Discovery Communications, Inc.
Form 10-Q
August 03, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2010

OR

¨ **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: 001-34177

DISCOVERY COMMUNICATIONS, INC.

(Exact name of Registrant as specified in its charter)

Delaware	**35-2333914**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
One Discovery Place Silver Spring, Maryland	**20910**
(Address of principal executive offices)	**(Zip Code)**

(240) 662-2000

(Registrant s telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report.)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (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 Exchange Act). Yes ¨ No x

Total number of shares outstanding of each class of the Registrant s common stock as of July 27, 2010:

Series A Common Stock, $0.01 par value	136,280,496
Series B Common Stock, $0.01 par value	6,589,084
Series C Common Stock, $0.01 par value	141,757,056

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements.

DISCOVERY COMMUNICATIONS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited; in millions, except par value)

	As of June 30, 2010	As of December 31, 2009 (recast)
ASSETS		
Current assets:		
Cash and cash equivalents (including $43 and $40 held by VIEs at 2010 and 2009, respectively)	$ 713	$ 623
Receivables, net	836	812
Content rights, net	81	75
Prepaid expenses and other current assets	185	161
Total current assets	1,815	1,671
Noncurrent content rights, net	1,206	1,207
Property and equipment, net	401	409
Goodwill	6,442	6,433
Intangible assets, net	625	643
Other noncurrent assets	585	589
Total assets	$ 11,074	$ 10,952
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 356	$ 446
Current portion of long-term debt	17	38
Other current liabilities	235	299
Total current liabilities	608	783
Long-term debt	3,594	3,457
Other noncurrent liabilities	309	443
Commitments and contingencies (Note 15)		
Redeemable noncontrolling interests	49	49
Equity:		
Discovery Communications, Inc. stockholders equity:		
Series A convertible preferred stock: $0.01 par value; 75 shares authorized; 71 shares issued and outstanding at 2010 and 2009	1	1
Series C convertible preferred stock: $0.01 par value; 75 shares authorized; 71 shares issued and outstanding at 2010 and 2009	1	1
Series A common stock: $0.01 par value; 1,700 shares authorized; 136 and 135 shares issued and outstanding at 2010 and 2009, respectively	1	1
Series B convertible common stock: $0.01 par value; 100 shares authorized; 7 shares issued and outstanding at 2010 and 2009		

Series C common stock: $0.01 par value; 2,000 shares authorized; 142 shares issued and outstanding at 2010 and 2009	2	2
Additional paid-in capital	6,636	6,600
Accumulated deficit	(111)	(387)
Accumulated other comprehensive loss	(44)	(21)
Total Discovery Communications, Inc. stockholders equity	6,486	6,197
Noncontrolling interests	28	23
Total equity	6,514	6,220
Total liabilities and equity	$ 11,074	$ 10,952

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

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DISCOVERY COMMUNICATIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited; in millions, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009 (recast)	2010	2009 (recast)
Revenues:				
Distribution	$ 449	$ 422	$ 894	$ 844
Advertising	435	367	783	668
Other	79	76	155	159
Total revenues	963	865	1,832	1,671
Costs of revenues, excluding depreciation and amortization listed below	254	251	521	500
Selling, general and administrative	304	295	588	561
Depreciation and amortization	33	39	66	76
Restructuring and impairment charges		35	3	38
Gains on dispositions		(252)		(252)
	591	368	1,178	923
Operating income	372	497	654	748
Interest expense, net	(48)	(60)	(106)	(117)
Loss on extinguishment of debt	(136)		(136)	
Other (expense) income, net	(37)	8	(41)	8
Income before income taxes	151	445	371	639
Provision for income taxes	(41)	(264)	(88)	(335)
Net income	110	181	283	304
Less net income attributable to noncontrolling interests	(3)	(2)	(7)	(6)
Net income attributable to Discovery Communications, Inc.	107	179	276	298
Stock dividends to preferred interests	(1)	(2)	(1)	(2)
Net income available to Discovery Communications, Inc. stockholders	$ 106	$ 177	$ 275	$ 296
Net income per share available to Discovery Communications, Inc. stockholders:				
Basic	$ 0.25	$ 0.42	$ 0.65	$ 0.70
Diluted	$ 0.25	$ 0.42	$ 0.64	$ 0.70
Weighted average shares outstanding:				
Basic	426	422	425	422

Diluted	431	424	430	423

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

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DISCOVERY COMMUNICATIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited; in millions)

	Six Months Ended June 30,	
	2010	2009 (recast)
Operating Activities		
Net income	$ 283	$ 304
Adjustments to reconcile net income to cash provided by operating activities:		
Stock-based compensation expense	94	98
Depreciation and amortization	67	78
Content amortization	350	338
Impairment charges		26
Gains on dispositions		(252)
Gains on sales of investments		(13)
Deferred income taxes	(44)	12
Noncash portion of loss on extinguishment of debt	12	
Other noncash expenses, net	43	35
Changes in operating assets and liabilities:		
Receivables, net	(31)	17
Content rights	(370)	(368)
Accounts payable and accrued liabilities	(159)	96
Stock-based compensation liabilities	(123)	(15)
Other, net	(32)	(19)
Cash provided by operating activities	90	337
Investing Activities		
Purchases of property and equipment	(20)	(32)
Business acquisitions, net of cash acquired	(38)	
Proceeds from dispositions		300
Proceeds from sales of investments		22
Investments in and advances to equity investees	(41)	(13)
Cash (used in) provided by investing activities	(99)	277
Financing Activities		
Net repayments of revolver loans		(315)
Borrowings from long-term debt, net of discount and issuance costs	2,970	478
Principal repayments of long-term debt	(2,883)	(518)
Principal repayments of capital lease obligations	(5)	(5)
Cash distributions to noncontrolling interests	(2)	(8)
Proceeds from stock option exercises	15	
Other financing activities, net	4	(3)
Cash provided by (used in) financing activities	99	(371)
Effect of exchange rate changes on cash and cash equivalents		2
Net change in cash and cash equivalents	90	245
Cash and cash equivalents, beginning of period	623	94

Cash and cash equivalents, end of period	$	713	$	339
Supplemental Cash Flow Information:				
Cash paid for interest, net:				
Periodic interest payments for debt, interest rate swaps and capital lease obligations	$	115	$	118
Make-whole premiums		114		
Interest rate swap termination payments		24		
Repayment of original issue discount on long-term debt		10		
Total cash paid for interest, net	$	263	$	118
Cash paid for taxes, net	$	178	$	89
Noncash Transactions:				
Assets acquired under capital lease arrangements	$	20	$	32
Stock dividends to preferred interests	$	1	$	2

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

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DISCOVERY COMMUNICATIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF EQUITY

(unaudited; in millions)

	Three Months Ended June 30, 2010			Three Months Ended June 30, 2009		
	Discovery Stockholders	Noncontrolling Interests	Total Equity	Discovery Stockholders (recast)	Noncontrolling Interests (recast)	Total Equity (recast)
Beginning balance	$ 6,365	$ 25	$ 6,390	$ 5,653	$ 20	$ 5,673
Comprehensive income:						
Net income	107	3	110	179	2	181
Other comprehensive income (loss):						
Foreign currency translation adjustments, net	(10)		(10)	39		39
Market value adjustments and reclassifications for securities and derivatives	6		6	21		21
Total comprehensive income	103	3	106	239	2	241
Stock dividends declared to preferred interests	(1)		(1)	(2)		(2)
Cash distributions to noncontrolling interests					(3)	(3)
Issuance of common stock in connection with stock-based plans and other	9		9			
Stock-based compensation	10		10	7		7
Ending balance	$ 6,486	$ 28	$ 6,514	$ 5,897	$ 19	$ 5,916

	Six Months Ended June 30, 2010			Six Months Ended June 30, 2009		
	Discovery Stockholders	Noncontrolling Interests	Total Equity	Discovery Stockholders (recast)	Noncontrolling Interests (recast)	Total Equity (recast)
Beginning balance	$ 6,197	$ 23	$ 6,220	$ 5,536	$ 21	$ 5,557
Comprehensive income:						
Net income	276	7	283	298	6	304
Other comprehensive income (loss):						
Foreign currency translation adjustments, net	(30)		(30)	29		29
Market value adjustments and reclassifications for securities and derivatives	7		7	24		24
Total comprehensive income	253	7	260	351	6	357
Stock dividends declared to preferred interests	(1)		(1)	(2)		(2)
Cash distributions to noncontrolling interests		(2)	(2)		(8)	(8)
Issuance of common stock in connection with stock-based plans and other	19		19			
Stock-based compensation	18		18	12		12
Ending balance	$ 6,486	$ 28	$ 6,514	$ 5,897	$ 19	$ 5,916

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

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DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE 1. DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Description of Business

Discovery Communications, Inc. (Discovery or the Company) is a leading nonfiction media and entertainment company that provides original and purchased programming across multiple distribution platforms throughout the world and owns and operates a diversified portfolio of website properties and other digital services. Discovery also develops and sells consumer and educational products and services as well as media sound services in the United States (U.S.) and internationally. The Company manages and reports its operations in three segments: U.S. Networks, consisting principally of domestic cable and satellite television network programming, web brands and other digital services; International Networks, consisting primarily of international cable and satellite television network programming; and Education and Other, consisting principally of curriculum-based service and product offerings and post-production sound services. Financial information for Discovery s reportable segments is set forth in Note 16.

