

ACCREDITED HOME LENDERS HOLDING CO

Form 10-Q

August 16, 2004

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2004

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 0-50179

ACCREDITED HOME LENDERS HOLDING CO.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

04-3669482
(I.R.S. Employer
Identification No.)

15090 Avenue of Science

San Diego, California 92128

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: 858-676-2100

Former name, former address and former fiscal year, if changed since last report: not applicable

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 or No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes or No

The number of outstanding shares of the registrant's common stock as of July 30, 2004 was 21,012,741.

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FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements. When used in this report, statements which are not historical in nature, including the words anticipate, estimate, should, expect, believe, intend and similar expressions are intended to identify forward-looking statements. These statements include statements containing a projection of revenues, earnings or losses, capital expenditures, dividends, capital structure or other financial terms.

The forward-looking statements in this report are based upon our management's beliefs, assumptions and expectations of our future operations and economic performance, taking into account the information currently available to them. These statements are not statements of historical fact. Forward-looking statements involve risks and uncertainties, some of which are not currently known to us, that may cause our actual results, performance or financial condition to be materially different from the expectations of future results, performance or financial condition that we express or imply in any forward-looking statements. Some of the important factors that could cause our actual results, performance or financial condition to differ materially from expectations are:

changes in demand for, or value of, mortgage loans due to the attributes of the loans we originate; the characteristics of our borrowers; and fluctuations in the real estate market, interest rates or the market in which we sell or securitize our loans;

a general deterioration in economic or political conditions;

our ability to protect and hedge our mortgage loan portfolio against adverse interest rate movements;

changes in government regulations that affect our ability to originate and service mortgage loans;

changes in the credit markets, which affect our ability to borrow money to originate mortgage loans;

the degree and nature of our competition;

our ability to employ and retain qualified employees; and

the other factors referenced in this report, including, without limitation, under the section entitled "ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations."

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the forward-looking events discussed in this report might not occur. We qualify any and all of our forward-looking statements entirely by these cautionary factors.

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In this Form 10-Q, unless the context requires otherwise, *Accredited, Company, we, our, and us* means *Accredited Home Lenders Holding Co. and its subsidiary*.

PART I**Item 1. Financial Statements****ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****CONDENSED CONSOLIDATED BALANCE SHEETS****(unaudited)**

(dollars in thousands)	December 31, 2003	June 30, 2004
	<u> </u>	<u> </u>
ASSETS		
Cash and cash equivalents	\$ 27,119	\$ 33,514
Restricted cash	209	4,483
Mortgage loans held for sale, net of market reserve of \$12,213 and \$ 13,698, respectively	1,277,075	1,968,641
Mortgage loans held for investment, net of allowance for loan losses of \$19,890 and \$40,080, respectively	2,090,237	3,259,932
Mortgage-related securities, at fair value	3,692	3,865
Mortgage servicing rights, net	1,119	542
Furniture, fixtures and equipment, net	20,674	30,401
Other receivables	44,911	45,139
Deferred income tax asset	16,052	42,872
Prepaid expenses and other assets	20,329	28,099
	<u> </u>	<u> </u>
TOTAL	\$ 3,501,417	\$ 5,417,488
	<u> </u>	<u> </u>
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES:		
Warehouse facilities	\$ 1,515,195	\$ 2,501,605
Securitization bond financing	1,724,389	2,563,389
Income taxes payable	2,949	32,704
Accounts payable and accrued liabilities	46,661	43,861
	<u> </u>	<u> </u>
Total liabilities	3,289,194	5,141,559
	<u> </u>	<u> </u>
COMMITMENTS AND CONTINGENCIES (Note 13)		
STOCKHOLDERS EQUITY:		
Preferred stock, \$.001 par value; authorized 5,000,000 shares; no shares issued and outstanding		
Common stock, \$.001 par value; authorized 40,000,000 shares; issued and outstanding 20,366,314 shares at December 31, 2003 and 20,909,251 shares at June 30, 2004 (including 326,113 and 532,561,	20	21

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respectively, of restricted stock awarded under the deferred compensation plan)

Additional paid-in capital	61,585	74,107
Note receivable for common stock	(1,250)	(1,250)
Unearned compensation	(5,623)	(11,240)
Retained earnings	157,491	214,291
	<u> </u>	<u> </u>
Total stockholders' equity	212,223	275,929
	<u> </u>	<u> </u>
TOTAL	\$ 3,501,417	\$ 5,417,488
	<u> </u>	<u> </u>

See notes to condensed consolidated financial statements.

