.5 million was attributable to increases in agency fees mainly incurred by our IGS subsidiary and \$0.4 million was attributable in increases in corporate legal expenses mainly incurred as a result of the investigation requested by the audit committee that occurred during the third quarter of 2006. The remaining \$1.9 million of the increase was attributable to the increased cash collections resulting from the increased number of accounts referred to independent contingent fee attorneys. This increase is consistent with the growth we experienced in our portfolio of defaulted consumer receivables and a portfolio management strategy shift implemented in mid-2002. This strategy resulted in us referring to the legal suit process more previously unsuccessfully liquidated accounts that have an identified means of repayment but that are nearing their legal statute of limitations, than had been referred historically. Legal cash collections represented 29.8% of total cash receipts for the three months ended September 30, 2006 compared to 32.4% for the three months ended September 30, 2005. Total legal expenses for the three months ended September 30, 2006 were 38.6% of legal cash collections compared to 34.5% for the three months ended September 30, 2005. Legal fees and costs increased from \$5.7 million for the three months ended September 30, 2005 to \$7.6 million, or an increase of 33.3%, for the three months ended September 30, 2006.

*Communications*

Communications expenses were \$1.5 million for the three months ended September 30, 2006, an increase of \$0.4 million or 36.4% compared to communications expenses of \$1.1 million for the three months ended September 30, 2005. The increase was attributable to growth in mailings and higher telephone expenses incurred to collect on a greater number of defaulted consumer receivables owned and serviced. Mailing expenses were responsible for 78.5% of this increase, while the remaining 21.5% was attributable to higher telephone expenses.



*Rent and Occupancy*

Rent and occupancy expenses were \$573,000 for the three months ended September 30, 2006, an increase of \$18,000 or 3.3% compared to rent and occupancy expenses of \$555,000 for the three months ended September 30, 2005. The increase was due to the addition of our new RDS facility as well as increased utility charges.

*Other Operating Expenses*

Other operating expenses were \$1,212,000 for the three months ended September 30, 2006, an increase of \$378,000 or 45.3% compared to other operating expenses of \$834,000 for the three months ended September 30, 2005. The increase was due to increases in travel and meals, repairs and maintenance, hiring expenses, taxes, fees and licenses and miscellaneous expenses. Travel and meals expenses increased by \$125,000, repairs and maintenance expenses increased by \$32,000, hiring expenses increased by \$40,000, taxes, fees and licenses increased by \$58,000 and miscellaneous expenses increased by \$123,000.

*Depreciation and Amortization*

Depreciation and amortization expenses were \$1.3 million for the three months ended September 30, 2006, which remained constant when compared to depreciation and amortization expenses of \$1.3 million for the three months ended September 30, 2005.

**Interest Income**

Interest income was \$171,000 for the three months ended September 30, 2006, a decrease of \$17,000 compared to interest income of \$188,000 for the three months ended September 30, 2005. This decrease is the result of reduced invested cash and investment balances in the 2006 quarter versus the same period in 2005.

**Interest Expense**

Interest expense was \$66,000 for the three months ended September 30, 2006, an increase of \$7,000 compared to interest expense of \$59,000 for the three months ended September 30, 2005. The increase is due to the larger unused line fee on our new revolving line of credit during the quarter versus the old line of credit as compared in the comparative period in 2005.

***Nine Months Ended September 30, 2006 Compared To Nine Months Ended September 30, 2005***

**Revenue**

Total revenue was \$139.4 million for the nine months ended September 30, 2006, an increase of \$30.2 million or 27.7% compared to total revenue of \$109.2 million for the nine months ended September 30, 2005.

*Income Recognized on Finance Receivables*

Income recognized on finance receivables was \$121.5 million for the nine months ended September 30, 2006, an increase of \$21.4 million or 21.4% compared to income recognized on finance receivables of \$100.1 million for the nine months ended September 30, 2005. The majority of the increase was due to an increase in our cash collections on our owned defaulted consumer receivables to \$177.6 million from \$144.1 million, an increase of 23.3%. Our amortization rate on our owned portfolio for the nine months ended September 30, 2006 was 31.6% while for the nine months ended September 30, 2005 it was 30.6%. During the nine months ended September 30, 2006, we acquired defaulted consumer receivables portfolios with an aggregate face value amount of \$6.73 billion at a cost of \$79.7 million. During the nine months ended September 30, 2005, we acquired defaulted consumer receivable portfolios with an aggregate face value of \$2.47 billion at a cost of \$57.3 million. In any period, we acquire defaulted consumer receivables that can vary dramatically in their age, type and ultimate collectibility. We may pay significantly different purchase rates for purchased receivables within any period as a result of this quality fluctuation.

In addition, market forces can drive pricing rates up or down in any period, irrespective of other quality fluctuations. As a result, the average purchase rate paid for any given period can fluctuate dramatically based on our particular buying activity in that period. However, regardless of the average purchase price, we intend to target a similar internal rate of return in pricing our portfolio acquisitions; therefore, the absolute rate paid is not necessarily relevant to estimated profitability of a period's buying.

Income recognized on finance receivables is shown net of valuation allowances recognized under SOP 03-3, which requires that a valuation allowance be taken for 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. For the nine months ended September 30, 2006 and 2005 we recorded allowance charges of \$650,000 and \$0, respectively.

#### *Commissions*

Commissions were \$17.8 million for the nine months ended September 30, 2006, an increase of \$8.7 million or 95.6% compared to commissions of \$9.1 million for the nine months ended September 30, 2005. Commissions increased as a result of the addition of our RDS government processing and collection business, as well as increases in revenue generated by our Anchor contingent fee business and IGS fee-for-service business as compared to the prior year period.

#### **Operating Expenses**

Total operating expenses were \$85.7 million for the nine months ended September 30, 2006, an increase of \$20.7 million or 31.9% compared to total operating expenses of \$65.0 million for the nine months ended September 30, 2005. Total operating expenses, including compensation and employee services expenses, were 43.9% of cash receipts excluding sales for the nine months ended September 30, 2006 compared with 42.4% for the same period in 2005.

#### *Compensation and Employee Services*

Compensation and employee services expenses were \$43.0 million for the nine months ended September 30, 2006, an increase of \$10.5 million or 32.3% compared to compensation and employee services expenses of \$32.5 million for the nine months ended September 30, 2005. Compensation and employee services expenses increased as total employees grew to 1,284 at September 30, 2006 from 1,005 at September 30, 2005. Compensation and employee services expenses as a percentage of cash receipts excluding sales increased to 22.0% for the nine months ended September 30, 2006 from 21.2% of cash receipts excluding sales for the same period in 2005 as a result of increased collector headcount as well as increases in salaries related to the hiring of non-collection personnel including several key new employees in our Information Technology department.

