Discover Financial Services
Form 10-Q
April 14, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended February 29, 2008

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

For the transition period from to

Commission File Number 001-33378

DISCOVER FINANCIAL SERVICES

(Exact name of registrant as specified in its charter)

Delaware	**36-2517428**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
2500 Lake Cook Road	
Riverwoods, Illinois 60015	**(224) 405-0900**
(Address of principal executive offices, including zip code)	**(Registrant s telephone number, including area code)**

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of accelerated filer, large accelerated filer and smaller reporting company in Rule 12b of the Exchange Act.

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer x (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act.) **Yes** ¨ **No** x

As of March 31, 2008 there were 479,322,614 shares of the registrant s Common Stock, par value $0.01 per share, outstanding.

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DISCOVER FINANCIAL SERVICES

Quarterly Report on Form 10-Q

For the quarterly period ended February 29, 2008

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Except as otherwise indicated or unless the context otherwise requires, Discover Financial Services, Discover, DFS, we, us, our, and the Company refer to Discover Financial Services and its subsidiaries.

We own or have rights to use the trademarks, trade names and service marks that we use in conjunction with the operation of our business, including, but not limited to: Discover, PULSE, Cashback Bonus, ShopDiscover, Discover Motiva Card, Miles by Discover Card, Discover Open Road Card and Discover Network. All other trademarks, trade names and service marks included in this quarterly report are the property of their respective owners.

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Part 1. Financial Information

Item 1. Financial Statements

DISCOVER FINANCIAL SERVICES

Consolidated Statements of Financial Condition

	February 29, 2008	November 30, 2007
	(unaudited)	
	(dollars in thousands, except per share amounts)	
Assets		
Cash and due from banks	$ 368,914	$ 362,697
Federal Funds sold	3,929,200	6,270,600
Interest-earning deposits in other banks	3,988,176	1,440,979
Commercial paper		11,191
Cash and cash equivalents	8,286,290	8,085,467
Investment securities:		
Available-for-sale (amortized cost of $809,497 and $425,681 at February 29, 2008 and November 30, 2007, respectively)	792,979	420,837
Held-to-maturity (market value $91,881 and $100,769 at February 29, 2008 and November 30, 2007, respectively)	99,527	104,602
Loan receivables:		
Loans held for sale	349,072	
Loan portfolio:		
Credit card	19,895,527	20,345,787
Commercial loans	312,211	234,136
Other consumer loans	485,871	251,194
Total loan portfolio	20,693,609	20,831,117
Total loan receivables	21,042,681	20,831,117
Allowance for loan losses	(860,378)	(759,925)
Net loan receivables	20,182,303	20,071,192
Accrued interest receivable	122,765	123,292
Amounts due from asset securitization	2,935,494	3,041,215
Premises and equipment, net	567,475	575,229
Goodwill	255,421	255,421
Intangible assets, net	57,900	59,769
Other assets	922,578	712,678
Assets of discontinued operations	3,105,327	3,926,403
Total assets	$ 37,328,059	$ 37,376,105
Liabilities and Stockholders Equity		
Deposits:		
Interest-bearing deposit accounts	$ 24,881,960	$ 24,643,517
Non-interest bearing deposit accounts	59,816	67,796
Total deposits	24,941,776	24,711,313
Short-term borrowings	250,000	250,000
Long-term borrowings	1,976,147	2,134,093
Accrued interest payable	248,480	264,965

Accrued expenses and other liabilities	1,599,633	1,317,842
Liabilities of discontinued operations	2,657,682	3,098,470
Total liabilities	31,673,718	31,776,683
Commitments, contingencies and guarantees (Note 9)		
Stockholders Equity:		
Preferred stock, par value $0.01 per share; 200,000,000 shares authorized; none issued or outstanding		
Common stock, par value $0.01 per share; 2,000,000,000 shares authorized; 479,269,154 and 477,762,018 shares issued at February 29, 2008 and November 30, 2007, respectively	4,793	4,777
Additional paid-in capital	2,885,610	2,846,127
Retained earnings	2,761,159	2,717,905
Accumulated other comprehensive income	5,191	32,032
Treasury stock, at cost; 142,245 and 73,795 shares at February 29, 2008 and November 30, 2007, respectively	(2,412)	(1,419)
Total stockholders equity	5,654,341	5,599,422
Total liabilities and stockholders equity	$ 37,328,059	$ 37,376,105

See Notes to Consolidated and Combined Financial Statements.