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(unaudited)**

(dollars and shares outstanding in thousands, except for earnings per share)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2003	2004	2003	2004
REVENUES:				
Interest income	\$ 40,317	\$ 84,673	\$ 72,614	\$ 145,299
Gain on sale of loans (including \$0, \$0, \$2,834 and \$0, respectively, with a related party)	62,909	77,619	106,080	132,349
Loan servicing income	1,928	1,646	3,810	3,209
Net gain (loss) on mortgage-related securities and derivatives	2,989	(68)	4,388	1,774
Other income (expense)	94	(72)	485	130
Total revenues	108,237	163,798	187,377	282,761
EXPENSES:				
Salaries, wages and benefits	26,921	39,707	50,823	75,101
Interest expense (including \$0, \$0, 597 and \$0, respectively, with a related party)	14,845	28,093	27,012	49,023
Occupancy	2,597	4,678	4,999	8,531
Provision for losses	9,871	17,843	16,379	25,292
Depreciation and amortization	966	2,249	2,083	4,023
General and administrative expenses	10,068	14,071	18,429	26,124
Total expenses	65,268	106,641	119,725	188,094
INCOME BEFORE INCOME TAXES	42,969	57,157	67,652	94,667
INCOME TAXES	17,187	22,863	27,060	37,867
NET INCOME	\$ 25,782	\$ 34,294	\$ 40,592	\$ 56,800
BASIC EARNINGS PER SHARE	\$ 1.34	\$ 1.69	\$ 2.56	\$ 2.81
DILUTED EARNINGS PER SHARE	\$ 1.25	\$ 1.60	\$ 2.13	\$ 2.65
WEIGHTED AVERAGE SHARES OUTSTANDING:				
BASIC	19,270	20,269	15,876	20,194
DILUTED	20,648	21,402	19,034	21,459

See notes to condensed consolidated financial statements.

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited)**

	Six Months Ended	
	June 30,	
	2003	2004
(dollars in thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 40,592	\$ 56,800
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	2,083	4,023
Amortization of unearned compensation	171	1,546
Loss on disposal of furniture, fixtures, and equipment	88	35
Mortgage loans held for sale originated, net of fees	(2,992,052)	(3,887,519)
Proceeds from sale of mortgage loans held for sale, net of fees	2,643,669	3,489,966
Collection of principal payments on mortgage loans held for sale	13,948	31,553
Net change in fair value hedge basis adjustment on mortgage loans held for sale and securitized loans	(4,825)	23,348
Amortization of net deferred origination fees on securitized loans	(274)	(565)
Cash received on mortgage-related securities	7,655	2,232
Net unrealized gain on mortgage-related securities	(5,113)	(1,629)
Accretion of mortgage-related securities	(521)	(233)
Amortization of mortgage servicing rights	1,111	577
Provision for losses	16,379	25,292
Deferred income taxes	(19,814)	(26,820)
Income tax deduction for disqualifying stock dispositions		2,694
Changes in assets and liabilities:		
Other receivables	(1,105)	(228)
Other assets	2,091	(4,292)
Accounts payable and accrued liabilities	(3,862)	(6,947)
Income taxes payable	17,165	29,755
Net cash used in operating activities	(282,614)	(260,412)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(7,263)	(13,785)
Mortgage loans held for investment originated	(398,048)	(1,869,454)
Principal payments on securitized loans	52,931	326,256
Net cash provided by investing activities	(352,380)	(1,556,983)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from warehouse credit facilities	376,413	986,410
Payments of borrowings on residual interest credit facility	(6,858)	
Proceeds from issuance of securitization bond financing	303,049	1,189,920
Payments of securitization bond financing	(68,916)	(350,920)
Change in restricted cash	(120)	(4,274)
Payments on capital leases	(182)	(12)
Proceeds from exercise of stock options	287	563
Proceeds from issuance of stock under ESPP	1,873	2,103
Net proceeds from initial public offering and concurrent private placement	38,294	