#### *Outside Legal and Other Fees and Services*

Outside legal and other fees and services expenses were \$29.4 million for the nine months ended September 30, 2006, an increase of \$7.2 million or 32.4% compared to outside legal and other fees and services expenses of \$22.2 million for the nine months ended September 30, 2005. Of the \$7.2 million increase, \$1.3 million was attributable to increases in outside fees and services, \$0.7 million was attributable to increases in agency fees mainly incurred by our IGS subsidiary and \$0.5 million was attributable to increases in corporate legal expenses mainly incurred as a result of the investigation requested by the audit committee that occurred during the third quarter of 2006. The remaining \$4.7 million of the increase was attributable to the increased cash collections resulting from the increased number of accounts referred to independent contingent fee attorneys. This increase is consistent with the growth we experienced in our portfolio of defaulted consumer receivables, and a portfolio management strategy shift implemented in mid-2002. This strategy resulted in us referring to the legal suit process previously unsuccessfully liquidated accounts that have an identified means of repayment but that are nearing their legal statute of limitations. Legal cash collections represented 28.8% of total cash receipts for the nine months ended September 30, 2006, compared to 30.7% for the nine months ended September 30, 2005. Total legal expenses for the nine months ended September 30, 2006 were 37.3% of legal cash collections compared to 34.6% for the nine months ended September 30, 2005. Legal fees and costs increased from \$16.3 million for the nine months ended September 30, 2005 to \$21.0 million, or 28.8%, for the nine months ended September 30, 2006.

*Communications*

Communications expenses were \$4.4 million for the nine months ended September 30, 2006, an increase of \$1.2 million or 37.5% compared to communications expenses of \$3.2 million for the nine months ended September 30, 2005. The increase was attributable to growth in mailings and higher telephone expenses incurred to collect on a greater number of defaulted consumer receivables owned and serviced. Mailings were responsible for 83.0% of this increase, while the remaining 17.0% is attributable to higher telephone expenses.

*Rent and Occupancy*

Rent and occupancy expenses were \$1.7 million for the nine months ended September 30, 2006, an increase of \$0.2 million or 13.3% compared to rent and occupancy expenses of \$1.5 million for the nine months ended September 30, 2005. Our new IGS and RDS facilities accounted for \$115,000 of the increase. The remaining increase was due mainly to increased utility charges.

*Other Operating Expenses*

Other operating expenses were \$3,494,000 for the nine months ended September 30, 2006, an increase of \$1,178,000 or 50.9% compared to other operating expenses of \$2,316,000 for the nine months ended September 30, 2005. The increase was due mainly to increases in miscellaneous expenses, travel and meals, hiring expenses, repairs and maintenance, taxes, fees and licenses, dues and subscriptions and advertising and marketing expenses. Miscellaneous expenses increased by \$350,000, travel and meals increased by \$338,000, hiring expenses increased by \$167,000, repairs and maintenance expenses increased by \$125,000, taxes, fees and licenses increased by \$108,000, dues and subscriptions increased by \$50,000 and advertising and marketing expenses increased by \$40,000.

*Depreciation and Amortization*

Depreciation and amortization expenses were \$3.8 million for the nine months ended September 30, 2006, an increase of \$500,000 or 15.2% compared to depreciation and amortization expenses of \$3.3 million for the nine months ended September 30, 2005. The increase was attributable to the depreciation and amortization of the acquired assets of RDS and the continued capital expenditures on equipment, software and computers related to our growth and systems upgrades. The amortization of our intangible assets accounted for 31.9% of the increase while the remaining increase of 68.1% resulted from continued capital expenditures on equipment, software and computers.

**Interest Income**

Interest income was \$415,000 for the nine months ended September 30, 2006, a decrease of \$61,000 or 12.8% compared to interest income of \$476,000 for the nine months ended September 30, 2005. This decrease is the result of reduced invested cash and investment balances in the first nine months of 2006 versus the same period in 2005.

**Interest Expense**

Interest expense was \$309,000 for the nine months ended September 30, 2006, an increase of \$123,000 or 66.1% compared to interest expense of \$186,000 for the nine months ended September 30, 2005. The increase is due mainly to the larger unused line fee on our new revolving line of credit during the first nine months of 2006 versus the old line of credit as compared in the comparative period in 2005.

**Supplemental Performance Data***Owned Portfolio Performance:*

The following table shows our portfolio buying activity by year, setting forth, among other things, the purchase price, unamortized purchase price (finance receivables, net), actual cash collections and estimated remaining cash collections as of September 30, 2006.

(\$ in thousands)

| Purchase<br>Period | Purchase<br>Price <sup>(1)</sup> | Unamortized<br>Purchase<br>Price<br>Balance at<br>September<br>30, 2006 <sup>(2)</sup> | Percentage<br>of<br>Purchase<br>Price<br>Remaining<br>Unamortized<br>at<br>September<br>30, 2006 <sup>(3)</sup> | Actual  | Estimated<br>Collections<br>Remaining | Total<br>Estimated<br>Collections | Total<br>Estimated<br>Collections<br>to<br>Purchase<br>Price | Adjusted |
|--------------------|----------------------------------|--|---|---|---------------------------------------|-----------------------------------|--|----------|
|                    |                                  |  |   | Cash<br>Collections<br>Including<br>Cash<br>Sales |                                       |                                   |  |          |
| 1996               | \$ 3,080                         | \$ 0   | 0%  | \$ 9,663  | \$ 64                                 | \$ 9,727                          | 316%   | 316%     |
| 1997               | \$ 7,685                         | \$ 0   | 0%  | \$ 23,789   | \$ 257                                | \$ 24,046                         | 313%   | 313%     |
| 1998               | \$ 11,089                        | \$ 0   | 0%  | \$ 34,075   | \$ 488                                | \$ 34,563                         | 312%   | 312%     |
| 1999               | \$ 18,898                        | \$ 0   | 0%  | \$ 60,284   | \$ 1,443                              | \$ 61,727                         | 327%   | 327%     |
| 2000               | \$ 25,015                        | \$ 0   | 0%  | \$ 94,369   | \$ 4,981                              | \$ 99,350                         | 397%   | 397%     |
| 2001               | \$ 33,467                        | \$ 715   | 2%  | \$ 137,555  | \$ 14,550                             | \$ 152,105                        | 454%   | 454%     |
| 2002               | \$ 42,278                        | \$ 2,748   | 6%  | \$ 139,084  | \$ 20,897                             | \$ 159,981                        | 378%   | 378%     |
| 2003               | \$ 61,463                        | \$ 9,325   | 15%   | \$ 161,153  | \$ 46,345                             | \$ 207,498                        | 338%   | 338%     |
| 2004               | \$ 59,335                        | \$ 17,773  | 30%   | \$ 95,884   | \$ 64,304                             | \$ 160,188                        | 270%   | 278%     |
| 2005               | \$ 144,319                       | \$ 110,342   | 76%   | \$ 75,658   | \$ 230,044                            | \$ 305,702                        | 212%   | 228%     |
| YTD 2006           | \$ 77,141                        | \$ 70,860  | 92%   | \$ 12,104   | \$ 149,818                            | \$ 161,922                        | 210%   | 223%     |

- (1) Purchase price refers to the cash paid to a seller to acquire defaulted consumer receivables, plus certain capitalized costs, less the purchase price refunded by the seller due to the return of non-compliant accounts (also defined as buybacks). Non-compliant



refers to the contractual representations and warranties provided for in the purchase and sale contract between the seller and us.

