Discovery Holding CO
Form 10-Q
November 13, 2006

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

Form 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2006

OR

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 000-51205

DISCOVERY HOLDING COMPANY
(Exact name of Registrant as specified in its charter)

State of Delaware	**20-2471174**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
12300 Liberty Boulevard Englewood, Colorado	**80112**
(Address of principal executive offices)	*(Zip Code)*

Registrant s telephone number, including area code:
(720) 875-4000

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer as defined in Rule 12b-2 of the Exchange Act.
Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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 number of outstanding shares of Discovery Holding Company s common stock as of October 31, 2006 was:

Series A common stock 268,124,397 shares; and

Series B common stock 12,075,056 shares.

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DISCOVERY HOLDING COMPANY

Condensed Consolidated Balance Sheets (unaudited)

	September 30, 2006	December 31, 2005
	amounts in thousands	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 151,848	250,352
Trade receivables, net	159,654	134,615
Prepaid expenses	13,779	10,986
Other current assets	5,571	4,433
Total current assets	330,852	400,386
Investments in marketable securities	51,052	
Investment in Discovery Communications, Inc. (Discovery or DCI) (note 8)	3,109,736	3,018,622
Property, plant, and equipment, net	270,838	256,245
Goodwill (note 7)	2,074,132	2,133,518
Other assets, net	18,332	10,465
Total assets	$ 5,854,942	5,819,236
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 39,733	26,854
Accrued payroll and related liabilities	30,706	21,651
Other accrued liabilities	27,042	23,949
Deferred revenue	28,031	17,491
Total current liabilities	125,512	89,945
Deferred income tax liabilities	1,168,116	1,131,505
Other liabilities	21,180	22,361
Total liabilities	1,314,808	1,243,811
Commitments and contingencies (note 9)		
Stockholders equity:		
Preferred stock, $.01 par value. Authorized 50,000,000 shares; no shares issued		
	2,681	2,681

Series A common stock, $.01 par value. Authorized 600,000,000 shares; issued and outstanding 268,125,377 shares at September 30, 2006 and 268,097,442 shares at December 31, 2005		
Series B common stock, $.01 par value. Authorized 50,000,000 shares; issued and outstanding 12,075,056 shares at September 30, 2006 and 12,106,093 shares at December 31, 2005	121	121
Series C common stock, $.01 par value. Authorized 600,000,000 shares; no shares issued		
Additional paid-in capital	5,713,492	5,712,304
Accumulated deficit	(1,189,105)	(1,137,821)
Accumulated other comprehensive earnings (loss)	12,945	(1,860)
Total stockholders equity	4,540,134	4,575,425
Total liabilities and stockholders equity	$ 5,854,942	5,819,236

See accompanying notes to condensed consolidated financial statements.

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DISCOVERY HOLDING COMPANY

Condensed Consolidated Statements of Operations and Comprehensive Earnings (Loss)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	amounts in thousands, except per share amounts			
Net revenue	$ 169,876	167,934	489,233	520,243
Operating expenses:				
Cost of services	111,503	109,323	318,725	335,767
Selling, general, and administrative, including stock-based compensation (note 3)	42,652	41,834	131,607	132,679
Restructuring and other charges	3,633	296	3,963	417
Depreciation and amortization	16,036	17,884	47,995	54,888
Impairment of goodwill (note 7)	93,402		93,402	
	267,226	169,337	595,692	523,751
Operating loss	(97,350)	(1,403)	(106,459)	(3,508)
Other income:				
Share of earnings of Discovery (note 8)	32,051	33,233	83,569	71,443
Other, net	2,581	1,680	7,054	1,697
	34,632	34,913	90,623	73,140
Earnings (loss) before income taxes	(62,718)	33,510	(15,836)	69,632
Income tax expense	(13,915)	(32,321)	(35,448)	(47,591)
Net earnings (loss)	(76,633)	1,189	(51,284)	22,041
Other comprehensive earnings (loss), net of taxes:				
Foreign currency translation adjustments	4,873	(2,714)	13,961	(10,736)
Unrealized holding gains (losses) arising during the period	160	(399)	844	212
Other comprehensive earnings (loss)	5,033	(3,113)	14,805	(10,524)
Comprehensive earnings (loss)	$ (71,600)	(1,924)	(36,479)	11,517
Basic and diluted earnings (loss) per common share (note 4)	$ (.27)		(.18)	.08

See accompanying notes to condensed consolidated financial statements.

DISCOVERY HOLDING COMPANY

Condensed Consolidated Statements of Cash Flows
(unaudited)

	Nine Months Ended September 30, 2006	2005
	amounts in thousands (note 5)	
Cash flows from operating activities:		
Net earnings (loss)	$ (51,284)	22,041
Adjustments to reconcile net earnings (loss) to net cash provided by operating activities:		
Depreciation and amortization	47,995	54,888
Stock-based compensation	1,200	3,743
Payments for stock-based compensation		(2,139)
Impairment of goodwill	93,402	
Share of earnings of Discovery	(83,569)	(71,443)
Deferred income tax expense	33,649	46,669
Other non-cash charges, net	135	323
Changes in assets and liabilities, net of acquisitions:		
Trade receivables	(21,875)	2,600
Prepaid expenses and other current assets	(3,730)	7,566
Payables and other liabilities	33,213	(2,412)
Net cash provided by operating activities	49,136	61,836
Cash flows from investing activities:		
Capital expenditures	(51,220)	(74,509)
Net purchases of marketable securities	(51,052)	
Cash paid for acquisitions, net of cash acquired	(46,793)	
Other investing activities, net	1,431	12,498
Net cash used in investing activities	(147,634)	(62,011)
Cash flows from financing activities:		
Net cash transfers from Liberty Media Corporation		206,044
Other financing activities, net	(6)	(7)
Net cash provided (used) by financing activities	(6)	206,037
Net increase (decrease) in cash and cash equivalents	(98,504)	205,862
Cash and cash equivalents at beginning of period	250,352	21,641
Cash and cash equivalents at end of period	$ 151,848	227,503

See accompanying notes to condensed consolidated financial statements.

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DISCOVERY HOLDING COMPANY

Condensed Consolidated Statement of Stockholders Equity
Nine months ended September 30, 2006
(unaudited)

	Preferred Stock	Common Stock Series A	Series B	Series C	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Earnings (loss)	Total Stockholders Equity
	amounts in thousands							
Balance at January 1, 2006		2,681	121		5,712,304	(1,137,821)	(1,860)	4,575,425
Net loss						(51,284)		(51,284)
Other comprehensive earnings							14,805	14,805
Stock compensation					1,188			1,188
Balance at September 30, 2006	$	2,681	121		5,713,492	(1,189,105)	12,945	4,540,134

See accompanying notes to condensed consolidated financial statements.

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DISCOVERY HOLDING COMPANY

Notes to Condensed Consolidated Financial Statements
September 30, 2006
(unaudited)

(1) Basis of Presentation

The accompanying condensed consolidated financial statements of Discovery Holding Company (DHC or the Company) represent a combination of the historical financial information of (1) Ascent Media Group, LLC (Ascent Media), a wholly-owned subsidiary of Liberty Media Corporation (Liberty), and Liberty s 50% ownership interest in Discovery for periods prior to the July 21, 2005 consummation of the spin off transaction (the Spin Off) described in note 2 and (2) DHC and its consolidated subsidiaries (including its 50% share of Discovery s earnings) for the periods following such date. The Spin Off has been accounted for at historical cost due to the pro rata nature of the distribution. Accordingly, DHC s historical financial statements are presented in a manner similar to a pooling of interests.

