

**PART III.**

The following required information is incorporated by reference to our definitive proxy statement for our 2007 Annual Meeting of Stockholders presently scheduled to be held in the second quarter of 2007:

Item 10. Directors, Executive Officers and Corporate Governance

Item 11. Executive Compensation

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

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

Item 14. Principal Accounting Fees and Services

We will file our definitive proxy statement for our 2007 Annual Meeting of stockholders with the Securities and Exchange Commission on or before April 30, 2007.

PART IV.

**Item 15. Exhibits and Financial Statement Schedules.**

(a) (1) Financial Statements

Included in Part II of this Report:

	<u>Page No.</u>
Discovery Holding Company:	
Management's Report on Internal Control over Financial Reporting . . . . .	II-15
Report of Independent Registered Public Accounting Firm. . . . .	II-16
Report of Independent Registered Public Accounting Firm. . . . .	II-17
Consolidated Balance Sheets, December 31, 2006 and 2005. . . . .	II-18
Consolidated Statements of Operations and Comprehensive Earnings (Loss), Years ended December 31, 2006, 2005 and 2004 . . . . .	II-19
Consolidated Statements of Cash Flows, Years Ended December 31, 2006, 2005 and 2004 . . . . .	II-20
Consolidated Statements of Stockholders' Equity, Years ended December 31, 2006, 2005 and 2004 . . . . .	II-21
Notes to Consolidated Financial Statements, December 31, 2006, 2005 and 2004 . . . . .	II-22

(a) (2) Financial Statement Schedules

Included in Part IV of this Report:

(i) All schedules have been omitted because they are not applicable, not material or the required information is set forth in the financial statements or notes thereto.

(ii) Separate financial statements for Discovery Communications, Inc.:

Report of Independent Registered Public Accounting Firm . . . . .	IV-3
Consolidated Balance Sheets, December 31, 2006 and 2005 . . . . .	IV-4
Consolidated Statements of Operations, Years ended December 31, 2006, 2005 and 2004. . . . .	IV-5
Consolidated Statements of Cash Flows, Years ended December 31, 2006, 2005 and 2004 . . . . .	IV-6
Consolidated Statements of Changes in Stockholders' Deficit, Years ended December 31, 2006, 2005 and 2004 . . . . .	IV-7
Notes to Consolidated Financial Statements . . . . .	IV-8

(a) (3) Exhibits

Listed below are the exhibits which are filed as a part of this Report (according to the number assigned to them in Item 601 of Regulation S-K):

2 — Plan of Acquisition, Reorganization, Arrangement, Liquidation or Succession:

2.1 Reorganization Agreement among Liberty Media Corporation, Discovery Holding Company ("DHC") and Ascent Media Group, Inc. (incorporated by reference to Exhibit 2.1 to DHC's Registration Statement on Form 10, dated July 15, 2005 (File No. 000-51205) (the "Form 10")).

3 — Articles of Incorporation and Bylaws:

3.1 Restated Certificate of Incorporation of DHC (incorporated by reference to Exhibit 3.1 to the Form 10).

3.2 Bylaws of DHC (incorporated by reference to Exhibit 3.2 to the Form 10).

4 — Instruments Defining the Rights of Securities Holders, including Indentures:

4.1 Specimen Certificate for shares of the Series A common stock, par value \$.01 per share, of DHC (incorporated by reference to Exhibit 4.1 to the Form 10).

4.2 Specimen Certificate for shares of the Series B common stock, par value \$.01 per share, of DHC (incorporated by reference to Exhibit 4.2 to the Form 10).

4.3 Rights Agreement between DHC and EquiServe Trust Company, N.A., as Rights Agent (incorporated by reference to Exhibit 4.3 to the Form 10).

10 — Material Contracts:

- 10.1 The Shareholders Agreement, dated as of November 30, 1991 (the "Stockholders' Agreement"), by and among Discovery Communications, Inc. ("Discovery"), Cox Discovery, Inc. ("Cox"), NewsChannels TDC Investments, Inc. ("NewChannels"), TCI Cable Education, Inc. ("TCID") and John S. Hendricks ("Hendricks") (incorporated by reference to Exhibit 10.1 to the Form 10).
- 10.2 First Amendment to the Stockholders' Agreement, dated as of December 20, 1996, by and among Discovery, Cox Communications Holdings, Inc. (the successor to Cox), Newhouse Broadcasting Corporation (the successor to NewChannels), TCID, Hendricks and for the purposes stated therein only, LMC Animal Planet, Inc. ("LMC") and Liberty Media Corporation, a Colorado corporation ("Liberty") (incorporated by reference to Exhibit 10.2 to the Form 10).
- 10.3 Second Amendment to the Stockholders' Agreement, dated as of September 7, 2000, by and among Discovery, Cox Communications Holdings, Inc. (the successor to Cox), Advance/Newhouse Programming Partnership (the successor to NewChannels), LMC Discovery, Inc. (formerly known as TCID) and Hendricks (incorporated by reference to Exhibit 10.3 to the Form 10).
- 10.4 Third Amendment to the Stockholders' Agreement, dated as of September, 2001, by and among Discovery, Cox, NewChannels, TCID, Hendricks and Advance Programming Holdings Corp. (incorporated by reference to Exhibit 10.4 to the Form 10).
- 10.5 Fourth Amendment to the Stockholders' Agreement, dated as of June 23, 2003, by and among Discovery, Cox NewChannels, TCID, Liberty Animal, Inc. (the successor in interest to LMC) for the purposes stated in the First Amendment to the Stockholders' Agreement, and Hendricks (incorporated by reference to Exhibit 10.5 to the Form 10).
- 10.6 Form of Tax Sharing Agreement between Liberty Media Corporation and DHC (incorporated by reference to Exhibit 10.6 to the Form 10).
- 10.7 Discovery Holding Company 2005 Incentive Plan (incorporated by reference to Exhibit 10.7 to the Form 10).
- 10.8 Discovery Holding Company 2005 Non-Employee Director Plan (incorporated by reference to Exhibit 10.8 to the Form 10).
- 10.9 Discovery Holding Company Transitional Stock Adjustment Plan (incorporated by reference to Exhibit 10.9 to the Form 10).
- 10.10 Agreement between DHC and John C. Malone (incorporated by reference to Exhibit 10.10 to the Form 10).
- 10.11 Agreement, dated June 24, 2005, between Discovery and DHC (incorporated by reference to Exhibit 10.11 to the Form 10).
- 10.12 Indemnification Agreement, dated as of June 24, 2005, between Cox and DHC (incorporated by reference to Exhibit 10.12 to the Form 10).
- 10.13 Indemnification Agreement, dated as of June 24, 2005, between NewChannels and DHC (incorporated by reference to Exhibit 10.13 to the Form 10).
- 10.14 Form of Indemnification Agreement with Directors and Executive Officers (incorporated by reference to Exhibit 10.14 to the Form 10).
- 21 — Subsidiaries of Discovery Holding Company, filed herewith.
  - 23.1 Consent of KPMG LLP, filed herewith.
  - 23.2 Consent of PricewaterhouseCoopers LLP, filed herewith.
  - 31.1 Rule 13a-14(a)/15d — 14(a) Certification, filed herewith.
  - 31.2 Rule 13a-14(a)/15d — 14(a) Certification, filed herewith.
  - 31.3 Rule 13a-14(a)/15d — 14(a) Certification, filed herewith.
- 32 — Section 1350 Certification, filed herewith.