Basis of Presentation

Changes in Basis of Presentation Recast

The 2009 financial information has been recast so that the basis of presentation is consistent with that of the 2010 financial information. This recast reflects (i) the adoption of the recent accounting guidance that amends the model for determining whether an entity should consolidate a variable interest entity (VIE), which resulted in the deconsolidation of the Oprah Winfrey Network (OWN) and Animal Planet Japan (APJ) joint ventures for all periods presented (Note 2), (ii) the results of operations of the Company s Antenna Audio business as discontinued operations (Note 3), and (iii) the realignment of the Company s commerce business, which is now reported as a component of the U.S. Networks segment for all periods presented whereas it was previously reported as a component of the Commerce, Education and Other segment (Note 16).

Unaudited Interim Financial Statements

These condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) applicable to 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 notes required by GAAP for complete financial statements. These condensed consolidated financial statements are unaudited; however, in the opinion of management, they reflect all adjustments, consisting of those of a normal recurring nature, necessary to present fairly the financial position, results of operations and cash flows for the periods presented in conformity with GAAP applicable to interim periods. The results of operations for the interim periods presented are not necessarily indicative of results for the full year or future periods. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in Discovery s Annual Report on Form 10-K for the year ended December 31, 2009 (2009 Form 10-K).

Use of Estimates

The preparation of financial statements in accordance with GAAP requires management to make estimates, judgments and assumptions that affect the amounts and disclosures reported in the consolidated financial statements and notes thereto. Management continually re-evaluates its estimates, judgments and assumptions and management s assessments could change. Actual results may differ from those estimates and could have a material impact on the consolidated financial statements.

Significant estimates inherent in the preparation of the Company s consolidated financial statements include consolidation of VIEs, accounting for acquisitions, dispositions, allowances for doubtful accounts, content rights, asset impairments, redeemable noncontrolling interests, fair value measurements, revenue recognition, depreciation and amortization, stock-based compensation, income taxes and contingencies.

Consolidation and Accounting for Investments

The consolidated financial statements include the accounts of Discovery, its majority-owned subsidiaries in which a controlling interest is maintained and VIEs for which the Company is the primary beneficiary. Investments in entities over which the Company has the ability to exercise significant influence but does not control and is not the primary beneficiary are accounted for using the equity method. Investments in entities over which the Company has no control or significant influence and is not the primary beneficiary are accounted for at fair value or using the cost method. Inter-company accounts and transactions have been eliminated.

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DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Foreign Currency

The functional currency of substantially all of the Company s international subsidiaries is the local currency. Assets and liabilities denominated in foreign currencies are translated at exchange rates in effect at the balance sheet date. The resulting asset and liability translation adjustments are included as a component of Accumulated other comprehensive loss on the Condensed Consolidated Balance Sheets. Foreign currency equity balances are translated at historical rates. Results of operations denominated in foreign currencies are translated at average exchange rates for the respective periods. Foreign currency transaction gains and losses are included in Operating income on the Condensed Consolidated Statements of Operations.

Reclassifications

In addition to the recast of the 2009 financial information noted above, certain reclassifications have been made to the 2009 financial information to conform to the 2010 financial information presentation. The reclassifications primarily include the separate presentation of Content amortization on the Condensed Consolidated Statements of Cash Flows, which was previously combined with changes in content and other operating assets and liabilities.

NOTE 2. NEW ACCOUNTING AND REPORTING PRONOUNCEMENTS

Pronouncements Adopted

Consolidation of Variable Interest Entities

In June 2009, the Financial Accounting Standards Board (FASB) issued an accounting standard that amends the guidance for interests in VIEs. Among other matters, the guidance amends the approach for determining the primary beneficiary of a VIE by requiring an analysis that places more reliance on qualitative rather than quantitative factors, continuous assessments of whether an entity is the primary beneficiary of a VIE and enhanced disclosures about an entity s involvement with a VIE. Effective January 1, 2010, the Company adopted the provisions of this guidance for all interests in VIEs, which have been retrospectively applied to all periods presented in this report. As a result of adopting the new guidance, the Company changed its accounting for the OWN and APJ joint ventures from consolidation to the equity method of accounting. The new guidance permits prospective or retrospective adoption. The Company believes retrospective adoption provides the most comparable and useful financial information for financial statement users and is more consistent with the information the Company s management uses to evaluate its business. Accordingly, the Company has recast the 2009 financial information to reflect the deconsolidation of the OWN and APJ joint ventures and its accounting for its interests in these entities using the equity method.

Prior to the adoption of the new guidance, operating losses generated by OWN were allocated 50-50 between the Company and the joint venture counterparty. As the Company has assumed all funding requirements for OWN, under the equity method of accounting Discovery is required to record 100% of OWN s operating losses up to the Company s funding obligation, which was $100 million as of June 30, 2010. The increase in the allocation of OWN s losses to Discovery resulted in a reduction of $6 million to Net income attributable to Discovery Communications, Inc. on the Condensed Consolidated Statements of Operations previously reported for the three and six months ended June 30, 2009, which reflects the portion of OWN s operating losses previously allocated to the joint venture counterparty. It was previously reported that the increase in the allocation of OWN s losses to Discovery will result in a reduction of $17 million to the Company s net income previously reported for the full year ended December 31, 2009. The Company has revised its estimate to a reduction of $11 million to Net income attributable to Discovery Communications, Inc. for the full year ended December 31, 2009, which is reflected on the Condensed Consolidated Balance Sheets as of December 31, 2009. The new guidance also resulted in a $4 million and $7 million reduction to Net income attributable to Discovery Communications, Inc. for the three and six months ended June 30, 2010, respectively.

Fair Value Measurements

In January 2010, the FASB issued guidance that requires additional disclosures about recurring and nonrecurring fair value measurements, including significant transfers into and out of Level 1 and Level 2 of the fair value measurement hierarchy, and separately presenting information regarding purchases, sales, issuances and settlements in the reconciliation of Level 3 fair value measurements. Discovery prospectively adopted the new guidance effective January 1, 2010, except for Level 3 reconciliation disclosures which will be effective for the Company on January 1, 2011. The adoption of the new guidance did not impact the Company s consolidated financial statements.

DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

In August 2009, the FASB issued guidance that reinforces that fair value of a liability is the price that would be paid to transfer the liability in an orderly transaction between market participants at the measurement date. Additionally, the update clarifies how the price of an identical or similar debt security that is traded or the price of the liability when it is traded as an asset should be considered in estimating the fair value of the issuer s liability and that the reporting entity must consider its own credit risk in measuring the liability s fair value. Effective September 30, 2009, the Company prospectively adopted the new guidance for all liabilities measured at fair value. The adoption of the new guidance resulted in changing the priority level of inputs used to measure the fair value of liabilities associated with the Company s deferred compensation plan from Level 2 to Level 1 within the fair value measurement hierarchy. However, the guidance did not change the Company s valuation techniques or impact the amounts or classifications recorded in the Company s consolidated financial statements.