Ascent Media has historically been comprised of three operating divisions or groups (see note 7). Ascent Media s Creative Services group provides services necessary to complete the creation of original content, including feature films, mini-series, television shows, television commercials, music videos, promotional and identity campaigns, and corporate communications programming. The group manipulates or enhances original visual images or audio captured in principal photography or creates new three dimensional images, animation sequences, or sound effects. The Media Management Services group provides owners of content libraries with an entire complement of facilities and services necessary to optimize, archive, manage, and repurpose media assets for global distribution via freight, satellite, fiber and the Internet. The Network Services group provides the facilities and services necessary to assemble and distribute programming content for cable and broadcast networks via fiber, satellite and the Internet to viewers in North America, Europe and Asia. Additionally, the Network Services group provides systems integration, design, consulting, engineering and project management services.

Substantially all of the assets of AccentHealth, LLC were acquired by a subsidiary of DHC in January 2006. AccentHealth operates an advertising-supported captive audience television network in doctor office waiting rooms nationwide.

Discovery is a global media and entertainment company that provides original and purchased cable and satellite television programming in the United States and over 160 other countries. Discovery also develops and sells branded commerce and educational product lines in the United States.

The accompanying interim condensed consolidated financial statements are unaudited but, in the opinion of management, reflect all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of the results for such periods. The results of operations for any interim period are not necessarily indicative of results for the full year. These condensed consolidated financial statements should be read in conjunction with the Company s consolidated financial statements and notes thereto included in its Annual Report on Form 10-K for the year ended December 31, 2005.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of revenue and expenses for each reporting period. The significant estimates made in preparation of the Company s consolidated financial statements primarily relate to valuation of goodwill, other intangible assets, long-lived assets, deferred tax assets, and the amount of the allowance for doubtful accounts. Actual results could differ from the estimates upon which the

carrying values were based.

Certain prior period amounts have been reclassified for comparability with the 2006 presentation.

(2) Spin Off Transaction

On July 21, 2005 (the Spin Off Date), Liberty completed the spin off of the capital stock of DHC. The Spin Off was effected as a dividend by Liberty to holders of its Series A and Series B common stock of shares of DHC Series A and Series B common stock, respectively. Holders of Liberty common stock on July 15, 2005 received 0.10 of a share of DHC Series A common stock for each share of Liberty Series A common stock owned and 0.10 of a

DISCOVERY HOLDING COMPANY

Notes to Condensed Consolidated Financial Statements (Continued)

share of DHC Series B common stock for each share of Liberty Series B common stock owned. Approximately 268.1 million shares of DHC Series A common stock and 12.1 million shares of DHC Series B common stock were issued in the Spin Off. The Spin Off did not involve the payment of any consideration by the holders of Liberty common stock and is intended to qualify as a tax-free transaction.

In addition to Ascent Media and its investment in Discovery, Liberty transferred $200 million in cash to a subsidiary of DHC prior to the Spin Off.

Following the Spin Off, the Company and Liberty operate independently, and neither has any stock ownership, beneficial or otherwise, in the other. In connection with the Spin Off, the Company and Liberty entered into certain agreements in order to govern certain of the ongoing relationships between the Company and Liberty after the Spin Off and to provide for an orderly transition. These agreements include a Reorganization Agreement, a Services Agreement and a Tax Sharing Agreement.

The Reorganization Agreement provides for, among other things, the principal corporate transactions required to effect the Spin Off and cross indemnities. Pursuant to the Services Agreement, Liberty provides the Company with office space and certain general and administrative services including legal, tax, accounting, treasury and investor relations support. The Company reimburses Liberty for direct, out-of-pocket expenses incurred by Liberty in providing these services and for the Company s allocable portion of facilities costs and costs associated with any shared services or personnel. Liberty and DHC have agreed that they will review cost allocations every six months and adjust such charges, if appropriate.

Under the Tax Sharing Agreement, Liberty is generally responsible for U.S. federal, state, local and foreign income taxes reported on a consolidated, combined or unitary return that includes the Company or one of its subsidiaries and Liberty or one of its subsidiaries. The Company is responsible for all other taxes that are attributable to the Company or one of its subsidiaries, whether accruing before, on or after the Spin Off. The Tax Sharing Agreement requires that the Company will not take, or fail to take, any action where such action, or failure to act, would be inconsistent with or prohibit the Spin Off from qualifying as a tax-free transaction. Moreover, the Company has indemnified Liberty for any loss resulting from (i) such action or failure to act or (ii) any agreement, understanding, arrangement or substantial negotiations entered into by DHC prior to the day after the first anniversary of the Spin Off Date, with respect to any transaction pursuant to which any of the other stockholders in Discovery would acquire shares of, or other interests in DHC s capital stock, in each case relating to the qualification of the Spin Off as a tax-free transaction.

(3) Stock-Based Compensation

As a result of the Spin Off and related adjustments to Liberty s stock incentive awards, options (Spin Off DHC Awards) to acquire an aggregate of approximately 2.0 million shares of DHC Series A common stock and 3.0 million shares of DHC Series B common stock were issued to employees of Liberty. In addition, employees of Ascent Media who held stock options or stock appreciation rights (SARs) to acquire shares of Liberty common stock prior to the Spin Off continue to hold such options. Pursuant to the Reorganization Agreement, DHC is responsible for all stock options related to DHC common stock, and Liberty is responsible for all incentive awards related to Liberty common stock. Notwithstanding the foregoing, the Company records stock-based compensation for all stock incentive awards held by DHC s and its subsidiaries employees regardless of whether such awards relate to DHC common stock or Liberty common stock. Any stock-based compensation recorded by DHC with respect to Liberty stock incentive awards is treated as a capital transaction with the offset to stock-based compensation expense reflected as an

adjustment of additional paid-in capital.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payments* (Statement 123R). Statement 123R, which is a revision of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (Statement 123) and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB Opinion No. 25), establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services, primarily focusing on transactions in which an entity obtains

DISCOVERY HOLDING COMPANY

Notes to Condensed Consolidated Financial Statements (Continued)

employee services. Statement 123R generally requires companies to measure the cost of employee services received in exchange for an award of equity instruments (such as stock options and restricted stock) based on the grant-date fair value of the award, and to recognize that cost over the period during which the employee is required to provide service (usually the vesting period of the award). Statement 123R also requires companies to measure the cost of employee services received in exchange for an award of liability instruments (such as stock appreciation rights that will be settled in cash) based on the current fair value of the award, and to remeasure the fair value of the award at each reporting date.

The Company adopted Statement 123R effective January 1, 2006. The provisions of Statement 123R allow companies to adopt the standard using the modified prospective method or to restate all periods for which Statement 123 was effective. The Company has adopted Statement 123R using the modified prospective method, and will continue to include in its financial statements for periods that begin after December 31, 2005 pro forma information as though the standard had been adopted for all periods presented.

Liberty calculated the grant-date fair value for all of its awards using the Black-Scholes Model. Liberty calculated the expected term of the awards using the methodology included in SEC Staff Accounting Bulletin No. 107. The volatility used in the calculation is based on the implied volatility of publicly traded Liberty options with a similar term (generally 20% 21%). Liberty uses the risk-free rate for Treasury Bonds with a term similar to that of the subject options. The Company has allocated the grant-date fair value of the Liberty awards to the Spin Off DHC Awards based on the relative trading prices of DHC and Liberty common stock after the Spin Off.

On May 4, 2006, each of the non-employee directors of DHC was granted 10,000 options to purchase DHC Series A common stock with an exercise price of $14.48. Such options vest one year from the date of grant, terminate 10 years from the date of grant and had a grant-date fair value of $4.47 per share, as determined by the Black-Scholes Model.

