PORTFOLIO RECOVERY ASSOCIATES INC
Form 10-K
February 27, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

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

For the fiscal year ended December 31, 2008

o **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)*

Registrant s telephone number, including area code: (888) 772-7326
Securities registered pursuant to Section 12(b) of the Act:
Common Stock, $0.01 par value per share
(Title of Class)

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

YES o NO þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 (d) of the Act.

YES o NO þ

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 and 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 þ NO o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment of this Form 10-K. o

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.

Non-accelerated filer o Smaller reporting company o

Large accelerated filer þ	Accelerated filer o

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES o NO þ

The aggregate market value of the common stock held by non-affiliates of the registrant as of June 30, 2008 was $556,412,722 based on the $37.50 closing price as reported on the NASDAQ Global Stock Market.

The number of shares of the registrant s Common Stock outstanding as of February 20, 2009 was 15,332,615.

Documents incorporated by reference: Portions of the Proxy Statement to be filed by approximately April 22, 2009 for our 2009 Annual Meeting of Stockholders are incorporated by reference into Items 11, 12 and 13 of Part III of this Form 10-K.

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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, 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, but are not limited to, the following:

continued deterioration of the economic environment including the stability of the financial system;

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;

changes in or interpretation of tax laws;

deterioration in economic conditions in the United States that may have an adverse effect on the our collections, results of operations, revenue and stock price;

changes in bankruptcy or collection agency laws that could negatively affect our business;

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

our work force could become unionized in the future, which could adversely affect the stability of our production and increase our costs;

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

our ability to retain existing clients and obtain new clients 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 (the SEC).

You should assume that the information appearing in this annual 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 Risk Factors section beginning on page 18, as well as Business section beginning on page 4 and the Management s Discussion and Analysis of Financial Condition and Results of Operations section beginning on page 32.

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.

PART I

Item 1. Business.

General

We are a full-service provider of outsourced receivables management and related services. Our primary business is the purchase, collection and management of portfolios of defaulted consumer receivables. These are the unpaid obligations of individuals to credit originators, which include banks, credit unions, consumer and auto finance companies and retail merchants. We also provide a broad range of contingent and fee-based services, including collateral-location services for credit originators via PRA Location Services, LLC (IGS) and revenue administration, audit and debt discovery/recovery services for government entities through PRA Government Services, LLC (RDS) and MuniServices, LLC (MuniServices). We believe that the strengths of our business are our sophisticated approach to portfolio pricing and servicing, our emphasis on developing and retaining our collection personnel, our sophisticated collections systems and procedures and our relationships with many of the largest consumer lenders in the United States. Our proven ability to service defaulted consumer receivables allows us to offer debt owners a complete outsourced solution to address their defaulted consumer receivables. The defaulted consumer receivables we collect are purchased from sellers of defaulted consumer debt. We intend to continue to build on our strengths and grow our business through the disciplined approach that has contributed to our success to date.

We use the following terminology throughout our reports: Cash Receipts refers to collections on our owned portfolios together with commission income and sales of finance receivables. Cash Collections refers to collections on our owned portfolios only, exclusive of commission income and sales of finance receivables. Amortization Rate refers to cash collections applied to principal as a percentage of total cash collections. Income Recognized on Finance Receivables refers to income derived from our owned debt portfolios and is shown net of valuation allowances. 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.

We specialize in receivables that have been charged-off by the credit originator. Because the credit originator and/or other debt servicing companies have unsuccessfully attempted to collect these receivables, we are able to purchase them at a substantial discount to their face value. From our 1996 inception through December 31, 2008, we acquired 1,290 portfolios with a face value of $39.9 billion for $1.1 billion, representing more than 19.1 million customer accounts. The success of our business depends on our ability to purchase portfolios of defaulted consumer receivables at appropriate valuations and to collect on those receivables effectively and efficiently. Since inception, we have been able to collect at an average rate of 2.5 to 3.0 times our purchase price for defaulted consumer receivables portfolios, as measured over a five to twelve year period, which has enabled us to generate increasing profits and positive operational cash flow.

We have achieved strong financial results since our formation, with cash collections growing from $10.9 million in 1998 to $326.7 million in 2008. Total revenue has grown from $6.8 million in 1998 to $263.3 million in 2008, a compound annual growth rate of 44%. Similarly, pro forma net income has grown from $402,000 in 1998 to net income of $45.4 million in 2008.

We were initially formed as Portfolio Recovery Associates, L.L.C., a Delaware limited liability company, on March 20, 1996. Prior to the formation of Portfolio Recovery Associates, Inc., members of our current management team played key roles in the development of a defaulted consumer receivables acquisition and divestiture operation for Household Recovery Services, a subsidiary of Household International, now owned by HSBC. In connection with our 2002 initial public offering (our IPO), all of the membership units of Portfolio Recovery Associates, L.L.C. were exchanged, simultaneously with the effectiveness of our registration statement, for a single class of the common stock of Portfolio Recovery Associates, Inc., a new Delaware corporation formed on August 7, 2002. Accordingly, the members of Portfolio Recovery Associates, L.L.C. became the common stockholders of Portfolio Recovery Associates, Inc., which became the parent company of Portfolio Recovery Associates, L.L.C. and its subsidiaries.

The Company maintains an Internet website at the following address: www.portfoliorecovery.com.

We make available on or through our website certain reports that we file with or furnish to the SEC in accordance with the Securities Exchange Act of 1934. These include our annual reports on Form 10-K, our quarterly reports on Form 10-Q and our current reports on Form 8-K. We make this information available on our website free of charge as soon as reasonably practicable after we electronically file the information with or furnish it to the SEC. The information that is filed with the SEC may be read or copied at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. In addition, information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at: www.sec.gov.

Reports filed with or furnished to the SEC are also available free of charge upon request by contacting our corporate office at:

Portfolio Recovery Associates, Inc.
Attn: Investor Relations
120 Corporate Boulevard, Suite 100
Norfolk, Virginia 23502

Competitive Strengths

Complete Outsourced Solution for Debt Owners

We offer debt owners a complete outsourced solution to address their defaulted consumer receivables. Depending on a debt owner s timing and needs, we can either purchase their defaulted consumer receivables, providing immediate cash, or locate collateral on their behalf for either a fee-for-service or a success fee. We can purchase receivables throughout the entire delinquency cycle, from receivables that have only been processed for collection internally by the debt owner to receivables that have been subject to multiple internal and external collection efforts. This flexibility helps us meet the needs of debt owners and allows us to become a trusted resource. Furthermore, our strength across multiple transaction and asset types provides the opportunity to cross-sell our services to debt owners, building on successful engagements. Through our RDS and MuniServices businesses, we have the ability to provide these services to local and state governments.

Disciplined and Proprietary Underwriting Process

One of the key components of our growth has been our ability to price portfolio acquisitions at levels that have generated profitable returns on investment. Since inception, we have been able to collect at an average rate of 2.5 to 3.0 times our purchase price for defaulted consumer receivables portfolios, as measured over a five to twelve year period, which has enabled us to generate increasing profits and operational cash flow. In order to price portfolios and forecast the targeted collection results for a portfolio, we use two separate internally developed statistical models and one externally developed model, which we may supplement with on-site due diligence and data obtained from the debt owner s collection process and loan files. One model analyzes the portfolio as one unit based on demographic comparisons, while the second and external models analyze each account in a portfolio using variables in a regression analysis. As we collect on our portfolios, the results are input back into the models in an ongoing process which we believe increases their accuracy. Through December 31, 2008, we have acquired 1,290 portfolios with a face value of $39.9 billion.

Ability to Hire, Develop and Retain Productive Collectors

We place considerable focus on our ability to hire, develop and retain effective collectors who are key to our continued growth and profitability. Several large military bases and numerous telemarketing, customer service and reservation phone centers are located near our headquarters and regional offices in Virginia, providing access to a large pool of eligible personnel. The Hutchinson, Kansas, Las Vegas, Nevada, Birmingham, Alabama, Jackson, Tennessee, Houston, Texas and Fresno, California areas also provide a sufficient potential workforce of eligible personnel. We have found that tenure is a primary driver of our collector effectiveness. We offer our collectors a competitive wage with the opportunity to receive unlimited incentive compensation based on performance, as well as an attractive benefits package, a comfortable working environment and the ability to work on a flexible schedule. Stock options were awarded to many of our collectors at the time of our IPO, and many tenured collectors were awarded nonvested shares in 2004, 2005 and 2006. We have a comprehensive training program for new owned portfolio collectors and provide continuing advanced training classes which are conducted in our four training centers. Recognizing the demands of the job, our management team has endeavored to create a professional and supportive environment for all of our employees.

Established Systems and Infrastructure

We have devoted significant effort to developing our systems, including statistical models, databases and reporting packages, to optimize our portfolio purchases and collection efforts. In addition, we believe that our technology infrastructure is flexible, secure, reliable and redundant, to ensure the protection of our sensitive data and to mitigate exposure to systems failure or unauthorized access. We believe that our systems and infrastructure give us meaningful advantages over our competitors. We have developed financial models and systems for pricing portfolio acquisitions, managing the collections process and monitoring operating results. We perform a static pool analysis monthly on each of our portfolios, inputting actual results back into our acquisition models, to enhance their accuracy. We monitor collection results continuously, seeking to identify and resolve negative trends immediately. Our comprehensive management reporting package is designed to fully inform our management team so that they may make timely operating decisions. This combination of hardware, software and proprietary modeling and systems has been developed by our management team through years of experience in this industry and we believe provides us with an important competitive advantage from the acquisition process all the way through collection operations.

Strong Relationships with Major Credit Originators

We have done business with most of the top consumer lenders in the United States. We maintain an extensive marketing effort and our senior management team is in contact on a regular basis with known and prospective credit originators. We believe that we have earned a reputation as a reliable purchaser of defaulted consumer receivables portfolios and as responsible collectors. Furthermore, from the perspective of the selling credit originator, the failure to close on a negotiated sale of a portfolio consumes valuable time and expense and can have an adverse effect on pricing when the portfolio is re-marketed. We have never been unable to close on a transaction. Similarly, if a credit originator sells a portfolio to a debt buyer which has a reputation for violating industry standard collecting practices, it can taint the reputation of the credit originator. We go to great lengths to collect from consumers in a responsible, professional and legally compliant manner. We believe our strong relationships with major credit originators provide us with access to quality opportunities for portfolio purchases.

Experienced Management Team

We have an experienced management team with considerable expertise in the accounts receivable management industry. Prior to our formation, our founders played key roles in the development and management of a consumer receivables acquisition and divestiture operation of Household Recovery Services, a subsidiary of

Household International, now owned by HSBC. As we have grown, the original management team has been expanded to include a group of experienced, seasoned executives.

Portfolio Acquisitions

Our portfolio of defaulted consumer receivables includes a diverse set of accounts that can be categorized by asset type, age and size of account, level of previous collection efforts and geography. To identify attractive buying opportunities, we maintain an extensive marketing effort with our senior officers contacting known and prospective sellers of defaulted consumer receivables. We acquire receivables of Visa®, MasterCard® and Discover® credit cards, private label credit cards, installment loans, lines of credit, bankrupt accounts, deficiency balances of various types, legal judgments, and trade payables, all from a variety of debt owners. These debt owners include major banks, credit unions, consumer finance companies, telecommunication providers, retailers, utilities, insurance companies, medical groups/hospitals, other debt buyers and auto finance companies. In addition, we exhibit at trade shows, advertise in a variety of trade publications and attend industry events in an effort to develop account purchase opportunities. We also maintain active relationships with brokers of defaulted consumer receivables.

The following chart categorizes our life to date owned portfolios as of December 31, 2008 into the major asset types represented (amounts in thousands):

Asset Type	**No. of Accounts**	**%**	**Life to Date Purchased Face Value of Defaulted Consumer Receivables(1)**	**%**
Visa/MasterCard/Discover	10,954	57.4%	$ 29,197,790	73.2%
Consumer Finance	4,955	26.0%	4,324,737	10.8%
Private Label Credit Cards	2,681	14.1%	3,347,550	8.4%
Auto Deficiency	484	2.5%	3,051,001	7.6%
Total:	**19,074**	**100.0%**	**$ 39,921,078**	**100.0%**

(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).

We have done business with most of the largest consumer lenders in the United States. Since our formation, we have purchased accounts from approximately 150 debt owners.

We have acquired portfolios at various price levels, depending on the age of the portfolio, its geographic distribution, our historical experience with a certain asset type or credit originator and similar factors. A typical defaulted consumer receivables portfolio ranges from $1 million to $150 million in face value and contains defaulted consumer receivables from diverse geographic locations with average initial individual account balances of $400 to $7,000.

The age of a defaulted consumer receivables portfolio (the time since an account has been charged-off) is an important factor in determining the price at which we will purchase a receivables portfolio. Generally, there is an inverse relationship between the age of a portfolio and the price at which we will purchase the portfolio. This relationship is due to the fact that older receivables typically are more difficult to collect. The accounts receivables management industry places receivables into categories depending on the number of collection agencies that have previously attempted to collect on the receivables. Fresh accounts are typically past due 120 to 270 days and charged-off by the credit originator, that are either being sold prior to any post-charge-off collection activity or are placed with a third-party for the first time. These accounts typically sell for the highest purchase price. Primary accounts are typically 360 to 450 days past due and charged-off, have been previously placed with one contingent fee servicer and receive a lower purchase price. Secondary and tertiary accounts are typically more than 660 days past due and charged-off, have been placed with two or three contingent fee servicers and receive even lower purchase prices. We also purchase accounts previously worked by four or more agencies and these are typically 1,260 days or more past due and receive an even lower price. In addition, we purchase accounts that are included in consumer bankruptcies. These bankrupt accounts are typically filed under Chapter

13 of the U.S. Bankruptcy Code and have an associated payment plan that can range from 3 to 5 years. We purchase bankrupt accounts in both forward flow and spot transactions and consequently, they can be at any age in the bankruptcy plan life cycle.

As shown in the following chart, as of December 31, 2008, we purchase accounts at any point in the delinquency cycle (amounts in thousands):

Account Type	**No. of Accounts**	**%**	**Life to Date Purchased Face Value of Defaulted Consumer Receivables(1)**	**%**
Fresh	783	4.1%	$ 2,897,585	7.3%
Primary	2,396	12.6%	4,086,581	10.2%
Secondary	3,272	17.2%	5,039,470	12.6%
Tertiary	3,672	19.3%	4,633,690	11.6%
BK Trustees	2,053	10.7%	8,631,036	21.6%
Other	6,898	36.1%	14,632,716	36.7%
Total:	**19,074**	**100.0%**	**$ 39,921,078**	**100.0%**

(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.

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. In addition, economic factors and bankruptcy trends vary regionally and are 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 December 31, 2008 (amounts in thousands):

Life to Date Purchased Face Value of

Geographic Distribution	No. of Accounts	%	Defaulted Consumer Receivables (1)	%	Original Purchase Price of Defaulted Consumer Receivables (2)	%
Texas	3,321	17%	$ 5,042,635	13%	$ 113,280	11%
California	1,838	10%	4,745,725	12%	110,357	10%
Florida	1,446	8%	3,834,238	10%	90,289	8%
New York	1,144	6%	2,686,008	7%	69,125	6%
Pennsylvania	658	3%	1,591,432	4%	46,224	4%
North Carolina	660	3%	1,399,197	4%	37,896	4%
Illinois	763	4%	1,354,505	3%	41,385	4%
Ohio	639	3%	1,331,921	3%	44,583	4%
Georgia	576	3%	1,254,007	3%	41,698	4%
New Jersey	445	2%	1,213,562	3%	31,934	3%
Michigan	487	3%	1,005,867	3%	33,127	3%
Virginia	504	3%	835,264	2%	24,947	2%
Massachusetts	352	2%	824,884	2%	21,500	2%
Tennessee	387	2%	821,304	2%	27,617	3%
South Carolina	338	2%	755,429	2%	20,246	2%
Arizona	291	2%	736,685	2%	17,268	2%
Other (3)	5,225	27%	10,488,415	25%	300,487	28%
Total:	**19,074**	**100%**	**$ 39,921,078**	**100%**	**$ 1,071,963**	**100%**

(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.

(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.

Purchasing Process

We acquire portfolios from debt owners through auctions and negotiated sales. In an auction process, the seller will assemble a portfolio of receivables and will either broadly offer the portfolio to the market or seek purchase prices from specifically invited potential purchasers. In a privately negotiated sale process, the debt owner will contact known, reputable purchasers directly, take bids and negotiate the terms of sale. We also acquire accounts in forward flow contracts. Under a forward flow contract, we agree to purchase defaulted consumer receivables from a debt owner on a periodic basis, at a set percentage of face value of the receivables over a specified time period. These agreements typically have a provision requiring that the attributes of the receivables to be sold will not significantly change each month and that the debt owner efforts to collect these receivables will not change. If this provision is not adhered to, the contract will allow for the early termination of the forward flow contract by the purchaser or call for a price renegotiation. Forward flow contracts are a consistent source of defaulted consumer receivables for accounts receivables management providers and provide the debt owner with a reliable source of revenue and a professional resolution of defaulted consumer receivables.

In a typical sale transaction, a debt owner distributes a computer data file containing ten to fifteen basic data fields on each receivables account in the portfolio offered for sale. Such fields typically include the consumer s name, address, outstanding balance, date of charge-off, date of last payment and the date the account was opened. We perform our initial due diligence on the portfolio by electronically cross-checking the data fields on the computer disk or data tape against the accounts in our owned portfolios and against national demographic and credit databases. We compile a variety of portfolio level reports examining all demographic data available. When valuing pools of bankrupt consumer receivables, we seek to access information on the status of each account s bankruptcy case.

In order to determine a purchase price for a portfolio, we use two separate internally developed computer models and one externally developed model, which we may supplement with on-site due diligence of the seller s collection operation and/or a review of their loan origination files, collection notes and work processes. We analyze the portfolio using our proprietary multiple regression model, which analyzes each account of the portfolio using variables in the regression model. In addition, we analyze the portfolio as a whole using an adjustment model, which uses an appropriate cash flow model depending upon whether it is a purchase of fresh, primary, secondary or tertiary accounts. Then, adjustments can be made to the cash flow model to compensate for demographic attributes supported by a detailed analysis of demographic data. Finally, we use a model that creates statistically similar portfolios from our existing accounts and develops collection curves for them that are used in our price modeling. From these models we derive our quantitative purchasing analysis which is used to help price transactions. The multiple regression model is also used to prioritize collection work efforts subsequent to purchase. With respect to prospective forward flow contracts and other long-term relationships, in addition to the procedures outlined above, as we receive new flows under the aforementioned contract we may obtain a representative test portfolio to evaluate and compare the performance of the portfolio to the projections we developed in our purchasing analysis. In addition, when purchasing bankrupt consumer receivables, we utilize a specifically designed pricing model.

Our due diligence and portfolio review results in a comprehensive analysis of the proposed portfolio. This analysis compares defaulted consumer receivables in the prospective portfolio with our collection history in similar portfolios. We then use our multiple regression model to value each account. Finally, we use the statistically similar portfolio analysis model to refine our curves. Using the three valuation approaches, we determine cash collections over the life of the portfolio. We then summarize all anticipated cash collections and associated direct expenses and project a collectibility value expressed both in dollars and liquidation percentage and a detailed expense projection over the portfolio s estimated six to ten year economic life. We use the total projected collectibility value and expenses to determine an appropriate purchase price.

We maintain a detailed static pool analysis on each portfolio that we have acquired, capturing all demographic data and revenue and expense items for further analysis. We use the static pool analysis to refine the underwriting models that we use to price future portfolio purchases. The results of the static pool analysis are input back into our models, increasing the accuracy of the models as the data set increases with every portfolio purchase and each day s collection efforts.

The quantitative and qualitative data derived in our due diligence is evaluated together with our knowledge of the current defaulted consumer receivables market and any subjective factors about the portfolio or the debt owner of which management may be aware. A portfolio acquisition approval memorandum is prepared for each prospective portfolio before a purchase price is submitted to the debt owner. This approval memorandum, which outlines the portfolio s anticipated collectibility and purchase structure, is distributed to members of our Investment Committee. The approval by the Committee sets a maximum purchase price for the portfolio. The Investment Committee is currently comprised of Steve Fredrickson, President and Chief Executive Officer, Kevin Stevenson, Executive Vice President, Chief Financial and Administrative Officer, Craig Grube, Executive Vice President Acquisitions, Mike Petit, President, Bankruptcy Services and Neal Stern, Senior Vice President and Chief Operating Officer Owned Portfolios. Due to travel arrangements, alternates can be named from time to time.

Once a portfolio purchase has been approved by our investment committee and the terms of the sale have been agreed to with the debt owner, the acquisition is documented in an agreement that contains customary terms and conditions. Provisions are typically incorporated for bankrupt, disputed, fraudulent or deceased accounts and typically, the debt owner either agrees to repurchase these accounts or replace them with acceptable replacement accounts within certain time frames.

Owned Collection Operations

Our work flow management system places, recalls and prioritizes accounts in collectors work queues, based on our analyses of our accounts and other demographic, credit and prior work collection attributes. We use this process to focus our work effort on those consumers most likely to pay on their accounts and to rotate to other collectors the non-paying but most likely to pay accounts from which other collectors have been unsuccessful in receiving payment. The majority of our collections occur as a result of telephone contact with consumers.

The collectability forecast for a newly acquired portfolio will help determine our initial collection strategy. Accounts which are determined to have the highest predicted collection probability may be sent immediately to collectors work queues. Less collectible accounts may be set aside as house accounts to be collected using a predictive dialer or another passive, low cost method. After owning an account for a month we begin reassessing the collectability on a daily basis based on a set of observed account behaviors. Some accounts may be worked using a letter and/or settlement strategy. We may obtain credit reports for various accounts after the collection process begins.

Our computer system allows each collector to view all the scanned documents relating to the consumer s account, which can include the original account application and payment checks. A typical collector work queue may include 650 to 1,000 accounts or more, depending on the skill level and tenure of the collector. The work queue is depleted and replenished automatically by our computerized work flow system.

On the initial contact call, the consumer is given a standardized presentation regarding the benefits of resolving his or her account with us. Emphasis is placed on determining the reason for the consumer s default in order to better assess the consumer s situation and create a plan for repayment. The collector is incentivized to have the consumer pay the full balance of the account. If the collector cannot obtain payment of the full balance, the collector will suggest a repayment plan which generally includes an approximate 20% down payment with the balance to be repaid over an agreed upon period. At times, when determined to be appropriate, and in many cases with management approval, a reduced lump-sum settlement may be agreed upon. If the consumer elects to utilize an installment plan, we have developed a system which enables us to make withdrawals from a consumer s bank account, in accordance with the directions of the customer.

If a collector is unable to establish contact with a consumer based on information received, the collector must undertake skip tracing procedures to develop important account information. Skip tracing is the process of developing new phone, address, job or asset information on a consumer, or verifying the accuracy of such information. Each collector does his or her own skip tracing using a number of computer applications available at his or her workstation, as well as a series of automated skip tracing procedures implemented by us on a regular basis.

Accounts for which the consumer has the likely ability, but not the willingness, to resolve their obligations are reviewed for legal action. Depending on the balance of the defaulted consumer receivable and the applicable state collection laws, we determine whether to commence legal action to judicially collect on the receivable. The legal process can take an extended period of time, but it also generates cash collections that likely would not have been realized otherwise.

During 2004, we began using a combination of internal staff (attorney and support), as well as external attorneys, to pursue legal collections in certain states and under certain circumstances. This has grown to over 40 states, utilizing the lower courts, in which we initiate law suits in amounts up to the jurisdictional limits of the respective courts. This distribution channel allows us to work accounts that we would not normally pursue through the use of contingent fee collection attorneys because of cost. Our legal recovery department also collects claims against estates in cases involving deceased debtors having assets at the time of death. Our legal recovery department oversees our internal legal collections and coordinates an independent nationwide collections attorney network which is responsible for the preparation and filing of judicial collection proceedings in multiple jurisdictions, determining the suit criteria, coordinating sales of property and instituting wage garnishments to satisfy judgments. This network consists of approximately 50 independent law firms who work on a flat fee or contingent fee basis. Legal cash collections generated by both our in house attorneys and outside independent contingent fee attorneys constituted approximately 28% of our total cash collections in 2008. As our portfolio matures, a larger number of accounts will be directed to our legal recovery department for judicial collection; consequently, we anticipate that legal cash collections will grow commensurately and comprise a larger percentage of our total cash collections.

Our bankruptcy department manages consumer filings under the U.S. Bankruptcy Code on debtor accounts derived from three sources; 1) the company s purchased pools of charged off and delinquent accounts, 2) our purchased pools of bankrupt accounts, and 3) our third party servicing client relationships. On company owned accounts, we file proofs of claim (POCs) or claim transfers and actively manage these accounts through the entire life cycle of the bankruptcy proceeding in order to substantiate our claims and ensure that we participate in any distributions to creditors. On accounts managed under a third party relationship, we work on either a full service contingency fee basis or a menu style fee for service basis.

We developed our proprietary Bankruptcy Management System (BMS) as a secure and highly automated platform for providing bankruptcy notification services, filing POCs and claim transfers, managing documents, administering our case load, posting and reconciling payments and providing customized reports. BMS is a robust system designed to manage claims processing and case management in a high volume environment. The system is highly flexible and its capacity is easily expanded. Daily processing volumes are managed to meet individual bar dates associated with each bankruptcy case and specific client turnaround times. BMS and its underlying business rules were developed with emphasis first on minimizing risks through strict compliance to the bankruptcy code, then on maximizing recoveries from automated claim filing and case administration.

Each of our employees goes through an entry level training program to familiarize them with BMS and the bankruptcy process, including a general overview of how we interact with the courts, debtor s attorneys and trustees. We also use a tiered process of cross training designed to familiarize advancing employees with a variety of operational assignments and analytical tasks. For example, we utilize specially trained employees to perform advanced data matching and analytics for clients, while others are tasked with resolving objections directly with attorneys and trustees. In rare circumstances, resolution to these objections may need to be affected by working through our network of local counsel.

Fee-for-Service Businesses

In order to provide debt owners with alternative collection solutions and to capitalize on common competencies between a fee-for-service collections operation and an acquired receivables portfolio business, we commenced our ARM third-party contingent fee collections operation in March 2001. In a contingent fee arrangement, debt owners typically place defaulted receivables with a third party collection agency once they have ceased their recovery efforts. The debt owners then pay the third-party agency a commission fee based upon the amount actually collected from the consumer. A contingent fee placement of defaulted consumer receivables is usually for a fixed time frame, typically four to six months, or as long as twelve months. At the end of this fixed period, the third-party agency will return the uncollected defaulted consumer receivables to the debt owner, which may then place the defaulted consumer receivables with another collection agency or sell the portfolio of receivables. We discontinued our ARM contingent fee operation during the second quarter of 2008.

The determination of the commission fee to be paid for third-party collections is generally based upon the age and potential collectibility of the defaulted consumer receivables being assigned for placement. For example, if there has been no prior third-party collection activity with respect to the defaulted consumer receivables, the commission fee would be lower than if there had been one or more previous collection agencies attempting to collect on the receivables. The earlier the placement of defaulted consumer receivables in the collection process, the higher the probability of receiving a cash collection and, therefore, the lower the cost to collect and the lower the commission fee. Other factors, such as the location of the consumers, the size of the defaulted consumer receivables, competition among third party agencies, and the clients collection procedures and work standards also contribute to establishing a commission fee.

Revenues from IGS are accounted for as commission revenue. IGS performs national skip tracing, asset location and collateral recovery services, principally for auto finance companies, for a fee. The amount of fee earned is generally dependent on several different outcomes: whether the debtor was found and a resolution on the account occurred, if the collateral was repossessed or if payment was made by the debtor to the debt owner. For example, if the debtor is not found, our fee is less than if the debtor is found and we are able to create a positive resolution on the account.

For RDS and MuniServices, our government processing and collection businesses, their 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. When audits are conducted, there are two components. The first is a charge for the hours incurred on conducting the audit. This charge is for hours worked. This charge is up-charged from the actual costs incurred. The gross billing is a component of the line item Commissions and the expense is included in the line item Compensation and employee services. The second item is for expenses incurred while conducting the audit. Most jurisdictions will reimburse us for direct expenses incurred for the audit including such items as travel and meals. The billed amounts are included in the line item Commissions and the expense component is included in its appropriate expense category, generally, Other operating expenses.

Competition

We face competition in both of the markets we serve owned portfolio and fee-for-service accounts receivable management from new and existing providers of outsourced receivables management services, including other purchasers of defaulted consumer receivables portfolios, third-party contingent fee collection agencies and debt owners that manage their own defaulted consumer receivables rather than outsourcing them. The accounts receivable management industry (owned portfolio and contingent fee) is highly fragmented and competitive, consisting of approximately 6,000 consumer and commercial agencies. We estimate that more than 90% of these agencies compete in the contingent fee market. There are few significant barriers for entry to new providers of contingent fee receivables management services and, consequently, the number of agencies serving the contingent fee market may continue to grow. Greater capital needs and the need for portfolio evaluation expertise sufficient to price portfolios effectively constitute significant barriers for entry to new providers of owned portfolio receivables management services.

We face bidding competition in our acquisition of defaulted consumer receivables and in obtaining placement of fee-for-service receivables. We also compete on the basis of reputation, industry experience and performance. Among the positive factors which we believe influence our ability to compete effectively in this market are our ability to bid on portfolios at appropriate prices, our reputation from previous transactions regarding our ability to close transactions in a timely fashion, our relationships with originators of defaulted consumer receivables, our team of well-trained collectors who provide quality customer service and compliance with applicable collections laws and our ability to collect on various asset types. Among the negative factors which we believe could influence our ability to compete effectively in this market are that some of our current competitors and possible new competitors may have substantially greater financial, personnel and other resources, greater adaptability to

changing market needs, longer operating histories and more established relationships in our industry than we currently have.

Information Technology

Technology Operating Systems and Server Platform

The architecture and design of our systems provides us with a technology system that is flexible, secure, reliable and redundant to ensure the protection of our sensitive data. We utilize Intel-based servers running Microsoft Windows 2000/2003 operating systems. In addition, we utilize a blend of purchased and proprietary software systems tailored to the needs of our business. These systems are designed to eliminate inefficiencies in our collections, continue to meet business objectives in a changing environment and meet compliance obligations with regulatory entities. Our proprietary software systems are being leveraged to manage location information and operational applications for MuniServices, IGS and RDS. We believe our custom solutions will enhance the overall investigative capabilities of this business while meeting compliance obligations with regulatory entities.

Network Technology

To provide delivery of our applications, we utilize Intel-based workstations across our entire business operations. The environment is configured to provide speeds of 100 megabytes to the desktops of our collections and administration staff. Our one gigabyte server network architecture supports high-speed data transport. Our network system is designed to be scalable and meet expansion and inter-building bandwidth and quality of service demands.

Database and Software Systems

The ability to access and utilize data is essential to PRA being able to operate nationwide in a cost-effective manner. Our centralized computer-based information systems support the core processing functions of our business under a set of integrated databases and are designed to be both replicable and scalable to accommodate our internal growth. This integrated approach helps to assure that data sources are processed efficiently. We use these systems for portfolio and client management, skip tracing, check taking, financial and management accounting, reporting, and planning and analysis. The systems also support our consumers, including on-line access to account information, account status and payment entry. We use a combination of Microsoft and Oracle database software to manage our portfolios, financial, customer and sales data, and we believe these systems will be sufficient for our needs for the foreseeable future. MuniServices, IGS and RDS all maintain unique, proprietary software systems that manage the movement of data, accounts and information throughout these business units. We believe these systems will be sufficient for our needs in the foreseeable future.

Redundancy, System Backup, Security and Disaster Recovery

Our data centers provide the infrastructure for collection services and uninterrupted support of data, applications and hardware for all of our business units. We believe our facilities and operations include sufficient redundancy, file back-up and security to ensure minimal exposure to systems failure or unauthorized access. The preparations in this area include the use of call centers in Virginia, Kansas, Alabama and Tennessee in order to help provide redundancy for data and processes should one site be completely disabled. We have a disaster recovery plan covering our business that is tested on a periodic basis. The combination of our locally distributed call control systems provides enterprise-wide call and data distribution between our call centers for efficient portfolio collection and business operations. In addition to data replication between the sites, incremental backups of both software and databases are performed on a daily basis and a full system backup is performed weekly. Backup data tapes are stored at an offsite location along with copies of schedules and production control procedures, procedures for recovery using an off-site data center, documentation and other critical information necessary for recovery and continued operation. Our Virginia headquarters has two separate telecommunications feeds, uninterruptible power supplies and natural gas and diesel-generators, all of which provide a level of redundancy should a power outage or interruption occur. We also have generators installed at each of our remote call centers, as well as our subsidiary locations in Alabama and as of April 2009, Nevada. We also employ rigorous physical and electronic security to protect our data. Our call centers have restricted card key access and appropriate additional physical security measures. Electronic protections include data encryption, firewalls and multi-level access controls.

Plasma Displays for Real Time Data Utilization

We utilize plasma displays at our main facility to aid in recovery of portfolios. The displays provide real-time business-critical information to our collection personnel for efficient collection efforts such as telephone, production, employee status, goal trending, training and corporate information.

Predictive Dialer Technology

The Avaya Proactive Contact Dialer ensures that our collection staff focuses on certain defaulted consumer receivables according to our specifications. Its predictive technology takes into account all campaign and dialing parameters and is able to automatically adjust its dialing pace to match changes in campaign conditions and provide the lowest possible wait times and abandon rates, with the highest volume of outbound calls. In addition, the dialer allows our collectors to handle only live voice calls by leaving automated messages on all calls where answering machines are detected. This feature allows our representatives to speak with more debtors per agent hour, and also increases our inbound call volume.

Employees

We employed 2,032 persons on a full-time basis, including the following number of front line operations employees by business: 1,478 on our owned portfolios, 158 working in our IGS operations, 67 working in our RDS government collections operation, and 71 working in our MuniServices operations, as of December 31, 2008. None of our employees are represented by a union or covered by a collective bargaining agreement. We believe that our relations with our employees are good.

Hiring

We recognize that our collectors are critical to the success of our business as a majority of our collection efforts occur as a result of telephone contact with consumers. We have found that the tenure and productivity of our collectors are directly related. Therefore, attracting, hiring, training, retaining and motivating our collection personnel is a major focus for us. We pay our collectors competitive wages and offer employees a full benefits program which includes comprehensive medical coverage, short and long term disability, life insurance, dental and vision coverage, pre-paid legal plan, an employee assistance program, supplemental indemnity, cancer, hospitalization, accident insurance, a flexible spending account for child care and a matching 401(k) program. In addition to a base wage, we provide collectors with the opportunity to receive unlimited compensation through an incentive compensation program that pays bonuses above a set monthly base, based upon each collector s collection results. This program is designed to ensure that employees are paid based not only on performance, but also on consistency. We have awarded stock based compensation to many of our tenured collectors. We believe that these practices have helped us achieve an annual post-training turnover rate of 59% in 2008.

A large number of telemarketing, customer-service and reservation phone centers are located near our Virginia headquarters. We believe that we offer a competitive and, in many cases, a higher base wage than many local employers and therefore have access to a large number of eligible personnel. In addition, there are several military bases in the area. We employ numerous military spouses and retirees and find them to be an excellent source of employees. We have also found the Las Vegas, Nevada, Hutchinson, Kansas, Birmingham, Alabama, Jackson, Tennessee, Houston, Texas and Fresno, California areas to provide a large potential workforce of eligible personnel.

