COLONY BANKCORP INC
Form 10-Q
November 02, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES

EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2018 COMMISSION FILE NUMBER 0-12436

COLONY BANKCORP, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

GEORGIA	58-1492391
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NUMBER)

115 SOUTH GRANT STREET, FITZGERALD, GEORGIA 31750

ADDRESS OF PRINCIPAL EXECUTIVE OFFICES

229/426-6000

REGISTRANT'S TELEPHONE NUMBER INCLUDING AREA CODE

INDICATE BY CHECK MARK WHETHER THE REGISTRANT (1) HAS FILED ALL REPORTS REQUIRED TO BE FILED BY SECTIONS 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 X NO

INDICATE BY CHECK MARK WHETHER THE REGISTRANT HAS SUBMITTED ELECTRONICALLY EVERY INTERACTIVE DATA FILE REQUIRED TO BE SUBMITTED PURSUANT TO RULE 405 OF REGULATION S-T (§232.405 OF THIS CHAPTER) DURING THE PRECEDING 12 MONTHS (OR FOR SUCH SHORTER PERIOD THAT THE REGISTRANT WAS REQUIRED TO SUBMIT AND POST SUCH FILES).

YES X NO

INDICATE BY CHECK MARK WHETHER THE REGISTRANT IS A LARGE ACCELERATED FILER, AN ACCELERATED FILER, A NON-ACCELERATED FILER, SMALLER REPORTING COMPANY, OR AN EMERGING GROWTH COMPANY. SEE THE DEFINITIONS OF “LARGE ACCELERATED FILER,” “ACCELERATED FILER,” “SMALLER REPORTING COMPANY,” AND “EMERGING GROWTH COMPANY” IN RULE 12b-2 OF THE EXCHANGE ACT.

LARGE ACCELERATED FILER
ACCELERATED FILER X
NON-ACCELERATED FILER (DO NOT CHECK IF A SMALLER REPORTING COMPANY)
SMALLER REPORTING COMPANY
EMERGING GROWTH COMPANY

IF AN EMERGING GROWTH COMPANY, INDICATE BY CHECK MARK IF THE REGISTRANT HAS ELECTED NOT TO USE THE EXTENDED TRANSITION PERIOD FOR COMPLYING WITH ANY NEW OR REVISED FINANCIAL ACCOUNTING STANDARDS PROVIDED PURSUANT TO SECTION 13(a) OF THE EXCHANGE ACT.

INDICATE BY CHECK MARK WHETHER THE REGISTRANT IS A SHELL COMPANY (AS DEFINED IN RULE 12B-2 OF THE EXCHANGE ACT).

YES NO X

INDICATE THE NUMBER OF SHARES OUTSTANDING OF EACH OF THE ISSUER'S CLASSES OF COMMON STOCK, AS OF THE LATEST PRACTICABLE DATE.

CLASS	OUTSTANDING AT NOVEMBER 2, 2018
COMMON STOCK, $1 PAR VALUE	8,444,908

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Forward Looking Statement Disclosure

Certain statements contained in this Quarterly Report that are not statements of historical fact constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (the Act), notwithstanding that such statements are not specifically identified. In addition, certain statements may be contained in the Company's future filings with the SEC, in press releases, and in oral and written statements made by or with the approval of the Company that are not statements of historical fact and constitute forward-looking statements within the meaning of the Act. Examples of forward-looking statements include, but are not limited to: (i) projections of revenues, income or loss, earnings or loss per share, the payment or nonpayment of dividends, capital structure and other financial items; (ii) statements of plans and objectives of Colony Bankcorp, Inc. or its management or Board of Directors, including those relating to products or services; (ii) statements of future economic performance; and (iv) statements of assumptions underlying such statements. Words such as "believes," "anticipates," "expects," "intends," "targeted and similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements.

Forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from those in such statements. Factors that could cause actual results to differ from those discussed in the forward-looking statements include, but are not limited to:

Local and regional economic conditions and the impact they may have on the Company and its customers and the Company's assessment of that impact.

Changes in estimates of future reserve requirements based upon the periodic review thereof under relevant regulatory and accounting requirements.

The effects of and changes in trade, monetary and fiscal policies and laws, including interest rate policies of the Federal Reserve Board.

Inflation, interest rate, market and monetary fluctuations.

Political instability.

Acts of war, terrorism or cyberterrorism.

The timely development and acceptance of new products and services and perceived overall value of these products and services by users.

Changes in consumer spending, borrowings and savings habits.

Technological changes.

Acquisitions and integration of acquired businesses.

The ability to increase market share and control expenses.

The effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) with which the Company and its subsidiary must comply.

The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters.

Changes in the Company’s organization, compensation and benefit plans.

The costs and effects of litigation and of unexpected or adverse outcomes in such litigation.

Greater than expected costs or difficulties related to the integration of new lines of business.

The Company’s success at managing the risks involved in the foregoing items.

Forward-looking statements speak only as of the date on which such statements are made. The Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made, or to reflect the occurrence of unanticipated events.

Readers should carefully review all disclosures we file from time to time with the Securities and Exchange Commission ("SEC").

PART 1. FINANCIAL INFORMATION

ITEM 1

FINANCIAL STATEMENTS

THE FOLLOWING FINANCIAL STATEMENTS ARE PROVIDED FOR COLONY BANKCORP, INC. AND ITS WHOLLY-OWNED SUBSIDIARY BANK, COLONY BANK

A. CONSOLIDATED BALANCE SHEETS – SEPTEMBER 30, 2018 (UNAUDITED) AND DECEMBER 31, 2017 (AUDITED).

B. CONSOLIDATED STATEMENTS OF INCOME – FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017 AND FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017 (UNAUDITED).

C. CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME – FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017 AND THE NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017 (UNAUDITED).

D. CONSOLIDATED STATEMENTS OF CASH FLOWS – FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017 (UNAUDITED).

THE CONSOLIDATED FINANCIAL STATEMENTS FURNISHED HAVE NOT BEEN AUDITED BY INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS, BUT REFLECT, IN THE OPINION OF MANAGEMENT, ALL ADJUSTMENTS (CONSISTING SOLELY OF NORMAL RECURRING ADJUSTMENTS) NECESSARY FOR A FAIR PRESENTATION OF THE RESULTS OF OPERATIONS FOR THE PERIODS PRESENTED.

THE RESULTS OF OPERATIONS FOR THE NINE MONTH PERIOD ENDED SEPTEMBER 30, 2018 ARE NOT NECESSARILY INDICATIVE OF THE RESULTS TO BE EXPECTED FOR THE FULL YEAR.

PART I (Continued)

Item 1 (Continued)

COLONY BANKCORP, INC. AND SUBSIDIARY CONSOLIDATED BALANCE SHEETS SEPTEMBER 30, 2018 AND DECEMBER 31, 2017 (DOLLARS IN THOUSANDS)

	September 30, 2018 (Unaudited)	December 31, 2017 (Audited)
ASSETS		
Cash and Cash Equivalents		
Cash and Due from Banks	**$ 10,149**	$ 23,145
Interest-Bearing Deposits	**21,764**	34,668
Investment Securities		
Available for Sale, at Fair Value	**318,032**	354,247
Federal Home Loan Bank Stock, at Cost	**3,594**	3,043
Loans	**779,443**	765,284
Allowance for Loan Losses	**(7,155)**	(7,508)
Unearned Interest and Fees	**(515)**	(495)
	771,773	757,281
Premises and Equipment	**27,744**	27,639
Other Real Estate (Net of Allowance of $815 and $1,451 as of September 30, 2018 and December 31, 2017, Respectively)	**2,173**	4,256
Other Intangible Assets	**18**	45
Other Assets	**30,949**	28,431
Total Assets	**$ 1,186,196**	$ 1,232,755

LIABILITIES AND STOCKHOLDERS' EQUITY
Deposits

Noninterest-Bearing	**$ 177,261**	$ 190,928
Interest-Bearing	**833,798**	877,057
	1,011,059	1,067,985
Borrowed Money		
Subordinated Debentures	**24,229**	24,229
Other Borrowed Money	**58,500**	47,500
	82,729	71,729
Other Liabilities	**3,420**	2,718
Stockholders' Equity		
Common Stock, Par Value $1 a Share; Authorized 20,000,000 Shares, Issued 8,444,908 and 8,439,258 Shares as of September 30, 2018 and December 31, 2017 respectively	**8,445**	8,439
Paid-In Capital	**25,970**	29,145
Retained Earnings	**66,916**	59,230
Accumulated Other Comprehensive (Loss), Net of Tax Benefits	**(12,343)**	(6,491)
	88,988	90,323
Total Liabilities and Stockholders' Equity	**$ 1,186,196**	$ 1,232,755

The accompanying notes are an integral part of these statements.

PART I (Continued)

Item 1 (Continued)

COLONY BANKCORP, INC. AND SUBSIDIARY CONSOLIDATED STATEMENTS OF INCOME THREE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017 AND NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017 (UNAUDITED) (DOLLARS IN THOUSANDS)

	Three Months Ended		**Nine Months Ended**	
	September 30, 2018	September 30, 2017	**September 30, 2018**	September 30, 2017
Interest Income				
Loans, Including Fees	**$10,255**	$9,754	**$30,048**	$28,884
Deposits with Other Banks	**48**	52	**192**	166
Investment Securities				
U.S. Government Agencies	**1,847**	1,684	**5,635**	4,932
State, County and Municipal	**25**	27	**77**	87
Corporate Debt	**27**	23	**84**	59
Dividends on Other Investments	**49**	38	**134**	109
	12,251	11,578	**36,170**	34,237
Interest Expense				
Deposits	**1,564**	1,191	**4,165**	3,559
Federal Funds Purchased	**3**	-	**4**	3
Borrowed Money	**579**	544	**1,602**	1,554
	2,146	1,735	**5,771**	5,116
Net Interest Income	**10,105**	9,843	**30,399**	29,121

Provision for Loan Losses	**61**	-	**131**	335
Net Interest Income After Provision for Loan Losses	**10,044**	9,843	**30,268**	28,786
Noninterest Income				
Service Charges on Deposits	**1,134**	1,169	**3,266**	3,315
Other Service Charges, Commissions and Fees	**803**	741	**2,414**	2,300
Mortgage Fee Income	**176**	241	**507**	629
Securities Gains (Losses)	**-**	-	**116**	-
Other	**292**	273	**860**	974
	2,405	2,424	**7,163**	7,218
Noninterest Expenses				
Salaries and Employee Benefits	**5,110**	4,802	**15,032**	14,467
Occupancy and Equipment	**1,052**	1,014	**3,077**	2,965
Other	**2,916**	2,564	**8,106**	7,976
	9,078	8,380	**26,215**	25,408
Income Before Income Taxes	**3,371**	3,887	**11,216**	10,596
Income Taxes	**676**	1,265	**2,264**	3,424
Net Income	**2,695**	2,622	**8,952**	7,172
Preferred Stock Dividends	**-**	-	**-**	211
Net Income Available to Common Stockholders	**$2,695**	$2,622	**$8,952**	$6,961
Net Income Per Share of Common Stock				
Basic	**$0.32**	$0.31	**$1.06**	$0.82
Diluted	**$0.32**	$0.30	**$1.04**	$0.81
Cash Dividends Paid Per Share of Common Stock	**$0.05**	$0.025	**$0.15**	$0.075
Weighted Average Basic Shares Outstanding	**8,439,415**	8,439,258	**8,439,310**	8,439,258
Weighted Average Diluted Shares Outstanding	**8,444,816**	8,629,523	**8,571,516**	8,631,566

The accompanying notes are an integral part of these statements.

PART I (Continued)

Item 1 (Continued)

COLONY BANKCORP, INC. AND SUBSIDIARY CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME THREE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017 AND NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017 (UNAUDITED) (DOLLARS IN THOUSANDS)

	Three Months Ended September 30, 2018	September 30, 2017	Nine Months Ended September 30, 2018	September 30, 2017
Net Income	**$2,695**	$ 2,622	**$8,952**	$ 7,172
Other Comprehensive Income:				
Gains (Losses) on Securities Arising During the Year	**(1,945)**	300	**(7,291)**	1,888
Tax Effect	**408**	(102)	**1,531**	(642)
Realized Gains on Sale of AFS Securities	**-**	-	**(116)**	-
Tax Effect	**-**	-	**24**	-
Change in Unrealized Gains (Losses) on Securities Available for Sale, Net of Reclassification Adjustment and Tax Effects	**(1,537)**	198	**(5,852)**	1,246
Comprehensive Income	**$1,158**	$ 2,820	**$3,100**	$ 8,418

The accompanying notes are an integral part of these statements.

PART I (Continued)

Item 1 (Continued)

COLONY BANKCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017
(UNAUDITED)
(DOLLARS IN THOUSANDS)

	Nine Months Ended	
	September 30, 2018	September 30, 2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Income	**$8,952**	$ 7,172
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Depreciation	**1,310**	1,240
Provision for Loan Losses	**131**	335
Securities (Gains)	**(116)**	-
Amortization and Accretion	**909**	1,077
(Gain) on Sale of Other Real Estate and Repossessions	**(168)**	(111)
Provision for Losses on Other Real Estate	**201**	256
Increase in Cash Surrender Value of Life Insurance	**(368)**	(404)
Loss on Sale of Premises & Equipment	**1**	(11)
Provision for Losses on Premises & Equipment	**170**	-
Other Prepaids, Deferrals and Accruals, Net	**813**	1,344
	11,835	10,898
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of Investment Securities Available for Sale	**(20,893)**	(54,448)
Proceeds from Maturities, Calls, and Paydowns of Investment Securities:		
Available for Sale	**37,667**	40,698
Proceeds from Sale of Investment Securities Available for Sale	**11,268**	-

Interest-Bearing Deposits in Other Banks	**12,904**	33,593
Net Loans to Customers	**(15,380)**	(18,360)
Purchase of Premises and Equipment	**(2,256)**	(913)
Proceeds from Sale of Other Real Estate and Repossessions	**2,769**	3,168
Federal Home Loan Bank Stock	**(551)**	(245)
Proceeds from Sale of Premises and Equipment	**8**	38
	25,536	3,531
CASH FLOWS FROM FINANCING ACTIVITIES		
Noninterest-Bearing Customer Deposits	**(13,667)**	3,647
Interest-Bearing Customer Deposits	**(43,259)**	(27,741)
Dividends Paid for Preferred Stock	**-**	(316)
Dividends Paid for Common Stock	**(1,266)**	(633)
Redemption of Preferred Stock	**-**	(9,360)
Repurchase of Warrants	**(3,175)**	-
Payments on Federal Home Loan Bank Advances	**(26,500)**	-
Proceeds from Federal Home Loan Bank Advances	**39,000**	5,000
Payments on Other Borrowed Money	**(1,507)**	(16)
Proceeds from Other Borrowed Money	**7**	5,016
	(50,367)	(24,403)
Net Decrease in Cash and Cash Equivalents	**(12,996)**	(9,974)
Cash and Cash Equivalents at Beginning of Period	**23,145**	28,822
Cash and Cash Equivalents at End of Period	**$10,149**	$ 18,848

The accompanying notes are an integral part of these statements.

PART I (Continued)

Item 1 (Continued)

COLONY BANKCORP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Summary of Significant Accounting Policies

Presentation

Colony Bankcorp, Inc. (the "Company") is a bank holding company located in Fitzgerald, Georgia. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Colony Bank, Fitzgerald, Georgia (the "Bank"). All significant intercompany accounts have been eliminated in consolidation. The accounting and reporting policies of the Company conform to generally accepted accounting principles and practices utilized in the commercial banking industry.

All dollars in notes to consolidated financial statements are rounded to the nearest thousand, except for per share amounts.

The consolidated financial statements in this report are unaudited, except for the December 31, 2017 consolidated balance sheet. All adjustments consisting of normal recurring accruals which are, in the opinion of management, necessary for fair presentation of the interim consolidated financial statements, have been included and fairly and accurately present the financial position, results of operations and cash flows of the Company. The results of operations for the nine months ended September 30, 2018 are not necessarily indicative of the results which may be expected for the entire year.

Nature of Operations

The Bank provides a full range of retail and commercial banking services for consumers and small- to medium-size businesses located primarily in central, south and coastal Georgia. The Bank is headquartered in Fitzgerald, Georgia with banking offices in Albany, Ashburn, Broxton, Centerville, Columbus, Cordele, Douglas, Eastman, Fitzgerald, Leesburg, Moultrie, Quitman, Rochelle, Savannah, Soperton, Sylvester, Statesboro, Thomaston, Tifton, Valdosta and Warner Robins. Lending and investing activities are funded primarily by deposits gathered through its retail banking office network.

Use of Estimates

In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the balance sheet date and revenues and expenses for the period. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans.

Reclassifications

In certain instances, amounts reported in prior years' consolidated financial statements have been reclassified to conform to statement presentations selected for 2018. Such reclassifications have not affected previously reported stockholders' equity or net income.

Concentrations of Credit Risk

Concentrations of credit risk can exist in relation to individual borrowers or groups of borrowers, certain types of collateral, certain types of industries, or certain geographic regions. The Company has a concentration in real estate loans as well as a geographic concentration that could pose an adverse credit risk. At September 30, 2018, approximately 87 percent of the Company's loan portfolio was concentrated in loans secured by real estate. A substantial portion of borrowers' ability to honor their contractual obligations is dependent upon the viability of the real estate economic sector. Collateral real estate values that secure land development, construction and speculative real estate loans in the Company's larger Metropolitan Statistical Area (MSA) markets have started showing signs of stabilization in values in recent years. In addition, a large portion of the Company's foreclosed assets are also located in these same geographic markets, making the recovery of the carrying amount of foreclosed assets susceptible to changes in market conditions. Management continues to monitor these concentrations and has considered these concentrations in its allowance for loan loss analysis.

PART I (Continued)

Item 1 (Continued)

(1) Summary of Significant Accounting Policies (Continued)

Concentrations of Credit Risk (Continued)

The success of the Company is dependent, to a certain extent, upon the economic conditions in the geographic markets it serves. Adverse changes in the economic conditions in these geographic markets would likely have a material adverse effect on the Company’s results of operations and financial condition. The operating results of the Company depend primarily on its net interest income. Accordingly, operations are subject to risks and uncertainties surrounding the exposure to changes in the interest rate environment.

At times, the Company may have cash and cash equivalents at financial institutions in excess of federal deposit insurance limits. The Company places its cash and cash equivalents with high credit quality financial institutions whose credit ratings are monitored by management to minimize credit risk.

Investment Securities

The Company classifies its investment securities as trading, available for sale or held to maturity. Securities that are held principally for resale in the near term are classified as trading. Trading securities are carried at fair value, with realized and unrealized gains and losses included in noninterest income. Currently, no securities are classified as trading. Securities acquired with both the intent and ability to be held to maturity are classified as held to maturity and reported at amortized cost. All securities not classified as trading or held to maturity are considered available for sale. Securities available for sale are reported at estimated fair value. Unrealized gains and losses on securities available for sale are excluded from earnings and are reported, net of deferred taxes, in accumulated other comprehensive income (loss), a component of stockholders’ equity. Gains and losses from sales of securities available for sale are computed using the specific identification method. Securities available for sale includes securities which may be sold to meet liquidity needs arising from unanticipated deposit and loan fluctuations, changes in regulatory capital requirements, or unforeseen changes in market conditions.

The Company evaluates each investment security held to maturity and available for sale security in a loss position for other-than-temporary impairment (OTTI). In estimating other-than-temporary impairment losses, management considers such factors as the length of time and the extent to which the market value has been below cost, the financial condition of the issuer and the Company's intent to sell and whether it is more likely than not that the Company will be required to sell the security before anticipated recovery of the amortized cost basis. If the Company intends to sell or if it is more likely than not that the Company will be required to sell the security before recovery, the OTTI write-down is recognized in earnings. If the Company does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the OTTI write-down is separated into an amount representing credit loss, which is recognized in earnings and an amount related to all other factors, which is recognized in other comprehensive income (loss).

Federal Home Loan Bank Stock

Investment in stock of a Federal Home Loan Bank (FHLB) is required for every federally insured institution that utilizes its services. FHLB stock is considered restricted, as defined in the accounting standards. The FHLB stock is reported in the consolidated financial statements at cost. Dividend income is recognized when earned.

Loans

Loans that the Company has the ability and intent to hold for the foreseeable future or until maturity are recorded at their principal amount outstanding, net of unearned interest and fees. Loan origination fees, net of certain direct origination costs, are deferred and amortized over the estimated terms of the loans using the straight-line method. Interest income on loans is recognized using the effective interest method.

A loan is considered to be delinquent when payments have not been made according to contractual terms, typically evidenced by nonpayment of a monthly installment by the due date.

When management believes there is sufficient doubt as to the collectability of principal or interest on any loan or generally when loans are 90 days or more past due, the accrual of applicable interest is discontinued and the loan is designated as nonaccrual, unless the loan is well secured and in the process of collection. Interest payments received on nonaccrual loans are either applied against principal or reported as income, according to management's judgment as to the collectability of principal. Loans are returned to an accrual status when factors indicating doubtful collectability on a timely basis no longer exist.

PART I (Continued)

Item 1 (Continued)

(1) Summary of Significant Accounting Policies (Continued)

Loans Modified in a Troubled Debt Restructuring ("TDR")

Loans are considered to have been modified in a TDR when, due to a borrower's financial difficulty, the Company makes certain concessions to the borrower that it would not otherwise consider for new debt with similar risk characteristics. Modifications may include interest rate reductions, principal or interest forgiveness, forbearance, and other actions intended to minimize economic loss and to avoid foreclosure or repossession of the collateral. Generally, a non-accrual loan that has been modified in a TDR remains on non-accrual status for a period of 6 months to demonstrate that the borrower is able to meet the terms of the modified loan. However, performance prior to the modification, or significant events that coincide with the modification, are included in assessing whether the borrower can meet the new terms and may result in the loan being returned to accrual status at the time of loan modification or after a shorter performance period. If the borrower's ability to meet the revised payment schedule is uncertain, the loan remains on non-accrual status. Once a loan is modified in a troubled debt restructuring it is accounted for as an impaired loan, regardless of its accrual status, until the loan is paid in full, sold or charged off. A TDR may cease being classified as impaired if the loan is subsequently modified at market terms and, has performed according to the modified terms for at least six months, and there has not been any prior principal forgiveness on a cumulative basis.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the inability to collect a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revisions as more information becomes available.

The allowance consists of specific, historical and general components. The specific component relates to loans that are classified as either doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan are lower than the carrying value of that loan. The historical component covers nonclassified loans and is based on historical loss experience adjusted for qualitative factors. A general component is maintained to cover uncertainties that could affect management’s estimate of probable losses. The general component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and historical losses in the portfolio. General valuation allowances are based on internal and external qualitative risk factors such as (1) changes in lending policies and procedures, including changes in underwriting standards and collections, charge offs, and recovery practices, (2) changes in international, national, regional, and local conditions, (3) changes in the nature and volume of the portfolio and terms of loans, (4) changes in the experience, depth, and ability of lending management, (5) changes in the volume and severity of past due loans and other similar conditions, (6) changes in the quality of the organization's loan review system, (7) changes in the value of underlying collateral for collateral dependent loans, (8) the existence and effect of any concentrations of credit and changes in the levels of such concentrations, and (9) the effect of other external factors (i.e. competition, legal and regulatory requirements) on the level of estimated credit losses.