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders of  
Discovery Communications, Inc.:

In our opinion, the accompanying consolidated balance sheets and related consolidated statements of operations, of changes in stockholders' deficit, and of cash flows, present fairly, in all material respects, the consolidated financial position of Discovery Communications, Inc. and its subsidiaries at December 31, 2006 and December 31, 2005, 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. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/PricewaterhouseCoopers LLP  
McLean, Virginia  
February 23, 2007

**DISCOVERY COMMUNICATIONS, INC.**  
**Consolidated Balance Sheets**

	December 31,	
	2006	2005
	in thousands, except share data	
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 52,263	34,491
Accounts receivable, less allowances of \$25,175 and \$35,079	657,552	565,407
Inventories	35,716	30,714
Deferred income taxes	76,156	88,765
Content rights, net	64,395	55,125
Other current assets	84,554	56,867
Total current assets	970,636	831,369
Property and equipment, net	424,041	397,578
Content rights, net, less current portion	1,253,553	1,175,988
Deferred launch incentives	207,032	255,259
Goodwill	365,266	254,989
Intangibles, net	107,673	142,938
Investments in and advances to unconsolidated affiliates	15,564	11,528
Deferred income taxes	—	69,316
Other assets	32,788	35,655
<b>TOTAL ASSETS</b>	<b>\$3,376,553</b>	<b>3,174,620</b>
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 316,804	283,326
Accrued payroll and employee benefits	122,431	88,000
Launch incentives payable	17,978	22,655
Content rights payable	57,694	97,075
Current portion of long-term incentive plan liabilities	43,274	20,690
Current portion of long-term debt	7,546	6,470
Income taxes payable	55,264	51,226
Unearned revenue	68,339	89,803
Other current liabilities	45,194	33,220
Total current liabilities	734,524	692,465
Long-term debt, less current portion	2,633,237	2,590,440
Derivative financial instruments, less current portion	8,282	18,592
Launch incentives payable, less current portion	10,791	21,910
Long-term incentive plan liabilities, less current portion	41,186	25,380
Content rights payable, less current portion	3,846	4,380
Deferred income taxes	46,289	—
Other liabilities	64,861	31,309
Total liabilities	3,543,016	3,384,476
Mandatorily redeemable interests in subsidiaries	94,825	272,502
Commitments and contingencies		
<b>Stockholders' deficit</b>		
Class A common stock; \$.01 par value; 100,000 shares authorized; 51,119 shares issued, less 719 shares of treasury stock	1	1
Class B common stock; \$.01 par value; 60,000 shares authorized; 50,615 shares issued and held in treasury stock	—	—
Additional paid-in capital	21,093	21,093
Accumulated deficit	(306,135)	(513,311)
Accumulated other comprehensive income	23,753	9,859
Total stockholders' deficit	(261,288)	(482,358)
<b>TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT</b>	<b>\$3,376,553</b>	<b>3,174,620</b>

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

**DISCOVERY COMMUNICATIONS, INC.**

**Consolidated Statements of Operations**

	Year Ended December 31,		
	2006	2005	2004
	in thousands		
<b>OPERATING REVENUE</b>			
Advertising . . . . .	\$1,243,500	1,187,823	1,133,807
Distribution . . . . .	1,434,901	1,198,686	976,362
Other . . . . .	<u>334,587</u>	<u>285,245</u>	<u>255,177</u>
Total operating revenue . . . . .	<u>3,012,988</u>	<u>2,671,754</u>	<u>2,365,346</u>
Cost of revenue, exclusive of depreciation shown below . . . . .	1,120,377	979,765	846,316
Selling, general & administrative . . . . .	1,209,420	1,054,816	927,855
Depreciation & amortization . . . . .	133,634	123,209	129,011
Gain on sale of long-lived asset . . . . .	—	—	(22,007)
Total operating expenses . . . . .	<u>2,463,431</u>	<u>2,157,790</u>	<u>1,881,175</u>
<b>INCOME FROM OPERATIONS</b> . . . . .	<u>549,557</u>	<u>513,964</u>	<u>484,171</u>
<b>OTHER INCOME (EXPENSE)</b>			
Interest, net . . . . .	(194,227)	(184,575)	(167,420)
Realized and unrealized gains from derivative instruments, net . . . . .	22,558	22,499	45,540
Minority interests in consolidated subsidiaries . . . . .	(2,451)	(43,696)	(54,940)
Equity in earnings of unconsolidated affiliates . . . . .	7,060	4,660	171
Other, net . . . . .	<u>1,467</u>	<u>9,111</u>	<u>2,299</u>
Total other expense, net . . . . .	<u>(165,593)</u>	<u>(192,001)</u>	<u>(174,350)</u>
<b>INCOME BEFORE INCOME TAXES</b> . . . . .	<u>383,964</u>	<u>321,963</u>	<u>309,821</u>
Income tax expense . . . . .	<u>176,788</u>	<u>162,343</u>	<u>141,799</u>
<b>NET INCOME</b> . . . . .	<u>\$ 207,176</u>	<u>159,620</u>	<u>168,022</u>

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

DISCOVERY COMMUNICATIONS, INC.

Consolidated Statements of Cash Flows

	Year Ended December 31,		
	2006	2005	2004
	in thousands		
<b>OPERATING ACTIVITIES</b>			
Net income	\$ 207,176	159,620	168,022
Adjustments to reconcile net income to cash provided by operations			
Depreciation and amortization	133,634	123,209	129,011
Amortization of deferred launch incentives and representation rights	77,778	83,411	107,757
Provision for losses on accounts receivable	3,691	12,217	959
Expenses arising from long-term incentive plans	39,233	49,465	71,515
Equity in earnings of unconsolidated affiliates	(7,060)	(4,660)	(171)
Deferred income taxes	108,903	109,383	105,522
Realized and unrealized gains on derivative financial instruments, net	(22,558)	(22,499)	(45,540)
Non-cash minority interest charges	2,451	43,696	54,940
Gain on sale of investments	(1,467)	(12,793)	—
Gain on sale of long-lived assets	—	—	(22,007)
Other non-cash (income) charges	2,447	9,675	(2,681)
<i>Changes in assets and liabilities, net of business combinations</i>			
Accounts receivable	(84,598)	(37,207)	(60,841)
Inventories	(4,560)	1,853	4,555
Other assets	(7,434)	(18,748)	(3,711)
Content rights, net of payables	(84,377)	(108,155)	(122,433)
Accounts payable and accrued liabilities	73,646	47,913	55,734
Representation rights	93,233	(6,000)	(479)
Deferred launch incentives	(49,386)	(35,731)	(74,696)
Long-term incentive plan liabilities	(841)	(325,756)	(240,752)
Cash provided by operations	479,911	68,893	124,704
<b>INVESTING ACTIVITIES</b>			
Acquisition of property and equipment	(90,138)	(99,684)	(88,100)
Business combinations, net of cash acquired	(194,905)	(400)	(17,218)
Purchase of intangibles	—	(583)	—
Investments in and advances to unconsolidated affiliates	—	(363)	(17,433)
Redemption of interests in subsidiaries	(180,000)	(92,874)	(148,880)
Proceeds from sale of investments	1,467	14,664	—
Proceeds from sale of long-lived assets	—	—	22,007
Cash used by investing activities	(463,576)	(179,240)	(249,624)
<b>FINANCING ACTIVITIES</b>			
Proceeds from issuance of long-term debt	316,813	1,785,955	1,848,000
Principal payments of long-term debt	(307,030)	(1,697,068)	(1,699,215)
Deferred financing fees	(1,144)	(4,810)	(8,499)
Contributions from minority shareholders	—	603	3,146
Other financing	(9,963)	32,153	(30,840)
Cash (used) provided by financing activities	(1,324)	116,833	112,592
Effect of exchange rate changes on cash	2,761	3,723	2,535
<b>CHANGE IN CASH AND CASH EQUIVALENTS</b>	17,772	10,209	(9,793)
Cash and cash equivalents, beginning of year	34,491	24,282	34,075
<b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>	<u>\$ 52,263</u>	<u>34,491</u>	<u>24,282</u>

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

DISCOVERY COMMUNICATIONS, INC.

Consolidated Statements of Changes in Stockholders' Deficit

	Class A		Additional Paid-In Capital	Accumulated Deficit	Other Comprehensive Income (Loss)			TOTAL
	At Par	Redeemable			Foreign Currency Translation	Unrealized Gain (Loss) on Investments	Unamortized Gain on Derivatives	
					in thousands			
<b>Balance, December 31, 2003</b> .....	\$1	—	21,093	(840,953)	14,323	3,771	—	(801,765)
Comprehensive income								
Net income .....				168,022				
Foreign currency translation, net of tax of \$5.2 million .....					8,409			
Unrealized loss on investments, net of tax of \$1.7 million .....						(2,592)		
Total comprehensive income .....								173,839
<b>Balance, December 31, 2004</b> .....	\$1	—	21,093	(672,931)	22,732	1,179	—	(627,926)
Comprehensive income								
Net income .....				159,620				
Foreign currency translation, net of tax of \$9.6 million .....					(16,017)			
Unrealized loss on investments, net of tax of \$0.1 million .....						(101)		
Unamortized gain on cash flow hedge, net of tax of \$1.3 million .....							2,066	
Total comprehensive income .....								145,568
<b>Balance, December 31, 2005</b> .....	\$1	—	21,093	(513,311)	6,715	1,078	2,066	(482,358)
Comprehensive income								
Net income .....				207,176				
Foreign currency translation, net of tax of \$8.8 million .....					14,458			
Unrealized loss on investments, net of tax of \$0.2 million .....						(355)		
Amortization of gain on cash flow hedge, net of tax of \$0.1 million .....							(209)	
Total comprehensive income .....								221,070
<b>Balance, December 31, 2006</b> .....	<u>\$1</u>	<u>—</u>	<u>21,093</u>	<u>(306,135)</u>	<u>21,173</u>	<u>723</u>	<u>1,857</u>	<u>(261,288)</u>

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

## DISCOVERY COMMUNICATIONS, INC.

### Notes to Consolidated Financial Statements

#### 1. Description of Business

Discovery Communications, Inc. (the "Company") is a privately-held, globally-diversified entertainment company whose operations are organized into four business units: U.S. Networks, International Networks, Commerce and Education. U.S. Networks operates cable and satellite television networks in the United States, including Discovery Channel, TLC, Animal Planet, The Travel Channel and Discovery Health Channel. International Networks operates cable and satellite television networks worldwide, including regional variants of Discovery Channel, Animal Planet, People & Arts, Discovery Travel & Living, and Discovery Real Time. Commerce operates over 100 Discovery Channel retail stores and manages consumer ventures in the United States. Education provides products and services to educational institutions and consumers.