Training

We provide a comprehensive multi-week training program for all new owned portfolio collectors. The first weeks of the training program is comprised of lectures to learn collection techniques, state and federal collection laws, systems, negotiation skills, skip tracing and telephone use. These sessions are then followed by additional weeks of practical experience conducting live calls with additional managerial supervision in order to provide employees with confidence and guidance while still contributing to our profitability. Each trainee must successfully pass a comprehensive examination before being assigned to the collection floor, as well as once a year thereafter. In addition, we conduct continuing advanced classes in our four training centers. Our technology and systems allow us to monitor individual employees and then offer additional training in areas of deficiency to increase productivity and ensure compliance.

Outsourced Collections Department

Legal Recovery

An important component of our collections effort involves our outsourced collections department and the judicial collection of accounts of customers who have the ability, but not the willingness, to resolve their obligations. Accounts for which the consumer is not cooperative and for which we can establish a garnishable job or attachable asset are reviewed for legal action. Additionally, we review accounts using a proprietary scoring model and select those accounts reflecting a high propensity to pay in a legal environment. Depending on the balance of the defaulted consumer receivable and the applicable state collection laws, we determine whether to commence legal action to collect on the receivable. The legal process can take an extended period of time, but it also generates cash collections that likely would not have been realized otherwise. During 2004, we began using a combination of internal staff (attorney and support), as well as external attorneys, to pursue legal collections in certain states and under certain circumstances. This has grown to 40 states, utilizing the lower courts, in which we initiate law suits in amounts up to the jurisdictional limits of the respective courts. This distribution channel allows us to work accounts that we would not normally pursue through the use of contingent fee collection attorneys because of cost. Our legal recovery department also collects claims against estates in cases involving deceased debtors having assets at the time of death. Our legal recovery department oversees internal legal collections and coordinates an independent nationwide attorney network which is responsible for the preparation and filing of judicial collection proceedings in multiple jurisdictions, determining the suit criteria, coordinating sales of property and instituting wage garnishments to satisfy judgments. This nationwide collections attorney network consists of approximately 50 independent law firms, all of which work on a contingent fee basis. Legal cash collections generated by both our in house attorneys and outside independent contingent fee attorneys constituted approximately 28% of our total cash collections in 2008. As our portfolio matures, a larger number of accounts will be directed to our outsourced collections department for judicial collection; consequently, we anticipate that legal collections will grow commensurately and comprise a larger percentage of our total cash collections.

Bankruptcy

Our bankruptcy department manages consumer filings under the U.S. Bankruptcy Code on debtor accounts derived from three sources; 1) the company s purchased pools of charged off and delinquent accounts, 2) our purchased pools of bankrupt accounts, and 3) our third party servicing client relationships. On company owned accounts, we file proofs of claim (POCs) or claim transfers and actively manage these accounts through the entire life cycle of the bankruptcy proceeding in order to substantiate our claims and ensure that we participate in any distributions to creditors. On accounts managed under a third party relationship, we work on either a full service contingency fee basis or a menu style fee for service basis.

We developed our proprietary Bankruptcy Management System (BMS) as a secure and highly automated platform for providing bankruptcy notification services, filing POCs and claim transfers, managing documents, administering our case load, posting and reconciling payments and providing customized reports. BMS is a robust system designed to manage claims processing and case management in a high volume environment. The system is highly flexible and its capacity is easily expanded. Daily processing volumes are managed to meet individual bar dates associated with each bankruptcy case and specific client turnaround times. BMS and its underlying business rules were developed with emphasis first on minimizing risks through strict compliance to the bankruptcy code, then on maximizing recoveries from automated claim filing and case administration.

Each of our employees goes through an entry level training program to familiarize them with BMS and the bankruptcy process, including a general overview of how we interact with the courts, debtor s attorneys and trustees. We also use a tiered process of cross training designed to familiarize advancing employees with a variety of operational assignments and analytical tasks. For example, we utilize specially trained employees to perform advanced data matching and analytics for clients, while others are tasked with resolving objections

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directly with attorneys and trustees. In rare circumstances, resolution to these objections may need to be affected by working through our network of local counsel.

Corporate Legal Department

Our corporate legal department manages general corporate governance, litigation management, insurance and risk management, corporate transactions, intellectual property, contract and document preparation and review, including real estate purchase and lease agreements and portfolio purchase documents, compliance with federal securities laws and other regulations and statutes, obtaining and maintaining multi-state licensing, bonding and insurance and dispute and complaint resolution. As a part of its compliance functions, our corporate legal department works with our internal auditor and the Audit Committee of our Board of Directors in the implementation of our Code of Ethics. In that connection, we have implemented companywide ethics training and mandatory ethics quizzes and have established a confidential telephone hotline to report suspected policy violations, fraud, embezzlement, deception in record keeping and reporting, accounting, auditing matters and other acts which are inappropriate, criminal and/or unethical. Our Code of Ethics policy is available at the Investor Relations page of our website. Our corporate legal department also provides guidance to our quality control department and assists with training our staff in relevant areas including extensive training on the Fair Debt Collection Practices Act and other relevant laws and regulations. Our corporate legal department distributes guidelines and procedures for collection personnel to follow when communicating with customers, customer s agents, attorneys and other parties during our recovery efforts. This includes overseeing the letter process and approving all communications to account debtors. In addition, our corporate legal department regularly researches, and provides collections personnel and our training department with summaries and updates of changes in, federal and state statutes and relevant case law, so that they are aware of and in compliance with changing laws and judicial decisions when skip-tracing or collecting accounts.

Regulation

Federal and state statutes establish specific guidelines and procedures which debt collectors must follow when collecting consumer accounts. It is our policy to comply with the provisions of all applicable federal laws and comparable state statutes in all of our recovery activities, even in circumstances in which we may not be specifically subject to these laws. Our failure to comply with these laws could have a material adverse effect on us in the event and to the extent that they apply to some or all of our recovery activities. Federal and state consumer protection, privacy and related laws and regulations extensively regulate the relationship between debt collectors and debtors, and the relationship between customers and credit card issuers. Significant federal laws and regulations applicable to our business as a debt collector include the following:

Fair Debt Collection Practices Act. This act imposes certain obligations and restrictions on the practices of debt collectors, including specific restrictions regarding communications with consumer customers, including the time, place and manner of the communications. This act also gives consumers certain rights, including the right to dispute the validity of their obligations and a right to sue debt collectors who fail to comply with its provisions, including the right to recover their attorney fees.

Fair Credit Reporting Act. This act places certain requirements on credit information providers regarding verification of the accuracy of information provided to credit reporting agencies and investigating consumer disputes concerning the accuracy of such information. We provide information concerning our accounts to the three major credit reporting agencies, and it is our practice to correctly report this information and to investigate credit reporting disputes. The Fair and Accurate Credit Transactions Act amended the Fair Credit Reporting Act to include additional duties applicable to data furnishers with respect to information in the consumer s credit file that the consumer identifies as resulting from identity theft, and requires that data furnishers have procedures in place to prevent such information from being furnished to credit reporting agencies.

Gramm-Leach-Bliley Act. This act requires that certain financial institutions, including collection agencies, develop policies to protect the privacy of consumers private financial information and provide notices to consumers advising them of their privacy policies. This act also requires that if private personal information concerning a consumer is shared with another unrelated institution, the consumer must be given an opportunity to opt out of having such information shared. Since we do not share consumer information with non-related entities, except as required by law, or except as needed to collect on the receivables, our consumers are not entitled to any

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opt-out rights under this act. This act is enforced by the Federal Trade Commission, which has retained exclusive jurisdiction over its enforcement, and does not afford a private cause of action to consumers who may wish to pursue legal action against a financial institution for violations of this act.

Electronic Funds Transfer Act. This act regulates the use of the Automated Clearing House (ACH) system to make electronic funds transfers. All ACH transactions must comply with the rules of the National Automated Check Clearing House Association (NACHA) and Uniform Commercial Code § 3-402. This act, the NACHA regulations and the Uniform Commercial Code give the consumer, among other things, certain privacy rights with respect to the transactions, the right to stop payments on a pre-approved fund transfer, and the right to receive certain documentation of the transaction. This act also gives consumers a right to sue institutions which cause financial damages as a result of their failure to comply with its provisions.

Telephone Consumer Protection Act. In the process of collecting accounts, we use automated predictive dialers to place calls to consumers. This act and similar state laws place certain restrictions on telemarketers and users of automated dialing equipment who place telephone calls to consumers.

Servicemembers Civil Relief Act. The Soldiers and Sailors Civil Relief Act of 1940 was amended in December 2003 as the Servicemembers Civil Relief Act (SCRA). The SCRA gives U.S. military service personnel relief from credit obligations they may have incurred prior to entering military service, and may also apply in certain circumstances to obligations and liabilities incurred by a servicemember while serving on active duty. The SCRA prohibits creditors from taking specified actions to collect the defaulted accounts of servicemembers. The SCRA impacts many different types of credit obligations, including installment contracts and court proceedings, and tolls the statute of limitations during the time that the servicemember is engaged in active military service. The SCRA also places a cap on interest bearing obligations of servicemembers to an amount not greater than 6% per year, inclusive of all related charges and fees.

Health Insurance Portability and Accountability Act. The Health Insurance Portability and Accountability Act (HIPAA) provides standards to protect the confidentiality of patients personal healthcare and financial information. Pursuant to HIPAA, business associates of health care providers, such as agencies which collect healthcare receivables, must comply with certain privacy and security standards established by HIPAA to ensure that the information provided will be safeguarded from misuse. This act is enforced by the Department of Health and Human Services and does not afford a private cause of action to consumers who may wish to pursue legal action against an institution for violations of this act.

U.S. Bankruptcy Code. In order to prevent any collection activity with bankrupt debtors by creditors and collection agencies, the U.S. Bankruptcy Code provides for an automatic stay, which prohibits certain contacts with consumers after the filing of bankruptcy petitions.

Additionally, there are some state statutes and regulations comparable to the above federal laws, and specific licensing requirements which affect our operations. State laws may also limit credit account interest rates and the fees, as well as limit the time frame in which judicial actions may be initiated to enforce the collection of consumer accounts.

Although we are not a credit originator, some of these laws directed toward credit originators may occasionally affect our operations because our receivables were originated through credit transactions, such as the following laws, which apply principally to credit originators:

Truth in Lending Act;

Fair Credit Billing Act; and

Equal Credit Opportunity Act.

Federal laws which regulate credit originators require, among other things, that credit card issuers disclose to consumers the interest rates, fees, grace periods and balance calculation methods associated with their credit card accounts. Consumers are entitled under current laws to have payments and credits applied to their accounts promptly, to receive prescribed notices and to require billing errors to be resolved promptly. Some laws prohibit discriminatory practices in connection with the extension of credit. Federal statutes further provide that, in some cases, consumers cannot be held liable for, or their liability is limited with respect to, charges to the credit card account that were a result of an unauthorized use of the credit card. These laws, among others, may give consumers a legal cause of action against us, or may limit our ability to recover amounts owing with respect to the receivables, whether or not we committed any wrongful act or omission in connection with the account. If the credit originator fails to comply with applicable statutes, rules and regulations, it could create claims and rights for consumers that could reduce or eliminate their obligations to repay the account and have a possible material adverse effect on us.

Accordingly, when we acquire defaulted consumer receivables, we contractually require credit originators to indemnify us against any losses caused by their failure to comply with applicable statutes, rules and regulations relating to the receivables before they are sold to us.

The U.S. Congress and several states have enacted legislation concerning identity theft. Additional consumer protection and privacy protection laws may be enacted that would impose additional requirements on the enforcement of and recovery on consumer credit card or installment accounts. Any new laws, rules or regulations that may be adopted, as well as existing consumer protection and privacy protection laws, may adversely affect our ability to recover the receivables. In addition, our failure to comply with these requirements could adversely affect our ability to enforce the receivables.

We cannot assure you that some of the receivables were not established as a result of identity theft or unauthorized use of a credit card and, accordingly, we could not recover the amount of the defaulted consumer receivables. As a purchaser of defaulted consumer receivables, we may acquire receivables subject to legitimate defenses on the part of the consumer. Our account purchase contracts allow us to return to the debt owners certain defaulted consumer receivables that may not be collectible, due to these and other circumstances. Upon return, the debt owners are required to replace the receivables with similar receivables or repurchase the receivables. These provisions limit to some extent our losses on such accounts.

In addition to our obligation to comply with applicable federal, state and local laws and regulations, we are also obligated to comply with judicial decisions reached in court cases involving legislation passed by any such governmental bodies.

Item 1A. Risk Factors.

To the extent not described elsewhere in this Annual Report, the following are risks related to our business.

A deterioration in economic conditions in the United States may have an adverse effect on our collections, results of operations, revenue and stock price

Our performance may be affected by economic conditions in the United States. If the United States economy deteriorates, personal bankruptcy filings may increase, and the ability of consumers to pay their debts could be adversely affected. This may in turn adversely impact our financial condition, results of operations, revenue and stock price. Other factors associated with the economy that could influence our performance include the financial stability of the lenders on our line of credit, our access to credit, and financial factors affecting consumers.

The current financial turmoil affecting the banking system and financial markets and the possibility that financial institutions may consolidate, go out of business or be taken over by the federal government have resulted in a tightening in credit markets. There could be a number of follow-on effects from the credit crisis and/or the federal government s response to the credit crisis on our business, including a decrease in the value of the our financial investments, the insolvency of lending institutions, including the lenders on our line of credit, resulting in our inability to obtain credit, and the inability of our customers to obtain credit to re-finance their obligations with us. These and other economic factors could have a material adverse effect on our financial condition and results of operations.

We may not be able to purchase defaulted consumer receivables at appropriate prices, and a decrease in our ability to purchase portfolios of receivables could adversely affect our ability to generate revenue

If we are unable to purchase defaulted receivables from debt owners at appropriate prices, or one or more debt owners stop selling defaulted receivables to us, we could lose a potential source of income and our business may be harmed.

The availability of receivables portfolios at prices which generate an appropriate return on our investment depends on a number of factors both within and outside of our control, including the following:

- the continuation of current growth trends in the levels of consumer obligations;
- sales of receivables portfolios by debt owners; and
- competitive factors affecting potential purchasers and credit originators of receivables.

Because of the length of time involved in collecting defaulted consumer receivables on acquired portfolios and the volatility in the timing of our collections, we may not be able to identify trends and make changes in our purchasing strategies in a timely manner.

We may be unable to obtain account documents for some of the accounts that we purchase. Our inability to provide account documents on accounts that are subject to judicial collections may negatively impact the liquidation rate on these accounts

When we collect accounts judicially, courts in certain jurisdictions require that a copy of the account statements or applications be attached to the pleadings in order to obtain a judgment against the account debtors. If we are unable to produce account documents, these courts will deny our claims.

We may not be able to collect sufficient amounts on our defaulted consumer receivables to fund our operations

Our business primarily consists of acquiring and servicing receivables that consumers have failed to pay and that the credit originator has deemed uncollectible and has generally charged-off. The debt owners generally make numerous attempts to recover on their defaulted consumer receivables, often using a combination of in-house recovery efforts and third-party collection agencies. These defaulted consumer receivables are difficult to collect and we may not collect a sufficient amount to cover our investment associated with purchasing the defaulted consumer receivables and the costs of running our business.

Our work force could become unionized in the future, which could adversely affect the stability of our production and increase our costs

Currently, none of our employees are represented by unions. However, our employees have the right at any time under the National Labor Relations Act to form or affiliate with a union. If some or all of our workforce were to become unionized and the terms of the collective bargaining agreement were significantly different from our current compensation arrangements, it could adversely affect the stability of our work force and increase our costs. In 2007, the Employee Free Choice Act H.R. 800 (EFCA) was passed in the U.S. House of Representatives, and currently remains in the Senate. The EFCA aims to amend the National Labor Relations Act, by making it easier for workers to organize unions and increasing the penalties employers may incur if they engage in labor practices in violation of the National Labor Relations Act. The EFCA requires the National Labor Relations Board (NLRB) to review petitions filed by employees for the purpose of creating a labor organization and to certify a bargaining representative without directing an election, if a majority of the bargaining unit employees have authorized designation of the representative. The EFCA also requires the parties to begin bargaining within 10 days of the receipt of the petition, or longer time if mutually agreed upon. EFCA would also require the NLRB to seek a federal injunction against an employer whenever there is reasonable cause to believe that the employer has discharged or discriminated against an employee to encourage or discourage membership in the labor organization, threatened to discharge or otherwise discriminate against an employee in order to interfere with, restrain, or coerce employees in the exercise of guaranteed collective bargaining rights, or engaged in any other related unfair labor practice that significantly interferes with, restrains, or coerces employees in the exercise of such guaranteed rights. The EFCA adds additional remedies for such violations, including back pay plus liquidated damages and civil penalties to be determined by the NLRB not to exceed $20,000 per infraction. This bill or a variation of it could be enacted in the future and could have an adverse impact on our operations.

We experience high employee turnover rates and we may not be able to hire and retain enough sufficiently trained employees to support our operations

The accounts receivables management industry is very labor intensive and, similar to other companies in our industry, we typically experience a high rate of employee turnover. Our annual turnover rate, excluding those employees that do not complete our multi-week training program, was 59% in 2008. We compete for qualified personnel with companies in our industry and in other industries. Our growth requires that we continually hire and train new collectors. A higher turnover rate among our collectors will increase our recruiting and training costs and limit the number of experienced collection personnel available to service our defaulted consumer receivables. If this were to occur, we would not be able to service our defaulted consumer receivables effectively and this would reduce our ability to continue our growth and operate profitability.

We serve markets that are highly competitive, and we may be unable to compete with businesses that may have greater resources than we have

We face competition in both of the markets we serve owned portfolio and fee based accounts receivable management from new and existing providers of outsourced receivables management services, including other purchasers of defaulted consumer receivables portfolios, third-party contingent fee collection agencies and debt owners that manage their own defaulted consumer receivables rather than outsourcing them. The accounts receivable management industry is highly fragmented and competitive, consisting of approximately 6,000 consumer and commercial agencies, most of which compete in the contingent fee business.

We face bidding competition in our acquisition of defaulted consumer receivables and in our placement of fee based receivables, and we also compete on the basis of reputation, industry experience and performance. Some of our current competitors and possible new competitors may have substantially greater financial, personnel and other resources, greater adaptability to changing market needs, longer operating histories and more established relationships in our industry than we currently have. In the future, we may not have the resources or ability to compete successfully. As there are few significant barriers for entry to new providers of fee based receivables management services, there can be no assurance that additional competitors with greater resources than ours will not enter the market. Moreover, there can be no assurance that our existing or potential clients will continue to outsource their defaulted consumer receivables at recent levels or at all, or that we may continue to offer competitive bids for defaulted consumer receivables portfolios. If we are unable to develop and expand our business or adapt to changing market needs as well as our current or future competitors are able to do, we may experience reduced access to defaulted consumer receivables portfolios at appropriate prices and reduced profitability.

We may not be successful at acquiring receivables of new asset types or in implementing a new pricing structure

We may pursue the acquisition of receivables portfolios of asset types in which we have little current experience. We may not be successful in completing any acquisitions of receivables of these asset types and our limited experience in these asset types may impair our ability to collect on these receivables. This may cause us to pay too much for these receivables and consequently, we may not generate a profit from these receivables portfolio acquisitions.

In addition, we may in the future provide a service to debt owners in which debt owners will place consumer receivables with us for a specific period of time for a flat fee. This fee may be based on the number of collectors assigned to the collection of these receivables, the amount of receivables placed or other bases. We may not be successful in determining and implementing the appropriate pricing for this pricing structure, which may cause us to be unable to generate a profit from this business.

Our collections may decrease if certain types of bankruptcy filings involving liquidations increase

Various economic trends and potential changes to existing legislation, may contribute to an increase in the amount of personal bankruptcy filings. Under certain bankruptcy filings a debtor s assets may be sold to repay creditors, but since the defaulted consumer receivables we service are generally unsecured we often would not be able to collect on those receivables. We cannot ensure that our collection experience would not decline with an increase in personal bankruptcy filings or a change in bankruptcy regulations or practices. If our actual collection experience with respect to a defaulted bankrupt consumer receivables portfolio is significantly lower than we projected when we purchased the portfolio, our financial condition and results of operations could deteriorate.

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

We intend to consider acquisitions of other companies in our industry that could complement our business, including the acquisition of entities offering greater access and expertise in other asset types and markets that are related but that we do not currently serve. If we do acquire other businesses, we may not be able to successfully integrate these businesses with our own and we may be unable to maintain our standards, controls and policies. Further, acquisitions may place additional constraints on our resources by diverting the attention of our management from other business concerns. Through acquisitions, we may enter markets in which we have no or limited experience. Moreover, any acquisition may result in a potentially dilutive issuance of equity securities, the incurrence of additional debt and amortization expenses of related intangible assets, all of which could reduce our profitability and harm our business.

The loss of IGS, RDS or MuniServices customers could negatively affect our operations

With respect to the acquisitions of IGS, RDS and MuniServices, a significant portion of the valuation was tied to existing client and customer relationships. Our customers, in general, may terminate their relationship with us on 90 days prior notice. In the event a customer or customers terminate or significantly cut back any relationship with us, it could reduce our profitability and harm our business and could potentially give rise to an impairment charge related to an intangible asset specifically ascribed to existing client and customer relationships.

We may not be able to continually replace our defaulted consumer receivables with additional receivables portfolios sufficient to operate efficiently and profitably

To operate profitably, we must continually acquire and service a sufficient amount of defaulted consumer receivables to generate revenue that exceeds our expenses. Fixed costs such as salaries and lease or other facility costs constitute a significant portion of our overhead and, if we do not continually replace the defaulted consumer receivables portfolios we service with additional portfolios, we may have to reduce the number of our collection personnel. We would then have to rehire collection staff as we obtain additional defaulted consumer receivables portfolios. These practices could lead to:

- low employee morale;
- fewer experienced employees;
- higher training costs;
- disruptions in our operations;
- loss of efficiency; and
- excess costs associated with unused space in our facilities.

Furthermore, heightened regulation of the credit card and consumer lending industry or changing credit origination strategies may result in decreased availability of credit to consumers, potentially leading to a future reduction in defaulted consumer receivables available for purchase from debt owners. We cannot predict how our ability to identify and purchase receivables and the quality of those receivables would be affected if there is a shift in consumer lending practices, whether caused by changes in the regulations or accounting practices applicable to debt owners, a sustained economic downturn or otherwise.

We may not be able to manage our growth effectively

We have expanded significantly since our formation and we intend to maintain our growth focus. However, our growth will place additional demands on our resources and we cannot ensure that we will be able to manage our growth effectively. In order to successfully manage our growth, we may need to:

- expand and enhance our administrative infrastructure;
- continue to improve our management, financial and information systems and controls; and
- recruit, train, manage and retain our employees effectively.

Continued growth could place a strain on our management, operations and financial resources. We cannot ensure that our infrastructure, facilities and personnel will be adequate to support our future operations or to effectively adapt to future growth. If we cannot manage our growth effectively, our results of operations may be adversely affected.

Our operations could suffer from telecommunications or technology downtime or increased costs

Our success depends in large part on sophisticated telecommunications and computer systems. The temporary or permanent loss of our computer and telecommunications equipment and software systems, through casualty or operating malfunction, could disrupt our operations. In the normal course of our business, we must record and process significant amounts of data quickly and accurately to access, maintain and expand the databases we use for our collection activities. Any failure of our information systems or software and our backup systems would interrupt our business operations and harm our business. Our headquarters are located in a region that is susceptible to hurricane damage, which may increase the risk of disruption of information systems and telephone service for sustained periods.

Further, our business depends heavily on services provided by various local and long distance telephone companies. A significant increase in telephone service costs or any significant interruption in telephone services could reduce our profitability or disrupt our operations and harm our business.

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

Our business relies on computer and telecommunications technologies and our ability to integrate these technologies into our business is essential to our competitive position and our success. Computer and telecommunications technologies are evolving rapidly and are characterized by short product life cycles. We may not be successful in anticipating, managing or adopting technological changes on a timely basis.

While we believe that our existing information systems are sufficient to meet our current demands and continued expansion, our future growth may require additional investment in these systems. We depend on having the capital resources necessary to invest in new technologies to acquire and service defaulted consumer receivables. We cannot ensure that adequate capital resources will be available to us at the appropriate time.

Our senior management team is important to our continued success and the loss of one or more members of senior management could negatively affect our operations

The loss of the services of one or more of our key executive officers or key employees could disrupt our operations. We have employment agreements with Steve Fredrickson, our president, chief executive officer and chairman of our board of directors, Kevin Stevenson, our executive vice president and chief financial and administrative officer, Craig Grube, our executive vice president of portfolio acquisitions, and most of our other senior executives. The current agreements contain non-compete provisions that survive termination of employment. However, these agreements do not and will not assure the continued services of these officers and we cannot ensure that the non-compete provisions will be enforceable. Our success depends on the continued service and performance of our key executive officers, and we cannot guarantee that we will be able to retain those individuals. The loss of the services of Mr. Fredrickson, Mr. Stevenson, Mr. Grube or other key executive officers could seriously impair our ability to continue to acquire or collect on defaulted consumer receivables and to manage and expand our business. Under one of our credit agreements, if both Mr. Fredrickson and Mr. Stevenson cease to be president and chief financial and administrative officer, respectively, it would constitute a default.

Our ability to recover and enforce our defaulted consumer receivables may be limited under federal and state laws

The businesses conducted by the Company s operating subsidiaries are subject to licensing and regulation by governmental and regulatory bodies in the many jurisdictions in which the Company operates and conducts its business. Federal and state laws may limit our ability to recover and enforce our defaulted consumer receivables regardless of any act or omission on our part. Some laws and regulations applicable to credit issuers may preclude us from collecting on defaulted consumer receivables we purchase if the credit issuer previously failed to comply with applicable laws in generating or servicing those receivables. Collection laws and regulations also directly apply to our business. Such laws and regulations are extensive and subject to change. Additional consumer protection and privacy protection laws may be enacted that would impose additional requirements on the enforcement of and collection on consumer credit receivables. Any new laws, rules or regulations that may be adopted, as well as existing consumer protection and privacy protection laws, may adversely affect our ability to collect on our defaulted consumer receivables and may harm our business. In addition, federal and state governmental bodies are considering, and may consider in the future, legislative proposals that would regulate the collection of our defaulted consumer receivables. Further, new tax law changes such as Internal Revenue Code Section 6050P (requiring 1099-C returns to be filed on discharge of indebtedness in excess of $600) could negatively impact our ability to collect or cause us to incur additional expenses. Although we cannot predict if or how any future legislation would impact our business, our failure to comply with any current or future laws or regulations applicable to us could limit our ability to collect on our defaulted consumer receivables, which could reduce our profitability and harm our business.

Our ability to recover on portfolios of bankrupt consumer receivables may be impacted by changes in federal laws or changes in the administrative practices of the various bankruptcy courts

We recover on consumer receivables that have filed for bankruptcy protection under available U.S. bankruptcy laws. We recover on consumer receivables that have filed for bankruptcy protection after we acquired them, and we also purchase accounts that are currently in bankruptcy proceedings. Our ability to recover on portfolios of bankruptcy consumer receivables may be impacted by changes in federal laws or changes in administrative practices of the various bankruptcy courts. Congress is considering legislation which, if passed, could allow bankruptcy judges to reduce and or modify mortgages and interest rates on a chapter 13 debtor s principal residence. If passed, this legislation may affect our ability to collect bankrupt accounts and it may temporarily disrupt our historical bankruptcy collection curves, making it more difficult to accurately price bankrupt accounts.

We are subject to examinations and challenges by tax authorities

Our industry is relatively unique and as a result there is not a set of well defined laws or regulations for us to follow that match our particular facts and circumstances for some tax positions. Therefore, certain tax positions we take are based on industry practice, tax advice and drawing similarities of our facts and circumstances to those in case law. These tax positions may relate to tax compliance, sales and use, franchise, gross receipts, payroll, property and income tax issues, including tax base and apportionment. Challenges made by tax authorities to our application of tax rules may result in adjustments to the timing or amount of taxable income or deductions or the allocation of income among tax jurisdictions, as well as, inconsistent positions between different jurisdictions on similar matters. If any such challenges are made and are not resolved in our favor, they could have an adverse effect on our financial condition and result of operations.

We utilize the interest method of revenue recognition for determining our income recognized on finance receivables, which is based on an analysis of projected cash flows that may prove to be less than anticipated and could lead to reductions in future revenues or impairment charges

We utilize the interest method to determine income recognized on finance receivables. Under this method, static pools of receivables we acquire are modeled upon their projected cash flows. A yield is then established which, when applied to the unamortized purchase price of the receivables, results in the recognition of income at a constant yield relative to the remaining balance in the pool of defaulted consumer receivables. Each static pool is analyzed monthly to assess the actual performance compared to that expected by the model. If the accuracy of the modeling process deteriorates or there is a decline in anticipated cash flows, we would suffer reductions in future revenues or a decline in the carrying value of our receivables portfolios or impairment charges, which in any case would result in lower earnings in future periods and could negatively impact our stock price.

We may be required to incur impairment charges as a result of the application of American Institute of Certified Public Accountants Statement of Position 03-3

In October 2003, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position 03-3 (SOP 03-3), Accounting for Loans or Certain Securities Acquired in a Transfer. SOP 03-3 provides guidance on accounting for differences between contractual and expected cash flows from an investor s initial investment in loans or debt securities acquired in a transfer if those differences are attributable, at least in part, to credit quality. SOP 03-3 is effective for loans acquired in fiscal years beginning after December 15, 2004 and amends Practice Bulletin 6 which remains in effect for loans acquired prior to the SOP 03-3 effective date. SOP 03-3 limits the revenue that may be accrued to the excess of the estimate of expected future cash flows over a portfolio s initial cost of accounts receivable acquired. SOP 03-3 requires that the excess of the contractual cash flows over expected cash flows not be recognized as an adjustment of revenue, expense, or on the balance sheet. SOP 03-3 initially freezes the internal rate of return, referred to as IRR, originally estimated when the accounts receivable are purchased for subsequent impairment testing. Rather than lower the estimated IRR if the original collection estimates are not received, effective January 1, 2005, the carrying value of a portfolio will be written down to maintain the then-current IRR. SOP 03-3 also amends Practice Bulletin 6 in a similar manner and applies to all loans acquired prior to January 1, 2005. Increases in expected future cash flows can be recognized prospectively through an upward adjustment of the IRR over a portfolio s remaining life. Any increased yield then becomes the new benchmark for impairment testing. SOP 03-3 provides that previously issued annual financial statements would not need to be restated. Historically, as we have applied the guidance of Practice Bulletin 6, we have moved yields upward and downward as appropriate under that guidance. However, since SOP 03-3 guidance does not permit yields to be lowered, under either the revised Practice Bulletin 6 or SOP 03-3, it will increase the probability of us having to incur impairment charges in the future, which could reduce our profitability in a given period and could negatively impact our stock price.

We incur increased costs as a result of enacted and proposed changes in laws and regulations

Enacted and proposed changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules proposed by the SEC and by the NASDAQ Global Stock Market, have resulted in increased costs to us as we implement their requirements. We continue to evaluate and monitor developments with respect to new and proposed rules and cannot predict or estimate the amount of the additional costs we will incur or the timing of such costs.

The future impact on us of Section 404 of the Sarbanes-Oxley Act of 2002 and the rules and regulations promulgated thereunder is unclear

As directed by Section 404 of the Sarbanes-Oxley Act of 2002, the SEC adopted rules requiring public companies to include a report by management on the company s internal control over financial reporting in our annual reports on Form 10-K. This report is required to contain an assessment by management of the effectiveness of such company s internal controls over financial reporting. In addition, the public accounting firm auditing a public company s financial statements must report on the effectiveness of the company s internal controls over financial reporting. In the future, if we are unable to comply with the requirements of Section 404 in a timely manner, it could result in an adverse reaction in the financial markets due to a loss of confidence in the reliability

of our internal controls over financial reporting, which could cause the market price of our common stock to decline and make it more difficult for us to finance our operations.

The market price of our shares of common stock could fluctuate significantly

Wide fluctuations in the trading price or volume of our shares of common stock could be caused by many factors, including factors relating to our company or to investor perception of our company (including changes in financial estimates and recommendations by research analysts), but also factors relating to (or relating to investor perception of) the accounts receivable management industry or the economy in general.

We may not be able to retain, renegotiate or replace our existing credit facility

If we are unable to retain, renegotiate or replace such facility, our growth could be adversely affected, which could negatively impact our business operations and the price of our common stock.

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

All of our receivable portfolios are pledged to secure amounts owed to our lenders. Our debt agreements impose a number of restrictive covenants on how we operate our business. Failure to satisfy any one of these covenants could result in all or any of the following consequences, each of which could have a materially adverse effect on our ability to conduct business:

- acceleration of outstanding indebtedness;
- our inability to continue to purchase receivables needed to operate our business; or
- our inability to secure alternative financing on favorable terms, if at all.

Our hedging strategies may not be successful in mitigating our risks associated with changes in interest rates and could adversely affect our results of operations and financial condition, as could our failure to comply with hedge accounting principles and interpretations

We entered into an interest rate swap transaction in December 2008 to mitigate our interest rate risk. Our hedging strategies rely on assumptions and projections. If these assumptions and projections prove to be incorrect or our hedges do not adequately mitigate the impact of changes in interest rates, we may experience volatility in our earnings that could adversely affect our results of operations and financial condition.

In addition, hedge accounting in accordance with SFAS 133 requires the application of significant subjective judgments to a body of accounting concepts that is complex and for which the interpretations have continued to evolve within the accounting profession and amongst the standard-setting bodies. Our failure to comply with hedge accounting principles and interpretations could result in the loss of the applicability of hedge accounting which could adversely affect our results of operations and financial condition.

Terrorist attacks, war and threats of attacks and war may adversely impact results of operations, revenue, and stock price

Terrorist attacks, war and the outcome of war and threats of attacks may adversely affect our results of operations, revenue and stock price. Any or all of these occurrences could have a material adverse effect on our results of operations, revenue and stock price.

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

The collections industry is governed by various US federal and state laws and regulations. Many states require us to be a licensed debt collector. The Federal Trade Commission has the authority to investigate consumer complaints against debt collection companies and to recommend enforcement actions and seek monetary penalties. If we fail to comply with applicable laws and regulations, it could result in the suspension, or termination of our ability to conduct collections which would materially adversely affect us. In addition, new federal and state laws or regulations or changes in the ways these rules or laws are interpreted or enforced could limit our activities in the future or significantly increase the cost of compliance.

Changes in governmental laws and regulations could increase our costs and liabilities or impact our operations

Changes in laws and regulations and the manner in which they are interpreted or applied may alter our business environment. This could affect our results of operations or increase our liabilities. These negative impacts could result from changes in collection laws, laws related to credit reporting, consumer bankruptcy, accounting standards, taxation requirements, employment laws and communications laws, among others. It is possible that we could become subject to additional liabilities in the future resulting from changes in laws and regulations that could result in an adverse effect on our results of operations and financial condition.

Our certificate of incorporation, by-laws and Delaware law contain provisions that may prevent or delay a change of control or that may otherwise be in the best interest of our stockholders

Our certificate of incorporation and by-laws contain provisions that may make it more difficult, expensive or otherwise discourage a tender offer or a change in control or takeover attempt by a third-party, even if such a transaction would be beneficial to our stockholders. The existence of these provisions may have a negative impact on the price of our common stock by discouraging third-party investors from purchasing our common stock. In particular, our certificate of incorporation and by-laws include provisions that:

- classify our board of directors into three groups, each of which will serve for staggered three-year terms;
- permit a majority of the stockholders to remove our directors only for cause;
- permit our directors, and not our stockholders, to fill vacancies on our board of directors;
- require stockholders to give us advance notice to nominate candidates for election to our board of directors or to make stockholder proposals at a stockholders meeting;
- permit a special meeting of our stockholders be called only by approval of a majority of the directors, the chairman of the board of directors, the chief executive officer, the president or the written request of holders owning at least 30% of our common stock;
- permit our board of directors to issue, without approval of our stockholders, preferred stock with such terms as our board of directors may determine;
- permit the authorized number of directors to be changed only by a resolution of the board of directors; and
- require the vote of the holders of a majority of our voting shares for stockholder amendments to our by-laws.