Loans identified as losses by management, internal loan review and/or regulatory agencies are charged off.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower’s prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan’s effective interest rate, the loan’s obtainable market price or the fair value of the collateral if the loan is collateral dependent.

PART I (Continued)

Item 1 (Continued)

(1) Summary of Significant Accounting Policies (Continued)

Allowance for Loan Losses (Continued)

A significant portion of the Company’s impaired loans are deemed to be collateral dependent. Management therefore measures impairment on these loans based on the fair value of the collateral. Collateral values are determined based on appraisals performed by qualified licensed appraisers hired by the Company or by senior members of the Company’s credit administration staff. The decision whether or not to obtain an external third-party appraisal usually depends on the type of property being evaluated. External appraisals are usually obtained on more complex, income producing properties such as hotels, shopping centers and businesses. Less complex properties such as residential lots, farm land and single family houses may be evaluated internally by senior credit administration staff. When the Company does obtain appraisals from external third-parties, the values utilized in the impairment calculation are “as is” or current market values. The appraisals, whether prepared internally or externally, may utilize a single valuation approach or a combination of approaches including the comparable sales, income and cost approach. Appraised amounts used in the impairment calculation are typically discounted 10 percent to account for selling and marketing costs, if the repayment of the loan is to come from the sale of the collateral. Although appraisals are not obtained each year on all impaired loans, the collateral values used in the impairment calculations are evaluated quarterly by management. Based on management’s knowledge of the collateral and the current real estate market conditions, appraised values may be further discounted to reflect facts and circumstances known to management since the most recent appraisal was performed.

Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in a level 3 classification of the inputs for determining fair value. Because of the high degree of judgment required in estimating the fair value of collateral underlying impaired loans and because of the relationship between fair value and general economic conditions, we consider the fair value of impaired loans to be highly sensitive to changes in market conditions.

Premises and Equipment

Premises and equipment are recorded at acquisition cost net of accumulated depreciation.

Depreciation is charged to operations over the estimated useful lives of the assets. The estimated useful lives and methods of depreciation are as follows:

Description	Life in Years	Method
Banking Premises	15-40	Straight-Line and Accelerated
Furniture and Equipment	5 -10	Straight-Line and Accelerated

Expenditures for major renewals and betterments are capitalized. Maintenance and repairs are charged to operations as incurred. When property and equipment are retired or sold, the cost and accumulated depreciation are removed from the respective accounts and any gain or loss is reflected in other income or expense.

Intangible Assets

Intangible assets consist of core deposit intangibles acquired in connection with a business combination. The core deposit intangible is initially recognized based on a valuation performed as of the consummation date. The core deposit intangible is amortized by the straight-line method over the average remaining life of the acquired customer deposits.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

PART I (Continued)

Item 1 (Continued)

(1) Summary of Significant Accounting Policies (Continued)

Statement of Cash Flows

For reporting cash flows, cash and cash equivalents include cash on hand, noninterest-bearing amounts due from banks and federal funds sold. Cash flows from demand deposits, interest-bearing checking accounts, savings accounts, loans and certificates of deposit are reported net.

Advertising Costs

The Company expenses the cost of advertising in the periods in which those costs are incurred.

Income Taxes

The provision for income taxes is based upon income for financial statement purposes, adjusted for nontaxable income and nondeductible expenses. Deferred income taxes have been provided when different accounting methods have been used in determining income for income tax purposes and for financial reporting purposes.

Deferred tax assets and liabilities are recognized based on future tax consequences attributable to differences arising from the financial statement carrying values of assets and liabilities and their tax bases. The differences relate primarily to depreciable assets (use of different depreciation methods for financial statement and income tax purposes) and allowance for loan losses (use of the allowance method for financial statement purposes and the direct write-off method for tax purposes). In the event of changes in the tax laws, deferred tax assets and liabilities are adjusted in the period of the enactment of those changes, with effects included in the income tax provision. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The Company and its subsidiary file a consolidated federal income tax return. The subsidiary pays its proportional share of federal income taxes to the Company based on its taxable income.

Positions taken in the Company's tax returns may be subject to challenge by the taxing authorities upon examination. Uncertain tax positions are initially recognized in the consolidated financial statements when it is more likely than not the position will be sustained upon examination by the tax authorities. Such tax positions are both initially and subsequently measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon settlement with the tax authority, assuming full knowledge of the position and all relevant facts. The Company provides for interest and, in some cases, penalties on tax positions that may be challenged by the taxing authorities. Interest expense is recognized beginning in the first period that such interest would begin accruing. Penalties are recognized in the period that the Company claims the position in the tax return. Interest and penalties on income tax uncertainties are classified within income tax expense in the consolidated statement of income.

Other Real Estate

Other real estate generally represents real estate acquired through foreclosure and is initially recorded at estimated fair value at the date of acquisition less the cost of disposal. Losses from the acquisition of property in full or partial satisfaction of debt are recorded as loan losses. Properties are evaluated regularly to ensure the recorded amounts are supported by current fair values, and valuation allowances are recorded as necessary to reduce the carrying amount to fair value less estimated cost of disposal. Routine holding costs and gains or losses upon disposition are included in other noninterest expense.

Bank-Owned Life Insurance

The Company has purchased life insurance on the lives of certain key members of management and directors. The life insurance policies are recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or amounts due that are probable at settlement, if applicable. Increases in the cash surrender value are recorded as other income in the consolidated statements of income. The cash surrender value of the insurance contracts is recorded in other assets on the consolidated balance sheets in the amount of $17,457 and $17,089 as of September 30, 2018 and December 31, 2017, respectively.

PART I (Continued)

Item 1 (Continued)

(1) Summary of Significant Accounting Policies (Continued)

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on securities available for sale, represent equity changes from economic events of the period other than transactions with owners and are not reported in the consolidated statements of income but as a separate component of the equity section of the consolidated balance sheets. Such items are considered components of other comprehensive income (loss). Accounting standards codification requires the presentation in the consolidated financial statements of net income and all items of other comprehensive income (loss) as total comprehensive income (loss).

Off-Balance Sheet Credit Related Financial Instruments

In the ordinary course of business, the Company has entered into commitments to extend credit, commercial letters of credit and standby letters of credit. Such financial instruments are recorded when they are funded.

Changes in Accounting Principles and Effects of New Accounting Pronouncements

ASU 2014-09, *Revenue from Contracts with Customers (Topic 606).* On January 1, 2018, the Company adopted ASU 2014-09 and all subsequent amendments to the ASU and ASC 606 which (1) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (2) revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as other real estate owned. The majority of the Company's revenues came from interest income and other sources, including loans and investment securities, that are outside the scope of ASC 606. With the exception of gain/losses on the sale of other real estate owned, the Company's services that fall within the scope of ASC 606 are presented within noninterest income and are recognized as revenue as the Company satisfies its obligations to the customer. Services within the scope of ASC 606 reported in noninterest income include service charges on deposit accounts, debit card interchange fees, and ATM fees. The net of gains and losses on the sale of other real estate owned are recorded in other noninterest expenses in the Company's consolidated statements of income. The adoption of ASC 606 did not change the timing or amount of revenue recognized for the

Company. Accordingly, no cumulative effect adjustment was recorded under the modified retrospective transition method. See Note 15 for further discussion on the Company's accounting policies for revenue source within the scope of ASC 606.

ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.* ASU 2016-01, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (viii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale. ASU 2016-01 is effective for the Company on January 1, 2018. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

ASU 2016-02, *Leases (Topic 842).* This ASU requires lessees to put most leases on their balance sheets but recognize expenses in the income statement in a manner similar to current accounting treatment. This ASU changes the guidance on sale-leaseback transactions, initial direct costs and lease execution costs, and, for lessors, modifies the classification criteria and the accounting for sales-type and direct financing leases. For public business entities, this ASU is effective for annual periods beginning after December 15, 2018, and interim periods therein. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. The Company is evaluating the impact of this ASU on its financial statements and disclosures.

PART I (Continued)

Item 1 (Continued)

(1) Summary of Significant Accounting Policies (Continued)

Changes in Accounting Principles and Effects of New Accounting Pronouncements (Continued)

ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326).* This ASU sets forth a "current expected credit loss" (CECL) model which requires the Company to measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions and reasonable supported forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost and applies to some off-balance sheet credit exposures. This ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company is currently assessing the impact of the adoption of this ASU on its consolidated financial statements.

ASU 2016-15, *Statement of Cash Flows (Topic 230) - Classification of Certain Cash Receipts and Cash Payments.* ASU 2016-15 provides guidance related to certain cash flow issues in order to reduce the current and potential future diversity in practice. ASU 2016-15 is effective for us on January 1, 2018 and did not have a significant impact on our financial statements.

ASU 2017-08, *Premium Amortization on Purchased Callable Debt Securities.* This ASU shortens the amortization period for the premium on certain purchased callable debt securities to the earliest call date. Today, entities generally amortize the premium over the contractual life of the security. The new guidance does not change the accounting for purchased callable debt securities held at a discount; the discount continues to be amortized to maturity. ASU No. 2017-08 is effective for interim and annual reporting periods beginning after December 15, 2018; early adoption is permitted. The guidance calls for a modified retrospective transition approach under which a cumulative-effect adjustment will be made to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. The Company is currently evaluating the provisions of ASU No. 2017-08 to determine the potential impact the new standard will have on the Company's Consolidated Financial Statements.

ASU 2018-02, *Income Statement – Reporting Comprehensive Income (Topic 220). Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.* This ASU allows an entity to elect a reclassification from accumulated other comprehensive income (AOCI) to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act (TCJ Act). ASU 2018-02 is effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption permitted. The Company elected to early adopt the provisions of ASU 2018-02 in the fourth quarter of 2017 and, as a result, reclassified $1.1 million from AOCI to retained earnings as of December 31, 2017.

ASU 2018-13, *Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement (Topic 820).* This ASU modifies the disclosure requirements on fair value measurements. ASU 2018-13 is effective for interim and annual reporting periods after December 15, 2019; early adoption is permitted. The Company is currently evaluating the provisions of ASU 2018-13 to determine the potential impact the new standard will have on the Company's Consolidated Financial Statements.

PART I (Continued)

Item 1 (Continued)

(2) Investment Securities

Investment securities as of September 30, 2018 and December 31, 2017 are summarized as follows:

September 30, 2018	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Securities Available for Sale:				
U. S. Government Agencies Mortgage-Backed	**$ 326,676**	**$ 52**	**$ (15,550)**	**$ 311,178**
State, County & Municipal	**4,024**	**4**	**(56)**	**3,972**
Corporate Bonds	**2,956**	**-**	**(74)**	**2,882**
	$ 333,656	**$ 56**	**$ (15,680)**	**$ 318,032**

December 31, 2017	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Securities Available for Sale:				
U. S. Government Agencies Mortgage-Backed	$ 354,931	$ 258	$ (8,466)	$ 346,723
State, County & Municipal	4,493	23	(23)	4,493
Corporate Bonds	2,048	12	-	2,060
Asset-Backed	993	-	(22)	971
	$ 362,465	$ 293	$ (8,511)	$ 354,247

The amortized cost and fair value of investment securities as of September 30, 2018, by contractual maturity, are shown hereafter. Expected maturities may differ from contractual maturities for certain investments because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. This is often the case with mortgage-backed securities, which are disclosed separately in the table below.

Securities

	Available for Sale	
	Amortized Cost	Fair Value
Due In One Year or Less	**$358**	**$356**
Due After One Year Through Five Years	**4,311**	**4,232**
Due After Five Years Through Ten Years	**1,134**	**1,136**
Due After Ten Years	**1,177**	**1,130**
	$6,980	**$6,854**
Mortgage-Backed Securities	**326,676**	**311,178**
	$333,656	**$318,032**

Proceeds from the sale of investments available for sale totaled $11,268 for the first nine months of 2018. The sale of investments available for sale during the first nine months of 2018 resulted in gross realized gains of $116 and losses of $0. The Bank did not sell any investments during the first nine months of 2017. Therefore the Bank did not have any proceeds, gains or losses during the first nine months of 2017.

Investment securities having a carrying value approximating $126,869 and $175,484 as of September 30, 2018 and December 31, 2017, respectively, were pledged to secure public deposits and for other purposes.

PART I (Continued)

Item 1 (Continued)

(2) Investment Securities (Continued)

Information pertaining to securities with gross unrealized losses at September 30, 2018 and December 31, 2017 aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	Less Than 12 Months		**12 Months or Greater**		**Total**	
	Fair Value	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**
September 30, 2018						
U. S. Government Agencies Mortgage-Backed	**$96,095**	**$ (3,370)**	**$209,451**	**$ (12,180)**	**$305,546**	**$ (15,550)**
State, County and Municipal	**2,498**	**(21)**	**1,258**	**(35)**	**3,756**	**(56)**
Corporate Bonds	**2,000**	**(35)**	**882**	**(39)**	**2,882**	**(74)**
	$100,593	**$ (3,426)**	**$211,591**	**$ (12,254)**	**$312,184**	**$ (15,680)**
December 31. 2017						
U.S. Government Agencies Mortgage-Backed	$120,139	$ (1,655)	$190,196	$ (6,811)	$310,335	$ (8,466)
State, County and Municipal	2,598	(23)	-	-	2,598	(23)
Asset-Backed	971	(22)	-	-	971	(22)
	$123,708	$ (1,700)	$190,196	$ (6,811)	$313,904	$ (8,511)

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

At September 30, 2018, 151 securities have unrealized losses which have depreciated 4.78 percent from the Company's amortized cost basis. These securities are guaranteed by either the U.S. Government, other governments or

U.S. corporations. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred and the results of reviews of the issuer's financial condition. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. As management has the ability to hold debt securities until maturity, or for the foreseeable future if classified as available-for-sale, no declines are deemed to be other than temporary.

PART I (Continued)

Item 1 (Continued)

(3) Loans

The following table presents the composition of loans segregated by class of loans, as of September 30, 2018 and December 31, 2017.

	September 30, 2018	December 31, 2017
Commercial and Agricultural		
Commercial	**$ 47,292**	$ 48,122
Agricultural	**21,415**	16,443
Real Estate		
Commercial Construction	**53,570**	45,214
Residential Construction	**12,897**	8,583
Commercial	**349,408**	351,172
Residential	**189,153**	194,049
Farmland	**70,069**	67,768
Consumer and Other		
Consumer	**18,623**	18,956
Other	**17,016**	14,977
Total Loans	**$ 779,443**	$ 765,284

Commercial and industrial loans are extended to a diverse group of businesses within the Company's market area. These loans are often underwritten based on the borrower's ability to service the debt from income from the business. Real estate construction loans often require loan funds to be advanced prior to completion of the project. Due to uncertainties inherent in estimating construction costs, changes in interest rates and other economic conditions, these loans often pose a higher risk than other types of loans. Consumer loans are originated at the Bank level. These loans are generally smaller loan amounts spread across many individual borrowers to help minimize risk.

Credit Quality Indicators. As part of the ongoing monitoring of the credit quality of the loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grade assigned to commercial and consumer loans, (ii) the level of classified commercial loans, (iii) net charge-offs, (iv) nonperforming loans, and (v) the general economic conditions in the Company’s geographic markets.

PART I (Continued)

Item 1 (Continued)

The Company uses a risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 1 to 8. A description of the general characteristics of the grades is as follows:

(3) Loans (Continued)

Grades 1 and 2 – Borrowers with these assigned grades range in risk from virtual absence of risk to minimal risk. Such loans may be secured by Company-issued and controlled certificates of deposit or properly-margined equity securities or bonds. Other loans comprising these grades are made to companies that have been in existence for a long period of time with many years of consecutive profits and strong equity, good liquidity, excellent debt service ability and unblemished past performance, or to exceptionally strong individuals with collateral of unquestioned value that fully secures the loans. Loans in this category fall into the “pass” classification.

Grades 3 and 4 – Loans assigned these “pass” risk grades are made to borrowers with acceptable credit quality and risk. The risk ranges from loans with no significant weaknesses in repayment capacity and collateral protection to acceptable loans with one or more risk factors considered to be more than average.

Grade 5 – This grade includes “special mention” loans on management’s watch list and is intended to be used on a temporary basis for pass grade loans where risk-modifying action is intended in the short-term.

Grade 6 – This grade includes “substandard” loans in accordance with regulatory guidelines. This category includes borrowers with well-defined weaknesses that jeopardize the payment of the debt in accordance with the agreed terms. Loans considered to be impaired are assigned this grade, and these loans often have assigned loss allocations as part of the allowance for loan and lease losses. Generally, loans on which interest accrual has been stopped would be included in this grade.

Grades 7 and 8 – These grades correspond to regulatory classification definitions of “doubtful” and “loss,” respectively. In practice, any loan with these grades would be for a very short period of time, and generally the Company has no loans with these assigned grades. Management manages the Company’s problem loans in such a way that uncollectible loans or uncollectible portions of loans are charged off immediately with any residual, collectible amounts assigned a risk grade of 6.

The following table presents the loan portfolio by credit quality indicator (risk grade) as of September 30, 2018 and December 31, 2017. Those loans with a risk grade of 1, 2, 3 or 4 have been combined in the pass column for presentation purposes. For the period ending September 30, 2018, the Company did not have any loans classified as “doubtful” or a “loss”.

September 30, 2018

	Pass	Special Mention	Substandard	Total Loans
Commercial and Agricultural				
Commercial	$45,612	$ 847	$ 833	$47,292
Agricultural	20,026	919	470	21,415
Real Estate				
Commercial Construction	52,181	631	758	53,570
Residential Construction	12,897	-	-	12,897
Commercial	335,844	7,000	6,564	349,408
Residential	173,987	4,543	10,623	189,153
Farmland	66,002	2,002	2,065	70,069
Consumer and Other				
Consumer	18,239	38	346	18,623
Other	17,010	6	-	17,016
Total Loans	$741,798	$ 15,986	$ 21,659	$779,443

PART I (Continued)

Item 1 (Continued)

(3) Loans (Continued)

December 31, 2017

	Pass	**Special Mention**	**Substandard**	**Total Loans**
Commercial and Agricultural				
Commercial	$46,469	$ 825	$ 828	$48,122
Agricultural	15,868	175	400	16,443
Real Estate				
Commercial Construction	41,282	578	3,354	45,214
Residential Construction	8,583	-	-	8,583
Commercial	338,776	7,663	4,733	351,172
Residential	177,963	4,865	11,221	194,049
Farmland	66,335	444	989	67,768
Consumer and Other				
Consumer	18,496	53	407	18,956
Other	14,969	8	-	14,977
Total Loans	$728,741	$ 14,611	$ 21,932	$765,284

A loan’s risk grade is assigned at the inception of the loan and is based on the financial strength of the borrower and the type of collateral. Loan risk grades are subject to reassessment at various times throughout the year as part of the Company’s ongoing loan review process. Loans with an assigned risk grade of 6 or below and an outstanding balance of $250,000 or more are reassessed on a quarterly basis. During this reassessment process individual reserves may be identified and placed against certain loans which are not considered impaired.

In assessing the overall economic condition of the markets in which it operates, the Company monitors the unemployment rates for its major service areas. The unemployment rates are reviewed on a quarterly basis as part of the allowance for loan loss determination.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Generally, loans are placed on nonaccrual status if principal or interest payments become 90 days past due or when, in management’s opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provision. Loans may be placed on nonaccrual status regardless of whether or not such loans are considered past due.

PART I (Continued)

Item 1 (Continued)

(3) Loans (Continued)

The following table represents an age analysis of past due loans and nonaccrual loans, segregated by class of loans, as of September 30, 2018 and December 31, 2017:

September 30, 2018

	Accruing Loans					
	30-89 Days Past Due	**90 Days or More Past Due**	**Total Accruing Loans Past Due**	**Nonaccrual Loans**	**Current Loans**	**Total Loans**
Commercial and Agricultural						
Commercial	**$376**	**$ -**	**$ 376**	**$471**	**$46,445**	**$47,292**
Agricultural	**65**	**-**	**65**			

The certificates of deposit and credit facilities represent our estimated debt service obligations, including both principle and interest. Interest was based on the interest rates in effect as of December 31, 2006, applied to the contractual repayment period.

(3) Purchase obligations include purchase commitments under our AIR MILES Reward Program, minimum payments under support and maintenance contracts and agreements to purchase other goods and services.

We believe that we will have access to sufficient resources to meet these commitments.

Economic Fluctuations

Although we cannot precisely determine the impact of inflation on our operations, we do not believe that we have been significantly affected by inflation. For the most part, we have relied on operating efficiencies from scale and technology, as well as decreases in technology and communication costs, to offset increased costs of employee compensation and other operating expenses.

Portions of our business are seasonal. Our revenues and earnings are favorably affected by increased consumer spending patterns leading up to and including holiday shopping period in the fourth quarter and, to a lesser extent, during the first quarter as credit card balances are paid down.

Regulatory Matters

World Financial Network National Bank is subject to various regulatory capital requirements administered by the Office of the Comptroller of the Currency, or OCC. World Financial Capital Bank is subject to regulatory capital requirements administered by both the Federal Deposit Insurance Corporation, or FDIC, and the State of Utah. Failure to meet minimum capital requirements can trigger certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a material adverse effect on our financial statements. Under the FDIC s order approving World Financial Capital Bank s application for deposit insurance, World Financial Capital Bank must meet specific capital ratios and paid-in capital minimums and must maintain adequate allowances for loan losses. If World Financial Capital Bank fails to meet the terms of the FDIC s order, the FDIC may withdraw insurance coverage from World Financial Capital Bank, and the State of Utah may withdraw its approval of World Financial Capital Bank. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, World Financial Network National Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. World Financial Network National Bank is limited in the amounts that it can dividend to us.

Quantitative measures established by regulations to ensure capital adequacy require World Financial Network National Bank to maintain minimum amounts and ratios of total and Tier 1 capital to risk weighted assets and of Tier 1 capital to average assets. Under the regulations, a well capitalized institution must have a Tier 1 capital ratio of at least 6%, a total capital ratio of at least 10% and a leverage ratio of at least 5% and not be subject to a capital directive order. An adequately capitalized institution must have a Tier 1 capital ratio of at least 4%, a total capital ratio of at least 8% and a leverage ratio of at least 4%, but 3% is allowed in some cases. Under these guidelines, World Financial Network National Bank is considered well capitalized. As of December 31, 2006, World Financial Network National Bank s Tier 1 capital ratio was 37.3%, total capital ratio was 39.1% and leverage ratio was 59.1%, and World Financial Network National Bank was not subject to a capital directive order. On April 22, 2005, World Financial Capital Bank received non-disapproval notification for a modification of the original three-year business plan. The letter of non-disapproval was issued jointly by the State of Utah and the FDIC. World Financial Capital Bank, under the terms of the letter, must maintain Total Risk-Based Capital equal to or exceeding 10% of total risk-based assets and must maintain Tier 1 capital to total assets ratio of not less than 16%. Both capital ratios were maintained at or above the indicated levels until the end of the bank s de novo period on November 30, 2006.

As part of an acquisition in 2003 by World Financial Network National Bank, which required approval by the OCC, the OCC required World Financial Network National Bank to enter into an operating agreement with the OCC and a capital adequacy and liquidity maintenance agreement with us. The operating agreement requires World Financial Network National Bank to continue to operate in a manner consistent with its current practices, regulatory guidelines and applicable law, including those related to affiliate transactions, maintenance of capital and corporate governance. This operating agreement has not required any changes in World

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Financial Network National Bank s operations. The capital adequacy and liquidity maintenance agreement memorializes our current obligations to World Financial Network National Bank.