#### 2. Summary of Significant Accounting Policies

##### *Principles of Consolidation*

The consolidated financial statements include the accounts of all majority-owned and controlled subsidiaries. In addition, the Company evaluates its relationships with other entities to identify whether they are variable interest entities as defined by Financial Accounting Standards Board ("FASB") Interpretation No. ("FIN") 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" as revised in December 2003 ("FIN 46R") and to assess whether it is the primary beneficiary of such entities. Variable Interest Entities ("VIEs") are generally entities that lack sufficient equity to finance their activities without additional financial support from other parties or whose equity holders possess rights not proportionate to their ownership. The equity method of accounting is used for affiliates over which the Company exercises significant influence but does not control.

All significant intercompany accounts and transactions have been eliminated in consolidation.

##### *Use of Estimates*

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results may differ from those estimates and could have a material impact on the consolidated financial statements.

The Company has issued redeemable interests in a number of its consolidated subsidiaries for which redemption events are outside of the Company's control. Estimating the redemption value of these interests requires complex contract interpretation and the use of fair value and future performance assumptions. Certain of our ventures with the British Broadcasting Company ("BBC") are operated under interim or unfinalized agreements, which contribute to the complexity of associated estimates.

Other significant estimates include the amortization method and recoverability of content rights, the valuation and recoverability of intangible assets and other long-lived assets, the valuation of deferred tax assets, the fair value of derivative financial instruments, and the adequacy of reserves associated with accounts receivable and retail inventory.

##### *Recent Accounting Pronouncements*

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109 ("FIN 48"), which clarifies the accounting for uncertainty in income tax positions. This Interpretation requires the Company to recognize in the consolidated financial statements the impact of a tax position that is more likely than not to be sustained upon examination by the applicable taxing authority based on the technical merits of the position. The provisions of FIN 48 will be effective for the Company as of the beginning of the Company's 2007 fiscal year, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on the consolidated financial statements.

## DISCOVERY COMMUNICATIONS, INC.

### Notes to Consolidated Financial Statements — (Continued)

#### *Revenue Recognition*

The Company derives revenue from four primary sources: (1) advertising revenue for commercial spots aired on the Company's networks, (2) distribution revenue from cable system and satellite operators (distributors), (3) retail sales of consumer products, and (4) educational product and service sales.

Advertising revenue is recorded net of agency commissions and audience deficiency liabilities in the period advertising spots are broadcast. Distribution revenue is recognized over the service period, net of launch incentives and other vendor consideration. Retail revenues are recognized either at the point-of-sale or upon product shipment. Educational service and product sales are generally recognized ratably over the term of the agreement or as the product is delivered.

#### *Advertising Costs*

The Company expenses advertising costs as incurred. The Company incurred advertising costs of \$207.7 million, \$208.6 million and \$170.3 million in 2006, 2005 and 2004.

#### *Cash and Cash Equivalents*

Highly liquid investments with original maturities of ninety days or less are recorded as cash equivalents. The Company had \$7.1 million and \$4.5 million in restricted cash included in other current assets as of December 31, 2006 and 2005. Book overdrafts representing outstanding checks in excess of funds on deposit are a component of accounts payable and total \$30.9 million and \$40.9 million in 2006 and 2005.

#### *Derivative Financial Instruments*

Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," requires every derivative instrument to be recorded on the balance sheet at fair value as either an asset or a liability. The statement also requires that changes in the fair value of derivatives be recognized currently in earnings unless specific hedge accounting criteria are met. From time to time, the Company uses financial instruments designated as a cash flow hedge of a forecasted transaction to hedge its exposures to interest rate risks. The effective changes in fair value of derivatives designated as cash flow hedges are recorded in accumulated other comprehensive income (loss). Amounts are reclassified from accumulated other comprehensive income (loss) as interest expense is recorded for debt. None of the Company's financial instruments were designated as a hedge in 2006 and 2004 and most of the Company's financial instruments were not designated as a hedge in 2005.

#### *Inventories*

Inventories are carried at the lower of cost or market and include inventory acquisition costs. Cost is determined using the weighted average cost method.

#### *Content Rights*

Costs incurred in the direct production, co-production or licensing of content rights are capitalized and stated at the lower of unamortized cost, fair value, or net realizable value. The Company evaluates the net realizable value of content by considering the fair value of the underlying produced and co-produced content and the net realizable values of the licensed content at least annually.

The costs of produced and co-produced content airing on the Company's networks are capitalized and amortized based on the expected realization of revenues, resulting in an accelerated basis over four years for developed networks (Discovery Channel, TLC, Animal Planet, and The Travel Channel) in the United States, and a straight-line basis over three to five years for developing networks in the United States and all International networks. The cost of licensed content is capitalized and amortized over the term of the license period based on the expected realization of revenues, resulting in an accelerated basis for developed networks in the United States, and a straight-line basis for all International networks, developing networks in the United States and educational ventures. The costs of content for electronic, video and hardcopy educational supplements and tools for educational ventures are amortized straight-line over a three to seven year period.

## DISCOVERY COMMUNICATIONS, INC.

### Notes to Consolidated Financial Statements — (Continued)

All produced and co-produced content is classified as long-term. The portion of the unamortized licensed content balance that will be amortized within one year is classified as a current asset.

#### *Property and Equipment*

Property and equipment are stated at cost less accumulated depreciation. Depreciation is recognized on a straight-line basis over the estimated useful lives of three to seven years for equipment, furniture and fixtures, five to forty years for building structure and construction, and six to thirteen years for satellite transponders. Leasehold improvements are amortized on a straight-line basis over the lesser of their estimated useful lives or the terms of the related leases, beginning on the date the asset is put into use. Equipment under capital lease represents the present value of the minimum lease payments at the inception of the lease, net of accumulated depreciation.

#### *Capitalized Software Costs*

All capitalized software costs are for internal use. Capitalization of costs occurs during the application development stage. Costs incurred during the pre and post implementation stages are expensed as incurred. Capitalized costs are amortized on a straight-line basis over their estimated useful lives of one to five years. Unamortized capitalized costs totaled \$61.4 million and \$59.1 million at December 31, 2006 and 2005. The Company capitalized software costs of \$21.6 million, \$23.2 million, and \$28.6 million in 2006, 2005 and 2004. Amortization of capitalized software costs totaled \$18.3 million, \$19.3 million, and \$18.4 million during 2006, 2005 and 2004. Write-offs of capitalized software totaled \$1.0 million and \$4.0 million in 2006 and 2004; there were no write-offs for capitalized software costs during 2005.

#### *Recoverability of Long-Lived Assets, Goodwill, and Intangible Assets*

The Company annually assesses the carrying value of its acquired intangible assets, including goodwill, and its other long-lived assets, including deferred launch incentives, to determine whether impairment may exist, unless indicators of impairment become evident requiring immediate assessment. Goodwill impairment is identified by comparing the fair value of the reporting unit to its carrying value. If the fair value of the reporting unit is less than its carrying value, an impairment loss is recorded to the extent that the implied fair value of the goodwill within the reporting unit is less than its carrying value. Intangible assets and other long-lived assets are grouped for purposes of evaluating recoverability at the lowest level for which independent cash flows are identifiable. If the carrying amount of an intangible asset, long-lived asset, or asset grouping exceeds its fair value, an impairment loss is recognized. Fair values for reporting units, goodwill and other intangible assets are determined based on discounted cash flows, market multiples, or comparable assets as appropriate.

The determination of recoverability of goodwill and other intangible and long-lived assets requires significant judgment and estimates regarding future cash flows, fair values, and the appropriate grouping of assets. Such estimates are subject to change and could result in impairment losses being recognized in the future. If different reporting units, asset groupings, or different valuation methodologies had been used, the impairment test results could have differed.