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DISCOVER FINANCIAL SERVICES

Consolidated and Combined Statements of Income

	For the Three Months Ended February 29, 2008	February 28, 2007
	(unaudited) (dollars in thousands, except per share amounts)	
Interest income:		
Consumer loans	$ 550,018	$ 569,393
Commercial loans	3,203	195
Federal Funds sold	41,279	5,021
Commercial paper	77	204
Investment securities	5,987	1,183
Deposits in other banks	22,437	
Other interest income	39,801	36,210
Total interest income	662,802	612,206
Interest expense:		
Deposits	309,799	187,258
Short-term borrowings	90	52,334
Long-term borrowings	29,552	12,215
Total interest expense	339,441	251,807
Net interest income	323,361	360,399
Provision for loan losses	305,632	147,198
Net interest income after provision for loan losses	17,729	213,201
Other income:		
Securitization income	713,497	508,300
Loan fee income	88,258	89,041
Discount and interchange revenue	51,896	79,581
Insurance	47,769	43,963
Merchant fees	18,844	25,326
Transaction processing revenue	25,954	24,510
Other income	29,326	19,628
Total other income	975,544	790,349
Other expense:		
Employee compensation and benefits	217,370	215,167
Marketing and business development	141,553	134,542
Information processing and communications	78,276	78,844
Professional fees	73,672	76,065
Premises and equipment	19,641	19,575
Other expense	71,831	67,648
Total other expense	602,343	591,841
Income from continuing operations before income tax expense	390,930	411,709
Income tax expense	152,101	151,891

Income from continuing operations	238,829	259,818
Loss from discontinued operations, net of tax	(157,615)	(26,186)
Net income	$ 81,214	$ 233,632
Basic earnings per share:		
Income from continuing operations	$ 0.50	$ 0.54
Loss from discontinued operations, net of tax	(0.33)	(0.05)
Net income	$ 0.17	$ 0.49
Diluted earnings per share:		
Income from continuing operations	$ 0.50	$ 0.54
Loss from discontinued operations, net of tax	(0.33)	(0.05)
Net income	$ 0.17	$ 0.49
Dividends paid per common share	$ 0.06	$

See Notes to Consolidated and Combined Financial Statements.

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DISCOVER FINANCIAL SERVICES

Consolidated and Combined Statements of Changes in Stockholders Equity

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Stockholders Equity
			(unaudited) (dollars and shares in thousands)				
Balance at November 30, 2006	1	$ 100	$ 2,636,265	$ 3,008,421	$ 129,986	$	$ 5,774,772
Comprehensive income:							
Net income				233,632			233,632
Foreign currency translation (accumulated amount of $128,749 at February 28, 2007)					(1,236)		
Net unrealized losses on investment securities					(176)		
Other					31		
Other comprehensive loss					(1,381)		(1,381)
Total comprehensive income							232,251
Capital contribution from Morgan Stanley			21,635				21,635
Cash dividends paid to Morgan Stanley				(500,000)			(500,000)
Balance at February 28, 2007	1	$ 100	$ 2,657,900	$ 2,742,053	$ 128,605	$	$ 5,528,658
Balance at November 30, 2007	477,762	$ 4,777	$ 2,846,127	$ 2,717,905	$ 32,032	$ (1,419)	$ 5,599,422
Adoption of FASB Interpretation No. 48				(8,743)			(8,743)
Comprehensive income:							
Net income				81,214			81,214
Foreign currency translation (accumulated amount of $28,358 at February 29, 2008)					(20,000)		
Net unrealized losses on investment securities					(6,841)		
Other comprehensive loss					(26,841)		(26,841)
Total comprehensive income							54,373
Purchases of treasury stock						(993)	(993)
Common stock issued under employee 401(k) plan	1,138	12	16,125				16,137
Common stock issued and stock-based compensation expense	369	4	23,409				23,413
Dividends				(29,217)			(29,217)
Other			(51)				(51)
Balance at February 29, 2008	479,269	$ 4,793	$ 2,885,610	$ 2,761,159	$ 5,191	$ (2,412)	$ 5,654,341

See Notes to Consolidated and Combined Financial Statements.

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DISCOVER FINANCIAL SERVICES

Consolidated and Combined Statements of Cash Flows

	For the Three Months Ended February 29, 2008	For the Three Months Ended February 28, 2007
	(unaudited) (dollars in thousands)	
Cash flows from operating activities		
Net income	$ 81,214	$ 233,632
Adjustments to reconcile net income to net cash provided by operating activities:		
Gains on sale of mortgages and installment loans		(422)
Net principal disbursed on loans originated for sale		(24,878)
Proceeds from sales of loans originated for sale		26,389
Impairment of disposal group	172,469	
Loss on investments	1,184	
Stock-based compensation expense	39,550	
Deferred income taxes	34,403	17,368
Depreciation and amortization on premises and equipment	29,755	30,667
Other depreciation and amortization	30,826	31,133
Provision for loan losses	324,477	195,386
Amortization of deferred revenues	(5,587)	(5,450)
Changes in assets and liabilities:		
(Increase) decrease in amounts due from asset securitization	103,244	(181,506)
(Increase) decrease in other assets	(30,053)	(12,855)
Increase (decrease) in accrued expenses and other liabilities	40,155	200,184
Net cash provided by operating activities	821,637	509,648
Cash flows from investing activities		
Maturities of investment securities	23,105	2,307
Purchases of investment securities	(17,962)	(4,274)
Proceeds from securitization and sale of loans held for investment	2,548,650	1,576,165
Net principal disbursed on loans held for investment	(3,109,438)	(700,288)
Purchases of premises and equipment	(20,359)	(27,997)
Net cash (used for) provided by investing activities	(576,004)	845,913
Cash flows from financing activities		
Net (decrease) increase in short-term borrowings	(208,973)	(3,543,737)
Repayment of long-term debt and bank notes	(157,677)	
Purchases of treasury stock	(993)	
Net increase (decrease) in deposits	221,807	4,316,854
Dividends paid to Morgan Stanley		(500,000)
Dividends paid	(29,217)	
Net cash (used for) provided by financing activities	(175,053)	273,117
Effect of exchange rate changes on cash and cash equivalents	(23,500)	(11)
Net increase in cash and cash equivalents	47,080	1,628,667
Cash and cash equivalents, at beginning of period	8,787,095	874,357
Cash and cash equivalents, at end of period	$ 8,834,175	$ 2,503,024