These representations and warranties from the sellers generally cover account holders death or bankruptcy and accounts settled or disputed prior to sale. The seller can replace or repurchase these accounts.

- (2) Unamortized purchase price balance refers to the purchase price less amortization over the life of the portfolio.
- (3) Percentage of purchase price remaining unamortized refers to the amount of unamortized purchase price divided by the purchase price.
- (4) Estimated remaining collections refers to the sum of all future

projected cash  
collections on  
our owned  
portfolios.

(5) Total estimated  
collections  
refers to the  
actual cash  
collections,  
including cash  
sales, plus  
estimated  
remaining  
collections.

(6) Total estimated  
collections to  
purchase price  
refers to the  
total estimated  
collections  
divided by the  
purchase price.

(7) Total estimated  
collections to  
purchase price  
adjusted refers  
to the total  
estimated  
collections  
divided by the  
purchase price  
after removing  
the impact of  
purchased  
bankrupt  
accounts.

The following graph shows the purchase price of our owned portfolios by year beginning in 1996 and includes the year to date acquisition amount for the nine months ended September 30, 2006 and 2005. The purchase price number represents the cash paid to the seller to acquire defaulted consumer receivables, plus certain capitalized costs, less the purchase price refunded by the seller due to the return of non-compliant accounts.

#### Portfolio Purchases by Year

We utilize a long-term approach to collecting our owned pools of receivables. This approach has historically caused us to realize significant cash collections and revenues from purchased pools of finance receivables years after they are originally acquired. As a result, we have in the past been able to reduce our level of current period acquisitions without a corresponding negative current period impact on cash collections and revenue.

The following table, which excludes any proceeds from cash sales of finance receivables, demonstrates our ability to realize significant multi-year cash collection streams on our owned pools:

#### Cash Collections By Year, By Year of Purchase

(in thousands)

| Purchase<br>Year | Purchase<br>Price | Cash Collection Period |         |          |          |          |          |          |           |           |           | YTD<br>2006 |    |
|------------------|-------------------|------------------------|---------|----------|----------|----------|----------|----------|-----------|-----------|-----------|-------------|----|
|                  |                   | 1996                   | 1997    | 1998     | 1999     | 2000     | 2001     | 2002     | 2003      | 2004      | 2005      |             |    |
|                  | \$ 3,080          | \$548                  | \$2,484 | \$ 1,890 | \$ 1,348 | \$ 1,025 | \$ 730   | \$ 496   | \$ 398    | \$ 285    | \$ 210    | \$ 187      | \$ |
|                  | 7,685             |                        | 2,507   | 5,215    | 4,069    | 3,347    | 2,630    | 1,829    | 1,324     | 1,022     | 860       | 490         | \$ |
|                  | 11,089            |                        |         | 3,776    | 6,807    | 6,398    | 5,152    | 3,948    | 2,797     | 2,200     | 1,811     | 1,148       | \$ |
|                  | 18,898            |                        |         |          | 5,138    | 13,069   | 12,090   | 9,598    | 7,336     | 5,615     | 4,352     | 2,393       | \$ |
|                  | 25,015            |                        |         |          |          | 6,894    | 19,498   | 19,478   | 16,628    | 14,098    | 10,924    | 6,387       | \$ |
|                  | 33,467            |                        |         |          |          |          | 13,048   | 28,831   | 28,003    | 26,717    | 22,639    | 12,827      | \$ |
|                  | 42,278            |                        |         |          |          |          |          | 15,073   | 36,258    | 35,742    | 32,497    | 19,503      | \$ |
|                  | 61,463            |                        |         |          |          |          |          |          | 24,308    | 49,706    | 52,640    | 34,500      | \$ |
|                  | 59,335            |                        |         |          |          |          |          |          |           | 18,019    | 46,475    | 31,385      | \$ |
|                  | 144,319           |                        |         |          |          |          |          |          |           |           | 18,968    | 56,689      | \$ |
| 2006             | 77,141            |                        |         |          |          |          |          |          |           |           |           | 12,104      | \$ |
|                  | \$483,770         | \$548                  | \$4,991 | \$10,881 | \$17,362 | \$30,733 | \$53,148 | \$79,253 | \$117,052 | \$153,404 | \$191,376 | \$177,613   | \$ |

When we acquire a new pool of finance receivables, our estimates typically result in a 84 - 96 month projection of cash collections. The following chart shows our historical cash collections (including cash sales of finance receivables) in relation to the aggregate of the total estimated collection projections made at the time of each respective pool purchase, adjusted for buybacks.

**Actual Cash Collections and Cash Sales vs. Original Projections**  
(\$ in millions)

*Owned Portfolio Personnel Performance:*

We measure the productivity of each collector each month, breaking results into groups of similarly tenured collectors. The following three tables display various productivity measures that we track.

**Collector by Tenure**

| Collector FTE at:               | 12/31/02 | 12/31/03 | 12/31/04 | 12/31/05 | 09/30/05 | 09/30/06 |
|---------------------------------|----------|----------|----------|----------|----------|----------|
| One year + <sup>1</sup>         | 210      | 241      | 298      | 327      | 324      | 324      |
| Less than one year <sup>2</sup> | 223      | 338      | 349      | 364      | 268      | 402      |
| Total <sup>2</sup>              | 433      | 579      | 647      | 691      | 592      | 726      |

<sup>1</sup> Calculated based on actual employees (collectors) with one year of service or more.

<sup>2</sup> Calculated using total hours worked by all collectors, including those in training to produce a full time equivalent FTE .

**Monthly Cash Collections by Tenure <sup>1</sup>**

| Average performance YTD         | 12/31/02 | 12/31/03 | 12/31/04 | 12/31/05 | 09/30/05 | 09/30/06 |
|---------------------------------|----------|----------|----------|----------|----------|----------|
| One year + <sup>2</sup>         | \$16,927 | \$18,158 | \$17,129 | \$16,694 | \$16,833 | \$18,120 |
| Less than one year <sup>3</sup> | \$ 8,689 | \$ 8,303 | \$ 9,363 | \$ 8,491 | \$ 8,931 | \$ 8,960 |

<sup>1</sup> Cash collection numbers include only accounts assigned to collectors. Significant cash collections do occur on unassigned accounts.