#### *Deferred Launch Incentives*

Consideration issued to cable and satellite distributors in connection with the execution of long-term network distribution agreements is deferred and amortized on a straight-line basis as a reduction to revenue over the terms of the agreements. Obligations for fixed launch incentives are recorded at the inception of the agreement. Obligations for performance-based arrangements are recorded when performance thresholds have been achieved. Following the renewal of a distribution agreement, the remaining deferred consideration is amortized over the extended period. Amortization of deferred launch incentives and interest on unpaid deferred launch incentives was \$79.1 million, \$74.1 million and \$98.4 million in 2006, 2005 and 2004.

#### *Foreign Currency Translation*

The Company's foreign subsidiaries' assets and liabilities are translated at exchange rates in effect at the balance sheet date, while results of operations are translated at average exchange rates for the respective periods. The resulting translation adjustments are included as a separate component of stockholders' deficit in accumulated other comprehensive income (loss).

**DISCOVERY COMMUNICATIONS, INC.**

**Notes to Consolidated Financial Statements — (Continued)**

*Long-term Incentive Plans*

Prior to October 2005, the Company maintained two unit-based, cash settled, long-term incentive plans. Under these plans, unit awards, which vest over a period of years, were granted to eligible employees and increased or decreased in value based on a specified formula of Company business metrics. The Company accounted for these units similar to stock appreciation rights and applied the guidance in FASB Interpretation Number 28, "Accounting for Stock Issued to Employees," ("FIN 28"). Accordingly, the Company adjusted compensation expense for changes in the accrued value of these awards over the period outstanding.

During August 2005, the Company discontinued one of its long-term incentive plans and settled all amounts with cash payments. In October 2005, the Company established a new long-term incentive plan for certain eligible employees. Substantially all participants in the remaining plan redeemed their vested units for cash payment and received units in the new plan.

Under the new plan, eligible employees receive cash settled unit awards indexed to the price of Class A Discovery Holding Company ("DHC") stock. As the units are indexed to the equity of another entity, the Company treats the units similar to a derivative, by determining their fair value each reporting period. The Company attributes compensation expense for the new awards on a straight-line basis; the Company attributes compensation expense for the initial grant of partially vested units by continuing to apply the FIN 28 model that was utilized over the awards' original vesting periods. Once units are fully vested, the Company recognizes all mark-to-market adjustments to fair value in each period as compensation expense. In March 2005, the Securities and Exchange Commission (the "SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107") regarding the classification of compensation expense associated with share-based payment awards. The Company has applied the provisions of SAB 107 and has recorded long term incentive compensation expense as a component of selling, general and administrative expenses. Prior year amounts have been reclassified to conform to current year presentation.

The Company classifies as a current liability 75% of the intrinsic value of the units that are vested or will become vested within one year. This amount corresponds to the value potentially payable should all participants separate from the Company. Upon voluntary termination of employment, the Company distributes 75% of unit benefits. The remainder is paid at the one-year anniversary of termination date.

*Mandatorily Redeemable Interests in Subsidiaries*

Mandatorily redeemable interests in subsidiaries are initially recorded at fair value. For those instruments with an estimated redemption value, the Company accretes or decretes to the estimated redemption value ratably over the period to the redemption date. Accretion and decreration are recorded as a component of minority interest expense. For instruments with a specified rate of return, the Company records interest expense as incurred. Cash receipts and payments for the sale or purchase of mandatorily redeemable interests in subsidiaries are included as a component of investing cash flows.

*Treasury Stock*

Treasury stock is accounted for using the cost method. The repurchased shares are held in treasury and are presented as if retired. There was no treasury stock activity for the three years ended December 31, 2006.

*Income Taxes*

Income taxes are recorded using the asset and liability method of accounting for income taxes. Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. A valuation allowance is provided for deferred tax assets if it is more likely than not such assets will be unrealized.

**DISCOVERY COMMUNICATIONS, INC.**

**Notes to Consolidated Financial Statements — (Continued)**

**3. Supplemental Disclosures to Consolidated Statements of Cash Flows**

	Year Ended December 31,		
	2006	2005	2004
	in thousands		
Cash paid for acquisitions:			
Fair value of assets acquired . . . . .	\$223,293	400	21,414
Fair value of liabilities assumed . . . . .	(28,388)	—	(4,196)
Cash paid for acquisitions, net of cash acquired . . . . .	194,905	400	17,218
Cash paid for interest . . . . .	\$196,195	171,151	166,584
Cash paid for income taxes . . . . .	\$ 70,215	27,678	28,999

**4. Business Combinations**

During February 2006, the Company acquired 98 percent of DMAX (formerly known as XXP), a free-to-air network in Germany. The results of operations have been included in the consolidated financial statements since that date. The acquisition of a free-to-air network is intended to support the Company's strategic priority of strengthening its global presence. The aggregate purchase price was \$60.2 million primarily in cash. Of the \$54.3 million of acquired intangible assets, \$23.0 million was assigned to contract-based distribution channels subject to amortization with a useful life of approximately 5 years and the remaining balance of \$31.3 million to goodwill.

In March 2006, the Company acquired all of the outstanding common shares of Antenna Audio Limited ("Antenna"), a provider of audio tours and multimedia at museums and cultural attractions around the globe. The results of Antenna's operations have been included in the consolidated financial statements since that date. The Company acquired Antenna to facilitate the expansion of its brand and media content to other platforms. The aggregate purchase price was \$64.4 million, primarily in cash. Of the \$49.1 million of acquired intangibles, \$6.4 million was assigned to assets subject to amortization with useful lives between two and seven years and the balance of \$42.7 million to goodwill.

In 2006, the Company also acquired the following four entities for a total cost of \$70.4 million, which was paid primarily in cash:

- Petfinder.com, a facilitator of pet adoptions and PetsIncredible, a producer and distributor of pet-training videos. The Company also has certain contingent considerations in connection with this acquisition payable in the event specific business metrics are achieved totaling up to \$13.5 million over 3 years, which could result in the recording of additional goodwill.
- Clearvue and SVE, Inc., a provider of curriculum-oriented media educational products.
- Academy123 Inc., a provider of online supplemental, educational content focusing largely on mathematics and sciences.
- Thinklink, Inc., a provider of formative assessment testing services to schools servicing students in grades K through 12.

Goodwill recognized for these transactions amounted to \$27.9 million. Purchased identifiable intangible assets for these acquisitions are being amortized on a straight-line basis over lives ranging from one to ten years (weighted-average life of 4.4 years).

DISCOVERY COMMUNICATIONS, INC.

Notes to Consolidated Financial Statements — (Continued)

The following table summarizes the estimated fair values of the assets acquired and the liabilities assumed at the dates of acquisition.

Asset (Liability)	DMAX	Antenna	Aggregation of	Total
			Remaining Acquisitions	
			in thousands	
Current assets and content . . . . .	\$10,119	21,403	8,843	40,365
Other tangible assets . . . . .	—	6,244	1,521	7,765
Finite-lived intangible assets . . . . .	23,006	6,383	43,989	73,378
Goodwill . . . . .	31,255	42,667	27,863	101,785
Liabilities assumed . . . . .	<u>(4,204)</u>	<u>(12,340)</u>	<u>(11,844)</u>	<u>(28,388)</u>
Cash paid, net of cash acquired . . . . .	<u>\$60,176</u>	<u>64,357</u>	<u>70,372</u>	<u>194,905</u>

Pro forma information related to 2006 acquisitions, either individually or in the aggregate, is not considered to be material to the Company's consolidated results of operations.

During 2004, the Company completed two acquisitions in its Education division, in which the Company acquired customer lists valued at \$14.6 million and covenants not to compete valued at \$0.6 million, which are being amortized over their useful lives of three years.

5. Content Rights

Content Rights	December 31,	
	2006	2005
	in thousands	
Produced content rights		
Completed . . . . .	\$ 1,594,549	1,272,331
In process . . . . .	161,942	122,366
Co-produced content rights		
Completed . . . . .	688,023	731,344
In process . . . . .	86,359	53,704
Licensed content rights		
Acquired . . . . .	229,878	214,100
Prepaid . . . . .	<u>10,386</u>	<u>3,371</u>
Content rights, at cost . . . . .	2,771,137	2,397,216
Accumulated amortization . . . . .	<u>(1,453,189)</u>	<u>(1,166,103)</u>
Content rights, net . . . . .	1,317,948	1,231,113
Current portion, licensed content rights . . . . .	<u>(64,395)</u>	<u>(55,125)</u>
Non-current portion . . . . .	<u>\$ 1,253,553</u>	<u>1,175,988</u>

Amortization of content rights was \$696.0 million, \$601.1 million and \$494.2 million in 2006, 2005 and 2004, and is recorded as a component of cost of revenue. Amortization of content rights includes incremental amortization for certain programs to net realizable value of \$34.6 million, \$8.0 million, and \$18.7 million in 2006, 2005 and 2004.