Recent Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments (SFAS No. 155), which amends Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133) and SFAS No. 140. SFAS No. 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 also clarifies and amends certain other provisions of SFAS No. 133 and SFAS No. 140. SFAS No. 155 is effective for all financial instruments acquired, issued or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided we have not yet issued financial statements, including for interim periods, for that fiscal year. We do not expect the adoption of SFAS No. 155 to have a material impact on our consolidated financial position, results of operations or cash flows.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets (SFAS No. 156). SFAS No. 156 amends SFAS No. 140 with respect to the accounting for separately-recognized servicing assets and liabilities. SFAS No. 156 addresses the recognition and measurement of separately-recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like (offset) accounting. The standard is effective for fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided we have not yet issued financial statements, including for interim periods, for that fiscal year. We do not expect the adoption of SFAS No. 156 to have a material impact on our consolidated financial position, results of operations or cash flows.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN No. 48). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes . FIN No. 48 prescribes a financial statement recognition threshold and measurement attribute of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The provisions of FIN No. 48 are effective for fiscal years beginning after December 15, 2006. We will adopt FIN 48 on January 1, 2007, as required. The cumulative effect of adopting FIN 48 will be a reduction to retained earnings of approximately $6.0 million to $10.0 million.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 establishes a new definition of fair value as well as a fair value hierarchy that prioritizes the information used to develop the assumptions, and requires new disclosures of assets and liabilities measured at fair value based on their level in the hierarchy. The standard is effective for fiscal years beginning after November 15, 2007. We are currently in the process of evaluating the effect that the adoption of SFAS No. 157 will have on our consolidated financial position, results of operations and cash flows.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Post-retirement plans (SFAS No. 158). Among other items, SFAS No. 158 requires recognition of the overfunded or underfunded status of an entity s defined benefit postretirement plan as an asset or liability in the financial statements, requires the measurement of defined benefit postretirement plan assets and obligations as of the end of the employer s fiscal year, and requires recognition of the funded status of defined benefit postretirement plans in other comprehensive income. The standard is effective for the Company as of December 31, 2006. The adoption of SFAS No. 158 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB No. 108). SAB No. 108 addresses quantifying the financial statement effects of misstatements, specifically, how the

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effects of prior year uncorrected errors must be considered in quantifying misstatements in the current year financial statements. SAB No. 108 does not amend or change the SEC Staff s previous positions in Staff Accounting Bulletin No. 99, Materiality, regarding qualitative considerations in assessing the materiality of misstatements. SAB No. 108 is effective for fiscal years beginning after November 15, 2006. We do not expect the adoption of SAB No. 108 to have a material impact on our consolidated financial position, results of operations or cash flows.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Market Risk

Market risk is the risk of loss from adverse changes in market prices and rates. Our primary market risks include off-balance sheet risk, interest rate risk, credit risk, foreign currency exchange rate risk and redemption reward risk.

Off-Balance Sheet Risk. We are subject to off-balance sheet risk in the normal course of business, including commitments to extend credit and through our securitization program. We sell substantially all of our credit card receivables to the WFN Trusts, qualifying special purpose entities. The trusts enter into interest rate swaps to reduce the interest rate sensitivity of the securitization transactions. The securitization program involves elements of credit, market, interest rate, legal and operational risks in excess of the amount recognized on the balance sheet through our retained interests in the securitization and the interest-only strips.

Interest Rate Risk. Interest rate risk affects us directly in our lending and borrowing activities. Our total interest incurred was approximately $202.8 million for 2006, which includes both on-and off-balance sheet transactions. Of this total, $47.6 million of the interest expense for 2006 was attributable to on-balance sheet indebtedness and the remainder to our securitized credit card receivables, which are financed off-balance sheet. To manage our risk from market interest rates, we actively monitor the interest rates and the interest sensitive components both on- and off-balance sheet to minimize the impact that changes in interest rates have on the fair value of assets, net income and cash flow. To achieve this objective, we manage our exposure to fluctuations in market interest rates by matching asset and liability repricings and through the use of fixed-rate debt instruments to the extent that reasonably favorable rates are obtainable with such arrangements. In addition, we enter into derivative financial instruments such as interest rate swaps and treasury locks to mitigate our interest rate risk on a related financial instrument or to lock the interest rate on a portion of our variable debt. We do not enter into derivative or interest rate transactions for trading or other speculative purposes. At December 31, 2006, we had $4.6 billion of debt, including $3.6 billion of off-balance sheet debt from our securitization program.

	As of December 31, 2006		
	Fixed rate	Variable rate	Total
		(In millions)	
Off-balance sheet	$ 2,650.0	$ 929.2	$ 3,579.2
On-balance sheet	694.3	350.1	1,044.4
	$ 3,344.3	$ 1,279.3	$ 4,623.6

At December 31, 2006, our fixed rate off-balance sheet debt was locked at a current effective interest rate of 4.7% through interest rate swap agreements. Additionally, our variable rate off-balance sheet debt has variable rate credit cards that are at least equal to that amount.

At December 31, 2006, our fixed rate on-balance sheet debt was subject to fixed rates with a weighted average interest rate of 5.7%.

The approach we use to quantify interest rate risk is a sensitivity analysis which we believe best reflects the risk inherent in our business. This approach calculates the impact on pretax income from an instantaneous and sustained increase in interest rates of 1.0%. In 2006, a 1.0% increase in interest rates would have resulted in an annual decrease to pretax income of approximately $8.5 million. Conversely, a corresponding decrease in interest rates would result in a comparable increase to pretax income. Our use of this methodology to quantify the market risk of financial instruments should not be construed as an endorsement of its accuracy or the accuracy of the related assumptions.

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Credit Risk. We are exposed to credit risk relating to the credit card loans we make to our clients customers. Our credit risk relates to the risk that consumers using the private label credit cards that we issue will not repay their revolving credit card loan balances. We have developed credit risk models designed to identify qualified consumers who fit our risk parameters. To minimize our risk of loan write-offs, we control approval rates of new accounts and related credit limits and follow strict collection practices. We monitor the buying limits, as well as set pricing regarding fees and interest rates charged.

Foreign Currency Exchange Rate Risk. We are exposed to fluctuations in the exchange rate between the U.S. and the Canadian dollar through our significant Canadian operations. We do not hedge any of our net investment exposure in our Canadian subsidiary. A 1% increase in the Canadian exchange rate would have resulted in an increase in pretax income of $0.8 million. Conversely, a corresponding decrease in the exchange rate would result in a comparable decrease to pretax income.

Redemption Reward Risk. Through our AIR MILES Reward Program, we are exposed to potentially increasing reward costs associated primarily with travel rewards. To minimize the risk of rising travel reward costs, we:

- have multi-year supply agreements with several Canadian, U.S. and international airlines;
- are seeking new supply agreements with additional airlines;
- periodically alter the total mix of rewards available to collectors with the introduction of new merchandise rewards, which are typically lower cost per AIR MILES reward mile than air travel;
- allow collectors to obtain certain travel rewards using a combination of reward miles and cash or cash alone in addition to using AIR MILES reward miles alone; and
- periodically adjust the number of AIR MILES reward miles required to be redeemed to obtain a reward.

A 1% increase in the cost of redemptions would have resulted in a decrease in pretax income of $2.6 million. Conversely, a corresponding decrease in the cost of redemptions would result in a comparable increase to pretax income.

Item 8. Financial Statements and Supplementary Data

Our consolidated financial statements begin on page F-1 of this Form 10-K.

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

None.

Item 9A. Controls and Procedures

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

As of December 31, 2006, we carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 of the Securities Exchange Act of 1934. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that as of December 31, 2006, our disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms and include controls and procedures designed to ensure that information we are required to disclose in such reports is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Management s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal controls over financial reporting are 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 in the United States.

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 or compliance with the policies or procedures may deteriorate.

Our evaluation of and conclusion on the effectiveness of internal control over financial reporting as of December 31, 2006 did not include the internal controls of ICOM, DoubleClick Email Solutions, or CPC because of the timing of these acquisitions, which were completed in February 2006, April 2006 and October 2006, respectively. As of December 31, 2006, these entities constituted $254.5 million of total assets, $96.4 million of revenues and $6.5 million of net income for the year then ended.

Under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of internal control over financial reporting. In conducting this evaluation, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control Integrated Framework.* Based on our evaluation and those criteria, our internal control over financial reporting was effective as of December 31, 2006.

During the fourth quarter of 2006, we completed the process of converting ICOM S and CPC s legacy general ledger platform to the platform utilized by our business units. There have been no other changes in our internal control over financial reporting during the fourth quarter ended December 31, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management s assessment of the effectiveness of internal control over financial reporting as of December 31, 2006, has been audited by Deloitte & Touche LLP, the independent registered public accounting firm who also audited our consolidated financial statements. Deloitte & Touche s attestation report on management s assessment of our internal control over financial reporting appears on page F-3.

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

Incorporated by reference to the Proxy Statement for the 2007 Annual Meeting of our stockholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2006.

Item 11. Executive Compensation

Incorporated by reference to the Proxy Statement for the 2007 Annual Meeting of our stockholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2006.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Incorporated by reference to the Proxy Statement for the 2007 Annual Meeting of our stockholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2006.

Item 13. Certain Relationships and Related Transactions, and Director Independence

Incorporated by reference to the Proxy Statement for the 2007 Annual Meeting of our stockholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2006.

Item 14. Principal Accounting Fees and Services

Incorporated by reference to the Proxy Statement for the 2007 Annual Meeting of our stockholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2006.

PART IV

Item 15. Exhibits, Financial Statement Schedules.

(a) The following documents are filed as part of this report:

(1) Financial Statements

(2) Financial Statement Schedule

(3) The following exhibits are filed as part of this Annual Report on Form 10-K or, where indicated, were previously filed and are hereby incorporated by reference.

Exhibit No.	Description
2.1	Agreement and Plan of Merger, dated as of October 8, 2004, by and among Alliance Data Systems Corporation, ADS Alliance Data Systems, Inc., Everest Nivole, Inc., The Relizon e-CRM Company and

	Relizon Holdings LLC (incorporated by reference to Exhibit No. 2.1 to our Current Report on Form 8-K filed with the SEC on October 29, 2004, File No. 0001-15749).
2.2	First Amendment to Agreement and Plan of Merger, dated as of October 8, 2004, by and among Alliance Data Systems Corporation, ADS Alliance Data Systems, Inc., Everest Nivole, Inc., The Relizon e-CRM Company and Relizon Holdings, LLC (incorporated by reference to Exhibit No. 2.2 to our Current Report on Form 8-K filed with the SEC on October 29, 2004, File No. 0001-15749).

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Exhibit No.	Description
2.3	Purchase Agreement, dated as of December 22, 2006, by and among DoubleClick Inc., Alliance Data Systems Corporation and Alliance Data FHC, Inc. (incorporated by reference to Exhibit No. 2.1 to our Current Report on Form 8-K filed with the SEC on December 28, 2006, File No. 0001-15749).
3.1	Second Amended and Restated Certificate of Incorporation of the Registrant (incorporated by reference to Exhibit No. 3.1 to our Registration Statement on Form S-1 filed with the SEC on March 3, 2000, File No. 333-94623).
3.2	Second Amended and Restated Bylaws of the Registrant (incorporated by reference to Exhibit No. 3.2 to our Registration Statement on Form S-1 filed with the SEC on March 3, 2000, File No. 333-94623).
3.3	First Amendment to the Second Amended and Restated Bylaws of the Registrant (incorporated by reference to Exhibit No. 3.3 to our Registration Statement on Form S-1 filed with the SEC on May 4, 2001, File No. 333-94623).
3.4	Second Amendment to the Second Amended and Restated Bylaws of the Registrant (incorporated by reference to Exhibit No. 3.4 to our Annual Report on Form 10-K, filed with the SEC on April 1, 2002, File No. 001-15749).
4	Specimen Certificate for shares of Common Stock of the Registrant (incorporated by reference to Exhibit No. 4 to our Quarterly Report on Form 10-Q filed with the SEC on August 8, 2003, File No. 001-15749).
10.1	Build-to-Suit Net Lease between Opus South Corporation and ADS Alliance Data Systems, Inc., dated January 29, 1998, as amended (incorporated by reference to Exhibit No. 10.10 to our Annual Report on Form 10-K, filed with the SEC on April 1, 2002, File No. 001-15749).
10.2	Commercial Lease Agreement by and between Waterview Parkway L.P. and ADS Alliance Data Systems, Inc., dated July 16, 1997 (incorporated by reference to Exhibit No. 10.22 to our Registration Statement on Form S-1 filed with the SEC on January 13, 2000, File No. 333-94623).
10.3	Lease between YCC Limited and London Life Insurance Company and Loyalty Management Group Canada Inc. dated May 28, 1997 and amended June 19, 1997 and January 15, 1998 (incorporated by reference to Exhibit No. 10.15 to our Registration Statement on Form S-1 filed with the SEC on January 13, 2000, File No. 333-94623).
10.4	Amendments of April 14, 2000, January 17, 2001, and June 12, 2002 to lease between YCC Limited and London Life Insurance Company and Loyalty Management Group Canada Inc. dated May 28, 1997, as amended (incorporated by reference to Exhibit No. 10.12 to our Annual Report on Form 10-K filed with the SEC on March 12, 2003, File No. 001-15749).
10.5	Amendment, dated September 27, 2002, to Lease between YCC Limited and London Life Insurance Company and Loyalty Management Group Canada, Inc., dated May 28, 1997, as amended (incorporated by reference to Exhibit No. 10.5 to our Annual Report on Form 10-K, filed with the SEC on March 3, 2006).
10.6	Amendment, dated February 18, 2005, to Lease between YCC Limited and London Life Insurance Company and Loyalty Management Group Canada, Inc., dated May 28, 1997, as amended (incorporated by reference to Exhibit No. 10.6 to our Annual Report on Form 10-K, filed with the SEC on March 3, 2006, File No. 001-15749).
10.7	Office Lease between Office City, Inc. and World Financial Network National Bank, dated December 24, 1986, and amended January 19, 1987, May 11, 1988, August 4, 1989 and August 18, 1999 (incorporated by reference to Exhibit No. 10.17 to our Registration Statement on Form S-1 filed with the SEC on January 13, 2000, File No. 333-94623).
10.8	Lease Agreement by and between Continental Acquisitions, Inc. and World Financial Network National Bank, dated July 2, 1990, and amended September 11, 1990, November 16, 1990 and

	February 18, 1991 (incorporated by reference to Exhibit No. 10.18 to our Registration Statement on Form S-1 filed with the SEC on January 13, 2000, File No. 333-94623).
10.9	Fourth Amendment to Lease Agreement by and between Partners at Brooksedge and ADS Alliance Data Systems, Inc., dated June 1, 2000 (incorporated by reference to Exhibit No. 10.1 to our Quarterly Report on Form 10-Q filed with the SEC on May 14, 2003, File No. 001-15749).

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Exhibit No.	Description
10.10	Fifth Amendment to Lease Agreement by and between Partners at Brooksedge and ADS Alliance Data Systems, Inc., dated June 30, 2001 (incorporated by reference to Exhibit No. 10.10 to our Annual Report on Form 10-K filed with the SEC on March 3, 2006, File No. 001-15749).
10.11	Indenture of Lease by and between OTR and ADS Alliance Data Systems, Inc., dated as of February 1, 2002, as amended (incorporated by reference to Exhibit No. 10.2 to our Quarterly Report on Form 10-Q filed with the SEC on May 14, 2003, File No. 001-15749).
10.12	Lease Agreement by and between Petula Associates, Ltd. and Compass International Services, dated August 28, 1998, as amended (incorporated by reference to Exhibit No. 10.1 to our Quarterly Report on Form 10-Q filed with the SEC on August 8, 2003, File No. 001-15749).
10.13	Lease Agreement by and between 601 Edgewater LLC and Epsilon Data Management, Inc., dated July 30, 2002 (incorporated by reference to Exhibit No. 10.17 to our Annual Report on Form 10-K filed with the SEC on March 4, 2005, File No. 001-15749).
10.14	Lease Agreement by and between Sterling Direct, Inc. and Sterling Properties, L.L.C., dated September 22, 1997, as subsequently assigned (incorporated by reference to Exhibit No. 10.18 to our Annual Report on Form 10-K filed with the SEC on March 4, 2005, File No. 001-15749).
10.15	Sublease by and between SonicNet, Inc. and Bigfoot Interactive, Inc., dated as of March 2003 (incorporated by reference to Exhibit No. 10.15 to our Annual Report on Form 10-K filed with the SEC on March 3, 2006, File No. 001-15749).
10.16	Lease Agreement by and between TM Park Avenue, LLC and Epsilon Interactive, LLC, dated February 10, 2006 (incorporated by reference to Exhibit No. 10.16 to our Annual Report on Form 10-K filed with the SEC on March 3, 2006, File No. 001-15749).
10.17	Lease Agreement by and between KDC-Regent I Investments, LP and Epsilon Data Management, Inc., dated May 31, 2005 (incorporated by reference to Exhibit No. 10.17 to our Annual Report on Form 10-K filed with the SEC on March 3, 2006, File No. 001-15749).
*10.18	Lease between 592423 Ontario Inc. and Loyalty Management Group Canada, Inc., dated November 14, 2005, to commence on September 17, 2007.
10.19	Lease Agreement by and between Morrison Taylor, Ltd. and ADS Alliance Data Systems, Inc. dated July 1, 1997, and amended June 18, 1998 (incorporated by reference to Exhibit No. 10.21 to our Registration Statement on Form S-1 filed with the SEC on January 13, 2000, File No. 333-94623).
*10.20	Lease Agreement by and between ADS Place Phase I, LLC and ADS Alliance Data Systems, Inc. dated August 25, 2006.
10.21	Capital Assurance and Liquidity Maintenance Agreement, dated August 28, 2003, by and between Alliance Data Systems Corporation and World Financial Network National Bank (incorporated by reference to Exhibit No. 10.3 to our Registration Statement on Form S-3 filed with the SEC on October 15, 2003, File No. 333-109713).
+10.22	Alliance Data Systems Corporation Executive Deferred Compensation Plan (incorporated by reference to Exhibit No. 10.23 to our Annual Report on Form 10-K filed with the SEC on March 4, 2005, File No. 001-15749).
+10.23	Alliance Data Systems Corporation Executive Annual Incentive Plan (incorporated by reference to Exhibit B to our Definitive Proxy Statement filed with the SEC on April 29, 2005, File No. 001-15749).
+10.24	Alliance Data Systems Corporation 2005 Incentive Compensation Plan (incorporated by reference to Exhibit No. 10.1 to our Quarterly Report on Form 10-Q, filed with the SEC on May 6, 2005, File No. 001-15749).
+10.25	

	Alliance Data Systems Corporation 2006 Incentive Compensation Plan (incorporated by reference to Exhibit No. 10.28 to our Annual Report on Form 10-K filed with the SEC on March 3, 2006, File No. 001-15749).
*+10.26	Alliance Data Systems Corporation 2007 Incentive Compensation Plan.

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Exhibit No.	Description
+10.27	Amended and Restated Alliance Data Systems Corporation and its Subsidiaries Stock Option and Restricted Stock Plan (incorporated by reference to Exhibit No. 10.34 to our Registration Statement on Form S-1 filed with the SEC on May 4, 2001, File No. 333-94623).
+10.28	Form of Alliance Data Systems Corporation Incentive Stock Option Agreement under the Amended and Restated Alliance Data Systems Corporation and its Subsidiaries Stock Option and Restricted Stock Plan (incorporated by reference to Exhibit No. 10.35 to our Registration Statement on Form S-1 filed with the SEC on January 13, 2000, File No. 333-94623).
+10.29	Form of Alliance Data Systems Corporation Non-Qualified Stock Option Agreement under the Amended and Restated Alliance Data Systems Corporation and its Subsidiaries Stock Option and Restricted Stock Plan (incorporated by reference to Exhibit No. 10.36 to our Registration Statement on Form S-1 filed with the SEC on January 13, 2000, File No. 333-94623).
+10.30	Alliance Data Systems Corporation Amended and Restated Employee Stock Purchase Plan (incorporated by reference to Exhibit C to our Definitive Proxy Statement filed with the SEC on April 29, 2005, File No. 001-15749).
+10.31	Alliance Data Systems Corporation 2003 Long-Term Incentive Plan (incorporated by reference to Exhibit No. 4.6 to our Registration Statement on Form S-8 filed with the SEC on June 18, 2003, File No. 333-106246).
+10.32	Alliance Data Systems Corporation 2005 Long-Term Incentive Plan (incorporated by reference to Exhibit A to our Definitive Proxy Statement filed with the SEC on April 29, 2005, File No. 001-15749).
+10.33	Form of Nonqualified Stock Option Agreement for awards under the Alliance Data Systems Corporation 2005 Long Term Incentive Plan (incorporated by reference to Exhibit No. 10.4 to our Current Report on Form 8-K filed with the SEC on August 4, 2005, File No. 001-15749).
+10.34	Form of Restricted Stock Award Agreement for awards under the Alliance Data Systems Corporation 2005 Long Term Incentive Plan (incorporated by reference to Exhibit No. 10.5 to our Current Report on Form 8-K filed with the SEC on August 4, 2005, File No. 001-15749).
+10.35	Form of Restricted Stock Unit Award Agreement under the Alliance Data Systems Corporation 2005 Long Term Incentive Plan (2006 grant), as amended (incorporated by reference to Exhibit No. 99.1 to our Current Report on Form 8-K filed with the SEC on April 4, 2006, File No. 001-15749).
+10.36	Form of Non-Employee Director Nonqualified Stock Option Agreement (incorporated by reference to Exhibit No. 10.1 to our Current Report on Form 8-K filed with the SEC on June 13, 2005, File No. 001-15749).
+10.37	Form of Non-Employee Director Share Award Letter (incorporated by reference to Exhibit No. 10.2 to our Current Report on Form 8-K filed with the SEC on June 13, 2005, File No. 001-15749).
+10.38	Alliance Data Systems Corporation Non-Employee Director Deferred Compensation Plan (incorporated by reference to Exhibit No. 10.1 to our Current Report on Form 8-K, filed with the SEC on June 9, 2006, File No. 001-15749).
+10.39	Form of Alliance Data Systems Associate Confidentiality Agreement (incorporated by reference to Exhibit No. 10.24 to our Annual Report on Form 10-K filed with the SEC on March 12, 2003, File No. 001-15749).
+10.40	Form of Alliance Data Systems Corporation Indemnification Agreement for Officers and Directors (incorporated by reference to Exhibit No. 10.1 to our Current Report on Form 8-K filed with the SEC on February 1, 2005, File No. 001-15749).
+10.41	Alliance Data Systems 401(k) Retirement and Savings Plan (incorporated by reference to Exhibit No. 99.1 to our Registration Statement on Form S-8 filed with the SEC on July 20, 2001,

	File No. 333-65556).
+10.42	Amendment, dated February 4, 2003, to Alliance Data Systems 401(k) Retirement and Savings Plan (incorporated by reference to Exhibit No. 10.7 to our Quarterly Report on Form 10-Q filed with the SEC on May 14, 2003, File No. 001-15749).