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid (received) during the period for:		
Interest expense	$ 389,201	$ 280,083
Income taxes, net of income tax refunds	$ (1,902)	$ (52,158)
Non-cash transactions:		
Exchange of retained seller s interest for certificated beneficial interests in DCENT	$ 385,000	$
Capital contributions (to) from Morgan Stanley	$	$ 21,635

See Notes to Consolidated and Combined Financial Statements.

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Notes to Consolidated and Combined Financial Statements

(unaudited)

1. Background and Basis of Presentation

Description of Business. Discover Financial Services (DFS or the Company) is a leading credit card issuer and electronic payment services company. The Company s business segments include U.S. Card and Third-Party Payments. The U.S. Card segment includes Discover Card-branded credit cards issued over Discover s signature card network (the Discover Network) and other consumer lending and deposit products offered through the Company s Discover Bank subsidiary. The Third-Party Payments segment includes the PULSE Network (PULSE), an automated teller machine, debit and electronic funds transfer network, and the Company s third-party payments business.

On February 7, 2008, the Company announced that it had entered into an agreement to sell the Company s U.K. credit card business (Goldfish) which represented substantially all of the Company s International Card segment. As a result, the International Card segment is presented in discontinued operations in this report. The Company completed the sale of the Goldfish business to Barclays Bank PLC on March 31, 2008. See Note 2: Discontinued Operations and Note 13: Subsequent Events for further details.

Distribution. On December 19, 2006, Morgan Stanley announced that its Board of Directors had authorized the spin-off of its Discover segment. On June 30, 2007, the Company was spun-off from Morgan Stanley through the distribution of DFS shares to holders of Morgan Stanley common stock (the Distribution). Prior to the Distribution, the Discover segment comprised Discover Financial Services, a wholly-owned subsidiary of Morgan Stanley, as well as certain other subsidiaries and assets related to credit card operations in the United Kingdom contributed to the Discover segment by Morgan Stanley in conjunction with the Distribution.

Basis of Presentation. The accompanying consolidated and combined financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated or combined financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The preparation of financial statements in conformity with GAAP requires the Company to make estimates and assumptions that affect the amounts reported in the consolidated and combined financial statements and related disclosures. Actual results could differ from these estimates. These interim consolidated and combined financial statements should be read in conjunction with the Company s 2007 audited consolidated and combined financial statements filed with the Company s annual report on Form 10-K for the year ended November 30, 2007.

The financial statements presented in this quarterly report for periods on or after the Distribution are presented on a consolidated basis and include the results of operations, financial condition and cash flows of the Company and its wholly-owned subsidiaries. The financial statements for the periods prior to the Distribution are presented on a combined basis and reflect the historical combined results of operations, financial condition and cash flows of the Morgan Stanley subsidiaries that comprised its Discover segment (as described in the preceding section) for the periods presented. The combined statements of income for periods prior to the Distribution reflect intercompany expense allocations made to the Discover segment by Morgan Stanley for certain corporate functions such as treasury, financial control, human resources, internal audit, legal, investor relations and various other functions historically provided by Morgan Stanley. Where possible, these allocations were made on a specific identification basis. Otherwise, such expenses were allocated by Morgan Stanley based on relative percentages of headcount or some other basis depending on the nature of the cost that was allocated. These historical cost allocations may not be indicative of costs the Company will incur to obtain these same services as an independent entity. See Note 12: Related Party Transactions for further information on expenses allocated by Morgan Stanley.

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The historical financial results in the combined financial statements presented for periods prior to the Distribution may not be indicative of the results that would have been achieved had the Company operated as a separate, stand-alone entity during those periods. The combined financial statements presented for those periods do not reflect any changes that have occurred or may yet occur in the financing and operations of the Company as a result of the Distribution. The Company has a capital structure different from the capital structure in the combined financial statements and accordingly, interest expense is not necessarily indicative of the interest expense the Company would have incurred as a separate, independent company. However, management believes that the combined financial statements presented for periods prior to the Distribution include all adjustments necessary for a fair presentation of the business. All intercompany balances and transactions of the Company have been eliminated.