The Company estimates that approximately 86% of unamortized costs of content rights at December 31, 2006 will be amortized within the next three years. The Company expects to amortize \$477.5 million of unamortized content rights, not including in-process and prepaid productions, during the next twelve months.

During April 2006, the Company terminated its existing agreement and entered into new agreements regarding its exclusive right to represent BBC America ("BBCA"), a cable network, in sales, marketing, distribution and other operational activities. In exchange for early termination of the previous agreement, the Company received \$93.2 million, resulting in a deferred gain of \$27.7 million. This deferred gain is recorded as a component of other current and non-current assets.

Goodwill and trademarks are not amortized. Customer lists are amortized on a straight-line basis over the estimated useful lives of three to seven years. Non-compete assets are amortized on a straight-line basis over the contractual term of one to seven years. Other intangibles are amortized on a straight-line basis over the estimated useful lives of three to ten years.

Purchase price in excess of the fair value of the assets and liabilities acquired of \$101.8 million and \$1.1 million was recorded to goodwill in 2006 and 2004. Changes of \$8.5 million, \$(2.5) million, and \$1.6 million in goodwill resulted from fluctuations in foreign currency in 2006, 2005 and 2004.

Goodwill and Intangible Assets	
2006	2005
in thousands	
Goodwill	\$365,266
Trademarks	12,322
Customer lists, net of accumulated amortization of \$136,049 and \$111,954	26,500
Distribution, net of accumulated amortization of \$4,072	21,331
Other, net of accumulated amortization of \$55,283 and \$41,107	47,520
Representation rights, net of amortization of zero and \$69,886	67,843
Goodwill and intangible assets, net	\$472,939
	<u>397,927</u>

8. Goodwill and Intangible Assets

In April 2006 and January 2005, the Company recorded gains of \$1.5 million and \$12.8 million, as a component of other non-operating expenses for the sale of certain equity investments, previously accounted for under the cost method. The gains represent the difference between the proceeds received and the net book value of the investments.

In 2004, the Company recorded a net gain of \$22.0 million on the sale of certain television technology patents. The transaction closed in August 2004, and the gain represents the sale price less costs to sell. The Company expensed all of the costs to develop this technology in prior years.

7. Sale of Equity Investments and Long-lived Assets

The cost and accumulated depreciation of equipment under capital leases was \$39.7 million and \$13.2 million at December 31, 2006, and \$23.5 million and \$7.0 million at December 31, 2005. Depreciation and amortization of property and equipment, including equipment under capital lease, was \$89.9 million, \$85.0 million and \$85.4 million in 2006, 2005 and 2004.

Property and Equipment	
2006	2005
in thousands	
Equipment and software	\$ 411,583
Land	28,781
Buildings	153,737
Furniture, fixtures, leasehold improvements and other	217,884
Assets in progress	11,833
Property and equipment, at cost	823,818
Accumulated depreciation and amortization	(399,777)
Property and equipment, net	\$ 424,041
	<u>397,578</u>

6. Property and Equipment

Notes to Consolidated Financial Statements — (Continued)

**DISCOVERY COMMUNICATIONS, INC.**

**Notes to Consolidated Financial Statements — (Continued)**

current liabilities, is being amortized on a straight-line basis over the six year term of the agreement, and is reported in other revenue. The cost of acquiring the representation rights was amortized on a straight-line basis over the fifteen-year term of the original agreement, and was reported as a reduction of other revenue.

Amortization of intangible assets including representation rights, totaled \$46.0 million, \$45.0 million and \$41.8 million in 2006, 2005 and 2004. The Company estimates that unamortized costs of intangible assets at December 31, 2006 will be amortized over the next five years as follows: \$37.0 million in 2007, \$28.3 million in 2008, \$13.2 million in 2009, \$10.4 million in 2010, and \$3.4 million in 2011.

**9. Investments**

The following table outlines the Company's less than wholly-owned ventures and the method of accounting during 2006:

<u>Affiliates:</u>	<u>Accounting Method</u>
<u>Joint Ventures with the BBC:</u>	
JV Programs LLC ("JVP") .....	Consolidated
Joint Venture Network LLC ("JVN") .....	Consolidated
Animal Planet United States (see Note 11) .....	Consolidated
Animal Planet Europe .....	Consolidated
Animal Planet Latin America .....	Consolidated
People & Arts Latin America .....	Consolidated
Animal Planet Asia .....	Consolidated
Animal Planet Japan ("APJ") .....	Consolidated
Animal Planet Canada .....	Equity
<u>Other Ventures:</u>	
Discovery Canada .....	Equity
Discovery Japan .....	Equity
Discovery Health Canada .....	Equity
Discovery Kids Canada .....	Equity
Discovery Civilization Canada .....	Equity
Meteor Studios .....	Equity

**Joint Ventures with the BBC**

The Company and the BBC have formed several cable and satellite television network joint ventures, JVP, a venture to produce and acquire factual-based content, and JVN, a venture to provide debt funding to these joint ventures.

In addition to its own funding requirements, the Company has assumed the BBC funding requirements, giving the Company preferential cash distribution with these ventures. The Company controls substantially all of the BBC ventures and consolidates them accordingly. As the BBC does not have risk of loss, no losses were allocated to minority interest for consolidated joint ventures with the BBC, and the Company recognizes both its and the BBC's share of earnings and losses in the equity method venture with the BBC.

In connection with the adoption of FIN 46R, the Company concluded that JVP and APJ are VIEs and the Company is the primary beneficiary. Therefore, on January 1, 2005, the Company began consolidating these entities, which had aggregate fair value net asset balances of \$58.0 million. There is no minority interest income or expense for JVP; minority interest for APJ is an expense of \$0.3 million in 2006 and income of \$1.4 million in 2005 and is reported as a component of minority interest expense. Previously, the Company accounted for JVP and APJ under the equity method of accounting.

**Other Ventures**

The Company is a partner in other international joint venture cable and satellite television networks. The Company provided no funding to these ventures in 2006. Funding to these joint ventures totaled \$0.2 million and \$3.3 million during

DISCOVERY COMMUNICATIONS, INC.

Notes to Consolidated Financial Statements — (Continued)

2005 and 2004. At December 31, 2006, the Company's maximum exposure to loss as a result of its involvement with these joint ventures is the \$15.6 million investment book value and future operating losses, should they occur, of these joint ventures that the Company is obligated to fund. These joint ventures have no third party debt. These other ventures do not require consolidation. These other ventures are accounted for under the equity method as the Company does not have a controlling financial interest.

Unaudited financial information of the Company's unconsolidated ventures (amounts do not reflect eliminations of activity with the Company):

<u>Operating Results (Unaudited)</u>	<u>Year Ended December 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
	in thousands		
Net Revenue . . . . .	\$123,486	111,872	163,630
Income from operations . . . . .	42,090	41,934	26,201
Net income . . . . .	24,463	24,634	8,688
	<u>December 31,</u>		
	<u>2006</u>	<u>2005</u>	
	in thousands		
<u>Balance Sheets (Unaudited)</u>			
Current assets . . . . .	\$ 77,767	68,529	
Total assets . . . . .	89,058	80,365	
Current liabilities . . . . .	25,515	24,204	
Total liabilities . . . . .	33,619	33,578	
Total shareholders' equity or partners' capital . . . . .	55,439	46,787	

10. Long-Term Debt

<u>Long-Term Debt</u>	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
	in thousands	
\$1,000,000.0 Term Loan, due quarterly December 2008 to October 2010 . . . . .	\$1,000,000	1,000,000
\$1,555,000.0 Revolving Loan, due October 2010 . . . . .	249,500	103,000
€260.0 Revolving Loan, due April 2009 . . . . .	187,828	—
7.81% Senior Notes, semi annual interest, due March 2006 . . . . .	—	300,000
8.06% Senior Notes, semi annual interest, due March 2008 . . . . .	180,000	180,000
7.45% Senior Notes, semi annual interest, due September 2009 . . . . .	55,000	55,000
8.37% Senior Notes, semi annual interest, due March 2011 . . . . .	220,000	220,000
8.13% Senior Notes, semi annual interest, due September 2012 . . . . .	235,000	235,000
Senior Notes, semi annual interest, due December 2012 . . . . .	90,000	90,000
6.01% Senior Notes, semi annual interest, due December 2015 . . . . .	390,000	390,000
Obligations under capital leases . . . . .	32,355	23,910
Other notes payable . . . . .	1,100	—
Total long-term debt . . . . .	2,640,783	2,596,910
Current portion . . . . .	(7,546)	(6,470)
Non-current portion . . . . .	<u>\$2,633,237</u>	<u>2,590,440</u>

In March 2006, the Company's United Kingdom ("UK") subsidiary, Discovery Communications Europe Limited ("DCEL"), entered into a €70.0 million three year multicurrency revolving credit agreement. In April 2006, the UK credit agreement was amended and restated to provide for syndication and to increase the revolving commitments to €260.0 million. The Company guarantees DCEL's obligations under the UK credit agreement. Borrowings under this agreement bear interest at London Interbank Offered Rate ("LIBOR") plus an applicable margin based on the Company's leverage ratios. The cost of the UK credit agreement also includes a fee on the revolving commitments (ranging from 0.1% to 0.3%) based on the Company's leverage ratio. DCEL capitalized £0.7 million (approximately U.S. \$1.4 million)

## DISCOVERY COMMUNICATIONS, INC.

### Notes to Consolidated Financial Statements — (Continued)

of deferred financing costs as a result of this transaction. At the end of 2006 there was £95.9 million (approximately U.S. \$187.8 million) outstanding under the multicurrency credit agreement with a weighted average interest rate of 5.91%. The interest rate during 2006 averaged 5.62%. The UK credit agreement matures April 2009.