Pronouncement Not Yet Adopted

Revenue Recognition for Multiple-Element Revenue Arrangements

In October 2009, the FASB issued a new standard that changes the determination of when the individual deliverables included in a multiple-element revenue arrangement may be treated as separate units of accounting, modifies the manner in which the transaction consideration is allocated across the separately identified deliverables and expands the disclosures required for multiple-element revenue arrangements. The Company will prospectively adopt the new standard effective January 1, 2011. The adoption will not have a significant impact on the Company s consolidated financial statements.

NOTE 3. ACQUISITION AND DISCONTINUED OPERATIONS

Acquisition

On February 17, 2010, the Company acquired all interests in an uplink facility in London, including its employees and operations, for $35 million in cash. The uplink center is used to deliver Discovery s networks in the United Kingdom and Europe, Africa and the Middle East, and will be integrated into the Company s International Networks segment. The acquisition will provide the Company more flexibility to expand the distribution of its content. The uplink facility has been included in the Company s operating results since the date of acquisition.

Discontinued Operations

During the second quarter of 2010, the Company committed to a plan to sell its Antenna Audio business within the next year with no significant continuing involvement in the operations or cash flows from the business subsequent to the sale. Antenna Audio, which provides audio, multimedia and mobile tours for museums, exhibitions, historic sites and visitor attractions around the world, is a component of the Company s International Networks segment. The results of operations of Antenna Audio, which were not significant for the three and six months ended June 30, 2010 and 2009, have been reflected as discontinued operations with the net results included in Other (expense) income, net on the Condensed Consolidated Statements of Operations. The assets and liabilities and cash flows of Antenna Audio, which were not material to the Company s financial position and cash flows, have not been reflected as discontinued operations on the Condensed Consolidated Balance Sheets or the Condensed Consolidated Statements of Cash Flows.

NOTE 4. VARIABLE INTEREST ENTITIES

In the normal course of business, the Company enters into joint ventures or makes investments with business partners that support its underlying business strategy and provide it the ability to enter new markets to expand the reach of its brands, develop new programming and distribute its existing content. In certain instances, an entity in which the Company makes an investment may qualify as a VIE. The Company s investments in entities determined to be VIEs primarily consist of various joint ventures formed with the British Broadcasting Corporation (BBC), the Discovery Kids Network joint venture and the OWN joint venture.

As of June 30, 2010 and December 31, 2009, the aggregate carrying values of investments in VIEs accounted for using the equity method was $419 million and $395 million, respectively, which were recorded as a component of Other noncurrent assets on the Condensed Consolidated Balance Sheets. For unconsolidated VIEs, the Company s risk of loss is typically limited to the carrying value of its investments and specified future funding commitments, which totaled $488 million as of June 30, 2010. Additionally, the Company may provide an unspecified amount of funding for certain joint ventures on an as-needed basis. No amounts have been recorded for the future funding commitments.

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DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

BBC Joint Ventures

The Company s joint ventures with the BBC principally consist of an entity formed to produce and acquire factual-based content and several cable and satellite television network ventures that deliver programming to audiences in Europe, Latin America and Asia. The Company provides the ventures with content, funding and services such as distribution, technological, sales and administrative support. For most BBC ventures, the Company currently holds a majority of the voting rights. Once certain levels of funding have been repaid to Discovery, the Company and the BBC will equally share voting control. The Company has assumed all funding requirements for the joint ventures. Therefore, losses generated by most ventures are initially allocated to the Company up to the amount of funding that the Company has provided to the ventures and any remaining losses are allocated to the Company and the BBC. However, the amount of losses allocated to the BBC is limited to the amount of cash that a venture previously distributed to the BBC. No cumulative operating losses generated by the ventures have been allocated to the BBC through June 30, 2010. Profits of most ventures are first allocated to the Company to repay any funding provided, with any excess profits allocated to the Company and the BBC.

Based upon the level of equity investment at risk, the Company has determined that the BBC joint ventures are VIEs. The Company has determined that it is the primary beneficiary of most ventures as it controls the activities that are most significant to the joint ventures operating performance and success, has assumed all funding requirements and will absorb losses or receive profit that are significant to the joint ventures. Accordingly, the Company consolidates most of the BBC joint ventures. The BBC s equity interests in consolidated ventures are reported as noncontrolling interests in the consolidated financial statements.

Certain assets of the consolidated BBC joint ventures are not available to settle obligations of the Company. As of June 30, 2010 and December 31, 2009, the Company s cash and cash equivalents included $43 million and $40 million, respectively, of cash related to consolidated joint ventures that is only available for use by the ventures, which is parenthetically disclosed on the Condensed Consolidated Balance Sheets. All other assets of the BBC ventures were not material to the Company s financial position.

Under certain terms outlined in the BBC joint venture arrangements, the BBC has the right every three years, commencing December 31, 2002, to put to the Company its interests in the People+Arts Latin America and Animal Planet joint ventures (Channel Groups), in each case for a value determined by a specified formula. In January 2009, the BBC requested that a determination be made whether such conditions have occurred with respect to the Channel Groups as of December 31, 2008. The contractual redemption value is based upon the exercise of the BBC put right and an estimate of the proceeds from a hypothetical sale of the Channel Groups and a distribution of the proceeds to the venture partners based on various rights and preferences. As the Company has funded all operations from inception of the ventures through June 30, 2010, the Company believes that it has accumulated rights and preferences in excess of the fair market value of the Channel Groups. However, due to the complexities of the redemption formula, the Company has accrued the noncontrolling redeemable interests to an estimated negotiated value of $49 million as of both June 30, 2010 and December 31, 2009. Changes in the assumptions used to estimate the redemption value could materially impact current estimates. The Company recorded no accretion to the redemption value during the three and six months ended June 30, 2010 and 2009. The Company is currently discussing with the BBC potential revisions to all of their contractual relationships, including the ownership of the joint ventures. While there can be no assurance that these or other negotiations would result in a definitive agreement, the Company expects that the cost of a negotiated acquisition of the BBC s interests in the joint ventures could substantially exceed the value of the put right.

In connection with the adoption of the FASB s recent guidance for interests in VIEs, effective January 1, 2010 the Company changed its accounting for its interest in one of the BBC joint ventures, APJ, from consolidation to the equity method (Note 2).

Discovery Kids Network Joint Venture

On May 22, 2009, Discovery and Hasbro, Inc. (Hasbro) formed a 50-50 joint venture, which currently operates the Discovery Kids Network in the U.S. The Discovery Kids Network is a pay-television network that provides children s and family entertainment and educational programming. The Discovery Kids Network will be rebranded as The Hub , which will launch in 2010.

In connection with the formation of the joint venture, Discovery contributed the assets of the Discovery Kids Network to the venture and Hasbro acquired a 50% ownership interest in the venture. In return, Discovery retained a 50% ownership interest in the venture and received consideration of $300 million in cash and a tax receivables agreement collectible over 20 years valued at $57 million. Upon purchase of its ownership interest, Hasbro received a step-up in tax basis for its portion of the joint venture assets. To the extent Hasbro has the ability to amortize this tax basis it is contractually obligated to share the tax benefit as part of purchase

DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

consideration. As part of this transaction the Company recognized a gain of $252 million, which included $127 million as a result of stepping up its basis for the 50% retained interest in the Discovery Kids Network and $125 million for the sale of 50% of its ownership interest to Hasbro.

The Company provides the venture with content, funding and services such as distribution, technological, sales and administrative support. The Company and Hasbro equally share in the profits and losses, funding requirements and voting rights of the Discovery Kids Network. Discovery has guaranteed a certain level of operating performance for the venture, which is reduced over time as performance targets are achieved. As of June 30, 2010, the remaining maximum exposure to loss under this performance guarantee was below $235 million. The fair value of the guarantee as of June 30, 2010 was not material. The Company believes the likelihood is remote that the performance guarantee will not be achieved and have a material adverse impact on the Company s financial position, operating results or cash flows. Discovery is committed to fund up to $15 million to the venture, none of which has been funded through June 30, 2010.