<sup>2</sup> Calculated using average YTD monthly cash collections of all collectors with one year or more of tenure.

<sup>3</sup> Calculated using weighted average YTD monthly cash collections of all collectors with less than one year of tenure, including those in training.

**YTD Cash Collections per Hour Paid <sup>1</sup>**

| Average performance YTD    | 12/31/02 | 12/31/03 | 12/31/04 | 12/31/05 | 09/30/05 | 09/30/06 |
|----------------------------|----------|----------|----------|----------|----------|----------|
| Total cash collections     | \$96.37  | \$108.27 | \$117.59 | \$133.39 | \$136.18 | \$147.54 |
| Non-legal cash collections | \$77.72  | \$ 80.10 | \$ 82.06 | \$ 89.25 | \$ 91.79 | \$100.80 |

<sup>1</sup> Cash collections  
(assigned and  
unassigned)  
divided by total  
hours paid  
(including  
holiday,  
vacation and  
sick time) to all  
collectors  
(including those  
in training).

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Cash collections have substantially exceeded revenue in each quarter since our formation. The following chart illustrates the consistent excess of our cash collections on our owned portfolios over the income recognized on finance receivables on a quarterly basis. The difference between cash collections and income recognized is referred to as payments applied to principal. It is also referred to as amortization. This amortization is the portion of cash collections that is used to recover the cost of the portfolio investment represented on the balance sheet.

**Cash Collections <sup>(1)</sup> vs. Income Recognized on Finance Receivables**

- (1) Includes cash collections on finance receivables only. Excludes commission fees and cash proceeds from sales of defaulted consumer receivables.

**Seasonality**

We depend on the ability to collect on our owned and serviced defaulted consumer receivables. Collections tend to be higher in the first and second quarters of the year and lower in the third and fourth quarters of the year, due to consumer payment patterns in connection with seasonal employment trends, income tax refunds, and holiday spending habits. Due to our historical quarterly increases in cash collections, our growth has partially masked the impact of this seasonality.

**Quarterly Cash Collections<sup>(1)</sup>**

- (1) Includes cash collections on finance receivables only. Excludes commission fees and cash proceeds from sales of defaulted consumer receivables.

The following table shows the changes in finance receivables, including the amounts paid to acquire new portfolios.

|   | Three Months Ended<br>September 30, |                | Nine Months Ended<br>September 30, |                |
|---|-------------------------------------|----------------|------------------------------------|----------------|
|   | 2006                                | 2005           | 2006                               | 2005           |
| Balance at beginning of period  | \$ 197,437,703                      | \$ 114,837,794 | \$ 193,644,670                     | \$ 105,188,906 |
| Acquisitions of finance receivables, net of buybacks <sup>(1)</sup>         | 32,249,112                          | 15,916,690     | 74,203,321                         | 56,133,504     |
| Cash collections applied to principal on finance receivables <sup>(2)</sup> | (17,923,345)                        | (13,508,013)   | (56,084,521)                       | (44,075,939)   |
| Balance at end of period  | \$ 211,763,470                      | \$ 117,246,471 | \$ 211,763,470                     | \$ 117,246,471 |
| Estimated Remaining Collections ( ERC <sup>(3)</sup> )                      | \$ 533,192,132                      | \$ 350,034,361 | \$ 533,192,132                     | \$ 350,034,361 |

(1) Agreements to purchase receivables typically include general representations and warranties from the sellers covering account holders death or bankruptcy and accounts settled or disputed prior to sale. The seller can replace or repurchase these accounts. We refer to repurchased accounts as buybacks. We also capitalize certain acquisition related costs.

(2)

Cash collections applied to principal (also referred to as amortization) on finance receivables consists of cash collections less income recognized on finance receivables.

- (3) Estimated Remaining Collections refers to the sum of all future projected cash collections on our owned portfolios. ERC is not a balance sheet item; however, it is provided here for informational purposes.

The following tables categorize our owned portfolios as of September 30, 2006 into the major asset types and account types represented, respectively:

| Asset Type                 | No. of<br>Accounts | %             | Life to Date Purchased<br>Face<br>Value of Defaulted<br>Consumer<br>Receivables <sup>(1)</sup> |               |
|----------------------------|--------------------|---------------|--|---------------|
|                            |                    |               | \$   | %             |
| Visa/MasterCard/Discover   | 5,335,151          | 50.3%         | \$ 16,083,847,263  | 69.4%         |
| Consumer Finance           | 3,025,366          | 28.5%         | 2,721,681,231  | 11.8%         |
| Private Label Credit Cards | 1,986,033          | 18.7%         | 2,721,053,272  | 11.8%         |
| Auto Deficiency            | 269,111            | 2.5%          | 1,631,038,237  | 7.0%          |
| <b>Total:</b>              | <b>10,615,661</b>  | <b>100.0%</b> | <b>\$ 23,157,620,003</b>   | <b>100.0%</b> |

- (1) The Life to Date Purchased Face Value of Defaulted



Consumer  
Receivables  
represents the  
original face  
amount  
purchased from  
sellers and has  
not been  
decremented by  
any adjustments  
including  
payments and  
buybacks  
( buybacks are  
defined as  
purchase price  
refunded by the  
seller due to the  
return of  
non-compliant  
accounts).

The following chart shows details of our life to date buying activity as of September 30, 2006. We actively seek to purchase both bankrupt and non-bankrupt accounts at any point in the delinquency cycle.

| <b>Account Type</b>        | <b>No. of</b>     |               | <b>Life to Date Purchased<br/>Face<br/>Value of Defaulted<br/>Consumer</b> |               |
|----------------------------|-------------------|---------------|--|---------------|
|                            | <b>Accounts</b>   | <b>%</b>      | <b>Receivables <sup>(1)</sup></b>  | <b>%</b>      |
| Fresh                      | 248,088           | 2.3%          | \$ 977,119,262   | 4.2%          |
| Primary                    | 1,135,342         | 10.7%         | 2,701,407,979  | 11.6%         |
| Secondary                  | 1,919,895         | 18.1%         | 3,820,775,310  | 16.5%         |
| Tertiary                   | 2,954,063         | 27.8%         | 3,677,479,193  | 15.9%         |
| BK Trustees <sup>(2)</sup> | 2,817,283         | 26.5%         | 5,712,766,540  | 24.7%         |
| Other <sup>(2)</sup>       | 1,540,990         | 14.6%         | 6,268,071,719  | 27.1%         |
| <b>Total:</b>              | <b>10,615,661</b> | <b>100.0%</b> | <b>\$ 23,157,620,003</b>   | <b>100.0%</b> |

(1) The Life to Date Purchased Face Value of Defaulted Consumer Receivables represents the original face amount purchased from sellers and has not been decremented by any adjustments including payments and buybacks ( buybacks are defined as purchase price refunded by the seller due to the return of non-compliant accounts).