In addition, we are subject to Section 203 of the Delaware General Corporation Law which provides certain restrictions on business combinations between us and any party acquiring a 15% or greater interest in our voting stock other than in a transaction approved by our board of directors and, in certain cases, by our stockholders. These provisions of our certificate of incorporation and by-laws and Delaware law could delay or prevent a change in control, even if our stockholders support such proposals. Moreover, these provisions could diminish the opportunities for stockholders to participate in certain tender offers, including tender offers at prices above the then-current market value of our common stock, and may also inhibit increases in the trading price of our common stock that could result from takeover attempts or speculation.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

Our principal executive offices and primary operations facility are located in approximately 100,000 square feet of leased space in three adjacent buildings in Norfolk, Virginia. This site can currently accommodate approximately 975 employees. We own a two-acre parcel of land across from our headquarters which we developed into a parking lot for use by our employees.

We own an approximately 22,000 square foot facility in Hutchinson, Kansas, comprised of two buildings, and contiguous parcels of land which are used primarily for employee parking. The Hutchinson site can currently accommodate approximately 250 employees.

We also lease a facility located in approximately 23,000 square feet of space in Hampton, Virginia which can accommodate approximately 300 employees.

We also lease a 13,500 square foot call center in Las Vegas, Nevada which can accommodate approximately 150 employees. In December 2008, we entered into a lease for an approximately 30,000 square foot call center in Las Vegas, Nevada. The leased space is currently under renovations and is expected to be completed during the second quarter of 2009. The newly leased space will be able to accommodate approximately 270 employees and will replace the 13,500 square foot call center.

We also lease a 15,000 square-foot facility in Birmingham, Alabama which can accommodate approximately 160 employees and approximately 400 square feet of space in Montgomery, Alabama.

We own a 34,000 square foot building and a nine-acre parcel of land in Jackson, Tennessee which can accommodate approximately 430 employees.

For our MuniServices business, we lease approximately 26,000 square feet of office space in several offices around the country, the majority of which is in Fresno, California. These offices can accommodate approximately 140 employees.

We also lease a facility located in approximately 6,000 square feet of space in Houston, Texas which can accommodate approximately 30 employees.

We do not consider any specific leased or owned facility to be material to our operations. We believe that equally suitable alternative facilities are available in all areas where we currently do business.

Item 3. Legal Proceedings.

From time to time, we are involved in various legal proceedings, most of 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. While we cannot predict the outcome of these proceedings, or of any other claims that may be brought against us, we do not believe that the collections related matters represent a substantial volume of our account, and it is not expected that these or any other legal proceedings or claims in which we are involved will, individually or in the aggregate, have a material impact on 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 4. Submission of Matters to a Vote of Securityholders.

None.

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Price Range of Common Stock

Our common stock (Common Stock) began trading on the NASDAQ Global Stock Market under the symbol PRAA on November 8, 2002. Prior to that time there was no public trading market for our common stock. The following table sets forth the high and low sales price for the Common Stock, as reported by the NASDAQ Global Stock Market, for the periods indicated.

	High	Low
2007		
Quarter ended March 31, 2007	$49.20	$41.63
Quarter ended June 30, 2007	$62.61	$43.50
Quarter ended September 30, 2007	$65.66	$44.26
Quarter ended December 31, 2007	$54.89	$36.28
2008		
Quarter ended March 31, 2008	$50.50	$27.43
Quarter ended June 30, 2008	$47.75	$37.12
Quarter ended September 30, 2008	$52.73	$35.09
Quarter ended December 31, 2008	$49.49	$24.70

As of February 4, 2009, there were 31 holders of record of the Common Stock. Based on information provided by our transfer agent and registrar, we believe that there are 24,183 beneficial owners of the Common Stock.

Stock Performance

The following graph compares from December 31, 2003, to December 31, 2008, the cumulative stockholder returns assuming an initial investment of $100 on January 1, 2004 in the Company s Common Stock, the stocks comprising the NASDAQ Global Market Composite Index, the NASDAQ Market Index (U.S.) and the stocks comprising a peer group index consisting of six peers. Any dividends paid during the five year period are assumed to be reinvested.

As of December 31,	2003	2004	2005	2006	2007	2008
PRAA	$100	$155	$175	$176	$152	$130
NASDAQ Global Market Composite Index	$100	$109	$110	$121	$126	$ 61
NASDAQ Market Index (U.S.)	$100	$109	$113	$127	$139	$ 81
Peer Group Index	$100	$116	$139	$136	$133	$ 88

The comparisons of stock performance shown above are not intended to forecast or be indicative of possible future performance of the Company s common stock. The Company does not make or endorse any predictions as to its future stock performance.

Equity Incentives

The table below provides information with respect to securities authorized for issuance under our equity compensation plans as of December 31, 2008:

Plan Category	Number of Securities Authorized for Issuance Under the Plan	Number of Securities to be Issued Upon Exercise of Outstanding Options or Nonvested Shares Under the Plan	Weighted-average Exercise Price of Outstanding Options and Nonvested Shares(1)	Number of Securities Remaining Available for Future Issuance Under the Equity Compensation Plan(2)
Equity Compensation plans approved by security holders	2,000,000	378,255	$ 5.61	843,495
Equity Compensation plans not approved by security holders	None	None	N/A	None
Total	2,000,000	378,255	$ 5.61	843,495

(1) Includes grants of nonvested shares, for which there is no exercise price, but with respect to which shares are awarded without cost when the restrictions have been realized. Excluding the impact of the nonvested shares, the weighted average exercise price of outstanding options is $17.24.

(2) Excludes 778,250 exercised options and

vested shares, which are not available for re-issuance.

Dividend Policy

Our board of directors sets our dividend policy. We do not currently pay regular dividends on our Common Stock; however, our board of directors may determine in the future to declare or pay dividends on our Common Stock. On April 23, 2007, the Company s Board of Directors authorized a special one-time cash dividend of $1.00 per share with a record date of May 9, 2007. The cash dividends were paid on June 8, 2007 and totaled $16,069,694. No dividends were paid during 2008. Any future determination as to the declaration and payment of dividends will be at the discretion of our board of directors and will depend on then existing conditions, including our financial condition, results of operations, contractual restrictions, capital requirements, business prospects and other factors that our board of directors may consider relevant.

Item 6. Selected Financial Data.

The following selected financial data should be read in conjunction with the audited consolidated financial statements.

	Years Ended December 31,				
(Dollars in thousands, except per share data)	**2008**	**2007**	**2006**	**2005**	**2004**
INCOME STATEMENT DATA:					
Revenues:					
Income recognized on finance receivables, net	$ 206,486	$ 184,705	$ 163,357	$ 134,674	$ 106,254
Commissions	56,789	36,043	24,965	13,851	7,142
Total revenues	263,275	220,748	188,322	148,525	113,396
Operating expenses:					
Compensation and employee services	88,073	69,022	58,142	44,332	36,620
Outside legal and other fees and services	61,752	47,474	40,139	29,965	21,408
Communications	10,304	8,531	5,876	4,424	3,638
Rent and occupancy	3,908	3,105	2,276	2,101	1,745
Other operating expenses	6,977	5,915	4,758	3,424	2,712
Depreciation and amortization	7,424	5,517	5,131	4,679	2,383
Total operating expenses	178,438	139,564	116,322	88,925	68,506
Income from operations	84,837	81,184	72,000	59,600	44,890
Net interest income/(expenses)	(11,091)	(3,285)	206	331	(51)
Income before income taxes	73,746	77,899	72,206	59,931	44,839
Provision for income taxes	28,384	29,658	27,716	23,159	17,388
Net income	$ 45,362	$ 48,241	$ 44,490	$ 36,772	$ 27,451
Net income per share					
Basic	$ 2.98	$ 3.08	$ 2.80	$ 2.35	$ 1.79
Diluted	$ 2.97	$ 3.06	$ 2.77	$ 2.28	$ 1.73
Weighted average shares					
Basic	15,229	15,646	15,911	15,642	15,357
Diluted	15,292	15,779	16,082	16,149	15,853
OPERATING AND OTHER FINANCIAL DATA:					
Cash collections and commissions (1)	$ 383,488	$ 298,209	$ 261,357	$ 205,226	$ 160,546
Operating expenses to cash collections and commissions	47%	47%	45%	43%	43%
Return on equity (2)	17%	20%	20%	21%	20%
Acquisitions of finance receivables, at cost (3)	$ 280,336	$ 263,809	$ 112,406	$ 149,645	$ 61,165
Acquisitions of finance receivables, at face value	$ 4,588,234	$ 11,113,830	$ 7,788,158	$ 5,307,918	$ 3,340,434
Employees at period end:					
Total employees	2,032	1,677	1,291	1,110	948
Ratio of collection personnel to total employees (4)	87%	88%	88%	88%	89%

(1) Includes both cash collected on finance receivables and commission fees earned during the relevant period.

(2) Calculated by dividing net income for each year by average monthly stockholders equity for the same year.

(3) Represents cash paid for finance receivables. It does not include certain capitalized costs or 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.

(4) Includes all collectors and all first-line collection supervisors at December 31.

Below is listed certain key balance sheet data for the periods presented:

	As of December 31,				
(Dollars in thousands)	**2008**	**2007**	**2006**	**2005**	**2004**
BALANCE SHEET DATA:					
Cash and cash equivalents	$ 13,901	$ 16,730	$ 25,101	$ 15,985	$ 24,513
Investments					23,950
Finance receivables, net	563,830	410,297	226,447	193,645	105,189
Total assets	657,840	476,307	293,378	247,772	175,176
Long-term debt			690	1,152	1,924
Total debt, including obligations under capital lease and line of credit	268,305	168,103	932	16,535	2,501
Total stockholders equity	283,863	235,280	247,278	195,322	151,389

Below is listed the quarterly consolidated income statements for the years ended December 31, 2008 and 2007:

	For the Quarter Ended							
(Dollars in thousands, except per share data)	**Dec. 31, 2008**	**Sept. 30, 2008**	**June 30, 2008**	**Mar. 31, 2008**	**Dec. 31, 2007**	**Sept. 30, 2007**	**June 30, 2007**	**Mar. 31, 2007**
INCOME STATEMENT DATA:								
Revenues:								
Income recognized on finance receivables, net	$48,073	$52,738	$53,047	$52,628	$46,741	$46,111	$46,387	$45,466
Commissions	18,898	15,848	10,567	11,476	10,583	8,529	8,389	8,542
Total revenues	66,971	68,586	63,614	64,104	57,324	54,640	54,776	54,008
Operating expenses:								
Compensation and employee services	23,091	22,983	20,872	21,127	18,584	17,322	16,681	16,435
Outside legal and other fees and services	15,352	16,709	15,118	14,573	12,944	11,847	11,246	11,437
Communications	2,769	2,263	2,403	2,869	2,604	2,038	2,005	1,884
Rent and occupancy	1,078	1,123	869	838	888	819	739	659
Other operating expenses	2,114	1,912	1,595	1,356	1,449	1,605	1,478	1,383
Depreciation and amortization	2,285	2,162	1,507	1,470	1,405	1,455	1,362	1,295
Total operating expenses	46,689	47,152	42,364	42,233	37,874	35,086	33,511	33,093
Income from operations	20,282	21,434	21,250	21,871	19,450	19,554	21,265	20,915
Net interest income (expense)	(2,927)	(3,049)	(2,646)	(2,469)	(2,107)	(1,072)	(218)	112
Income before income taxes	17,355	18,385	18,604	19,402	17,343	18,482	21,047	21,027
Provision for income taxes	6,746	6,930	7,178	7,530	6,667	6,787	8,058	8,146
Net income	$10,609	$11,455	$11,426	$11,872	$10,676	$11,695	$12,989	$12,881
Net income per share								
Basic	$ 0.69	$ 0.75	$ 0.75	$ 0.78	$ 0.71	$ 0.76	$ 0.81	$ 0.81
Diluted	$ 0.69	$ 0.75	$ 0.75	$ 0.78	$ 0.70	$ 0.75	$ 0.80	$ 0.80
Weighted average shares								
Basic	15,283	15,267	15,193	15,170	15,136	15,451	16,005	15,993
Diluted	15,329	15,336	15,268	15,237	15,230	15,577	16,168	16,140

Below is listed the quarterly consolidated balance sheets for the years ended December 31, 2008 and 2007:

	Quarter Ended							
(Dollars in thousands)	**Dec. 31, 2008**	**Sept. 30, 2008**	**June 30, 2008**	**Mar. 31, 2008**	**Dec. 31, 2007**	**Sept. 30, 2007**	**June 30, 2007**	**Mar. 31, 2007**
BALANCE SHEET DATA:								
Assets								
	$ 13,901	$ 28,006	$ 16,333	$ 16,816	$ 16,730	$ 14,464	$ 15,042	$ 27,883

Cash and cash equivalents								
Finance receivables, net	563,830	535,430	515,367	477,754	410,297	326,476	288,648	243,568
Property and equipment, net	23,884	23,354	17,332	16,631	16,171	15,217	13,510	12,201
Income taxes receivable	3,587	3,715	3,539	2,791	3,022	2,621	2,424	
Goodwill	27,546	28,058	18,620	18,620	18,620	18,620	18,287	18,288
Intangible assets, net	13,429	13,747	4,322	4,684	5,046	5,399	5,773	6,263
Other assets	11,663	9,251	5,775	5,923	6,422	4,435	4,354	4,614
Total assets	$657,840	$641,561	$581,288	$543,219	$476,308	$387,232	$348,038	$312,817
Liabilities and Stockholders Equity								
Liabilities								
Accounts payable	$ 3,438	$ 4,527	$ 4,630	$ 4,008	$ 4,055	$ 2,815	$ 2,456	$ 4,220
Accrued expenses	4,314	5,294	4,647	4,499	4,471	3,614	3,477	3,063
Income taxes payable								1,765
Accrued payroll and bonuses	9,850	9,605	4,833	4,818	6,820	6,445	4,327	4,203
Deferred tax liability	88,070	81,350	72,577	64,661	57,579	51,018	43,970	37,849
Line of credit	268,300	267,300	234,300	216,800	168,000	100,000	38,000	
Long-term debt							19	572
Obligations under capital lease	5	23	45	70	103	138	174	208
Total liabilities	373,977	368,099	321,032	294,856	241,028	164,030	92,423	51,880
Stockholders equity								
Common stock	153	153	152	152	152	151	160	160
Additional paid in capital	74,574	74,873	73,121	72,654	71,443	70,044	114,142	116,383
Retained earnings	209,047	198,436	186,983	175,557	163,685	153,007	141,313	144,394
Accumulated other comprehensive income	89							
Total stockholders equity	283,863	273,462	260,256	248,363	235,280	223,202	255,615	260,937
Total liabilities and stockholders equity	$657,840	$641,561	$581,288	$543,219	$476,308	$387,232	$348,038	$312,817

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.
Results of Operations

The following table sets forth certain operating data in dollars and as a percentage of total revenues for the years ended December 31, 2008, 2007 and 2006:

(Dollars in thousands)	**2008**		**2007**		**2006**	
Revenues:						
Income recognized on finance receivables, net	$ 206,486	78.4%	$ 184,705	83.7%	$ 163,357	86.7%
Commissions	56,789	21.6	36,043	16.3	24,965	13.3
Total revenues	263,275	100.0	220,748	100.0	188,322	100.0
Operating expenses:						
Compensation and employee services	88,073	33.5	69,022	31.3	58,142	30.9
Outside legal and other fees and services	61,752	23.5	47,474	21.5	40,139	21.3
Communications	10,304	3.9	8,531	3.9	5,876	3.1
Rent and occupancy	3,908	1.4	3,105	1.4	2,276	1.2
Other operating expenses	6,977	2.7	5,915	2.6	4,758	2.6
Depreciation and amortization	7,424	2.8	5,517	2.5	5,131	2.7
Total operating expenses	178,438	67.8	139,564	63.2	116,322	61.8
Income from operations	84,837	32.2	81,184	36.8	72,000	38.2
Interest income	60	0.0	419	0.2	584	0.3
Interest expense	(11,151)	(4.2)	(3,704)	(1.7)	(378)	(0.2)
Income before income taxes	73,746	28.0	77,899	35.3	72,206	38.3
Provision for income taxes	28,384	10.8	29,658	13.4	27,716	14.7
Net income	$ 45,362	17.2%	$ 48,241	21.9%	$ 44,490	23.6%

Year Ended December 31, 2008 Compared to Year Ended December 31, 2007

Revenues

Total revenues were $263.3 million for the year ended December 31, 2008, an increase of $42.6 million or 19.3% compared to total revenues of $220.7 million for the year ended December 31, 2007.

Income Recognized on Finance Receivables, net

Income recognized on finance receivables, net was $206.5 million for the year ended December 31, 2008, an increase of $21.8 million or 11.8% compared to $184.7 million for the year ended December 31, 2007. The majority of the increase was due to an increase in our cash collections on our owned defaulted consumer receivables to $326.7 million from $262.2 million, an increase of $64.5 million or 24.6%. Our finance receivables amortization rate, including the net allowance charge, on our owned portfolios for the year ended December 31, 2008 was 36.8% while for the year ended December 31, 2007 it was 29.6%. During the year ended December 31, 2008, we acquired defaulted consumer receivables portfolios with an aggregate face value amount of $4.6 billion at an original purchase price of $280.3 million. During the year ended December 31, 2007, we acquired defaulted consumer receivable portfolios with an aggregate face value of $11.1 billion at an original purchase price of $263.8 million. In any period, we acquire defaulted consumer receivable portfolios 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 (after direct expenses) 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 changes in 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 years ended December 31, 2008 and 2007, we recorded net allowance charges of $19.4 million and $2.9 million, respectively.

Commissions

Commissions were $56.8 million for the year ended December 31, 2008, an increase of $20.8 million or 57.8% compared to commissions of $36.0 million for the year ended December 31, 2007. Commissions grew as a result of the acquisition of MuniServices, LLC (MuniServices) on July 1, 2008, as well as increases in revenue generated by our IGS fee-for-service business and RDS government processing and collection business, partially offset by a decrease in our Anchor contingent fee business, which ceased operations during the second quarter of 2008, as compared to the prior year period.

Operating Expenses

Total operating expenses were $178.4 million for the year ended December 31, 2008, an increase of $38.8 million or 27.8% compared to total operating expenses of $139.6 million for the year ended December 31, 2007. Total operating expenses were 46.5% of cash receipts for the year ended December 31, 2008 compared with 46.8% for the same period in 2007.

Compensation and Employee Services

Compensation and employee services expenses were $88.1 million for the year ended December 31, 2008, an increase of $19.1 million or 27.7% compared to compensation and employee services expenses of $69.0 million for the year ended December 31, 2007. This increase is mainly due to the acquisition of MuniServices as well as an overall increase in our owned portfolio collection staff. This increase was offset by a reversal or decrease of $1.2 million during 2008 of estimated share-based compensation costs that had been accrued in 2007 related to the 2007 Long Term Incentive Programs because the achievement of the performance targets of the program were unlikely to be achieved. Compensation and employee services expenses increased as total employees grew from 1,677 at December 31, 2007 to 2,032 at December 31, 2008. Additionally, existing employees received normal salary increases. Compensation and employee services expenses as a percentage of cash receipts decreased to 23.0% for the year ended December 31, 2008 from 23.2% of cash receipts for the same period in 2007.

Outside Legal and Other Fees and Services

Outside legal and other fees and services expenses were $61.8 million for the year ended December 31, 2008, an increase of $14.3 million or 30.1% compared to outside legal and other fees and services expenses of $47.5 million for the year ended December 31, 2007. Of the $14.3 million increase, $6.6 million was attributable to increases in agency fees mainly incurred by our IGS subsidiary, $0.9 million was attributable to an increase in corporate legal and accounting fees, $1.3 million was attributable to an increase in other outside fees and services, partially offset by a $0.6 million decrease in credit bureau fees. Of the remaining $6.1 million increase, $2.2 million was attributable to incremental legal costs advanced to our third party collection attorneys. Based on an analysis of our legal accounts and their liquidation potential, it was determined that we were underinvested in terms of costs advanced to attorneys. The remaining $3.9 million was attributable to the increased legal fees and costs incurred resulting from the increased number of accounts referred to both our in house attorneys and outside independent contingent fee attorneys. Total outside legal expenses paid to independent contingent fee attorneys for the year ended December 31, 2008 were 39.4% of legal cash collections generated by independent contingent fee attorneys compared to 34.6% for the year ended December 31, 2007. Outside legal fees and costs paid to independent contingent fee attorneys increased from $29.1 million for the year ended December 31, 2007 to $33.3 million, an increase of $4.2 million or 14.4%, for the year ended December 31, 2008. Additionally, as disclosed previously, we also effectuate legal collections using our own in house attorneys. Total legal expenses incurred by our in house attorneys for the year ended December 31, 2008 were 41.4% of legal cash collections generated by our in house attorneys compared to 29.0% for the year ended December 31, 2007. Legal fees and costs incurred by our in house attorneys increased from $1.6 million for the year ended December 31, 2007 to $3.5 million, an increase of $1.9 million or 119.0%, for the year ended December 31, 2008.

Communications

Communications expenses were $10.3 million for the year ended December 31, 2008, an increase of $1.8 million or 21.2% compared to communications expenses of $8.5 million for the year ended December 31, 2007. The increase was attributable to growth in mailings and higher telephone expenses driven by a greater number of defaulted consumer receivables to work, as well as a significant expansion of our automated dialer seats and related calls that are generated by the dialer. Mailings were responsible for 54.8% or $1.0 million of this increase, while the remaining 45.2% or $0.8 million was attributable to increased call volumes.

Rent and Occupancy

Rent and occupancy expenses were $3.9 million for the year ended December 31, 2008, an increase of $0.8 million or 25.8% compared to rent and occupancy expenses of $3.1 million for the year ended December 31, 2007. The increase was primarily due to the expansion of space in our Norfolk, Virginia administrative and executive facility and the acquisition of MuniServices, as well as increased utility charges. The new Norfolk, Virginia administrative and executive facility accounted for $355,000 of the increase, the MuniServices location accounted for $293,000 of the increase and other occupancy charges accounted for $253,000 of the increase. In addition, there was a decrease of $74,000 in storage and other facility charges.

Other Operating Expenses

Other operating expenses were $7.0 million for the year ended December 31, 2008, an increase of $1.1 million or 18.6% compared to other operating expenses of $5.9 million for the year ended December 31, 2007. The increase was due to increases in travel and meals, miscellaneous expenses, repairs and maintenance, dues and subscriptions and other expenses as well as decreases in taxes (non-income), fees and licenses and hiring expenses. Travel and meals increased by $201,000, miscellaneous expenses increased by $268,000, repairs and maintenance increased by $508,000, dues and subscriptions increased by $125,000 and other expenses increased by $75,000. Taxes (non-income), fees and licenses decreased by $37,000 and hiring expenses decreased by $77,000.

Depreciation and Amortization

Depreciation and amortization expenses were $7.4 million for the year ended December 31, 2008, an increase of $1.9 million or 34.5% compared to depreciation and amortization expenses of $5.5 million for the year ended December 31, 2007. The increase is mainly due to capital purchases in our administrative and executive facility in Norfolk, Virginia as well as additional expense incurred related to the amortization of intangible assets in the acquisition of MuniServices on July 1, 2008, and the acquisition of the assets of Broussard Partners and Associates, Inc. (BPA) on August 1, 2008. Additional increases are the result of continued capital expenditures on equipment, software and computers related to our growth and systems upgrades.

Interest Income

Interest income was $60,000 for the year ended December 31, 2008, a decrease of $359,000 or 85.7% compared to interest income of $419,000 for the year ended December 31, 2007. This decrease is mainly due to lower average invested cash and cash equivalents balances during the year ended December 31, 2008 compared to the same period in 2007.

Interest Expense

Interest expense was $11.2 million for the year ended December 31, 2008, an increase of $7.5 million compared to interest expense of $3.7 million for the year ended December 31, 2007. The increase is mainly due to a significant increase in outstanding borrowings on our line of credit during the year ended December 31, 2008 compared to the same period in 2007. The increase was offset by a decrease in our weighted average interest rate which decreased to 4.60% for the year ended December 31, 2008 as compared to 6.64% for the year ended December 31, 2007.

Provision for Income Taxes

Income tax expense was $28.4 million for the year ended December 31, 2008, a decrease of $1.3 million or 4.4% compared to income tax expense of $29.7 million for the year ended December 31, 2007. The decrease is mainly due to a 5.4% decrease in pre-tax income, down from $77.9 million in 2007, to $73.7 million in 2008, offset by a slight increase in the effective tax rate from 38.1% for the year ended December 31, 2007 to 38.5% for the year ended December 31, 2008. The higher effective tax rate was due mainly to more state tax credits generated during the year ended December 31, 2007 as compared to the same period in 2008.

Year Ended December 31, 2007 Compared to Year Ended December 31, 2006

Revenues

Total revenues were $220.7 million for the year ended December 31, 2007, an increase of $32.4 million or 17.2% compared to total revenues of $188.3 million for the year ended December 31, 2006.

Income Recognized on Finance Receivables, net

Income recognized on finance receivables, net was $184.7 million for the year ended December 31, 2007, an increase of $21.3 million or 13.0% compared to $163.4 million for the year ended December 31, 2006. The majority of the increase was due to an increase in our cash collections on our owned defaulted consumer receivables to $262.2 million from $236.4 million, an increase of $25.8 million or 10.9%. Our finance receivables amortization rate, including the allowance charge, on our owned portfolios for the year ended December 31, 2007 was 29.6% while for the year ended December 31, 2006 it was 30.9%. During the year ended December 31, 2007, we acquired defaulted consumer receivables portfolios with an aggregate face value amount of $11.1 billion at an original purchase price of $263.8 million. During the year ended December 31, 2006, we acquired defaulted consumer receivable portfolios with an aggregate face value of $7.8 billion at an original purchase price of $112.4 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. 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 (after direct expenses) 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 changes in 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 years ended December 31, 2007 and 2006, we recorded net allowance charges of $2.9 million and $1.1 million, respectively.

Commissions

Commissions were $36.0 million for the year ended December 31, 2007, an increase of $11.0 million or 44.0% compared to commissions of $25.0 million for the year ended December 31, 2006. Commissions grew as a result of increases in revenue generated by our IGS fee-for-service business and RDS government processing and collection business offset by a decrease in our ARM contingent fee business compared to the prior year period.

Operating Expenses

Total operating expenses were $139.6 million for the year ended December 31, 2007, an increase of $23.3 million or 20.0% compared to total operating expenses of $116.3 million for the year ended December 31, 2006. Total operating expenses were 46.8% of cash receipts for the year ended December 31, 2007 compared with 44.5% for the same period in 2006.

Compensation and Employee Services

Compensation and employee services expenses were $69.0 million for the year ended December 31, 2007, an increase of $10.9 million or 18.8% compared to compensation and employee services expenses of $58.1 million for the year ended December 31, 2006. Compensation and employee services expenses increased as total employees grew from 1,291 at December 31, 2006 to 1,677 at December 31, 2007, primarily to accommodate our owned portfolio purchasing growth. Additionally, existing employees received normal salary increases. Compensation and employee services expenses as a percentage of cash receipts increased to 23.2% for the year ended December 31, 2007 from 22.3% of cash receipts for the same period in 2006, mainly due to a significant increase in employee staffing, especially in our newer Jackson, Tennessee call center, with a corresponding decrease in collector productivity caused mostly by the addition of this less tenured collection staff.

Outside Legal and Other Fees and Services

Outside legal and other fees and services expenses were $47.5 million for the year ended December 31, 2007, an increase of $7.4 million or 18.5% compared to outside legal and other fees and services expenses of $40.1 million for the year ended December 31, 2006. Of the $7.4 million increase, $4.6 million was attributable to increases in agency fees mainly incurred by our IGS subsidiary, $0.4 million was attributable to increases in outside fees and services, and $0.2 million was attributable to increases in credit bureau fees. This was offset by a $0.1 million decrease in corporate legal expenses. The remaining $2.3 million increase was attributable to the increased legal fees and costs incurred resulting from the increased number of accounts referred to both our in house attorneys and outside independent contingent fee attorneys. Total outside legal expenses paid to independent contingent fee attorneys for the year ended December 31, 2007 were 34.6% of legal cash collections generated by independent contingent fee attorneys compared to 36.1% for the year ended December 31, 2006. Outside legal fees and costs paid to independent contingent fee attorneys increased from $27.5 million for the year ended December 31, 2006 to $29.1 million, an increase of $1.6 million or 5.8%, for the year ended December 31, 2007. Additionally, as disclosed previously, we also effectuate legal collections using our own in house attorneys. Total legal expenses incurred by our in house attorneys for the year ended December 31, 2007 were 29.0% of legal cash collections generated by our in house attorneys compared to 26.4% for the year ended December 31, 2006. Legal fees and costs incurred by our in house attorneys increased from $1.0 million for the year ended December 31, 2006 to $1.6 million, an increase of $0.6 million or 37.5%, for the year ended December 31, 2007.

Communications

Communications expenses were $8.5 million for the year ended December 31, 2007, an increase of $2.6 million or 44.1% compared to communications expenses of $5.9 million for the year ended December 31, 2006. 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 as well as the addition of our new call center in Jackson, Tennessee. Mailings were responsible for 53.8% or $1.4 million of this increase, while the remaining 46.2% or $1.2 million was attributable to increased call volumes.

Rent and Occupancy

Rent and occupancy expenses were $3.1 million for the year ended December 31, 2007, an increase of $0.8 million or 34.8% compared to rent and occupancy expenses of $2.3 million for the year ended December 31, 2006. The increase was primarily due to the addition of our new RDS facility, the addition of our new Norfolk, Virginia administrative and executive facility as well as increased utility charges. Of the $0.8 million increase in 2007, the new RDS location accounted for $123,000 of the increase, the new Norfolk, Virginia administrative and executive facility accounted for $391,000 of the increase and utility and other occupancy charges accounted for $233,000 of the increase. In addition, there was an increase of $83,000 in storage and other facility charges.

Other Operating Expenses

Other operating expenses were $5.9 million for the year ended December 31, 2007, an increase of $1.2 million or 22.9% compared to other operating expenses of $4.8 million for the year ended December 31, 2006. The increase was due to increases in travel and meals, miscellaneous expenses, repairs and maintenance, taxes (non-income), fees and licenses and other expenses. Travel and meals increased by $317,000, miscellaneous

expenses increased by $465,000, repairs and maintenance increased by $114,000, taxes (non-income), fees and licenses increased by $231,000 and other expenses increased by $30,000.

Depreciation and Amortization

Depreciation and amortization expenses were $5.5 million for the year ended December 31, 2007, an increase of $0.4 million or 7.8% compared to depreciation and amortization expenses of $5.1 million for the year ended December 31, 2006. The increase is mainly due to capital purchases for our new call center in Jackson, Tennessee, as well as capital purchases for the addition of our new RDS facility, our new administrative and executive facility in Norfolk, Virginia and our expanded call center in Hutchinson, Kansas. These increases were offset by a decrease in the amortization expense on intangible assets of $0.4 million for the year ended December 31, 2007, when compared to the prior year period.

Interest Income

Interest income was $419,000 for the year ended December 31, 2007, a decrease of $165,000 or 28.3% compared to interest income of $584,000 for the year ended December 31, 2006. This decrease is the result of lower average invested cash and cash equivalents balances during the year ended December 31, 2007 compared to the same period in 2006.

Interest Expense

Interest expense was $3,704,000 for the year ended December 31, 2007, an increase of $3,325,000 compared to interest expense of $379,000 for the year ended December 31, 2006. The increase is mainly due to a significant increase in outstanding borrowings on our lines of credit during the year ended December 31, 2007 compared to the same period in 2006.

Provision for Income Taxes

Income tax expense was $29.7 million for the year ended December 31, 2007, an increase of $2.0 million or 7.2% compared to income tax expense of $27.7 million for the year ended December 31, 2006. The increase is mainly due to a 7.9% increase in pre-tax income, up from $72.2 million in 2006, to $77.9 million in 2007, offset by a slight reduction in the effective tax rate from 38.4% for year ended December 31, 2006 versus 38.1% for the year ended December 31, 2007. The lower effective tax rate was due mainly to state tax credits.

Supplemental Performance Data

Owned Portfolio Performance:

The following tables show certain data related to our owned portfolio. These tables describe the purchase price, cash collections and related multiples. Further, these tables disclose our entire portfolio, the portfolio of purchased bankrupt accounts only and our entire portfolio less the impact of our purchased bankrupt accounts. The accounts represented in the purchased bankruptcy tables are those accounts that were bankrupt at the time of purchase. This contrasts with accounts that file bankruptcy after we purchase them.