Recently Issued Accounting Pronouncements

In March 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (Statement No. 161). The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity s financial condition, financial performance, and cash flows. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Statement No. 161 will impact disclosures only and will not have an impact on the Company s consolidated financial condition, results of operations or cash flows.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007), *Business Combinations* (Statement No. 141R), which replaces Statement of Financial Accounting Standards No. 141, *Business Combinations* (Statement No. 141) issued in 2001. Whereas its predecessor applied only to business combinations in which control was obtained by transferring consideration, the revised standard applies to all transactions or other events in which one entity obtains control over another. Statement No. 141R defines the acquirer as the entity that obtains control over one or more other businesses and defines the acquisition date as the date the acquirer achieves control. Statement No. 141R requires the acquirer to recognize assets acquired, liabilities assumed and any noncontrolling interest in the acquiree at their respective fair values as of the acquisition date. The revised standard changes the treatment of acquisition-related costs, restructuring costs related to an acquisition that the acquirer expects but is not obligated to incur, contingent consideration associated with the purchase price and preacquisition contingencies associated with acquired assets and liabilities. Statement No. 141R retains the guidance in Statement No. 141 for identifying and recognizing intangible assets apart from goodwill. The revised standard applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company will apply the provisions of Statement No. 141R to any business acquisition which occurs on or after the date the standard becomes effective.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51*, (Statement No. 160). Statement No. 160 will affect only those entities that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. A noncontrolling interest (or *minority interest*) is the portion of equity in a subsidiary not attributable, directly or indirectly, to a parent. Statement No. 160 establishes accounting and reporting standards for noncontrolling interests and for the deconsolidation of a subsidiary, topics for which there had been limited authoritative guidance. Statement No. 160 clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements rather than a liability or a mezzanine equity item. Statement No. 160 is effective on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company does not currently have any subsidiaries that get deconsolidated or for which a noncontrolling interest exists. As such, the adoption of Statement No. 160 is not expected to have an impact on the Company s consolidated financial condition, results of operations or cash flows.

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In June 2007, the FASB s Emerging Issues Task Force (EITF) ratified Issue No. 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards* (EITF 06-11), which clarifies the accounting for income tax benefits related to dividends paid on stock-based awards. The issue is effective for awards declared in fiscal years beginning after December 15, 2007, and interim periods within those years. EITF 06-11 is not expected to have a material impact on the Company s consolidated financial condition, results of operations or cash flows.

2. Discontinued Operations

On February 7, 2008, the Company and Barclays Bank PLC entered into a definitive sale and purchase agreement relating to the sale of £129 million of net assets (equivalent to approximately $258 million) of the Company s Goldfish business, previously reported as the International Card segment. The Company completed the sale of the Goldfish business to Barclays Bank PLC on March 31, 2008. The aggregate sale price under the agreement was £35 million (equivalent to approximately $70 million), which was paid in cash at closing and is subject to a potential post-closing adjustment.

In the quarter ended February 29, 2008, the Company reclassified the net assets of the Goldfish business to discontinued operations and restated prior periods for comparability. The Company recorded a loss from discontinued operations of $158 million in the first quarter of 2008. This included an after tax loss of $172 million from the write-down of net assets to fair value, which included the write-down of $37 million of other intangibles that had previously been measured at fair value on a non-recurring basis, and income from operations of $14 million which included gains from the sale of other assets.

Assets and liabilities of discontinued operations related to the sale of the Company s Goldfish business were as follows (dollars in thousands):

	February 29, 2008	November 30, 2007
Assets:		
Cash and cash equivalents	$ 547,885	$ 701,628
Loan receivables and other assets	2,557,442	3,224,775
Total assets	3,105,327	3,926,403
Liabilities:		
Borrowings	2,602,908	2,925,426
Other liabilities	54,774	173,044
Total liabilities	2,657,682	3,098,470
Net assets	$ 447,645	$ 827,933

The following table provides summary financial information for discontinued operations related to the sale of the Company s Goldfish business (dollars in thousands):

	For the Three Months Ended	
	February 29, 2008	February 28, 2007
Revenues(1)	$ 98,564	$ 71,275
Income (loss) from discontinued operations	$ 23,630	$ (40,248)
Loss on impairment of discontinued operations	(235,630)	

Pretax loss from discontinued operations	(212,000)	(40,248)
Income tax benefit	(54,385)	(14,062)
Loss from discontinued operations, net of tax	$ (157,615)	$ (26,186)

(1) Revenues are the sum of net interest income and other income.