(2) Included in Other are purchased

accounts that were previously included in BK Trustees. These accounts have been reclassified to more properly reflect historical buying and the nature of the accounts.

We also review the geographic distribution of accounts within a portfolio because we have found that certain states have more debtor-friendly laws than others and, therefore, are less desirable from a collectibility perspective. These facts are considered in our pricing analysis. In addition, historical payment patterns due to economic factors and bankruptcy trends vary regionally and are also factored into our maximum purchase price equation.

The following chart sets forth our overall life to date portfolio of defaulted consumer receivables geographically as of September 30, 2006:

| Geographic Distribution | No. of            |             | Life to Date Purchased Face Value of Defaulted Consumer Receivables <sup>(1)</sup> |             | Original Purchase Price of Defaulted Consumer Receivables <sup>(2)</sup> |             |
|-------------------------|-------------------|-------------|--|-------------|--|-------------|
|                         | Accounts          | %           |  | %           |  | %           |
| Texas                   | 2,108,748         | 20%         | \$ 2,867,498,158   | 12%         | \$ 60,173,591  | 12%         |
| California              | 1,032,668         | 10%         | 2,771,920,861  | 12%         | 52,963,843   | 11%         |
| Florida                 | 811,271           | 8%          | 2,306,440,331  | 10%         | 46,068,542   | 9%          |
| New York                | 615,775           | 6%          | 1,662,590,662  | 7%          | 35,728,651   | 7%          |
| Pennsylvania            | 313,653           | 3%          | 871,512,580  | 4%          | 20,554,499   | 4%          |
| New Jersey              | 249,234           | 2%          | 801,351,094  | 3%          | 15,691,973   | 3%          |
| Ohio                    | 347,193           | 3%          | 766,208,887  | 3%          | 16,785,243   | 3%          |
| Illinois                | 349,332           | 3%          | 755,229,924  | 3%          | 16,839,041   | 3%          |
| North Carolina          | 296,225           | 3%          | 723,845,290  | 3%          | 16,993,008   | 3%          |
| Georgia                 | 274,045           | 3%          | 644,312,001  | 3%          | 16,766,297   | 3%          |
| Michigan                | 293,943           | 3%          | 583,619,674  | 3%          | 14,194,451   | 3%          |
| Massachusetts           | 226,754           | 2%          | 536,336,947  | 2%          | 10,626,449   | 2%          |
| Virginia                | 190,943           | 2%          | 433,899,042  | 2%          | 10,453,330   | 2%          |
| Arizona                 | 158,983           | 1%          | 427,833,339  | 2%          | 8,404,028  | 2%          |
| Maryland                | 169,491           | 2%          | 418,997,085  | 2%          | 8,659,202  | 2%          |
| Missouri                | 304,095           | 3%          | 415,068,967  | 2%          | 8,945,383  | 2%          |
| Other <sup>(3)</sup>    | 2,873,308         | 26%         | 6,170,955,161  | 27%         | 135,225,350  | 29%         |
| <b>Total:</b>           | <b>10,615,661</b> | <b>100%</b> | <b>\$ 23,157,620,003</b>   | <b>100%</b> | <b>\$ 495,072,881</b>  | <b>100%</b> |

- (1) The Life to Date Purchased Face Value of Defaulted Consumer Receivables represents the original face amount purchased from sellers and has not been decremented by any adjustments including payments and buybacks ( buybacks are defined as purchase price refunded by the seller due to the return of non-compliant accounts).
- (2) The Original Purchase Price of Defaulted Consumer Receivables represents the cash paid to sellers to acquire portfolios of defaulted consumer receivables.
- (3) Each state included in Other represents less than 2% of the face value of total defaulted consumer receivables.

## Liquidity and Capital Resources

Historically, our primary sources of cash have been cash flows from operations, bank borrowings and equity offerings. Cash has been used for acquisitions of finance receivables, corporate acquisitions, repayments of bank borrowings, purchases of property and equipment and working capital to support our growth.

We believe that funds generated from operations, together with existing cash and available borrowings under our credit agreement will be sufficient to finance our current operations, planned capital expenditure requirements, and internal growth at least through the next twelve months. However, we could require additional debt or equity financing if we were to make any significant acquisitions requiring cash during that period.

Cash generated from operations is dependent upon our ability to collect on our defaulted consumer receivables. Many factors, including the economy and our ability to hire and retain qualified collectors and managers, are essential to our ability to generate cash flows. Fluctuations in these factors that cause a negative impact on our business could have a material impact on our expected future cash flows.

Our operating activities provided cash of \$43.5 million and \$48.0 million for the nine months ended September 30, 2006 and 2005, respectively. In these periods, cash from operations was generated primarily from net income earned through cash collections and commissions received for the period which increased from \$27.3 million for the nine months ended September 30, 2005 to \$33.1 million for the nine months ended September 30, 2006. The remaining increase was due to changes in other accounts related to our operating activities.

Our investing activities used cash of \$20.7 million and \$6.2 million during the nine months ended September 30, 2006 and 2005, respectively. Cash used in investing activities is primarily driven by acquisitions of defaulted consumer receivables, purchases of auction rate certificates and variable rate demand notes and purchases of property and equipment. Cash provided by investing activities is primarily driven by cash collections applied to principal on finance receivables and the sale of auction rate certificates and variable rate demand notes.

Our financing activities used cash of \$12.1 million and provided cash of \$1.1 million during the nine months ended September 30, 2006 and 2005, respectively. Cash used in financing activities is primarily driven by payments on our revolving lines of credit, long term debt and capital lease obligations. Cash is provided by proceeds from debt financing, stock option exercises and income tax benefits from share based compensation.

Cash paid for interest expenses was \$342,188 and \$186,000 for the nine months ended September 30, 2006 and 2005, respectively. The interest expenses were paid for our revolving lines of credit, capital lease obligations and other long-term debt.