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Exhibit No.	Description
+10.43	Amendment No. 2, dated April 7, 2003, to Alliance Data Systems 401(k) Retirement and Savings Plan (incorporated by reference to Exhibit No. 10.8 to our Quarterly Report on Form 10-Q filed with the SEC on May 14, 2003, File No. 001-15749).
+10.44	Amendment No. 3, dated May 8, 2003, to Alliance Data Systems 401(k) Retirement and Savings Plan (incorporated by reference to Exhibit No. 10.9 to our Quarterly Report on Form 10-Q filed with the SEC on May 14, 2003, File No. 001-15749).
+10.45	Amendment No. 4, dated June 9, 2003, to Alliance Data Systems 401(k) Retirement and Savings Plan (incorporated by reference to Exhibit No. 10.32 to our Annual Report on Form 10-K filed with the SEC on March 5, 2004, File No. 001-15749).
+10.46	Amendment No. 5, dated September 29, 2003, to Alliance Data Systems 401(k) Retirement and Savings Plan (incorporated by reference to Exhibit No. 10.33 to our Annual Report on Form 10-K filed with the SEC on March 5, 2004, File No. 001-15749).
+10.47	Amendment No. 6, dated December 12, 2003, to Alliance Data Systems 401(k) Retirement and Savings Plan (incorporated by reference to Exhibit No. 10.34 to our Annual Report on Form 10-K filed with the SEC on March 5, 2004, File No. 001-15749).
+10.48	Amendment No. 7, dated December 12, 2003, to Alliance Data Systems 401(k) Retirement and Savings Plan (incorporated by reference to Exhibit No. 10.35 to our Annual Report on Form 10-K filed with the SEC on March 5, 2004, File No. 001-15749).
+10.49	Amendment No. 8, dated December 12, 2003, to Alliance Data Systems 401(k) Retirement and Savings Plan (incorporated by reference to Exhibit No. 10.36 to our Annual Report on Form 10-K filed with the SEC on March 5, 2004, File No. 001-15749).
+10.50	Letter employment agreement with J. Michael Parks, dated February 19, 1997 (incorporated by reference to Exhibit 10.39 to our Registration Statement on Form S-1 filed with the SEC on January 13, 2000, File No. 333-94623).
+10.51	Letter employment agreement with Ivan Szeftel, dated May 4, 1998 (incorporated by reference to Exhibit 10.40 to our Registration Statement on Form S-1 filed with the SEC on January 13, 2000, File No. 333-94623).
10.52	Amended and Restated License to Use the Air Miles Trade Marks in Canada, dated as of July 24, 1998, by and between Air Miles International Holdings N.V. and Loyalty Management Group Canada Inc. (incorporated by reference to Exhibit No. 10.43 to our Registration Statement on Form S-1 filed with the SEC on January 13, 2000, File No. 333-94623) (assigned by Air Miles International Holdings N.V. to Air Miles International Trading B.V. by a novation agreement dated as of July 18, 2001).
10.53	Amended and Restated License to Use and Exploit the Air Miles Scheme in Canada, dated July 24, 1998, by and between Air Miles International Trading B.V. and Loyalty Management Group Canada Inc. (incorporated by reference to Exhibit No. 10.44 to our Registration Statement on Form S-1 filed with the SEC on January 13, 2000, File No. 333-94623).
10.54	Second Amended and Restated Pooling and Servicing Agreement, dated as of January 17, 1996 amended and restated as of September 17, 1999 and August 2001 by and among WFN Credit Company, LLC, World Financial Network National Bank, and BNY Midwest Trust Company (incorporated by reference to Exhibit No. 4.6 to the Registration Statement on Form S-3 of world financial network credit card master trust filed with the SEC on July 5, 2001, File No. 333-60418).
10.55	Second Amendment to the Second Amended and Restated Pooling and Servicing Agreement, dated as of May 19, 2004, among World Financial Network National Bank, WFN Credit Company, LLC and BNY Midwest Trust Company (incorporated by reference to Exhibit No. 4.1 to the Current Report on

Form 8-K filed by WFN Credit Company, LLC, World Financial Network Credit Card Master Trust and World Financial Network Credit Card Master Note Trust on August 4, 2004, File Nos. 333-60418, 333-60418-01 and 333-113669).

Exhibit No.	Description
10.56	Third Amendment to the Second Amended and Restated Pooling and Servicing Agreement, dated as of March 30, 2005, among World Financial Network National Bank, WFN Credit Company, LLC and BNY Midwest Trust Company (incorporated by reference to Exhibit No. 4.1 to the Current Report on Form 8-K filed by World Financial Network Credit Card Master Trust and World Financial Network Credit Card Master Note Trust on April 4, 2005, File Nos. 333-60418, 333-60418-01 and 333-113669).
10.57	Omnibus Amendment, dated as of March 31, 2003, among WFN Credit Company, LLC, World Financial Network Credit Card Master Trust, World Financial Network National Bank and BNY Midwest Trust Company (incorporated by reference to Exhibit No. 4 to the Current Report on Form 8-K filed by WFN Credit Company, LLC and World Financial Network Credit Card Master Trust on April 22, 2003, File Nos. 333-60418 and 333-60418-01).
10.58	Transfer and Servicing Agreement, dated as of August 1, 2001, between WFN Credit Company, LLC, World Financial Network National Bank, and World Financial Network Credit Card Master Note Trust (incorporated by reference to Exhibit No. 4.3 to the Registration Statement on Form S-3 of World Financial Network Credit Card Master Trust filed with the SEC on July 5, 2001, File No. 333-60418).
10.59	First Amendment to the Transfer and Servicing Agreement, dated as of November 7, 2002, among WFN Credit Company, LLC, World Financial Network National Bank and World Financial Network Credit Card Master Note Trust (incorporated by reference to Exhibit No. 4.2 to the Current Report on Form 8-K filed by WFN Credit Company, LLC and World Financial Network Credit Card Master Trust on November 20, 2002, File Nos. 333-60418 and 333-60418-01).
10.60	Third Amendment to the Transfer and Servicing Agreement, dated as of May 19, 2004, among WFN Credit Company, LLC, World Financial Network National Bank and World Financial Network Credit Card Master Note Trust (incorporated by reference to Exhibit No. 4.2 of the Current Report on Form 8-K filed by WFN Credit Company, LLC, World Financial Network Credit Card Master Trust and World Financial Network Credit Card Master Note Trust on August 4, 2004, File Nos. 333-60418, 333-60418-01 and 333-113669).
10.61	Fourth Amendment to the Transfer and Servicing Agreement, dated as of March 30, 2005, among WFN Credit Company, LLC, World Financial Network National Bank and World Financial Network Credit Card Master Note Trust (incorporated by reference to Exhibit No. 4.2 to the Current Report on Form 8-K filed by World Financial Network Credit Card Master Trust and World Financial Network Credit Card Master Note Trust on April 4, 2005, File Nos. 333-60418, 333-60418-01 and 333-113669).
10.62	Receivables Purchase Agreement, dated as of August 1, 2001, between World Financial Network National Bank and WFN Credit Company, LLC (incorporated by reference to Exhibit No. 4.8 to the Registration Statement on Form S-3 of World Financial Network Credit Card Master Trust filed with the SEC on July 5, 2001, File No. 333-60418).
10.63	Master Indenture, dated as of August 1, 2001, between World Financial Network Credit Card Master Note Trust and BNY Midwest Trust Company, as supplemented by the Series 2001-A Indenture Supplement, the Series 2002-A Indenture Supplement, the Series 2002-VFN Supplement (incorporated by reference to Exhibit No. 4.1 to the Registration Statement on Form S-3 filed with the SEC by WFN Credit Company, LLC and World Financial Network Credit Card Master Trust on July 5, 2001, File Nos. 333-60418 and 333-60418-01).
10.64	Series 2003-A Indenture Supplement, dated as of June 19, 2003 (incorporated by reference to Exhibit No. 4.1 to the Current Report on Form 8-K filed by World Financial Network Credit Card Master Trust filed with the SEC on August 28, 2003, File No. 333-60418-01).
10.65	Series 2004-A Indenture Supplement, dated as of May 19, 2004 (incorporated by reference to Exhibit No. 4.1 to the Current Report on Form 8-K filed with the SEC by WFN Credit Company, LLC, World

Financial Network Credit Card Master Trust and World Financial Network Credit Card Master Note Trust on May 27, 2004, File Nos. 333-60418, 333-60418-01 and 333- 113669).

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Exhibit No.	Description
10.66	Series 2004-B Indenture Supplement, dated as of September 22, 2004 (incorporated by reference to Exhibit No. 4.1 to the Current Report on Form 8-K filed with the SEC by WFN Credit Company, LLC, World Financial Network Credit Card Master Trust and World Financial Network Credit Card Master Note Trust on September 28, 2004, File Nos. 333-60418, 333-60418-01 and 333-113669).
10.67	Series 2004-C Indenture Supplement, dated as of September 22, 2004 (incorporated by reference to Exhibit No. 4.2 of the Current Report on Form 8-K filed with the SEC by WFN Credit Company, LLC, World Financial Network Credit Card Master Trust and World Financial Network Credit Card Master Note Trust on September 28, 2004, File Nos. 333-60418, 333-60418-01 and 333-113669).
10.68	Supplemental Indenture No. 1, dated as of August 13, 2003, between World Financial Network Credit Card Master Note Trust and BNY Midwest Trust Company (incorporated by reference to Exhibit No. 4.2 of the Current Report on Form 8-K filed with the SEC by WFN Credit Company, LLC and World Financial Network Credit Card Master Trust on August 28, 2003, File Nos. 333-60418 and 333-60418-01).
10.69	Issuance Supplement to Series 2003-A Indenture Supplement, dated as of August 14, 2003, between World Financial Network Credit Card Master Note Trust and BNY Midwest Trust Company (incorporated by reference to Exhibit No. 4.3 of the Current Report on Form 8-K filed with the SEC by World Financial Network Credit Card Master Trust on August 28, 2003, File No. 333-60418-01).
10.70	Credit Agreement (3-Year), dated as of April 10, 2003, by and among Alliance Data Systems Corporation, the guarantors from time to time party thereto, the lenders from time to time party thereto, and Harris Trust and Savings Bank, as Administrative Agent (incorporated by reference to Exhibit No. 10.2 to Amendment No. 1 to our Registration Statement on Form S-3 filed with the SEC on April 16, 2003, File No. 333-104314).
10.71	First Amendment to Credit Agreement (3-Year), dated as of October 21, 2004, by and among Alliance Data Systems Corporation, the Guarantor party thereto, the Banks party thereto, and Harris Trust and Savings Bank, as Administrative Agent and Letter of Credit Issuer (incorporated by reference to Exhibit No. 10.3 to our Quarterly Report on Form 10-Q filed with the SEC on November 5, 2004, File No. 001-15749).
10.72	Second Amendment to Credit Agreement (3-Year), dated as of April 7, 2005, by and among Alliance Data Systems Corporation, the Guarantor party thereto, the Banks party thereto, and Harris Trust and Savings Bank, as Administrative Agent and Letter of Credit Issuer (incorporated by reference to Exhibit No. 99.1 to our Current Report on Form 8-K filed with the SEC on April 13, 2005, File No. 001-15749).
10.73	Third Amendment to Credit Agreement (3-Year), dated as of October 28, 2005, by and among Alliance Data Systems Corporation, the Guarantor party thereto, the Banks party thereto, and Harris N.A., as Administrative Agent and Letter of Credit Issuer (incorporated by reference to Exhibit No. 99.1 to our Current Report on Form 8-K filed with the SEC on October 31, 2005, File No. 001-15749).
10.74	Fourth Amendment to Credit Agreement (3-Year), dated as of December 21, 2005, by and among Alliance Data Systems Corporation, the Guarantor party thereto, the Banks party thereto, and Harris N.A., as Administrative Agent and Letter of Credit Issuer (incorporated by reference to Exhibit No. 99.1 to our Current Report on Form 8-K filed with the SEC on December 27, 2005, File No. 001-15749).
10.75	Credit Agreement (364-Day), dated as of April 10, 2003, by and among Alliance Data Systems Corporation, the guarantors from time to time party thereto, the lenders from time to time party thereto, and Harris Trust and Savings Bank, as Administrative Agent (incorporated by reference to Exhibit No. 10.3 to Amendment No. 1 to our Registration Statement on Form S-3 filed with the SEC on

April 16, 2003, File No. 333-104314).

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Exhibit No.	Description
10.76	First Amendment to Credit Agreement (364-Day) dated as of April 8, 2004, by and among Alliance Data Systems Corporation, the guarantors from time to time party thereto, the lenders from time to time party thereto, and Harris Trust and Savings Bank, as Administrative Agent (incorporated by reference to Exhibit No. 10.1 to our Quarterly Report on Form 10-Q filed with the SEC on May 7, 2004, File No. 001-15749).
10.77	Second Amendment to Credit Agreement (364-Day), dated as of October 21, 2004, by and among Alliance Data Systems Corporation, the Guarantor party thereto, the Banks party thereto, and Harris Trust and Savings Bank, as Administrative Agent and Letter of Credit Issuer (incorporated by reference to Exhibit No. 10.4 to our Quarterly Report on Form 10-Q filed with the SEC on November 5, 2004, File No. 001-15749).
10.78	Third Amendment to Credit Agreement (364-Day), dated as of April 7, 2005, by and among Alliance Data Systems Corporation, the Guarantor party thereto, the Banks party thereto, and Harris Trust and Savings Bank, as Administrative Agent and Letter of Credit Issuer (incorporated by reference to Exhibit No. 99.2 to our Current Report on Form 8-K filed with the SEC on April 13, 2005, File No. 001-15749).
10.79	Fourth Amendment to Credit Agreement (364-Day), dated as of October 28, 2005, by and among Alliance Data Systems Corporation, the Guarantor party thereto, the Banks party thereto, and Harris N.A., as Administrative Agent and Letter of Credit Issuer (incorporated by reference to Exhibit No. 99.2 to our Current Report on Form 8-K filed with the SEC on October 31, 2005, File No. 001-15749).
10.80	Fifth Amendment to Credit Agreement (364-Day), dated as of December 21, 2005, by and among Alliance Data Systems Corporation, the Guarantor party thereto, the Banks party thereto, and Harris N.A., as Administrative Agent and Letter of Credit Issuer (incorporated by reference to Exhibit No. 99.2 to our Current Report on Form 8-K filed with the SEC on December 27, 2005, File No. 001-15749).
10.81	Sixth Amendment to Credit Agreement (364-Day), dated as of April 6, 2006, by and among Alliance Data Systems Corporation, the Guarantors party thereto, the Banks party thereto, and Harris N.A, as Administrative Agent and Letter of Credit Issuer (incorporated by reference to Exhibit No. 10.2 to our Quarterly Report on Form 10-Q filed with the SEC on May 5, 2006, File No. 001-15749).
10.82	Credit Agreement (Canadian), dated as of April 10, 2003, by and among Loyalty Management Group Canada Inc., the guarantors from time to time party thereto, the lenders from time to time party thereto, and Harris Trust and Savings Bank, as Administrative Agent (incorporated by reference to Exhibit No. 10.4 to Amendment No. 1 to our Registration Statement on Form S-3 filed with the SEC on April 16, 2003, File No. 333-104314).
10.83	First Amendment to Credit Agreement (Canadian), dated as of October 21, 2004, by and among Loyalty Management Group Canada Inc., the Guarantors party thereto, the Banks party thereto, Bank of Montreal, as Letter of Credit Issuer, and Harris Trust and Savings Bank, as Administrative Agent (incorporated by reference to Exhibit No. 10.5 to our Quarterly Report on Form 10-Q filed with the SEC on November 5, 2004, File No. 001-15749).
10.84	Second Amendment to Credit Agreement (Canadian), dated as of April 7, 2005, by and among Loyalty Management Group Canada Inc., the Guarantors party thereto, the Banks party thereto, Bank of Montreal, as Letter of Credit Issuer, and Harris Trust and Savings Bank, as Administrative Agent (incorporated by reference to Exhibit No. 99.3 to our Current Report on Form 8-K filed with the SEC on April 13, 2005, File No. 001-15749).
10.85	

Third Amendment to Credit Agreement (Canadian), dated as of October 28, 2005, by and among Loyalty Management Group Canada Inc., the Guarantors party thereto, the Banks party thereto, Bank of Montreal, as Letter of Credit Issuer, and Harris N.A., as Administrative Agent (incorporated by reference to Exhibit No. 99.3 to our Current Report on Form 8-K filed with the SEC on October 31, 2005, File No. 001-15749).

Exhibit No.	Description
10.86	Fourth Amendment to Credit Agreement (Canadian), dated as of December 21, 2005, by and among Loyalty Management Group Canada Inc., the Guarantors party thereto, the Banks party thereto, Bank of Montreal, as Letter of Credit Issuer, and Harris N.A., as Administrative Agent (incorporated by reference to Exhibit No. 99.3 to our Current Report on Form 8-K filed with the SEC on December 27, 2005, File No. 001-15749).
10.87	Credit Agreement, dated as of January 3, 2006, by and among Alliance Data Systems Corporation, ADS Alliance Data Systems, Inc., as Guarantor, the Banks party thereto, and Harris N.A., as Administrative Agent and Lead Arranger (incorporated by reference to Exhibit No. 99.1 to our Current Report on Form 8-K filed with the SEC on January 9, 2006, File No. 001-15749).
10.88	First Amendment to Pledge Agreement, dated as of January 3, 2006, by and among Alliance Data Systems Corporation, ADS Alliance Data Systems, Inc. and Harris N.A. (incorporated by reference to Exhibit No. 99.2 to our Current Report on Form 8-K filed with the SEC on January 9, 2006, File No. 001-15749).
10.89	First Amendment to Intercreditor and Collateral Agency Agreement, dated as of January 3, 2006, by and among Alliance Data Systems Corporation, ADS Alliance Data Systems, Inc., Harris N.A. and the other parties thereto (incorporated by reference to Exhibit No. 99.3 to our Current Report on Form 8-K filed with the SEC on January 9, 2006, File No. 001-15749).
10.90	Note Purchase Agreement, dated as of May 1, 2006, by and among Alliance Data Systems Corporation and the Purchasers party thereto (incorporated by reference to Exhibit No. 10.1 to our Current Report on Form 8-K, filed with the SEC on May 18, 2006, File No. 001-15749).
10.91	Subsidiary Guaranty, dated as of May 1, 2006, by ADS Alliance Data Systems, Inc. in favor of the holders from time to time of the Notes (incorporated by reference to Exhibit No. 10.2 to our Current Report on Form 8-K, filed with the SEC on May 18, 2006, File No. 001-15749).
10.92	Credit Agreement, dated as of September 29, 2006, by and among Alliance Data Systems Corporation and certain subsidiaries parties thereto, as Guarantors, Bank of Montreal, as Administrative Agent, Co-Lead Arranger and Sole Book Runner, and various other agents and banks (incorporated by reference to Exhibit No. 10.1 to our Current Report on Form 8-K filed with the SEC on October 2, 2006, File No. 001-15749).
10.93	Joinder to Subsidiary Guaranty, dated as of September 29, 2006, by each of Epsilon Marketing Services, LLC, Epsilon Data Marketing, LLC and Alliance Data Foreign Holdings, Inc. in favor of the holders from time to time of the Senior Notes issued under the Note Purchase Agreement (incorporated by reference to Exhibit No. 10.2 to our Current Report on Form 8-K filed with the SEC on October 2, 2006, File No. 001-15749).
10.94	Credit Agreement, dated as of January 24, 2007, by and among Alliance Data Systems Corporation, certain subsidiaries parties thereto as Guarantors, the Banks from time to time parties thereto, and Bank of Montreal, as Administrative Agent (incorporated by reference to Exhibit No. 10.1 to our Current Report on Form 8-K filed with the SEC on January 25, 2007, File No. 001-15749).
+10.95	Form of Change in Control Agreement, dated as of September 25, 2003, by and between ADS Alliance Data Systems, Inc. and each of Daniel P. Finkelman, Edward J. Heffernan, John W. Scullion, Ivan M. Szeftel, Transient C. Taylor, Dwayne H. Tucker and Alan M. Utay (incorporated by reference to Exhibit No. 10.1 to our Registration Statement on Form S-3 filed with the SEC on October 15, 2003, File No. 333-109713).
+10.96	Change in Control Agreement, dated as of September 25, 2003, by and between ADS Alliance Data Systems, Inc. and J. Michael Parks (incorporated by reference to Exhibit No. 10.2 to our Registration Statement on Form S-3 filed with the SEC on October 15, 2003, File No. 333-109713).

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Exhibit No.	Description
10.97	Stockholders Agreement, dated as of June 12, 2001, among Alliance Data Systems Corporation, Limited Commerce Corp., Welsh, Carson, Anderson, and Stowe VI, L.P., Welsh, Carson, Anderson & Stowe VII, L.P., Welsh, Carson, Anderson & Stowe VIII, L.P., WCAS Information Partners, L.P., WCAS Capital Partners II, L.P., and WCAS Capital Partners III, L.P. (incorporated by reference to Exhibit No. 10.14 to our Annual Report on Form 10-K, filed with the SEC on April 1, 2002, File No. 001-15749).
10.98	First Amendment, dated as of April 9, 2003, to Stockholders Agreement, dated as of June 12, 2001, among Alliance Data Systems Corporation, Limited Commerce Corp., Welsh, Carson, Anderson, and Stowe VI, L.P., Welsh, Carson, Anderson & Stowe VII, L.P., Welsh, Carson, Anderson & Stowe VIII, L.P., WCAS Information Partners, L.P., WCAS Capital Partners II, L.P., and WCAS Capital Partners III, L.P. (incorporated by reference to Exhibit No. 10.1 to Amendment No. 1 to our Registration Statement on Form S-3 filed with the SEC on April 16, 2003, File No. 333-104314).
*+10.99	Form of Restricted Stock Unit Award Agreement under the Alliance Data Systems Corporation 2005 Long Term Incentive Plan (2007 grant).
*+10.100	Form of Agreement for 2007 Special Award under the Alliance Data Systems Corporation 2005 Long Term Incentive Plan.
*+10.101	Form of Canadian Nonqualified Stock Option Agreement for awards under the Alliance Data Systems Corporation 2005 Long Term Incentive Plan.
*+10.102	Form of Canadian Restricted Stock Award Agreement for awards under the Alliance Data Systems Corporation 2005 Long Term Incentive Plan.
*+10.103	Form of Canadian Restricted Stock Unit Award Agreement under the Alliance Data Systems Corporation 2005 Long Term Incentive Plan (2007 grant).
*+10.104	Form of Canadian Agreement for 2007 Special Award under the Alliance Data Systems Corporation 2005 Long Term Incentive Plan.
*21	Subsidiaries of the Registrant.
*23.1	Consent of Deloitte & Touche LLP.
*31.1	Certification of Chief Executive Officer of Alliance Data Systems Corporation pursuant to Rule 13a-14(a) promulgated under the Securities Exchange Act of 1934, as amended.
*31.2	Certification of Chief Financial Officer of Alliance Data Systems Corporation pursuant to Rule 13a-14(a) promulgated under the Securities Exchange Act of 1934, as amended.
*32.1	Certification of Chief Executive Officer of Alliance Data Systems Corporation pursuant to Rule 13a-14(b) promulgated under the Securities Exchange Act of 1934, as amended, and Section 1350 of Chapter 63 of Title 18 of the United States Code.
*32.2	Certification of Chief Financial Officer of Alliance Data Systems Corporation pursuant to Rule 13a-14(b) promulgated under the Securities Exchange Act of 1934, as amended, and Section 1350 of Chapter 63 of Title 18 of the United States Code.