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3. Loan Receivables

Loan receivables consist of the following (dollars in thousands):

	February 29, 2008	November 30, 2007
Loans held for sale	$ 349,072	$
Loan portfolio:		
Credit card	19,895,527	20,345,787
Commercial loans	312,211	234,136
Total credit card, including consumer and commercial	20,207,738	20,579,923
Other consumer loans	485,871	251,194
Total loan portfolio	20,693,609	20,831,117
Total loan receivables	21,042,681	20,831,117
Allowance for loan losses	(860,378)	(759,925)
Net loan receivables	$ 20,182,303	$ 20,071,192

Net proceeds from loan sales are as follows (dollars in thousands):

	For the Three Months Ended February 29, 2008	February 28, 2007
Net proceeds from credit card securitizations	$ 2,548,650	$ 1,576,165
Net proceeds from mortgage and installment loan sales		25,967
Total net proceeds from loan sales	$ 2,548,650	$ 1,602,132

On February 29, 2008, the Company exchanged $385 million of its seller s interest in the Discover Card Master Trust I for the issuance of certificated Class B and Class C notes issued by the Discover Card Execution Note Trust (DCENT), which the Company now holds as other retained beneficial interests. The seller s interest was included in loan receivables, which was reduced as a result of this transaction. These certificated notes are classified as investment securities available-for-sale on the Company s statement of financial condition.

Activity in the allowance for loan losses is as follows (dollars in thousands):

	For the Three Months Ended February 29, 2008	February 28, 2007
Balance at beginning of period	$ 759,925	$ 703,917
Additions:		
Provision for loan losses	305,632	147,198
Deductions:		
Charge-offs	(245,628)	(229,124)
Recoveries	40,449	41,183

Net charge-offs	(205,179)	(187,941)
Balance at end of period	$ 860,378	$ 663,174

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Information regarding net charge-offs of interest and fee revenues on credit card loans is as follows (dollars in thousands):

	For the Three Months Ended February 29, 2008	For the Three Months Ended February 28, 2007
Interest accrued subsequently charged off, net of recoveries (recorded as a reduction of interest income)	$ 56,973	$ 46,691
Loan fees accrued subsequently charged off, net of recoveries (recorded as a reduction to loan fee income)	$ 24,069	$ 21,553

Information regarding loan receivables that are over 90 days delinquent and accruing interest and loan receivables that are not accruing interest is as follows (dollars in thousands):

	February 29, 2008	November 30, 2007
Loans over 90 days delinquent and accruing interest	$ 335,246	$ 271,227
Loans not accruing interest	$ 109,746	$ 102,286

4. Deposits

The Company s deposits consist of brokered and direct certificates of deposits, money market deposit accounts, and, to a lesser degree, deposits payable upon demand.

A summary of interest-bearing deposit accounts is as follows (dollars in thousands):

	February 29, 2008	November 30, 2007
Certificates of deposit in amounts less than $100,000	$ 19,516,877	$ 19,385,024
Certificates of deposit in amounts of $100,000 or greater	861,739	775,717
Savings deposits, including money market deposit accounts	4,503,344	4,482,776
	$ 24,881,960	$ 24,643,517
Average annual interest rate	5.12%	5.18%

Certificates of deposit had the following maturities at February 29, 2008 (dollars in thousands):

Year	Amount
2008	$ 8,817,262
2009	$ 5,350,988
2010	$ 2,625,008
2011	$ 911,376
2012	$ 1,535,357
Thereafter[1]	$ 1,138,625

(1) Includes certificates of deposits which may be called by the Company prior to their contractual maturity at specific intervals of time.

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5. Long-Term Borrowings

Long-term borrowings consist of borrowings and capital leases having original maturities of one year or more. The following table provides a summary of the outstanding amounts and general terms of the Company s long-term borrowings (dollars in thousands):

Funding source	February 29, 2008	November 30, 2007	Maturity	Interest Rate
Bank notes	$ 249,886	$ 249,856	2 / 09	3-month LIBOR + 15 basis points
Secured borrowings	922,386	1,080,063	various (final maturity 12 / 10)	Commercial paper rate + 50 basis points
Unsecured borrowings:				
Floating rate senior notes	400,000	400,000	6 / 10	3-month LIBOR + 53 basis points
Fixed rate senior notes	399,242	399,222	6 / 17	6.45% fixed
Total unsecured borrowings	799,242	799,222		
Capital lease obligations	4,633	4,952	various	6.26%
Total long-term borrowings	$ 1,976,147	$ 2,134,093		

The Company negotiated a 59-month $2.5 billion unsecured credit agreement that became effective July 2, 2007. The credit agreement provides for a revolving credit commitment of up to $2.5 billion (of which the Company may borrow up to 30% and Discover Bank may borrow up to 100% of the revolving credit commitment). The credit agreement provides for a commitment fee on the unused portion of the facility, which can range from 0.07% to 0.175% depending on the index debt ratings. Loans outstanding under the credit facility bear interest at a margin above the Federal Funds rate, LIBOR, the EURIBO rate or the Euro Reference rate. The terms of the credit agreement include various affirmative and negative covenants, including financial covenants related to the maintenance of certain capitalization and tangible net worth levels, and certain double leverage, delinquency and tier 1 capital to managed loans ratios. The credit agreement also includes customary events of default with corresponding grace periods, including, without limitation, payment defaults, cross-defaults to other agreements evidencing indebtedness for borrowed money and bankruptcy-related defaults. The commitments may be terminated upon an event of default. As of February 29, 2008, the Company had not drawn down any of the outstanding credit.