As of September 30, 2006, the following DHC options were outstanding and vested:

	DHC Series A	Weighted Average Exercise Price	DHC Series B	Weighted Average Exercise Price
Outstanding	1,966,396	$ 15.42	2,996,525	$ 18.87
Exercisable	1,449,886	$ 16.15	2,876,465	$ 18.99

As of September 30, 2006, the total compensation cost related to unvested equity awards was $1.5 million. Such amount will be recognized in the Company s consolidated statements of operations through 2009.

Prior to the adoption of Statement 123R, the Company applied the intrinsic-value-based method of accounting prescribed by APB Opinion No. 25, to account for its fixed-plan stock options. Under this method, compensation expense was recorded on the date of grant only if the current market price of the underlying stock exceeded the

exercise price and was recognized on a straight-line basis over the vesting period.

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DISCOVERY HOLDING COMPANY

Notes to Condensed Consolidated Financial Statements (Continued)

The following table illustrates the effect on net earnings for the three and nine months ended September 30, 2005 as if the fair-value-based method of Statement 123R had been applied to all outstanding and unvested awards. Compensation expense for SARs was the same under APB Opinion No. 25 and Statement 123R. Accordingly, no pro forma adjustment for such awards is included in the following table.

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
	amounts in thousands, except per share amounts	
Net earnings, as reported	$ 1,189	22,041
Add:		
Stock-based employee compensation expense included in reported net earnings, net of taxes	119	2,222
Deduct:		
Stock-based employee compensation expense determined under fair value based method for all awards, net of taxes	(1,574)	(8,890)
Pro forma net earnings (loss)	$ (266)	15,373
Pro forma basic and diluted earnings per share:		
As reported	$	.08
Pro forma for fair value stock compensation	$	.05

(4) Earnings Per Common Share

Basic earnings per common share (EPS) is computed by dividing net earnings by the weighted average number of common shares outstanding for the period. The weighted average number of shares outstanding for each of the three and nine month periods ended September 30, 2006 is 279,949,000, and the weighted average number of shares outstanding for periods prior to the Spin Off Date is 280,199,000 shares, which is the number of shares that were issued on the Spin Off Date. Dilutive EPS presents the dilutive effect on a per share basis of potential common shares as if they had been converted at the beginning of the periods presented. Due to the relative insignificance of the dilutive securities in 2006 and 2005, their inclusion does not impact the EPS amount as reported in the accompanying condensed consolidated statements of operations.

(5) Supplemental Disclosure of Cash Flow Information

	Nine Months Ended September 30, 2006	2005
	amounts in thousands	
Cash paid for acquisitions:		
Fair value of assets acquired	$ 48,264	
Net liabilities assumed	(1,471)	
Cash paid for acquisitions, net of cash acquired	$ 46,793	

(6) Acquisition

Effective January 27, 2006, a subsidiary of DHC acquired substantially all of the assets of AccentHealth, LLC s healthcare media business (AccentHealth) for cash consideration of $46,793,000, subject to potential post-closing adjustments. AccentHealth operates an advertising-supported captive audience television network in doctor

DISCOVERY HOLDING COMPANY

Notes to Condensed Consolidated Financial Statements (Continued)

office waiting rooms nationwide. The Company recorded goodwill of $32,224,000 and other intangible assets of $9,800,000 in connection with this acquisition. Such amounts are preliminary and are subject to adjustment pending completion of the Company s purchase price allocation process. The excess purchase price over the fair value of assets acquired is attributable to the growth potential of AccentHealth and expected compatibility with Ascent Media s existing Network Services group.

For financial reporting purposes, the acquisition is deemed to have occurred on February 1, 2006. The results of operations of AccentHealth have been included in the consolidated results of DHC as part of the Network Services group since the date of acquisition. On a pro forma basis, the results of operations of AccentHealth are not significant to those of DHC.

(7) Goodwill

Goodwill is comprised of the following:

	September 30, 2006	December 31, 2005
	amounts in thousands	
Goodwill		
Creative Services group	$ 106,599	106,599
Media Management Services group		93,402
Network Services group	196,533	162,517
Discovery	1,771,000	1,771,000
Total goodwill	$ 2,074,132	2,133,518

GAAP requires companies to allocate enterprise-level goodwill to all reporting units, including equity method investments. Accordingly, the Company has allocated $1,771,000,000 of enterprise-level goodwill to its investment in Discovery. This allocation is performed for goodwill impairment testing purposes only and does not change the reported carrying value of the investment. However, to the extent the investment is disposed of in the future, the allocated goodwill will be relieved and included in the calculation of the gain or loss on disposal.

On August 18, 2006, Ascent Media announced that it intends to streamline its structure into two global operating divisions Creative Services group and Network Services group to better align Ascent Media s organization with the company s strategic goals and to respond to changes within the industry driven by technology and customer requirements. The operations of the current Media Management Services group are to be realigned with the other two groups. Such realignment is expected to be completed in the fourth quarter of 2006.

As technology and customer requirements drive changes in this industry, revenue and operating cash flows have been declining for this group. As a result of the restructuring, and the declining financial performance of the Media Management Services group, including ongoing operating losses, the Media Management Services group was tested

for goodwill impairment in the third quarter of 2006, prior to DHC s annual goodwill valuation assessment of the entire company. DHC estimated the fair value of that reporting unit principally by using trading multiples of revenue and operating cash flows of similar companies in the industry. In September 2006, Ascent Media recognized a goodwill impairment loss for the Media Management Services group of $93,402,000, which represents the excess of the carrying value over the implied fair value of such goodwill.

(8) Investment in Discovery

The Company has a 50% ownership interest in Discovery and accounts for its investment using the equity method of accounting. Discovery is a global media and entertainment company, that provides original and purchased video programming in the United States and over 160 other countries. Discovery also develops and sells branded commerce and educational product lines in the United States.

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DISCOVERY HOLDING COMPANY

Notes to Condensed Consolidated Financial Statements (Continued)

DHC s carrying value for Discovery was $3,109,736,000 at September 30, 2006. In addition, as described in note 7, enterprise-level goodwill of $1,771,000,000 has been allocated to the investment in Discovery.

Summarized financial information for DCI is as follows:

Consolidated Balance Sheets

	September 30, 2006	December 31, 2005
	amounts in thousands	
Cash and cash equivalents	$ 52,270	34,491
Other current assets	911,974	796,878
Property and equipment, net	397,409	397,578
Goodwill and intangible assets	445,024	397,927
Programming rights, long term	1,262,535	1,175,988
Other assets	276,341	371,758
Total assets	$ 3,345,553	3,174,620
Current liabilities	$ 649,668	692,465
Long term debt	2,639,146	2,590,440
Other liabilities	167,619	101,571
Mandatorily redeemable equity in subsidiaries	189,248	272,502
Stockholders deficit	(300,128)	(482,358)
Total liabilities and stockholders deficit	$ 3,345,553	3,174,620

Consolidated Statements of Operations

	Nine Months Ended September 30,	
	2006	2005
	amounts in thousands	
Revenue	$ 2,114,544	1,900,549
Cost of revenue	(744,063)	(659,861)
Selling, general and administrative	(842,575)	(737,843)
Equity-based compensation	(10,561)	(18,786)
Depreciation and amortization	(95,051)	(90,579)

Operating income	422,294	393,480
Interest expense	(149,806)	(130,212)
Other income, net	21,261	9,388
Income tax expense	(126,610)	(129,770)
Net earnings	$ 167,139	142,886

(9) Commitments and Contingencies

The Company is involved in litigation and similar claims incidental to the conduct of its business. In management s opinion, none of the pending actions is likely to have a material adverse impact on the Company s financial position or results of operations.

The Company and its subsidiaries lease offices, satellite transponders and certain equipment under lease arrangements.