* Filed herewith.

\+ Management contract, compensatory plan or arrangement.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

ALLIANCE DATA SYSTEMS CORPORATION

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders of
Alliance Data Systems Corporation

We have audited the accompanying consolidated balance sheets of Alliance Data Systems Corporation and subsidiaries (the Company) as of December 31, 2005 and 2006, and the related consolidated statements of income, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on the financial statements and financial statement schedule 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, such consolidated financial statements present fairly, in all material respects, the financial position of Alliance Data Systems Corporation and subsidiaries as of December 31, 2005 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 2 to the consolidated financial statements, as of January 1, 2006, the Company changed its method of accounting for employee stock-based compensation.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 26, 2007 expressed an unqualified opinion on management s assessment of the effectiveness of the Company s internal control over financial reporting and an unqualified opinion on the effectiveness of the Company s internal control over financial reporting. As described in our report dated February 26, 2007, management excluded from their assessment the internal control over financial reporting of iCom Information & Communications, Inc. (ICOM), DoubleClick Email Solutions and CPC Associates, Inc. (CPC) which were acquired in February, April and October, 2006, respectively; accordingly, our audit of the Company s internal control over financial reporting did not include the internal control over financial reporting at ICOM, DoubleClick Email Solutions, or CPC.

/s/ Deloitte & Touche LLP

Dallas, Texas
February 26, 2007

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders of
Alliance Data Systems Corporation

We have audited management s assessment, included in the accompanying Management s Report on Internal Control Over Financial Reporting, that Alliance Data Systems Corporation and subsidiaries (the Company) maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. As described in Management s Report on Internal Control Over Financial Reporting, management excluded from their assessment the internal control over financial reporting at iCom Information & Communication, Inc. (ICOM), DoubleClick Email Solutions and CPC Associates, Inc. (CPC) which were acquired in February, April and October, 2006, respectively, and whose collective financial statements reflect total assets and revenues constituting seven and five percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2006. Accordingly, our audit did not include the internal control over financial reporting at ICOM, DoubleClick Email Solutions or CPC. The Company 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. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of 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, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed by, or under the supervision of, the company s principal executive and principal financial officers, or persons performing similar functions, 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. 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 the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the 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, management s assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal*

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Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule as of and for the year ended December 31, 2006 of the Company and our report dated February 26, 2007, expressed an unqualified opinion and includes an explanatory paragraph regarding the Company s change in its method of accounting for employee stock-based compensation; on those financial statements and financial statement schedule.

/s/ Deloitte & Touche LLP

Dallas, Texas
February 26, 2007

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ALLIANCE DATA SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,		
	2004	**2005**	**2006**
	(In thousands, except per share amounts)		
Revenues			
Transaction	$ 592,019	$ 616,589	$ 660,305
Redemption	226,726	275,840	352,801
Securitization income and finance charges, net	355,912	405,868	579,742
Database marketing fees and direct marketing services	52,830	194,775	319,704
Other revenue	29,951	59,365	86,190
Total revenue	1,257,438	1,552,437	1,998,742
Operating expenses			
Cost of operations (exclusive of depreciation and amortization disclosed separately below)	916,201	1,124,590	1,434,620
General and administrative	77,740	91,532	91,815
Depreciation and other amortization	62,586	58,565	65,443
Amortization of purchased intangibles	28,812	41,142	59,597
Total operating expenses	1,085,339	1,315,829	1,651,475
Operating income	172,099	236,608	347,267
Fair value loss on interest rate derivative	808		
Interest income	(2,554)	(4,017)	(6,595)
Interest expense	9,526	18,499	47,593
Income before income taxes	164,319	222,126	306,269
Provision for income taxes	61,948	83,381	116,664
Net income	$ 102,371	$ 138,745	$ 189,605
Net income per share:			
Basic	$ 1.27	$ 1.69	$ 2.38
Diluted	$ 1.22	$ 1.64	$ 2.32
Weighted average shares:			
Basic	80,614	82,208	79,735
Diluted	84,040	84,637	81,686

See accompanying notes to consolidated financial statements.

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ALLIANCE DATA SYSTEMS CORPORATION

CONSOLIDATED BALANCE SHEETS

	December 31, 2005	December 31, 2006
	(In thousands, except per share amounts)	
ASSETS		
Cash and cash equivalents	$ 143,213	$ 180,075
Due from card associations	58,416	108,671
Trade receivables, less allowance for doubtful accounts ($2,079 and $5,325 at December 31, 2005 and 2006, respectively)	203,883	271,563
Seller s interest and credit card receivables, less allowance for doubtful accounts ($38,415 and $45,919 at December 31, 2005 and 2006, respectively)	479,108	569,389
Deferred tax asset, net	70,221	88,722
Other current assets	87,612	91,555
Total current assets	1,042,453	1,309,975
Redemption settlement assets, restricted	260,963	260,957
Property and equipment, net	162,972	208,327
Due from securitizations	271,256	325,457
Intangible assets, net	265,000	263,934
Goodwill	858,470	969,971
Other non-current assets	64,968	65,394
Total assets	$ 2,926,082	$ 3,404,015
LIABILITIES AND STOCKHOLDERS EQUITY		
Accounts payable	$ 67,384	$ 112,582
Accrued expenses	198,707	201,904
Merchant settlement obligations	127,038	188,336
Certificates of deposit	342,600	294,800
Credit facilities and other debt, current	235,843	7,902
Other current liabilities	76,999	72,196
Total current liabilities	1,048,571	877,720
Deferred tax liability, net	62,847	44,234
Deferred revenue (Note 9)	610,533	651,506
Certificates of deposit	36,500	4,200
Long-term and other debt	222,001	737,475
Other liabilities	24,523	17,347
Total liabilities	2,004,975	2,332,482
Commitments and contingencies (Note 16)		
Stockholders equity:		

Common stock, $0.01 par value; authorized, 200,000 shares; issued, 84,765 shares and 86,872 shares at December 31, 2005 and 2006, respectively	848	869
Unearned compensation	(14,504)	
Additional paid-in capital	743,545	834,680
Treasury stock, at cost, 4,360 shares and 7,218 shares at December 31, 2005 and 2006, respectively)	(154,952)	(300,950)
Retained earnings	338,081	527,686
Accumulated other comprehensive income	8,089	9,248
Total stockholders equity	921,107	1,071,533
Total liabilities and stockholders equity	$ 2,926,082	$ 3,404,015

See accompanying notes to consolidated financial statements.

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ALLIANCE DATA SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

	Common Stock Shares	Common Stock Amount	Unearned Compensation	Additional Paid-In Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
January 1, 2004	80,043	800		611,550	(6,151)	96,965	(833)	702,331
Net income						102,371		102,371
Other comprehensive income, net of tax:								
Reclassifications into earnings							482	482
Net unrealized loss on securities available-for-sale							(144)	(144)
Foreign currency translation adjustments							4,965	4,965
Other comprehensive income							5,303	
Total comprehensive income								
Issuance of restricted stock	491	5	(7,739)	22,461				14,727
Other common stock issued, including income tax benefits	2,231	23		45,765				45,788
December 31, 2004	82,765	828	(7,739)	679,776	(6,151)	199,336	4,470	870,520
Net income						138,745		138,745
Other comprehensive income, net of tax:								
Net unrealized gain on securities available-for-sale							414	414
Foreign currency translation adjustments							3,205	3,205
							3,619	

Other comprehensive income								
Total comprehensive income								
Amortization of unearned compensation			6,546					6,546
Purchase of treasury shares					(148,801)			(148,801)
Issuance of restricted stock	471	5	(13,311)	20,903				7,597
Other common stock issued, including income tax benefits	1,529	15		42,866				42,881
December 31, 2005	84,765	848	(14,504)	743,545	(154,952)	338,081	8,089	921,107
Net income						189,605		189,605
Other comprehensive income, net of tax:								
Net unrealized gain on securities available-for-sale							1,880	1,880
Foreign currency translation adjustments							(721)	(721)
Other comprehensive income							1,159	
Reversal of unearned compensation upon adoption of SFAS No. 123(R)			14,504	(14,504)				
Stock compensation expense				43,053				43,053
Purchase of treasury shares					(145,998)			(145,998)
Other common stock issued, including income tax benefits	2,107	21		62,586				62,607
December 31, 2006	86,872	$ 869	$	$ 834,680	$ (300,950)	$ 527,686	$ 9,248	$ 1,071,533

See accompanying notes to consolidated financial statements.

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ALLIANCE DATA SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2004	**2005**	**2006**
		(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 102,371	$ 138,745	$ 189,605
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	91,398	99,707	125,040
Deferred income taxes	31,154	(13,475)	(27,772)
Provision for doubtful accounts	2,487	22,055	38,141
Non-cash stock compensation	15,767	14,143	43,053
Fair value gain on interest-only strip	(6,553)	(23,300)	(19,470)
Change in operating assets and liabilities, net of acquisitions:			
Change in trade accounts receivable	(602)	(37,592)	(50,947)
Change in merchant settlement activity	17,936	1,637	11,043
Change in other assets	(3,240)	(8,619)	(3,282)
Change in accounts payable and accrued expenses	(7,394)	42,757	57,084
Change in deferred revenue	30,827	43,288	43,353
Change in other liabilities	(17,831)	743	(8,728)
Purchase of credit card receivables	(34,417)	(186,419)	(73,555)
Proceeds from sale of credit card receivable portfolios	105,538		154,445
Tax benefit of stock option exercises	11,209	13,648	
Excess tax benefits from stock-based compensation			(17,521)
Other	9,979	1,763	8,291
Net cash provided by operating activities	348,629	109,081	468,780
CASH FLOWS FROM INVESTING ACTIVITIES:			
Change in redemption settlement assets	(10,464)	(10,983)	(396)
Payments for acquired businesses, net of cash acquired	(329,493)	(140,901)	(205,567)
Net increase in seller s interest and credit card receivables	(48,441)	(106,785)	(203,764)
Change in due from securitizations	40,181	(1,005)	(32,698)
Capital expenditures	(48,329)	(65,900)	(100,352)
Other	(3,313)	(5,377)	(195)
Net cash used in investing activities	(399,859)	(330,951)	(542,972)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Borrowings under debt agreements	770,388	1,272,260	3,629,869
Repayment of borrowings	(627,037)	(1,155,735)	(3,345,869)
Certificates of deposit issuances	90,600	379,100	336,300
Repayments of certificates of deposit	(196,300)	(94,700)	(416,400)
Payment of capital lease obligations	(5,810)	(6,409)	(7,935)

Excess tax benefits from stock-based compensation			17,521
Proceeds from issuance of common stock	34,528	29,106	48,831
Purchase of treasury shares		(145,043)	(145,998)
Other			(4,049)
Net cash provided by financing activities	66,369	278,579	112,270
Effect of exchange rate changes on cash and cash equivalents	1,525	2,095	(1,216)
Change in cash and cash equivalents	16,664	58,804	36,862
Cash and cash equivalents at beginning of year	67,745	84,409	143,213
Cash and cash equivalents at end of year	$ 84,409	$ 143,213	$ 180,075
SUPPLEMENTAL CASH FLOW INFORMATION:			
Interest paid	$ 9,274	$ 16,423	$ 40,628
Income taxes paid, net of refunds	$ 21,094	$ 58,237	$ 141,935

See accompanying notes to consolidated financial statements.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Description of the Business Alliance Data Systems Corporation (ADSC or, including its wholly owned subsidiaries, the Company) is a leading provider of loyalty and marketing solutions derived from transaction rich data. The Company partners with its clients to develop unique insight into consumer behavior. The Company uses that insight to create and manage customized solutions that the Company believes enhances consumer experiences and enable its clients to build stronger, mutually-beneficial relationships with their customers. The Company focuses on facilitating and managing interactions between its clients and their customers through multiple distribution channels including in-store, catalog and on-line. Through the Credit Services and Marketing Services segments, the Company assists its clients in identifying and acquiring new customers and helps to increase the loyalty and profitability of its clients existing customers.

The Company operates in three reportable segments: Marketing Services, Credit Services and Transaction Services. Marketing Services provides loyalty programs, such as the AIR MILES® Reward Program, and integrated direct marketing solutions that combine database marketing technology and analytics with a broad range of direct marketing services, that includes email marketing campaigns. Credit Services provides private label credit card receivables financing. Credit Services generally securitizes the credit card receivables that it underwrites from its private label credit card programs. Transaction Services encompasses card processing, billing and payment processing and customer care for specialty and petroleum retailers (processing services), customer information system hosting, customer care and billing and payment processing for regulated and de-regulated utilities (utility services) and other processing-oriented businesses.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation The accompanying consolidated financial statements include the accounts of ADSC and its wholly owned subsidiaries. All significant intercompany transactions have been eliminated.

Cash and Cash Equivalents The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

Due from Card Associations and Merchant Settlement Obligations Due from card associations and merchant settlement obligations result from the Company s merchant services and associated settlement activities. Due from card associations is generated from credit card transactions, such as MasterCard, Visa, American Express, and Discover Card at merchant locations. The Company records corresponding settlement obligations for amounts payable to merchants. These accounts are settled with the respective card association or merchant on different days.

Seller s Interest and Credit Card Receivables Credit card receivables are generally securitized immediately or shortly after origination. As part of its securitization agreements, the Company is required to retain an interest in the credit card receivables, which is referred to as seller s interest. Seller s interest is carried at fair value and credit card receivables are carried at lower of cost or market less an allowance for doubtful accounts. In its capacity as a servicer of the credit card receivables, the Company receives a servicing fee from the World Financial Network Credit Card Master Trust, World Financial Network Credit Card Master Note Trust and World Financial Network Credit Card Master Trust III (WFN Trusts). The Company believes that serving fees received represent adequate compensation based on the amount currently demanded by the market place. Additionally, these fees are the same as would fairly compensate a substitute servicer should one be required and, thus, the Company records neither a servicing asset nor servicing liability.

Allowance for Doubtful Accounts The Company specifically analyzes accounts receivable and historical bad debts, customer credit-worthiness, current economic trends, and changes in its customer payment terms and collection trends when evaluating the adequacy of its allowance for doubtful accounts. Any change in the assumptions used in analyzing a specific account receivable may result in an additional allowance for doubtful accounts being recognized in the period in which the change occurs.

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Redemption Settlement Assets, Restricted These securities relate to the redemption fund for the AIR MILES Reward Program and are held in trust for the benefit of funding redemptions by collectors. These assets are restricted to funding rewards for the collectors by certain of our sponsor contracts. These securities are stated at fair value, with the unrealized gains and losses, net of tax, reported as a component of accumulated other comprehensive income. Debt securities that the Company does not have the positive intent and ability to hold to maturity are classified as securities available-for-sale.

Property and Equipment Furniture, fixtures, computer equipment and software, and leasehold improvements are carried at cost, less accumulated depreciation and amortization. Depreciation and amortization, including capital leases are computed on a straight-line basis, using estimated lives ranging from three to 15 years. Leasehold improvements are amortized over the remaining lives of the respective leases or the remaining useful lives of the improvements, whichever is shorter. Software development (costs to create new platforms for certain of the Company s information systems) and conversion costs (systems, programming and other related costs to allow conversion of new client accounts to the Company s processing systems) are capitalized in accordance with Statement of Position (SOP) 98-1 Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and are amortized on a straight-line basis over the length of the associated contract or benefit period, which generally ranges from three to five years.

Revenue Recognition

The Company s policy follows the guidance from SEC Staff Accounting Bulletin (SAB) No. 104 Revenue Recognition . SAB No. 104 provides guidance on the recognition, presentation, and disclosure of revenue in financial statements. The Company recognizes revenues when persuasive evidence of an arrangement exists, the services have been provided to the client, the sales price is fixed or determinable, and collectibility is reasonably assured.

Transaction The Company earns transaction fees, which are principally based on the number of transactions processed or statements generated and are recognized as such services are performed. Included are reimbursements received for out-of-pocket expenses.

Database marketing fees and direct marketing services For maintenance and service programs, revenue is recognized as services are provided. Revenue associated with a new database build is deferred until client acceptance. Upon acceptance, it is then recognized over the term of the related agreement as the services are provided.

AIR MILES Reward Program The Company allocates the proceeds received from sponsors for the issuance of AIR MILES reward miles based on relative fair values between the redemption element of the award ultimately provided to the collector (the Redemption element) and the service element (the Service element). The Service element consists of direct marketing and support services provided to sponsors.

The fair value of the Service element is based on the estimated fair value of providing the services on a third-party basis. The revenue related to the Service element of the AIR MILES reward miles is initially deferred and amortized over the period of time beginning with the issuance of the AIR MILES reward miles and ending upon their expected redemption (the estimated life of an AIR MILES reward mile, or 42 months). Revenue associated with the Service element is recorded as part of transaction revenue.

The fair value of the Redemption element of the AIR MILES reward miles issued is determined based on separate pricing offered by the Company as well as other objective evidence. The revenue related to the Redemption element is deferred until the collector redeems the AIR MILES reward miles or over the estimated life of an AIR MILES reward mile in the case of AIR MILES reward miles that the Company estimates will go unused by the collector base (breakage). The Company currently estimates breakage to be

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

one-third of AIR MILES reward miles issued. There have been no changes to management s estimate of the life of a mile or breakage in the periods presented.

Securitization income Securitization income represents gains and losses on securitization of credit card receivables and interest income on seller s interest and credit card receivables held on the balance sheet less a provision for doubtful accounts of $1.8 million, $20.9 million and $33.8 million for the years ended December 31, 2004, 2005, and 2006, respectively. For the years ended December 31, 2004, 2005 and 2006, the Company recognized $2.0 million, zero and $2.7 million, respectively, in gains, related to the securitization of new credit card receivables accounted for as sales. The Company records gains or losses on the securitization of credit card receivables on the date of sale based on cash received, the estimated fair value of assets sold and retained, and liabilities incurred in the sale. The anticipated excess cash flow essentially represents an interest-only (I/O) strip, consisting of the excess of finance charges and certain other fees over the sum of the return paid to certificate holders and credit losses over the estimated outstanding period of the receivables. The amount initially allocated to the I/O strip at the date of a securitization reflects the allocated original basis of the relative fair values of those interests. The amount recorded for the I/O strip is reduced for distributions on the I/O strip, which the Company receives from the related trust, and is adjusted for changes in the fair value of the I/O strip, which are reflected in other comprehensive income. Because there is not a highly liquid market for these assets, management estimates the fair value of the I/O strip primarily based upon discount, payment and default rates, which is the method we assume that another market participant would use to purchase the I/O strip.

In recording and accounting for the I/O strip, management makes assumptions about rates of payments and defaults, which reflect economic and other relevant conditions that affect fair value. Due to subsequent changes in economic and other relevant conditions, the actual rates of payments and defaults would generally differ from our initial estimates, and these differences could sometimes be material. If actual payment and default rates are higher than previously assumed, the value of the I/O strip could be permanently impaired and the decline in the fair value would be recorded in earnings.

The Company recognizes the implicit forward contract to sell new receivables during a revolving period at its fair value at the time of sale. The implicit forward contract is entered into at the market rate and thus, its initial measure is zero at inception. In addition, the Company does not mark the forward contract to fair value in accounting periods following the securitization as management has concluded that the fair value of the implicit forward contract in subsequent periods is not material.

Finance charges, net Finance charges, net of credit losses, represents revenue earned on customer accounts serviced by the Company, and is recognized in the period in which it is earned.

Securitization Sales The Company s securitization of its credit card receivables involves the sale to a trust and is accomplished primarily through the public and private issuance of asset-backed securities by the special purpose entities. The Company removes credit card receivables from its Consolidated Balance Sheets for those asset securitizations that qualify as sales in accordance with Statement of Financial Accounting Standard (SFAS) No. 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities-a replacement of FASB Statement No. 125 . The Company has determined that the WFN Trusts are qualifying special purpose entities as defined by SFAS No. 140, and that all current securitizations qualify as sales.

Goodwill and Other Intangible Assets Goodwill and indefinite lived intangible assets are not amortized, but are reviewed at least annually for impairment or more frequently if circumstances indicate that an impairment may have occurred, using the market comparable and discounted cash flow methods. Separable intangible assets that have finite useful lives are amortized over those useful lives.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Earnings Per Share Basic earnings per share is based only on the weighted average number of common shares outstanding, excluding any dilutive effects of options or other dilutive securities. Diluted earnings per share is based on the weighted average number of common and potentially dilutive common shares (dilutive stock options, unvested restricted stock and other dilutive securities outstanding during the year).

The following table sets forth the computation of basic and diluted net income per share for the periods indicated:

	Year Ended December 31, 2004	2005	2006
	(In thousands, except per share amounts)		
Numerator			
Net income available to common stockholders	$ 102,371	$ 138,745	$ 189,605
Denominator			
Weighted average shares, basic	80,614	82,208	79,735
Weighted average effect of dilutive securities:			
Net effect of dilutive stock options and unvested restricted stock	3,426	2,429	1,951
Denominator for diluted calculation	84,040	84,637	81,686
Basic			
Net income per share	$ 1.27	$ 1.69	$ 2.38
Diluted			
Net income per share	$ 1.22	$ 1.64	$ 2.32

Management Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amount 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.

Currency Translation The assets and liabilities of the Company s subsidiaries outside the U.S., primarily Canada, are translated into U.S. dollars at the rates of exchange in effect at the balance sheet dates. Income and expense items are translated at the average exchange rates prevailing during the period. Gains and losses resulting from currency transactions are recognized currently in income, and those resulting from translation of financial statements are included in accumulated other comprehensive income.

Advertising Costs The Company participates in various advertising and marketing programs. The cost of advertising and marketing programs are expensed in the period incurred. The Company has recognized advertising expenses of $30.2 million, $39.7 million and $76.7 million for the years ended 2004, 2005 and 2006.

Stock Compensation Expense Effective January 1, 2006, the Company adopted the provisions of, and accounted for stock-based compensation in accordance with, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)) which supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25). Under the fair value recognition provisions, stock-based compensation expense is measured at the grant date based on the fair value of the award and is recognized ratably over the requisite service period. The Company elected the modified prospective method, under which prior periods are

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

not revised for comparative purposes. The valuation provisions of SFAS No. 123(R) apply to new grants and to grants that were outstanding as of the effective date and are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation expense estimated for the Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS No. 123) pro forma disclosures, adjusted for forfeitures.

The following table sets forth the pro forma amounts of net income and net income per share, for years ended December 31, 2004 and 2005 that would have resulted if the Company had accounted for the stock-based awards under the fair value recognition provisions of SFAS No. 123:

	Year Ended December 31,	
	2004	2005
	(In thousands, except per share amounts)	
Net income, as reported	$ 102,371	$ 138,745
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	10,249	8,839
Deduct: Total stock-based employee compensation expense determined under fair value based method for all stock option awards, net of related tax effects	(19,756)	(22,849)
	$ 92,864	$ 124,735
Net income per share:		
Basic-as reported	$ 1.27	$ 1.69
Basic-pro forma	$ 1.15	$ 1.52
Diluted-as reported	$ 1.22	$ 1.64
Diluted-pro forma	$ 1.11	$ 1.47

Income Taxes Deferred income taxes are provided for differences arising in the timing of income and expenses for financial reporting and for income tax purposes using the asset/liability method of accounting. Under this method, deferred income taxes are recognized for the future tax consequences attributable to the differences between the financial statements carrying amounts of existing assets and liabilities and their respective tax bases, using enacted tax rates.