6. Employee Benefit Plans

The Company sponsors defined benefit pension and other postretirement plans for its eligible U.S. employees. Net periodic benefit cost expensed by the Company included the following components (dollars in thousands):

	Pension For the Three Months Ended		Postretirement For the Three Months Ended	
	February 29, 2008	February 28, 2007	February 29, 2008	February 28, 2007
Service cost, benefits earned during the period	$ 4,206	$ 4,825	$ 269	$ 274
Interest cost on projected benefit obligation	4,998	4,951	361	328
Expected return on plan assets	(6,009)	(5,474)		
Net amortization	(560)	515	(116)	(138)
Net periodic benefit cost	$ 2,635	$ 4,817	$ 514	$ 464

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7. Income Taxes

Income tax expense from continuing operations consisted of the following (dollars in thousands):

	For the Three Months Ended February 29, 2008	For the Three Months Ended February 28, 2007
Current:		
U.S. federal	$ 127,700	$ 126,902
U.S. state and local	21,752	11,143
International	(5)	2
Total	149,447	138,047
Deferred:		
U.S. federal	2,247	13,551
U.S. state and local	407	293
Total	2,654	13,844
Income tax expense	$ 152,101	$ 151,891

The following table reconciles the Company s effective tax rate from continuing operations to the U.S. federal statutory income tax rate:

	For the Three Months Ended February 29, 2008	For the Three Months Ended February 28, 2007
U.S. federal statutory income tax rate	35.0%	35.0%
U.S. state and local income taxes, net of U.S. federal income tax benefits	3.2	1.8
Other	0.7	0.1
Effective income tax rate	38.9%	36.9%

The Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48) on December 1, 2007. As a result of adoption, the Company recorded an $8.7 million reduction to the December 1, 2007 balance of retained earnings.

The total amount of unrecognized tax benefits at the date of adoption on December 1, 2007 was $242.8 million, of which $51.8 million of unrecognized tax benefits would favorably affect the effective tax rate if recognized.

The Company continues to recognize accrued interest and penalties related to unrecognized tax benefits as a component of income tax expense, consistent with its policy prior to the adoption of FIN 48. The accrued balance of interest and penalties related to unrecognized tax benefits at December 1, 2007 was $41.0 million.

The Company is under continuous examination by the IRS and the tax authorities for various states. The tax years under examination vary by jurisdiction; for example, the current IRS examination covers 1999 through 2005. The Company regularly assesses the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years examinations. A liability for unrecognized tax benefits has been established that the Company believes is adequate in relation to the potential for additional assessments. Once established, unrecognized tax benefits are adjusted only when there is more information available or when an event occurs necessitating a change. It is reasonably possible that the unrecognized tax benefit will significantly increase or decrease within the next twelve months. Based on current progress with the federal audit, it is not possible to quantify the impact such changes may have on the effective tax rate.

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8. Earnings Per Share

Basic earnings per share (EPS) is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the assumed conversion of all dilutive securities. On June 30, 2007, the Distribution by Morgan Stanley was completed to the Morgan Stanley stockholders of one share of DFS common stock for every two shares of Morgan Stanley common stock held on June 18, 2007. As a result, on July 2, 2007, the Company had 477,235,927 shares of common stock outstanding and this share amount is being utilized for the calculation of basic and diluted EPS for the three months ended February 28, 2007. The same number of shares is being used for diluted EPS as for basic EPS as no common stock of DFS was traded prior to July 2, 2007 and no DFS equity awards were outstanding for the prior periods.

The following table presents the calculation of basic and diluted EPS (dollars and shares in thousands, except per share amounts):

	For the Three Months Ended	
	February 29, 2008	**February 28, 2007**
Numerator:		
Income from continuing operations	$ 238,829	$ 259,818
Loss from discontinued operations, net of tax	(157,615)	(26,186)
Net income	$ 81,214	$ 233,632
Denominator:		
Weighted average common shares outstanding	478,518	477,236
Effect of dilutive stock options and restricted stock units	3,226	
Weighted average common shares outstanding and common stock equivalents	481,744	477,236
Basic earnings per share:		
Income from continuing operations	$ 0.50	$ 0.54
Loss from discontinued operations, net of tax	(0.33)	(0.05)
Net income	$ 0.17	$ 0.49
Diluted earnings per share:		
Income from continuing operations	$ 0.50	$ 0.54
Loss from discontinued operations, net of tax	(0.33)	(0.05)
Net income	$ 0.17	$ 0.49