DISCOVERY HOLDING COMPANY

Notes to Condensed Consolidated Financial Statements (Continued)

(10) Related Party Transactions

Certain third-party general and administrative and spin off related costs were paid by Liberty on behalf of the Company prior to the Spin Off and reflected as expenses in the accompanying condensed consolidated statements of operations. In addition, certain general and administrative and other expenses are charged by Liberty to DHC pursuant to the Services Agreement. Such expenses aggregated $1,695,000 and $4,655,000 for the nine months ended September 30, 2006 and 2005, respectively.

Ascent Media provides services such as satellite uplink, systems integration, origination, and post-production to Discovery. Revenue recorded by Ascent Media for these services for the nine months ended September 30, 2006 and 2005 aggregated $24,977,000 and $25,223,000, respectively.

(11) Information About Operating Segments

The Company s chief operating decision maker, or his designee (the CODM), has identified the Company s reportable segments based on (i) financial information reviewed by the CODM and (ii) those operating segments that represent more than 10% of the Company s consolidated revenue or earnings before taxes. In addition, those equity investments whose share of earnings represent more than 10% of the Company s earnings before taxes are considered reportable segments.

Based on the foregoing criteria, the Company s business units have been aggregated into five reportable segments: the Creative Services group, the Media Management Services group, and the Network Services group, which are all operating segments of Ascent Media, Corporate and other, and Discovery, which is an equity affiliate (see note 7).

The Creative Services group provides post-production services, which are comprised of services necessary to complete the creation of original content including feature films, television shows, movies of the week/mini series, television commercials, music videos, promotional and identity campaigns and corporate communications programming. The Media Management Services group provides (i) content storage services, which are comprised of facilities and services necessary to optimize, archive, manage and repurpose media assets for global distribution via freight, satellite, fiber and the Internet; (ii) access to all forms of content, duplication and formatting services; (iii) language conversions and laybacks; (iv) restoration and preservation of old or damaged content; (v) mastering from motion picture film to high resolution or data formats; (vi) digital audio and video encoding services; and (vii) digital media management services for global home video, broadcast, pay-per-view and emerging new media distribution channels. The Network Services group provides broadcast services, which are comprised of services necessary to assemble and distribute programming for cable and broadcast networks via fiber and satellite to viewers in North America, Europe and Asia. AccentHealth is included in the Network Services group broadcast services. Additionally, the Network Services group provides systems integration, design, consulting, engineering and project management services.

The accounting policies of the segments that are consolidated subsidiaries are the same as those described in the summary of significant accounting policies and are consistent with GAAP.

The Company evaluates the performance of these operating segments based on financial measures such as revenue and operating cash flow. The Company defines operating cash flow as revenue less operating expenses and selling, general and administrative expense (excluding stock and other equity-based compensation). The Company believes

this is an important indicator of the operational strength and performance of its businesses, including the ability to service debt and capital expenditures. In addition, this measure allows management to view operating results and perform analytical comparisons and identify strategies to improve performance. This measure of performance excludes depreciation and amortization, stock and other equity-based compensation, restructuring and other charges and impairment of goodwill which are included in the measurement of operating income pursuant to GAAP. Accordingly, operating cash flow should be considered in addition to, but not as a substitute for, operating income, cash flow provided by operating activities and other measures of financial performance prepared in accordance with GAAP.

DISCOVERY HOLDING COMPANY

Notes to Condensed Consolidated Financial Statements (Continued)

The Company s reportable segments are strategic business units that offer different products and services. They are managed separately because each segment requires different technologies, distribution channels and marketing strategies.

Summarized financial information concerning the Company s reportable segments is presented in the following tables:

	Consolidated Reportable Segments					
	Creative Services group	Media Management Services group	Network Services group(1)	Corporate and other	Consolidated Total	Equity Affiliate-Discovery
	amounts in thousands					
Nine months ended September 30, 2006						
Revenue from external customers	$ 224,482	80,656	184,095		489,233	2,114,544
Operating cash flow (deficit)	$ 35,812	710	36,364	(32,785)	40,101	527,906
Capital expenditures	$ 11,949	7,845	28,930	2,496	51,220	40,109
Total assets	$ 311,427	94,953	387,250	5,061,312	5,854,942	3,345,553
Nine months ended September 30, 2005						
Revenue from external customers	$ 225,008	87,778	207,457		520,243	1,900,549
Operating cash flow (deficit)	$ 40,363	9,739	41,101	(35,663)	55,540	502,845
Capital expenditures	$ 19,678	19,605	31,440	3,786	74,509	77,609

(1) Included in Network Services group revenue is broadcast services revenue of $117,478,000 and $110,436,000 and systems integration revenue of $66,617,000 and $97,021,000 for the nine months ended September 30, 2006 and 2005, respectively.

	Consolidated Reportable Segments					
	Creative Services group	Media Management Services group	Network Services group(1)	Corporate and other	Consolidated Total	Equity Affiliate-Discovery
	amounts in thousands					

Three months ended September 30, 2006						
Revenue from external customers	$ 74,119	27,950	67,807		169,876	721,937
Operating cash flow (deficit)	$ 10,780	(1,099)	16,046	(9,791)	15,936	192,433
Capital expenditures	$ 3,596	3,744	10,274	1,206	18,820	14,334
Three months ended September 30, 2005						
Revenue from external customers	$ 73,215	27,730	66,989		167,934	639,182
Operating cash flow (deficit)	$ 12,483	1,291	14,327	(11,198)	16,903	170,580
Capital expenditures	$ 9,481	7,728	4,990	1,157	23,356	16,980

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DISCOVERY HOLDING COMPANY

Notes to Condensed Consolidated Financial Statements (Continued)

(1) Included in Network Services group revenue is broadcast services revenue of $40,676,000 and $38,781,000 and systems integration revenue of $27,131,000 and $28,208,000 for the three months ended September 30, 2006 and 2005, respectively.

The following table provides a reconciliation of segment operating cash flow to earnings (loss) before income taxes.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	amounts in thousands			
Segment operating cash flow	$ 15,936	16,903	40,101	55,540
Stock-based compensation	(215)	(126)	(1,200)	(3,743)
Depreciation and amortization	(16,036)	(17,884)	(47,995)	(54,888)
Impairment of goodwill	(93,402)		(93,402)	
Share of earnings of Discovery	32,051	33,233	83,569	71,443
Other, net	(1,052)	1,384	3,091	1,280
Earnings (loss) before income taxes	$ (62,718)	33,510	(15,836)	69,632

Information as to the Company s operations in different geographic areas is as follows:

	Nine Months Ended September 30,	
	2006	2005
	amounts in thousands	
Revenue		
United States	$ 373,697	392,562
United Kingdom	98,976	113,537
Other countries	16,560	14,144
	$ 489,233	520,243

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

Certain statements in this Quarterly Report on Form 10-Q constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including statements regarding our business, marketing strategies, integration of acquired businesses, new service offerings, and anticipated sources and uses of capital. Where, in any forward-looking statement, we express an expectation or belief as to future results or events, such expectation or belief is expressed in good faith and believed to have a reasonable basis, but such statements necessarily involve risks and uncertainties, and there can be no assurance that the statement of expectation or belief will result or be achieved or accomplished. The following include some but not all of the factors that could cause actual results or events to differ materially from those anticipated:

general economic and business conditions and industry trends including the timing of, and spending on, feature film and television production;

spending on domestic and foreign television advertising and spending on domestic and foreign first-run and existing content libraries;

the regulatory and competitive environment of the industries in which we, and the entities in which we have interests, operate;

continued consolidation of the broadband distribution and movie studio industries;

fluctuations in foreign currency exchange rates and political unrest in international markets;

uncertainties inherent in the development and integration of new business lines, acquired businesses and business strategies;

uncertainties associated with product and service development and market acceptance, including the development and provision of programming for new television and telecommunications technologies;

changes in distribution and viewing of television programming, including the expanded deployment of personal video recorders, video on demand and IP television and their impact on television advertising revenue;

rapid technological changes;

future financial performance, including availability, terms and deployment of capital;

the ability of suppliers and vendors to deliver products, equipment, software and services;

the outcome of any pending or threatened litigation;

availability of qualified personnel;

the possibility of an industry-wide strike or other job action by or affecting a major entertainment industry union;

changes in, or failure or inability to comply with, government regulations, including, without limitation, regulations of the Federal Communications Commission, and adverse outcomes from regulatory proceedings;

changes in the nature of key strategic relationships with partners and joint venturers;

competitor responses to our products and services, and the products and services of the entities in which we have interests; and

threatened terrorists attacks and ongoing military action in the Middle East and other parts of the world.