In March 2006 the Company borrowed additional funds under its Revolving Loan to redeem the maturing \$300.0 million Senior Notes. At the end of 2006 there was \$1,249.5 million outstanding under the Revolving Loan with a weighted average interest rate of 6.35%. The amount available under the Revolving Loan was \$1,302.8 million, net of amounts committed for standby letters of credit of \$2.7 million issued under the credit facility. At the end of 2005 there was \$1,103.0 million outstanding with a weighted interest rate of 5.32%. The average interest rate under the U.S. Credit Agreement was 6.01% and 4.41% in 2006 and 2005.

In October 2005, the Company refinanced its syndicated bank credit agreement, replacing the existing Term Loan and the Revolving Facility, which had principal payments beginning in 2007 and final maturity in 2009, with a new \$1,000 million Term Loan and \$1,555 million Revolving Facility, with principal payments beginning in 2008 and final maturity in 2010. The Term and Revolving Loans are unsecured. Interest, which is payable quarterly at a minimum, is based on LIBOR plus a margin based on the Company's leverage ratio or prime. The cost of the Revolving Facility includes a fee on the revolving commitment (ranging from 0.1% to 0.3%) based on the Company's leverage ratios.

In November 2005, the Company modified the outstanding unsecured Senior Notes. In December 2005, the Company issued two series of unsecured Senior Notes, \$90.0 million of floating rate Senior Notes due December 2012 and \$390.0 million of 6.01% Senior Notes due December 2015. The weighted average interest rate on the floating rate Senior Note was 6.10% at December 31, 2006 and 5.33% at December 31, 2005. The average interest rate under the floating rate Senior Note during 2006 was 5.85%.

The Company capitalized \$4.8 million in deferred financing costs in 2005 as a result of these transactions. The Company expensed \$4.2 million in capitalized costs as a component of interest expense associated with the refinancing of the previous credit arrangement.

The Company uses derivative instruments to modify its exposure to interest rate fluctuations on its debt. The Term Loans, Revolving Facility, and Senior Notes contain covenants that require the Company to meet certain financial ratios and place restrictions on the payment of dividends, sale of assets, borrowing level, mergers, and purchases of capital stock, assets, and investments.

Future principal payments under the current debt arrangements, excluding obligations under capital leases and other notes payable, are as follows: none in 2007, \$242.5 million in 2008, \$617.8 million in 2009, \$812.0 million in 2010, \$220.0 million in 2011 and \$715.0 million from 2012 to 2015. Future minimum payments under capital leases are as follows: \$9.3 million in 2007, \$7.3 million in 2008, \$7.3 million in 2009, \$5.1 million in 2010, \$4.5 million in 2011 and \$5.4 million thereafter.

#### 11. Mandatorily Redeemable Interests in Subsidiaries

<u>Mandatorily Redeemable Interests in Subsidiaries</u>	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
	in thousands	
Discovery Times .....	\$ —	106,862
Animal Planet LLC .....	—	80,000
Animal Planet LP .....	48,950	48,840
People & Arts Latin America and Animal Planet Channel Group .....	<u>45,875</u>	<u>36,800</u>
Mandatorily redeemable interests in subsidiaries .....	<u>\$94,825</u>	<u>272,502</u>

#### *Discovery Times*

In April 2002, the Company sold a 50% interest in Discovery Times Channel to the New York Times ("NYT") for \$100.0 million. Due to the NYT's redemption rights, this transaction resulted in no gain or loss to the Company. In September 2006, NYT exercised its right to put its interest back to the Company for \$100.0 million. Prior to the exercised put, the Company accreted or decreted the mandatorily redeemable interest in a subsidiary through the redemption date to its estimated redemption value, never decreting below the NYT's estimated minority interest. The Company updated its

**DISCOVERY COMMUNICATIONS, INC.**

**Notes to Consolidated Financial Statements — (Continued)**

estimate of the redemption value and estimated minority interest each period. The Company recorded decrease of \$6.9 million in 2006 as a result of the redemption, and decrease of \$19.5 million in 2005 and accretion of \$1.3 million in 2004 as a result of valuation adjustments to minority interest expense.

*FitTV (formerly known as The Health Network)*

Fox Entertainment Group ("FEG") had the right, from December 2003 to February 2004, to put its FitTV interests back to the Company. In December 2003, FEG notified the Company of its intention to put its interest in FitTV back to the Company. The Company acquired this interest for approximately \$92.9 million in 2005. The Company recorded decrease of \$1.1 million in 2004 to minority interest expense.

*Animal Planet LLC*

In April 2004, the BBC notified the Company of its intention to put its interest in Animal Planet LLC back to the Company. The redemption value of \$80.0 million was paid in April 2006. The Company recorded accretion of \$30.0 million and \$50.0 million in 2005 and 2004 to minority interest expense.

*Animal Planet LP*

One of the Company's stockholders held 44,000 senior preferred partnership units of Animal Planet LP ("APLP") that have a redemption value of \$44.0 million and carry a rate of return ranging from 8.75% to 13%. Payments are made quarterly and totaled \$4.6 million during 2006 and 2005 and \$5.8 million during 2004. APLP's senior preferred partnership units may be called by APLP during the period January 2007 through December 2011 for \$44.0 million, and may be put to the Company by the holder beginning in January 2012 for \$44.0 million. In January 2007, the Company exercised its call rights and paid \$44.0 million plus accrued interest of \$0.5 million on January 31, 2007. At December 31, 2006, and 2005, the Company has recorded this security at the redemption value of \$44.0 million plus accrued returns of \$5.0 million and \$4.8 million. Preferred returns have been recorded as a component of interest expense based on a constant rate of return of 10.75% through the full term and aggregated \$4.7 million in 2006, 2005 and 2004.

*People & Arts Latin America and Animal Planet Channel Group*

The BBC has the right, upon a failure of the People & Arts Latin America or the Animal Planet Channel Group (comprised of Animal Planet Europe, Animal Planet Asia, and Animal Planet Latin America), the Channel Groups, to achieve certain financial performance benchmarks to put its interests back to the Company for a value determined by a specified formula every three years which commenced December 31, 2002. The Company accretes the mandatorily redeemable equity in a subsidiary to its estimated redemption value through the applicable redemption date. The redemption value estimate is based on a contractual formula considering the projected results of each network within the channel group.

Based on the Company's calculated performance benchmarks, the BBC has the right to put their interests as of December 2005. The BBC has 90 days following the valuation of the Channel Groups by an independent appraiser to exercise their right. During 2006 the Company was notified that the BBC is evaluating whether to execute their rights under the agreement. As of December 31, 2006, the BBC has not advised the Company of their intention. The Company is now accreting to the 2008 redemption date and has estimated a redemption value of \$45.9 million as of December 31, 2006. Accretion to the redemption value has been recorded as a component of minority interest expense of \$9.1 million, \$34.6 million, and \$2.2 million in 2006, 2005 and 2004.