On November 29, 2005, we entered into a Loan and Security Agreement for a revolving line of credit jointly offered by Bank of America, N. A. and Wachovia Bank, National Association. This agreement was amended on May 9, 2006, to include RBC Centura Bank as an additional lender. The agreement is a revolving line of credit in an amount equal to the lesser of \$75,000,000 or twenty percent of our estimated remaining collections of all its eligible asset pools. The new line of credit replaces our previous \$25,000,000 credit facility with RBC Centura Bank, which was terminated (without having any borrowings under the line in 2005) on November 28, 2005. Borrowings under the new revolving credit facility bear interest at a floating rate equal to the LIBOR Market Index Rate plus 1.75% and expires on November 29, 2008. The loan is collateralized by substantially all of our tangible and intangible assets. The agreement provides for:

restrictions on monthly borrowings are limited to 20% of Estimated Remaining Collections; a funded debt to EBITDA ratio of less than 1.0 to 1.0 calculated on a rolling twelve-month average; tangible net worth of at least 100% of prior quarter tangible net worth plus 25% of cumulative positive net income since the end of such fiscal quarter, plus 100% of the net proceeds from any equity offering; and restrictions on change of control.

This facility had no amounts outstanding at September 30, 2006. As of September 30, 2006 we are in compliance with all of the covenants of this agreement.

As of September 30, 2006 there are three loans outstanding. On February 20, 2002, one of our subsidiaries entered into an additional arrangement for a \$500,000 commercial loan in order to finance construction of a parking lot at our Norfolk, Virginia location. This loan bears interest at a fixed rate of 6.47% and matures on September 1, 2007. On May 1, 2003, we entered into a commercial loan agreement in the amount of \$975,000 to finance equipment purchases for our Hampton, Virginia location. This loan bears interest at a fixed rate of 4.25% and matures on May 1, 2008. On January 9, 2004, we entered into a commercial loan agreement in the amount of \$750,000 to finance equipment purchases at our newly leased Norfolk facility. This loan bears interest at a fixed rate of 4.45% and matures on January 1, 2009. The loans are collateralized by the related asset and require us to maintain net worth greater than \$20 million and a cash flow coverage ratio of at least 1.5 to 1.0 calculated on a rolling twelve-month average.

### Contractual Obligations

Our contractual obligations as of September 30, 2006 are as follows:

| Contractual Obligations             | Total        | Payments due by period |               |             |                   |
|-------------------------------------|--------------|------------------------|---------------|-------------|-------------------|
|                                     |              | Less than 1 year       | 1 - 3 years   | 4 - 5 years | More than 5 years |
| Operating Leases                    | \$15,697,051 | \$ 2,243,179           | \$ 4,863,804  | \$4,192,855 | \$4,397,213       |
| Long-Term Debt                      | 842,890      | 492,620                | 350,270       |             |                   |
| Capital Lease Obligations           | 291,321      | 148,539                | 142,782       |             |                   |
| Purchase Commitments <sup>(1)</sup> | 42,184,524   | 41,991,179             | 193,345       |             |                   |
| Employment Agreements               | 9,591,700    | 4,481,088              | 5,110,612     |             |                   |
| Total                               | \$68,607,486 | \$49,356,605           | \$ 10,660,813 | \$4,192,855 | \$4,397,213       |

(1) The Purchase Commitments amount includes the maximum remaining amount to be purchased under forward flow contracts for the purchase of charged-off consumer debt in the amount of \$37.9 million. In addition,

\$2 million represents the potential payout we may incur as additional purchase price in association with the acquisition of the assets of IGS Nevada, Inc. The earn out provisions are defined in the asset purchase agreement dated October 1, 2004 between the owners of IGS Nevada, Inc. and Portfolio Recovery Associates, Inc.

**Off Balance Sheet Arrangements**

We do not have any off balance sheet arrangements as defined by Regulation S-K 303(a)(4) promulgated under the Securities Exchange Act of 1934.

**Recent Accounting Pronouncements**

On December 16, 2004, the Financial Accounting Standards Board ( FASB ) issued FASB statement No. 123(R), Share-Based Payment, ( SFAS 123R ). SFAS 123R revises FASB statement No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ) and requires companies to expense the fair value of employee stock options and other forms of stock-based compensation. In addition to revising SFAS 123, SFAS 123R supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and amends FASB Statement No. 95, Statement of Cash Flows. SFAS 123R applies to all stock-based compensation transactions in which a company acquires services by (1) issuing its stock or other equity instruments, except through arrangements resulting from employee stock-ownership plans (ESOPs) or (2) incurring liabilities that are based on the company's stock price. SFAS 123R is effective for annual periods that begin after June 15, 2005; however, early adoption is encouraged. We have determined that all of our existing stock-based awards are equity instruments. We previously adopted SFAS 123 on January 1, 2002 and have been expensing equity based compensation since that time. We adopted SFAS 123R on January 1, 2006. The adoption of SFAS 123R had no material impact on our financial statements.

On July 13, 2006, The FASB issued Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes, which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with FASB Statement 109, Accounting for Income Taxes. FIN 48 provides guidance on the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting for interim periods, disclosures, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the impact FIN 48 will have on our financial statements.

On September 13, 2006, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin No. 108 Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 ). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in a misstatement that, when all relevant quantitative and qualitative factors are considered, is material and therefore must be quantified. SAB 108 is effective for fiscal years ending on or after November 15, 2006. We are currently evaluating the impact SAB 108 will have on our financial statements.

On September 15, 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. The changes to current practice resulting from the application of SFAS 157 relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the impact SFAS 157 will have on our financial statements.

#### **Critical Accounting Policies**

The preparation of financial statements and related disclosures in conformity with U.S. generally accepted accounting principles and our discussion and analysis of our financial condition and results of operations require our management to make judgments, assumptions, and estimates that affect the amounts reported in our consolidated financial statements and accompanying notes. We base our estimates on historical experience and on various other assumptions we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates and such differences may be material.

Management believes our critical accounting policies and estimates are those related to revenue recognition, valuation of acquired intangibles and goodwill and income taxes. Management believes these policies to be critical because they are both important to the portrayal of our financial condition and results, and they require management to make judgments and estimates about matters that are inherently uncertain. Our senior management has reviewed these critical accounting policies and related disclosures with the Audit Committee of our Board of Directors.

#### *Revenue Recognition*

We acquire accounts that have experienced deterioration of credit quality between origination and our acquisition of the accounts. The amount paid for an account reflects our determination that it is probable we will be unable to collect all amounts due according to the account's contractual terms. At acquisition, we review each account to determine whether there is evidence of deterioration of credit quality since origination and if it is probable that we will be unable to collect all amounts due according to the account's contractual terms. If both conditions exist, we determine whether each such account is to be accounted for individually or whether such accounts will be assembled into pools based on common risk characteristics. We consider expected prepayments and estimate the amount and timing of undiscounted expected principal, interest and other cash flows for each acquired portfolio and subsequently aggregated pools of accounts. We determine 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) based on our proprietary acquisition models. The remaining amount, representing the excess of the account's cash flows expected to be collected over the amount paid, is accreted into income recognized on finance receivables over the remaining life of the account or pool (accretable yield).