These forward-looking statements and such risks, uncertainties and other factors speak only as of the date of this Quarterly Report, and we expressly disclaim any obligation or undertaking to disseminate any updates or revisions to any forward-looking statement contained herein, to reflect any change in its expectations with regard thereto, or any other change in events, conditions or circumstances on which any such statement is based.

The following discussion and analysis provides information concerning our results of operations and financial condition. This discussion should be read in conjunction with our accompanying condensed consolidated financial

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statements and the notes thereto; and our Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2005.

Overview

We are a holding company and our businesses and assets include Ascent Media and AccentHealth, which we consolidate, and a 50% ownership interest in Discovery, which we account for using the equity method of accounting. Accordingly, as described below, Discovery s revenue is not reflected in the revenue we report in our consolidated financial statements. In addition to the foregoing assets, immediately prior to the Spin Off, Liberty transferred to a subsidiary of our company $200 million in cash. The Spin Off was effected on July 21, 2005 as a distribution by Liberty to holders of its Series A and Series B common stock of shares of our Series A and Series B common stock, respectively. The Spin Off did not involve the payment of any consideration by the holders of Liberty common stock and is intended to qualify as a tax-free spin off. The Spin Off has been accounted for at historical cost due to the pro rata nature of the distribution.

Following the Spin Off, we and Liberty operate independently, and neither has any stock ownership, beneficial or otherwise, in the other.

Ascent Media provides creative, media management and network services to the media and entertainment industries. Ascent Media s clients include major motion picture studios, independent producers, broadcast networks, cable programming networks, advertising agencies and other companies that produce, own and/or distribute entertainment, news, sports, corporate, educational, industrial and advertising content. Ascent Media s operations are organized into the following four groups: Creative Services group, Media Management Services group, Network Services group and Corporate and other. Ascent Media has few long-term or exclusive agreements with its Creative Services and Media Management Services customers.

On August 18, 2006, Ascent Media announced that it intends to streamline its structure into two global operating divisions Creative Services group and Network Services group to better align Ascent Media s organization with the company s strategic goals and to respond to changes within the industry driven by technology and customer requirements. The operations of the current Media Management Services group are to be realigned with the other two groups. The Corporate and other group would remain intact. As part of this restructuring, Ascent Media s Chief Executive Officer, along with other officers, either have left or will be leaving the company. Day-to-day management of Ascent Media is now the responsibility of Ascent Media s Management Committee, which is comprised of certain of Ascent Media s senior management. The review of Ascent Media s operations and resulting realignment of the operating structure is expected to be completed during the fourth quarter of 2006. However, certain restructuring activities have already been undertaken and related charges recorded during the third quarter of 2006.

Our most significant asset is Discovery, in which we do not have a controlling financial interest. Discovery is a global media and entertainment company that provides original and purchased video programming in the U.S. and over 160 other countries. Discovery also develops and sells branded commerce and educational product lines in the United States. We account for our interest in Discovery using the equity method of accounting. Accordingly, our share of the results of operations of Discovery is reflected in our consolidated results as earnings or losses of Discovery. To assist the reader in better understanding and analyzing our business, we have included a separate discussion and analysis of Discovery s results of operations and liquidity below.

Acquisition

Effective January 27, 2006, one of our subsidiaries acquired substantially all of the assets of AccentHealth, LLC s healthcare media business for cash consideration of $46,793,000, subject to potential post-closing adjustments. AccentHealth operates an advertising-supported captive audience television network in doctor office waiting rooms nationwide. For financial reporting purposes, the acquisition is deemed to have occurred on February 1, 2006, and the results of operations of AccentHealth have been included in our consolidated results since the date of acquisition.

Operating Cash Flow

We evaluate the performance of our operating segments based on financial measures such as revenue and operating cash flow. We define operating cash flow as revenue less cost of services and selling, general and administrative expense (excluding stock and other equity-based compensation). We believe this is an important indicator of the operational strength and performance of our businesses, including their ability to invest in ongoing capital expenditures and service any debt. In addition, this measure allows management to view operating results and perform analytical comparisons and identify strategies to improve performance. This measure of performance excludes depreciation and amortization, stock and other equity-based compensation, restructuring and other charges and impairment of goodwill which are included in the measurement of operating income pursuant to GAAP. Accordingly, operating cash flow should be considered in addition to, but not as a substitute for, operating income, cash flow provided by operating activities and other measures of financial performance prepared in accordance with GAAP. See note 11 to the accompanying condensed consolidated financial statements for a reconciliation of operating cash flow to earnings (loss) before income taxes.

Results of Operations

Our consolidated results of operations include general and administrative expenses incurred at the DHC corporate level, 100% of the results of Ascent Media and AccentHealth and our 50% share of earnings of Discovery.

Ascent Media s Creative Services group revenue is primarily generated from fees for video and audio post production, special effects and editorial services for the television, feature film and advertising industries. Generally, these services pertain to the completion of feature films, television programs and advertisements. These projects normally span from a few days to three months or more in length, and fees for these projects typically range from $10,000 to $1,000,000 per project. The Media Management Services group provides owners of film libraries a broad range of restoration, preservation, archiving, professional mastering and duplication services. The scope of media management services vary in duration from one day to several months depending on the nature of the service, and fees typically range from less than $1,000 to $100,000 per project. Additionally, the Media Management Services group includes Ascent Media s digital services group, which is developing new products and services for studios, networks, producers, advertisers and distributors to create, repurpose and distribute digital media. The Network Services group s revenue consists of fees relating to facilities and services necessary to assemble and transport programming for cable and broadcast networks across the world via freight, fiber, satellite and the Internet. AccentHealth is included in the Network Services group broadcast services. Additionally, the group earns revenue by providing systems integration and field support services, technology consulting services, design and implementation of advanced video systems, engineering project management, technical help desk and field service. Approximately 30% of the Network Services group s revenue relates to systems integration and engineering services which are provided on a project basis over terms generally ranging from three to twelve months. Approximately 70% of the Network Services group s revenue relates to broadcast services, satellite operations and fiber services that are earned monthly under long-term contracts ranging generally from one to seven years. Cost of services and operating expenses consists primarily of production wages, facility costs, materials and other direct costs and selling, general and administrative expenses.

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Corporate related items and expenses are reflected in Corporate and other, below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	amounts in thousands			
Segment Revenue				
Creative Services group	$ 74,119	73,215	224,482	225,008
Media Management Services group	27,950	27,730	80,656	87,778
Network Services group	67,807	66,989	184,095	207,457
Corporate and other				
	$ 169,876	167,934	489,233	520,243
Segment Operating Cash Flow				
Creative Services group	$ 10,780	12,483	35,812	40,363
Media Management Services group	(1,099)	1,291	710	9,739
Network Services group	16,046	14,327	36,364	41,101
Corporate and other	(9,791)	(11,198)	(32,785)	(35,663)
	$ 15,936	16,903	40,101	55,540

Revenue. Total revenue increased 1.2% and decreased 6.0% for the three and nine months ended September 30, 2006, respectively, as compared to the corresponding prior year periods. The Creative Services group revenue remained relatively flat for the three and nine months ended September 30, 2006, as compared to corresponding prior year periods. Both periods experienced a small increase in U.S. revenue, driven primarily by a higher number of feature film projects for post production services and strength in commercial services. Conversely, U.K. revenue experienced a decline for both periods, driven by television film services for the three month period, and by both commercial and television film services for the nine month period.