Based upon the level of equity investment at risk, the Company has determined that the Discovery Kids Network is a VIE. The Company has determined that it is not the primary beneficiary of the venture because it does not control the activities that are most significant to the joint venture s operating performance and success and the venture partners share equally in the funding requirements and operating results of the joint venture. Accordingly, beginning May 22, 2009, Discovery ceased to consolidate the gross operating results of the Discovery Kids Network and began accounting for its interests in the venture using the equity method. However, as Discovery continues to be involved in the operations of the joint venture, the Company has not presented the financial position, results of operations and cash flows of the Discovery Kids Network recorded through May 21, 2009 as discontinued operations. Accordingly, the Company s consolidated results of operations for 2009 include the gross operating results of Discovery Kids through May 21, 2009, whereas for subsequent periods Discovery records only its proportionate share of the joint venture s net operating results as a component of Other (expense) income, net on the Condensed Consolidated Statements of Operations.

OWN Joint Venture

The Company has an investment in OWN, a 50-50 joint venture with Harpo, Inc. (Harpo), which will operate a television network and website that will provide adult lifestyle content focused on self-discovery and self-improvement. Discovery has agreed to contribute its interest in the Discovery Health Channel and certain DiscoveryHealth.com content and Harpo will contribute the Oprah.com website and content, which is expected to occur in 2011, at which time the Discovery Health Channel will be rebranded and operated by the joint venture. The Company provides the venture content, funding and services such as distribution, technological, licensing, sales and administrative support. The Company has assumed all funding requirements, but equally shares voting control with Harpo. Initially, cash distributions will be made by OWN to the Company to repay prior funding. Upon repayment of prior funding, subsequent cash distributions made by OWN will be shared equally between the Company and Harpo.

As of June 30, 2010, Discovery is committed to loan up to $100 million to the venture through September 30, 2011 to fund operations, of which $74 million has been funded through June 30, 2010. To the extent funding the joint venture in excess of $100 million is necessary, the Company may provide additional funds through a member loan or require the venture to seek third party financing. Discovery expects to recoup the entire amount loaned to OWN provided that the joint venture is profitable and has sufficient funds to repay the Company. The parties are currently discussing a number of matters regarding the OWN Network, including the programming and development pipeline and a likely increase in the Company s funding commitment.

Based upon the level of equity investment at risk, the Company has determined that OWN is a VIE. The Company has determined that it is not the primary beneficiary of the venture as it does not control the activities that are most significant to the joint venture s operating performance and success. Accordingly, the Company accounts for its investment in OWN using the equity method. Currently, the Company absorbs all losses generated by OWN as a result of its funding obligations.

Pursuant to the venture agreement, Harpo has the right to require Discovery to purchase Harpo s interest in OWN every two and one half years commencing five years from the launch of OWN, which is expected to occur in 2011. The put arrangement provides that the Company would purchase Harpo s interests at fair market value up to a maximum put amount. The maximum put amount is a range from $100 million on the first

put exercise date five years after launch up to $400 million on the fourth put exercise date 12.5 years after launch.

In connection with the adoption of the FASB s recent guidance for interests in VIEs, effective January 1, 2010 the Company changed its accounting for its interest in OWN from consolidation to the equity method (Note 2).

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DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

NOTE 5. FAIR VALUE MEASUREMENTS

Certain of the Company s assets and liabilities are recorded at fair value. Fair value measurements are classified according to the following three-level fair value hierarchy established by the FASB.

Level 1	measurements based on observable inputs such as quoted prices for identical instruments in active markets.
Level 2	measurements based on inputs such as quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and assumptions are observable in active markets.
Level 3	measurements based on valuations derived from present value and other valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis consisted of the following (in millions).

	As of June 30, 2010			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash Equivalents:				
Money market mutual funds	$ 291	$	$	$ 291
U.S. Treasury securities	300			300
Trading securities:				
Mutual funds	49			49
Total assets	$ 640	$	$	$ 640
Liabilities:				
Deferred compensation plan	$ 49	$	$	$ 49
Derivatives (Note 8)		10		10
Other		2		2
Total liabilities	$ 49	$ 12	$	$ 61
Redeemable noncontrolling interests (Note 4)	$	$	$ 49	$ 49

For investments in securities that are measured using quoted prices in active markets, the total fair value is the published market price per unit in active markets multiplied by the number of units held without consideration of transaction costs. Cash equivalents represent investments in highly liquid instruments with original maturities of 90 days or less. The Company maintains a Rabbi Trust which includes investments to fund certain of its deferred compensation plans. Investments in the trust are classified as trading securities, which are recorded in Prepaid expenses and other current assets in the Condensed Consolidated Balance Sheets. The fair value of the deferred compensation plan liability is determined based on the fair value of the related investments elected by employees.

The fair value of derivative instruments, which consist of interest rate swaps, is determined based on the present value of future cash flows using observable inputs, including interest rates, yield curves, and credit spreads.

The fair value of the redeemable noncontrolling interests is an estimated negotiated value.

The Company s carrying values for other financial instruments such as cash, accounts receivable and accounts payable approximated fair value.

There were no changes in Level 3 measurements during the three and six months ended June 30, 2010 and 2009.

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DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis

During the three months ended June 30, 2009, certain intangible assets and capitalized software costs with an aggregate carrying value of $47 million were written down to a fair value of $21 million, resulting in pretax impairment charges of $26 million. Fair value measurements were required due to a decline in expected future operating results. The fair values of these assets were determined by the application of a discounted cash flows model and market based approach, which used Level 3 inputs. Cash flows were determined based on Company estimates of future operating results and discounted using an internal rate of return consistent with that used by the Company to evaluate cash flows of other assets of a similar nature. The market approach relied on public information related to certain financial measures.

NOTE 6. CONTENT RIGHTS

Content rights consisted of the following (in millions).

	As of June 30, 2010	As of December 31, 2009 (recast)
Produced content rights:		
Completed	$ 1,832	$ 1,710
In-production	217	209
Co-produced content rights:		
Completed	421	448
In-production	83	85
Licensed content rights:		
Acquired	274	261
Prepaid	11	13
Content rights, at cost	2,838	2,726
Accumulated amortization	(1,551)	(1,444)
Total content rights, net	1,287	1,282
Less current portion	81	75
Noncurrent portion	$ 1,206	$ 1,207

Content amortization expense was $165 million and $172 million for the three months ended June 30, 2010 and 2009, respectively, and $350 million and $338 million for the six months ended June 30, 2010 and 2009, respectively. Amortization expense for the three months ended June 30, 2010 and 2009 included write-offs of capitalized content costs of $7 million and $17 million, respectively, and $31 million and $26 million for the six months ended June 30, 2010 and 2009, respectively. The write-offs, which resulted from the Company s the decision not to proceed with certain programs, was recorded at the Company s U.S. Networks and International Networks segments. Amortization expense was recorded as a component of Costs of revenues in the Condensed Consolidated Statements of Operations.

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DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

NOTE 7. DEBT

Outstanding debt consisted of the following (in millions).

	As of June 30, 2010	As of December 31, 2009
$1.5 billion Term Loan B, due quarterly September 2007 to May 2014	$	$ 1,463
$500 million Term Loan C, due quarterly June 2009 to May 2014		496
8.37% Senior Notes, semi-annual interest, due March 2011		220
8.13% Senior Notes, semi-annual interest, due September 2012		235
Floating Rate Senior Notes, semi-annual interest, due December 2012 (1.23% at December 31, 2009)		90
6.01% Senior Notes, semi-annual interest, due December 2015		390
5.625% Senior Notes, semi-annual interest, due August 2019	500	500
3.70% Senior Notes, semi-annual interest, due June 2015	850	
5.05% Senior Notes, semi-annual interest, due June 2020	1,300	
6.35% Senior Notes, semi-annual interest, due June 2040	850	
Capital lease and other obligations	119	114
Total long-term debt	3,619	3,508
Unamortized discount	(8)	(13)
Long-term debt, net	3,611	3,495
Less current portion of long-term debt	17	38
Noncurrent portion of long-term debt	$ 3,594	$ 3,457

On June 3, 2010, Discovery Communications, LLC (DCL), a wholly-owned subsidiary of the Company, issued $850 million aggregate principal amount of 3.70% Senior Notes maturing on June 1, 2015 (the 2015 Notes), $1.30 billion aggregate principal amount of 5.05% Senior Notes maturing on June 1, 2020 (the 2020 Notes) and $850 million aggregate principal amount of 6.35% Senior Notes maturing on June 1, 2040 (the 2040 Notes and together with the 2015 Notes and the 2020 Notes, the Public Senior Notes Issued in 2010). DCL received net proceeds of $2.97 billion from the offering after considering the $6 million issuance discount and $24 million of issuance costs recorded as deferred financing costs.