Long-Lived Assets Long-lived assets and other intangible assets are evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets or intangibles may not be recoverable. Recoverability is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

Recently Issued Accounting Standards In February 2006, FASB issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments (SFAS No. 155), which amends SFAS No. 133 and SFAS No. 140. SFAS No. 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 also clarifies and amends certain other provisions of SFAS No. 133 and SFAS No. 140. SFAS No. 155 is effective for all financial instruments acquired, issued or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided we have not yet issued financial statements, including for interim periods, for that fiscal year. The Company does not expect the adoption of SFAS No. 155 to have a material impact on our consolidated financial position, results of operations or cash flows.

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets (SFAS No. 156). SFAS No. 156 amends SFAS No. 140 with respect to the accounting for separately-recognized servicing assets and liabilities. SFAS No. 156 addresses the recognition and measurement of separately-recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like (offset) accounting. The standard is effective for fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided we have not yet issued financial statements, including for interim periods, for that fiscal year. The Company does not expect the adoption of SFAS No. 156 to have a material impact on our consolidated financial position, results of operations or cash flows.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN No. 48). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes . FIN No. 48 prescribes a financial statement recognition threshold and measurement attribute of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The provisions of FIN No. 48 are effective for fiscal years beginning after December 15, 2006. The Company will adopt FIN 48 on January 1, 2007, as required. The cumulative effect of adopting FIN 48 primarily will be a reduction to retained earnings of approximately $6.0 million to $10.0 million.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 establishes a new definition of fair value as well as a fair value hierarchy that prioritizes the information used to develop the assumptions, and requires new disclosures of assets and liabilities measured at fair value based on their level in the hierarchy. The standard is effective for fiscal years beginning after November 15, 2007. The Company is currently in process of evaluating the effect of the adoption of SFAS No. 157 on our consolidated financial position, results of operations and cash flows.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Post-retirement plans (SFAS No. 158). Among other items, SFAS No. 158 requires recognition of the overfunded or underfunded status of an entity s defined benefit postretirement plan as an asset or liability in the financial statements, requires the measurement of defined benefit postretirement plan assets and obligations as of the end of the employer s fiscal year, and requires recognition of the funded status of defined benefit postretirement plans in other comprehensive income. The standard is effective for the Company as of December 31, 2006. The adoption of SFAS No. 158 did not have a material impact on our consolidated financial position, results of operations and cash flows.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB No. 108). SAB No. 108 addresses quantifying the financial statement effects of misstatements, specifically, how the effects of prior year uncorrected errors must be considered in quantifying misstatements in the current year financial statements. SAB No. 108 does not amend or change the SEC Staff s previous positions in Staff Accounting Bulletin No. 99, Materiality, regarding qualitative considerations in assessing the materiality of misstatements. SAB No. 108 is effective for fiscal years beginning after November 15, 2006. The Company does expect the adoption of SAB No. 108 to have a material impact on our consolidated financial position, results of operations or cash flows.

Reclassifications For purposes of comparability, certain prior period amounts have been reclassified to conform with the current year presentation.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. BUSINESS ACQUISITIONS

During the past three years the Company completed the following acquisitions:

Business	Month Acquired	Consideration	Segment
2006:			
iCom Information & Communications, Inc.	February 2006	Cash for Assets and Common Stock	Marketing Services
DoubleClick Email Solutions	April 2006	Cash for Assets and Common Stock	Marketing Services
Big Designs, Inc.	August 2006	Cash for Assets	Marketing Services
CPC Associates, Inc.	October 2006	Cash for Common Stock	Marketing Services
2005:			
Atrana Solutions, Inc.	May 2005	Cash for Common Stock	Transaction Services
Bigfoot Interactive, Inc.	September 2005	Cash for Equity	Marketing Services
2004:			
Epsilon Data Management, Inc.	October 2004	Cash for Common Stock	Marketing Services
Capstone Consulting Partners, Inc.	November 2004	Cash for Common Stock	Transaction Services

2006 Acquisitions:

In February 2006, the Company acquired Toronto-based iCom Information & Communications, Inc. (ICOM), a leading provider of targeted list, marketing data and communications solutions for the pharmaceutical, tobacco and fast moving consumer goods industries in North America. Total consideration paid was approximately $36.1 million as of the closing date, including acquisition costs. As a result of this acquisition, the Company acquired $10.8 million of customer contracts, $2.3 million of capitalized software, $13.2 of net assets and $9.8 million of goodwill. The results of operations for ICOM have been included since the date of acquisition and are reflected in our Marketing Services segment.

In April 2006, the Company acquired DoubleClick Email Solutions, a permission-based email marketing service provider, with operations across North America, Europe and Asia/Pacific. Total consideration paid was approximately $91.1 million, including acquisition costs. As a result of this acquisition, the Company acquired approximately $26.8 million of customer contracts, $2.3 million of capitalized software, $0.4 million associated with a non-compete agreement, $6.0 million in net assets and $55.6 million of goodwill. An independent valuation was conducted to assign a fair market value to the intangible assets identified as part of the acquisition. The results of operations for DoubleClick Email Solutions have been included since the date of acquisition and are reflected in our Marketing Services segment.

In August 2006, the Company acquired Big Designs, a design agency that specializes in creative development for both print and on-line media. Total consideration paid was approximately $5.0 million. As a result of this acquisition, the Company acquired approximately $0.7 million of customer contracts, $0.5 million associated with a non-compete agreement, $0.1 of net assets and $3.7 million of goodwill. The results of operations for Big Designs have been included since the date of acquisition and are reflected in our Marketing Services segment.

In October 2006, the Company acquired CPC Associates, Inc. (CPC), a provider of data products and services used to increase effectiveness of direct-response marketing programs for a variety of business sectors. Total consideration paid was approximately $72.5 million, including acquisition costs. As a result of this acquisition, the Company acquired approximately $16.8 million of customer contracts, $0.7 million in purchased software, $0.6 million in tradenames, $1.6 million in net assets and $52.9 million in goodwill. An independent valuation was conducted to assign a fair market value to the intangible assets identified as part of

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. BUSINESS ACQUISITIONS (Continued)

the acquisition. The results of operations for CPC have been included since the date of acquisition and are reflected in our Marketing Services segment.

Pro forma information has not been included for these acquisitions, as the impact is not material.

2005 Acquisitions:

In May 2005, the Company acquired the stock of Atrana Solutions Inc., a provider of point-of-sale technology services. Total consideration paid was approximately $13.1 million. The results of operations for Atrana have been included since the date of acquisition and are reflected in our Transaction Services segment.

On September 30, 2005, the Company acquired Bigfoot Interactive Inc., (Epsilon Interactive), a leading full-service provider of strategic ROI-focused email communications and marketing automation solutions. Total consideration paid was approximately $133.5 million. The results of operations for Epsilon Interactive have been included since the date of acquisition and are reflected in our Marketing Services segment. Pro forma information has not been included as the impact is not material.

2004 Acquisitions:

In October 2004, the Company completed the acquisition of Epsilon Data Management, Inc. (Epsilon). The results of operations have been included since of the date of acquisition. Epsilon has provided customer management and loyalty solutions for over 35 years. Epsilon utilizes database technologies and analytics to evaluate value, growth and loyalty of its clients customers and assists clients in acquiring new customer relationships. The merger consideration consisted of approximately $310.0 million in cash. The base purchase price of $310.0 million was adjusted to $314.5 million as a result of customary post-closing purchase price adjustments and closing costs. Additional closing costs were also paid in 2004.

In November 2004, the Company acquired Capstone Consulting Partners, Inc. (Capstone), a provider of management consulting and technical services to the energy industry. Total consideration paid in connection with the acquisition was approximately $11.4 million. In connection with the acquisition, the Company is required to pay the seller additional consideration for exceeding certain revenue targets, as defined in the acquisition agreement. The contingent payment is limited to $15.0 million. As of December 31, 2005, the Company had met the initial threshold and recorded a purchase price adjustment of $15.0 million of which $5.0 million was paid in 2006 and the remaining $10.0 million was paid in January of 2007.

Purchase Price Allocation:

The following table summarizes the purchase price for the acquisitions, and the allocation thereof:

	2004	2005	2006
		(In thousands)	

Identifiable intangible assets	$ 113,980	$ 31,284	$ 56,610
Capitalized software	12,400	4,942	5,275
Goodwill	218,622	110,589	122,003
Other net (liabilities) assets	(17,786)	(251)	20,880
Purchase price	$ 327,216	$ 146,564	$ 204,768

4. REDEMPTION SETTLEMENT ASSETS

Redemption settlement assets consist of cash and cash equivalents and securities available-for-sale and are designated for settling redemptions by collectors of the AIR MILES Reward Program in Canada under

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. REDEMPTION SETTLEMENT ASSETS (Continued)

certain contractual relationships with sponsors of the AIR MILES Reward Program. These assets are primarily denominated in Canadian dollars. Realized gains and losses from the sale of investment securities were not material. The principal components of redemption settlement assets, which are carried at fair value, are as follows:

	December 31, 2005				December 31, 2006			
		Unrealized				Unrealized		
	Cost	Gains	Losses	Fair value	Cost	Gains	Losses	Fair Value
	(In thousands)							
Cash and cash equivalents	$ 56,651	$	$	$ 56,651	$ 21,583	$	$	$ 21,583
Government bonds	47,746	162	(194)	47,714	53,017	109	(159)	52,967
Corporate bonds	157,336	107	(845)	156,598	186,262	767	(622)	186,407
Total	$ 261,733	$ 269	$ (1,039)	$ 260,963	$ 260,862	$ 876	$ (781)	$ 260,957

In accordance with FASB Staff Position FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* the following table shows the gross unrealized losses and fair value for those investments that were in an unrealized loss position as of December 31, 2005 and 2006, aggregated by investment category and the length of time that individual securities have been in a continuous loss position:

	December 31, 2005					
	Less than 12 months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Government bonds	$ 23,658	$ (194)	$	$	$ 23,658	$ (194)
Corporate bonds	80,568	(437)	34,722	(408)	115,290	(845)
Total	$ 104,226	$ (631)	$ 34,722	$ (408)	$ 138,948	$ (1,039)

	December 31, 2006					
	Less than 12 months		12 Months or Greater		Total	
		Unrealized	Fair	Unrealized		Unrealized

	Fair Value	Losses	Value	Losses	Fair Value	Losses
			(In thousands)			
Government bonds	$ 3,465	$ (13)	$ 23,582	$ (146)	$ 27,047	$ (159)
Corporate bonds	39,942	(151)	78,298	(471)	118,240	(622)
Total	$ 43,407	$ (164)	$ 101,880	$ (617)	$ 145,287	$ (781)

Market values were determined for each individual security in the investment portfolio. When evaluating the investments for other-than-temporary impairment, the Company reviews factors such as the length of time and extent to which fair value has been below cost basis, the financial condition of the issuer, and the Company s ability and intent to hold the investment for a period of time, which may be sufficient for anticipated recovery in market value. The unrealized losses on the Company s investments during 2006 in government and corporate bond securities were caused primarily by changes in interest rates. The Company typically invests in highly-rated securities with low probabilities of default. The Company also has the ability to hold the investments until maturity. As of December 31, 2006, the Company does not consider the investments to be other-than-temporarily impaired.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. REDEMPTION SETTLEMENT ASSETS (Continued)

The net carrying value and estimated fair value of the securities at December 31, 2006 by contractual maturity are as follows:

	Amortized Cost	Estimated Fair Value
	(In thousands)	
Due in one year or less	$ 97,353	$ 97,780
Due after one year through five years	163,509	163,177
Due after five years through ten years		
Due after ten years		
Total	$ 260,862	$ 260,957

5. PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	December 31, 2005	December 31, 2006
	(In thousands)	
Software development and conversion costs	$ 145,022	$ 154,333
Computer equipment and purchased software	115,248	135,005
Furniture and fixtures	65,850	78,863
Leasehold improvements	58,222	63,528
Capital leases	21,874	33,142
Construction in progress	7,686	10,783
Total	413,902	475,654
Accumulated depreciation	(250,930)	(267,327)
Property and equipment, net	$ 162,972	$ 208,327

Depreciation expense totaled $36.3 million, $41.2 million and $50.2 million for the years ended December 31, 2004, 2005, and 2006, respectively, and includes amortization of capital leases. Amortization associated with capitalized software development and conversion costs totaled $27.5 million, $20.3 million and $19.9 million for the years ended December 31, 2004, 2005, and 2006, respectively.

6. SECURITIZATION OF CREDIT CARD RECEIVABLES

The Company regularly securitizes its credit card receivables to the WFN Trusts. During the initial phase of a securitization reinvestment period, the Company generally retains principal collections in exchange for the transfer of additional credit card receivables into the securitized pool of assets. During the amortization or accumulation period of a securitization, the investors share of principal collections (in certain cases, up to a maximum specified amount each month) is either distributed to the investors or held in an account until it accumulates to the total amount due, at which time it is paid to the investors in a lump sum. The Company s outstanding securitizations are scheduled to begin their amortization or accumulation periods at various times between 2007 and 2011 and thereafter.

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. SECURITIZATION OF CREDIT CARD RECEIVABLES (Continued)

The following table shows the maturities of borrowing commitments as of December 31, 2006 for the WFN Trusts by year:

	2007	2008	2009	2010	2011 & Thereafter	Total
			(In thousands)			
Public notes	$ 600,000	$ 600,000	$ 500,000	$	$ 950,000	$ 2,650,000
Private conduits[1]	1,085,714					1,085,714
Total	$ 1,685,714	$ 600,000	$ 500,000	$	$ 950,000	$ 3,735,714

(1) Represents borrowing capacity, not outstanding borrowings.

Seller s interest and credit card receivables, less allowance for doubtful accounts consists of:

	December 31, 2005	December 31, 2006
	(In thousands)	
Seller s interest	$ 203,614	$ 253,170
Credit card receivables	310,698	338,864
Other receivables	3,211	23,274
Allowance	(38,415)	(45,919)
	$ 479,108	$ 569,389

Due from securitizations consists of:

	December 31, 2005	December 31, 2006
	(In thousands)	
Spread deposits	$ 117,844	$ 128,787

I/O strips	88,763	110,060
Residual interest in securitization trust	53,514	82,110
Excess funding deposits	11,135	4,500
	$ 271,256	$ 325,457

The Company is required to maintain minimum interests ranging from 4% to 10% of the securitized credit card receivables. This requirement is met through seller s interest and is supplemented through the excess funding deposits. Excess funding deposits represent cash amounts deposited with the trustee of the securitizations. Residual interest in securitization represents a subordinated interest in the cash flows of the WFN Trusts.

The spread deposits and I/O strips are initially recorded at their allocated carrying amount based on relative fair value. Fair value is determined by computing the present value of the estimated cash flows, using the dates that such cash flows are expected to be released to the Company, at a discount rate considered to be commensurate with the risks associated with the cash flows. The amounts and timing of the cash flows are estimated after considering various economic factors including payment rates, delinquency, default and loss assumptions. I/O strips, seller s interest and other interests retained are periodically evaluated for impairment based on the fair value of those assets.

Fair values of I/O strips and other interests retained are based on a review of actual cash flows and on the factors that affect the amounts and timing of the cash flows from each of the underlying credit card

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. SECURITIZATION OF CREDIT CARD RECEIVABLES (Continued)

receivable pools. Based on this analysis, assumptions are validated or revised as deemed necessary, the amounts and the timing of anticipated cash flows are estimated and fair value is determined. The Company has one collateral type, private label credit card receivables.

At December 31, 2006, key economic assumptions and the sensitivity of the current fair value of residual cash flows to immediate 10% and 20% adverse changes in the assumptions are as follows:

	Assumptions	Impact on Fair Value of 10% Change	Impact on Fair Value of 20% Change
		(In thousands)	
Fair value of I/O strip	$ 110,060		
Weighted average life	7.25 months		
Discount rate	11.0%	$ (333)	$ (664)
Expected yield, net of dilution	17.1%	(26,359)	(52,502)
Interest expense	5.9%	(989)	(1,971)
Net charge-offs rate	7.2%	(7,962)	(15,816)

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 10 percent variation in assumptions generally cannot be extrapolated because the relationship of the change in an assumption to the change in fair value may not be linear. Also, in this table the effect of a variation in a particular assumption on the fair value of the retained interest is calculated without changing any other assumption; in practice, changes in one factor may result in changes in another, which might magnify or counteract the sensitivities.

Spread deposits, carried at estimated fair value, represent deposits that are held by a trustee or agent and are used to absorb shortfalls in the available net cash flows related to securitized credit card receivables if those available net cash flows are insufficient to satisfy certain obligations of the WFN Trusts. The fair value of spread deposits is based on the weighted average life of the underlying securities and the discount rate. The discount rate is based on a risk adjusted rate paid on the series. The amount required to be deposited is approximately 3.8% of the investor s interest in the WFN Trusts. Spread deposits are generally released proportionately as investors are repaid, although some spread deposits are released only when investors have been paid in full. None of these spread deposits were required to be used to cover losses on securitized credit card receivables in the three-year period ended December 31, 2006.

The table below summarizes certain cash flows received from and paid to securitization trusts:

	Year Ended December 31,		
	2004	2005	2006
		(In millions)	

Proceeds from collections reinvested in previous credit card securitizations	$ 7,060.4	$ 7,192.8	$ 7,341.4
Proceeds from new securitizations	1,400.0		500.0
Servicing fees received	59.3	59.4	64.1
Other cash flows received on retained interests	317.9	349.5	505.8

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. SECURITIZATION OF CREDIT CARD RECEIVABLES (Continued)

The tables below present quantitative information about the components of total credit card receivables managed, delinquencies and net charge-offs:

	December 31, 2005	December 31, 2006
	(In millions)	
Total credit card receivables managed	$ 3,714.5	$ 4,171.3
Less credit card receivables securitized	3,486.6	3,832.4
Add credit card receivables securitized for which we do not bear the risk of loss	82.8	
Credit card receivables	$ 310.7	$ 338.9
Principal amount of managed credit card receivables 90 days or more past due	$ 69.3	$ 88.1

	Year Ended December 31, 2004	2005	2006
		(In thousands)	
Net managed charge-offs	$ 205,454	$ 207,397	$ 180,449

7. INTANGIBLE ASSETS AND GOODWILL

Intangible assets consist of the following:

	December 31, 2005 Gross Assets	Accumulated Amortization	Net	Amortization Life and Method
		(In thousands)		
Finite Lived Assets				
Customer contracts and lists	$ 243,906	$ (73,766)	$ 170,140	2-20 years straight line
Premium on purchased credit card portfolios	77,529	(14,700)	62,829	5-10 years straight line, accelerated
Collector database	60,186	(42,292)	17,894	30 years 15% declining balance
Noncompete agreements	2,400	(1,545)	855	2-5 years straight line
Favorable lease	1,000	(68)	932	4 years straight line

	$ 385,021	$ (132,371)	$ 252,650	
Indefinite Lived Assets				
Tradenames	12,350		12,350	Indefinite life
Total intangible assets	$ 397,371	$ (132,371)	$ 265,000	

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. INTANGIBLE ASSETS AND GOODWILL (Continued)

	December 31, 2006			
	Gross Assets	Accumulated Amortization	Net	Amortization Life and Method
		(In thousands)		
Finite Lived Assets				
Customer contracts and lists	$ 292,272	$ (111,486)	$ 180,786	2-20 years straight line
Premium on purchased credit card portfolios	72,108	(21,861)	50,247	5-10 years straight line, accelerated
Collector database	60,067	(44,916)	15,151	30 years 15% declining balance
Customer databases	2,900	(181)	2,719	4 years straight line
Noncompete agreements	1,800	(458)	1,342	2-5 years straight line
Favorable lease	1,000	(341)	659	4 years straight line
Tradenames	550	(34)	516	4 years straight line
Purchased data lists	449	(285)	164	1 year accelerated basis
	$ 431,146	$ (179,562)	$ 251,584	
Indefinite Lived Assets				
Tradenames	12,350		12,350	Indefinite life
Total intangible assets	$ 443,496	$ (179,562)	$ 263,934	

As a result of acquisitions during 2006, the Company acquired $55.1 million of customer contracts with a weighted average life of 5 years, tradenames of $0.6 million with a weighted average life of 4 years and non-compete agreements of $0.9 million with a weighted average life of 2 years.

Amortization expense related to the intangible assets was approximately $27.6 million, $38.2 million and $54.9 million for the years ended December 31, 2004, 2005, and 2006, respectively.

The estimated amortization expense related to intangible assets for the next five years is as follows:

	For Years Ending December 31, (In thousands)
2007	$ 54,348
2008	49,535
2009	38,078
2010	35,783

2011	23,453
2012 & thereafter	50,387

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. INTANGIBLE ASSETS AND GOODWILL (Continued)

Goodwill

The changes in the carrying amount of goodwill for the years ended December 31, 2005 and 2006 respectively, are as follows:

	Marketing Services	Credit Services	Transaction Services	Total
		(In thousands)		
December 31, 2004	$ 405,272	$	$ 303,874	$ 709,146
Goodwill acquired during year	101,913		8,676	110,589
Effects of foreign currency translation	6,504		340	6,844
Other, primarily final purchase price adjustments	9,362		22,529	31,891
December 31, 2005	$ 523,051	$	$ 335,419	$ 858,470
Goodwill acquired during year	122,003			122,003
Effects of foreign currency translation	(369)		(21)	(390)
Other, primarily final purchase price adjustments	(9,660)		(452)	(10,112)
December 31, 2006	$ 635,025	$	$ 334,946	$ 969,971

The Company completed annual impairment tests for goodwill on July 31, 2004, 2005, and 2006 and determined at each date that no impairment exists. No further testing of goodwill impairments will be performed until July 31, 2007, unless circumstances exist that indicate that an impairment may have occurred.

8. ACCRUED EXPENSES

Accrued expenses consist of the following:

	December 31, 2005	December 31, 2006
	(In thousands)	
Accrued payroll and benefits	$ 77,433	$ 93,781
Accrued taxes	56,488	42,384
Accrued other liabilities	64,786	65,739
Accrued liabilities	$ 198,707	$ 201,904

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. DEFERRED REVENUE

A reconciliation of deferred revenue for the AIR MILES Reward Program is as follows:

	Deferred Revenue		
	Service	Redemption (In thousands)	Total
December 31, 2004	158,026	389,097	547,123
Cash proceeds	107,568	190,758	298,326
Revenue recognized	(86,829)	(168,901)	(255,730)
Effects of foreign currency translation	6,134	14,680	20,814
December 31, 2005	184,899	425,634	610,533
Cash proceeds	123,204	242,359	365,563
Revenue recognized	(103,485)	(217,354)	(320,839)
Other		(1,361)	(1,361)
Effects of foreign currency translation	(901)	(1,489)	(2,390)
December 31, 2006	$ 203,717	$ 447,789	$ 651,506

10. DEBT

Debt consists of the following:

	December 31,	
	2005	2006
	(In thousands)	
Certificates of deposit	$ 379,100	$ 299,000
Senior notes		500,000
Credit facilities	441,000	225,000
Other	16,844	20,377
	836,944	1,044,377
Less: current portion	(578,443)	(302,702)
Long-term portion	$ 258,501	$ 741,675

Certificates of Deposit

Terms of the certificates of deposit range from three months to 24 months with annual interest rates ranging from 3.9% to 5.0% at December 31, 2005 and 4.3% to 6.0% at December 31, 2006. Interest is paid monthly and at maturity.