The Media Management Services group revenue increased $220,000 and decreased $7,122,000 for the three and nine months ended September 30, 2006, respectively. The increase for the three month period was primarily a result of higher duplication and library services in the United Kingdom and the favorable changes in foreign currency exchange rates of $401,000, offset by a decline in lab services in the United States. The decrease for the nine month period is due to lower traditional media and DVD services from Ascent Media s major customers, lower lab services and unfavorable changes in foreign currency exchange rates of $408,000, offset by higher library services in the United Kingdom.

The Network Services group revenue increased $818,000 and decreased $23,362,000 for the three and nine months ended September 30, 2006, respectively. The increase for the three month period was due to (i) the impact of the AccentHealth acquisition which contributed $6,197,000, (ii) increased content distribution in the United States and Singapore and (iii) the favorable changes in foreign currency exchange rates of $900,000. These increases were offset by (i) a decline in revenue in the United Kingdom of $3,109,000 primarily due to the termination of certain content distribution contracts and (ii) a decline in systems integration and services revenue of $4,049,000 due to large one-time projects in 2005. The decrease for the nine month period reflects (i) a decline in systems integration and services revenue of $32,595,000 as a result of significant one-time projects in 2005 and (ii) lower revenue in the

United Kingdom of $10,328,000 primarily as a result of termination of content distribution contracts. These decreases were partially offset by higher revenue due to the acquisition of AccentHealth of $14,646,000, as well as increased content distribution activity in the United States and Singapore.

Cost of Services. Cost of services increased $2,180,000 or 2.0% and decreased $17,042,000 or 5.1% for the three and nine months ended September 30, 2006, respectively, as compared to the corresponding prior year periods. The increase for the three month period is primarily attributable to the impact of the AccentHealth acquisition which contributed $1,656,000 for the three month period, combined with an unfavorable change in foreign currency exchange rates of $997,000. The decrease for the nine month period reflects the revenue declines driving lower material costs, offset by the AccentHealth acquisition which contributed $4,389,000 for the nine month period. As a percent of revenue, cost of services was consistent at 65.6% and 65.1% for the three months ended September 30, 2006 and 2005, respectively, and 65.1% and 64.5% for the nine months ended September 30,

2006 and 2005, respectively, as decreases in materials cost were offset by increases in labor cost. Labor costs as a percent of revenue were higher for all groups in 2006 due to revenue mix. In the Creative Services group, the increase is a result of revenue mix towards more labor intensive feature services in 2006. In the Media Management Services group, the projects have become increasingly more integrated, with complex work flows requiring a higher level of production and support labor. In the Network Services group, there is a decrease in material costs due to the revenue mix resulting from lower system integration contracts, offset by higher labor costs.

Selling, General and Administrative. Ascent Media s selling, general and administrative expenses (SG&A) were flat for the three and nine months ended September 30, 2006 as compared to the corresponding prior year periods. For the three month period, lower personnel costs from continued reorganization and integration efforts both in the U.S. and U.K were offset by the acquisition of AccentHealth which added $2,197,000 of SG&A expenses for the quarter, along with unfavorable changes in foreign currency exchange rates of $515,000. For the nine month period, the acquisition of AccentHealth added $4,580,000 of SG&A expenses offset by lower personnel costs and professional fees and favorable changes in foreign currency exchange rates of $501,000. As a percent of revenue, SG&A increased from 24.8% to 26.7% for the nine month period due to the acquisition of AccentHealth and the fixed-cost nature of a large percentage of these expenses.

Corporate and other operating cash flow improved $2,878,000 in 2006 primarily due to lower Ascent Media corporate expenses, partially offset by an increase in DHC corporate, general and administrative expenses which were $6,053,000 and $4,655,000 for the nine months ended September 30, 2006 and 2005, respectively.

Restructuring Charges. During the three months ended September 30, 2006, Ascent Media recorded restructuring charges of $3,963,000 primarily related to severance as part of the ongoing restructuring. These restructuring activities were primarily in the Corporate and other group in the United States and United Kingdom. During the three months ended September 30, 2005, Ascent Media recorded restructuring charges of $296,000 related to reductions in headcount. These restructuring activities were implemented to improve operating efficiencies and effectiveness primarily in the Creative Services group.

Depreciation and Amortization. The decrease in depreciation and amortization expense for the three and nine months ended September 30, 2006 is due to a combination of assets becoming fully depreciated partially offset by capital expenditures and the AccentHealth acquisition.

Stock-Based Compensation. In 2001, Ascent Media granted to certain of its officers and employees stock options (the Ascent Media Options) with exercise prices that were less than the market price of Ascent Media common stock on the date of grant. The Ascent Media Options became exercisable for Liberty shares in connection with Liberty s 2003 acquisition of the Ascent Media outstanding common stock that it did not already own. Prior to January 1, 2006, we amortized the in-the-money value of these options over the 5-year vesting period. Certain Ascent Media employees also hold options and stock appreciation rights granted by companies acquired by Ascent Media in the past several years and exchanged for Liberty options and SARs. Prior to January 1, 2006 we recorded compensation expense for the SARs based on the underlying stock price and vesting of such awards.

Effective January 1, 2006, we adopted Statement No. 123R. Statement No. 123R requires that we amortize the grant date fair value of our stock option and SAR Awards that qualify as equity awards as stock compensation expense over the vesting period of such Awards. Statement No. 123R also requires that we record the liability associated with our liability awards at fair value each reporting period and that the change in fair value be reflected as stock compensation expense in our condensed consolidated statement of operations. Prior to adoption of Statement No. 123R, the amount of expense associated with stock-based compensation was generally based on the vesting of the related stock options and stock appreciation rights and the market price of the underlying common stock. The expense reflected in our condensed consolidated financial statements was based on the market price of the underlying common stock as of the

date of the financial statements.

As of September 30, 2006, the total compensation cost related to unvested equity awards was $1.5 million. Such amount will be recognized in our consolidated statements of operations through 2009.

Impairment of Goodwill. On August 18, 2006, Ascent Media announced that it intends to streamline its structure into two global operating divisions Creative Services group and Network Services group to better align Ascent Media s organization with the company s strategic goals and to respond to changes within the industry driven by technology and customer requirements. The operations of the current Media Management Services group

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would be realigned with the other two groups. Such realignment is expected to be completed in the fourth quarter of 2006.

As technology and customer requirements drive changes in this industry, revenue and operating cash flows have been declining for this group. As a result of the restructuring, and the declining financial performance of the Media Management Services group, including ongoing operating losses, the Media Management Services group was tested for goodwill impairment in the third quarter of 2006, prior to DHC s annual goodwill valuation assessment of the entire company. DHC estimated the fair value of that reporting unit principally by using trading multiples of revenue and operating cash flows of similar companies in the industry. In September 2006, Ascent Media recognized a goodwill impairment loss for the Media Management Services group of $93,402,000, which represents the excess of the carrying value over the implied fair value of such goodwill.

Share of Earnings of Discovery. Our share of earnings of Discovery decreased $1,182,000 or 3.6% and increased $12,126,000 or 17.0% for the three and nine months ended September 30, 2006, respectively, as compared to the corresponding prior year periods. The three month period decrease was due to lower operating income in 2006, mainly due to a significant long-term incentive plan benefit in the prior year, and due to higher interest expense in 2006. The nine month increase is due to higher operating income partially offset by higher interest expense in 2006.

We have provided a more detailed discussion of Discovery s results of operations below.