Entire Portfolio ($ in thousands)

Purchase Period	Purchase Price (1)	Life to Date Reserve Allowance (2)	Unamortized Purchase Price Balance at December 31, 2008 (3)	Percentage of Purchase Price Remaining Unamortized at December 31, 2008 (4)	Actual Cash Collections Including Cash Sales	Estimated Remaining Collections (5)	Total Estimated Collections (6)	Total Estimated Collections to Purchase Price (7)
1996	$ 3,080	$ 0	$ 0	0%	$ 9,898	$ 30	$ 9,928	322%
1997	$ 7,685	$ 0	$ 0	0%	$ 24,688	$ 150	$ 24,838	323%
1998	$ 11,089	$ 0	$ 0	0%	$ 35,831	$ 362	$ 36,193	326%
1999	$ 18,898	$ 0	$ 0	0%	$ 64,698	$ 866	$ 65,564	347%
2000	$ 25,020	$ 0	$ 0	0%	$ 104,855	$ 2,650	$ 107,505	430%
2001	$ 33,481	$ 105	$ 234	1%	$ 156,953	$ 5,040	$ 161,993	484%
2002	$ 42,325	$ 0	$ 0	0%	$ 170,609	$ 6,587	$ 177,196	419%
2003	$ 61,449	$ 495	$ 2,156	4%	$ 219,894	$ 15,665	$ 235,559	383%
2004	$ 59,178	$ 1,760	$ 4,630	8%	$ 155,011	$ 26,575	$ 181,586	307%
2005	$ 143,213	$ 5,750	$ 50,272	35%	$ 213,551	$ 106,958	$ 320,509	224%
2006	$ 107,802	$ 7,510	$ 55,384	51%	$ 116,723	$ 107,490	$ 224,213	208%
2007	$ 258,772	$ 7,380	$ 193,669	75%	$ 157,274	$ 355,745	$ 513,019	198%
2008	$ 278,511	$ 620	$ 257,485	92%	$ 61,277	$ 487,447	$ 548,724	197%

Purchased Bankruptcy Portfolio ($ in thousands)

Purchase Period	Purchase Price (1)	Life to Date Reserve Allowance (2)	Unamortized Purchase Price Balance at December 31, 2008 (3)	Percentage of Purchase Price Remaining Unamortized at December 31, 2008 (4)	Actual Cash Collections Including Cash Sales	Estimated Remaining Collections (5)	Total Estimated Collections (6)	Total Estimated Collections to Purchase Price (7)
1996	$ 0	$ 0	$ 0	0%	$ 0	$ 0	$ 0	0%
1997	$ 0	$ 0	$ 0	0%	$ 0	$ 0	$ 0	0%
1998	$ 0	$ 0	$ 0	0%	$ 0	$ 0	$ 0	0%
1999	$ 0	$ 0	$ 0	0%	$ 0	$ 0	$ 0	0%
2000	$ 0	$ 0	$ 0	0%	$ 0	$ 0	$ 0	0%

2001	$ 0	$ 0	$ 0	0%	$ 0	$ 0	$ 0	0%
2002	$ 0	$ 0	$ 0	0%	$ 0	$ 0	$ 0	0%
2003	$ 0	$ 0	$ 0	0%	$ 0	$ 0	$ 0	0%
2004	$ 7,469	$ 1,240	$ 332	4%	$ 13,485	$ 745	$ 14,230	191%
2005	$ 29,302	$ 535	$ 3,598	12%	$ 38,056	$ 5,414	$ 43,470	148%
2006	$ 17,643	$ 1,360	$ 3,038	17%	$ 21,585	$ 6,151	$ 27,736	157%
2007	$ 78,933	$ 0	$ 62,077	79%	$ 30,822	$ 87,556	$ 118,378	150%
2008	$ 111,063	$ 0	$ 105,049	95%	$ 14,024	$ 167,098	$ 181,122	163%

Entire Portfolio less Purchased Bankruptcy Portfolio ($ in thousands)

Purchase Period	**Purchase Price [(1)]**	**Life to Date Reserve Allowance [(2)]**	**Unamortized Purchase Price Balance at December 31, 2008 [(3)]**	**Percentage of Purchase Price Remaining Unamortized at December 31, 2008 [(4)]**	**Actual Cash Collections Including Cash Sales**	**Estimated Remaining Collections [(5)]**	**Total Estimated Collections [(6)]**	**Total Estimated Collections to Purchase Price [(7)]**
1996	$ 3,080	$ 0	$ 0	0%	$ 9,898	$ 30	$ 9,928	322%
1997	$ 7,685	$ 0	$ 0	0%	$ 24,688	$ 150	$ 24,838	323%
1998	$ 11,089	$ 0	$ 0	0%	$ 35,831	$ 362	$ 36,193	326%
1999	$ 18,898	$ 0	$ 0	0%	$ 64,698	$ 866	$ 65,564	347%
2000	$ 25,020	$ 0	$ 0	0%	$ 104,855	$ 2,650	$ 107,505	430%
2001	$ 33,481	$ 105	$ 234	1%	$ 156,953	$ 5,040	$ 161,993	484%
2002	$ 42,325	$ 0	$ 0	0%	$ 170,609	$ 6,587	$ 177,196	419%
2003	$ 61,449	$ 495	$ 2,156	4%	$ 219,894	$ 15,665	$ 235,559	383%
2004	$ 51,709	$ 520	$ 4,298	8%	$ 141,526	$ 25,830	$ 167,356	324%
2005	$ 113,911	$ 5,215	$ 46,674	41%	$ 175,495	$ 101,544	$ 277,039	243%
2006	$ 90,159	$ 6,150	$ 52,346	58%	$ 95,138	$ 101,339	$ 196,477	218%
2007	$ 179,839	$ 7,380	$ 131,592	73%	$ 126,452	$ 268,189	$ 394,641	219%
2008	$ 167,448	$ 620	$ 152,436	91%	$ 47,253	$ 320,349	$ 367,602	220%

(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) Life to date reserve allowance refers

to the total amount of allowance charges incurred on our owned portfolios net of any reversals.

(3) Unamortized purchase price balance refers to the purchase price less amortization over the life of the portfolio.

(4) Percentage of purchase price remaining unamortized refers to the amount of unamortized purchase price divided by the purchase price.

(5) Estimated remaining collections refers to the sum of all future projected cash collections on our owned portfolios.

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

(7) Total estimated collections to

purchase price refers to the total estimated collections divided by the purchase price.

The following graph shows the purchase price of our owned portfolios by year beginning in 1996. 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.

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

The following tables, which exclude any proceeds from cash sales of finance receivables, demonstrates our ability to realize significant multi-year cash collection streams on our owned portfolios.

Cash Collections By Year, By Year of Purchase Entire Portfolio

ase							Cash Collection Period						
e	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	20
080	$548	$2,484	$ 1,890	$ 1,348	$ 1,025	$ 730	$ 496	$ 398	$ 285	$ 210	$ 237	$ 102	$
685		2,507	5,215	4,069	3,347	2,630	1,829	1,324	1,022	860	597	437	
089			3,776	6,807	6,398	5,152	3,948	2,797	2,200	1,811	1,415	882	
898				5,138	13,069	12,090	9,598	7,336	5,615	4,352	3,032	2,243	1
020					6,894	19,498	19,478	16,628	14,098	10,924	8,067	5,202	3
481						13,048	28,831	28,003	26,717	22,639	16,048	10,011	6
325							15,073	36,258	35,742	32,497	24,729	16,527	9
449								24,308	49,706	52,640	43,728	30,695	18
178									18,019	46,475	40,424	30,750	19
213										18,968	75,145	69,862	49
802											22,971	53,192	40
772												42,263	115
511													61
503	$548	$4,991	$10,881	$17,362	$30,733	$53,148	$79,253	$117,052	$153,404	$191,376	$236,393	$262,166	$326

Cash Collections By Year, By Year of Purchase Purchased Bankruptcy Portfolio

ase							Cash Collection Period						
e	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	20
	$	$	$	$	$	$	$	$	$	$	$	$	$
469									743	4,554	3,956	2,777	1
302										3,777	15,500	11,934	6
643											5,608	9,455	6
933												2,850	27
063													14
410	$	$	$	$	$	$	$	$	$ 743	$ 8,331	$ 25,064	$ 27,016	$ 56

Cash Collections By Year, By Year of Purchase Entire Portfolio less Purchased Bankruptcy Portfolio

ase							Cash Collection Period						
e	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	20
080	$548	$2,484	$ 1,890	$ 1,348	$ 1,025	$ 730	$ 496	$ 398	$ 285	$ 210	$ 237	$ 102	$
685		2,507	5,215	4,069	3,347	2,630	1,829	1,324	1,022	860	597	437	
089			3,776	6,807	6,398	5,152	3,948	2,797	2,200	1,811	1,415	882	
898				5,138	13,069	12,090	9,598	7,336	5,615	4,352	3,032	2,243	1
020					6,894	19,498	19,478	16,628	14,098	10,924	8,067	5,202	3
481						13,048	28,831	28,003	26,717	22,639	16,048	10,011	6
325							15,073	36,258	35,742	32,497	24,729	16,527	9
449								24,308	49,706	52,640	43,728	30,695	18
709									17,276	41,921	36,468	27,973	17
911										15,191	59,645	57,928	42
159											17,363	43,737	34
839												39,413	87
448													47
093	$548	$4,991	$10,881	$17,362	$30,733	$53,148	$79,253	$117,052	$152,661	$183,045	$211,329	$235,150	$269

When we acquire a new portfolio 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.

Owned Portfolio Personnel Performance:

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

Collector by Tenure

Tenure at:	**12/31/04**	**12/31/05**	**12/31/06**	**12/31/07**	**12/31/08**
One year +(1)	298	327	340	327	452
Less than one year (2)	349	364	375	553	739
Total(2)	647	691	715	880	1191

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

(2) Calculated using total hours worked by all collectors, including those in training to produce a full time equivalent FTE.

Cash Collections per Hour Paid (1)

Average performance	**12/31/04**	**12/31/05**	**12/31/06**	**12/31/07**	**12/31/08**
Total cash collections	$117.59	$133.39	$146.03	$135.77	$131.29
Non-legal cash collections(2)	$ 82.06	$ 89.25	$ 99.06	$ 91.93	$ 96.95
Non-bk cash collections(3)		$128.02	$132.15	$123.10	$111.17

(1) Cash collections (assigned and unassigned) divided by total hours paid (including holiday, vacation and

sick time) to all collectors (including those in training).

(2) Represents total cash collections less legal cash collections.

(3) Represents total cash collections less bankruptcy cash collections. Although we began bankruptcy portfolio purchasing in 2004, we began calculating this metric in 2005.

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 income recognized on finance receivables on a quarterly basis. The difference between cash collections and income recognized on finance receivables is referred to as payments applied to principal. It is also referred to as amortization of purchase price. This amortization is the portion of cash collections that is used to recover the cost of the portfolio investment represented on the balance sheet.

(1) Includes cash collections on finance receivables only. Excludes commissions 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. Historically, our growth has partially masked the impact of this seasonality.

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

The following table displays our quarterly cash collections by source, for the periods indicated.

Cash Collection Source ($ in thousands)	Q42008	Q32008	Q22008	Q12008	Q42007	Q32007	Q22007	Q12007
Call Center & Other Collections	$ 41,268	$ 43,949	$ 46,892	$ 44,883	$ 35,551	$ 36,001	$ 36,107	$ 37,841
External Legal Collections	18,424	21,590	22,471	21,880	20,861	21,384	20,911	20,844
Internal Legal Collections	2,652	2,106	1,947	1,819	1,443	1,449	1,357	1,400
Purchased Bankruptcy Collections	16,904	15,362	13,732	10,820	7,245	6,317	6,231	7,223

The following table shows the components of outside legal and other fees and services for the years ended December 31, 2008, 2007 and 2006 (amounts in thousands):

	2008	2007	2006
Legal fees and costs (1)	$ 36,805	$ 30,720	$ 28,412
Agency fees (2)	16,065	9,467	4,906
Other outside fee and services	8,882	7,287	6,821
	$ 61,752	$ 47,474	$ 40,139

(1) Legal fees and costs represent legal fees and costs incurred by both our inhouse attorneys and outside contingent fee attorneys.

(2) Agency fees are primarily incurred by our IGS skip tracing business.

The following table shows the changes in finance receivables, including the amounts paid to acquire new portfolios, for the years ended December 31, 2008, 2007 and 2006 (amounts in thousands):

	2008	2007	2006
Balance at beginning of year	$ 410,297	$ 226,448	$ 193,645
Acquisitions of finance receivables, net of buybacks (1)	273,746	261,310	105,838
Cash collections applied to principal on finance receivables (2)	(120,213)	(77,461)	(73,035)
Balance at end of year	$ 563,830	$ 410,297	$ 226,448
Estimated Remaining Collections (ERC (3))	$ 1,115,565	$ 902,565	$ 553,223

(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, net of allowance charges.

(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.

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, business acquisitions, repurchase of our common stock, payment of cash dividends, 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 other significant acquisitions requiring cash during that period. In addition, we file taxes using the cost recovery method for income recognition. If we were to receive an unfavorable ruling on our tax method, we may be required to pay our current deferred taxes in the near-term, possibly requiring additional financing from other sources.

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 $81.7 million, $80.4 million and $59.5 million for the years ended December 31, 2008, 2007 and 2006, respectively. In these periods, cash from operations was generated primarily from net income earned through cash collections and commissions received for the period. The increase was due mostly to changes in deferred taxes. Net income decreased to $45.4 million for the year ended December 31, 2008 from $48.2 million for the year ended December 31, 2007 and increased from $44.5 million for the year ended December 31, 2006. Net cash provided by operating activities was also impacted by the amount of income taxes paid during the period which was $3,200, $5.3 million and $18.8 million for the years ended December 31, 2008, 2007 and 2006, respectively. The remaining changes were due to net changes in other accounts related to our operating activities.

Our investing activities used cash of $185.7 million, $192.9 million and $39.7 million for the years ended December 31, 2008, 2007 and 2006, respectively. The majority of the change was due to acquisitions of finance receivables which increased to $273.7 million for the year ended December 31, 2008 from $261.3 million for the year ended December 31, 2007 and $105.8 million for the year ended December 31, 2006. Cash provided by investing activities is primarily driven by cash collections applied to principal on finance receivables. Cash used in investing activities is primarily driven by acquisitions of defaulted consumer receivables, purchases of property and equipment and business acquisitions.

Our financing activities provided cash of $101.2 and $104.2 million in 2008 and 2007, respectively, and used cash of $10.7 million in 2006. Cash used in financing activities is primarily driven by payments on our line of credit, principal payments on long-term debt and capital lease obligations, repurchases of our common stock and cash dividends paid on our common stock. Cash provided by financing activities is primarily driven by proceeds from draws on our line of credit and stock option exercises. The majority of the change was due to net proceeds received from our line of credit partially offset by cash used to pay a cash dividend on our common stock and the repurchase of 1,000,000 shares of our common stock during the year ended December 31, 2007. We had net draws on our line of credit of $100.3 and 168.0 million for 2008 and 2007, respectively, compared to net repayments of $15.0 million for 2006. Also, in accordance with the adoption of SFAS 123R on January 1, 2006, the benefit derived from share-based compensation was $0.4 million, $1.6 million and $2.4 million in 2008, 2007 and 2006, respectively. This was previously classified in operating activities. In addition, the exercise of stock options and stock warrants generated cash from financing activities of $0.6 million for the year ended December 31, 2008, $2.1 million for the year ended December 31, 2007 and $2.5 million for the year ended December 31, 2006.

Cash paid for interest expense was approximately $11,322,000, $2,779,000 and $411,000 for the years ended December 31, 2008, 2007 and 2006, respectively. The majority of interest expenses were paid on our lines of credit, capital lease obligations and other long-term debt. The increase was caused by higher average balances on our line of credit for the year ended December 31, 2008 when compared to the years ended December 31, 2007 and December 31, 2006. This increase was offset by a decrease in the weighted average interest rate on our line of credit which decreased to 4.60% for the year ended December 31, 2008 as compared to 6.64% and 6.23% for the years ended December 31, 2007 and 2006, respectively.

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. The agreement was amended on May 9, 2006 to include RBC Centura Bank as an additional lender, again on May 4, 2007 to increase the line of credit to $150,000,000 and incorporate a $50,000,000 non-revolving fixed rate sub-limit, again on October 26, 2007 to increase the line of credit to $270,000,000, again on March 18, 2008 to increase the non-revolving fixed rate sub-limit to $100,000,000, again on May 2, 2008 to include SunTrust Bank as an additional lender and to increase the line of credit to $340,000,000, and again on September 3, 2008 to include JP Morgan Chase Bank as an additional lender and to increase the line of credit to $365,000,000. The agreement is a line of credit in an amount equal to the lesser of $365,000,000 or 30% of our estimated remaining collections of all our eligible asset pools. Borrowings under the revolving credit facility bear interest at a floating rate equal to the one month LIBOR Market Index Rate plus 1.40%, which was 1.836% at December 31, 2008, and the facility expires on May 2, 2011. We also pays an unused line fee equal to three-tenths of one percent, or 30 basis points, on any unused portion of the line of credit. The loan is collateralized by substantially all of our tangible and intangible assets.

The agreement provides as follows:

monthly borrowings may not exceed 30% of estimated remaining collections;

funded debt to EBITDA (defined as net income, less income or plus loss from discontinued operations and extraordinary items, plus income taxes, plus interest expense, plus depreciation, depletion, amortization (including finance receivable amortization) and other non-cash charges) ratio must be less than 2.0 to 1.0 calculated on a rolling twelve-month average;

tangible net worth must be at least 100% of tangible net worth reported at September 30, 2005, plus 25% of cumulative positive net income since the end of such fiscal quarter, plus 100% of the net proceeds from any equity offering without giving effect to reductions in tangible net worth due to repurchases of up to $100,000,000 of the Company s common stock; and

restrictions on change of control.

As of December 31, 2008, outstanding borrowings under the facility totaled $268,300,000, of which $50,000,000 was part of the non-revolving fixed rate sub-limit which bears interest at 6.80% and expires on May 4, 2012. As of December 31, 2008, we are in compliance with all of the covenants of the agreement.

Contractual Obligations

The following summarizes our contractual obligations that exist as of December 31, 2008 (amounts in thousands):

		Payments due by period			
Contractual Obligations	**Total**	**Less than 1 year**	**1 - 3 years**	**4 - 5 years**	**More than 5 years**
Operating Leases	$ 21,724	$ 3,638	$ 6,756	$ 6,064	$ 5,266
Line of Credit [1]	293,280	8,352	233,795	51,133	
Capital Lease Obligations	5	5			
Purchase Commitments [2]	75,138	74,678	442	18	
Employment Agreements	16,477	9,080	7,397		
Total	$ 406,624	$ 95,753	$ 248,390	$ 57,215	$ 5,266

(1) To the extent that a balance is outstanding on our lines of credit, the revolving portion would be due in May,

2011 and the non-revolving fixed rate sub-limit portion would be due in May 2012. This amount also includes estimated interest and unused line fees due on the line of credit for both the fixed rate and variable rate components as well as interest due on our interest rate swap. This estimate also assumes that the balance on the line of credit remains constant from the December 31, 2008 balance of $268.3 million and the balance is paid in full at its respective maturity.

(2) This 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 approximately $71.6 million.

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 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 was originally effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years but was amended on February 6, 2008 to defer the effective date for one year for certain nonfinancial assets and liabilities. We adopted SFAS 157 on January 1, 2008, which had no material impact on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 is effective for fiscal years beginning after November 15, 2007. SFAS 159 allows entities to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. If a company elects the fair value option for an eligible item, changes in that item s fair value in subsequent reporting periods must be recognized in current earnings. SFAS 159 also establishes presentation and disclosure requirements designed to draw comparison between entities that elect different measurement attributes for similar assets and liabilities. We adopted SFAS 159 on January 1, 2008, which had no material impact on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141R Business Combinations (SFAS 141R). SFAS 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination, recognizing assets acquired and liabilities assumed arising from contingencies, and determining what information to disclose to enable users of the financial statement to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for acquisitions consummated in fiscal years beginning after December 15, 2008. We expect SFAS 141R will have an impact on our consolidated financial statements when effective, but the nature and magnitude of the specific effects will depend upon the nature, terms and size of the acquisitions we consummate after the effective date.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements (SFAS 160). SFAS 160 changes the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity. This new consolidation method significantly changes the accounting for transactions with minority interest holders. SFAS 160 is effective for fiscal years beginning after December 15, 2008 with early application prohibited. We believe that SFAS 160 will have no material impact on our consolidated financial statements.

In March 2008, the FASB issued SFAS 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS 161). SFAS 161 requires expanded disclosures regarding the location and amounts of derivative instruments in an entity s financial statements, how derivative instruments and related hedged items are accounted for under SFAS 133, Accounting for Derivative Instruments and Hedging Activities , and how derivative instruments and related hedged items affect an entity s financial position, operating results and cash flows. SFAS 161 is effective for periods beginning on or after November 15, 2008. We believe SFAS 161 will have no material impact on our consolidated financial statements.

In April 2008, the FASB issued FSP 142-3, Determination of the Useful Life of Intangible Assets , (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets . FSP 142-3 is effective for fiscal years beginning after December 15, 2008. We believe FSP 142-3 will have no material impact on our consolidated 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 may be established. These pools are aggregated based on certain common risk criteria. Each static pool is recorded at cost, which includes certain direct costs of acquisition paid to third parties, and is accounted for as a single unit for the recognition of income, 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. SOP 03-3 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 and is recorded as a reduction in revenue in the consolidated income statements with a corresponding valuation allowance offsetting the finance receivables, net, on the consolidated balance sheets. 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. We generally do not allow accretion in the first six to twelve months. 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. These pools are not aggregated with other portfolios. 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.

We establish 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 December 31, 2008 and 2007, we had a $23.6 million and $4.2 million valuation allowance on our finance receivables, 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.

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, the portfolios which are placed for servicing are owned by our clients and are placed under a contingent fee commission arrangement. Our subsidiary is paid to collect funds from the client s debtors and earns a commission generally expressed as a percentage of the gross collection amount. The Commissions line of our income statement reflects the contingent fee amount earned, and not the gross collection amount. We discontinued our ARM contingent fee operation during the second quarter of 2008.

Our skip tracing subsidiary utilizes gross reporting under EITF 99-19. 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 business 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. When we conduct 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. This charge is up-charged from the actual costs incurred. The gross billing is a component of the line item Commissions and the expense is included in the line item Compensation and employee services. The second item is for expenses incurred while conducting the audit. Most jurisdictions will reimburse us for direct expenses incurred for the audit including such items as travel and meals. The billed amounts are included in the line item Commissions and the expense component is included in its appropriate expense category, generally Other operating expenses.

We account for our gain on cash sales of finance receivables under 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; and (2) we estimate the fair value of those reporting units to which the goodwill relates and then 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 December 31, 2008, there was no impairment of goodwill or other intangible assets. 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. Beginning with the adoption of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) as of January 1, 2007, we recognize the effect of the income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgement occurs.

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 principal 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 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 7A. Quantitative and Qualitative Disclosure About Market Risk.

Our exposure to market risk relates to interest rate risk with our variable rate credit line. The average borrowings on our variable rate credit line were $182.4 million for the year ended December 31, 2008. Assuming a 200 basis point increase in interest rates, interest expense would have increased by $3.7 million and $0.6 million for the years ended December 31, 2008 and 2007, respectively. As of December 31, 2008 and 2007, we had $218.3 million and $118.0 million, respectively, of variable rate debt outstanding on our credit lines. We do not have any other variable rate debt outstanding as of December 31, 2008. Significant increases in future interest rates on the variable rate credit line could lead to a material decrease in future earnings assuming all other factors remained constant.

Item 8. Financial Statements and Supplementary Data.
Index to Financial Statements

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Portfolio Recovery Associates, Inc.:

We have audited Portfolio Recovery Associates, Inc. s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Portfolio Recovery Associates, Inc. s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control Over Financial Reporting (Item 9A). Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Portfolio Recovery Associates, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Portfolio Recovery Associates, Inc. acquired MuniServices, LLC (MuniServices) during 2008, and management excluded from its assessment of the effectiveness of Portfolio Recovery Associates, Inc.   s internal control over financial reporting as of December 31, 2008, MuniServices   internal control over financial reporting associated with less than 5% of the total assets and total revenues reflected in the consolidated financial statements of Portfolio Recovery Associates, Inc. and subsidiaries as of and for the year ended December 31, 2008. Our audit of internal control over financial reporting of Portfolio Recovery Associates, Inc. also excluded an evaluation of the internal control over financial reporting of MuniServices.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Portfolio Recovery Associates, Inc. and subsidiaries (the Company) as of December 31, 2008 and 2007, and the related consolidated income statements, and statements of changes in stockholders   equity and comprehensive income, and cash flows for the years then ended, and our report dated February 27, 2009 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP
Norfolk, Virginia
February 27, 2009

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Portfolio Recovery Associates, Inc.:

We have audited the accompanying consolidated balance sheets of Portfolio Recovery Associates, Inc. and subsidiaries (the Company) as of December 31, 2008 and 2007, and the related consolidated income statements, and statements of changes in stockholders equity and comprehensive income, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Portfolio Recovery Associates, Inc. and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

As discussed in note 2 to the consolidated financial statements, the Company adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*, effective January 1, 2007.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Portfolio Recovery Associates, Inc. s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 27, 2009 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ KPMG LLP
Norfolk, Virginia
February 27, 2009

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of Portfolio Recovery Associates, Inc.:

In our opinion, the consolidated statements of income, stockholders equity, and cash flows for the year ended December 31, 2006 present fairly, in all material respects, the results of operations and cash flows of Portfolio Recovery Associates, Inc. and its subsidiaries for the year ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

McLean, Virginia

March 1, 2007

Portfolio Recovery Associates, Inc.
Consolidated Balance Sheets
December 31, 2008 and 2007
(Amounts in thousands, except per share amounts)

	2008	2007
Assets		
Cash and cash equivalents	$ 13,901	$ 16,730
Finance receivables, net	563,830	410,297
Income taxes receivable	3,587	3,022
Property and equipment, net	23,884	16,171
Goodwill	27,546	18,620
Intangible assets, net	13,429	5,046
Other assets	11,663	6,421
Total assets	$ 657,840	$ 476,307
Liabilities and Stockholders Equity		
Liabilities:		
Accounts payable	$ 3,438	$ 4,055
Accrued expenses	4,314	4,471
Accrued payroll and bonuses	9,850	6,819
Deferred tax liability	88,070	57,579
Line of credit	268,300	168,000
Obligations under capital lease	5	103
Total liabilities	373,977	241,027
Commitments and contingencies (Note 18)		
Stockholders equity:		
Preferred stock, par value $0.01, authorized shares, 2,000, issued and outstanding shares - 0		
Common stock, par value $0.01, authorized shares, 30,000, 15,398 issued and 15,286 outstanding shares at December 31, 2008, and 15,159 issued and outstanding at December 31, 2007	153	152
Additional paid-in capital	74,574	71,443
Retained earnings	209,047	163,685
Accumulated other comprehensive income	89	
Total stockholders equity	283,863	235,280
Total liabilities and stockholders equity	$ 657,840	$ 476,307

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

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Portfolio Recovery Associates, Inc.
Consolidated Income Statements
For the years ended December 31, 2008, 2007 and 2006
(Amounts in thousands, except per shares amounts)

	2008	2007	2006
Revenues:			
Income recognized on finance receivables, net	$ 206,486	$ 184,705	$ 163,357
Commissions	56,789	36,043	24,965
Total revenues	263,275	220,748	188,322
Operating expenses:			
Compensation and employee services	88,073	69,022	58,142
Outside legal and other fees and services	61,752	47,474	40,139
Communications	10,304	8,531	5,876
Rent and occupancy	3,908	3,105	2,276
Other operating expenses	6,977	5,915	4,758
Depreciation and amortization	7,424	5,517	5,131
Total operating expenses	178,438	139,564	116,322
Income from operations	84,837	81,184	72,000
Other income and (expense):			
Interest income	60	419	584
Interest expense	(11,151)	(3,704)	(378)
Income before income taxes	73,746	77,899	72,206
Provision for income taxes	28,384	29,658	27,716
Net income	$ 45,362	$ 48,241	$ 44,490
Net income per common share			
Basic	$ 2.98	$ 3.08	$ 2.80
Diluted	$ 2.97	$ 3.06	$ 2.77
Weighted average number of shares outstanding			
Basic	15,229	15,646	15,911
Diluted	15,292	15,779	16,082

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

Portfolio Recovery Associates, Inc.
Consolidated Statements of Changes in Stockholders Equity and Comprehensive Income
For the years ended December 31, 2008, 2007 and 2006
(Amounts in thousands, except per share amount)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders Equity
Balance at December 31, 2005	$ 158	$ 108,064	$ 87,101	$	$ 195,323
Net income			44,490		44,490
Exercise of stock options, warrants and vesting of nonvested shares	2	2,501			2,503
Amortization of share-based compensation		2,117			2,117
SFAS123R adoption reclass of payroll liability to additional paid-in capital		426			426
Income tax benefit from share-based compensation		2,420			2,420
Balance at December 31, 2006	$ 160	$ 115,528	$ 131,591	$	$ 247,279
Net income			48,241		48,241
Exercise of stock options and vesting of nonvested shares	2	2,072			2,074
Issuance of common stock for acquisition		50			50
Repurchase and cancellation of common stock	(10)	(50,547)			(50,557)
Cash dividends paid ($1.00 per common share)			(16,070)		(16,070)
Amortization of share-based compensation		2,575			2,575
Income tax benefit from share-based compensation		1,575			1,575
Adoption of FIN 48		190	(77)		113
Balance at December 31, 2007	$ 152	$ 71,443	$ 163,685	$	$ 235,280
Net income			45,362		45,362
Net unrealized change in:					
Interest rate swap derivative				89	89
Comprehensive income					45,451

Exercise of stock options and vesting of nonvested shares	1	606			607
Issuance of common stock for acquisition		1,847			1,847
Amortization of share-based compensation		141			141
Income tax benefit from share-based compensation		357			357
Reversal of FIN 48 reserve		180			180
Balance at December 31, 2008	$ 153	$ 74,574	$ 209,047	$ 89	$ 283,863

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

Portfolio Recovery Associates, Inc.
Consolidated Statements of Cash Flows
For the years ended December 31, 2008, 2007 and 2006

	2008	2007	2006
Cash flows from operating activities:			
Net income	$ 45,362	$ 48,241	$ 44,490
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of share-based compensation	141	2,575	2,117
Depreciation and amortization	7,424	5,517	5,131
Deferred tax expense	30,854	24,126	11,107
Changes in operating assets and liabilities:			
Other assets	(2,218)	(2,339)	(437)
Accounts payable	(1,167)	1,164	559
Income taxes	(385)	(1,319)	(4,568)
Accrued expenses	(413)	1,816	339
Accrued payroll and bonuses	2,120	575	729
Net cash provided by operating activities	81,718	80,356	59,467
Cash flows from investing activities:			
Purchases of property and equipment	(6,139)	(8,662)	(6,869)
Acquisition of finance receivables, net of buybacks	(273,746)	(261,310)	(105,838)
Collections applied to principal on finance receivables	120,213	77,461	73,035
Purchases of auction rate certificates			(1,450)
Sales of auction rate certificates			1,450
Acquisitions, including acquisition costs and net of cash acquired	(26,041)	(409)	
Net cash used in investing activities	(185,713)	(192,920)	(39,672)
Cash flows from financing activities:			
Dividends paid		(16,070)	
Proceeds from exercise of options and warrants	607	2,074	2,503
Income tax benefit from share-based compensation	357	1,575	2,420
Draws on line of credit	171,300	171,000	
Principal payments on line of credit	(71,000)	(3,000)	(15,000)
Repurchases of common stock		(50,557)	
Principal payments on long-term debt		(690)	(462)
Principal payments on capital lease obligations	(98)	(139)	(140)
Net cash provided by/(used in) financing activities	101,166	104,193	(10,679)

Net (decrease)/increase in cash and cash equivalents	(2,829)	(8,371)	9,116
Cash and cash equivalents, beginning of year	16,730	25,101	15,985
Cash and cash equivalents, end of year	$ 13,901	$ 16,730	$ 25,101
Supplemental disclosure of cash flow information:			
Cash paid for interest	$ 11,322	$ 2,779	$ 411
Cash paid for income taxes	$ 3	$ 5,289	$ 18,764
Noncash investing and financing activities:			
SFAS123R adoption reclass of payroll liability to additional paid-in capital	$	$	$ 426
Acquisitions Common stock issued	$ 1,847	$ 50	$
Net unrealized change in interest rate swap derivative	$ 89	$	$

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

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Portfolio Recovery Associates, Inc.
Notes to Consolidated Financial Statements

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. Two of PRA Inc s wholly owned subsidiaries, Thomas West Associates, LLC (TWA), and PRA Bankruptcy Services, LLC (PRA BS) were dissolved as entities on May 8, 2006 and August 8, 2008, respectively. Another subsidiary, PRA II, was dissolved immediately prior to the IPO. 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.

On December 28, 1999, PRA formed a wholly owned subsidiary, PRA Holding I, LLC (PRA Holding I), and is the sole member. The purpose of PRA Holding I is to enter into leases of office space and hold the Company s real property (see Note 10) in Hutchinson, Kansas, Norfolk, Virginia and other real and personal property.

On June 1, 2000, PRA formed a wholly owned subsidiary, PRA Receivables Management, LLC (d/b/a Anchor Receivables Management) (Anchor) and was the sole initial member. Anchor was organized as a contingent collection agency and contracted with holders of finance receivables to attempt collection efforts on a contingent basis for a stated period of time. Anchor became fully operational during April 2001. The Company purchased the equity interest in Anchor from PRA immediately after the IPO. The Company discontinued its Anchor contingent fee operation during the second quarter of 2008, but PRA Receivables Management, LLC continues to serve as the operational entity for the Company s bankruptcy department.

On October 1, 2004, the Company acquired the assets of IGS Nevada, Inc., a privately held company specializing in asset-location and debt resolution services (the resulting business is referred to herein as IGS). On September 10, 2004, the Company created a wholly owned subsidiary, PRA Location Services, LLC d/b/a IGS to operate IGS.

On July 29, 2005, the Company acquired substantially all of the assets and liabilities of Alatax, Inc., a provider of outsourced business revenue administration, audit and debt discovery/recovery services for local governments (the resulting business is referred to herein as RDS). Although most of its clients are located in Alabama, RDS, through PRA Government Services, LLC, a wholly owned subsidiary formed by the Company on June 23, 2005, began expanding into surrounding states.

PRA Funding, LLC and PRA III were merged into PRA on November 24, 2003.

On October 13, 2006, PRA formed a wholly owned subsidiary, PRA Holding II, LLC (PRA Holding II), and is the sole member. The purpose of PRA Holding II is to hold the Company s real property in Jackson, Tennessee and other real and personal property.

On July 1, 2008, the Company acquired 100% of the membership interests of MuniServices, LLC (the resulting business is referred to herein as MuniServices). MuniServices was founded in 1978 and is a provider of revenue enhancement and related services to state and local governments. Although most of its clients are in California, it also serves clients in Texas, Florida, Pennsylvania, Georgia, Nevada and the District of Columbia. MuniServices has a workforce of approximately 115 employees. The President of MuniServices and three other members of the management team have entered into long-term employment agreements with the Company and continue to manage

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Portfolio Recovery Associates, Inc.
Notes to Consolidated Financial Statements

MuniServices. The consolidated income statement includes the results of operations of MuniServices for the period from July 1, 2008 through December 31, 2008. The transaction was completed at a price of $24.6 million, consisting of $22.5 million in cash and $2.1 million in PRA Inc common stock. The total purchase price could increase by a total of $4.5 million in stock through contingent payments in 2009 and 2010, related to specific operating goals.

On August 1, 2008, the Company acquired substantially all of the assets of Broussard Partners and Associates, Inc. (BPA), which is operating as a part of RDS. BPA, founded in 1995, is a provider of audit services to parishes in Louisiana, with 34 of the state s 64 parishes as clients. BPA has a workforce of approximately 25 employees. The President of BPA has entered into a long-term employment agreement with RDS. The consolidated income statement includes the results of operations of BPA for the period from August 1, 2008 through December 31, 2008.

2. Summary of Significant Accounting Policies:

Principles of accounting and consolidation: The consolidated financial statements of the Company are prepared in accordance with U.S. generally accepted accounting principles and include the accounts of PRA Inc, PRA, PRA Holding I, PRA Holding II, IGS, RDS and MuniServices. All significant intercompany accounts and transactions have been eliminated.

Cash and cash equivalents: The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. Included in cash and cash equivalents are funds held on the behalf of others arising from the collection of accounts placed with the Company. The balance of the funds held on behalf of others was $1,112,175 and $1,263,563 at December 31, 2008 and 2007, respectively. There is an offsetting liability that is included in Accounts payable on the accompanying consolidated balance sheets.

Investments: The Company accounts for its investments under the guidance of the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard (SFAS) No. 115 (SFAS 115), Accounting for Certain Investments in Debt and Equity Securities. At December 31, 2008 and 2007, the Company did not have any investments on the consolidated balance sheets; however, it did purchase investments during 2006.

Other assets: Other assets consist mainly of trade accounts receivable, prepaid expenses and derivatives used for hedging purposes.

Concentrations of credit risk: Financial instruments, which potentially expose the Company to concentrations of credit risk, consist primarily of cash and cash equivalents and investments. The Company places its cash and cash equivalents and investments with high quality financial institutions. At times, cash balances may be in excess of the amounts insured by the Federal Deposit Insurance Corporation.

Derivative Instruments and Hedging Activities: The Company accounts for derivatives and hedging activities in accordance with FASB Statement No. 133, Accounting for Derivative Instruments and Certain Hedging Activities, as amended, which requires entities to recognize all derivative instruments as either assets or liabilities in the balance sheet at their respective fair values. For derivatives designated in hedging relationships, changes in the fair value are either offset through earnings against the change in fair value of the hedged item attributable to the risk being hedged or recognized in accumulated other comprehensive income until the hedged item is recognized in earnings.