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Net cash provided by financing activities	643,840	1,823,790
NET INCREASE IN CASH AND CASH EQUIVALENTS	8,846	6,395
BEGINNING BALANCE, CASH AND CASH EQUIVALENTS	11,300	27,119
ENDING BALANCE, CASH AND CASH EQUIVALENTS	\$ 20,146	\$ 33,514
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	\$ 22,532	\$ 42,214
Income taxes	\$ 29,749	\$ 32,208
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Transfer of loans held for sale to loans held for investment	\$ 397,682	\$ 1,533,903
Transfer of loans held for sale to real estate owned, included in other assets	\$ 4,923	\$ 3,478
Transfer of mortgage related securities from other liabilities	\$	\$ 543
Unearned compensation	\$ 241	\$ (84)
Deferred compensation	\$	\$ 7,209
Conversion of convertible debt to common stock	\$ 3,000	\$
Conversion of preferred stock to common stock	\$ 5,113	\$
Conversion of warrants to common stock	\$ 1	\$

See notes to condensed consolidated financial statements.

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

For The Six Months Ended June 30, 2003 and 2004 (Unaudited)

1. THE COMPANY AND A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation The consolidated financial statements include the accounts of Accredited Home Lenders Holding Co. (**AHLHC**), a Delaware corporation, and its wholly-owned subsidiary Accredited Home Lenders, Inc. (**AHL**) and **AHL** 's wholly-owned subsidiary Accredited Mortgage Loan REIT Trust (**REIT**) (collectively the **Company**). **REIT** was formed in May 2004 as a Maryland real estate investment trust for the purpose of acquiring, holding and managing real estate assets. See Note 15 **Subsequent Event** . The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. All intercompany balances and transactions have been eliminated. The unaudited consolidated financial statements presented herein should be read in conjunction with the audited consolidated financial statements and related notes thereto included in Accredited Home Lenders Holding Co. 's Annual Report on Form 10-K for the year ended December 31, 2003.

On February 14, 2003, **AHLHC** completed an initial public offering (the **Offering**) whereby 9,650,000 shares of its common stock (of which 4,493,022 shares were offered by **AHLHC**) were sold to the public resulting in gross proceeds of \$35.9 million to **AHLHC**. In addition, **AHLHC** sold 510,697 shares of its common stock in a concurrent private placement resulting in gross proceeds of \$3.8 million to **AHLHC**. Concurrently, 5,893,546 shares of common stock of **AHLHC** were issued in exchange for all of the issued and outstanding shares of common stock of **AHL** as part of a reorganization whereby **AHL** became a wholly-owned subsidiary of **AHLHC**. The acquisition of **AHL** has been accounted for at historical cost in a manner similar to a pooling of interests, and the accompanying consolidated financial statements have been prepared assuming the reorganization had occurred as of the first day of the earliest period presented herein. The consolidated financial position and results of operations of the **Company** for the periods prior to the date of the reorganization consist of those of **AHL**.

On March 18, 2003, the underwriters of the **Company** 's **Offering** purchased an additional 907,500 shares of common stock (of which 649,993 shares were offered by the **Company**) at \$7.44 per share upon partial exercise of their over-allotment option pursuant to the **Offering**, resulting in gross proceeds of \$4.8 million to the **Company**.

General The **Company** engages in the business of originating, financing, securitizing, selling and servicing non-prime mortgage loans secured by residential real estate. The **Company** focuses on borrowers who may not meet conforming underwriting guidelines because of higher loan-to-value ratios, the nature or absence of income documentation, limited credit histories, high levels of consumer debt, or past credit difficulties. The **Company** originates loans primarily based upon the borrower 's willingness and ability to repay the loan and the adequacy of the collateral.