Income Taxes. For the nine months ended September 30, 2006, we recorded income tax expense of $35,448,000, but had a net loss before taxes of $15,836,000. The net loss resulted from a $93,402,000 goodwill impairment charge recorded in the third quarter of 2006, for which we receive no tax benefit. Our effective tax rate was 68.3% for the nine months ended September 30, 2005. Subsequent to the Spin Off, we assessed our historical weighted average state tax rate and determined to increase such rate. This increase resulted in additional tax expense in the third quarter of 2005 in the amount of $13,507,000. In addition, our income tax expense was higher than the federal income tax rate of 35% due to state and foreign tax expense.

Net Earnings. Our net earnings decreased from $22,041,000 for the nine months ended September 30, 2005 to a net loss of $51,284,000 for the nine months ended September 30, 2006. The 2006 net loss is due to a goodwill impairment loss of $93,402,000, partially offset by the other aforementioned fluctuations in revenue and expenses.

Liquidity and Capital Resources

Our primary sources of funds are cash on hand and cash flows from operating activities. During the nine months ended September 30, 2006, our primary uses of cash were capital expenditures ($51,220,000) and cash paid for acquisitions ($46,793,000). Of the foregoing 2006 capital expenditures, $17,478,000 relates to the buildout of Ascent Media s existing facilities for specific customer contracts. The remainder of Ascent Media s capital expenditures relate to purchases of new equipment and the upgrade of existing facilities and equipment. Ascent Media currently expects to spend an additional $16,000,000 for capital expenditures in 2006, which we expect will be funded with Ascent Media s cash from operations and cash on hand. At September 30, 2006, we have approximately $154 million of corporate cash and short-term investments. We expect that these funds will be sufficient to meet our working capital needs, capital expenditure requirements and other investing activities for the foreseeable future.

We do not have access to the cash Discovery generates from its operations, unless Discovery pays a dividend on its capital stock or otherwise distributes cash to its stockholders. Historically, Discovery has not paid any dividends on its capital stock, and we do not have sufficient voting control to cause Discovery to pay dividends or make other payments or advances to us.

Discovery

We hold a 50% ownership interest in Discovery and account for this investment using the equity method of accounting. Accordingly, in our consolidated financial statements we record our share of Discovery s net income or loss available to common shareholders and reflect this activity in one line item in our consolidated statement of operations as Share of earnings of Discovery. The following financial information of Discovery for the nine months ended September 30, 2006 and 2005 and related discussion is presented to provide the reader with additional analysis of the operating results and financial position of Discovery. Because we do not control the

decision-making process or business management practices of Discovery, we rely on Discovery to provide us with financial information prepared in accordance with GAAP that we use in the application of the equity method. The following discussion and analysis of Discovery s operations and financial position has been prepared based on information that we receive from Discovery and represents our views and understanding of its operating performance and financial position based on such information. Discovery is not a separately traded public company, and we do not have the ability to cause Discovery s management to prepare its own management s discussion and analysis for our purposes. Accordingly, we note that the material presented in this section might be different if Discovery s management had prepared it.

The following discussion of Discovery s results of operations is presented on a consolidated basis. In order to provide a better understanding of Discovery s operations, we have also included a summarized presentation of revenue and operating cash flow of Discovery s three operating groups: Discovery networks U.S., or U.S. networks, Discovery networks international, or international networks, and Discovery commerce, education and other.

The U.S. networks is Discovery s largest division, which owns and operates 12 cable and satellite channels and provides distribution and advertising sales services for BBC America and BBC World News. International networks manages a portfolio of channels, led by the Discovery Channel and Animal Planet brands, that are distributed in virtually every pay-television market in the world via an infrastructure that includes major operational centers in London, Singapore, New Delhi and Miami. Discovery commerce, education and other includes Discovery s retail chain store operations and other direct consumer marketing activities, as well as Discovery education, which was formed to manage Discovery s distribution of education content to schools and consumers.

Consolidated Results of Discovery

	Nine Months Ended September 30,	
	2006	**2005**
	amounts in thousands	
Revenue:		
Advertising	$ 887,627	875,565
Distribution	1,063,138	879,428
Other	163,779	145,556
Total revenue	2,114,544	1,900,549
Expenses:		
Cost of revenue	(744,063)	(659,861)
Selling, general and administrative (SG&A) expense	(842,575)	(737,843)
Operating cash flow	527,906	502,845
Expenses arising from long-term incentive plans	(10,561)	(18,786)
Depreciation and amortization	(95,051)	(90,579)
Operating income	422,294	393,480
Other income (expense):		
Interest expense, net	(149,806)	(130,212)

Unrealized gains from derivative instruments, net		11,562	16,018
Minority interests in consolidated subsidiaries		3,077	(23,754)
Other		6,622	17,124
Earnings before income taxes		293,749	272,656
Income tax expense		(126,610)	(129,770)
Net earnings	$	167,139	142,886

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Business Segment Results of Discovery

	Nine Months Ended September 30,	
	2006	2005
	amounts in thousands	
Revenue:		
U.S. networks	$ 1,409,671	1,299,389
International networks	623,148	520,040
Discovery commerce, education and other	81,725	81,120
Total revenue	$ 2,114,544	1,900,549
Operating Cash Flow:		
U.S. networks	$ 545,365	494,583
International networks	92,694	73,062
Discovery commerce, education and other	(110,153)	(64,800)
Total operating cash flow	$ 527,906	502,845

Note: Discovery commerce, education and other includes intercompany eliminations.

Revenue. Discovery s consolidated revenue increased 11% for the nine months ended September 30, 2006, as compared to the corresponding prior year period. Increased revenue was primarily due to a 21% increase in distribution revenue combined with a 13% increase in other revenue during the same period. Other revenue increased primarily due to acquisitions in Discovery s education and travel media businesses. Advertising revenue was relatively consistent as a 2% decline in the U.S. Networks advertising sales was offset by a 15%, or $24,523,000 increase in advertising sales internationally.

Distribution revenue grew 19% at the U.S. networks and 24% at the international networks. The increase in distribution revenue at the U.S. networks is due to a 13% increase in paying subscription units combined with contractual rate increases at most networks. Much of the growth in paying subscription units is occurring at networks that are carried on the digital tier due to the expiration of free viewing periods. Launch amortization at the U.S. networks was relatively consistent during the nine months ended September 30, 2006, increasing from $51,595,000 during the first nine months of 2005 to $52,341,000 in 2006. Increases in distribution revenue at the international networks were driven principally by a 16% increase in paying subscription units helped by growth in paying subscription units in Europe, Latin America and Asia of 23% on a combined basis. Many of Discovery s domestic networks are currently distributed to substantially all of the cable television and direct broadcast satellite homes in the U.S. Accordingly, the rate of growth in U.S. distribution revenue in future periods may be less than historical rates.

Advertising revenue, which includes revenue from paid programming, remained consistent primarily due to a 2% decrease at the U.S. Networks, offset by a 15% increase at the international networks. The increase in international networks advertising revenue was due primarily to higher viewership in Europe and Latin America combined with an increased subscriber base in most markets worldwide. The reduction in advertising revenue at the U.S. networks was

due primarily to lower advertising sell-out rates and industry-wide pricing pressure. Paid programming, where Discovery sells blocks of time primarily for infomercials that are aired during the overnight hours on certain networks, represented 6% of total advertising revenue for each of the nine month periods ended September 30, 2006 and 2005.

Included in other revenue is education revenue, which increased 33% or $7,579,000, and commerce revenue, which decreased 5% or $4,087,000.

Cost of Revenue. Cost of revenue increased 13% for the nine months ended September 30, 2006, as compared to the corresponding prior year period. As a percent of revenue, cost of revenue was consistent at 35% for both the nine months ended September 30, 2006 and 2005. The increase over the prior year period primarily resulted from higher programming expense due to continued investment across the U.S. networks combined with increases in Europe associated with the lifestyles initiative.