Credit Facilities

At the beginning of fiscal year 2006, the Company maintained three credit agreements with aggregate revolving lending commitments of $515.0 million with the capability to increase such commitments up to $550.0 million as follows:

3-year credit agreement revolving lending commitments of $250.0 million and a maturity date of April 3, 2008;

364-day credit agreement revolving lending commitments of $230.0 million and a maturity date of April 6, 2006; and

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. DEBT (Continued)

Canadian credit agreement revolving lending commitments of $35.0 million and a maturity date of April 3, 2008.

During January 2006, the Company entered into an additional credit agreement to increase its borrowing capacity by an incremental $300.0 million. This credit agreement included usual and customary negative covenants for credit agreements of this type. On January 5, 2006, the Company borrowed $300.0 million under this credit agreement, which the Company used for general corporate purposes, including other debt repayment, repurchases of its common stock in connection with its stock repurchase program, mergers and acquisitions, and capital expenditures. The Company paid in full the $300.0 million credit agreement on May 16, 2006 with a portion of the proceeds from the senior notes (described below) and permitted such $300.0 million credit agreement to terminate pursuant to its terms on its scheduled maturity date, June 30, 2006.

On April 6, 2006, the Company amended its 364-day credit agreement to extend the maturity date from April 6, 2006 to April 5, 2007.

Advances under these four credit facilities were in the form of either base rate loans or eurodollar loans. The interest rate on base rate loans fluctuated based upon the higher of (1) the interest rate announced by the administrative agent as its prime rate and (2) the Federal funds rate plus 0.5%, in each case with no additional margin. The interest rate on eurodollar loans fluctuated based upon the rate at which eurodollar deposits in the London interbank market are quoted plus a margin of 0.5% to 1.0% based upon the ratio of total debt under these credit facilities to consolidated Operating EBITDA, as each term is defined in the credit facilities. The credit facilities were secured by pledges of stock of certain of the Company s subsidiaries and pledges of certain intercompany promissory notes.

On September 29, 2006, the Company entered into a new consolidated credit agreement to provide for a $540.0 million revolving credit facility with a U.S. $50.0 million sublimit for Canadian dollar borrowings and a $50.0 million sublimit for swing line loans (the 2006 credit facility). Additionally, the 2006 credit facility includes an uncommitted accordion feature of up to $210.0 million in the aggregate allowing for future incremental borrowings, subject to certain conditions. The lending commitments under the 2006 credit facility are scheduled to terminate September 29, 2011. The 2006 credit facility is unsecured. Each of ADS Alliance Data Systems, Inc., Alliance Data Foreign Holding, Inc., Epsilon Marketing Services, LLC and Epsilon Data Management, LLC are guarantors under the 2006 facility.

As of December 31, 2006, the Company has borrowed approximately $225.0 million under the 2006 credit facility for general corporate purposes and to pay off and terminate the 3-year credit agreement, the 364-day credit agreement and the Canadian credit agreement. At December 31, 2006, borrowings under the 2006 credit facility had a weighted average interest rate of 6.4%.

Advances under the 2006 credit facility are in the form of either base rate loans or eurodollar loans and may be denominated in U.S. dollars or Canadian dollars. The interest rate for base rate loans denominated in U.S. dollars fluctuates and is equal to the higher of (1) the Bank of Montreal s prime rate and (2) the Federalfunds rate plus 0.5%, in either case with no additional margin. The interest rate for base rate loans denominated in Canadian dollars fluctuates and is equal to the higher of (1) the Bank of Montreal s prime rate for Canadian dollar loans and (2) the CDOR rate plus 1%, in either case with no additional margin. The interest rate for eurodollar loans denominated in U.S. or Canadian dollars fluctuates based on the rate at which deposits of U.S. dollars or Canadian dollars, respectively, in the London interbank market are quoted plus a margin of 0.5% to 1.0% based upon the Company s Senior Leverage Ratio as defined in the 2006 credit facility.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. DEBT (Continued)

Among other fees, the Company pays a facility fee of 0.1% to 0.2% per annum (due quarterly) on the aggregate commitments under the 2006 credit facility, whether used or unused, based upon the Company s Senior Leverage Ratio as defined in the 2006 credit facility. The Company will also pay fees with respect to any letters of credit issued under the 2006 credit facility.

The 2006 credit facility includes usual and customary negative covenants for credit agreements of this type, including, but not limited to, restrictions on the Company s ability, and in certain instances, its subsidiaries ability, to consolidate or merge; substantially change the nature of its business; sell, transfer or dispose of assets; create or incur indebtedness; create liens; pay dividends and repurchase stock; and make investments. The negative covenants are subject to certain exceptions, as specified in the 2006 credit facility. The 2006 credit facility also requires the Company to satisfy certain financial covenants, including maximum ratios of Total Capitalization and Senior Leverage as determined in accordance with the 2006 credit facility and a minimum ratio of Consolidated Operating EBITDA to Consolidated Interest Expense as determined in accordance with the 2006 credit facility.

The 2006 credit facility also includes customary events of default, including, among other things, payment default, covenant default, breach of representation or warranty, bankruptcy, cross-default, material ERISA events, a change of control of the Company, material money judgments and failure to maintain subsidiary guarantees.

Senior Notes

On May 16, 2006, the Company entered into a senior note purchase agreement and issued and sold $250.0 million aggregate principal amount of 6.00% Series A Notes due May 16, 2009 and $250.0 million aggregate principal amount of 6.14% Series B Notes due May 16, 2011. The proceeds were used to retire the $300.0 million credit agreement, to repay other debt and for general corporate purposes.

The Series A and Series B Notes will accrue interest on the unpaid balance thereof at the rate of 6.00% and 6.14% per annum, respectively, from May 16, 2006, payable semiannually, on May 16 and November 16 in each year, commencing with November 16, 2006, until the principal has become due and payable. The note purchase agreement includes usual and customary negative covenants and events of default for transactions of this type. The senior notes are unsecured. The payment obligations under the senior notes are guaranteed by certain of the Company s existing and future subsidiaries, originally ADS Alliance Data Systems, Inc. Due to their status as guarantors under the 2006 credit facility and pursuant to a Joinder to Subsidiary Guaranty dated as of September 29, 2006, three additional subsidiaries of the Company became guarantors of the senior notes, including Alliance Data Foreign Holdings, Inc., Epsilon Marketing Services, LLC and Epsilon Data Management, LLC.

On April 27, 2006, the Company entered into a treasury rate lock agreement with a notional amount of $250.0 million to mitigate its exposure to increases in interest rates associated with the placement of the senior notes. Effective April 28, 2006, the treasury lock was terminated and the Company realized a loss of $0.2 million.

Other The Company has other minor borrowings, primarily capital leases, with varying interest rates.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. DEBT (Continued)

Maturities Debt at December 31, 2006 matures as follows (in thousands):

2007	$ 302,702
2008	11,352
2009	252,760
2010	1,863
2011	475,700
Thereafter	
	$ 1,044,377

11. INCOME TAXES

The Company files a consolidated federal income tax return.

	Year Ended December 31,		
	2004	2005	2006
	(In thousands)		
Components of income before income taxes:			
Domestic	$ 117,040	$ 157,027	$ 227,044
Foreign	47,279	65,099	79,225
Total	$ 164,319	$ 222,126	$ 306,269
Components of income tax expense are as follows:			
Current			
Federal	$ 4,348	$ 52,290	$ 92,442
State	2,114	4,793	6,362
Foreign	24,332	39,773	45,632
Total current	30,794	96,856	144,436
Deferred			
Federal	36,091	5,092	(16,780)
State	630	(3,033)	(1,870)
Foreign	(5,567)	(15,534)	(9,122)
Total deferred	31,154	(13,475)	(27,772)

Total provision for income taxes	$ 61,948	$ 83,381	$ 116,664

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. INCOME TAXES (Continued)

A reconciliation of recorded federal provision for income taxes to the expected amount computed by applying the federal statutory rate of 35% for all periods to income before income taxes is as follows:

	Year Ended December 31,		
	2004	2005	2006
	(In thousands)		
Expected expense at statutory rate	$ 57,511	$ 77,744	$ 107,194
Increase (decrease) in income taxes resulting from:			
State income taxes, net of federal benefit	1,387	1,144	3,996
Foreign earnings at other than United States rates	531	293	398
Non-deductible expenses	1,512	1,439	4,244
Texas law change, net of federal expense			(1,076)
Canadian rate reduction			3,321
Other, net	1,007	2,761	(1,413)
Total	$ 61,948	$ 83,381	$ 116,664

Deferred tax assets and liabilities consist of the following:

	December 31,	
	2005	2006
	(In thousands)	
Deferred tax assets		
Deferred revenue	$ 105,304	$ 112,547
Allowance for doubtful accounts	6,665	16,105
Net operating loss carryforwards and other carryforwards	34,579	53,592
Depreciation	2,476	9,267
Stock-based compensation and other employee benefits	6,919	16,684
Accrued expenses and other	11,417	15,597
Total deferred tax assets	167,360	223,792
Valuation Allowance	(15,931)	(32,070)
Deferred tax assets, net of valuation allowance	151,429	191,722
Deferred tax liabilities		
Deferred income	$ 35,988	$ 35,948

Servicing rights		31,167		38,788
Intangible assets		76,900		72,498
Total deferred tax liabilities		144,055		147,234
Net deferred tax asset	$	7,374	$	44,488
Amounts recognized in the consolidated balance sheet:				
Current assets	$	70,221	$	88,722
Non-current liabilities	$	62,847	$	44,234

At December 31, 2006, the Company has, for federal income tax purposes, approximately $87.5 million of net operating loss carryovers (NOLs) and approximately $2.0 million of tax credits (credits), which expire at various times through the year 2025. Pursuant to Section 382 of the Internal Revenue Code, the Company s utilization of such NOLs and approximately $2.0 million of tax credits are subject to an annual

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. INCOME TAXES (Continued)

limitation. The Company believes it is more likely than not that a portion of the federal NOLs and credits will expire before being utilized. Therefore, in accordance with FAS No. 109, Accounting for Income Taxes , the Company has established a valuation allowance on the portion of NOLs and credits that the Company expects to expire prior to utilization.

At December 31, 2006, the Company has state income tax NOLs of approximately $356.9 million and state credits of approximately $2.0 million available to offset future state taxable income. The state NOLs and credits will expire at various times through the year 2026. The Company believes it is more likely than not that a portion of the state NOLs and credits will expire before being utilized. Therefore, in accordance with SFAS No. 109, Accounting for Income Taxes , the Company has established a valuation allowance on the portion of NOLs and credits that the Company expects to expire prior to utilization.

At December 31, 2006, the Company has foreign income tax NOLs of approximately $18.0 million and capital losses of approximately $6.3 million. The foreign NOLs expire at various times through the year 2016. The Company believes it is more likely than not that all foreign NOLs will expire before being utilized and capital gains will not be generated to utilize the capital losses in the foreseeable future. Therefore, in accordance with SFAS No. 109, Accounting for Income Taxes , the Company has established a valuation allowance on the portion of NOLs that are expected to expire prior to utilization, as well as the entire capital loss.

As of December 31, 2006, the Company s valuation allowance has increased, which is primarily attributable to the anticipated expiration of acquired companies NOLs. Almost all of these NOLs are subject to an annual limitation under Internal Revenue Code Section 382 and are expected to expire prior to utilization as a result of this limitation.

The Company has unremitted earnings of foreign subsidiaries of approximately $73.6 million. A deferred tax liability has not been established on the unremitted earnings, as it is management s intention to permanently reinvest those earnings in foreign jurisdictions. If a portion were to be remitted, management believes income tax credits would substantially offset any resulting tax liability.

Of the total tax benefits resulting from the exercise of employee stock options and other employee stock programs, the amounts recorded to stockholders equity were approximately $11.2 million, $13.6 million and $17.5 million for the years ended 2004, 2005 and 2006, respectively.

In May 2006, Texas repealed its current income tax and replaced it with a gross margins tax that is understood to be accounted for as an income tax. The Company becomes subject to the Texas margins tax beginning January 1, 2007. As a result of the repeal of the former Texas income tax and enactment of the new margins tax, the Company recorded a net tax benefit of $1.1 million representing the new tax credits available under the enacted Texas margins tax.

The Canadian corporate income tax rates for years beginning in 2008 forward have been decreased. For 2006, the Company recorded $3.3 million of income tax expense to reduce the net deferred tax assets in Canada related to the future lower income tax rates.

As a matter of course, the Company is regularly examined by federal, state and foreign tax authorities. Although the results of these examinations are uncertain, based on currently available information, the Company believes that the ultimate outcome will not have a material adverse effect on the Company s financial statements.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. STOCKHOLDERS EQUITY

On June 8, 2005, the Company s Board of Directors authorized a repurchase program to acquire up to an aggregate of $80.0 million of its outstanding common stock through June 2006. On October 27, 2005, the Company s Board of Directors authorized a second stock repurchase program to acquire up to an additional $220.0 million of its outstanding common stock through October 2006.

On September 28, 2006, the Company s Board of Directors authorized a third stock repurchase program to acquire up to an additional $600.0 million of its outstanding common stock through December 2008, in addition to any amount remaining available at the expiration of the second stock repurchase program.

Under the plans, the Company has acquired 3,942,100 shares and 2,857,672 shares for approximately $148.8 million and $146.0 million for the years ended December 31, 2005 and 2006, respectively.

13. STOCK COMPENSATION PLANS

The Company has adopted equity compensation plans to advance the interests of the Company by rewarding certain employees for their contributions to the financial success of the Company and thereby motivating them to continue to make such contributions in the future.

On April 4, 2003, the Board of Directors of the Company adopted the 2003 long term incentive plan and the stockholders approved it at the Company s 2003 annual meeting of stockholders on June 10, 2003. This plan reserves 6,000,000 shares of common stock for grants of incentive stock options, nonqualified stock options, restricted stock awards and performance shares to officers, employees, non-employee directors and consultants performing services for the Company or its affiliates.

On June 7, 2005, at the annual meeting of stockholders, the stockholders approved and adopted the Company s 2005 long term incentive plan, effective July 1, 2005. This plan reserves 4,750,000 shares of common stock for grants of incentive stock options, nonqualified stock options, restricted stock awards, restricted stock units and performance shares to officers, employees, non-employee directors and consultants performing services for the Company or its affiliates. Terms of all awards are determined by the Board of Directors or the compensation committee of the Board of Directors or its designee at the time of award.

Effective January 1, 2006, the Company adopted the provisions of, and accounted for stock-based compensation in accordance with, SFAS No. 123(R)which supersedes APB No. 25. Under the fair value recognition provisions, stock-based compensation expense is measured at the grant date based on the fair value of the award and is recognized ratably over the requisite service period. The Company elected the modified prospective method, under which prior periods are not revised for comparative purposes. The valuation provisions of SFAS No. 123(R) apply to new grants and to grants that were outstanding as of the effective date and are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation expense estimated under SFAS No. 123 pro forma disclosures, adjusted for forfeitures.

In November 2005, the FASB issued Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards (FSP 123R-3). The Company has elected to adopt the alternative transition method provided in FSP 123R-3 for calculating the tax effects of stock-based compensation under SFAS No. 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in-capital pool (APIC pool) related to the tax effects of stock-based compensation, and for determining the subsequent impact on the APIC pool and consolidated statements of cash flows of the tax effects of stock-based compensation awards that are outstanding upon adoption of SFAS No. 123(R).

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. STOCK COMPENSATION PLANS (Continued)

Total stock-based compensation expense recognized in the Company s consolidated statements of income for the years ended December 31, 2004, 2005, and 2006, is as follows:

	Year Ended December 31, 2004	2005	2006
		(In thousands)	
Cost of operations	$ 2,339	$	$ 26,982
General and administrative	13,428	14,143	16,071
Total	$ 15,767	$ 14,143	$ 43,053

As the amount of stock-based compensation expense recognized is based on awards ultimately expected to vest, the amount recognized in the Company s results of operations has been reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on the Company s historical experience. Prior to the adoption of SFAS No. 123(R), the Company accounted for forfeitures as they occurred in accordance with APB No. 25 and did not estimate forfeitures. As a result, upon adoption of SFAS No. 123(R) the Company recognized a cumulative effect of a change in accounting principle of $0.8 million, net of tax, to reverse compensation expense recognized for those awards not expected to vest.

Prior to the adoption of SFAS No. 123(R), the Company accounted for stock-based awards to employees using the intrinsic value method in accordance with APB No. 25. Under the intrinsic value method, stock-based compensation expense for employee stock options was not recognized in the Company s results of operations as the exercise price equaled the fair market value of the underlying stock at the date of grant. In accordance with the modified prospective transition method, the Company s prior year financial statements have not been restated to reflect the impact of the adoption of SFAS No. 123(R).

Restricted Stock

During 2006, the Company has awarded both service-based and performance-based restricted stock units. Fair value of the restricted stock is estimated on the date of grant. In accordance with SFAS No. 123(R), the Company recognizes the estimated stock-based compensation expense, net of estimated forfeitures, over the applicable service period.

Service-based restricted stock awards typically vest ratably over a three year period. Performance-based restricted stock awards vest if specified performance measures tied to the Company s financial performance are met. The vesting provisions of 86,314 performance-based restricted stock unit awards issued in 2006 to eight employees were modified in March 2006. The vesting provisions, which were dependent on the Company s cash earnings per share (EPS) growth as compared to the S&P 500, were modified such that under the new terms, the vesting provisions are dependent on the Company s year-over-year cash EPS growth. The number of shares that vest may range from zero to 200%. A minimum cash EPS growth rate of 10% is necessary for the minimum 50% vesting, 18% cash EPS growth for a 100% vesting, and 36% cash EPS growth (or more) for a maximum 200% vesting. The modification had no impact on the fair value of the award; however, it did result in a change in estimate of the most likely outcome of the number of shares to vest. The incremental stock-based compensation expense recorded as a result of the change in estimate was not material.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. STOCK COMPENSATION PLANS (Continued)

	Performance-Based	Service-Based[1]	Total
Balance at January 1, 2004			
Shares granted	125,778	195,347	321,125
Shares vested	(121,778)	(4,347)	(126,125)
Shares cancelled	(4,000)		(4,000)
Balance at December 31, 2004		191,000	191,000
Shares granted	153,086	388,794	541,880
Shares vested	(141,693)	(78,876)	(220,569)
Shares cancelled	(11,393)	(31,078)	(42,471)
Balance at December 31, 2005		469,840	469,840
Shares granted	242,015	626,672	868,687
Shares vested	(8,100)	(130,793)	(138,893)
Shares cancelled	(14,460)	(75,765)	(90,225)
Balance at December 31, 2006	219,455	889,954	1,109,409

(1) Amounts include 4,347, 4,489 and 3,206 shares of stock issued to the Board of Directors for 2004, 2005 and 2006, respectively. The shares vest immediately, but are subject to transfer restrictions until one year after the director s service on the Board terminates.

The weighted average grant-date fair value per share was $45.17 for restricted stock awards granted for the year ended December 31, 2006.

Stock Options

Stock option awards are granted with an exercise price equal to the market price of the Company s stock. Options typically vest ratably over three years and expire ten years after the date of grant. As of January 1, 2005, the fair value of each option award is estimated on the date of grant using a binomial lattice model. Prior to January 1, 2005, the fair value of each option award was estimated on the grant date using a Black-Scholes valuation model. The following table indicates the assumptions used in estimating fair value for the years ended December 31, 2004, 2005 and 2006.

	Year Ended December 31,		
	2004	2005	2006

Expected dividend yield			
Risk-free interest rate	3.4%	2.94%-4.76%	4.53%-4.65%
Expected life of options (years)	4.0	6.4	7.1
Assumed volatility	38.0%	28.8%-43.6%	31.9%-37.0%
Weighted average fair value	$ 11.94	$16.60	$18.46

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. STOCK COMPENSATION PLANS (Continued)

The following table summarizes stock option activity under the Company s equity compensation plans:

	Outstanding Options	Outstanding Weighted Average Exercise Price		Exercisable Options	Exercisable Weighted Average Exercise Price	
	(In thousands, except per share amounts)					
Balance at January 1, 2004	7,072	$	16.20			
Granted	2,001		32.93			
Exercised	(2,131)		14.80			
Cancelled	(327)		23.00			
Balance at December 31, 2004	6,615	$	21.33	3,261	$	14.08
Granted	2,102		41.00			
Exercised	(1,506)		17.86			
Cancelled	(531)		32.80			
Balance at December 31, 2005	6,680	$	27.19	3,319	$	18.01
Granted	620	$	43.44			
Exercised	(2,053)		21.57			
Cancelled	(375)		29.96			
Balance at December 31, 2006	4,872	$	30.98	2,697	$	23.80
At December 31, 2006 Vested or Expected to Vest	4,391	$	30.07			

Based on the market value on their respective exercise dates, the total intrinsic value of options exercised during the year ended December 31, 2006 was approximately $64.5 million.

The following table summarizes information concerning currently outstanding and exercisable stock options at December 31, 2006:

Outstanding Remaining Contractual	Weighted Average	Exercisable	Weighted Average

Range of Exercise Prices	Options	Life (Years)		Exercise Price	Options		Exercise Price
		(In thousands, except per share amounts)					
$9.00 to $12.00	499	3.9	$	11.55	499	$	11.55
$12.01 to $15.00	634	4.0	$	14.97	634	$	14.97
$15.01 to $22.00	34	5.9	$	18.65	34	$	18.65
$22.01 to $29.00	598	6.5	$	24.14	597	$	24.13
$29.01 to $39.00	963	7.3	$	31.97	498	$	31.83
$39.01 to $47.00	2,125	8.3	$	41.78	435	$	41.47
$47.01 to $54.00	19	9.4	$	53.34		$	
	4,872				2,697		

The aggregate intrinsic value of options outstanding as of December 31, 2006 was approximately $153.4 million. The aggregate intrinsic value of options outstanding and options exercisable expected to vest as of December 31, 2006 was approximately

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. STOCK COMPENSATION PLANS (Continued)

$142.3 million and $104.6 million with a weighted average remaining contractual life of 6.7 years and 5.8 years, respectively. The number of options outstanding expected to vest is impacted by our forfeiture rate assumptions.

14. EMPLOYEE BENEFIT PLANS

On June 7, 2005, at the annual meeting of stockholders, the stockholders approved and adopted the Amended and Restated Employee Stock Purchase Plan (the ESPP), effective on July 1, 2005. No employee may purchase more than $25,000 in stock under the ESPP in any calendar year, and no employee may purchase stock under the ESPP if such purchase would cause the employee to own more than 5% of the voting power or value of the Company s common stock. The ESPP provides for three month offering periods, commencing on the first trading day of each calendar quarter and ending on the last trading day of each calendar quarter. The purchase price of the common stock upon exercise shall be 85% of the fair market value of shares on the applicable purchase date as determined by averaging the high and low trading prices of the last trading day of each quarter. An employee may elect to pay the purchase price of such common stock through payroll deductions. The maximum number of shares that were reserved for issuance under the ESPP is 1,500,000 shares, and subject to adjustment as provided in the ESPP. Employees are required to hold any stock purchased through the ESPP for 180 days prior to any sale or withdrawal of shares. Approximately 646,427 shares of common stock have been purchased under the plan since its adoption, with approximately 82,474 shares purchased in 2006.