Prior to January 1, 2005, we accounted for our investment in finance receivables using the interest method under the guidance of Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans. Effective January 1, 2005, we adopted and began to account for our investment in finance receivables using the interest method under the guidance of AICPA SOP 03-3, Accounting for Loans or Certain Securities Acquired in a Transfer. For loans acquired in fiscal years beginning prior to December 15, 2004, Practice Bulletin 6 is still effective; however, Practice Bulletin 6 was amended by SOP 03-3 as described further in this note. For loans acquired in fiscal years beginning after December 15, 2004, SOP 03-3 is effective. Under the guidance of SOP 03-3 (and the amended Practice Bulletin 6), static pools of accounts are 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, principal payments and loss provision. Once a static pool is established for a 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). SOP 03-3 (and the amended Practice Bulletin 6) requires that the excess of the contractual cash flows over expected cash flows not be recognized as an adjustment of revenue or expense or on the balance sheet. The SOP initially freezes the internal rate of return, referred to as IRR, estimated when the accounts receivable are purchased as the basis for subsequent impairment testing. Significant increases in expected future cash flows may be recognized prospectively through an upward adjustment of the IRR over a portfolio's remaining life. Any increase to the IRR then becomes the new benchmark for impairment testing. Effective for fiscal years beginning after December 15, 2004 under SOP 03-3 and the amended Practice Bulletin 6, rather than lowering the estimated IRR if the collection estimates are not received, the carrying value of a pool would be written down to maintain the then current IRR. Income on finance receivables is accrued quarterly based on each static pool's effective IRR. Quarterly cash flows greater than the interest accrual will reduce the carrying value of the static pool. Likewise, cash flows that are less than the accrual will accrete the carrying balance. The IRR is estimated and periodically recalculated based on the timing and amount of anticipated cash flows using our proprietary collection models. 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, we use the cost recovery method when collections on a particular pool of accounts cannot be reasonably predicted. Under the cost recovery method, no revenue is recognized until we have fully collected the cost of the portfolio, or until such time that we consider the collections to be probable and estimable and begin to recognize income based on the interest method as described above.

In accordance with SOP 03-3, valuation allowances are established to reflect only those losses incurred after acquisition (that is, the present value of cash flows initially expected at acquisition that are no longer expected to be collected). At September 30, 2006, we had a \$850,000 valuation allowance on our finance receivables. Prior to January 1, 2005, in the event that a reduction of the yield to as low as zero in conjunction with estimated future cash collections that were inadequate to amortize the carrying balance, an allowance charge would be taken with a corresponding write-off of the receivable balance.

We utilize the provisions of Emerging Issues Task Force 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent (EITF 99-19) to commission revenue from our contingent fee, skip-tracing and government processing and collection subsidiaries. EITF 99-19 requires an analysis to be completed to determine if certain revenues should be reported gross or reported net of their related operating expense. This analysis includes an assessment of who retains inventory/credit risk, who controls vendor selection, who establishes pricing and who remains the primary obligor on the transaction. Each of these factors was considered to determine the correct method of recognizing revenue from our subsidiaries.

For our contingent fee subsidiary, revenue is recognized at the time customer (debtor) funds are collected. The portfolios are owned by the clients and the collection effort is outsourced to our subsidiary under a commission fee arrangement. The clients retain control and ownership of the accounts we service. These revenues are reported on a net basis and are included in the line item Commissions.

Our skip tracing subsidiary utilizes gross reporting under this EITF. We generate revenue by working an account and successfully locating a customer for our client. An investigative fee is received for these services. In addition, we incur agent expenses where we hire a third-party collector to effectuate repossession. In many cases we have an arrangement with our client which allows us to bill the client for these fees. We have determined these fees to be gross revenue based on the criteria in EITF 99-19 and they are recorded as such in the line item Commissions, primarily because we are primarily liable to the third party collector. There is a corresponding expense in Outside legal and other fees and services for these pass-through items.

Our government processing and collection subsidiary utilizes both gross and net reporting under this EITF. RDS's primary source of income is derived from servicing taxing authorities in several different ways: processing all of their tax payments and tax forms, collecting delinquent taxes, identifying taxes that are not being paid and auditing tax payments. The processing and collection pieces are standard commission based billings or fee for service transactions and are included in the line item Commissions. When RDS conducts an audit, there are two components. The first is a charge for the hours incurred on conducting the audit. This charge is for hours worked and includes a profit margin above our actual cost. The gross billing is a component of Commissions and the expense is included in Compensation and Employee Services. The second item is for expenses incurred while conducting the audit. Most jurisdictions will reimburse RDS for direct expenses incurred for the audit including such items as travel and meals. The billed amounts are included in Commissions and the expense component is included in their appropriate expense category, generally Other operating expenses.

We account for our gain on cash sales of finance receivables under Statement of Financial Accounting Standards ( SFAS ) No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Gains on sale of finance receivables, representing the difference between the sales price and the unamortized value of the finance receivables sold, are recognized when finance receivables are sold.

We apply a financial components approach that focuses on control when accounting and reporting for transfers and servicing of financial assets and extinguishments of liabilities. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, eliminates financial assets when control has been surrendered, and eliminates liabilities when extinguished. This approach provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

#### *Valuation of Acquired Intangibles and Goodwill*

In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, we are required to perform a review of goodwill for impairment annually or earlier if indicators of potential impairment exist. The review of goodwill for potential impairment is highly subjective and requires that: (1) goodwill is allocated to various reporting units of our business to which it relates; (2) we estimate the fair value of those reporting units to which the goodwill relates; and (3) we determine the book value of those reporting units. If the estimated fair value of reporting units with allocated goodwill is determined to be less than their book value, we are required to estimate the fair value of all identifiable assets and liabilities of those reporting units in a manner similar to a purchase price allocation for an acquired business. This requires independent valuation of certain unrecognized assets. Once this process is complete, the amount of goodwill impairment, if any, can be determined.

We believe that, as of September 30, 2006, there was no impairment of goodwill. However, changes in various circumstances including changes in our market capitalization, changes in our forecasts, and changes in our internal business structure could cause one of our reporting units to be valued differently thereby causing an impairment of goodwill. Additionally, in response to changes in our industry and changes in global or regional economic conditions, we may strategically realign our resources and consider restructuring, disposing or otherwise exiting businesses, which could result in an impairment of some or all of our identifiable intangibles or goodwill.

#### *Income Taxes*

We record a tax provision for the anticipated tax consequences of the reported results of operations. In accordance with SFAS No. 109, Accounting for Income Taxes, the provision for income taxes is computed using the asset and liability method, under which deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the financial reporting and tax bases of assets and liabilities, and for

operating losses and tax credit carry-forwards. Deferred tax assets and liabilities are measured using the currently enacted tax rates that apply to taxable income in effect for the years in which those tax assets are expected to be realized or settled.