DCL may, at its option, redeem some or all of the Public Senior Notes Issued in 2010 at any time by paying a make-whole premium, plus accrued and unpaid interest, if any, to the date of repurchase. Interest on these notes is payable on June 1 and December 1 of each year, beginning on December 1, 2010. The Public Senior Notes Issued in 2010 are unsecured and rank equally in right of payment with all of DCL s other unsecured senior indebtedness and are fully and unconditionally guaranteed on an unsecured and unsubordinated basis by Discovery.

The Company used the net proceeds of the offering plus cash on hand to repay $1.46 billion outstanding under its Term Loan B, $487 million outstanding under its Term Loan C, net of the original issue discount, $220 million outstanding under its 8.37% Senior Notes due March 2011, $235 million outstanding under its 8.13% Senior Notes due September 2012, $90 million outstanding under its Floating Rate Senior Notes due December 2012, $390 million outstanding under its 6.01% Senior Notes due December 2015 and $114 million for make-whole premiums. These transactions resulted in a loss on extinguishment of debt of $136 million, which included the $114 million for make-whole premiums, $12 million of non-cash write-offs of unamortized deferred financing costs and $10 million for the repayment of the original issue discount on the

Company s term loans.

In addition to the debt instruments listed above, the Company also has access to a $1.55 billion revolving line of credit. The line of credit expires in October 2010. The Company is currently assessing its options to enter into a new facility. There were no amounts drawn under the line of credit as of June 30, 2010 and December 31, 2009. If the Company were to draw on the line of credit, the debt would be due in October 2010 and interest would be payable based on either (i) LIBOR plus a margin which would range from 0.40% to 0.95% based on the Company s leverage ratio, or (ii) the prime lending rate.

DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The revolving line of credit and the indentures governing all of the public senior notes contain certain covenants, events of default and other customary provisions. The Company was in compliance with all covenants as of June 30, 2010 and December 31, 2009.

As of June 30, 2010 and December 31, 2009 the fair value of the Company s debt was $3.68 billion and $3.61 billion, respectively. The fair value of the Company s publicly traded debt was determined using quoted market prices and the fair value of the private debt was estimated based on current market rates and credit pricing for similar debt types and maturities.

NOTE 8. DERIVATIVE FINANCIAL INSTRUMENTS

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 enter into or hold derivative financial instruments for speculative trading purposes.

The Company is exposed to the impact of interest rate changes primarily through its borrowing activities. For fixed rate debt the Company may enter into variable interest rate swaps effectively converting fixed rate borrowings to variable rate borrowings indexed to LIBOR in order to reduce the amount of interest paid. The Company may designate variable interest rate swaps as fair value hedges. For variable rate debt the Company may enter into fixed interest rate swaps to effectively fix the amount of interest paid in order to mitigate the impact of interest rate changes on earnings. The Company may designate fixed interest rate swaps as cash flow hedges.

The Company transacts business globally and is subject to risks associated with changing foreign currency exchange rates. The Company may enter into spot, forward and option contracts that change in value as foreign currency exchange rates change. These contracts hedge forecasted foreign currency transactions in order to mitigate fluctuations in its earnings and cash flows associated with changes in foreign currency exchange rates. The Company may designate foreign exchange spot, forward and option contracts as cash flow hedges. There were no significant foreign exchange derivative instruments outstanding during the three and six months ended June 30, 2010 and 2009.

Gains or losses on the effective portion of derivative instruments designated as hedging instruments are initially recorded in Accumulated other comprehensive loss on the Condensed Consolidated Balance Sheets and reclassified either into the same account on the Condensed Consolidated Statements of Operations in which the hedged item is recognized or Other (expense) income, net when there is a change in designation. Gains or losses on derivative instruments after a change in designation would be recorded in Other (expense) income, net. As of June 30, 2010, there were no significant unrealized gains or losses for derivative instruments recorded in Accumulated other comprehensive loss.

The Company may also enter into derivative instruments that are not designated as hedges and do not qualify for hedge accounting. These contracts are intended to mitigate economic exposures of the Company. Gains or losses on these derivative instruments are recorded in Other (expense) income, net.

The Company records all derivative instruments at fair value on a gross basis in the Condensed Consolidated Balance Sheets.

As a result of refinancing most of its debt in June 2010 (Note 7), during the three and six months ended June 30, 2010 the Company discontinued hedge accounting for $1.39 billion and $1.76 billion, respectively, notional amounts of fixed interest rate swaps designated as cash flow hedges. The change in designation resulted in reclassifying losses of $23 million and $27 million for the three and six months ended June 30, 2010, respectively, from Accumulated other comprehensive loss on the Condensed Consolidated Balance Sheets to Other (expense) income, net on the Condensed Consolidated Statements of Operations. In June 2010, fixed and variable interest rate swaps with a total notional amount of $1.81 billion either matured or were settled prior to maturity for which the Company paid $24 million.

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DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following tables present the notional amount and fair value of the Company s derivatives as of June 30, 2010 and December 31, 2009 (in millions).

		Asset Derivatives			
		As of June 30, 2010		As of December 31, 2009	
	Balance Sheet Location	Notional	Fair Value	Notional	Fair Value
Derivatives designated as hedging instruments:					
Interest rate contracts	Other noncurrent assets	$	$	$ 760	$ 4
Derivatives not designated as hedging instruments:					
Interest rate contracts	Other noncurrent assets			50	3
Total asset derivatives		$	$	$ 810	$ 7

		Liability Derivatives			
		As of June 30, 2010		As of December 31, 2009	
	Balance Sheet Location	Notional	Fair Value	Notional	Fair Value
Derivatives designated as hedging instruments:					
Interest rate contracts	Other current liabilities	$	$	$ 900	$ 21
Interest rate contracts	Other noncurrent liabilities			100	
Total				1,000	21
Derivatives not designated as hedging instruments:					
Foreign exchange contracts	Other current liabilities			1	
Interest rate contracts	Other current liabilities	375	10		
Interest rate contracts	Other noncurrent liabilities			375	19
Total		375	10	376	19
Total liability derivatives		$ 375	$ 10	$ 1,376	$ 40

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DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following table presents the impact of derivative instruments on income and other comprehensive income (loss) for the three and six months ended June 30, 2010 and 2009 (in millions).

	Instrument Type	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Derivatives designated as hedging instruments:					
Amount recognized in Other comprehensive income (loss), gross of tax	Interest rate contacts	$ (18)	$ 24	$ (31)	$ 17
Amount reclassified from Accumulated other comprehensive loss into Interest expense, net	Interest rate contacts	$ (4)	$ (13)	$ (18)	$ (25)
Amount excluded from effectiveness testing and recorded in Other (expense) income, net	Interest rate contacts	$	$ (1)	$	$
Derivatives not designated as hedging instruments:					
Amount recognized in Other (expense) income, net	Interest rate contacts	$ (27)	$ 4	$ (28)	$ 9
Amount recognized in Other (expense) income, net	Foreign exchange contracts	$	$ (5)	$	$

Certain of the Company s derivative instruments contain credit-risk related contingent features, such as requirements that the Company comply with its credit agreements and cross-default provisions under which the Company will be in default upon the occurrence of certain cross-default events, such as failure to make payments when due in respect to any indebtedness exceeding certain threshold amounts. If the Company were to trigger any of these provisions, the derivative contracts would be in default and the counterparties could request immediate settlement on all of their outstanding derivative contracts with the Company. As of June 30, 2010 and December 31, 2009, the aggregate fair value of all derivative instruments with credit-risk related contingent features that were in liability positions was $10 million and $40 million, respectively.

NOTE 9. STOCK-BASED COMPENSATION

The Company has various incentive plans under which cash-settled unit awards (DAP units), stock appreciation rights (SARs), stock options, performance based restricted stock units (PRSUs) and service based restricted stock units (RSUs) have been issued.

DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Stock-Based Compensation Expense

Stock-based compensation expense recognized by the Company consisted of the following (in millions).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
DAP units	$ 39	$ 32	$ 63	$ 52
SARs	1	20	13	33
Stock options	8	7	15	12
PRSUs and RSUs	2		3	
Other		2		1
Total stock-based compensation expense	$ 50	$ 61	$ 94	$ 98
Tax benefit recognized	$ 20	$ 22	$ 35	$ 36

Compensation expense for all stock-based awards was recorded as a component of Selling, general and administrative on the Condensed Consolidated Statements of Operations. As of June 30, 2010 and December 31, 2009, the Company recorded total liabilities of $96 million and $143 million, respectively, for cash-settled awards. The current portion of the liability for cash-settled awards was $94 million at June 30, 2010.

Stock-Based Award Activity

DAP Units

A summary of the DAP units activity for the six months ended June 30, 2010 is presented below (in millions, except price and years).

	DAP Units	Weighted-Average Grant Price	Weighted-Average Remaining Contractual Term (years)
Unvested as of December 31, 2009	12.4	$ 19.36	
Granted	2.0	$ 31.81	
Vested	(3.8)	$ 17.59	
Forfeited	(0.3)	$ 24.98	
Unvested as of June 30, 2010	10.3	$ 22.22	1.14
Vested and expected to vest as of June 30, 2010	10.1	$ 22.23	1.12
Vested and unpaid as of June 30, 2010	0.5	$ 21.71	

DAP units represent the right to receive a cash payment for the amount by which the vesting price exceeds the grant price. The vesting price is the average closing price of the Company s common stock over the 10 trading days immediately preceding and including the vesting date and the 10 trading days immediately subsequent to the vesting date. The grant price is based on the average closing price of the Company s common stock over the 10 trading days immediately preceding and including the grant date and the 10 trading days immediately following the grant date. For certain awards the average grant price and average vesting price include a premium. Unit awards vest ratably in increments of 25% per year over four years beginning one year from the grant date based on continuous service and are generally settled within sixty days of vesting. DAP units generally provide for accelerated vesting upon retirement or after reaching a specified age and years of service.

Because DAP units are cash-settled, the Company remeasures the fair value and compensation expense of outstanding units each reporting date until settlement. The weighted-average fair value of DAP units outstanding as of June 30, 2010 and December 31, 2009 was $19.12 and $15.53, respectively, per unit. During the six months ended June 30, 2010 and 2009, the Company made cash payments totaling $67 million and $3 million, respectively, to settle vested DAP units. As of June 30, 2010, there was $98 million of unrecognized compensation cost, net of estimated forfeitures, related to DAP units, which is expected to be recognized over a weighted-average period of 2.02 years.

DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

SARs

A summary of the SARs activity for the six months ended June 30, 2010 is presented below (in millions, except price and years).

	SARs	Weighted-Average Grant Price	Weighted-Average Remaining Contractual Term (years)
Outstanding as of December 31, 2009	3.1	$ 14.48	
Granted		$	
Exercised	(3.0)	$ 14.46	
Forfeited		$	
Outstanding as of June 30, 2010	0.1	$ 19.98	4.10
Vested and expected to vest as of June 30, 2010	0.1	$ 19.98	4.10

SARs entitle the holder to receive a cash payment for the amount by which the price of the Company s common stock exceeds the base price established on the grant date. SARs are granted with a base price equal to or greater than the closing market price of the Company s common stock on the date of grant. Substantially all SARs consisted of two separate vested tranches with the first tranche having vested 100% on March 15, 2009 and the second tranche having vested 100% on March 15, 2010. Vesting is based on continuous service. Holders were able to exercise the first tranche of SARs at their election until March 15, 2010. The payment to settle exercises of the first tranche of SARs was based on the amount by which the price of the Company s common stock on the exercise date exceeded the base price established on the grant date. All outstanding SARs for the second tranche were automatically exercised as of March 31, 2010. The payment to settle the second tranche of SARs was based on the amount by which the average closing price of the Company s common stock over the 10 trading days immediately preceding and including the vesting date and the 10 trading days immediately subsequent to the vesting date exceeded the base price established on the grant date. During the six months ended June 30, 2010 and 2009, the Company made cash payments totaling $54 million and $10 million, respectively, related to settlement of SARs.

Stock Options

A summary of the stock options activity for the six months ended June 30, 2010 is presented below (in millions, except price and years).

	Stock Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (years)
Outstanding as of December 31, 2009	17.2	$ 16.31	
Granted	1.6	$ 32.99	
Exercised	(1.1)	$ 15.06	
Forfeited	(0.3)	$ 16.09	

Outstanding as of June 30, 2010	17.4	$	17.94	5.63
Vested and expected to vest as of June 30, 2010	16.7	$	17.90	5.80
Exercisable as of June 30, 2010	3.7	$	14.89	5.21

Stock options are granted with an exercise price equal to or in excess of the closing market price of the Company s common stock on the date of grant. Substantially all stock options vest ratably either in increments of approximately 33 1/3% each year over three years or in 25% increments each year over four years beginning one year from the grant date based on continuous service and expire three to ten years from the date of grant. Stock option awards generally provide for accelerated vesting upon retirement or after reaching a specified age and years of service.

DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The weighted-average grant date fair value of options granted during the six months ended June 30, 2010 and 2009 was $12.18 and $5.34, respectively, per option. During the six months ended June 30, 2010, the Company received cash payments totaling $15 million from the exercise of stock options. There were no stock option exercises during the six months ended June 30, 2009. As of June 30, 2010, there was $76 million of unrecognized compensation cost, net of expected forfeitures, related to stock options, which is expected to be recognized over a weighted-average period of 2.32 years.

PRSUs

A summary of the PRSUs activity for the six months ended June 30, 2010 is presented below (in millions, except price).

	PRSUs	Weighted-Average Grant Price	
Outstanding as of December 31, 2009		$	
Granted	0.9	$	32.83
Converted		$	
Forfeited		$	
Outstanding as of June 30, 2010	0.9	$	32.79
Vested and expected to vest as of June 30, 2010	0.6	$	32.66

The Company has granted PRSUs to certain senior level executives. PRSUs represent the contingent right to receive shares of the Company s Series A common stock, substantially all of which vest over three to four years based on continuous service and whether the Company achieves certain operating performance targets. The performance targets for substantially all PRSUs are cumulative measures over a three year period of the Company s adjusted operating income before depreciation and amortization (as defined in Note 16), free cash flows and revenues. The number of PRSUs that vest principally range from 0% to 100% based on a sliding scale where achieving or exceeding the performance target will result in 100% of the PRSUs vesting and achieving less than 80% of the target will result in no portion of the PRSUs vesting. Additionally, for certain PRSUs the Company s Compensation Committee has discretion in determining the final amount of units that vest. Upon vesting, each PRSU becomes convertible into a share of the Company s Series A common stock on a one-for-one basis. Holders of PRSUs would not receive payments or accruals of dividends or dividend equivalents in the event the Company was to pay regular cash dividends until such PRSUs are converted into shares of the Company s stock.

The Company records compensation cost for PRSUs ratably over the longer of the service period or performance period assuming a portion of the performance targets will be achieved. If the Company determines that achievement of the performance targets is not probable, the Company ceases recording compensation expense and all previously recognized compensation expense for the award is reversed in the period in which the Company determines that the performance targets are not probable of being achieved.

Compensation expense is separately recorded for each vesting tranche of PRSUs for a particular grant. For most PRSUs, the Company measures the fair value and related compensation cost based on the closing price of the Company s Series A common stock on the grant date. For PRSUs for which the Company s Compensation Committee has discretion in determining the final amount of units that vest, compensation cost is remeasured at each reporting date based on the closing price of the Company s Series A common stock. There were no PRSUs outstanding during the six months ended June 30, 2009.

As of June 30, 2010, there was $18 million of unrecognized compensation cost, net of expected forfeitures, related to PRSUs, which is expected to be recognized over a weighted-average period of 2.57 years based on the Company s current assessment of the PRSUs that will vest, which

may differ from actual results.

RSUs

RSUs vest ratably each year over periods of one to four years based on continuous service. As of June 30, 2010, there were approximately 500,000 outstanding RSUs with a weighted-average grant price of $32.06. There was $14 million of unrecognized compensation cost, net of expected forfeitures as of June 30, 2010, related to RSUs, which is expected to be recognized over a weighted-average period of 3.01 years.