The following securities were considered anti-dilutive and therefore were excluded from the computation of diluted EPS (shares in thousands):

	For the Three Months Ended	
	February 29, 2008	**February 28, 2007**
Number of anti-dilutive securities (stock options and restricted stock units) outstanding at end of period	5,891	

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9. Commitments, Contingencies and Guarantees

Lease commitments. The Company leases various office space and equipment under capital and non-cancelable operating leases which expire at various dates through 2013. At February 29, 2008, future minimum payments on leases with remaining terms in excess of one year, including those related to Goldfish, consist of the following (dollars in thousands):

	February 29, 2008	
	Capitalized Leases	Operating Leases
2008	$ 1,185	$ 4,727
2009	1,579	6,652
2010	1,579	4,881
2011	790	3,415
2012		3,333
Thereafter		2,406
Total minimum lease payments	5,133	$ 25,414
Less: amount representing interest	500	
Present value of net minimum lease payments	$ 4,633	

Unused commitments to extend credit. At February 29, 2008, the Company had unused commitments to extend credit for consumer and commercial loans of approximately $259 billion, including commitments related to loans of the Goldfish business. Such commitments arise primarily from agreements with customers for unused lines of credit on certain credit cards, provided there is no violation of conditions established in the related agreement. These commitments, substantially all of which the Company can terminate at any time and which do not necessarily represent future cash requirements, are periodically reviewed based on account usage and customer creditworthiness.

Guarantees. The Company has certain obligations under certain guarantee arrangements, including contracts and indemnification agreements that contingently require the Company to make payments to the guaranteed party based on changes in an underlying (such as a security) related to an asset or a liability of a guaranteed party. Also included as guarantees are contracts that contingently require the Company to make payments to the guaranteed party based on another entity s failure to perform under an agreement. The Company s use of guarantees is disclosed below by type of guarantee.

Securitized Asset Representations and Warranties. As part of the Company s securitization activities, the Company provides representations and warranties that certain securitized assets conform to specified guidelines. The Company may be required to repurchase such assets or indemnify the purchaser against losses if the assets do not meet certain conforming guidelines. Due diligence is performed by the Company to ensure that asset guideline qualifications are met. The maximum potential amount of future payments the Company could be required to make would be equal to the current outstanding balances of all assets subject to such securitization activities. The Company has not recorded any contingent liability in the consolidated and combined financial statements for these representations and warranties, and management believes that the probability of any payments under these arrangements is remote.

Merchant Chargeback Guarantees. The Company issues credit cards and owns and operates the Discover Network in the United States. The Company is contingently liable for certain transactions processed on the Discover Network in the event of a dispute between the cardholder and a merchant. The contingent liability arises if the disputed transaction involves a merchant or merchant acquirer with whom Discover Network has a direct relationship. If a dispute is resolved in the cardholder s favor, the Discover Network will credit or refund the disputed amount to the Discover Network card issuer, who in turn credits its cardholder s account. Discover Network will then charge back the transaction to the merchant or merchant acquirer. If

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the Discover Network is unable to collect the amount from the merchant or merchant acquirer, it will bear the loss for the amount credited or refunded to the cardholder. In most instances, a payment requirement by the Discover Network is unlikely to arise because most products or services are delivered when purchased, and credits are issued by merchants on returned items in a timely fashion. However, where the product or service is not provided until some later date following the purchase, the likelihood of payment by the Discover Network increases. The maximum potential amount of future payments related to these contingent liabilities is estimated to be the portion of the total Discover Network transaction volume processed to date for which timely and valid disputes may be raised under applicable law and relevant issuer and cardholder agreements. However, the Company believes that amount is not representative of the Company s actual potential loss exposure based on the Company s historical experience. The actual amount of the potential exposure cannot be quantified as the Company cannot determine whether the current or cumulative transaction volumes may include or result in disputed transactions.

At February 29, 2008, the Company was also contingently liable for resolution of cardmember disputes associated with credit cards issued by its U.K. subsidiary on the Mastercard and Visa network. The maximum potential amount of future payments related to these contingent liabilities is estimated to be the portion of the total U.K. cardmember sales transaction volume billed to date for which timely and valid disputes may be raised under applicable law, and relevant issuer and cardmember agreements.

The table below summarizes certain information regarding merchant chargeback guarantees:

	For the Three Months Ended	
	February 29, 2008	**February 28, 2007**
Losses related to merchant chargebacks (in thousands)		
Discover Network	$ 1,896	$ 1,767
U. K. subsidiary	177	193
Total losses related to merchant chargebacks	$ 2,073	$ 1,960
Aggregate transaction volume (in millions)		
Discover Network	$ 24,547	$ 22,841
U. K. subsidiary	2,951	3,169
Total aggregate transaction volume(1)	$ 27,498	$ 26,010

(1) Represents period transactions processed on Discover Network to which a potential liability exists as well as U.K. cardmember sales transactions which, in aggregate, can differ from credit card sales volume.