The Company only enters into derivative contracts that it intends to designate as a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge). For all hedging relationships, the Company formally documents the hedging relationship and its risk-management objective and strategy for undertaking the hedge, the hedging instrument, the hedged item, the nature of the risk being hedged, how the hedging instrument s effectiveness in offsetting the hedged risk will be assessed prospectively and retrospectively, and a description of the method of measuring ineffectiveness. The Company also formally assesses, both at the hedge s inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting cash flows of hedged items. For derivative instruments that are designated and qualify as a cash-flow hedge, the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Gains and losses on the

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derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings.

The Company discontinues hedge accounting prospectively when it determines that the derivative is no longer effective in offsetting cash flows of the hedged item, the derivative expires or is sold, terminated, or exercised, the derivative is dedesignated as a hedging instrument because it is unlikely that a forecasted transaction will occur, or management determines that designation of the derivative as a hedging instrument is no longer appropriate.

In all situations in which hedge accounting is discontinued and the derivative is retained, the Company continues to carry the derivative at its fair value on the balance sheet and recognizes any subsequent changes in its fair value in earnings. When it is probable that a forecasted transaction will not occur, the Company discontinues hedge accounting and recognizes immediately in earnings gains and losses that were accumulated in other comprehensive income.

Finance receivables and income recognition: 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 the portfolio both by account and aggregate pool 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. 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 may be established. These pools are aggregated based on certain common risk criteria. Each static pool is recorded at cost, which includes certain direct costs of acquisition paid to third parties, and is accounted for as a single unit for the recognition of income, 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. SOP 03-3 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 recorded as a reduction in revenue in the consolidated income statements with a corresponding valuation allowance offsetting the finance receivables, net, on the consolidated balance sheets. 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 Company generally does not allow accretion in the first six to twelve months. The IRR is estimated and periodically recalculated based on the timing and amount of anticipated cash flows using the

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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 December 31, 2008 and 2007, the Company had unamortized purchased principal (purchase price) in pools accounted for under the cost recovery method of $3,668,133 and $6,301,373, 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 December 31, 2008 and 2007, the Company had an allowance against its finance receivables of $23.6 million and $4.2 million, 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.

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 December 31, 2008, 2007 and 2006 was $3,078,560, $2,434,916 and $1,322,721, respectively. During the years ended December 31, 2008, 2007 and 2006 the Company capitalized $1,250,940, $1,683,951 and $805,640, respectively, of these direct acquisition fees. During the years ended December 31, 2008, 2007 and 2006 the Company amortized $607,296, $571,756 and $511,320, 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.

Commissions: The Company utilizes the provisions of Emerging Issues Task Force 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent (EITF 99-19) to record commission revenue from its 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 who retains inventory/credit risk, who controls vendor selection, who establishes pricing and who remains the primary obligor on the transaction. The Company considers each of these factors to determine the correct method of recognizing revenue from its subsidiaries.

For the Company s contingent fee collection subsidiary, the portfolios that are placed for servicing are owned by its clients and are placed under a contingent fee commission arrangement. The Company s subsidiary is paid to collect funds from the client s debtors and earns a commission generally expressed as a percentage of the gross collection amount. The Commissions line of the income statement reflects the contingent fee amount earned, and not the gross collection amount. The Company discontinued its Anchor contingent fee operation during the second quarter of 2008.

The Company s skip tracing subsidiary utilizes gross reporting under EITF 99-19. IGS generates revenue by working an account and successfully locating a customer for their client. An investigative fee is received for these services. In addition, the Company incurs agent expenses where it hires a third-party collector to effectuate repossession. In many cases the Company has an arrangement with its client which allows it to bill the client for these fees. The Company has 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 the Company is primarily liable to the third

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party collector. There is a corresponding expense in Outside Legal and Other Fees and Services for these pass-through items.

The Company s government processing and collection subsidiaries utilize both gross and net reporting under EITF 99-19. The Company s government processing and collection business 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. When audits are conducted, there are two components. The first is a charge for the hours incurred on conducting the audit. This charge is for hours worked. This charge is up-charged from the actual costs incurred. The gross billing is a component of the line item Commissions and the expense is included in the line item Compensation and employee services. The second item is for expenses incurred while conducting the audit. Most jurisdictions will reimburse the Company for direct expenses incurred for the audit including such items as travel and meals. The billed amounts are included in the line item Commissions and the expense component is included in its appropriate expense category, generally, Other operating expenses.

Property and equipment: Property and equipment, including improvements that significantly add to the productive capacity or extend useful life, are recorded at cost, while maintenance and repairs are expensed currently. Property and equipment are depreciated over their useful lives using the straight-line method of depreciation. Software and computer equipment is amortized or depreciated over three to five years. Furniture and fixtures are depreciated over five years. Equipment is depreciated over five to seven years. Leasehold improvements are depreciated over the lesser of the useful life, which ranges from three to ten years, or the remaining life of the leased property. Building improvements are depreciated over ten to thirty-nine years. When property is sold or retired, the cost and related accumulated depreciation are removed from the balance sheet and any gain or loss is included in the income statement.

Intangible assets: The Company adopted SFAS No. 142, Goodwill and Other Intangible Assets (SFAS 142) on October 1, 2004. Prior to this date, the Company had no assets in this category. With the acquisitions of IGS on October 1, 2004, RDS on July 29, 2005, The Palmer Group on July 25, 2007, MuniServices on July 1, 2008, and BPA on August 1, 2008, the Company purchased certain tangible and intangible assets. Intangible assets purchased included client and customer relationships, non-compete agreements, trademarks and goodwill. In accordance with SFAS 142, the Company is amortizing the IGS client relationships over seven years, The Palmer Group customer relationship over 2.42 years, the RDS and BPA customer relationships over ten years and the MuniServices customer relationships over 11 years. The Company is amortizing the non-compete agreements over three years for the IGS, RDS and MuniServices acquisitions and 2.42 years for the BPA acquisition. The Company is amortizing trademarks over 14 years for the MuniServices acquisition. The Company reviews these intangible assets at least annually for impairment, and when a triggering event occurs. In addition, goodwill, pursuant to SFAS 142, is not amortized but rather reviewed annually for impairment, and when a triggering event occurs.

Income taxes: The Company records a tax provision for the anticipated tax consequences of the reported results of operations. In accordance with SFAS No. 109, Accounting for Income Taxes, (SFAS 109) 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. Beginning with the adoption of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48) as of January 1, 2007, the Company recognizes the effect of the income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs. Prior to the adoption of FIN 48, the Company recognized the effect of income tax positions only if such positions were probable of being sustained.

Effective with the Company s 2002 tax filings, the Company adopted the cost recovery method of income recognition for tax purposes. The Company believes cost recovery to be an acceptable tax revenue recognition method for companies in the bad debt purchasing industry and results in the reduction of current taxable income as,

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for tax purposes, collections on finance receivables are applied first to principal to reduce the finance receivables to zero before any income is recognized.

The Company believes that 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 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 the Company subsequently realizes 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 management s expectations could have a material impact on the Company s results of operations and financial position.

Advertising costs: Advertising costs are expensed when incurred.

Operating leases: General abatements or prepaid leasing costs are recognized on a straight-line basis over the life of the lease. In addition, future minimum lease payments (including the impact of rent escalations) are expensed on a straight-lined basis over the life of the lease. Material leasehold improvements are capitalized and depreciated over the remaining life of the lease.

Capital leases: Leases are analyzed to determine if they meet the definition of a capital lease as defined in SFAS No. 13, Accounting for Leases. Those lease arrangements that meet one of the four criteria are considered capital leases. As such, the leased asset is capitalized and amortized on a straight-line basis over the shorter of the lease term or the estimated useful life of the asset. The lease is recorded as a liability with each payment amortizing the principal balance and a portion classified as interest expense.

Stock-based compensation: The Company applied the intrinsic value method provided for under Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, for all warrants issued to employees prior to January 1, 2002. For warrants and options issued to non-employees, the Company followed the fair value method of accounting as prescribed under SFAS No. 123, Accounting for Stock Based Compensation (SFAS 123). On January 1, 2002, the Company adopted SFAS 123 on a prospective basis for all warrants and options granted and reported the change in accounting principle using the retroactive restatement method as prescribed in SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosure. Effective January 1, 2006, the Company adopted FASB Statement No. 123R (SFAS 123R), Share-Based Payment using the modified prospective approach.

Use of estimates: The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Significant estimates have been made by management with respect to the timing and amount of future cash collections of the Company s finance receivables portfolios. Actual results could differ from these estimates making it reasonably possible that a change in these estimates could occur within one year. On a quarterly basis, management reviews the estimates of future cash collections, and whether it is reasonably possible that its assessments of collectibility may change based on actual results and other factors.

Estimated fair value of financial instruments: The Company applies the provisions of SFAS No. 107, Disclosures About Fair Value of Financial Instruments, to its financial instruments. Its financial instruments consist of cash and cash equivalents, finance receivables, net, line of credit and derivative instruments. See Note 13 for additional disclosure.

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Recent Accounting Pronouncements: 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 was originally effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years but was amended on February 6, 2008 to defer the effective date for one year for certain nonfinancial assets and liabilities. The Company adopted SFAS 157 on January 1, 2008, which had no material impact on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 is effective for fiscal years beginning after November 15, 2007. SFAS 159 allows entities to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. If a company elects the fair value option for an eligible item, changes in that item s fair value in subsequent reporting periods must be recognized in current earnings. SFAS 159 also establishes presentation and disclosure requirements designed to draw comparison between entities that elect different measurement attributes for similar assets and liabilities. The Company adopted SFAS 159 on January 1, 2008, which had no material impact on its consolidated financial statements

In December 2007, the FASB issued SFAS No. 141R, Business Combinations (SFAS 141R). SFAS 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination, recognizing assets acquired and liabilities assumed arising from contingencies, and determining what information to disclose to enable users of the financial statement to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for acquisitions consummated in fiscal years beginning after December 15, 2008. The Company expects SFAS 141R will have an impact on its consolidated financial statements when effective, but the nature and magnitude of the specific effects will depend upon the nature, terms and size of the acquisitions that the Company consummates after the effective date.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements (SFAS 160). SFAS 160 changes the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity. This new consolidation method significantly changes the accounting for transactions with minority interest holders. SFAS 160 is effective for fiscal years beginning after December 15, 2008 with early application prohibited. The Company believes SFAS 160 will have no material impact on its consolidated financial statements.

In March 2008, the FASB issued SFAS 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS 161). SFAS 161 requires expanded disclosures regarding the location and amounts of derivative instruments in an entity s financial statements, how derivative instruments and related hedged items are accounted for under SFAS 133, Accounting for Derivative Instruments and Hedging Activities , and how derivative instruments and related hedged items affect an entity s financial position, operating results and cash flows. SFAS 161 is effective for periods beginning on or after November 15, 2008. The Company believes SFAS 161 will have no material impact on its consolidated financial statements.

In April 2008, the FASB issued Staff Position (FSP) 142-3, Determination of the Useful Life of Intangible Assets (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets . FSP 142-3 is effective for fiscal years beginning after December 15, 2008. The Company believes FSP 142-3 will have no material impact on its consolidated financial statements.

3. Finance Receivables, net:

As of December 31, 2008 and 2007, the Company had $563,830,227 and $410,296,594, respectively, remaining of finance receivables, net. Changes in finance receivables, net for the years ended December 31, 2008 and 2007, were as follows (amounts in thousands):

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	2008	2007
Balance at beginning of year	$ 410,297	$ 226,448
Acquisitions of finance receivables, net of buybacks	273,746	261,310
Cash collections	(326,699)	(262,166)
Income recognized on finance receivables, net	206,486	184,705
Cash collections applied to principal	(120,213)	(77,461)
Balance at end of year	$ 563,830	$ 410,297

At the time of acquisition, the life of each pool is generally estimated to be between 84 to 96 months based on projected amounts and timing of future cash receipts using the proprietary models of the Company. As of December 31, 2008, the Company had $563,830,227 in finance receivables, net included in the consolidated balance sheet. Based upon current projections, cash collections applied to principal will be as follows for the following years ending December 31, (amounts in thousands):

2009	$ 123,092
2010	137,922
2011	125,508
2012	97,999
2013	47,108
2014	22,250
2015	8,478
2016	1,473
	$ 563,830

During the year ended December 31, 2008, the Company purchased $4.6 billion of face value of charged-off consumer receivables. During the year ended December 31, 2007, the Company purchased $11.1 billion of face value of charged-off consumer receivables. At December 31, 2008, the estimated remaining collections on the receivables purchased during 2008 and 2007 were $487,446,858 and $355,745,176, respectively.

Accretable yield represents the amount of income recognized on finance receivables the Company can expect to generate over the remaining life of its existing portfolios based on estimated future cash flows as of December 31, 2008 and 2007. Reclassifications from nonaccretable difference to accretable yield primarily result from the Company s increase in its estimate of future cash flows. Reclassifications to nonaccretable difference from accretable yield results from allowance charges that exceed the Company s increase in its estimate of future cash flows. Changes in accretable yield for the years ended December 31, 2008 and 2007 were as follows (amounts in thousands):

	2008	2007
Balance at beginning of year	$ 492,268	$ 326,775
Income recognized on finance receivables, net	(206,486)	(184,705)
Additions	288,854	279,726
Reclassifications (to)/from nonaccretable difference	(22,901)	70,472
Balance at end of year	$ 551,735	$ 492,268

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During the years ended December 31, 2008, 2007 and 2006, the Company recorded a $20,405,000, $3,210,000 and $1,100,000 allowance charge, respectively, on portfolios that had underperformed expectations. During the years ended December 31, 2008 and 2007, the Company also reversed $1,015,000 and $280,000, respectively, of allowance charges recorded in prior periods. The changes in the valuation allowance for finance receivables for the years ended December 31, 2008, 2007 and 2006 are as follows (amounts in thousands):

	2008	2007	2006
Balance at beginning of year	$ 4,230	$ 1,300	$ 200
Allowance charges recorded	20,405	3,210	1,100
Reversal of previously recorded allowance charges	(1,015)	(280)	
Change in allowance charge	19,390	2,930	1,100
Balance at end of year	$ 23,620	$ 4,230	$ 1,300

4. Operating Leases:

The Company rents office space and equipment under operating leases. Rental expense was $3,060,710, $2,511,842 and $1,915,103 for the years ended December 31, 2008, 2007 and 2006, respectively.

Future minimum lease payments for operating leases at December 31, 2008, are as follows (amounts in thousands):

2009	$ 3,638
2010	3,646
2011	3,111
2012	3,031
2013	3,034
Thereafter	5,266
	$ 21,726

5. Intangible Assets, net:

With the acquisition of IGS on October 1, 2004, RDS on July 29, 2005, The Palmer Group on July 25, 2007, MuniServices on July 1, 2008, and BPA on August 1, 2008, the Company purchased certain tangible and intangible assets. Intangible assets purchased included client and customer relationships, non-compete agreements, trademarks and goodwill. In accordance with the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard (SFAS) No. 142, Goodwill and Other Intangible Assets (SFAS 142), the Company is amortizing the IGS client relationships over seven years, The Palmer Group customer relationship over 2.42 years, the RDS and BPA customer relationships over ten years and the MuniServices customer relationships over 11 years. The Company is amortizing the non-compete agreements over three years for the IGS, RDS and MuniServices acquisitions and 2.42 years for the BPA acquisition. The Company is amortizing trademarks over 14 years for the MuniServices acquisition. The combined original weighted average amortization period is 9.14 years. The Company reviews these relationships at least annually for impairment. Total amortization expense for the years ended December 31, 2008, 2007 and 2006 was $2,140,942, $1,834,404 and $2,268,652, respectively.

Intangible assets consist of the following at December 31, 2008 and 2007 (amounts in thousands):

	2008	2007
Client and customer relationships	$ 17,823	$ 9,926

Non-compete agreements	2,527	2,000
Trademarks	2,100	
Accumulated amortization	(9,021)	(6,880)
Intangible assets, net	$ 13,429	$ 5,046

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Amortization expense relating to the non-compete agreements is calculated on a straight-line method (which approximates the pattern of economic benefit concept) for the IGS, MuniServices and BPA non-compete agreements and a pattern of economic benefit concept for the RDS non-compete agreements. Amortization expense relating to the client and customer relationships is calculated using a pattern of economic benefit concept for the IGS, RDS and MuniServices acquisitions, straight-line over the length of the contract for The Palmer Group acquisition and straight-line over their estimated useful lives of ten years for the BPA acquisition. Amortization expense relating to the trademarks is calculated using a pattern of economic benefit concept for the MuniServices acquisition. The pattern of economic benefit concept relies on expected net cash flows from all existing clients. The rate of amortization of the client relationships will fluctuate annually to match these expected cash flows.

The future amortization of these intangible assets is estimated to be as follows as of December 31, 2008 (amounts in thousands):

2009	$ 2,673
2010	2,552
2011	2,033
2012	1,414
2013	1,190
Thereafter	3,567
	$ 13,429

In addition, goodwill, pursuant to SFAS 142, is not amortized but rather is reviewed at least annually for impairment. During the fourth quarter of 2008, the Company underwent its annual review of goodwill. Based upon the results of this review, which was conducted as of October 1, 2008, no impairment charges to goodwill or the other intangible assets were necessary as of the date of this review. The Company believes that nothing has occurred since the review was performed through December 31, 2008, that would indicate a triggering event and thereby necessitate an impairment charge to goodwill or the other intangible assets. At December 31, 2008 and December 31, 2007, the carrying value of goodwill was $27,545,582 and $18,620,277, respectively. The changes in goodwill for the years ended December 31, 2008 and 2007 are as follows (amounts in thousands):

	Goodwill
December 31, 2006	$ 18,287
Acquistion of The Palmer Group	333
December 31, 2007	18,620
Acquistion of MuniServices and BPA	8,926
December 31, 2008	$ 27,546

6. Acquisitions:

On July 1, 2008, the Company acquired 100% of the membership interests of MuniServices. MuniServices was founded in 1978 and is a provider of revenue enhancement and related services to state and local governments. Although most of its clients are in California, it also serves clients in Texas, Florida, Pennsylvania, Georgia, Nevada and the District of Columbia. MuniServices has a workforce of approximately 115 employees. The President of MuniServices and three other members of the management team have entered into long-term employment agreements. The consolidated income statement for 2008 includes the results of operations of MuniServices for the period from July 1, 2008 through December 31, 2008.

The transaction was completed at a price of $24.6 million, consisting of $22.5 million in cash and $2.1 million in PRA Inc common stock. The total purchase price could increase by a total of $4.5 million in stock through contingent payments in 2009 and 2010, related to specific operating goals. The common stock component of the purchase price resulted in the issuance of 163,622 shares of unregistered stock to the sellers of MuniServices of which 112,018 shares are being held in escrow and are subject to the earn out and target revenue provisions of the asset purchase agreement. If the earn out and target revenue provisions are met, the shares held in escrow will be issued resulting in additional purchase price which will be allocated to goodwill. The share count was determined by using a formula agreed to by both parties and contained within the purchase agreement.

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On August 1, 2008, the Company acquired substantially all of the assets of Broussard Partners and Associates, Inc. (BPA), which is operating as a part of RDS. BPA, founded in 1995, is a provider of audit services to parishes in Louisiana, with 34 of the state s 64 parishes as clients. BPA has a workforce of approximately 25 employees. The President of BPA has entered into a long-term employment agreement with RDS. The consolidated income statement for 2008 includes the results of operations of BPA for the period from August 1, 2008 through December 31, 2008.

Both of these acquisitions provided the Company additional clients and contracts in the government sector. These clients are located in geographic regions the Company had not previously been servicing. The following is an allocation of the purchase price to the assets acquired and liabilities assumed in connection with the acquisitions of MuniServices and BPA (amounts in thousands):

Purchase price, including acquisition costs and net of cash received	$ 27,888
Accounts receivable and prepaid expenses (included in other assets)	(2,935)
Customer relationships	(7,898)
Non-compete agreements	(527)
Trademarks	(2,100)
Fixed assets	(6,857)
Deferred tax asset	(363)
Accounts payable	549
Accrued expenses	257
Accrued payroll	912
Goodwill	$ 8,926

7. Capital Leases:

Leased assets included in property and equipment consists of the following as of December 31, 2008 and 2007 (amounts in thousands):

	2008	2007
Software	$ 270	$ 270
Computer equipment	39	48
Furniture and fixtures	1,260	1,260
Equipment	27	27
Less accumulated amortization	(1,519)	(1,413)
	$ 77	$ 192

Amortization expense recognized on capital leases for the years ended December 31, 2008, 2007 and 2006 was $115,079, $143,313 and $183,904, respectively. Future minimum lease payments for these capital leases as of December 31, 2008 were $5,675, and these leases were paid in full in January 2009.

8. 401(k) Retirement Plan:

The Company sponsors a defined contribution plan. Under the plan, all employees over twenty-one years of age are eligible to make voluntary contributions to the plan up to 100% of their compensation, subject to Internal Revenue Service limitations after completing six months of service, as defined in the plan. The Company makes matching contributions of up to 4% of an employee s salary. Total compensation expense related to these contributions was $959,902, $843,387 and $682,115 for the years ended December 31, 2008, 2007 and 2006, respectively.

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9. Line of Credit:

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. The agreement was amended on May 9, 2006 to include RBC Centura Bank as an additional lender, again on May 4, 2007 to increase the line of credit to $150,000,000 and incorporate a $50,000,000 non-revolving fixed rate sub-limit, again on October 26, 2007 to increase the line of credit to $270,000,000, again on March 18, 2008 to increase the non-revolving fixed rate sub-limit to $100,000,000, again on May 2, 2008 to include SunTrust Bank as an additional lender and to increase the line of credit to $340,000,000, and again on September 3, 2008 to include J.P. Morgan Chase Bank as an additional lender and to increase the line of credit to $365,000,000. The agreement is a line of credit in an amount equal to the lesser of $365,000,000 or 30% of the Company s estimated remaining collections of all its eligible asset pools. Borrowings under the revolving credit facility bear interest at a floating rate equal to the one month LIBOR Market Index Rate plus 1.40%, which was 1.836% at December 31, 2008, and the facility expires on May 2, 2011. The Company also pays an unused line fee equal to three-tenths of one percent, or 30 basis points, on any unused portion of the line of credit. The loan is collateralized by substantially all the tangible and intangible assets of the Company. The agreement provides as follows:

monthly borrowings may not exceed 30% of estimated remaining collections;

funded debt to EBITDA (defined as net income, less income or plus loss from discontinued operations and extraordinary items, plus income taxes, plus interest expense, plus depreciation, depletion, amortization (including finance receivable amortization) and other non-cash charges) ratio must be less than 2.0 to 1.0 calculated on a rolling twelve-month average;

tangible net worth must be at least 100% of tangible net worth reported at September 30, 2005, plus 25% of cumulative positive net income since the end of such fiscal quarter, plus 100% of the net proceeds from any equity offering without giving effect to reductions in tangible net worth due to repurchases of up to $100,000,000 of the Company s common stock; and

restrictions on change of control.

As of December 31, 2008 and 2007, outstanding borrowings under the facility totaled $268,300,000 and $168,000,000, respectively, of which $50,000,000 was part of the non-revolving fixed rate sub-limit which bears interest at 6.80% and expires on May 4, 2012. As of December 31, 2008, the Company is in compliance with all of the covenants of the agreement.

10. Derivative Instruments:

The Company may periodically enter into derivative financial instruments, typically interest rate swap agreements, to reduce its exposure to fluctuations in interest rates on variable-rate debt and their impact on earnings and cash flows. The Company does not utilize derivative financial instruments with a level of complexity or with a risk greater than the exposure to be managed nor does it enter into or hold derivatives for trading or speculative purposes. The Company periodically reviews the creditworthiness of the swap counterparty to assess the counterparty s ability to honor its obligation. Based on the provisions of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities as amended and interpreted, the Company records derivative financial instruments at fair value.

On December 16, 2008, the Company entered into an interest rate forward rate swap transaction (the Swap) with J.P. Morgan Chase Bank, National Association pursuant to an ISDA Master Agreement which contains customary representations, warranties and covenants. The Swap has an effective date of January 1, 2010, with an initial notional amount of $50,000,000. Under the Swap, the Company will receive a floating interest rate based on 1-month LIBOR Market Index Rate and will pay a fixed interest rate of 1.89% through maturity of the Swap on May 1, 2011. Notwithstanding the terms of the Swap, the Company is ultimately obligated for all amounts due and payable under the credit facility.

The Company s financial derivative instrument is designated and qualifies as a cash flow hedge, and the effective portion of the gain or loss on such hedge is reported as a component of other comprehensive income in the consolidated financial statements. To the extent that the hedging relationship is not effective, the ineffective portion of the change in fair value of the derivative is recorded in other income (expense). The hedge was considered effective for the period from December 16, 2008 through December 31, 2008. Hedges that receive designated hedge

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accounting treatment are evaluated for effectiveness at the time that they are designated, as well as through the hedging period.

The fair value of the Company s cash flow hedge has been recorded as an asset and is included with other assets in the consolidated balance sheet. The fair value of the asset was $88,813 at December 31, 2008. Changes in fair value were recorded as an adjustment to other comprehensive income of $88,813 at December 31, 2008. The Company had no derivative instruments as of December 31, 2007. Amounts in other comprehensive income will be reclassified into earnings under certain situations; for example, if the occurrence of the transaction is no longer probable or no longer qualifies for hedge accounting. The Company does not expect to reclassify any amount currently included in other comprehensive income into earnings within the next 12 months.

11. Property and equipment, net:

Property and equipment, at cost, consist of the following as of December 31, 2008 and 2007 (amounts in thousands):

	2008	2007
Software	$ 14,380	$ 6,147
Computer equipment	7,951	6,083
Furniture and fixtures	5,150	4,758
Equipment	5,370	4,742
Leasehold improvements	3,449	2,557
Building and improvements	5,948	5,123
Land	992	939
Accumulated depreciation and amortization	(19,356)	(14,178)
Property and equipment, net	$ 23,884	$ 16,171

Depreciation and amortization expense, relating to property and equipment, for the years ended December 31, 2008, 2007 and 2006 was $5,283,058, $3,682,686 and $2,861,976, respectively.

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 December 31, 2008 and 2007, the Company has incurred and capitalized $1,036,275 and $524,456, respectively, of these direct payroll costs related to software developed for internal use. As of December 31, 2008 and 2007, of these costs, $593,560 and $98,511, respectively, 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 seven years. Amortization expense and remaining unamortized costs relating to this internally developed software as of and for the year ended December 31, 2008 were $88,543 and $332,718, respectively. Amortization expense and remaining unamortized costs relating to this internally developed software as of and for the year ended December 31, 2007 were $21,454 and $404,491, respectively.

12. Long-Term Debt:

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 was 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 were $9,797 and the loan was paid in full at its maturity date of September 1, 2007.

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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 with a fixed rate of 4.25%. This loan was collateralized by computer equipment. Monthly payments were $18,096, and the loan was paid in full on May 7, 2007.

On January 9, 2004, the Company entered into a commercial loan agreement to finance equipment purchases at one of its leased Norfolk facilities in the amount of $750,000 with a fixed rate of 4.45%. Monthly payments were $13,975, and the loan was paid in full on May 7, 2007.

13. Estimated Fair Value of Financial Instruments:

The accompanying consolidated financial statements include various estimated fair value information as of December 31, 2008 and 2007, as required by SFAS No. 107, Disclosures About Fair Value of Financial Instruments and amended by SFAS No. 157 (SFAS 157), Fair Value Measurements. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 also requires the consideration of differing levels of inputs in the determination of fair values. Based upon the fact there are no quoted prices in active markets or other observable market data, the Company used unobservable inputs for computation of the fair value of finance receivables, net. Disclosure of the estimated fair values of financial instruments often requires the use of estimates. The Company uses the following methods and assumptions to estimate the fair value of financial instruments.

Cash and cash equivalents: The carrying amount approximates fair value.

Finance receivables, net: The Company records purchased receivables at cost, which represents a significant discount from the contractual receivable balances due. The cost of the receivables is reduced as cash is received based upon the guidance of Practice Bulletin 6 and as amended by SOP 03-3. The carrying amount of finance receivables, net, as of December 31, 2008 and 2007 was approximately $564,000,000 and $410,000,000, respectively. The Company computed the fair value of these receivables using proprietary pricing models that the Company utilizes to make portfolio purchase decisions. As of December 31, 2008 and 2007, using the aforementioned methodology, the Company computed the approximate fair value to be $565,000,000 and $451,000,000, respectively.

Line of credit: The carrying amount approximates fair value, as the interest rates approximate the rate currently offered to the Company for similar debt instruments of comparable maturities by the Company s bankers.

Derivative instrument: The carrying amount approximates fair value, which is determined using pricing models developed based on the LIBOR swap rate and other observable market data, adjusted for nonperformance risk of both the counterparty and the Company.

14. Share-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 (Amended 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.

Effective January 1, 2002, the Company adopted the fair value recognition provisions of SFAS 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 SFAS No. 123R (SFAS 123R), Share-Based Payment using the modified prospective approach. The adoption of SFAS 123R had no material impact on the Company s Consolidated Income Statement or on previously reported interim periods. As of December 31, 2008, total estimated future compensation costs related to awards of nonvested shares (not including nonvested shares granted under the Long-Term Incentive Program) were approximately $3.3 million. The weighted average remaining life is 1.1 years for stock options and 3.4 years for nonvested shares (not including nonvested shares granted under the Long-Term Incentive Program). Based upon

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historical data, the Company used an annual forfeiture rate of 14% for stock options and between 20%-40% 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 historically 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 share-based compensation expense was $140,590, $2,575,253 and $2,116,631 for the years ended December 31, 2008, 2007 and 2006, respectively. Tax benefits resulting from tax deductions in excess of share-based compensation expense recognized under the fair value recognition provisions of SFAS 123R (windfall tax benefits) are credited to additional paid-in capital in the Company s Consolidated Balance Sheets. Realized tax shortfalls are first offset against the cumulative balance of windfall tax benefits, if any, and then charged directly to income tax expense. The total tax benefit realized from share-based compensation expense was approximately $0.9 million, $2.4 million and $3.0 million for the years ended December 31, 2008, 2007 and 2006, respectively.

Stock Options

The Company created the 2002 Stock Option Plan on November 7, 2002. The plan was amended in 2004 to enable the Company to issue restricted shares of stock to its employees and directors. 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 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 December 31, 2008, 895,000 options have been granted under the Amended Plan, of which 118,905 have been cancelled and are eligible for regrant. These options are accounted for under SFAS 123R and all expenses for 2008, 2007 and 2006 are included in earnings as a component of compensation and employee services expense.

The following summarizes all option related transactions from December 31, 2005 through December 31, 2008 (amounts in thousands, except per share amounts):

	Options Outstanding	Weighted-Average Exercise Price Per Share	Weighted-Average Fair Value Per Share
December 31, 2005	505	$ 15.12	$ 3.06
Exercised	(189)	13.19	2.76
Cancelled	(15)	13.00	2.71
December 31, 2006	301	16.43	3.27
Exercised	(130)	15.97	3.33
Cancelled	(8)	13.00	2.71
December 31, 2007	163	16.97	3.25
Exercised	(38)	15.87	3.31
Cancelled	(2)	21.50	4.60
December 31, 2008	123	$ 17.24	$ 3.21

All of the stock options were issued to employees of the Company except for 40,000 that were issued to non-employee directors. Non-employee directors were granted 20,000 stock options in 2004. No stock options were granted in 2008, 2007 or 2006. The total intrinsic value of options exercised during the years ended December 31, 2008, 2007 and 2006, was approximately $0.9 million, $4.1 million, and $6.3 million, respectively.

The following information is as of December 31, 2008 (amounts in thousands except per share amounts):

	Options Outstanding				Options Exercisable		
Exercise Prices	Number Outstanding	Average Remaining Contractual Life	Weighted-Average Exercise Price Per Share	Aggregate Intrinsic Value	Number Exercisable	Weighted-Average Exercise Price Per Share	Aggregate Intrinsic Value
$13.00	85	0.9	$ 13.00	$ 1,763	85	$ 13.00	$ 1,763
$16.16	5	0.9	16.16	97	5	16.16	97
$27.77 - $29.79	33	1.7	28.28	183	30	28.22	169
Total as of December 31, 2008	123	1.1	$ 17.24	$ 2,043	120	$ 16.95	$ 2,029

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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.

Nonvested Shares

Prior to the approval of the Amended Plan on May 12, 2004, nonvested shares were issued by the Company as an incentive to attract new employees and, effective May 12, 2004, are being issued pursuant to the Amended Plan to directors and existing employees as well. Generally, nonvested share awards are issued at market value and typically vest ratably over five years. Nonvested share grants are expensed over their vesting period.

The following summarizes all nonvested share transactions from December 31, 2005 through December 31, 2008(amounts in thousands except per share amounts):

	Nonvested Shares Outstanding	Weighted-Average Price at Grant Date
December 31, 2005	135	$ 34.96
Granted	83	46.88
Vested	(28)	33.88
Cancelled	(19)	37.75
December 31, 2006	171	40.59
Granted	9	43.42
Vested	(41)	38.74
Cancelled	(16)	38.23
December 31, 2007	123	41.72
Granted	27	37.47
Vested	(37)	39.55
Cancelled	(15)	40.05
December 31, 2008	98	$ 41.60

The total grant date fair value of shares vested during the years ended December 31, 2008, 2007 and 2006, was $1,446,897, $1,584,621 and $940,644, respectively.

Long-Term Incentive Programs

Pursuant to the Amended Plan, on March 30, 2007 and January 4, 2008, the Compensation Committee approved the grant of 96,550 and 80,000, respectively, of performance based nonvested shares. The shares were granted to key employees of the Company. The grants are performance based and cliff vest after the requisite service period of three years if certain financial goals are met. The goals are based upon cumulative diluted earnings per share (EPS) totals for the 2007, 2008 and 2009 years for the 2007 grant and EPS totals for the 2008, 2009 and 2010 years for the 2008 grant, as well as the return on invested capital for the same periods. The number of shares vested can double if the financial goals are exceeded or no shares can vest if the financial goals are not met. For both the 2007 and 2008 grants, the Company was expensing the nonvested shares over the requisite service period of three years beginning January 1, 2007 and 2008, respectively. During 2008, the Company reversed $1.2 million of estimated compensation costs that had been previously accrued relating to the 2007 Long Term Incentive Program because the achievement of the performance targets of the program were deemed unlikely to be achieved. During 2008, no estimated compensation costs were accrued relating to the 2008 Long Term Incentive Program because the achievement of the performance targets of the program were deemed unlikely to be achieved. In the future, if the Company believes that the performance targets of the programs will be achieved, an adjustment to the expense will be made at that time based on the probable outcome. The Company assumed a 7.5% forfeiture rate for these grants and the shares have a weighted average life of 1.47 years at December 31, 2008.

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15. 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 options and nonvested share awards. Share-based awards that are contingent upon the attainment of performance goals are not included in the computation of diluted EPS until the performance goals have been attained. The dilutive effect of stock options and nonvested shares is computed using the treasury stock method, which assumes any proceeds that could be obtained upon the exercise of stock options and vesting of nonvested shares would be used to purchase common shares at the average market price for the period. The assumed proceeds include the windfall tax benefit that would be received upon assumed exercise. The following table provides a reconciliation between the computation of basic EPS and diluted EPS for the years ended December 31, 2008, 2007 and 2006 (amounts in thousands, except per share amounts):

	For the years ended December 31,								
	2008			2007			2006		
	Net Income	Weighted Average Common Shares	EPS	Net Income	Weighted Average Common Shares	EPS	Net Income	Weighted Average Common Shares	EPS
Basic EPS	$45,362	15,229	$2.98	$48,241	15,646	$3.08	$44,490	15,911	$2.80
Dilutive effect of stock options and nonvested share awards		63			133			171	
Diluted EPS	$45,362	15,292	$2.97	$48,241	15,779	$3.06	$44,490	16,082	$2.77

As of December 31, 2008, 2007 and 2006, there were no antidilutive options outstanding.