DISCOVERY COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

NOTE 10. RESTRUCTURING AND IMPAIRMENT CHARGES

During the six months ended June 30, 2010, the Company recorded $3 million of exit and restructuring charges as part of its continued efforts to reduce its cost structure. The charges, which included severance and contract termination costs, were incurred by the Company s International Networks segment.

During the three and six months ended June 30, 2009, the Company recorded $9 million and $12 million, respectively, of exit and restructuring charges in connection with a reorganization of portions of its operations to better align the organization structure with its strategic priorities and to reduce its cost structure. The charges include severance costs and contract termination costs and were incurred primarily at the Company s U.S. Networks and International Networks segments and its Corporate operations.

Refer to Assets and liabilities measured at fair value on a non-recurring basis in Note 5 for a description of impairment charges recorded during the three months ended June 30, 2009.

NOTE 11. INCOME TAXES

The Company s provisions for income taxes were $41 million and $264 million and the effective tax rates were 27% and 59% for the three months ended June 30, 2010 and 2009, respectively. For the six months ended June 30, 2010 and 2009, the Company s provisions for income taxes were $88 million and $335 million, respectively, and the effective tax rates were 24% and 52%, respectively. Discovery s effective tax rates for the three and six months ended June 30, 2010 differed from the federal statutory rate of 35% due primarily to a $13 million tax expense reduction for a change in the Company s election to claim foreign tax credits that were previously taken as deductions and production activity deductions, which were partially offset by state taxes. The Company may file additional amended returns in the future to claim foreign tax credits that were previously taken as deductions based on the ability to currently use additional foreign tax credits. Additionally, the Company s effective tax rate for the six months ended June 30, 2010 differed from the statutory rate due to the reversal of a $28 million foreign tax reserve. In February 2010, a foreign tax authority completed its tax audit and provided the Company notification that certain tax years will not be adjusted for a matter for which it previously recorded a reserve for uncertain tax positions.

The effective tax rates for the three and six months ended June 30, 2009 differed from the federal income tax rate of 35% due primarily to a permanent difference on the $252 million gain from the sale and deconsolidation of the Company s ownership interest in the Discovery Kids Network in May 2009, state income taxes, and to a lesser extent, deduction for domestic production activities. The increases were partially offset by the release of a valuation allowance of $12 million on a previously recorded capital loss.

NOTE 12. NET INCOME PER SHARE AVAILABLE TO DISCOVERY COMMUNICATIONS, INC. STOCKHOLDERS

The following table presents a reconciliation of the weighted average number of shares outstanding between basic and diluted net income per share for the three and six months ended June 30, 2010 and 2009 (in millions).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Weighted average shares outstanding basic	426	422	425	422
Dilutive effect of equity awards	5	2	5	1
Weighted average shares outstanding diluted	431	424	430	423

Basic net income per share is computed by dividing Net income available to Discovery Communications, Inc. stockholders by the weighted average number of shares outstanding during the period. The weighted average number of shares outstanding for the three and six months ended June 30, 2010 and 2009 include Discovery s outstanding Series A, Series B and Series C common shares, as well as Discovery s outstanding Series A and Series C convertible preferred shares. All series of the Company s common and preferred shares are included in the weighted average number of shares outstanding when calculating both basic and diluted net income per share as the holder of each common and preferred series legally participates equally in any per share distributions whether through dividends or in liquidation.

Diluted net income per share adjusts basic net income per share for the dilutive effect of outstanding stock options, stock settled SARs and RSUs that are either fully vested or vest based only on service conditions, using the treasury stock method. The Company has also granted PRSUs that vest based on both service and the Company s achievement of operating performance targets. For performance based instruments, diluted net income per share also adjusts basic net income per share for the number of potential common shares (for stock options) and number of common shares (for PRSUs) for which the performance targets have been achieved when the effect is dilutive and excludes such instruments when the performance targets have not been achieved.

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The calculation of diluted net income per share for both the three and six months ended June 30, 2010 excluded stock options, RSUs and PRSUs totaling 4 million because their inclusion would have been anti-dilutive or the performance targets were not achieved. Additionally, the diluted net income per share calculation for both the three and six months ended June 30, 2010 excluded 1 million contingently issuable preferred shares placed in escrow for which specific conditions have not yet been met.

The calculation of diluted net income per share for the three and six months ended June 30, 2009 excluded stock options totaling 16 million and 17 million, respectively, because their inclusion would have been anti-dilutive. Additionally, the diluted net income per share calculation for both the three and six months ended June 30, 2009 excluded approximately 2 million contingently issuable preferred shares placed in escrow for which specific conditions had not yet been met.

NOTE 13. SUPPLEMENTAL DISCLOSURES

Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities consisted of the following (in millions).

	As of June 30, 2010	As of December 31, 2009 (recast)
Accounts payable	$ 43	$ 63
Accrued payroll and related benefits	139	191
Content rights payable	55	50
Accrued income taxes	19	38
Accrued interest	25	25
Accrued other	75	79
Total accounts payable and accrued liabilities	$ 356	$ 446

Other (Expense) Income, Net

Other (expense) income, net consisted of the following (in millions).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009 (recast)	2010	2009 (recast)
Unrealized gains on derivative instruments, net	$ 6	$ 4	$ 5	$ 15
Realized losses on derivative instruments, net	(33)		(33)	(6)
Loss from equity investees	(10)	(9)	(17)	(14)
Realized gains on sales of investments		13		13
Loss from discontinued operations, net of tax		(1)		(3)
Other, net		1	4	3

Total other (expense) income, net	$ (37)	$ 8	$ (41)	$ 8

During the three months ended June 30, 2009, the Company sold an investment in equity securities for $22 million, which resulted in a pretax gain of $13 million. Approximately $6 million of the pretax gain was a reclassification of unrealized gain from Other comprehensive income (loss).

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NOTE 14. RELATED PARTY TRANSACTIONS

The following is a description of companies that are considered related parties as a result of common directorship and ownership.

DIRECTV, Liberty Global, Inc., Liberty Media Corporation, and Ascent Media Corporation

The Company s Board of Directors includes two members who served as directors of DIRECTV through June 16, 2010, including John C. Malone, the Chairman of the Board of DIRECTV. Dr. Malone beneficially owned DIRECTV Class B common stock representing approximately 24% of the aggregate voting power of DIRECTV. Effective June 16, 2010, Dr. Malone converted his Class B common stock into DIRECTV Class A common stock, which reduced his voting interest to 3% of DIRECTV and Dr. Malone and the other member of the Company s Board of Directors who served as a DIRECTV director resigned from the DIRECTV Board.

Transactions with DIRECTV through June 16, 2010 have been reported as related party transactions. Effective with the conversion of Dr. Malone s DIRECTV stock and Dr. Malone and the other member resigning from the DIRECTV board, transactions with DIRECTV after June 16, 2010 are not reported as related party transactions. Revenues from transactions with DIRECTV were $50 million, or 5% of total revenues, and $52 million, or 6% of total revenues, for the three months ended June 30, 2010 and 2009, respectively, and $104 million, or 6% of total revenues, and $103 million, or 6% of total revenues, for the six months ended June 30, 2010 and 2009, respectively. Expenses from transactions with DIRECTV for the three and six months ended June 30, 2010 and 2009 were not significant. The Company s Receivables, net balances included $44 million and $42 million due from DIRECTV as of June 30, 2010 and December 31, 2009, respectively. The Receivables, net balance with DIRECTV as of June 30, 2010 related to transactions occurring through June 16, 2010.

Discovery s Board also includes three members who serve as directors of Liberty Global, Inc. (Liberty Global), including Dr. Malone, who is Chairman of the Board of Liberty Global, and three persons who are currently directors of Liberty Media Corporation (Liberty Media), also including Dr. Malone, the Chairman of the Board of Liberty Media. Dr. Malone beneficially owns shares representing approximately 40% of the aggregate voting power of Liberty Global and also beneficially owns shares of Liberty Media representing approximately 35% of the aggregate voting power of its outstanding stock. Revenues from transactions with both Liberty Global and Liberty Media totaled $7 million, or 1% of total revenues, for both the three months ended June 30, 2010 and 2009, respectively, and $18 million, or 1% of total revenues, and $15 million, or 1% of total revenues, for the six months ended June 30, 2010 and 2009, respectively. Expenses from transactions with both Liberty Global and Liberty Media for the three and six months ended June 30, 2010 and 2009 were not significant. The Company s Receivables, net balances included insignificant amounts due from both Liberty Global and Liberty Media as of June 30, 2010 and December 31, 2009.