**DISCOVERY COMMUNICATIONS, INC.**

**Notes to Consolidated Financial Statements — (Continued)**

**12. Commitments and Contingencies**

<u>Future Minimum Payments</u>	<u>Year Ending December 31,</u>			
	<u>Leases</u>	<u>Content</u>	<u>Other</u>	<u>Total</u>
	<i>in thousands</i>			
2007 .....	\$ 83,533	260,829	86,965	431,327
2008 .....	78,999	55,447	61,467	195,913
2009 .....	60,850	50,556	54,635	166,041
2010 .....	52,683	44,129	17,388	114,200
2011 .....	47,932	43,295	7,876	99,103
Thereafter .....	<u>176,070</u>	<u>43,837</u>	<u>1,120</u>	<u>221,027</u>
Total .....	<u>\$500,067</u>	<u>498,093</u>	<u>229,451</u>	<u>1,227,611</u>

Expenses recorded in connection with operating leases, including rent expense, were \$142.5 million, \$142.1 million and \$127.8 million for the years ended December 31, 2006, 2005 and 2004. The Company receives contributions from certain landlords to fund leasehold improvements. Such contributions are recorded as deferred rent and amortized as reductions to lease expense over the lease term. Certain of the Company's leases provide for rental rates that increase or decrease over time. The Company recognizes operating lease minimum rentals on a straight-line basis over the lease term. The Company's deferred rent balance was \$37.4 million and \$29.8 million at December 31, 2006 and 2005. The lease term begins on the date the Company has access to the leased property.

In August 2005, the Company subleased rented property and guaranteed third party performance under the lease. The guarantee for the \$5.2 million value of the lease is full and unconditional, through March 2008. The Company has other guarantees totaling \$4.1 million.

The Company has certain contingent considerations in connection with the acquisition of Petfinder.com payable in the event specific business metrics are achieved totaling up to \$13.5 million over 3 years (see Note 4).

In connection with the long-term distribution agreements for certain of its European cable networks, the Company committed to pay a satellite system operator 25% to 49% of the fair value of these networks, if any, as of December 31, 2006. The Company completed negotiations for the renewed distribution agreements including additional European cable networks in January 2007, including an inducement payment of £100.0 million (approximately U.S. \$185.4 million), which also settled any liabilities from the prior agreement. The value of the networks, and the Company's liability thereon, are materially impacted by the terms of future renewed distribution agreements with the satellite system operator. The commitment was designed as an inducement for renewed distribution agreements. As of December 31, 2006, the Company has recorded a liability of \$10.4 million associated with this arrangement based on the range of estimated values of the networks at the termination of the agreement without renewed distribution agreements. The balance of the inducement payment will be deferred and amortized as a reduction of revenue over a five year period.

The Company is solely responsible for providing financial, operational and administrative support to the JVP, JVN, Animal Planet Latin America, People & Arts Latin America, Animal Planet Asia, and Animal Planet Europe ventures and has committed to do so through at least fiscal 2007.

The Company is involved in litigation incidental to the conduct of its business. In addition, the Company is involved in negotiations with organizations holding the rights to music used in the Company's content. As global music rights societies evolve, the Company uses all information available to estimate appropriate obligations. During 2005, DCI analyzed its music rights reserves and recorded a net reduction to cost of revenue of approximately \$11.0 million. The Company believes the reserves related to these music rights are adequate and does not expect the outcome of such litigation and negotiations to have a material adverse effect on the Company's results of operations, cash flows, or financial position.

**13. Employee Savings Plans**

The Company maintains employee savings plans, defined contribution savings plans and a supplemental deferred compensation plan for certain management employees, together the "Savings Plans." The Company contributions to the Savings Plans were \$9.9 million, \$8.2 million and \$6.8 million during 2006, 2005 and 2004.

**DISCOVERY COMMUNICATIONS, INC.**

**Notes to Consolidated Financial Statements — (Continued)**

**14. Long-term Incentive Plans**

In October 2005, the Company established a new long-term incentive plan. At inception of the plan, eligible participants in one of the Company's previously established long-term incentive plans chose to either continue in that plan or to redeem their vested units at the December 31, 2004 valuation and receive partially vested units in the new plan. Substantially all participants in the previously established plan redeemed their vested units and received partially vested units in the new plan. Certain eligible employees were granted new units in the new plan.

Units partially vested in the new plan have vesting similar to units in the previously established plan. New units awarded vest 25% per year. The units in the new plan are indexed to the market price of Class A DHC stock. Every two years, one quarter of the units awarded will expire and the employee will receive a cash payment for the increase in value throughout an eight-year period after the grant date. The Company has authorized the issuance of up to 31.9 million units under this plan.

Prior to October 2005, the Company maintained two unit-based, long-term incentive plans with substantially similar terms. Units were awarded to eligible employees following their one-year anniversary of hire and vested 25% per year thereafter. Upon exercise, participants received the increase in value from the date of issuance. The value of the units was based on changes in the Company's value as estimated by an external investment-banking firm utilizing a specified formula of Company business metrics. The average assumptions used in the valuation model included adjusted projected operating cash flows segregated by business group. The valuation also included a business group specific discount rate and terminal value based on business risk. The intrinsic value for unit appreciation had been recorded as compensation expense over the period the units were outstanding. In August 2005, the Company discontinued one of these plans, which resulted in the full vesting and cash redemption of units at the December 31, 2004 valuation, including a 25% premium on appreciated value.

Upon voluntary termination of employment, the Company distributes 75% of the intrinsic value of the participant's vested units, as participants are required to comply with post-employment obligations for one year in order to receive remaining benefits. The Company's cash disbursements under the new plan aggregated \$0.3 million in 2006. There were no payments during 2005 related to the new plan. The Company's cash disbursements under the prior plans aggregated \$325.8 million and \$45.9 million during 2005 and 2004. Compensation expense under the prior plans was \$20.4 million and \$68.8 million in 2005 and 2004. The fair value of the units issued under the new plan has been determined using the Black-Scholes option-pricing model. The expected volatility represents the calculated volatility of the DHC stock price over each of the various contractual terms. As a result of the limited trading history of the DHC stock, this amount was determined based on an analysis of DHC's industry peer group over the corresponding periods.

In 2006 and 2005, the weighted average assumptions used in this option-pricing model were as follows:

<u>Weighted Average Assumptions</u>	<u>Year Ended December 31,</u>	
	<u>2006</u>	<u>2005</u>
Risk-free interest rate . . . . .	4.79%	4.36%
Expected term (years) . . . . .	4.42	4.75
Expected volatility . . . . .	27.07%	30.36%
Dividend yield . . . . .	0%	0%

The weighted average grant date fair values of units granted during 2006 and 2005 were \$6.48 and \$5.83. The weighted average fair values of units outstanding are \$6.71 and \$6.63 at December 31, 2006 and 2005. Compensation expense in connection with the new plan was \$39.2 million in 2006 and \$29.1 million in 2005. Included in the 2005 expense is \$12.8 million related to the exchange of the partially vested units which represents the difference between the fair value of the award and the intrinsic value of the award attributable to prior vesting. The accrued fair values of units outstanding under the new plan were \$84.2 million and \$45.5 million at December 31, 2006 and 2005.

DISCOVERY COMMUNICATIONS, INC.

Notes to Consolidated Financial Statements — (Continued)

The following table summarizes information about unit transactions (units in millions) for the new plan:

	2006		2005	
	Units	Weighted Average Exercise Price	Units	Weighted Average Exercise Price
Outstanding at January 1	24.2	\$14.82	—	\$ —
Units exchanged	—	—	7.8	12.77
Units granted	3.5	16.36	16.4	15.81
Units exercised	(0.1)	13.12	—	—
Units redeemed/cancelled	(1.3)	15.43	—	—
Outstanding at December 31	<u>26.3</u>	<u>15.00</u>	<u>24.2</u>	<u>14.82</u>
Vested at December 31	<u>8.5</u>	<u>\$13.78</u>	<u>1.6</u>	<u>\$11.22</u>

The Company has classified as a current liability \$43.3 million for the intrinsic value of units that are or will become fully vested and potentially payable in the next twelve months. The aggregate intrinsic value of units outstanding at December 31, 2006 and 2005 is \$82.0 million and \$50.1 million. At December 31, 2006, there was \$92.0 million of unrecognized compensation cost related to unvested units, which the Company expects to recognize over a weighted average period of 2.2 years.

The following table summarizes information about unit awards outstanding at December 31, 2006 (units in millions):

Unit Price	Outstanding		Vested	
	Number of Units	Weighted Average Remaining Years of Contractual Life	Number of Units	Weighted Average Remaining Years of Contractual Life
\$3.48	0.1	3.75	0.1	3.75
\$7.06	0.6	3.75	0.6	3.75
\$12.52	5.1	3.75	3.3	3.70
\$15.81	17.1	3.74	4.5	0.83
\$16.22	1.1	4.25	—	—
\$15.84	1.3	4.75	—	—
\$17.22	<u>1.0</u>	<u>4.93</u>	<u>—</u>	<u>—</u>
Total	<u>26.3</u>	<u>3.86</u>	<u>8.5</u>	<u>2.20</u>

The following table summarizes information about unit transactions (units in millions) for previously established plans:

	2005		2004	
	Units	Weighted Average Exercise Price	Units	Weighted Average Exercise Price
Outstanding at January 1	25.6	\$24.10	19.1	\$18.18
Units exchanged	(7.8)	34.31	—	—
Units granted	0.5	37.35	8.7	34.22
Units redeemed/cancelled	(18.3)	20.53	(2.2)	13.49
Outstanding at December 31	<u>—</u>	<u>—</u>	<u>25.6</u>	<u>24.10</u>
Vested at December 31	<u>—</u>	<u>\$ —</u>	<u>17.5</u>	<u>\$19.76</u>

DISCOVERY COMMUNICATIONS, INC.