The Company has not recorded any contingent liability in the consolidated and combined financial statements for this guarantee at February 29, 2008 and November 30, 2007. The Company mitigates this risk by withholding settlement from merchants and merchant acquirers or obtaining escrow deposits from certain merchant acquirers or merchants that are considered higher risk due to various factors such as time delays in the delivery of products or services and concerning merchant behavior.

The table below provides information regarding the settlement withholdings and escrow deposits (dollars in thousands):

	February 29, 2008	**November 30 2007**
Settlement withholdings and escrow deposits	$ 66,892	$ 52,683

Settlement withholdings and escrow deposits are recorded in interest-bearing deposit accounts and accrued expenses and other liabilities on the Company s consolidated statement of financial condition.

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10. Fair Value Disclosures

In accordance with Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*, the Company is required to disclose the fair value of financial instruments for which it is practical to estimate fair value. To obtain fair values, observable market prices are used if available. In some instances, observable market prices are not readily available for certain financial instruments and fair value is determined using present value or other techniques appropriate for a particular financial instrument. These techniques involve some degree of judgment and as a result are not necessarily indicative of the amounts the Company would realize in a current market exchange. The use of different assumptions or estimation techniques may have a material effect on the estimated fair value amounts.

The following table provides the estimated fair values of financial instruments (dollars in thousands):

	February 29, 2008		November 30, 2007	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Financial Assets				
Cash and cash equivalents	$ 8,286,290	$ 8,286,290	$ 8,085,467	$ 8,085,467
Investment securities:				
Available-for-sale	$ 792,979	$ 792,979	$ 420,837	$ 420,837
Held-to-maturity	$ 99,527	$ 91,881	$ 104,602	$ 100,769
Net loan receivables	$ 20,182,303	$ 20,334,360	$ 20,071,192	$ 20,215,713
Amounts due from asset securitization	$ 2,935,494	$ 2,935,494	$ 3,041,215	$ 3,041,215
Other assets:				
Derivative financial instruments	$ 11,695	$ 11,695	$ 2,643	$ 2,643
Financial Liabilities				
Deposits	$ 24,941,776	$ 25,262,211	$ 24,711,313	$ 24,782,822
Short-term borrowings	$ 250,000	$ 250,000	$ 250,000	$ 250,000
Long-term borrowings	$ 1,976,147	$ 1,881,926	$ 2,134,093	$ 2,091,902
Accrued expenses and other liabilities:				
Derivative financial instruments	$ 1,655	$ 1,655	$ 19,532	$ 19,532

Cash and cash equivalents. The carrying value of cash and cash equivalents approximates fair value due to maturities of less than three months.

Investment securities available-for-sale. The carrying values of investment securities classified as available-for-sale are recorded at their fair values. Fair values of retained interests in Class B and C notes issued by DCENT are estimated utilizing information obtained from investment banks for investments with similar terms, capturing current market spreads. Fair values of other investments are based on quoted market prices utilizing public information for similar transactions.

Investment securities held-to-maturity. The estimated fair values of investment securities classified as held-to-maturity are based on quoted market prices utilizing public information for the same or comparable transactions or information provided through third-party advisors.

Net loan receivables. The Company s loan receivables consist of loans held for sale and the loan portfolio, which includes loans to consumers and commercial loans. The carrying value of loans held for sale, which consists entirely of consumer loans, approximates fair value as a result of the short-term nature of these assets. To estimate the fair value of the remaining loan receivables, loans are aggregated into pools of similar loan types, characteristics and expected repayment terms. The fair values of the loans are estimated by discounting future cash flows using a rate at which similar loans could be made under current market conditions.

Amounts due from asset securitization. Carrying values of the portion of amounts due from asset securitization that are short-term in nature approximate their fair values. Fair values of the remaining assets

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recorded in amounts due from asset securitization reflect the present value of estimated future cash flows utilizing management s best estimate of key assumptions with regard to credit card receivable performance and interest rate environment projections.

Deposits. The carrying values of money market deposit, non-interest bearing deposits, interest-bearing demand deposits and savings accounts approximates fair value due to the liquid nature of these deposits. For time deposits for which readily available market rates do not exist, fair values are estimated by discounting future cash flows using market rates currently offered for deposits with similar remaining maturities.

Short-term borrowings. The carrying values of short-term borrowings approximate their fair values. Term and overnight Federal Funds purchased are short-term in nature and have maturities of less than one year. Other short-term borrowings have variable rates of interest and are assumed to approximate fair values due to their automatic ability to reprice with changes in the market.

Long-term borrowings. The fair values of long-term borrowings are determined by discounting cash flows of future interest accruals at market rates currently offered for borrowings with similar remaining maturities or repricing terms. The carrying values of bank notes approximate their fair values due to the quarterly repricing of interest rates to current market rates. The carrying values of secured and unsecured borrowings with variable rates are assumed to approximate fair values due to their automatic ability to reprice with changes in the