Effective with our 2002 tax filings, we adopted the cost recovery method of income recognition for tax purposes. We believe cost recovery to be an acceptable method for companies in the bad debt purchasing industry and results in the reduction of current taxable income as, for tax purposes, collections on finance receivables are applied first to principle to reduce the finance receivables to zero before any income is recognized.

We believe it is more likely than not that forecasted income, including income that may be generated as a result of certain tax planning strategies, together with the tax effects of the deferred tax liabilities, will be sufficient to fully recover the remaining deferred tax assets. In the event that all or part of the deferred tax assets are determined not to be realizable in the future, a valuation allowance would be established and charged to earnings in the period such determination is made. Similarly, if we subsequently realize deferred tax assets that were previously determined to be unrealizable, the respective valuation allowance would be reversed, resulting in a positive adjustment to earnings or a decrease in goodwill in the period such determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with our expectations could have a material impact on our results of operations and financial position.

**Item 3. Quantitative and Qualitative Disclosure About Market Risk.**

Our exposure to market risk relates to interest rate risk with our variable rate credit line. As of September 30, 2006, we had no variable rate debt outstanding on our revolving credit lines. Currently, we have no variable rate debt outstanding. A 10% change in future interest rates on the variable rate credit line would not lead to a material decrease in future earnings assuming all other factors remained constant.

**Item 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures.* We maintain disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial and Administrative Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized 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 necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Also, controls may become inadequate because of changes in conditions and the degree of compliance with the policies or procedures may deteriorate. We conducted an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, the principal executive officer and principal financial officer have concluded that, as of September 30, 2006, our disclosure controls and procedures were effective.

*Changes in Internal Control Over Financial Reporting.* There was no change in our internal control over financial reporting that occurred during the quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

*Audit Committee Investigation.* In June 2006, the Company's management was advised by one of its non-Information Technology (IT) employees that an employee of the IT department (who had previously given notice of his resignation) had made allegations concerning possible internal control deficiencies which he alleged were caused by the actions of certain members of the Company's IT department, including himself. The non-IT employee immediately brought the conversation to the attention of the Company's Human Resources Department, which promptly informed and brought the issue to the attention of senior management. Senior management then immediately began to address these issues in accordance with its written Ethics Complaint Procedure, and concurrently reported the allegations to the chairman of the Audit Committee.

The Audit Committee promptly hired independent counsel to conduct an investigation into the allegations. The investigation, which occurred in June and July, included interviews of several members of the Company's IT department and certain members of the Company's senior management team, a review of all email messages sent by or to certain members of the Company's senior management team from January 1, 2004 to the present, a review of other email messages sent by or to several members of the Company's IT department over varying time periods depending on accessibility and the individuals' involvement in the allegations, and a review of relevant documents, including a memorandum describing the Company's financial controls prepared by senior management.

There was non-documentary corroboration of certain of the allegations concerning non-financial control deficiencies, including allegations that some non-financial records had been retroactively adjusted by members of the Company's IT department during 2004 and 2005, and that some former employees' access to certain non-financial systems had not been fully removed in a timely manner.

The Audit Committee's investigation of the other allegations uncovered documentary evidence which either disproved or cast doubt on the accuracy of such allegations.

The Audit Committee concluded that:

- \* none of the deficiencies related to access to financial information. The Company had appropriate safeguards already in place to prevent improper access to financial information,
- \* no former employees had attempted to access the Company's systems after their termination,
- \* there was no adverse effect on the Company's ability to initiate, authorize, record, process or report financial data reliably in accordance with generally accepted accounting principles,
- \* there is no more than a remote likelihood that any of these non-financial deficiencies did result, or could have resulted, in a material misstatement of the Company's financial statements,
- \* prior to the allegations being made, no member of senior management had knowledge of, or was involved in any behavior which led to, these non-financial deficiencies, and
- \* the employees in question did not utilize the Company's confidential hotline to report these non-financial control allegations or otherwise report these allegations to management in a timely manner.

To address the findings of the investigation, the Company has taken appropriate personnel actions with respect to its IT department and has increased its level of oversight of IT issues. The IT employee whose conduct was the principal subject of the investigation is no longer employed by the Company, and two highly qualified IT executives have been added in leadership positions. All IT employees are now required to complete quarterly internal control disclosure statements concerning their knowledge of any breakdowns in the Company's internal controls. Additionally, the Company has implemented additional professional development for all employees in connection with compliance matters, including distributing regular reminders about the Company's hotline for fraud and compliance issues via email and other means of communication, mandatory ethics training for all employees and mandatory annual ethics testing.

The results of the investigation and the steps to be taken by the Company to prevent a recurrence of the deficiencies have been disclosed to the Company's independent registered public accountants.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

From time to time, we are involved in various legal proceedings which are incidental to the ordinary course of our business. We regularly initiate lawsuits against consumers and are occasionally countersued by them in such actions. Also, consumers occasionally initiate litigation against us, in which they allege that we have violated a state or federal law in the process of collecting on an account. We do not believe that these routine matters represent a substantial volume of our accounts or that, individually or in the aggregate, they are material to our business or financial condition. We are not a party to any material legal proceedings and we are unaware of any contemplated material actions against us.

### **Item 1A. Risk Factors**

An investment in our common stock involves a high degree of risk. You should carefully consider the specific risk factors listed under Part I, Item 1A of our Annual Report on Form 10-K filed on March 3, 2006, together with all other information included or incorporated in our reports filed with the Securities and Exchange Commission. Any such risks may materialize, and additional risks not known to us, or that we now deem immaterial, may arise. In such event, our business, financial condition, results of operations or prospects could be materially adversely affected. If that occurs, the market price of our common stock could fall, and you could lose all or part of your investment.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of the Security Holders**

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

31.1 Section 302 Certifications of Chief Executive Officer.

31.2 Section 302 Certifications of Chief Financial Officer.

32.1 Section 906 Certifications of Chief Executive Officer and Chief Financial Officer.



**SIGNATURES**

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

PORTFOLIO RECOVERY ASSOCIATES,  
INC.  
(Registrant)

Date: October 30, 2006

By: /s/ Steven D. Fredrickson  
Steven D. Fredrickson  
Chief Executive Officer, President and  
Chairman of the Board of Directors  
(Principal Executive Officer)

Date: October 30, 2006

By: /s/ Kevin P. Stevenson  
Kevin P. Stevenson  
Chief Financial and Administrative  
Officer,  
Executive Vice President, Treasurer and  
Assistant Secretary (Principal Financial  
and  
Accounting Officer)

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