Restricted Cash Cash held on behalf of employees for the Employee Stock Purchase Plan and flexible spending accounts is classified as restricted cash. In addition, the **Company** has deposited \$4.2 million in a bank account to cover the risk of loss on its errors and omissions

liability coverage. This amount is also classified as restricted cash.

Mortgage Banking Activities The Company derives its revenue from the interest earned on mortgage loans and from the sale of loans to various third-party investors under purchase and sale agreements. Loan sales

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

may be either on a servicing retained or released basis, and may take the form of a securitization. The Company may also retain interest-only strips or the right to other excess cash flows. Gains or losses resulting from loan sales are recognized at the time of sale, based on the difference between the net sales proceeds, including retained interests, and the allocated book value of the loans sold.

In the past, the Company has entered into securitizations structured as sales and retained a residual interest. The Company also sold loans to a third-party securitizer and retained the right to receive future payments based upon certain excess cash flows (primarily excess interest or prepayment penalties) generated by such loans. The revenue recognized from such transactions included an adjustment for such residual interests or excess cash flows (collectively, mortgage-related securities) based upon the net present value of the amount expected to be received from the underlying loans less amounts paid to investors, estimated credit losses, servicing fees, as well as mortgage insurance fees, guarantee fees, and trustee fees for the securitizations. The net present value of the mortgage-related securities is determined based on assumptions for loan prepayments, defaults and other factors that market participants would demand for such financial instruments.

The Company measures mortgage-related securities like debt securities classified as trading securities under Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Accordingly, mortgage-related securities are recorded at fair value with any unrealized gains or losses recorded in the results of operations in the period of change in fair value. The Company determines the fair value of mortgage-related securities at origination and at each reporting period by discounting the estimated net future cash flows using assumptions that market participants would use to estimate fair value, including assumptions about interest rates, credit losses, and prepayment speeds. To the Company's knowledge, there is no active market for the sale of such mortgage-related securities; accordingly, the Company's estimate of fair value is subjective.

In the ordinary course of business, an investor may request that the Company refund a portion of the premium paid on the sale of mortgage loans if a loan is prepaid in full within a certain amount of time from the date of sale. The Company records a reserve for estimated premium recapture on loans sold, which is charged to gain on sale of loans.

Securitized Loans and Securitization Bond Financing Since July 2002, the Company has completed a total of seven securitizations totaling \$ 3.2 billion structured as a financing under Statement of Financial Accounting Standards (SFAS) No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement No. 125*.

These securitizations are structured legally as sales, but for accounting purposes are treated as financings under SFAS No. 140. These securitizations do not meet the qualifying special purpose entity criteria under SFAS No. 140 and related interpretations because after the loans are securitized, the securitization trusts may acquire derivatives relating to beneficial interests retained by the Company and, the Company, as servicer, subject to applicable contractual provisions, has discretion, consistent with prudent mortgage servicing practices, to determine whether to sell or work out any loans securitized through the securitization trusts that become troubled. Accordingly, the loans remain on the balance sheet (referred to as securitized loans), retained interests are not created, and securitization bond financing replaces the warehouse debt originally associated with the securitized loans. The Company records interest income on securitized loans and interest expense on the bonds issued in the securitizations over the life of the securitizations. Deferred debt issuance costs and discount related to the bonds are amortized on a level yield basis over the estimated life of the bonds.

The Company periodically evaluates the need for or the adequacy of the allowance for loan losses on its securitized loans and loans held for securitization. Provision for loan losses on securitized loans and loans held

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

for securitization is made in an amount sufficient to maintain credit loss allowances at a level considered appropriate to cover probable losses in such portfolio. The Company defines a loan as impaired at the time the loan becomes 90 days or more delinquent under its payment terms. Probable losses are determined based on segmenting the portfolio relating to their contractual delinquency status and applying the Company's historical loss experience. The Company also uses other analytical tools to determine the reasonableness of the allowance for loan losses. Loss estimates are reviewed periodically and adjustments are reported in earnings. As these estimates are influenced by factors outside of the Company's control, there is uncertainty inherent in these estimates, making it reasonably possible that they could change. Carrying values are written down to fair value when the loan is foreclosed or deemed uncollectible.