On June 7, 2005, the stockholders, at the annual meeting of stockholders, approved the Executive Annual Incentive Plan. Under the plan, the Company may grant to each eligible employee, including executive officers and other key employees, incentive awards to receive cash upon the achievement of pre-established performance goals. No participant may be granted performance awards in excess of $5.0 million in any calendar year.

The Company maintains a 401(k) retirement savings plan, which covers all eligible U.S. employees. Participants can, in accordance with Internal Revenue Service (IRS) guidelines, set aside both pre-and post-tax savings in this account. In addition to an employee s savings, the Company contributes to plan participants accounts. The Alliance 401(k) and Retirement Savings Plan was amended effective January 1, 2004 to better benefit the majority of Company employees. The plan is an IRS-approved safe harbor plan design that eliminates the need for most discrimination testing. Eligible employees can participate in the plan immediately upon joining the Company and after six months of employment begin receiving Company matching contributions. On the first three percent of savings, the Company matches dollar-for-dollar. An additional fifty cents for each dollar an employee contributes is matched for savings of more than three percent and up to five percent of pay. All Company matching contributions are immediately vested. In addition to the Company match, the Company annually may make an additional contribution based on the profitability of the Company. This contribution, subject to Board of Directors approval, is based on a percentage of pay and is subject to a five year vesting schedule. The participants in the plan can direct their contributions and the Company s matching contribution to nine investment options, including the Company s common stock. Company contributions for employees age 65 or older vest immediately. Contributions for the years ended December 31, 2004, 2005 and 2006 were $11.3 million, $14.2 million and $15.2 million, respectively.

The Company also provides a Deferred Profit Sharing Plan for its Canadian employees after one year of service. Company contributions range from one to four percent of earnings, based on years of service. This program changed effective January 1, 2007, and as a result, Company contributions range from one to five percent of earnings, based on years of service.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. EMPLOYEE BENEFIT PLANS (Continued)

The Company also maintains an Executive Deferred Compensation Plan. The Executive Deferred Compensation Plan provides an opportunity for a select group of management and highly compensated employees to defer on a pre-tax basis a portion of their regular compensation and bonuses payable for services rendered and to receive certain employer contributions.

15. COMPREHENSIVE INCOME

The components of comprehensive income, net of tax effect, are as follows:

	Year Ended December 31,		
	2004	2005	2006
	(In thousands)		
Net income	$ 102,371	$ 138,745	$ 189,605
Reclassification into earnings	482		
Unrealized (loss) gain on securities available-for-sale	(144)	414	1,880
Foreign currency translation adjustments[1]	4,965	3,205	(721)
Total comprehensive income	$ 107,674	$ 142,364	$ 190,764

[1] Primarily related to the impact of changes in the Canadian currency exchange rate.

The components of accumulated other comprehensive income are as follows:

	Year Ended December 31,	
	2005	2006
	(In thousands)	
Unrealized gain on securities available-for-sale	$ 3,511	$ 5,391
Unrealized foreign currency gain	4,578	3,857
Total comprehensive income	$ 8,089	$ 9,248

16. COMMITMENTS AND CONTINGENCIES

AIR MILES Reward Program

The Company has entered into contractual arrangements with certain AIR MILES Sponsors that result in fees being billed to those Sponsors upon the redemption of reward miles issued by those Sponsors. The Company has obtained letters of credit and other assurances from those Sponsors for the Company s benefit that expire at various dates. These letters of credit and other assurances totaled $113.5 million at December 31, 2006, which exceeds the amount of the Company s estimate of its obligation to provide travel and other rewards upon the redemption of the reward miles issued by those Sponsors.

The Company currently has an obligation to provide Collectors with travel and other rewards upon the redemption of AIR MILES reward miles. The Company believes that the redemption settlements assets, including the letters of credit and other assurances mentioned above, are sufficient to meet that obligation.

The Company has entered into certain long-term arrangements to purchase tickets from airlines and other suppliers in connection with redemptions under the AIR MILES Reward Program. These long-term arrangements allow the Company to make purchases at set prices. Under these agreements, the Company is required to pay annual minimums of approximately $22.1 million.

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. COMMITMENTS AND CONTINGENCIES (Continued)

Leases

The Company leases certain office facilities and equipment under noncancellable operating leases and is generally responsible for property taxes and insurance related to such facilities. Lease expense was $43.7 million, $45.9 million and $50.2 million for the years ended December 31, 2004, 2005, and 2006, respectively.

Future annual minimum rental payments required under noncancellable operating and capital leases, some of which contain renewal options, as of December 31, 2006 are:

Year:	Operating Leases	Capital Leases
	(In thousands)	
2007	$ 42,536	$ 9,149
2008	34,648	7,797
2009	25,685	3,023
2010	18,879	1,971
2011	14,914	712
Thereafter	63,527	
Total	$ 200,189	22,652
Less amount representing interest		(2,275)
Total present value of minimum lease payments		$ 20,377

Regulatory Matters

WFNNB is subject to various regulatory capital requirements administered by the Office of the Comptroller of the Currency. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, WFNNB must meet specific capital guidelines that involve quantitative measures of its assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Before WFNNB can pay dividends to ADSC, it must obtain prior regulatory approval if all dividends declared in any calendar year would exceed its net profits for that year plus its retained net profits for the preceding two calendar years, less any transfers to surplus. In addition, WFNNB may only pay dividends to the extent that retained net profits, including the portion transferred to surplus, exceed bad debts. Moreover, to pay any dividend, WFNNB must maintain adequate capital above regulatory guidelines. Further, if a regulatory authority believes that WFNNB is engaged in or is about to engage in an unsafe or unsound banking practice, which, depending on its financial condition, could include the payment of dividends, the authority may require, after notice and hearing, that WFNNB cease and desist from the unsafe practice.

Quantitative measures established by regulation to ensure capital adequacy require WFNNB to maintain minimum amounts and ratios of total and Tier 1 capital (as defined in the regulations) to risk weighted assets (as defined) and of Tier 1 capital to average assets (as defined) (total capital ratio , Tier 1 capital ratio and leverage ratio , respectively). Under the regulations, a well capitalized institution must have a Tier 1 capital ratio of at least 6%, a total capital ratio of at least 10% and a leverage ratio of at least 5% and not be subject to a capital directive order. An adequately capitalized institution must have a Tier 1 capital ratio of at least 4%, a total capital ratio of at least 8% and a leverage ratio of at least 4%, but 3% is allowed in some

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. COMMITMENTS AND CONTINGENCIES (Continued)

cases. Under these guidelines, WFNNB is considered well capitalized. As of December 31, 2006, WFNNB s Tier 1 capital ratio was 37.3%, total capital ratio was 39.1% and leverage ratio was 59.1%, and WFNNB was not subject to a capital directive order.

The Company s industrial bank, World Financial Capital Bank, is authorized to do business by the State of Utah and the Federal Deposit Insurance Corporation. World Financial Capital Bank is subject to capital ratios and paid-in capital minimums and must maintain adequate allowances for loan losses. While the consequence of losing the World Financial Capital Bank authority to do business would be significant, the Company believes that the risk of such loss is minimal as a result of the precautions it has taken and the management team it has in place.

As part of an acquisition in 2003 by World Financial Network National Bank, which required approval by the OCC, the OCC required World Financial Network National Bank to enter into an operating agreement with the OCC and a capital adequacy and liquidity maintenance agreement with the Company. The operating agreement requires World Financial Network National Bank to continue to operate in a manner consistent with its current practices, regulatory guidelines and applicable law, including those related to affiliate transactions, maintenance of capital and corporate governance. This operating agreement has not required any changes in World Financial Network National Bank s operations. The capital adequacy and liquidity maintenance agreement memorializes the Company s current obligations to World Financial Network National Bank.

If either of the Company s depository institution subsidiaries, World Financial Network National Bank or World Financial Capital Bank, failed to meet the criteria for the exemption from the definition of bank in the Bank Holding Company Act under which it operates, and if the Company did not divest such depository institution upon such an occurrence, the Company would become subject to regulation under the Bank Holding Company Act. This would require the Company to cease certain activities that are not permissible for companies that are subject to regulation under the Bank Holding Company Act.

Cardholders

The Company s Credit Services segment is active in originating private label and co-branded credit cards in the United States. The Company reviews each potential customer s credit application and evaluates the applicant s financial history and ability and perceived willingness to repay. Credit card loans are made primarily on an unsecured basis. Cardholders reside throughout the United States and are not significantly concentrated in any one area.

Holders of credit cards issued by the Company have available lines of credit, which vary by cardholders that can be used for purchases of merchandise offered for sale by clients of the Company. These lines of credit represent elements of risk in excess of the amount recognized in the financial statements. The lines of credit are subject to change or cancellation by the Company. As of December 31, 2006, the Company had approximately 29.3 million cardholders, having unused lines of credit averaging $947 per account.

Legal Proceedings

From time to time, the Company is involved in various claims and lawsuits arising in the ordinary course of business that it believes will not have a material adverse affect on its business or financial condition, including claims and lawsuits alleging breaches of contractual obligations.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

17. FINANCIAL INSTRUMENTS

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financial needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit through charge cards. Such instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of these instruments reflect the extent of the Company s involvement in particular classes of financial instruments.

Fair Value of Financial Instruments The estimated fair values of the Company s financial instruments were as follows:

	December 31,			
	2005		2006	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In thousands)			
Financial assets				
Cash and cash equivalents	$ 143,213	$ 143,213	$ 180,075	$ 180,075
Due from card associations	58,416	58,416	108,671	108,671
Trade receivables, net	203,883	203,883	271,563	271,563
Seller s interest and credit card receivables, net	479,108	479,108	569,389	569,389
Redemption settlement assets, restricted	260,963	260,963	260,957	260,957
Due from securitizations	271,256	271,256	325,457	325,457
Financial liabilities				
Accounts payable	67,384	67,384	112,582	112,582
Merchant settlement obligations	127,038	127,038	188,336	188,336
Debt	836,944	836,944	1,044,377	1,048,477

The following methods and assumptions were used by the Company in estimating fair values of financial instruments as disclosed herein:

Cash and cash equivalents, due from card associations, trade receivables, net, accounts payable, and merchant settlement obligations The carrying amount approximates fair value due to the short maturity.

Seller s interest and credit card receivables, net The carrying amount of credit card receivables approximates fair value due to the short maturity, and the average interest rates approximate current market origination rates.

Redemption settlement assets Fair value for securities are based on quoted market prices.

Due from securitizations The spread deposits and I/O strips are recorded at their fair value. The carrying amount of excess funding deposits approximates its fair value due to the relatively short maturity period and average interest rates, which approximate current market rates.

Debt The fair value was estimated based on the current rates available to the Company for debt with similar remaining maturities.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

18. PARENT-ONLY FINANCIAL STATEMENTS

ADSC provides guarantees under the credit facilities on behalf of certain of its subsidiaries. The stand alone parent-only financial statements are presented below.

Balance Sheets

	December 31, 2005	December 31, 2006
	(In thousands)	
Assets:		
Cash and cash equivalents	$ 5	$ 20
Investment in subsidiaries	733,444	1,262,115
Intercompany receivables	874,157	805,768
Other assets	3,171	3,073
Total assets	$ 1,610,777	$ 2,070,976
Liabilities:		
Current debt	$ 230,000	$
Long-term debt	211,000	725,000
Other liabilities	248,670	274,443
Total liabilities	689,670	999,443
Stockholders equity	921,107	1,071,533
Total liabilities and stockholders equity	$ 1,610,777	$ 2,070,976

Statements of Income

	Year Ended December 31, 2004	2005	2006
		(In thousands)	
Interest from loans to subsidiaries	$ 20,049	$ 27,235	$ 33,996
Dividends from subsidiaries	100,900	100,000	102,500
Total revenue	120,949	127,235	136,496
Interest expense, net	4,429	11,665	34,061
Other expenses	239	140	184

Total expenses	4,668	11,805	34,245
Income before income taxes and equity in undistributed net income of subsidiaries	116,281	115,430	102,251
Provision for income taxes	4,567	10,192	1,399
Income before equity in undistributed net income of subsidiaries	111,714	105,238	100,852
Equity in undistributed net income of subsidiaries	(9,343)	33,507	88,753
Net income	$ 102,371	$ 138,745	$ 189,605

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

18. PARENT-ONLY FINANCIAL STATEMENTS (Continued)

Statements of Cash Flows

	Year Ended December 31, 2004	2005	2006
	(In thousands)		
Net cash (used in) provided by operating activities	$ (8,926)	$ 18,292	$ (97,857)
Investing activities:			
Net cash paid for corporate acquisitions	(314,453)	(140,901)	(205,567)
Net cash used in investing activities	(314,453)	(140,901)	(205,567)
Financing activities:			
Credit facility and subordinated debt	765,000	1,264,000	3,599,000
Repayment of credit facility and subordinated debt	(577,000)	(1,126,000)	(3,315,000)
Excess tax benefit from share-based awards			17,521
Other			(3,415)
Purchase of treasury shares		(145,043)	(145,998)
Net proceeds from issuances of common stock	34,528	29,106	48,831
Dividends paid	100,900	100,000	102,500
Net cash provided by financing activities	323,428	122,063	303,439
Increase (decrease) in cash and cash equivalents	49	(546)	15
Cash and cash equivalents at beginning of year	502	551	5
Cash and cash equivalents at end of year	$ 551	$ 5	$ 20

19. SEGMENT INFORMATION

Operating segments are defined by SFAS No. 131 Disclosure About Segments of an Enterprise and Related Information as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company s chief operating decision making group is the Executive Committee of management, which consists of the Chairman of the Board and Chief Executive Officer, Chief Operating Officer, and all Executive Vice Presidents. The operating segments are reviewed separately because each operating segment represents a strategic business unit that generally offers different products and serves different markets.

The Company operates in three reportable segments: Marketing Services, Credit Services and Transaction Services.

Marketing Services provides loyalty programs, such as the AIR MILES Reward Program, and integrated direct marketing solutions that combine database marketing technology and analytics with a broad range of direct marketing services, that includes email marketing campaigns. The Marketing Services segment has two operating segments, AIR MILES Reward Program and U.S. Marketing Services, that have been aggregated to one reportable segment.

Credit Services provides private label, commercial and co-brand credit card receivables financing. Credit Services generally securitizes the credit card receivables that it underwrites from its private label credit card programs.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

19. SEGMENT INFORMATION (Continued)

Transaction Services encompasses card processing, billing and payment processing and customer care for specialty and petroleum retailers (processing services), customer information system hosting, customer care and billing and payment processing for regulated and de-regulated municipal utilities (utility services) and point-of-sale services (merchant services).

The Transaction Services segment performs card processing and servicing activities for cardholder accounts generated by the Credit Services segment. For this, the Transaction Services segment receives a fee equal to its direct costs before corporate overhead plus a margin. The margin is based on estimated current market rates for similar services. This fee represents an operating cost to the Credit Services segment and a corresponding revenue for the Transaction Services segment. Inter-segment sales are eliminated upon consolidation. Revenues earned by the Transaction Services segment from servicing the Credit Services segment, and consequently paid by the Credit Services segment to the Transaction Services segment, are set forth opposite Other and eliminations in the tables below.

The accounting policies of the operating segments are generally the same as those described in the summary of significant accounting policies. Corporate overhead is allocated equally across the segments.

Interest expense, net and income taxes are not allocated to the segments in the computation of segment operating profit for internal evaluation purposes. Total assets are not allocated to the segments.

Year Ended December 31, 2004	Marketing Services	Credit Services	Transaction Services (In thousands)	Other/ Elimination	Total
Revenues	$ 375,630	$ 513,988	$ 681,736	$ (313,916)	$ 1,257,438
Adjusted EBITDA[1]	56,081	125,718	97,465		279,264
Depreciation and amortization	21,674	7,938	61,786		91,398
Stock compensation expense	5,256	5,256	5,255		15,767
Operating income	29,151	112,524	30,424		172,099
Fair value loss on interest rate derivative		(808)			(808)
Interest expense, net				6,972	6,972
Income before income taxes	$ 29,151	$ 111,716	$ 30,424	$ (6,972)	$ 164,319
Capital expenditures	$ 17,263	$ 1,375	$ 29,691	$	$ 48,329

Year Ended December 31, 2005	Marketing Services	Credit Services	Transaction Services (In thousands)	Other/ Elimination	Total
Revenues	$ 604,145	$ 561,413	$ 699,884	$ (313,005)	$ 1,552,437

Adjusted EBITDA[1]	97,903	162,481	90,074		350,458
Depreciation and amortization	36,477	6,647	56,583		99,707
Stock compensation expense	4,714	4,714	4,715		14,143
Operating income	56,712	151,120	28,776		236,608
Interest expense, net				14,482	14,482
Income before income taxes	$ 56,712	$ 151,120	$ 28,776	$ (14,482)	$ 222,126
Capital expenditures	$ 20,340	$ 2,152	$ 43,408	$	$ 65,900

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

19. SEGMENT INFORMATION (Continued)

Year Ended December 31, 2006	Marketing Services	Credit Services	Transaction Services (In thousands)	Other/ Elimination	Total
Revenues	$ 849,158	$ 731,338	$ 776,036	$ (357,790)	$ 1,998,742
Adjusted EBITDA(1)	159,186	248,204	107,970		515,360
Depreciation and amortization	58,681	13,690	52,669		125,040
Stock compensation expense	18,162	8,451	16,440		43,053
Operating income	82,343	226,063	38,861		347,267
Interest expense, net				40,998	40,998
Income before income taxes	$ 82,343	$ 226,063	$ 38,861	$ (40,998)	$ 306,269
Capital expenditures	$ 32,652	$ 1,996	$ 65,704	$	$ 100,352

(1) Adjusted EBITDA is a non-GAAP financial measure equal to net income, the most directly comparable GAAP financial measure, plus stock compensation expense, provision for income taxes, interest expense, net, fair value loss on interest rate derivative, other expenses, depreciation and amortization. Adjusted EBITDA is presented in accordance with SFAS No. 131 as it is the primary performance metric by which senior management is evaluated.

Information concerning principal geographic areas is as follows:

	United States	Canada	Other	Total
Revenues				
Year Ended December 31, 2004	$ 913,378	$ 338,919	$ 5,141	$ 1,257,438
Year Ended December 31, 2005	1,135,968	412,193	4,276	1,552,437
Year Ended December 31, 2006	1,413,957	571,920	12,865	1,998,742
Long lived assets				
December 31, 2005	$ 1,339,530	$ 544,099	$	$ 1,883,629
December 31, 2006	1,519,199	560,182	14,659	2,094,040

20. SUBSEQUENT EVENTS

In December 2006, the Company entered into an agreement to acquire Abacus, a division of DoubleClick Inc. Abacus is a leading provider of data, data management and analytical services for the retail and catalog industry as well as other industries. The acquisition closed in February 2007. Total consideration paid was approximately $435 million in cash.

In January 2007, the Company entered into a short term credit agreement with the Bank of Montreal which provides for loans to the Company in a maximum amount of $400.0 million. At the closing of this bridge loan, the Company borrowed $300.0 million for general corporate purposes including the repayment of debt and the financing of permitted acquisitions. The bridge loan includes an uncommitted accordion feature of up to $100.0 million, subject to certain conditions. The bridge loan is scheduled to mature on July 24, 2007. The bridge loan is unsecured. The bridge loan must be prepaid prior to the scheduled maturity date if the Company or any subsidiary issues any debt or equity securities, subject to certain exceptions.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

21. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

Unaudited quarterly results of operations for the years ended December 31, 2005 and 2006 are presented below.

	Quarter Ended			
	March 31, 2005	June 30, 2005	September 30, 2005	December 31, 2005
	(In thousands, except per share amounts)			
Revenues	$ 375,875	$ 370,568	$ 384,813	$ 421,181
Operating expenses	313,626	313,221	325,008	363,974
Interest expense, net	2,761	2,353	2,422	6,946
Income before income taxes	59,488	54,994	57,383	50,261
Provision for income taxes	22,306	20,611	21,532	18,932
Net income	$ 37,182	$ 34,383	$ 35,851	$ 31,329
Net income per share basic	$ 0.45	$ 0.42	$ 0.43	$ 0.39
Net income per share diluted	$ 0.43	$ 0.40	$ 0.42	$ 0.38

	Quarter Ended			
	March 31, 2006	June 30, 2006	September 30, 2006	December 31, 2006
	(In thousands, except per share amounts)			
Revenues	$ 477,231	$ 490,447	$ 506,584	$ 524,480
Operating expenses	377,823	407,265	417,375	449,012
Interest expense, net	8,537	10,059	10,639	11,763
Income before income taxes	90,871	73,123	78,570	63,705
Provision for income taxes	34,450	28,328	29,790	24,096
Net income	$ 56,421	$ 44,795	$ 48,780	$ 39,609
Net income per share basic	$ 0.70	$ 0.56	$ 0.61	$ 0.50
Net income per share diluted	$ 0.69	$ 0.55	$ 0.60	$ 0.48

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, Alliance Data Systems Corporation has duly caused this annual report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

Alliance Data Systems Corporation

By: /s/ J. Michael Parks
J. Michael Parks
Chairman of the Board, Chief Executive Officer
and Director

Date: February 26, 2007

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of Alliance Data Systems Corporation and in the capacities and on the dates indicated.

Name	Title	Date
/s/ J. Michael Parks	Chairman of the Board, Chief Executive Officer and Director	February 26, 2007
J. Michael Parks		
/s/ Edward J. Heffernan	Executive Vice President and Chief Financial Officer	February 26, 2007
Edward J. Heffernan		
/s/ Michael D. Kubic	Senior Vice President, Corporate Controller, and Chief Accounting Officer	February 26, 2007
Michael D. Kubic		
/s/ Bruce K. Anderson	Director	February 26, 2007
Bruce K. Anderson		
/s/ Roger H. Ballou	Director	February 26, 2007
Roger H. Ballou		
/s/ Lawrence M. Benveniste, Ph.D.	Director	February 26, 2007

Lawrence M. Benveniste, Ph.D.		
/s/ D. Keith Cobb	Director	February 26, 2007
D. Keith Cobb		
/s/ E. Linn Draper, Jr., Ph.D.	Director	February 26, 2007
E. Linn Draper, Jr., Ph.D.		
/s/ Kenneth R. Jensen	Director	February 26, 2007
Kenneth R. Jensen		
/s/ Robert A. Minicucci	Director	February 26, 2007
Robert A. Minicucci		

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SCHEDULE II

ALLIANCE DATA SYSTEMS CORPORATION

CONSOLIDATED VALUATION AND QUALIFYING ACCOUNTS

Description	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Other Accounts	Write-Offs Net of Recoveries	Balance at End of Period
Allowance for Doubtful Accounts Trade receivables:					
Year Ended December 31, 2004	$ 1,316	$ 495	$ 342	$ (695)	$ 1,458
Year Ended December 31, 2005	1,458	799	$ 40	(218)	2,079
Year Ended December 31, 2006	2,079	3,550	$ 208	(512)	5,325
Allowance for Doubtful Accounts Seller s interest and credit card receivables:					
Year Ended December 31, 2004	17,151	1,797	2,535	(9,810)	11,673
Year Ended December 31, 2005	11,673	20,916	21,698	(15,872)	38,415
Year Ended December 31, 2006	38,415	33,777	4,802	(31,075)	45,919