16. Stockholders Equity:

Shares of common stock outstanding were as follows for the years ended December, 31 2008, 2007 and 2006 (amounts in thousands)**:**

	Common Stock
December 31, 2005	15,767
Exercise of warrants, options and vesting of nonvested shares	220
December 31, 2006	15,987
Exercise of options and vesting of nonvested shares	171
Issuance of common stock for acquisition	1
Repurchase and cancellation of common stock	(1,000)
December 31, 2007	15,159
Exercise of options and vesting of nonvested shares	75
Issuance of common stock for acquisition	52

December 31, 2008	15,286

Cash Dividends Paid on Common Stock:

On April 23, 2007, the Company s Board of Directors authorized a special one-time cash dividend of $1.00 per share with a record date of May 9, 2007. The cash dividends were paid on June 8, 2007 and totaled $16,069,694. There were no cash dividends paid or authorized during 2008 or 2006.

Share Repurchase Program:

On April 23, 2007, the Company s Board of Directors authorized a share repurchase program to buyback one million of the Company s outstanding shares of common stock on the open market. The timing and volume of share purchases were dependent on several factors, including market conditions. During the year ended December 31, 2007, the Company purchased 1,000,000 shares of its common stock at an average per share price of $50.56. The program was completed during 2007.

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17. Income Taxes:

The Company records a tax provision for the anticipated tax consequences of the reported results of operations. In accordance with SFAS 109, 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.

On July 13, 2006, the FASB issued FIN 48. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS109. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The evaluation of a tax position in accordance with FIN 48 is a two-step process. The first step is recognition: the enterprise determines whether it is more-likely- than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement: a tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured as the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met.

The Company adopted the provisions of FIN 48 with respect to all of its tax positions as of January 1, 2007. Total unrecognized tax benefits as of December 31, 2008 and 2007 were $0 and $180,000, respectively. Due to the approval by the Internal Revenue Service of an application for a change in accounting method with respect to one of the Company s tax positions, the balance of unrecognized tax benefits at the date of adoption was reduced from $388,000 to $180,000 at September 30, 2007. The reduction of $208,000 did not have an impact on the annual effective rate since the ultimate deductibility of these benefits was highly certain, and only the timing of deductibility was uncertain. On September 15, 2008, the 2004 tax year closed and is no longer subject to examination by major taxing jurisdictions, including the Internal Revenue Service. As a result, the remaining unrecognized tax benefits balance of $180,000 was reversed. The reversal was an adjustment to additional paid-in-capital and did not affect the annual effective tax rate. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (amounts in thousands):

Balance at January 1, 2007	$	379
Additions for tax position of prior year		9
Decrease due to change in accounting method for tax purposes		(208)
Balance at December 31, 2007	$	180
Decrease due to lapse of statute of limitations		(180)
Balance at December 31, 2008	$	

The Company was notified on June 21, 2007 that it would be examined by the Internal Revenue Service for the 2005 tax year. As of December 31, 2008, the tax years subject to examination by the major taxing jurisdictions, including the Internal Revenue Service, are 2003 and 2005 and subsequent years. The 2003 tax year remains open to examination because of a net operating loss that originated in that year but was not fully utilized until the 2005 tax year. On February 19, 2009, the Company received a Notice of Proposed Adjustment dated February 18, 2009. The notice states that the government has made a preliminary finding that the use of cost recovery for tax income recognition purposes does not clearly reflect income. The Company intends to appeal the government s preliminary findings via the normal administrative process unless an agreement can be reached at the local level. The Company

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believes it has substantial authority for using the cost recovery method and that it is more-likely-than-not that it will be successful in the appeals process.

FIN 48 requires the recognition of interest, if the tax law would require interest to be paid on the underpayment of taxes, and recognition of penalties, if a tax position does not meet the minimum statutory threshold to avoid payment of penalties. Penalties and interest may be classified as either penalties and interest expense or income tax expense. Management has elected to classify accrued penalties and interest as income tax expense. Accrued penalties and interest as of January 1, 2007, in the amount of $77,000, were recorded to beginning of year retained earnings. Since January 1, 2007, the Company has accrued additional interest of approximately $34,000. Due to the approved application for change in accounting method, the balance of accrued penalties and interest was reduced by $67,000 during 2007. As a result of the lapse in the statute of limitations, the 2004 tax year closed as of September 15, 2008 resulting in the reversal of the remaining $44,000 of accrued interest.

The income tax expense recognized for the years ended December 31, 2008, 2007 and 2006 is composed of the following (amounts in thousands):

For the year ended December 31, 2008	**Federal**	**State**	**Total**
Current tax benefit	$ (2,108)	$ (362)	$ (2,470)
Deferred tax expense	26,414	4,440	30,854
Total income tax expense	$24,306	$4,078	$28,384

For the year ended December 31, 2007	**Federal**	**State**	**Total**
Current tax expense	$ 4,870	$ 454	$ 5,324
Deferred tax expense	21,229	3,105	24,334
Total income tax expense	$26,099	$3,559	$29,658

For the year ended December 31, 2006	**Federal**	**State**	**Total**
Current tax expense	$14,345	$2,265	$16,610
Deferred tax expense	9,563	1,543	11,106
Total income tax expense	$23,908	$3,808	$27,716

The Company has recognized a net deferred tax liability of $88,069,756 and $57,578,782 as of December 31, 2008 and 2007, respectively. The components of this net deferred tax liability are as follows (amounts in thousands):

	2008	**2007**
Deferred tax assets:		
Employee compensation	$ 529	$ 898
Allowance for doubtful accounts	794	
State tax credit	685	591
Intangible assets and goodwill	379	501
Section 467 leases	277	

Other	133	170
Total deferred tax assets	2,797	2,160
Deferred tax liabilities:		
Depreciation expense	788	89
Prepaid expenses	658	418
Cost recovery	89,421	59,232
Total deferred tax liability	90,867	59,739
Net deferred tax liabilities	$88,070	$57,579

Portfolio Recovery Associates, Inc.
Notes to Consolidated Financial Statements

A valuation allowance has not been provided at December 31, 2008 or 2007 since management believes it is more likely than not that the deferred tax assets will be realized. In the event that all or part of the deferred tax assets are determined not to be realizable in the future, an adjustment to the valuation allowance would be charged to earnings in the period such determination is made. Similarly, if the Company subsequently realizes 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 management s expectations could have a material impact on the Company s results of operations and financial position. At December 31, 2008, the Company had state income tax credit carryforwards of approximately $1.1 million which will begin to expire starting in the year ending December 31, 2021. The Company also incurred state net operating loss carryforwards in 2008 of approximately $1.5 million, which will begin to expire starting in the year ending December 31, 2013.

The Company believes cost recovery to be an acceptable tax revenue recognition 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 principal to reduce the finance receivables to zero before any taxable income is recognized. The temporary difference from the use of cost recovery for income tax purposes resulted in a deferred tax liability at December 31, 2008 and 2007.

A reconciliation of the Company s expected tax expense at statutory tax rates to actual tax expense for the years ended December 31, 2008, 2007 and 2006 consists of the following components (amounts in thousands):

	2008	2007	2006
Federal tax at statutory rates	$25,811	$27,265	$25,272
State tax expense, net of federal benefit	2,651	2,313	2,475
Other	(78)	80	(31)
Total income tax expense	$28,384	$29,658	$27,716

18. 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, most of which expire on December 31, 2011. Such agreements provide for base salary payments as well as bonuses which are based on the attainment of specific management goals. Future compensation under these agreements is approximately $16.5 million. The agreements also contain confidentiality and non-compete provisions.

Litigation:

The Company is from time to time subject to routine legal proceedings which are incidental to the ordinary course of our business. The Company initiates lawsuits against consumers and are occasionally countersued by them in such actions. Also, consumers occasionally initiate litigation against the Company, in which they allege that the Company has violated a state or federal law in the process of collecting on an account. 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.

Forward Flow Agreements:

The Company is party to several forward flow agreements that allow for the purchase of defaulted consumer receivables at pre-established prices. The maximum remaining amount to be purchased under forward flow agreements at December 31, 2008 is $71.6 million.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 9A. 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 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, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that 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 December 31, 2008, our disclosure controls and procedures were effective.

Management s Report on Internal Control Over Financial Reporting. We are responsible for establishing and maintaining effective internal control over financial reporting. Internal control over financial reporting is defined in Exchange Act Rules 13a-15(f) and 15d-15(f) as a process designed by, or under the supervision of, the company s principal executive and principal financial officers and effected by the company s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements.

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we carried out an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Based on its assessment, management has determined that, as of December 31, 2008, its internal control over financial reporting was effective based on the criteria set forth in the COSO framework. The Company s independent registered public accounting firm, KPMG LLP, has issued an audit report on the effectiveness of our internal control over financial reporting, as of December 31, 2008 which is included herein.

The scope of management s assessment of internal controls over financial reporting did not include our recently acquired subsidiary, MuniServices, which was excluded from our evaluation. This business represents less than 5% of total assets and total revenues reflected in our consolidated financial statements as of and for the year ended December 31, 2008.

Changes in Internal Control Over Financial Reporting. There was no change in our internal control over financial reporting that occurred during the quarter ended December 31, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information.

None.

PART III

Item 10. Directors and Executive Officers of the Registrant.

The following table sets forth certain information as of February 11, 2009 about the Company s directors and executive officers.

Name	Position	Age
Steven D. Fredrickson	President, Chief Executive Officer and Chairman of the Board	49
Kevin P. Stevenson	Executive Vice President, Chief Financial and Administrative Officer, Treasurer and Assistant Secretary	44
Craig A. Grube	Executive Vice President Acquisitions	48
Judith S. Scott	Executive Vice President, General Counsel and Secretary	63
William P. Brophey	Director*	71
Penelope W. Kyle	Director	61
David N. Roberts	Director	46
Scott M. Tabakin	Director*	50
James M. Voss	Director*	66

* Member of the Company s audit committee (the Audit Committee), which has been established in accordance with Section 3(a)(58)(A) of the Exchange Act. In the opinion of the Board, Mr. Voss and Mr. Tabakin are independent directors who qualify as audit committee financial experts, pursuant to Section 401(h) of Regulations S-K.

Steven D. Fredrickson, President, Chief Executive Officer and Chairman of the Board. Prior to co-founding Portfolio Recovery Associates in 1996, Mr. Fredrickson was Vice President, Director of Household Recovery Services (HRSC) Portfolio Services Group from late 1993 until February 1996. At HRSC Mr. Fredrickson was ultimately responsible for HRSC s portfolio sale and purchase programs, finance and accounting, as well as other functional areas. Prior to joining HRSC, he spent five years with Household Commercial Financial Services managing a national commercial real estate workout team and five years with Continental Bank of Chicago as a member of the FDIC workout department, specializing in corporate and real estate workouts. He received a B.S. degree from the University of Denver and a M.B.A. degree from the University of Illinois. He is a past board member of the American Asset Buyers Association.

Kevin P. Stevenson, Executive Vice President, Chief Financial and Administrative Officer, Treasurer and Assistant Secretary. Prior to co-founding Portfolio Recovery Associates in 1996, Mr. Stevenson served as Controller and Department Manager of Financial Control and Operations Support at HRSC from June 1994 to March 1996, supervising a department of approximately 30 employees. Prior to joining HRSC, he served as Controller of Household Bank s Regional Processing Center in Worthington, Ohio where he also managed the collections, technology, research and ATM departments. While at Household Bank, Mr. Stevenson participated in eight bank acquisitions and numerous branch acquisitions or divestitures. He is a certified public accountant and received his B.S.B.A. with a major in accounting from the Ohio State University.

Craig A. Grube, Executive Vice President, Acquisitions. Prior to joining Portfolio Recovery Associates in March 1998, Mr. Grube was a senior officer and director of Anchor Fence, Inc., a manufacturing and distribution business from 1989 to March 1997, when the company was sold. Between the time of the sale and March 1998, Mr. Grube continued to work for Anchor Fence. Prior to joining Anchor Fence, he managed distressed corporate debt for the FDIC at Continental Illinois National Bank for five years. He received his B.A. degree from Boston College and his M.B.A. degree from the University of Illinois.

Judith S. Scott, Executive Vice President, General Counsel and Secretary. Prior to joining Portfolio Recovery Associates in March 1998, Ms. Scott held senior positions, from 1991 to March 1998, with Old Dominion University as Director of its Virginia Peninsula campus; from 1985 to 1991, as General Counsel of a computer manufacturing firm; as Senior Counsel in the Office of the Governor of Virginia from 1982 to 1985; as Senior Counsel for the Virginia Housing Development Authority from 1976 to 1982, and as Assistant Attorney General for the Commonwealth of Virginia from 1975 to 1976. Ms. Scott received her B.S. in business administration from

343,181

19,201

2.0

Performance stock awarded in:

2003

255,000

$

32.05

185,000

$

32.05

12,500

$

31.90

57,500

$

32.06

3,217

0.4

2006

285,000

$

54.21

$

$

285,000

$

54.21

15,946

6.4

Total performance stock awards

540,000

185,000

12,500

342,500

19,163

5.4

Total awards

1,140,730

375,774

79,275

685,681

$

38,364

3.7

---

(1) Determined using the $55.95 closing price of First Community common stock on September 30, 2006.

Compensation expense related to awards of restricted and performance stock is based on the fair value of the underlying stock on the award date and is recognized over the vesting period using the straight-line method. The vesting of performance stock awards and recognition of related compensation expense may occur over a shorter vesting period if financial performance targets are achieved earlier than anticipated. Restricted and performance stock amortization totaled $2.1 million and $1.1 million for the quarter ended September 30, 2006 and 2005, and $5.6 million and $2.8 million for the nine months ended September 30, 2006 and 2005 and is included in compensation expense in the accompanying consolidated statements of earnings.

Stock Options.

We adopted the fair value method of accounting for stock options effective January 1, 2003, using the prospective method of transition specified in SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123.* The cost of all stock options granted on or after January 1, 2003 is based on their fair value and is included as a component of compensation expense over the vesting period for such options. For stock options granted prior to January 1, 2003, the Company applied the intrinsic value-based method of accounting prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Accordingly, no compensation cost was recognized for fixed stock option awards granted prior to January 1, 2003, with an exercise price equal to or greater than the fair market value of the underlying stock on the date of grant. The Company has not granted stock options since the first quarter of 2003 and all stock options vested as of March 31, 2006. Had we determined compensation expense for our stock-based compensation plan consistent with SFAS No. 123, *Accounting for Stock-Based Compensation*, our net earnings and earnings per share for the quarter and nine months

NOTE 6 STOCK COMPENSATION (Continued)

ended September 30, 2005 would have been reduced to the pro forma amounts indicated in the table below:

	Quarter Ended September 30, 2005 (Dollars in thousands, except per share data	Nine Months Ended
Reported net earnings	$ 12,994	$ 35,074
Add: Stock based compensation expense included in net earnings, net of tax	666	1,620
Deduct: All stock based compensation expense, net of tax	(734)	(1,823)
Pro forma net earnings	$ 12,926	$ 34,871
Basic net earnings per share as reported	$ 0.79	$ 2.18
Pro forma basic net earnings per share	$ 0.79	$ 2.17
Diluted net earnings per share as reported	$ 0.78	$ 2.13
Pro forma diluted net earnings per share	$ 0.77	$ 2.12

A summary of the status of our stock options outstanding and the changes during the nine months ended September 30, 2006 is presented in the table below:

	Shares	Weighted-Average Exercise Price	Aggregate Intrinsic Value(1) (Dollars in thousands)
Outstanding at December 31, 2005	543,793	$ 21.05	
Exercised	(408,420)	21.14	
Outstanding and exercisable at September 30, 2006	135,373	$ 20.78	$ 4,761

(1) Calculated as the difference between the $55.95 closing price of First Community common stock on September 30, 2006 and the weighted average exercise price.

Both restricted and performance stock and stock options are permitted to be awarded to officers, directors, key employees and consultants under the terms described in the 2003 Plan. The 2003 Plan authorizes grants of stock-based compensation instruments to purchase or issue up to 3,500,000 shares of authorized but unissued Company common stock, subject to adjustments provided by the 2003 Plan. As of November 1, 2006, there were 999,696 shares available for grant under the 2003 Plan.

NOTE 7 BORROWINGS AND SUBORDINATED DEBENTURES

Borrowings.

At September 30, 2006, we had $513.4 million of borrowings outstanding. Borrowings included $428.4 million of overnight advances and $85.0 million of term advances from the Federal Home Loan Bank of San Francisco (the FHLB). The weighted average cost of these borrowings was 5.31% at September 30, 2006. The term advances begin to mature in December 2006. Our aggregate remaining secured borrowing capacity from the FHLB was $473.0 million as of September 30, 2006.

The Company renewed its revolving credit line with U.S. Bank for $70 million. The revolving credit line matures on August 2, 2007 and is secured by a pledge of all of the outstanding capital stock of Pacific Western. The credit agreement requires the Company to maintain certain financial and capital ratios, among other covenants and conditions. This revolving credit line replaces the previous revolving credit line

NOTE 7 BORROWINGS AND SUBORDINATED DEBENTURES (Continued)

arrangements with U.S. Bank for $50 million and The Northern Trust Company for $20 million which matured on August 3, 2006.

Subordinated Debentures.

The Company had an aggregate of $129.9 million of subordinated debentures outstanding with a weighted average cost of 8.86% at September 30, 2006. The subordinated debentures were issued in eight separate series. Each issuance has a maturity of thirty years from its date of issue. The subordinated debentures were issued to trusts established by us and Foothill, which in turn issued trust preferred securities. The proceeds from the issuance of the securities were used primarily to fund several of our acquisitions.

Generally and with certain limitations, we are permitted to call the debentures in the first five years upon the occurrence of any of the following three events: (i) a change in the tax treatment of the debentures stemming from a change in the IRS laws; (ii) a change in the regulatory treatment of the underlying trust preferred securities as Tier 1 capital; and (iii) a requirement to register the underlying trust as a registered investment company. Under certain of our series of issuances, redemption in the first five years may be subject to a prepayment penalty. Trust I may not be called for 10 years from the date of issuance unless one of the three events described above has occurred and then a prepayment penalty applies. In addition, there is a prepayment penalty if the Trust I debentures are called 10 to 20 years from the date of its issuance, although they may be called at par after 20 years.

The following table summarizes the terms of each issuance:

Series	Date Issued	Amount	Earliest Call Date By Company Without Penalty(1)	Fixed or Variable Rate	Rate Adjuster	Current Rate(2)	Next Reset Date
	(Dollars in thousands)						
Trust I	9/7/2000	$ 8,248	9/7/2020	Fixed	N/A	10.60 %	N/A
Trust II	12/18/2001	10,310	12/18/2006	Variable	3-month LIBOR +3.60%	8.99 %	12/14/2006
Trust III	11/28/2001	10,310	12/8/2006	Variable	6-month LIBOR +3.75%	9.17 %	12/8/2006
Trust IV	6/26/2002	10,310	6/26/2007	Variable	3-month LIBOR +3.55%	8.92 %	12/21/2006
Trust F(3)	12/19/2002	8,248	12/19/2007	Variable	3-month LIBOR +3.25%	8.62 %	12/21/2006
Trust V	8/15/2003	10,310	9/17/2008	Variable	3-month LIBOR +3.10%	8.49 %	12/14/2006
Trust VI	9/3/2003	10,310	9/15/2008	Variable	3-month LIBOR +3.05%	8.44 %	12/13/2006
Trust VII	2/5/2004	61,856	4/23/2009	Variable	3-month LIBOR +2.75%	8.13 %	01/26/2007
Total		$ 129,902					

(1) As described above, certain issuances may be called earlier without penalty upon the occurrence of certain events.

(2) As of October 27, 2006; excludes debt issuance costs.

(3) Acquired in the Foothill merger.

As previously mentioned, the subordinated debentures were issued to trusts established by us and Foothill, which in turn issued $126 million of trust preferred securities. These securities are currently included in our Tier I capital for purposes of determining the Company s Tier I and total risk-based capital ratios. The Board of Governors of the Federal Reserve System, which is the holding company s banking regulator, has promulgated a modification of the capital regulations affecting trust preferred securities. Under this modification, beginning March 31, 2009, the Company will be required to use a more restrictive formula to determine the amount of trust preferred securities that can be included in regulatory Tier I capital. At that time, the Company will be allowed to include in Tier I capital an amount of trust preferred securities equal to no more than 25% of the sum of all core capital elements, which is generally defined as

NOTE 7 BORROWINGS AND SUBORDINATED DEBENTURES (Continued)

shareholders equity less certain intangibles, including goodwill, core deposit intangibles and customer relationship intangibles, net of any related deferred income tax liability. The regulations currently in effect through December 31, 2008, limit the amount of trust preferred securities that can be included in Tier I capital to 25% of the sum of core capital elements without a deduction for permitted intangibles. We have determined that our Tier I capital ratios would remain above the well-capitalized level had the modification of the capital regulations been in effect at September 30, 2006. We expect that our Tier I capital ratios will be at or above the existing well-capitalized levels on March 31, 2009, the first date on which the modified capital regulations must be applied.

In October, we received permission from the Federal Reserve Bank of San Francisco to redeem $20.6 million in subordinated debentures, which we expect to redeem in December. Although this redemption will reduce our regulatory leverage and risk-based capital ratios, we expect to remain well capitalized after redemption.

NOTE 8 COMMITMENTS AND CONTINGENCES

Lending Commitments.

The Banks are party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of their customers. Such financial instruments include commitments to extend credit, standby letters of credit and financial guarantees. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets. The contract or notional amounts of such instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

Commitments to extend credit amounting to $1.1 billion and $1.0 billion were outstanding as of September 30, 2006 and December 31, 2005. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Standby letters of credit and financial guarantees amounting to $73.3 million and $62.1 million were outstanding as of September 30, 2006 and December 31, 2005. Standby letters of credit and financial guarantees are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support private borrowing arrangements. Most guarantees expire within one year from the date of issuance. The Company generally requires collateral or other security to support financial instruments with credit risk. Management does not anticipate that any material loss will result from the outstanding commitments to extend credit, standby letters of credit or financial guarantees.

Legal Matters.

On June 8, 2004, the Company was served with an amended complaint naming First Community and Pacific Western as defendants in a class action lawsuit filed in Los Angeles Superior Court pending as Gilbert et. al v. Cohn et al, Case No. BC310846 (the Gilbert Litigation). A former officer of First Charter Bank, N.A. (First Charter), which the Company acquired in October 2001, was also named as a defendant. That former officer left First Charter in May of 1997 and later became a principal of Four Star Financial Services, LLC (Four Star), an affiliate of 900 Capital Services, Inc. (900 Capital).

On April 18, 2005, the plaintiffs filed the second amended class action complaint. The second amended complaint alleged that the former officer of First Charter improperly induced several First Charter customers to invest in 900 Capital or affiliates of 900 Capital and further alleges that Four Star,

NOTE 8 COMMITMENTS AND CONTINGENCES (Continued)

900 Capital and some of their affiliated entities perpetuated their fraud upon investors through various accounts at First Charter, First Community and Pacific Western with those banks purported knowing participation in and/or willful ignorance of the scheme. The key allegations in the second amended complaint dated back to the mid-1990s and the second amended complaint alleged several counts for relief including aiding and abetting, conspiracy, fraud, breach of fiduciary duty, relief pursuant to the California Business and Professions Code, negligence and relief under the California Securities Act stemming from an alleged fraudulent scheme and sale of securities issued by 900 Capital and Four Star. In disclosures provided to the parties, plaintiffs have asserted that the named plaintiffs have suffered losses well in excess of $3.85 million, and plaintiffs have asserted that losses to the class total many tens of millions of dollars. While we understand that the plaintiffs intend to seek to certify a class for purposes of pursuing a class action, a class has not yet been certified and no motion for class certification has been filed. On June 15, 2005, we filed a demurrer to the second amended complaint, and on August 22, 2005, the Court sustained our demurrer as to each of the counts therein, granting plaintiffs leave to amend on four of the six counts, and dismissing the other counts outright.

On August 12, 2005, the Company was notified by Progressive Casualty Insurance Company (Progressive), its primary insurance carrier with respect to the Gilbert Litigation that Progressive had determined that, based upon the allegations in the second amended complaint filed in the Gilbert Litigation, there is no coverage with respect to the Gilbert Litigation under the Company s insurance policy with Progressive. Progressive also notified the Company that it was withdrawing its agreement to fund defense costs for the Gilbert Litigation and reserving its right to seek reimbursement from the Company for any defense costs advanced pursuant to the insurance policy. Through December 31, 2005, Progressive had advanced to the Company approximately $690,000 of defense costs with respect to the Gilbert Litigation.

On August 12, 2005, Progressive filed an action in federal district court for declaratory relief, currently pending as Progressive Casualty Insurance Company, etc., v. First Community Bancorp, etc., et al., Case No. 05-5900 SVW (MAWx) (the Progressive Litigation), seeking a declaratory judgment with respect to the parties rights and obligations under Progressive s policy with the Company. On October 11, 2005, the Company filed in federal court a motion to dismiss or stay the Progressive Litigation.

In November 2005, along with certain other defendants, we reached an agreement in principle with respect to the Gilbert Litigation. The proposed settlement, toward which First Community would contribute $775,000, is subject to the final settlement terms and documentation being agreed upon by First Community, the plaintiffs and other parties who are also contributing to this settlement. Additionally, the settlement is subject to approval by the Los Angeles Superior Court. The proposed contribution by First Community of $775,000 was accrued in 2005.

The parties to the proposed settlement are still engaged in the process of finalizing their agreement regarding the terms and conditions of the settlement. In the course of this process, the law firm representing the plaintiffs sought court approval to withdraw as counsel for one of the named plaintiffs, which approval was granted.

While we believe that this settlement, if finalized, will end our exposure to the underlying claims by participating class members, we cannot be certain that a final settlement will be reached or that we will not be subject to further claims by parties related to the same claims who did not participate in the settlement. In connection with the Gilbert Litigation settlement, we also reached a settlement in principle with Progressive Casualty Insurance Co. in the Progressive Litigation. The settlement with Progressive, which includes an additional contribution by Progressive under First Community s policy toward the settlement of the Gilbert Litigation and a dismissal by Progressive of any claims against First Community for reimbursement, is contingent upon the consummation of the Gilbert Litigation settlement.

NOTE 8 COMMITMENTS AND CONTINGENCES (Continued)

In the ordinary course of our business, we are party to various other legal actions, which we believe are incidental to the operation of our business. Although the ultimate outcome and amount of liability, if any, with respect to these other legal actions to which we are currently a party cannot presently be ascertained with certainty, in the opinion of management, based upon information currently available to us, any resulting liability is not likely to have a material adverse effect on the Company s consolidated financial position, results of operations or cash flows.

NOTE 9 IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140* (SFAS 155). This statement: (i) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require separation; (ii) clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement No. 133; (iii) establishes a requirement to evaluate interests in securitized financial assets to identify derivatives; (iv) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and (v) amends Statement No. 140 to eliminate the prohibition on a qualifying SPE from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This statement is effective for all financial instruments acquired or issued after December 31, 2006. We do not expect there to be any material effect on either our financial condition or results of operations when we adopt SFAS 155.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140* (SFAS 156). This statement requires that all separately recognized servicing rights be initially measured at fair value, if practicable. For each class of separately recognized servicing assets and liabilities, this statement permits the servicing assets and liabilities to be reported at either fair value or at amortized cost. Under the fair value approach, servicing assets and liabilities will be recorded at fair value at each reporting date with changes in fair value recorded in earnings in the period in which the changes occur. Under the amortized cost method, servicing assets and liabilities are amortized in proportion to and over the period of estimated net servicing income or net servicing loss and are assessed for impairment based on fair value at each reporting date. SFAS 156 is effective for us on January 1, 2007. We will adopt SFAS 156 on January 1, 2007, and are presently reviewing the standard to determine what effect, if any, it will have on our financial condition and results of operations.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The evaluation of a tax position is a two-step process including: (i) a recognition process to determine whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position, and (ii) a measurement process whereby a tax position that meets the more-likely-than-not recognition threshold is calculated to determine the amount of benefit to be recognized in the financial statements. FIN 48 is effective for us on January 1, 2007. Any cumulative effect of applying the provisions of FIN 48 will be recognized as an adjustment to the beginning balance of retained earnings. We do not expect there to be any material effect on either our financial condition or results of operations when we adopt FIN 48.

NOTE 9 IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS (Continued)

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures abour fair value measurements. Fair value is defined as a market-based measurement and should be determined based on assumptions that a market participant would use when pricing an asset or liability. The market participant s assumptions should include assumptions abour risk as well as the effect of a restriction on the sale or use of an asset. Additionally, this statement establishes a fair value hierarchy that provides the highest priority to quoted prices in active markets and the lowest priority to unobservable data. This statement is effective for us on January 1, 2008. We are presently reviewing the standard to determine what effect, if any, it will have on our financial condition and results of operations.

In September 2006, the SEC issued Staff Accounting Bulletin 108, (SAB), Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. This SAB provides guidance on the consideration of prior year misstatements in determining whether the current year s financial statements are materially misstated. The SEC staff indicates that registrants should quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. This SAB is effective for fiscal years ending after November 15, 2006. Registrants may either restate their financials for any material misstatements arising from the application of this SAB or recognize a cumulative effect of applying SAB 108 within the current year opening balance in retained earnings. We are presently reviewing the standard to determine what effect, if any, it will have on our financial condition and results of operations.

NOTE 10 SHAREHOLDERS EQUITY MATTERS

On May 16, 2005, we filed a registration statement with the SEC regarding the sale of up to 3,400,000 shares of our common stock, no par value per share, which we may offer and sell, from time to time, in amounts, at prices and on terms that we will determine at the time of any particular offering. To date, we have issued 2,935,766 shares of common stock under this registration statement for net proceeds of $158.5 million, including the sale of 1,891,086 shares of our common stock for $109.5 million in January 2006. We used these proceeds to augment our capital in support of our acquisitions. We expect to use the net proceeds from any additional sales of our securities to fund future acquisitions of banks and other financial institutions, as well as for general corporate purposes.

On May 3, 2006, our Board of Directors authorized the repurchase of up to one million shares of the Company s common stock over the next twelve months, subject to market conditions and corporate and regulatory requirements. As of September 30, 2006 no shares have been repurchased. The stock repurchase program may be limited or terminated at any time without prior notice.

NOTE 11 SUBSEQUENT EVENTS

On October 26, 2006, following the completion of the Community Bancorp acquisition and the subsequent merger of Community National Bank, a wholly-owned subsidiary of Community Bancorp, with and into First National, the Company completed its plan of consolidation by merging First National with and into Pacific Western, with Pacific Western as the surviving entity in an as if pooling transaction.

On October 23, 2006, we sold investment securities with a par value of $101.8 million. We recorded a pre-tax loss on this sale of approximately $2.3 million. Cash proceeds from the sale of these investment securities were used to reduce our overnight borrowings from the FHLB.

On October 30, 2006, we received permission from the Federal Reserve Bank of San Francisco to redeem $20.6 million of series Trust II and Trust III subordinated debentures. We intend to redeem these securities in December.

ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Information

This Quarterly Report on Form 10-Q contains certain forward-looking information about the Company and its subsidiaries, which statements are intended to be covered by the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical fact are forward-looking statements. Such statements involve inherent risks and uncertainties, many of which are difficult to predict and are generally beyond the control of the Company. We caution readers that a number of important factors could cause actual results to differ materially from those expressed in, implied or projected by, such forward-looking statements. Risks and uncertainties include, but are not limited to:

- planned acquisitions and related cost savings cannot be realized or realized within the expected time frame;
- revenues are lower than expected;
- credit quality deterioration which could cause an increase in the provision for credit losses;
- competitive pressure among depository institutions increases significantly;
- the Company s ability to complete planned acquisitions, to successfully integrate acquired entities, or to achieve expected synergies and operating efficiencies within expected time-frames or at all;
- the integration of acquired businesses or our subsidiary banks costs more, takes longer or is less successful than expected;
- the possibility that personnel changes will not proceed as planned;
- the cost of additional capital is more than expected;
- a change in the interest rate environment reduces interest margins;
- asset/liability repricing risks and liquidity risks;
- pending legal matters may take longer or cost more to resolve or may be resolved adversely to the Company;
- general economic conditions, either nationally or in the market areas in which the Company does or anticipates doing business, are less favorable than expected;
- the economic and regulatory effects of the continuing war on terrorism and other events of war, including the war in Iraq;
- legislative or regulatory requirements or changes adversely affecting the Company s business;
- regulatory changes resulting from the consolidation and conversion of our subsidiary banks into a single state-chartered bank;
- changes in the securities markets; and
- regulatory approvals for announced or future acquisitions cannot be obtained on the terms expected or on the anticipated schedule.

If any of these risks or uncertainties materializes, or if any of the assumptions underlying such forward-looking statements proves to be incorrect, our results could differ materially from those expressed in, implied or projected by, such forward-looking statements. The Company assumes no obligation to update such forward-looking statements.

Overview

We are a bank holding company registered under the Bank Holding Company Act of 1956, as amended. Our principal business is to serve as the holding company for our subsidiary banks, which as of September 30, 2006, were First National Bank and Pacific Western Bank, which we refer to as the Banks. Through the holding company structure, First Community creates operating efficiencies for the Banks by consolidating core administrative, operational and financial functions that serve both of the Banks. The Banks reimburse the holding company for the services performed on their behalf, pursuant to an expense allocation agreement.

The Banks are full-service community banks offering a broad range of banking products and services including: accepting time and demand deposits; originating commercial loans, including asset-based lending and factoring, real estate and construction loans, Small Business Administration guaranteed loans, or SBA loans, consumer loans, mortgage loans and international loans for trade finance; providing tax free real estate exchange accommodation services; and providing other business-oriented products. At September 30, 2006, our gross loans totaled $3.6 billion of which 23% consisted of commercial loans, 76% consisted of commercial real estate loans, including construction loans, and 1% consisted of consumer and other loans. These percentages also include some foreign loans, primarily to individuals or entities with business in Mexico, representing approximately 3% of total loans. Our portfolio s value and credit quality is affected in large part by real estate trends in Southern California.

The Banks compete actively for deposits, and we tend to solicit noninterest-bearing deposits. In managing the top line of our business, we focus on loan growth and loan yield, deposit cost, and net interest margin, as net interest income, on a year-to-date basis, accounts for 77% of our net revenues (net interest income plus noninterest income).

Plan of Consolidation and Conversion

As previously disclosed, Pacific Western completed its conversion to a state chartered nonmember bank effective September 13, 2006. On October 26, 2006, following the completion of the Community Bancorp acquisition and the subsequent merger of Community National Bank, a wholly-owned subsidiary of Community Bancorp, with and into First National, the Company completed its plan of consolidation by merging First National with and into Pacific Western, with Pacific Western as the surviving entity in an as if pooling transaction.

First Community issued 4,677,908 shares of First Community common stock to Community Bancorp stockholders and approximately $6.1 million in cash was delivered to holders of outstanding and unexercised Community Bancorp options. The aggregate deal value for financial reporting purposes was approximately $268.7 million. As part of the plan of consolidation and conversion, both First Community and Pacific Western Bank have moved their headquarters to 401 West A Street in San Diego, California.