Effective January 25, 2010, Dr. Malone joined the Board of Directors of Ascent Media Corporation (AMC). Dr. Malone owns 0.9% of AMC s Series A common stock and 93.8% of AMC s Series B common stock, effectively providing him voting equity securities representing approximately 31.5% of the voting power with respect to the general election of directors.

Transactions with AMC on and subsequent to January 25, 2010 have been reported as related party transactions as a result of Dr. Malone joining AMC s board. Operating expenses from transactions with AMC were $4 million, or 1% of total operating expenses, and $10 million, or 1% of total operating expenses, for the three and six months ended June 30, 2010, respectively. Revenues from transactions with AMC for the three and six months ended June 30, 2010 were not significant. Additionally, the Company acquired the London uplink facility from a subsidiary of AMC for $35 million on February 17, 2010 (Note 3).

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Dr. Malone serves as a director on Discovery s board and owns shares representing approximately 23% of the aggregate voting power (other than with respect to the election of the common stock directors) of Discovery s outstanding stock. Dr. Malone controls approximately 32% of the Company s aggregate voting power relating to the election of the eight common stock directors, assuming that the preferred stock held by Advance/Newhouse Programming Partnership has not been converted into shares of Discovery s common stock.

As a result of this common directorship and ownership, transactions with DIRECTV, Liberty Global, Liberty Media and AMC and their subsidiaries and equity method investees are considered related party transactions. The majority of the amounts received under contractual arrangements with DIRECTV, Liberty Global and Liberty Media entities relate to multi-year network distribution arrangements and network services. Revenues under these arrangements include annual rate increases and are based on the number of subscribers receiving the related programming. AMC provides services, such as satellite uplink, systems integration, origination and post-production to Discovery.

Other Related Parties

Other related parties primarily include unconsolidated investees accounted for using the equity method, including unconsolidated VIEs described in Note 4. The Company provides equity method investees with content, funding or services such as distribution, technological, licensing, sales and administrative support. Revenues from transactions with the Company s other related parties were $16 million, or 2% of total revenues, and $8 million, or 1% of total revenues, for the three months ended June 30, 2010 and 2009, respectively, and $21 million, or 1% of total revenues, and $13 million, or 1% of total revenues, for the six months ended June 30, 2010 and 2009, respectively. Expenses from transactions with the Company s other related parties for the three and six months ended June 30, 2010 and 2009 were not significant. The Company s Receivables, net balances included insignificant amounts due from the Company s other related parties as of June 30, 2010 and December 31, 2009. The Company s Other noncurrent assets balance as of June 30, 2010 included $14 million for the net carrying value of amounts due from equity investees. The Company s Other current liabilities balance as of December 31, 2009 included an insignificant amount due to equity investees.

NOTE 15. COMMITMENTS AND CONTINGENCIES

Commitments and Guarantees

As more fully described in Note 22 of the Company s consolidated financial statements included in its 2009 Form 10-K, the Company has various commitments primarily consisting of programming and talent commitments, operating and capital lease arrangements, purchase obligations for goods and services, employment contracts, sponsorship commitments, future funding commitments related to certain equity investments (Note 4) and the obligation to issue additional preferred shares under the anti-dilution provisions of its outstanding preferred stock if certain conditions are met. These arrangements result from the Company s normal course of business and represent obligations that may be payable over several years. The Company is also subject to redeemable put options with respect to noncontrolling interests in certain cable and satellite television network joint ventures (Note 4). Additionally, the Company has guaranteed a certain level of operating performance for the Discovery Kids Network joint venture (Note 4). The Company s commitments have not materially changed from those disclosed in the 2009 Form 10-K.

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Legal Matters

In the normal course of business, the Company has pending claims and legal proceedings. It is the opinion of the Company s management, based on information available at this time, that none of the current claims and proceedings will have a material adverse effect on the Company s consolidated financial position, results of operations or cash flows.

Concentrations of Credit Risk

Derivatives Counterparties

The risk associated with a derivative transaction is that the counterparty will default on payments due to Discovery. If there is a default, the Company may have to acquire a replacement derivative from a different counterparty at a higher cost or may be unable to find a suitable replacement. Discovery s derivative credit exposure relates principally to interest rate derivative contracts. Typically, the Company seeks to manage these exposures by contracting with experienced counterparties that are investment grade-rated. These counterparties consist of large financial institutions that have a significant presence in the derivatives market. At June 30, 2010, the Company did not anticipate nonperformance by any of its counterparties.

Lender Counterparties

The risk associated with a debt transaction is that the counterparty will not be available to fund as obligated under the terms of Discovery s revolving line of credit. If funding under the revolving line of credit is unavailable, the Company may have to acquire a replacement credit facility from a different counterparty at a higher cost or may be unable to find a suitable replacement. Typically, the Company seeks to manage these exposures by contracting with experienced large financial institutions and monitoring the credit quality of its lenders. At June 30, 2010, the Company did not anticipate nonperformance by any of its counterparties.

Customers

The Company s trade receivables do not represent a significant concentration of credit risk as of June 30, 2010 due to the wide variety of customers and markets in which the Company operates and their dispersion across many geographic areas.

NOTE 16. REPORTABLE SEGMENTS

In the first quarter of 2010, the Company realigned its commerce business, which sells and licenses Discovery branded merchandise, from the Commerce, Education and Other segment into the U.S. Networks segment in order to better align the management of the Company s online operations. In connection with this realignment, the Commerce, Education and Other segment was renamed the Education and Other segment. The 2009 financial information has been recast to reflect the realignment. Accordingly, the results of operations of the commerce business are included as a component of the U.S. Networks segment for all periods presented.

The Company s reportable segments are determined based on (i) financial information reviewed by the chief operating decision maker (CODM), the Chief Executive Officer, (ii) internal management and related reporting structure and (iii) the basis upon which the CODM makes resource allocation decisions.

The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies, except that certain inter-segment transactions that are eliminated at the consolidated level are not eliminated at the segment level as they are treated similar to third-party sales transactions in determining segment performance. Inter-segment transactions, which primarily include the purchase of advertising and content between segments, were not material for the periods presented.

The Company evaluates the operating performance of its segments based on financial measures such as revenues and adjusted operating income before depreciation and amortization (Adjusted OIBDA). Adjusted OIBDA is defined as revenues less costs of revenues and selling, general and administrative expenses excluding: (i) mark-to-market stock-based compensation, (ii) depreciation and amortization, (iii) amortization of deferred launch incentives, (iv) exit and restructuring charges, (v) certain impairment charges and (vi) gains (losses) on business and asset dispositions. The Company uses this measure to assess the operating results and

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performance of its segments, perform analytical comparisons, identify strategies to improve performance and allocate resources to each segment. The Company believes Adjusted OIBDA is relevant to investors because it allows them to analyze the operating performance of each segment using the same metric management uses and also provides investors a measure to analyze the operating performance of each segment against historical data. The Company excludes mark-to-market stock-based compensation, exit and restructuring charges, certain impairment charges and gains (losses) on business and asset dispositions from the calculation of Adjusted OIBDA due to their volatility or non-recurring nature. The Company also excludes depreciation of fixed assets and amortization of intangible assets and deferred launch incentives as these amounts do not represent cash payments in the current reporting period. Adjusted OIBDA should be considered in addition to, but not a substitute for, operating income, net income, cash flows provided by operating activities and other measures of financial performance reported in accordance with GAAP.

The following tables present summarized financial information for each of the Company s reportable segments (in millions).

Revenues by Segment

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009 (recast)	2010	2009 (recast)
U.S. Networks	$ 620	$ 562	$ 1,166	$ 1,084
International Networks	306	267	589	511
Education and Other	33	35	70	71
Corporate and inter-segment eliminations	4	1	7	5
Total revenues	$ 963	$ 865	$ 1,832	$ 1,671

Adjusted OIBDA by Segment

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009 (recast)	2010	2009