Mortgage loans held for investment Both securitized loans and loans held for securitization are classified as mortgage loans held for investment. The loans held for securitization are carried at the lower of aggregate cost (including hedge basis adjustments) or market. See discussion above for securitized loans.

Derivative Financial Instruments As part of the Company's interest rate management process, the Company uses derivative financial instruments such as Eurodollar futures and options. In connection with three of the securitizations structured as financings, the Company entered into interest rate cap agreements. It is not the Company's policy to use derivatives to speculate on interest rates. In accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted, derivative financial instruments are reported on the consolidated balance sheets at their fair value.

The Company designates certain derivative financial instruments as hedge instruments under SFAS No. 133, and, at trade date, these instruments and their hedging relationship are identified, designated and documented. For derivative financial instruments designated as hedge instruments, the Company evaluates the effectiveness of these hedges against the mortgage loans being hedged to ensure that there remains adequate correlation in the hedge relationship. To hedge the adverse effect of interest rate changes on the fair market value of mortgage loans held for sale and for investment, the Company is using derivatives as fair value hedges under SFAS No. 133. Once the hedge relationship is established, the realized and unrealized changes in fair value of both the hedge instruments and mortgage loans are recognized in the consolidated statement of operations in the period in which the changes occur. Any change in the fair value of mortgage loans held for sale recognized as a result of hedge accounting is reversed at the time the mortgage loans are sold. This results in a correspondingly higher or lower gain on sale of loans at such time. Any change in the fair value of securitized loans is amortized over the fixed rate period of the loan on a level yield basis. This results in a corresponding adjustment to interest income. The net amount recorded in the consolidated statement of operations is referred to as hedge ineffectiveness. The Company is in the process of developing the use of cash flow hedging on its securitized loans and projects the implementation to occur in the third quarter of 2004. The Company does not expect the change from fair value hedging to cash flow hedging to have a material impact on the financial statements.

For derivative financial instruments not designated as hedge instruments, realized and unrealized changes in fair value are recognized in the consolidated statements of operations in the period in which the changes occur.

Provision for Losses Market valuation adjustments have been provided on certain nonperforming loans, other loans held for sale and real estate owned. These adjustments are based on the Company's estimate of expected losses, calculated using loss severity and loss frequency rate assumptions, and are based on the value that the Company could reasonably expect to obtain from a sale, that is, other than in a forced or

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liquidation sale. Provision for losses on securitized loans is recorded in an amount sufficient to maintain the allowance for loan losses at a level considered appropriate to cover probable losses on such loans. Provision for losses also includes net losses on real estate owned. The Company also accrues liabilities associated with loans sold which may be required to be repurchased due to breaches of representations and warranties and early payment defaults. The Company periodically evaluates the estimates used in calculating expected losses and adjustments are reported in

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earnings. As these estimates are influenced by factors outside of the Company's control and as uncertainty is inherent in these estimates, it is reasonably possible that they could change.

Escrow and Fiduciary Funds The Company maintains segregated bank accounts in trust for investors with respect to payments on securitized loans and mortgage loans serviced for investors, as well as for mortgagors with respect to property tax and hazard insurance premium payments escrowed by mortgagors with the Company. Such accounts amounted to \$35.4 million and \$65.1 million at December 31, 2003 and June 30, 2004, respectively, and are excluded from the Company's assets and liabilities.

Stock-Based Compensation SFAS No. 123, *Accounting for Stock-Based Compensation*, encourages, but does not require, companies to record compensation cost for stock-based employee compensation plans at fair value.