Key Performance Indicators

Among other factors, our operating results depend generally on the following:

The Level of Our Net Interest Income

Net interest income is the excess of interest earned on our interest-earning assets over the interest paid on our interest-bearing liabilities. Our primary interest-earning assets are loans and investment securities. Our primary interest-bearing liabilities are deposits, borrowings, and subordinated debentures. We attempt to increase our net interest income by maintaining a high level of noninterest-bearing deposits. At September 30, 2006, approximately 45% of our deposits were noninterest-bearing. Although we have borrowing capacity under various credit lines, we have traditionally borrowed funds only for short term liquidity needs such as funding loan demand in excess of deposit growth, managing deposit flows and interim acquisition financing. Net proceeds from our other long-term borrowings, consisting of subordinated debentures, were used to fund certain of our acquisitions. Our general policy is to price our deposits in the bottom half or third-quartile of our competitive peer group, resulting in deposit products that bear somewhat lower interest rates. While our deposit balances will fluctuate depending on deposit holders perceptions of alternative yields available in the market, we attempt to minimize these variances by attracting a high percentage of noninterest-bearing deposits, which generally have no expectation of yield.

Loan Growth

We generally seek new lending opportunities in the $500,000 to $10 million range, try to limit loan maturities for commercial loans to one year, for construction loans up to 18 months, and for commercial real estate loans up to ten years, and to price lending products so as to preserve our interest spread and net interest margin. We sometimes encounter strong competition in pursuing lending opportunities such that potential borrowers obtain loans elsewhere at lower rates than those we offer.

The Magnitude of Credit Losses

We stress credit quality in originating and monitoring the loans we make and measure our success by the level of our nonperforming assets and the corresponding level of our allowance for credit losses. Our allowance for credit losses is the sum of our allowance for loan losses and our reserve for unfunded loan commitments. Provisions for credit losses are charged to operations as and when needed for both on and off balance sheet credit exposure. Loans which are deemed uncollectible are charged off and deducted from the allowance for loan losses. Recoveries on loans previously charged off are added to the allowance for loan losses. The provision for credit losses reflects our judgments about the adequacy of the allowance for loan losses and the reserve for unfunded loan commitments. In determining the amount of the provision, we consider certain quantitative and qualitative factors including our historical loan loss experience, the volume and type of lending we conduct, the results of our credit review process, the amounts of classified and nonperforming assets, regulatory policies, general economic conditions, underlying collateral values, off-balance sheet exposures, and other factors regarding collectibility and impairment. During the third quarter of 2006, we made no provision for credit losses.

We review our loans periodically to determine whether there has been any deterioration in credit quality stemming from economic conditions or other factors which may affect collectibility of our loans. Changes in economic conditions, such as increases in the general level of interest rates and negative conditions in borrowers businesses, could negatively impact our customers and cause us to adversely classify loans and increase portfolio loss factors. Because we have a concentration in real estate loans, any deterioration in the real estate markets may negatively impact our borrowers and could lead to increased provisions for credit losses. Approximately 76% of our gross loans are real estate related, with construction loans and real estate mortgage loans representing 21% and 55%, respectively, of gross loans. Further, we subject acquired loans to periodic review under our standards once the acquisitions are completed. Such reviews could result in downgrades to adversely classified status. Because adversely classified loans generally require a higher allowance for credit losses, increases in classified loans generally result in increased provisions for credit losses.

The Level of Our Noninterest Expense

Our noninterest expense includes fixed and controllable overhead, the major components of which are compensation, occupancy, data processing, professional fees and communications. We measure success in controlling such costs through monitoring of the efficiency ratio. We calculate the efficiency ratio by dividing noninterest expense by the sum of net interest income and noninterest income. Accordingly, a

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lower percentage reflects lower expenses relative to income. The consolidated efficiency ratios have been as follows:

Quarterly Period	Ratio
Third quarter 2006	45.5 %
Second quarter 2006	45.7 %
First quarter 2006	47.2 %
Fourth quarter 2005	48.3 %
Third quarter 2005	50.1 %
Second quarter 2005	49.1 %
First quarter 2005	53.6 %

Additionally, our operating results, through September 30, 2006, have been influenced significantly by the four acquisitions we completed since January 1, 2005, which added approximately $1.9 billion in assets. Our assets at September 30, 2006, total approximately $4.6 billion. While the quarterly noninterest expense amounts have generally increased from the second quarter of 2005, the quarterly efficiency ratio has generally decreased over the same time period driven by increased net interest income and improvement in operating efficiencies.

Critical Accounting Policies

The Company s accounting policies are fundamental to understanding management s discussion and analysis of results of operations and financial condition. The Company has identified several policies as being critical because they require management to make particularly difficult, subjective and/or complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts would be reported under different conditions or using different assumptions. These policies relate to the allowance for credit losses and the carrying values of goodwill, other intangible assets and deferred income tax assets. For further information, refer to our Annual Report on Form 10-K for the year ended December 31, 2005.

Results of Operations

Earnings Performance

We analyze our performance based on net earnings determined in accordance with U.S. generally accepted accounting principles. The comparability of financial information is affected by our acquisitions. Operating results include the operations of acquired entities from the dates of acquisition. The following table presents net earnings and summarizes per share data and key financial ratios:

	Quarter Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
	(Dollars in thousands, except per share data)			
Net interest income	$ 61,745	$ 40,780	$ 171,735	$ 113,577
Noninterest income	4,776	3,514	12,817	10,347
Net revenues	66,521	44,294	184,552	123,924
Provision for credit losses			9,600	1,420
Noninterest expense	30,256	22,213	84,988	63,056
Income taxes	14,890	9,087	36,877	24,374
Net earnings before accounting change	21,375	$ 12,994	53,087	$ 35,074
Accounting change			142	
Net earnings(1)	$ 21,375	$ 12,994	$ 53,229	$ 35,074
Average interest-earning assets	$ 3,711,039	$ 2,529,171	$ 3,412,785	$ 2,453,844
Profitability measures:				
Basic earnings per share:				
Net earnings before accounting change	$ 0.88	$ 0.79	$ 2.41	$ 2.18
Accounting change(2)				
Basic earnings per share	$ 0.88	$ 0.79	$ 2.41	$ 2.18
Diluted earnings per share:				
Net earnings before accounting change	$ 0.88	$ 0.78	$ 2.39	$ 2.13
Accounting change(2)				
Diluted earnings per share	$ 0.88	$ 0.78	$ 2.39	$ 2.13
Net interest margin	6.60 %	6.40 %	6.73 %	6.19 %
Return on average assets	1.87 %	1.71 %	1.72 %	1.61 %
Return on average equity	9.6 %	12.5 %	9.5 %	11.9 %
Efficiency ratio	45.5 %	50.1 %	46.1 %	50.9 %

(1) Our results include First American subsequent to August 12, 2005, Pacific Liberty subsequent to October 7, 2005, Cedars subsequent to January 4, 2006, and Foothill subsequent to May 9, 2006.

(2) Less than $0.01 per share for the nine months ended September 30, 2006.

The improvement in net earnings in the third quarter of 2006 compared to the same period of 2005 resulted from increased net interest margin and average loan growth. The increase in average loans was due to both organic loan growth and loans added to the portfolio from our acquisitions. Our net interest margin increased 20 basis points to 6.60% for the third quarter of 2006 compared to the same period in 2005. This increase was due to the positive impact the increases in market interest rates have had on our loan portfolio. The increase in noninterest income for the third quarter of 2006 compared to the same period in 2005 is attributed to increased commissions and fees for both loans and deposit related services as loan and deposit balances have increased. The increase in noninterest expense for the third quarter of 2006 over the same period of 2005 is largely the result of higher compensation and occupancy expense, which is the result of additional staff and branch locations added through acquisitions.

The improvement in net earnings for the first nine months of 2006 compared to the same period of 2005 is due mostly to acquisitions and organic loan growth.

Net Interest Income. *Net interest income, which is our principal source of revenue, represents the difference between interest earned on assets and interest paid on liabilities. Net interest margin is net interest income expressed as a percentage of average interest-earning assets. Net interest income is affected by changes in both interest rates and the volume of average interest-earning assets and interest-bearing liabilities. The following table presents, for the periods indicated, the distribution of average assets, liabilities and shareholders equity, as well as interest income and yields earned on average interest-earning assets and interest expense and costs on average interest-bearing liabilities:*

	Quarter Ended September 30, 2006			2005		
	Average Balance	Interest Income or Expense	Average Yield or Cost	Average Balance	Interest Income or Expense	Average Yield or Cost
	(Dollars in thousands)					
ASSETS						
Interest-earning assets:						
Loans, net of unearned income(1)(2)	$ 3,451,376	$ 74,726	8.59 %	$ 2,231,702	$ 44,533	7.92 %
Investment securities(2)	254,608	2,730	4.25 %	232,677	1,635	2.79 %
Federal funds sold	4,731	62	5.20 %	64,592	564	3.46 %
Other earning assets	324	4	4.90 %	200	2	3.97 %
Total interest-earning assets	3,711,039	77,522	8.29 %	2,529,171	46,734	7.33 %
Noninterest-earning assets:						
Other assets	828,501			481,848		
Total assets	$ 4,539,540			$ 3,011,019		
LIABILITIES AND SHAREHOLDERS EQUITY						
Interest-bearing liabilities:						
Interest checking	$ 252,045	105	0.17 %	$ 190,847	28	0.06 %
Money market	930,323	5,158	2.20 %	730,117	1,838	1.00 %
Savings	141,920	56	0.16 %	101,788	63	0.25 %
Time certificates of deposit	374,784	3,298	3.49 %	212,748	1,085	2.02 %
Total interest-bearing deposits	1,699,072	8,617	2.01 %	1,235,500	3,014	0.97 %
Other interest-bearing liabilities	453,085	7,160	6.27 %	214,833	2,940	5.43 %
Total interest-bearing liabilities	2,152,157	15,777	2.91 %	1,450,333	5,954	1.63 %
Noninterest-bearing liabilities:						
Demand deposits	1,437,035			1,099,769		
Other liabilities	69,025			47,185		
Total liabilities	3,658,217			2,597,287		
Shareholders equity	881,323			413,732		
Total liabilities and shareholders equity	$ 4,539,540			$ 3,011,019		
Net interest income		$ 61,745			$ 40,780	
Net interest spread			5.38 %			5.70 %
Net interest margin			6.60 %			6.40 %

(1) Includes nonaccrual loans and unearned income.

(2) Yields on loans and securities have not been adjusted to a tax equivalent basis because the impact is not material.

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Third Quarter Analysis. Our net interest margin for the third quarter of 2006 was 6.60%, an increase of 20 basis points when compared to the same period of 2005 and a decrease of 19 basis points when compared to the second quarter of 2006. The decrease in the net interest margin in the third quarter of 2006 compared to the second quarter of 2006 is due mainly to the impact of the mix and rate structure of deposits acquired in the Foothill acquisition, the competitive interest rate pressures on new loan originations, and increased borrowings used to fund loans and deposit flows. The net interest margin expansion for the third quarter of 2006 compared to the same period of 2005 is due mainly to the combination of our increased loan volume and our higher prime lending rate, offset in part by increased funding costs. Average loans increased $1.2 billion to $3.5 billion for the third quarter of 2006 compared to the same period of 2005. The increase was due to both organic growth and loans acquired in the four acquisitions that we completed since June 30, 2005. Yields on average earning assets were 8.29% and 7.33% for the third quarters of 2006 and 2005 and are driven mostly by our loan yields. The average loan yield increased 67 basis points to 8.59% for the third quarter of 2006 compared to the same period of 2005 due mainly to the increase in our prime lending rate in response to the gradual rise in market interest rates. The significant amount of noninterest-bearing demand deposits we maintain also helps to increase net interest income and expand our net interest margin; we averaged $1.4 billion of noninterest-bearing deposits during the third quarter of 2006, or 46% of average total deposits, compared to $1.1 billion, or 47% of average total deposits, for the same period of 2005. Our overall cost of deposits, which includes demand deposits, was 1.09% for the third quarter of 2006, compared to 0.51% in the third quarter of 2005; this increase in deposit costs is a result of upward adjustments made in rates offered on money market and certain time deposits in response to competition as well as the impact of the higher-cost deposits acquired in the Cedars and Foothill acquisitions.

Interest income increased $30.8 million for the third quarter of 2006 compared to the same period of 2005 while interest expense increased $9.8 million for the third quarter of 2006 when compared to the same period of 2005. The increase in interest income is driven mostly by loan growth and the increased loan yields. The increased interest expense is due to an increase in interest-bearing deposits and Federal Home Loan Bank, or FHLB, advances and the cost of all funding sources. Average interest bearing deposits increased $463.6 million and other interest-bearing liabilities increased $238.3 million contributing $4.7 million to the increase in interest expense for the third quarter of 2006 compared to the same period in 2005. Our deposits increased due mostly to our 2005 and 2006 acquisitions and we used FHLB advances to fund loan demand and deposit flows. The upward adjustments made in rates offered on money market and certain time deposits in response to competition as well as the impact of the higher-cost deposits obtained in our acquisitions contributed $3.8 million to the increase in interest expense for the third quarter of 2006 compared to the same period of 2005. Additionally, the repricing of our other interest-bearing liabilities, including subordinated debentures and both overnight and term borrowings from the FHLB, in the higher interest rate environment increased interest expense $1.3 million over these same time periods.

	Nine Months Ended September 30, 2006 Average Balance (Dollars in thousands)	Interest Income or Expense	Average Yield or Cost	2005 Average Balance	Interest Income or Expense	Average Yield or Cost
ASSETS						
Interest-earning assets:						
Loans, net of unearned income(1)(2)	$ 3,154,518	$ 203,005	8.60 %	$ 2,165,192	$ 123,082	7.60 %
Investment securities(2)	251,374	7,484	3.98 %	249,061	5,680	3.05 %
Federal funds sold	6,006	192	4.27 %	39,354	866	2.94 %
Other earning assets	887	24	3.62 %	237	5	2.82 %
Total interest-earning assets	3,412,785	210,705	8.25 %	2,453,844	129,633	7.06 %
Noninterest-earning assets:						
Other assets	724,119			454,293		
Total assets	$ 4,136,904			$ 2,908,137		
LIABILITIES AND SHAREHOLDERS EQUITY						
Interest-bearing liabilities:						
Interest checking	$ 234,226	248	0.14 %	$ 189,812	86	0.06 %
Money market	845,304	11,419	1.81 %	715,556	4,576	0.86 %
Savings	127,477	171	0.18 %	90,596	127	0.19 %
Time certificates of deposit	398,627	9,544	3.20 %	209,708	2,631	1.68 %
Total interest-bearing deposits	1,605,634	21,382	1.78 %	1,205,672	7,420	0.82 %
Other interest-bearing liabilities	386,558	17,588	6.08 %	231,072	8,636	5.00 %
Total interest-bearing liabilities	1,992,192	38,970	2.62 %	1,436,744	16,056	1.49 %
Noninterest-bearing liabilities:						
Demand deposits	1,340,100			1,037,834		
Other liabilities	58,036			40,872		
Total liabilities	3,390,328			2,515,450		
Shareholders equity	746,576			392,687		
Total liabilities and shareholders equity	$ 4,136,904			$ 2,908,137		
Net interest income		$ 171,735			$ 113,577	
Net interest spread			5.63 %			5.57 %
Net interest margin			6.73 %			6.19 %

(1) Includes nonaccrual loans and unearned income.

(2) Yields on loans and securities have not been adjusted to a tax-equivalent basis because the impact is not material.

Nine Month Analysis. The growth in net interest income and the 54 basis point increase in our net interest margin for the nine months ended September 30, 2006, compared to the same period of 2005 was largely a result of higher average loan balances and increased loan yields, offset by higher funding costs.

Net interest income increased $58.2 million mostly as a result of the $989.3 million increase in average loans for the first nine months of 2006, when compared to the same period of 2005. Interest earned on average loans increased $79.9 million; this increase was mainly a result of increased in average loans from both organic growth and acquisition activity coupled with increased yields..

Interest expense increased $22.9 million year-over-year due mostly to an increase in our total funding sources as well as the cost of such funds. The cost of our interest-bearing liabilities increased 113 basis points for the nine months ended September 30, 2006, when compared to the same period of 2005 and was

the result of both higher deposit cost as well as an increase in the costs of our borrowed funds. The cost of our interest-bearing deposits increased 96 basis points for the nine months ended September 30, 2006, when compared to the same period for 2005 as we continue to increase selected deposit rates in response to competition. Similar to the quarter analysis, the cost of deposits for the first nine months of 2006 is affected by the mix and rate structure of the deposits acquired in the First American, Pacific Liberty, Cedars and Foothill acquisitions. Average other interest bearing liabilities, which include FHLB advances and subordinated debt, increased $155.5 million. The cost of our FHLB advances and subordinated debt increased 108 basis points to 6.08% as these borrowings continue to reprice in the higher interest rate environment.

Provision for Credit Losses. The provision for credit losses reflects our judgments about the adequacy of the allowance for loan losses and the reserve for unfunded loan commitments. In determining the amount of the provision, we consider certain quantitative and qualitative factors including our historical loan loss experience, the volume and type of lending we conduct, the results of our credit review process, the amounts of classified and nonperforming assets, regulatory policies, general economic conditions, underlying collateral values, off-balance sheet exposures, and other factors regarding collectibility and impairment. To the extent we experience, for example, documentation deficiencies in acquired loans, adverse changes in collateral values, or negative changes in economic and business conditions which adversely affect our borrowers, our classified loans may increase. Increases in our classified loans generally result in provisions for credit losses. During the third quarter of 2006, we took no provision for credit losses.

Our nonaccrual loans increased $5.3 million to $20.9 million at September 30, 2006 compared to $15.6 million at June 30, 2006. The increase is largely the result of five loan relationships totaling $5.4 million that were placed on nonaccrual status at the end of the quarter. Nonaccrual loans totaled $16.8 million at October 25, 2006. Components of this $4.1 million reduction include $2.8 million of principal reductions, both payments and payoffs, and $2.9 million in loans returned to accrual status after being brought current, offset by $1.5 million in new loans being placed on nonaccrual status. We previously disclosed that we adversely classified certain Cedars-acquired loans in accordance with our criteria during the second quarter. During the third quarter these loans were reduced by $5.9 million through full repayment. We continue to work on our plan to reduce these loans by strengthening the underlying documentation, obtaining additional collateral and/or payments from borrowers, or possibly selling selected loans.

At September 30, 2006, the ratio of our allowance for credit losses to loans, net of unearned income, was 1.47% compared to 1.51% at June 30, 2006**.** The allowance for total credit losses totaled $51.9 million at September 30, 2006, and was comprised of the allowance for loan losses of $43.9 million and the reserve for unfunded loan commitments of $8.0 million. Although we expect the actions we are taking to reduce the Company s nonaccrual and classified loans will be successful, no assurance can be given that we will ultimately be successful and that losses will not be recognized.

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Noninterest Income. The following table summarizes noninterest income by category for the periods indicated:

	Quarter Ended(1) September 30, 2006 (Dollars in thousands)	June 30, 2006	March 31, 2006	December 31, 2005	September 30, 2005
Service charges and fees on deposit accounts	$ 2,412	$ 1,986	$ 1,559	$ 1,511	$ 1,594
Other commissions and fees	1,624	1,641	1,554	1,164	1,055
Gain on sale of loans, net				129	208
Increase in cash surrender value of life insurance	616	531	421	407	392
Other income	124	178	171	332	265
Total noninterest income	$ 4,776	$ 4,336	$ 3,705	$ 3,543	$ 3,514

(1) Our quarterly results include First American subsequent to August 12, 2005, Pacific Liberty subsequent to October 7, 2005, Cedars subsequent to January 4, 2006 and Foothill subsequent to May 9, 2006.

Noninterest income increased for the quarter ended September 30, 2006, compared to each of the other quarterly periods presented due largely to increased service charges and fees on deposit accounts. This increase is due primarily to the increase in the number of deposit accounts, the balances in such accounts and an increase in certain per item charges. Other commissions and fees declined compared to the previous quarter due mostly to an $81,000 decline in merchant card income as we sold the merchant card portfolios obtained in the Cedars and Foothill acquisitions. Otherwise, commissions and fees have increased for other services, such as letters of credit and foreign exchange.

Noninterest Expense. The following table summarizes noninterest expense by category for the periods indicated:

	Quarter Ended(1) September 30, 2006 (Dollars in thousands)	June 30, 2006	March 31, 2006	December 31, 2005	September 30, 2005
Compensation	$ 15,708	$ 14,865	$ 15,230	$ 13,227	$ 12,107
Occupancy	3,809	3,905	3,145	2,866	2,819
Furniture and equipment	1,073	981	761	740	679
Data processing	1,773	1,719	1,335	1,305	1,223
Other professional services	1,529	1,016	1,120	985	1,741
Business development	327	353	347	335	334
Communications	839	749	626	548	516
Insurance and assessments	716	492	472	426	411
Intangible asset amortization	1,791	1,577	1,149	1,066	915
Other	2,691	2,832	2,058	2,860	1,468
Total noninterest expense	$ 30,256	$ 28,489	$ 26,243	$ 24,358	$ 22,213
Efficiency ratio	45.5 %	45.7 %	47.2 %	48.3 %	50.1 %

(1) Our quarterly results include First American subsequent to August 12, 2005, Pacific Liberty subsequent to October 7, 2005, Cedars subsequent to January 4, 2006 and Foothill subsequent to May 9, 2006.

Noninterest expense for the third quarter of 2006 totaled $30.3 million compared to $22.2 million for the same period in 2005 and $28.5 million for the second quarter of 2006. The increase compared to the third quarter of 2005 relates mostly to increased compensation expense resulting from additional staff added through our acquisitions, pay rate increases, and increased employee benefits costs. Occupancy costs increased due to additional office locations added by acquisitions and most other general operating expenses increased due to the four acquisitions completed since August 2005. Our branch network expanded to 56 locations as of September 30, 2006 compared to 35 branches at the end of June 2005. Other professional services declined due to a decrease in legal fees, which is in turn attributed to a legal settlement reached in the fourth quarter of 2005.

The increase in noninterest expense for the third quarter compared to the second quarter of 2006 is due mainly to an increase in compensation costs, other professional services and assessments. Compensation increased mostly due to increased benefit costs, increased stock award amortization expense and increased staffing levels to support the business, including the effect of the Foothill acquisition. Other professional services increased due to legal fees and our decision to outsource facilities management beginning in August 2006. The increase in insurance and assessments included an additional $145,000 in relation to Pacific Western Bank s charter conversion. The decrease in other expense is due to a combination of items including $406,000 of accruals for certain branch consolidation costs incurred in the second quarter with no similar items in the third quarter. Other expense for the third quarter included a $220,000 increase in customer-related and loan related expenses attributed to increased earnings credits and loan production, $84,000 more in amortization of SBA servicing assets due to prepayments, and a $58,000 increase in shareholder expenses due to our acquisition activity.

Noninterest expense includes amortization of restricted and performance stock, which is included in compensation, and intangible asset amortization. Restricted and performance stock amortization totaled $2.1 million for the third quarter of 2006 compared to $1.1 million for the third quarter of 2005 and $1.9 million for the second quarter of 2006. The increase compared to the prior quarters resulted largely from additional awards made during 2006. Amortization expense for all restricted and performance stock awards is estimated to be $7.5 million for 2006. Intangible asset amortization increased $215,000 for the third quarter of 2006 compared to the second quarter of 2006 due to additional amortization resulting from the Foothill acquisition. Intangible asset amortization is estimated to be $6.3 million for 2006, excluding any effect from the Community Bancorp acquisition. The 2006 estimates of both restricted and performance stock award expense and intangible asset amortization are subject to change.

Income Taxes. Our statutory income tax rate is approximately 42.0%, representing a blend of the statutory federal income tax rate of 35.0% and the California income tax rate of 10.84%. Due to the exclusion from taxable income of income on certain investments, our actual effective income tax rates were 41.1% and 41.2% for the quarters ended September 30, 2006 and 2005.

Balance Sheet Analysis

Loans. The following table presents the balance of each major category of loans at the dates indicated:

	At September 30, 2006 Amount (Dollars in thousands)	% of total	At December 31, 2005 Amount	% of total
Loan Category:				
Domestic:				
Commercial	$ 705,546	20 %	$ 639,393	26 %
Real estate, construction	755,813	21	570,080	23
Real estate, mortgage	1,952,547	55	1,117,030	45
Consumer	46,910	1	47,221	2
Foreign:				
Commercial	88,826	3	94,930	4
Other, including real estate	6,656	*	8,320	*
Gross loans	3,556,298	100 %	2,476,974	100 %
Less: unearned income	(13,703)		(9,146)	
Less: allowance for loan losses	(43,943)		(27,303)	
Total net loans	$ 3,498,652		$ 2,440,525	

* Amount is less than 1%.

Allowance for Credit Losses. The allowance for credit losses is the combination of the allowance for loan losses and the reserve for unfunded loan commitments. The allowance for loan losses is reported as a reduction of outstanding loan balances and the reserve for unfunded loan commitments is included within other liabilities.

An allowance for loan losses is maintained at a level deemed appropriate by management to adequately provide for known and inherent risks in the loan portfolio and other extensions of credit at the balance sheet date. The allowance is based upon a continuing review of the portfolio, past loan loss experience, current economic conditions which may affect the borrowers ability to pay, and the underlying collateral value of the loans. Loans which are deemed to be uncollectible are charged off and deducted from the allowance. The provision for loan losses and recoveries on loans previously charged off are added to the allowance.

The Company s determination of the allowance for loan losses is sensitive to the assigned credit risk ratings and inherent loss rates at any given point in time. Therefore, we present sensitivity information to provide insight regarding the impact adverse changes in risk ratings may have on our allowance for loan losses. The sensitivity information does not imply any expectation of future deterioration in our loans risk ratings and it does not necessarily reflect the nature and extent of future changes in the allowance for loan losses due to the numerous quantitative and qualitative factors considered in determining our allowance for loan losses. At September 30, 2006, in the event that 1 percent of our loans were downgraded from the pass to substandard category within our current allowance methodology, the allowance for loan losses would increase by approximately $7.5 million. Given current processes employed by the Company, management believes the risk ratings and inherent loss rates currently assigned are appropriate. It is possible that others, given the same information, may at any point in time reach different reasonable conclusions that could be significant to the Company s financial statements.

At September 30, 2006, the allowance for credit losses totaled $51.9 million and was comprised of the allowance for loan losses of $43.9 million and the reserve for unfunded loan commitments of $8.0 million.

The following table presents the changes in our allowance for loan losses at or for the periods indicated:

	As of or for the Quarter Ended September 30, 2006 (Dollars in thousands)	Year Ended 12/31/05	Quarter Ended September 30, 2005
Balance at beginning of period	$ 43,448	$ 24,083	$ 28,142
Loans charged off:			
Commercial	(5)	(1,646)	(410)
Real estate construction	(115)		
Real estate mortgage		(100)	(6)
Consumer	(22)	(180)	(38)
Foreign	(225)	(1,592)	(896)
Total loans charged off	(367)	(3,518)	(1,350)
Recoveries on loans charged off:			
Commercial	328	2,106	117
Real estate mortgage		11	2
Consumer	34	241	56
Foreign		2	
Total recoveries on loans charged off	362	2,360	175
Net (charge-offs) recoveries	(5)	(1,158)	(1,175)
Provision for loan losses	500	1,345	(520)
Additions due to acquisitions		3,033	1,522
Balance at end of period	$ 43,943	$ 27,303	$ 27,969

The allowance for loan losses increased by $16.6 million since December 31, 2005 due to the provision made in the second quarter of 2006 and the allowances acquired in the Cedars and Foothill acquisitions. Management believes the allowance for loan losses is adequate. In making its evaluation, management considers certain quantitative and qualitative factors including the Company s historical loss experience, the volume and type of lending conducted by the Company, the amounts of classified and nonperforming assets, regulatory policies, general economic conditions, underlying collateral values, and other factors regarding the collectibility of loans in the Company s portfolio.

In addition to the allowance for credit losses, we have a nonaccretable discount, representing the excess of the unpaid balances over the estimated fair values of certain loans acquired in the Cedars acquisition. Such amount totals $3.2 million at September 30, 2006, and is offset against the individual loan balances. At September 30, 2006, the gross amount of these loans is $15.2 million and their carrying amount is $12.0 million.

The following table presents the changes in our reserve for unfunded loan commitments for the periods indicated:

	As of or for the Quarter Ended September 30, 2006 (Dollars in thousands)	Year Ended 12/31/05	Quarter Ended September 30, 2005
Balance at beginning of period	$ 8,475	$ 5,424	$ 3,307
Provision	(500)	75	520
Additions due to acquisitions		169	66
Balance at end of period	$ 7,975	$ 5,668	$ 3,893

Management also believes that the reserve for unfunded loan commitments is adequate. In making this determination, we use the same methodology for the reserve for unfunded loan commitments as we do for the allowance for loan losses and consider the same qualitative factors, as well as an estimate of the probability of drawdown of the commitments correlated to their credit risk rating.

The following table presents the changes in our allowance for credit losses at or for the periods indicated:

	As of or for the Quarter Ended September 30, 2006 (Dollars in thousands)	**Year Ended 12/31/05**	**Quarter Ended September 30, 2005**
Balance at beginning of period	$ 51,923	$ 29,507	$ 31,449
Provision for credit losses		1,420	
Net (charge-offs) recoveries	(5)	(1,158)	(1,175)
Additions due to acquisitions		3,202	1,588
Balance at end of period	$ 51,918	$ 32,971	$ 31,862

Credit Quality. We define nonperforming assets as: (i) loans past due 90 days or more and still accruing; (ii) loans which have ceased accruing interest, which we refer to as nonaccrual loans ; and (iii) assets acquired through foreclosure, including other real estate owned. Impaired loans are loans for which it is probable that we will not be able to collect all amounts due according to the original contractual terms of the loan agreement. Nonaccrual loans may include impaired loans and are those on which the accrual of interest is discontinued when collectibility of principal or interest is uncertain or payments of principal or interest have become contractually past due 90 days.

Nonaccrual loans increased to $20.9 million, or 0.59% of loans, net of unearned income, at September 30, 2006, from $8.4 million, or 0.34% of loans net of unearned income, at December 31, 2005. As a result of our efforts to reduce nonaccrual loans, nonaccrual loans totaled $16.8 million at October 25, 2006. Components of this reduction include $2.8 million of principal reductions, and $2.9 million in loans returned to accrual status after being brought current, offset by $1.5 million in new loans placed on nonaccrual status.

As of September 30, 2006, we had no loans past due 90 days and still accruing interest. Management is not aware of any additional significant loss potential that has not already been considered in the estimation of the allowance for credit losses. We believe reserves are adequate on our nonperforming loans to cover the loss exposure as measured by our methodology.

The following table shows the historical trends in our loans, allowance for credit losses, nonperforming assets and key credit quality statistics as of and for the periods indicated:

	As of or for the Quarter Ended September 30, 2006 (Dollars in thousands)		Year Ended 12/31/05		Quarter Ended September 30, 2005	
Loans, net of unearned income	$ 3,542,595		$ 2,467,828		$ 2,303,373	
Allowance for credit losses	51,918		32,971		31,862	
Average loans, net of unearned income	3,451,376		2,231,975		2,231,702	
Nonperforming assets:						
Nonaccrual loans	$ 20,907		$ 8,422		$ 12,420	
Other real estate owned					43	
Nonperforming assets	$ 20,907		$ 8,422		$ 12,463	
Charged-off loans	$ (367	)	$ (3,518	)	$ (1,350	)
Recoveries	362		2,360		175	
Net charge-offs	$ (5	)	$ (1,158	)	$ (1,175	)
Allowance for credit losses to loans, net of unearned income	1.47	%	1.34	%	1.38	%
Allowance for credit losses to nonaccrual loans and leases	248.3		391.5		256.5	
Allowance for credit losses to nonperforming assets	248.3		391.5		255.7	
Nonperforming assets to loans, net of unearned income and OREO	0.59		0.34		0.54	
Annualized net charge offs to average loans, net of unearned income			(0.05	)	(0.21	)
Nonaccrual loans to loans, net of unearned income	0.59		0.34		0.54	

Deposits. The following table presents the balance of each major category of deposits at the dates indicated:

	At September 30, 2006		At December 31, 2005	
	Amount (Dollars in thousands)	% of deposits	Amount	% of deposits
Noninterest-bearing	$ 1,354,726	45 %	$ 1,179,808	49 %
Interest-bearing:				
Interest checking	247,596	8	184,293	8
Money market accounts	925,942	31	666,383	28
Savings	134,802	4	104,559	4
Time deposits under $100,000	124,696	4	107,655	4
Time deposits over $100,000	234,092	8	162,663	7
Total interest-bearing	1,667,128	55	1,225,553	51
Total deposits	$ 3,021,854	100 %	$ 2,405,361	100 %

Deposits increased $616.5 million to $3.0 billion at September 30, 2006, from year end 2005. During the first nine months of 2006, we acquired $996.0 million in deposits through the Cedars and Foothill acquisitions. Excluding acquired deposits, total deposits declined $379.7 million, composed of $182.7 million of noninterest-bearing deposits and $197.0 million of interest-bearing deposits. The deposit outflow is a result of realigning acquired deposits within our pricing structure and competitive forces.

At September 30, 2006, deposits of foreign customers, primarily located in Mexico and Canada, totaled $126.4 million or 4% of total deposits.

Regulatory Matters

The regulatory capital guidelines as well as the actual capital ratios for First National, Pacific Western, and the Company as of September 30, 2006, are as follows:

	Minimum Regulatory Requirements Well Capitalized	Actual Pacific Western	First National	Company Consolidated
Tier 1 leverage capital ratio	5.00 %	10.42 %	13.40 %	11.41 %
Tier 1 risk-based capital ratio	6.00 %	10.23 %	13.06 %	11.17 %
Total risk-based capital	10.00 %	11.42 %	14.32 %	12.42 %

We have issued and outstanding $129.9 million of subordinated debentures to trusts established by us and Foothill, which in turn issued $126.0 million of trust preferred securities. These securities are treated as regulatory capital for purposes of determining the Company s capital ratios. The Board of Governors of the Federal Reserve System, which is the holding company s banking regulator, has promulgated a modification of the capital regulations affecting trust preferred securities. Under this modification, beginning March 31, 2009, the Company will be required to use a more restrictive formula to determine the amount of trust preferred securities that can be included in regulatory Tier I capital. At that time, the Company will be allowed to include in Tier I capital an amount of trust preferred securities equal to no more than 25% of the sum of all core capital elements, which is generally defined as shareholders equity less certain intangibles, including goodwill, core deposit intangibles and customer relationship intangibles, net of any related deferred income tax liability. The regulations currently in effect through December 31, 2008, limit the amount of trust preferred securities that can be included in Tier I capital to 25% of the sum of core capital elements without a deduction for permitted intangibles. We have determined that our Tier I capital ratios would remain above the well-capitalized level had the modification of the capital regulations been in effect at September 30, 2006. We expect that our Tier I capital ratios will be at or above the existing well-capitalized levels on March 31, 2009, the first date on which the modified capital regulations must be applied.

In October, we received permission from the Federal Reserve Bank of San Francisco to redeem $20.6 million in subordinated debentures, which we expect to redeem in December. Although this redemption will reduce our regulatory leverage and risk-based capital ratios, we expect to remain well capitalized after redemption.

Liquidity Management

Liquidity. The goals of our liquidity management are to ensure the ability of the Company to meet its financial commitments when contractually due and to respond to other demands for funds such as the ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers who may need assurance that sufficient funds will be available to meet their credit needs. We have an Executive Asset/Liability Management Committee, or Executive ALM Committee, which is comprised of members of senior management and responsible for managing balance sheet and off-balance sheet commitments to meet the needs of customers while achieving our financial objectives. Our Executive ALM Committee meets regularly to review funding capacities, current and forecasted loan demand, and investment opportunities.