Notes to Consolidated Financial Statements — (Continued)

15. Income Taxes

<u>Income Tax Expense</u>	<u>Year Ended December 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
	in thousands		
Current			
Federal .....	\$ 3,906	(1,479)	(231)
State .....	4,101	(3,205)	3,952
Foreign .....	59,879	57,644	32,556
Total current income tax provision .....	<u>67,886</u>	<u>52,960</u>	<u>36,277</u>
Deferred			
Federal .....	103,672	95,098	95,761
State .....	3,707	16,298	7,723
Foreign .....	(3,637)	(3,851)	—
Total deferred income tax expense .....	<u>103,742</u>	<u>107,545</u>	<u>103,484</u>
Change in valuation allowance .....	5,160	1,838	2,038
Total income tax expense .....	<u>\$176,788</u>	<u>162,343</u>	<u>141,799</u>

<u>Deferred Income Tax Assets and Liabilities</u>	<u>December 31,</u>			
	<u>2006</u>		<u>2005</u>	
	<u>Current</u>	<u>Non-current</u>	<u>Current</u>	<u>Non-current</u>
	in thousands			
Assets				
Loss carryforwards .....	\$19,855	27,712	43,470	61,974
Compensation .....	30,981	15,563	15,185	12,432
Accrued expenses .....	12,088	14,981	17,769	—
Reserves and allowances .....	10,938	—	10,392	463
Tax credits .....	—	8,574	—	3,823
Derivative financial instruments .....	—	3,141	—	7,052
Investments .....	—	10,445	—	86,039
Intangibles .....	—	104,078	—	41,401
Other .....	4,301	20,897	3,689	11,732
	78,163	205,391	90,505	224,916
Valuation allowance .....	—	(26,552)	—	(21,392)
Total deferred income tax assets .....	<u>78,163</u>	<u>178,839</u>	<u>90,505</u>	<u>203,524</u>
Liabilities				
Accelerated depreciation .....	—	(6,164)	—	(11,948)
Content rights and deferred launch incentives .....	—	(200,732)	—	(109,009)
Foreign currency translation .....	—	(12,936)	—	(4,103)
Unrealized gains on investments .....	—	(861)	—	(1,920)
Other .....	(2,007)	(4,435)	(1,740)	(7,228)
Total deferred income tax liabilities .....	<u>(2,007)</u>	<u>(225,128)</u>	<u>(1,740)</u>	<u>(134,208)</u>
Deferred income tax assets (liabilities), net .....	<u>\$76,156</u>	<u>(46,289)</u>	<u>88,765</u>	<u>69,316</u>

The fair values of cash and cash equivalents, receivables, and accounts payable approximate their carrying values. Marketable equity securities are carried at fair value and fluctuations in fair value are recorded through other

**Fair Value of Financial Instruments**

During 2005, the Company entered into several treasury locks to hedge a forecasted debt financing transaction. The value of the hedges at closing was \$3.3 million. These derivatives received hedge accounting treatment and the deferred gain has been recorded as a component of Other Comprehensive Income (Loss), net of taxes and is being amortized as an adjustment to interest expense.

The foreign exchange instruments used are spot, forward, and option contracts. Additionally, the Company enters into non-designated forward contracts to hedge non-dollar denominated cash flows and foreign currency balances. At December 31, 2006 and 2005, the notional amount of foreign exchange derivative contracts was \$364.1 million and \$91.4 million. As a result of unrealized mark to market adjustments, the Company recognized a \$2.0 million gain and \$2.3 million and \$0.4 million in losses on these instruments during 2006, 2005 and 2004. The fair value of these derivative instruments is recorded as a component of long-term liabilities and other current liabilities in the consolidated balance sheets. These derivative instruments did not receive hedge accounting treatment.

The Company's interest expense is exposed to movements in short-term interest rates. Derivative instruments, including both fixed to variable and variable to fixed interest rate instruments, are used to modify this exposure. These instruments include a combination of swaps, caps, collars, and other structured instruments to modify interest rate exposure. At December 31, 2006 and 2005, the variable to fixed interest rate instruments have a notional principal amount of \$1,025.0 million and \$1,200.0 million and have a weighted average interest rate of 5.09% and 5.82%. At December 31, 2006 and 2005, the fixed to variable interest rate agreements have a notional principal amount of \$225.0 million and have a weighted average interest rate of 9.86% and 8.39%. At December 31, 2006, the Company held an unexercised interest rate swap put with a notional amount of \$25.0 million at a fixed rate of 5.44%. As a result of unrealized mark to market adjustments, the Company recorded \$10.4 million, \$29.1 million and \$44.1 million in gains on these instruments during 2006, 2005 and 2004. The fair value of these derivative instruments is recorded as a component of long-term liabilities and other current liabilities in the consolidated balance sheets. Changes in the fair value of these derivative instruments are recorded as a component of operating cash flows. These derivative instruments did not receive hedge accounting treatment.

The Company uses derivative financial instruments to modify its exposure to market risks from changes in interest rates and foreign exchange rates. The Company does not hold or enter into financial instruments for speculative trading purposes.

**Derivative Financial Instruments**

**16. Financial Instruments**

Deferred tax assets are reduced by a valuation allowance relating to the state tax benefits attributable to net operating losses in certain jurisdictions where realizability is not more likely than not.

The Company has Federal operating loss carryforwards of \$56.7 million that began to expire in 2021 and state operating loss carryforwards of \$728.1 million in various state jurisdictions available to offset future taxable income that expire in various amounts through 2025. The Company also has \$8.6 million of alternative minimum tax credits that do not have an expiration date.

Increase (decrease) in tax rate arising from:

Reconciliation of Effective Tax Rate	
2006	2005
Year Ended December 31,	
Federal statutory rate	35.0%
Increase (decrease) in tax rate arising from:	
State income taxes, net of Federal benefit	1.4
Foreign income taxes, net of Federal benefit	8.5
Other	1.1
Effective income tax rate	46.0%
	50.4%
	45.8%

Notes to Consolidated Financial Statements — (Continued)

DISCOVERY COMMUNICATIONS, INC.

Notes to Consolidated Financial Statements — (Continued)

comprehensive income. Losses on investments that are other than temporary declines in value are recorded in the statement of operations.

The carrying amount of the Company's borrowings was \$2,641 million and the fair value was \$2,702.0 million at December 31, 2006. The carrying amount of the Company's borrowings was \$2,597.0 million and the fair value was \$2,674.0 million at December 31, 2005.

The carrying amount of all derivative instruments represents their fair value. The net fair value of the Company's short and long-term derivative instruments is \$(6.5) million at December 31, 2006; 18.0%, 37.0%, 0.0%, 2.0%, and 43.0% of these derivative instrument contracts will expire in 2007, 2008, 2009, 2010 and thereafter. The net fair value of the Company's short and long-term derivative instruments was \$(19.8) million at December 31, 2005.

The fair value of derivative contracts was estimated by obtaining interest rate and volatility market data from brokers. As of December 31, 2006, an estimated 100 basis point parallel shift in the interest rate yield curve would change the fair value of the Company's portfolio by approximately \$9.5 million.

*Credit Concentrations*

The Company continually monitors its positions with, and the credit quality of, the financial institutions that are counterparties to its financial instruments and does not anticipate nonperformance by the counterparties. In addition, the Company limits the amount of investment credit exposure with any one institution.

The Company's trade receivables and investments do not represent a significant concentration of credit risk at December 31, 2006 due to the wide variety of customers and markets in which the Company operates and their dispersion across many geographic areas.

**17. Related Party Transactions**

The Company identifies related parties as investors and their consolidated businesses, the Company's equity investments, and the Company's executive management. The most significant transactions with related parties result from companies that distribute networks, produce content, or provide media uplink services. Gross revenue earned from related parties was \$90.0 million, \$73.7 million and \$71.8 million in 2006, 2005 and 2004. Accounts receivable from these entities were \$15.0 million and \$17.0 million at December 31, 2006 and 2005. Purchases from related parties totaled \$83.3 million, \$71.4 million, and \$133.2 million in 2006, 2005 and 2004; of these \$8.4 million, \$23.1 million and \$91.0 million relate to capitalized assets. Amounts payable to these parties totaled \$2.4 million and \$2.3 million at December 31, 2006 and 2005.