SG&A Expenses. SG&A expenses increased 14% for the nine months ended September 30, 2006, as compared to the corresponding prior year period. SG&A expenses were relatively consistent at the U.S. networks and within the commerce group, but increased 18% at the international networks and more than doubled ($39,182,000 increase) at the education group. As a percent of revenue, International SG&A expense was consistent at 43% for both the nine months ended September 30, 2006 and 2005. The expense increase at the international networks was caused by increases in personnel expense resulting from adding headcount as the business expands, particularly in the U.K. and Europe, combined with an increase in marketing expense associated with branding and awareness efforts, particularly in Europe, in association with the lifestyles category initiative. The increase at Discovery education is due to increases in personnel, overhead and marketing expenses to accommodate the growth of the business and drive awareness and demand for the new consumer homework help service, *Cosmeo.*

Expenses Arising from Long-term Incentive Plans. Expenses arising from long-term incentive plans are related to Discovery s unit-based, long-term incentive plan, or LTIP, for its employees who meet certain eligibility criteria. Units are awarded to eligible employees and generally vest at a rate of 25% per year. In August 2005, Discovery discontinued one of its LTIPs and settled all amounts with cash. Discovery established a new LTIP in October 2005 (the 2005 LTIP Plan) for certain eligible employees pursuant to which participants in Discovery s remaining plan could elect to (1) continue in such plan or (2) redeem vested units and convert partially vested units to the 2005 LTIP Plan. Substantially all participants in the remaining plan redeemed their vested units and received partially vested units in the 2005 LTIP Plan. Certain eligible employees were also granted new units in the 2005 LTIP Plan. The value of units in the 2005 LTIP Plan is indexed to the value of DHC Series A common stock, and upon redemption, participants receive a cash payment based on the change in market price of DHC Series A common stock. Under the old plans, upon exercise, participants received a cash payment for the increase in value of the units from the unit value on the date of issuance determined by the year over year change in Discovery s aggregate equity value, using a consistent methodology. The change in unit value of LTIP awards outstanding is recorded as compensation expense over the period outstanding. Compensation expense aggregated $10,561,000 for the nine months ended September 30, 2006 compared to $18,786,000 for the same period in 2005. The decrease is primarily the result of the change in unit value determination for the 2005 LTIP Plan units. If the remaining vested LTIP awards at September 30, 2006 were redeemed, the aggregate cash payments by Discovery would be approximately $9,072,000.

Depreciation and Amortization. The increase in depreciation and amortization for the nine months ended September 30, 2006 is due to an increase in new assets placed in service during 2005, combined with acquisition activity occurring during the first nine months of 2006.

Other Income and Expense

Interest Expense. The increase in interest expense for the nine months September 30, 2006 is primarily due to an increase in interest rates during 2005 and 2006 combined with an increase in the company s average debt balance.

Unrealized Gains from Derivative Instruments, net. Unrealized gains from derivative transactions relate primarily to Discovery s use of derivative instruments to modify its exposure to interest rate fluctuations on its debt. These instrument contracts include a combination of swaps, caps, collars and other structured instruments. As a result of unrealized mark to market adjustments, Discovery recognized $11,562,000 and $16,018,000 in unrealized gains on these instruments during the nine months ended September 30, 2006 and 2005, respectively. The foreign exchange hedging instruments used by Discovery are spot, forward and option contracts. Additionally, Discovery enters into non-designated forward contracts to hedge non-dollar denominated cash flows and foreign currency balances.

Minority Interests in Consolidated Subsidiaries. Minority interest represents increases and decreases in the estimated redemption value of mandatory redeemable interests in subsidiaries which are initially recorded at fair value.

Other. Other income in 2005 relates primarily to the gain on sale of one of Discovery s investments.

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Income Taxes. Discovery s effective tax rate was 43% and 48% for the nine months ended September 30, 2006 and 2005, respectively. Discovery s effective tax rate differed from the federal income tax rate of 35% primarily due to foreign and state taxes.

Liquidity and Capital Resources

Discovery generated $270,606,000 and used $29,103,000 of cash from operations during the nine months ended September 30, 2006 and 2005, respectively. Discovery s cash provided by operations during the nine months ended September 30, 2006 resulted from operating cash flow offset by interest expense of $149,806,000 and working capital fluctuations. Cash used in operations during the nine months ended September 30, 2005 resulted from operating cash flow offset by interest expense of $130,212,000, payments associated with the company s long-term incentive plan in the amount of $265,072,000 and working capital fluctuations.

During the nine months ended September 30, 2006, Discovery spent $40,109,000 on capital expenditures, paid $179,019,000 for business acquisitions net of the cash acquired, and paid $80,000,000 to acquire mandatorily redeemable securities related to minority interests in certain subsidiaries. Subsequent to September 30, 2006, Discovery paid $100,000,000 to acquire mandatorily redeemable securities. During the nine months ended September 30, 2005, Discovery paid $92,874,000 to acquire mandatorily redeemable securities related to minority interests in certain subsidiaries and spent $77,609,000 on capital expenditures.

In addition to cash provided by operations, Discovery funds its activities with proceeds borrowed under various debt facilities, including a term loan, two revolving loan facilities and various senior notes payable. During the nine months ended September 30, 2006 and 2005, net borrowings under debt facilities were $71,909,000 and $217,000,000 respectively. Total commitments of these facilities were $4,059,000,000 at September 30, 2006. Debt outstanding on these facilities aggregated $2,653,800,000 at September 30, 2006, providing excess debt availability of $1,405,200,000. Discovery s ability to borrow the unused capacity is dependent on its continuing compliance with its covenants at the time of, and after giving effect to, a requested borrowing.

All term and revolving loans and senior notes are unsecured. The debt facilities contain covenants that require Discovery to meet certain financial ratios and place restrictions on the payment of dividends, sale of assets, additional borrowings, mergers, and purchases of capital stock, assets and investments. Discovery has indicated it is in compliance with all debt covenants at September 30, 2006.

During 2006, including amounts discussed above, Discovery expects to spend up to $100,000,000 for capital expenditures and $200,000,000 for interest expense. Payments to satisfy LTIP obligations are not expected to be significant in 2006. Discovery believes that its cash flow from operations and borrowings available under its credit facilities will be sufficient to fund its working capital requirements.

Discovery has agreements covering leases of satellite transponders, facilities and equipment. These agreements expire at various dates through 2020. Discovery is obligated to license programming under agreements with content suppliers that expire over various dates. Discovery also has other contractual commitments arising in the ordinary course of business.

In connection with the execution of long-term distribution agreements for certain of its European cable networks, Discovery is committed to pay a distributor a percentage of the increase in the value of these networks, if any. Discovery has recorded a liability for the estimated value of these networks, excluding any value attributed to the potential renewal of the distribution agreements. The effect of such renewal, which is expected during the fourth quarter of 2006, would result in a payment significantly greater than the amount currently accrued.

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

Foreign Currency Risk

We continually monitor our economic exposure to changes in foreign exchange rates and may enter into foreign exchange agreements where and when appropriate. Substantially all of our foreign transactions are denominated in foreign currencies, including the liabilities of our foreign subsidiaries. Although our foreign transactions are not generally subject to significant foreign exchange transaction gains or losses, the financial statements of our foreign subsidiaries are translated into United States dollars as part of our consolidated financial reporting. As a result, fluctuations in exchange rates affect our financial position and results of operations.

Item 4. ***Controls and Procedures***

In accordance with Exchange Act Rules 13a-15 and 15d-15, the Company carried out an evaluation, under the supervision and with the participation of management, including its chief executive officer, principal ac