Historically, the primary liquidity source of the Banks is their core deposit bases. The Banks have not relied on large denomination time deposits. Since quarter end, Pacific Western Bank has committed to

$55.0 million in short-term wholesale CD funds. Although such funds have cost up to 10 basis points less than alternative borrowing sources for similar time horizons, these deposits tend to be more expensive than our usual deposit pricing structure. To meet short-term liquidity needs, the Banks maintain balances in Federal funds sold, interest-bearing deposits in other financial institutions and investment securities having maturities of five years or less as well as secured lines of credit. On a consolidated basis, liquid assets (cash, Federal funds sold, interest-bearing deposits in financial institutions and investment securities available-for-sale) as a percentage of total deposits were 11% as of September 30, 2006.

As an additional source of liquidity, the Banks have established secured borrowing relationships with the FHLB, which allowed the Banks to borrow approximately $989.4 million in the aggregate as of September 30, 2006. The Banks use the secured borrowing facility at the FHLB to fund loan demand in the absence of deposits and to manage liquidity for deposit flows. With the securities sale, the acquisition of Community Bancorp and the merger of the Banks on October 26,2006, our aggregate secured borrowing capacity with the FHLB totaled approximately $1.5 billion as of October 31, 2006. In addition, the Banks maintain unsecured lines of credit with three correspondent banks for the purchase of overnight funds. These lines are subject to availability of funds and as of September 30, 2006, they totaled $120.0 million. With the consolidation of the Banks during October these unsecured lines of credit total $60.0 million; we are in the process of increasing these unsecured borrowing limits under the Pacific Western Bank entity.

The primary sources of liquidity for the Company, on a stand-alone basis, include the dividends from the Banks and our ability to raise capital, issue subordinated debt and secure outside borrowings. On May 16, 2005, we filed a registration statement with the SEC regarding the sale of up to 3,400,000 shares of our common stock, no par value per share, which we may offer and sell, from time to time, in amounts, at prices and on terms that we will determine at the time of any particular offering. To date, we have issued 2,935,766 shares of common stock under this registration statement for net proceeds of $158.5 million including the 1,891,086 shares of common stock issued during the first quarter of 2006 for net proceeds of $109.5 million. We used these proceeds to augment our capital in support of our acquisitions. We expect to use the net proceeds from any additional sales of our securities to fund future acquisitions of banks and other financial institutions, as well as for general corporate purposes. The Company renewed its revolving credit line with U.S. Bank for $70 million. The revolving credit line matures on August 2, 2007 and is secured by a pledge of all of the outstanding capital stock of Pacific Western. The credit agreement requires the Company to maintain certain financial and capital ratios, among other covenants and conditions. This revolving credit line replaces the previous revolving credit line arrangements with U.S. Bank for $50 million and The Northern Trust Company for $20 million which matured on August 3, 2006.

The holding company s primary source of income is the receipt of dividends from the Banks. The availability of dividends from the Banks is subject to limitations imposed by applicable state and federal laws and regulations. Dividends paid by state banks are regulated by the DFI under its general supervisory authority as it relates to a bank s capital requirements. A state bank may declare a dividend without the approval of the DFI as long as the total dividends declared in a calendar year do not exceed the total retained profits for the preceding three fiscal years. Dividends paid by national banks are regulated by the OCC under its general supervisory authority as it relates to a bank s capital requirements. A national bank may declare a dividend without the approval of the OCC as long as the total dividends declared in a calendar year do not exceed the total of net profits for that year combined with the retained profits for the preceding two years. The Banks paid First Community $15.0 million in dividends during the nine months ended September 30, 2006. The amount of dividends available for payment by the Banks to the holding company at September 30, 2006, was $69.4 million.

Contractual Obligations. The known contractual obligations of the Company at September 30, 2006, are as follows:

	At September 30, 2006 and Due Within One Year	One to Three Years	Three to Five Years	After Five Years	Total
	(Dollars in thousands)				
Short-term debt obligations	$ 468,400	$	$	$	$ 468,400
Long-term debt obligations	20,620	45,000		109,282	174,902
Operating lease obligations	10,394	19,683	16,200	28,406	74,683
Other contractual obligations	3,106				3,106
Total	$ 502,520	$ 64,683	$ 16,200	$ 137,688	$ 721,091

Debt obligations are discussed in Note 7 of Notes to Unaudited Condensed Consolidated Financial Statements contained in Item 1. Unaudited Consolidated Financial Statements. Operating lease obligations are discussed in the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2005. The other contractual obligations relate to the minimum liability associated with our data and item processing contract with a third-party provider. The contractual obligations table above does not include our merger-related liability, which was $2.8 million at September 30, 2006. See Note 2 of Notes to Unaudited Condensed Consolidated Financial Statements contained in Item 1. Unaudited Consolidated Financial Statements.

We believe that we will be able to meet our contractual obligations as they come due through the maintenance of adequate cash levels. We expect to maintain adequate cash levels through profitability, loan and securities repayment and maturity activity, and continued deposit gathering activities. We believe we have in place sufficient borrowing mechanisms for short-term liquidity needs.

Off-Balance Sheet Arrangements

Our obligations also include off-balance sheet arrangements consisting of loan-related commitments, of which only a portion are expected to be funded. At September 30, 2006, our loan-related commitments, including standby letters of credit and financial guarantees, totaled $1.2 billion. The commitments which result in a funded loan increase our profitability through net interest income. Therefore, during the year, we manage our overall liquidity taking into consideration funded and unfunded commitments as a percentage of our liquidity sources. Our liquidity sources have been and are expected to be sufficient to meet the cash requirements of our lending activities.

Asset/Liability Management and Interest Rate Sensitivity

Interest Rate Risk. Our market risk arises primarily from credit risk and interest rate risk inherent in our lending and deposit gathering activities. To manage our credit risk, we rely on adherence to our underwriting standards and loan policies as well as our allowance for credit losses methodology. To manage our exposure to changes in interest rates, we perform asset and liability management activities which are governed by guidelines pre-established by our Executive ALM Committee and approved by our Board of Directors Asset/Liability Management Committee, or Board ALCO. Our Executive ALM Committee and Board ALCO monitor our compliance with our asset/liability management policies. These policies focus on providing sufficient levels of net interest income while considering acceptable levels of interest rate exposure as well as liquidity and capital constraints.

Market risk sensitive instruments are generally defined as derivatives and other financial instruments, which include investment securities, loans, deposits, and borrowings. At September 30, 2006, we had not used any derivatives to alter our interest rate risk profile or for any other reason. However, both the repricing characteristics of our fixed rate loans and floating rate loans, as well as our significant percentage of noninterest-bearing deposits compared to interest-earning assets, may influence our interest rate risk profile. Our financial instruments include loans receivable, Federal funds sold, interest-bearing deposits in financial institutions, Federal Reserve Bank and Federal Home Loan Bank stock, investment securities, deposits, borrowings and subordinated debentures.

We measure our interest rate risk position on a monthly basis using three methods: (i) net interest income simulation analysis; (ii) market value of equity modeling; and (iii) traditional gap analysis. The results of these analyses are reviewed by the Executive ALM Committee monthly and the Board ALCO quarterly. If hypothetical changes to interest rates cause changes to our simulated net present value of equity and/or net interest income outside our pre-established limits, we may adjust our asset and liability mix in an effort to bring our interest rate risk exposure within our established limits. We evaluated the results of our net interest income simulation and market value of equity models prepared as of September 30, 2006. These simulation models demonstrate that our balance sheet is asset-sensitive. An asset-sensitive balance sheet suggests that in a rising interest rate environment, our net interest margin would increase, and during a falling or sustained low interest rate environment, our net interest margin would decrease.

The net interest margin for the third quarter of 2006 declined 19 basis points compared to the net interest margin for the second quarter of 2006 even though market interest rates increased during these periods. The net interest margin compression was caused by a combination of the competitive interest rate pressures on new loan originations, an increase in the cost of deposits, a decrease in noninterest bearing deposits, and increased borrowings to support loan growth and deposit flows.

Net interest income simulation. We used a simulation model to measure the estimated changes in net interest income that would result over the next 12 months from immediate and sustained changes in interest rates as of September 30, 2006. This model is an interest rate risk management tool and the results are not necessarily an indication of our future net interest income. This model has inherent limitations and these results are based on a given set of rate changes and assumptions at one point in time. We have assumed no growth in either our interest-sensitive assets or liabilities over the next 12 months; therefore, the results reflect an interest rate shock to a static balance sheet.

This analysis calculates the difference between net interest income forecasted using both increasing and declining interest rate scenarios and net interest income forecasted using a base market interest rate derived from the current treasury yield curve. In order to arrive at the base case, we extend our balance sheet at September 30, 2006 one year and reprice any assets and liabilities that would contractually reprice or mature during that period using the products pricing as of September 30, 2006. Based on such repricings, we calculated an estimated net interest income and net interest margin. The effects of certain balance sheet attributes, such as fixed-rate loans, floating rate loans that have reached their floors and the volume of noninterest-bearing deposits as a percentage of earning assets, impact our assumptions and consequently the results of our interest rate risk management model. Changes that may vary significantly from our assumptions include loan and deposit growth or contraction, changes in the mix of our earning assets or funding sources, and future asset/liability management decisions, all of which may have significant effects on our net interest income.

The net interest income simulation model includes various assumptions regarding the repricing relationship for each of our assets and liabilities. Many of our assets are floating rate loans, which are assumed to reprice immediately and to the same extent as the change in market rates according to their contracted index. Some loans and investment vehicles include the opportunity of prepayment (imbedded options) and the simulation model uses national indexes to estimate these prepayments and reinvest the proceeds there from at current simulated yields. Our deposit products reprice at our discretion and are assumed to reprice more slowly, usually repricing less than the change in market rates.

The simulation analysis does not account for all factors that impact this analysis, including changes by management to mitigate the impact of interest rate changes or the impact a change in interest rates may have on our credit risk profile, loan prepayment estimates and spread relationships which can change regularly. Interest rate changes cause changes in actual loan prepayment rates which will differ from the market estimates we used in this analysis. In addition, the simulation analysis does not make any assumptions regarding loan fee income, which is a component of our net interest income and tends to increase our net interest margin. Management reviews the model assumptions for reasonableness on a quarterly basis.

The following table presents as of September 30, 2006, forecasted net interest income and net interest margin for the next 12 months using a base market interest rate and the estimated change to the base scenario given immediate and sustained upward and downward movements in interest rates of 100, 200 and 300 basis points.

Interest rate scenario	**Estimated Net Interest Income**	**Percentage Change From Base**	**Estimated Net Interest Margin**	**Estimated Net Interest Margin Change From Base**
	(Dollars in thousands)			
Up 300 basis points	$ 259,016	11.6 %	6.67 %	0.68 %
Up 200 basis points	$ 249,302	7.4 %	6.42 %	0.43 %
Up 100 basis points	$ 241,375	4.0 %	6.22 %	0.23 %
BASE CASE	$ 232,181		5.99 %	
Down 100 basis points	$ 222,725	(4.1)%	5.75 %	(0.24)%
Down 200 basis points	$ 213,810	(7.9)%	5.52 %	(0.47)%
Down 300 basis points	$ 208,923	(10.0)%	5.40 %	(0.59)%

Our simulation results indicate our interest rate risk position was asset sensitive as the simulated impact of an immediate upward movement in interest rates would result in increases in net interest income over the subsequent 12 month period while an immediate downward movement in interest rates would result in a decrease in net interest income over the next 12 months. In comparing the September 30, 2006 simulation results to the end of 2005 and the quarterly reporting periods during 2006, our third quarter model indicates we are less asset sensitive than these prior reporting periods. The decline in our asset sensitivity is mostly a result of: (i) the impact of our acquisition activity, including the addition of Foothill s liability sensitive profile; (ii) deposit realignment due to acquisitions and the impact of the higher interest rate environment on customers deposit requirements; (iii) net deposit outflows being replaced with short-term FHLB advances; and (iv) the competitive forces on loan originations.

Market value of equity. We measure the impact of market interest rate changes on the net present value of estimated cash flows from our assets, liabilities and off-balance sheet items, defined as the market value of equity, using a simulation model. This simulation model assesses the changes in the market value of our interest-sensitive financial instruments that would occur in response to an instantaneous and sustained increase or decrease in market interest rates of 100, 200 and 300 basis points. This analysis assigns significant value to our noninterest-bearing deposit balances. The projections are by their nature forward-looking and therefore inherently uncertain, and include various assumptions regarding cash flows and interest rates. This model is an interest rate risk management tool and the results are not necessarily an indication of our actual future results. Actual results may vary significantly from the results suggested by the market value of equity table. Loan prepayments and deposit attrition, changes in the mix of our earning assets or funding sources, and future asset/liability management decisions, among others, may vary significantly from our assumptions.

The base case is determined by applying various current market discount rates to the estimated cash flows from the different types of assets, liabilities and off-balance sheet items existing at September 30,

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2006. The following table shows the projected change in the market value of equity for the set of rate shocks presented as of September 30, 2006:

Interest rate scenario	Estimated Market Value (Dollars in thousands)	Percentage change From Base	Percentage of total assets	Ratio of Estimated Market Value to Book Value
Up 300 basis points	$ 1,139,012	1.9 %	24.8 %	127.4 %
Up 200 basis points	$ 1,132,981	1.3 %	24.6 %	126.8 %
Up 100 basis points	$ 1,126,240	0.7 %	24.5 %	126.0 %
BASE CASE	$ 1,118,127		24.3 %	125.1 %
Down 100 basis points	$ 1,107,465	(1.0)%	24.1 %	123.9 %
Down 200 basis points	$ 1,091,287	(2.4)%	23.7 %	122.1 %
Down 300 basis points	$ 1,062,037	(5.0)%	23.1 %	118.8 %

The results of our market value of equity model indicate that an immediate and sustained increase in interest rates would increase the market value of equity from the base case while a decrease in interest rates would decrease the market value of equity.

Gap analysis. As part of the interest rate management process, we use a gap analysis. A gap analysis provides information about the volume and repricing characteristics and relationship between the amounts of interest-sensitive assets and interest-bearing liabilities at a particular point in time. An effective interest rate strategy attempts to match the volume of interest sensitive assets and interest bearing liabilities repricing over different time intervals. The following table illustrates the volume and repricing characteristics of our balance sheet at September 30, 2006 over the indicated time intervals:

	At September 30, 2006 Amounts Maturing or Repricing In 3 Months Or Less (Dollars in thousands)	Over 3 Months to 12 Months	Over 1 Year to 5 Years	Over 5 Years	Non-sensitive(1)	Total
ASSETS						
Cash and deposits in financial institutions	$ 287	$	$	$	$ 116,057	$ 116,344
Federal funds sold	10,500					10,500
Investment securities	51,118	32,531	131,991	19,312		234,952
Loans, net of unearned income	1,868,959	124,530	970,850	578,256		3,542,595
Other assets					697,083	697,083
Total assets	$ 1,930,864	$ 157,061	$ 1,102,841	$ 597,568	$ 813,140	$ 4,601,474
LIABILITIES AND SHAREHOLDERS EQUITY						
Noninterest-bearing demand deposits	$	$	$	$	$ 1,354,726	$ 1,354,726
Interest-bearing demand, money market and savings	1,308,340					1,308,340
Time deposits	190,436	152,015	16,337			358,788
Borrowings	428,400	40,000	45,000			513,400
Subordinated debentures	121,654			8,248		129,902
Other liabilities					41,841	41,841
Shareholders equity					894,477	894,477
Total liabilities and shareholders equity	$ 2,048,830	$ 192,015	$ 61,337	$ 8,248	$ 2,291,044	$ 4,601,474
Period gap	$ (117,966)	$ (34,954)	$ 1,041,504	$ 589,320	$ (1,477,904)	
Cumulative interest-earning assets	$ 1,930,864	$ 2,087,925	$ 3,190,766	$ 3,788,334		
Cumulative interest-bearing liabilities	$ 2,048,830	$ 2,240,845	$ 2,302,182	$ 2,310,430		
Cumulative gap	$ (117,966)	$ (152,920)	$ 888,584	$ 1,477,904		
Cumulative interest-earning assets to cumulative interest-bearing liabilities	94.2 %	93.2 %	138.6 %	164.0 %		
Cumulative gap as a percent of:						
Total assets	(2.6)%	(3.3)%	19.3 %	32.1 %		
Interest-earning assets	(3.1)%	(4.0)%	23.5 %	39.0 %		

(1) Assets or liabilities which do not have a stated interest rate.

All amounts are reported at their contractual maturity or repricing periods. This analysis makes certain assumptions as to interest rate sensitivity of savings and interest-bearing checking accounts which have no stated maturity and have had very little price fluctuation in the recent past. Money market accounts are repriced at management s discretion and generally are more rate sensitive.

In using this interest rate risk management tool, we focus on the gap sensitivity identified as the cumulative one year gap. The preceding table indicates that we had a negative one year cumulative gap of $152.9 million at September 30, 2006. This gap position suggests that we are liability-sensitive and if rates were to increase, our net interest margin would most likely decrease. Conversely, if rates were to decrease, our net interest margin would most likely increase.

At June 30, 2006, the gap analysis at that date showed a positive one year cumulative gap of $131.9 million. The change in the cumulative one year gap from June 30 to September 30, 2006, is the result of (a) third quarter organic loan growth centered in mini-perm real estate loans which will have their first repricing in five years and (b) an increase in short-term FHLB borrowings used to fund loan growth and deposit flows. To moderate the effect this may have on our interest rate profile and net interest margin, we expect to shrink our balance sheet and reduce outstanding borrowings. In addition to the securities sale completed on October 23, 2006, and the expected retirement of $20.6 million in subordinated debentures in December, we are planning to further reduce borrowings through selected dispositions of loans.

The liability-sensitive result of the gap table is not consistent with the conclusions in our net interest income simulation and market value of equity model results due mostly to inherent limitations of a gap table which are described more fully below. The Company s asset-sensitive profile is due to the fact that future changes in interest rates will effect our loan yields more than the cost of funding sources. As a result, actual results may vary significantly from the results suggested by the gap table. The gap table assumes a static balance sheet, as does the net interest income simulation, and, accordingly, looks at the repricing of existing assets and liabilities without consideration of new loans and deposits that reflect a more current interest rate environment. Unlike the net interest income simulation, however, the interest rate risk profile of certain deposit products and floating rate loans that have reached their floors cannot be captured effectively in a gap table. Although the table shows the amount of certain assets and liabilities scheduled to reprice in a given time frame, it does not reflect when or to what extent such repricings may actually occur. For example, interest-bearing demand, money market and savings deposits are shown to reprice in the first three months, but we may choose to reprice these deposits more slowly and incorporate only a portion of the movement in market rates based on market conditions at that time. Alternatively, a loan which has reached its floor may not reprice despite a change in market interest rates causing such loan to act like a fixed rate loan regardless of its scheduled repricing date. For example, a loan already at its floor would not reprice if the adjusted rate was less than its floor. The gap table as presented is not able to factor in the flexibility we believe we have in repricing either deposits or the floors on our loans.

We believe the estimated effect of a change in interest rates is better reflected in our net interest income and market value of equity simulations which incorporate many of the factors mentioned.

ITEM 3. Quantitative and Qualitative Disclosure about Market Risk

Please see the section above titled Asset/Liability Management and Interest Rate Sensitivity in Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations which provides an update to our quantitative and qualitative disclosure about market risk. This analysis should be read in conjunction with text under the caption Quantitative and Qualitative Disclosure About Market Risk in our Annual Report on Form 10-K for the year ended December 31, 2005, which text is incorporated herein by reference. Our analysis of market risk and market-sensitive financial information contains forward-looking statements and is subject to the disclosure at the beginning of Item 2 regarding such forward-looking information.

ITEM 4. Controls and Procedures

As of the end of the period covered by this report, an evaluation was carried out by the Company s management, with the participation of the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, these disclosure controls and procedures were effective.

There have been no changes in the Company s internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. Legal Proceedings

There have been no material developments in our legal proceedings previously reported in Item 3 to Part I of our Annual Report on Form 10-K for the fiscal year ended December 31, 2005 and Quarterly Reports on Form 10-Q for the quarters ended March 31, 2006 and June 30, 2006.

See also Note 8 of the Notes to Unaudited Condensed Consolidated Financial Statements in Part I of this report for additional discussion of legal proceedings, which information is incorporated herein by reference.

In the ordinary course of our business, we are party to various other legal actions, which we believe are incidental to the operation of our business. Although the ultimate outcome and amount of liability, if any, with respect to these other legal actions to which we are currently a party cannot presently be ascertained with certainty, in the opinion of management, based upon information currently available to us, any resulting liability is not likely to have a material adverse effect on the Company s consolidated financial position, results of operations or cash flows.

ITEM 1A. RISK FACTORS.

The following disclosure updates our disclosure set forth in Section 1A. Risk Factors in Part I of our Annual Report on Form 10-K for the year ended December 31, 2005.

Ownership of our common stock involves risk. You should carefully consider, in addition to the other information set forth herein, the following risk factors.

Our business is subject to interest rate risk and variations in interest rates may negatively affect our financial performance.

Changes in the interest rate environment may reduce our profits. It is expected that we will continue to realize income from the differential or spread between the interest earned on loans, securities and other interest earning assets, and interest paid on deposits, borrowings and other interest bearing liabilities. Net interest spreads are affected by the difference between the maturities and repricing characteristics of interest earning assets and interest bearing liabilities. In addition, loan volume and yields are affected by market interest rates on loans, and rising interest rates generally are associated with a lower volume of loan originations. We cannot assure you that we can minimize our interest rate risk. In addition, while an increase in the general level of interest rates may increase our net interest margins and loan yield, it may adversely affect the ability of certain borrowers with variable rate loans to pay the interest on and principal of their obligations. Accordingly, changes in levels of market interest rates could materially and adversely affect our net interest spread, asset quality, loan origination volume and overall profitability.

We face strong competition from financial services companies and other companies that offer banking services which could negatively affect our business.

We conduct our banking operations primarily in Southern California. Increased competition in our market may result in reduced loans and deposits. Ultimately, we may not be able to compete successfully against current and future competitors. Many competitors offer the same banking services that we offer in our service area. These competitors include national banks, regional banks and other community banks. We also face competition from many other types of financial institutions, including without limitation, savings and loan institutions, finance companies, brokerage firms, insurance companies, credit unions, mortgage banks and other financial intermediaries. In particular, our competitors include several major financial companies whose greater resources may afford them a marketplace advantage by enabling them to maintain numerous banking locations and ATMs and conduct extensive promotional and advertising campaigns.

Additionally, banks and other financial institutions with larger capitalization and financial intermediaries not subject to bank regulatory restrictions have larger lending limits and are thereby able to serve the credit needs of larger customers. Areas of competition include interest rates for loans and deposits, efforts to obtain deposits, and range and quality of products and services provided, including new technology driven products and services. Technological innovation continues to contribute to greater competition in domestic and international financial services markets as technological advances enable more companies to provide financial services. We also face competition from out-of-state financial intermediaries that have opened low-end production offices or that solicit deposits in our market areas. If we are unable to attract and retain banking customers, we may be unable to continue our loan growth and level of deposits and our results of operations and financial condition may otherwise be adversely affected.

Changes in economic conditions, in particular an economic slowdown in Southern California, could materially and negatively affect our business.

Our business is directly impacted by factors such as economic, political and market conditions, broad trends in industry and finance, legislative and regulatory changes, changes in government monetary and fiscal policies and inflation, all of which are beyond our control. A deterioration in economic conditions, whether caused by national or local concerns, in particular an economic slowdown in Southern California, could result in the following consequences, any of which could hurt our business materially: loan delinquencies may increase; problem assets and foreclosures may increase; demand for our products and services may decrease; low cost or noninterest bearing deposits may decrease; and collateral for loans made by us, especially real estate, may decline in value, in turn reducing customers borrowing power, and reducing the value of assets and collateral associated with our existing loans. These circumstances may lead to an increase in nonaccrual and classified loans, which generally results in a provision for credit losses and in turn reduces the Company s net earnings. The State of California continues to face fiscal challenges upon which the long term impact on the State s economy cannot be predicted.

A downturn in the real estate market could negatively affect our business.

A downturn in the real estate market could negatively affect our business because a significant portion (approximately 76% as of September 30, 2006) of our loans is secured by real estate. Our ability to recover on defaulted loans by selling the real estate collateral would then be diminished and we would be more likely to suffer losses on defaulted loans. Substantially all of our real property collateral is located in Southern California. If there is a significant decline in real estate values, especially in Southern California, the collateral for our loans would provide less security. Real estate values could be affected by, among other things, an economic slowdown, an increase in interest rates, earthquakes and other natural disasters particular to California.

We are dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect our prospects.

We currently depend heavily on the services of our chairman, John Eggemeyer, our chief executive officer, Matthew Wagner, and a number of other key management personnel. The loss of Mr. Eggemeyer s or Mr. Wagner s services or that of other key personnel could materially and adversely affect our results of operations and financial condition. Our success also depends, in part, on our ability to attract and retain additional qualified management personnel. Competition for such personnel is strong in the banking industry and we may not be successful in attracting or retaining the personnel we require.

We are subject to extensive regulation which could adversely affect our business.

Our operations are subject to extensive regulation by federal and state governmental authorities, and we are subject to various laws and judicial and administrative decisions imposing requirements and restrictions on part or all of our operations. Because our business is highly regulated, the laws, rules and regulations applicable to us are subject to regular modification and change. There are currently proposed laws, rules and regulations that, if adopted, would impact our operations. There can be no assurance that these proposed laws, rules and regulations, or any other laws, rules or regulations, will not be adopted in the future, which could (i) make compliance much more difficult or expensive, (ii) restrict our ability to originate, broker or sell loans or accept certain deposits, (iii) further limit or restrict the amount of commissions, interest or other charges earned on loans originated or sold by us, or (iv) otherwise adversely affect our business or prospects for business. Additionally, in order to conduct certain activities, including acquisitions, we are required to obtain regulatory approval. There can be no assurance that any required approvals can be obtained, or obtained without conditions or on a timeframe acceptable to us. For more information, please see the section entitled See Item 1. Business Supervision and Regulation in Part I of our Annual Report on Form 10-K for the year ended December 31, 2005.

We are exposed to transactional, currency and legal risk related to our foreign loans that is in addition to risks we face on loans to U.S. based borrowers.

A portion of our loan portfolio is represented by credit we extend and loans we make to businesses located outside the United States, predominantly in Mexico. These loans, which include commercial loans, real estate loans and credit extensions for the financing of international trade, are subject to risks in addition to risks we face with our loans to businesses located in the United States including, but not limited to, currency risk, transaction risk, country risk and legal risk. While these loans are denominated in U.S. dollars, the ability of the borrower to repay may be affected by fluctuations in the borrower s home country currency relative to the U.S. dollar. Additionally, while most of our foreign loans are insured by U.S.-based institutions, guaranteed by a U.S.-based entity, or collateralized with U.S.-based assets or real property, our ability to collect in the event of default is subject to a number of conditions, as well as deductibles and co-payments with respect to insurance, and we may not be successful in obtaining partial or full repayment or reimbursement from the insurers. Furthermore, foreign laws may restrict our ability to foreclose on, take a security interest in, or seize collateral located in the foreign country.

We are exposed to risk of environmental liabilities with respect to properties to which we take title.

In the course of our business, we may own or foreclose and take title to real estate, and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we ever become subject to significant environmental liabilities, our business, financial condition, liquidity and results of operations could be materially and adversely affected.

Our ability to pay dividends is restricted by law and contractual arrangements and depends on capital distributions from the Banks which are subject to regulatory limits.

Our ability to pay dividends to our shareholders is subject to the restrictions set forth in California law. In addition, our ability to pay dividends to our shareholders is restricted in specified circumstances under indentures governing the trust preferred securities we have issued and under the revolving credit agreements to which we are a party. See Item 5. Market for Registrant s Common Equity and Related Stockholder Matters Dividends in Part II of our Annual Report on Form 10-K for the year ended December 31, 2005 for more information on these restrictions. We cannot assure you that we will meet the criteria specified under California law or under these agreements in the future, in which case we may reduce or stop paying dividends on our common stock.

The primary source of our income from which we pay dividends is the receipt of dividends from our Banks.

The availability of dividends from the Banks is limited by various statutes and regulations. It is possible, depending upon the financial condition of the bank in question and other factors, that the Board of Governors of the Federal Reserve System, and/or the Federal Deposit Insurance Corporation (FDIC) and/or the California Department of Financial Institutions could assert that payment of dividends or other payments is an unsafe or unsound practice. In the event our subsidiaries were unable to pay dividends to us, we in turn would likely have to reduce or stop paying dividends on our common stock. Our failure to pay dividends on our common stock could have a material adverse effect on the market price of our common stock. See Item 1. Business Supervision and Regulation in Part I of our Annual Report on Form 10-K for the year ended December 31, 2005 for additional information on the regulatory restrictions to which we and our Banks are subject.

Only a limited trading market exists for our common stock which could lead to price volatility.

Our common stock was designated for quotation on the Nasdaq National Market in June 2000 and trading volumes since that time have been modest. The limited trading market for our common stock may cause fluctuations in the market value of our common stock to be exaggerated, leading to price volatility in excess of that which would occur in a more active trading market of our common stock. In addition, even if a more active market in our common stock develops, we cannot assure you that such a market will continue or that shareholders will be able to sell their shares.

Our allowance for credit losses may not be adequate to cover actual losses.

In accordance with accounting principles generally accepted in the United States, we maintain an allowance for loan losses to provide for loan defaults and non-performance and a reserve for unfunded loan commitments, which when combined, we refer to as the allowance for credit losses. Our allowance for credit losses may not be adequate to cover actual credit losses, and future provisions for credit losses could materially and adversely affect our operating results. Our allowance for credit losses is based on prior experience, as well as an evaluation of the risks in the current portfolio. The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates that may be beyond our control, and these losses may exceed current estimates. Our federal and state regulators, as an integral part of their examination process, review our loans and allowance for credit losses. While we believe that our allowance for credit losses is adequate to cover current losses, we cannot assure you that we will not further increase the allowance for credit losses or that regulators will not require us to increase this allowance. Either of these occurrences could materially and negatively affect our earnings. See Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations in Part II to our Annual Report on Form 10-K for the year ended December 31, 2005 for more information.

Our acquisitions may subject us to unknown risks.

We have completed 18 acquisitions since May 2000 including the Community Bancorp acquisition in October 2006, including the two subsidiaries around which the Company was formed. Certain events may arise after the date of an acquisition, or we may learn of certain facts, events or circumstances after the closing of an acquisition, that may affect our financial condition or performance or subject us to risk of loss. These events include, but are not limited to: litigation resulting from circumstances occurring at the acquired entity prior to the date of acquisition; loan downgrades and credit loss provisions resulting from underwriting of certain acquired loans determined not to meet our credit standards; personnel changes that cause instability within a department; delays in implementing new policies or procedures, or the failure to apply new policies or procedures; and, other events relating to the performance of our business. Acquisitions involve inherent uncertainty and we cannot determine all potential events, facts and circumstances that could result in loss, or give assurances that our investigation or mitigation efforts will be sufficient to protect against any such loss.

Concentrated ownership of our common stock creates a risk of sudden changes in our share price.

As of November 3, 2006, directors and members of our executive management team owned or controlled approximately 9.9% of our common stock, excluding shares that may be issued to executive officers upon vesting of restricted and performance stock awards and exercise of stock options. Investors who purchase our common stock may be subject to certain risks due to the concentrated ownership of our common stock. The sale by any of our large shareholders of a significant portion of that shareholder s holdings could have a material adverse effect on the market price of our common stock. In addition, the registration of any significant amount of additional shares of our common stock will have the immediate effect of increasing the public float of our common stock and any such increase may cause the market price of our common stock to decline or fluctuate significantly.

Our largest shareholder is a registered bank holding company and the activities and regulation of such shareholder may affect the permissible activities of the Company.

Castle Creek Capital, LLC, which we refer to as Castle Creek, is controlled by our chairman, John M. Eggemeyer, and beneficially owned approximately 6.2% of the Company as of November 3, 2006. Castle Creek is a registered bank holding company under the Bank Holding Company Act of 1956, as amended, and is regulated by the Board of Governors of the Federal Reserve System, or FRB. Under FRB guidelines, holding companies must be a source of strength for their subsidiaries. See Item 1. Business Supervision and Regulation Bank Holding Company Regulation in Part I to our Annual Report on Form 10-K for the year ended December 31, 2005 for more information. Regulation of Castle Creek by the FRB may adversely affect the activities and strategic plans of the Company should the FRB determine that Castle Creek or any other company in which Castle Creek has invested has engaged in any unsafe or unsound banking practices or activities. While we have no reason to believe that the FRB is proposing to take any action with respect to Castle Creek that would adversely affect the Company, we remain subject to such risk.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

(c) Issuer Repurchases of Common Stock

Through the Company s Directors Deferred Compensation Plan, or the DDCP, participants in the DDCP may invest deferred amounts in the Company s common stock. The Company has the discretion whether to track purchases of common stock as if made, or to fully fund the DDCP via actual purchases of common stock with deferred amounts. Purchases of Company common stock by the rabbi trust of the DDCP are considered repurchases of common stock by the Company since the rabbi trust is an asset of the Company. Actual purchases of Company common stock via the DDCP are made through open market purchases pursuant to the terms of the DDCP, which since the amendment of the DDCP in August 2003 includes a predetermined formula and schedule for the purchase of such stock in accordance with Rule 10b5-1 of the Securities Exchange Act of 1934. Pursuant to the terms of the DDCP, generally, purchases are actually made or deemed to be made in the open market on the 15th of the month (or the next trading day) following the day on which deferred amounts are contributed to the DDCP. No actual purchases were made by the DDCP during the quarter ended September 30, 2006.

On May 3, 2006, our Board of Directors authorized the repurchase of up to one million shares of the Company s common stock over the next twelve months, subject to market conditions and corporate and regulatory requirements. As of September 30, 2006 no shares have been repurchased. The stock repurchase program may be limited or terminated at any time without prior notice.

ITEM 4. Submission of Matters to a Vote of Security Holders

(a) The Company held a special shareholders meeting on September 27, 2006.

(b) At the special shareholder meeting, the shareholders voted on an amendment to First Community s bylaws whereby the number of directors on the First Community board will range from seven to fifteen with the exact number at any time to be determined by resolution of the board of directors. This measure was approved. The results of the voting were as follows:

Matter	Votes For	Votes Against	Withheld	Abstentions	Broker Non-votes
Amend the Company bylaws to provide that the number of directors on the First Community board will range from seven to fifteen	18,048,450	123,723		111,418	

ITEM 6. Exhibits

Exhibit Number	Description
3.1	Restated Articles of Incorporation of First Community Bancorp, dated April 26, 2006 (Exhibit 3.1 to Form 10-Q filed on May 5, 2006 and incorporated herein by this reference).
3.2	Restated Bylaws of First Community Bancorp dated November 8, 2006.
31.1	Rule 13a-14(a) / 15d-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) / 15d-14(a) Certification of Chief Financial Officer.
32.1	Section 1350 Certification of Chief Executive Officer.
32.2	Section 1350 Certification of Chief Financial Officer.

We have not included as exhibits certain instruments with respect to our long-term debt, the amount of debt authorized under each of which does not exceed 10% of our total assets, and we agree to furnish a copy of any such instrument to the Securities and Exchange Commission upon request.

SIGNATURES

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

FIRST COMMUNITY BANCORP

Date: November 8, 2006

/s/ VICTOR R. SANTORO
Victor R. Santoro
Executive Vice President and Chief Financial Officer

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