The Company has been accounting for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Accordingly, compensation cost for stock options is measured as the excess, if any, of the fair value of the Company's stock at the date of grant over the grant price.

The Company has adopted the disclosure only provisions of SFAS No. 123. Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant date for awards consistent with the provisions of SFAS No. 123, the Company's net income would have been reduced to the pro forma amounts as follows (dollars in thousands):

	Three Months Ended June 30,	
	2003	2004
Net income, as reported	\$ 25,782	\$ 34,294
Add: Stock-based compensation included in reported net income, net of tax	41	11
Deduct: Stock-based employee compensation expense determined using fair value method, net of tax	(96)	(465)
Pro forma net income	\$ 25,727	\$ 33,840
Earnings per share:		
Basic as reported	\$ 1.34	\$ 1.69
Basic pro forma	\$ 1.34	\$ 1.67
Diluted as reported	\$ 1.25	\$ 1.60
Diluted pro forma	\$ 1.25	\$ 1.58

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	Six Months Ended June 30,	
	2003	2004
Net income, as reported	\$ 40,592	\$ 56,800
Add: Stock-based compensation included in reported net income, net of tax	70	79
Deduct: Stock-based employee compensation expense determined using fair value method, net of tax	(172)	(930)
Pro forma net income	\$ 40,490	\$ 55,949
Earnings per share:		
Basic as reported	\$ 2.56	\$ 2.81
Basic pro forma	\$ 2.55	\$ 2.77
Diluted as reported	\$ 2.13	\$ 2.65
Diluted pro forma	\$ 2.13	\$ 2.61

The fair value of each option grant is estimated as of the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions: no dividends, an expected option life of five

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

years, a risk-free rate of 2.9% and 3.3% (six months ended June 30, 2003 and 2004, respectively) and a 40.1% and 56.0% weighted average volatility (six months ended June 30, 2003 and 2004, respectively). The Company's volatility is calculated as an average of its own volatility and the mean of its closest competitors' volatility for the respective periods due to the limited period of time since the Offering. The weighted average fair value at grant date was \$1.71 and \$19.20 for options granted during the six months ended June 30, 2003 and 2004, respectively.

Segment Reporting While the Company's management monitors the revenue streams through wholesale and retail loan originations, operations are managed and financial performance is evaluated by the Company's chief operating decision-maker on a company-wide basis. The Company has identified REIT and AHL as separate operating segments, however they are aggregated to a single reporting segment for financial reporting due to commonality and similarity of operations. See Note 14 for supplemental condensed consolidating financial information.

Use of Estimates in the Preparation of Financial Statements The preparation of these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the valuation of the mortgage-related securities, mortgage servicing rights, derivative financial instruments and hedged assets, the determination of the market reserve on loans and the allowance for loan losses on securitized loans and loans held for investment, and the determination of the reserves for repurchases.

Reclassifications Certain items in the prior year financial statements have been reclassified to conform to the current year presentation.

Recent Accounting Developments In March 2004, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 105 (SAB 105). SAB 105 contains specific guidance that significantly limits opportunities for registrants to recognize an asset related to a commitment to originate a mortgage loan that will be held for sale prior to funding the loan, which differs from the current accounting guidance provided by Statement of Financial Accounting Standards No. 149 (SFAS 149). SFAS 149 requires that the entity that makes the mortgage loan commitment record the commitment on its balance sheet at fair value, but does not address how to measure the fair value of the loan commitment. SAB 105 requires that fair value measurement of loan commitments include only differences between the guaranteed interest rate in the loan commitment and a market interest rate, excluding any expected cash flows related to the customer relationship or loan servicing. SAB 105 is effective for new loan commitments accounted for as derivatives entered into after March 31, 2004. SAB 105 permits registrants to continue to use previously applied accounting policies to commitments entered into on or before March 31, 2004. We quote interest rates to borrowers, which are generally subject to change by us. Although we typically honor such interest rate quotes, the quotes do not constitute interest rate locks, minimizing the potential interest rate exposure. We do not account for our interest rate quotes as derivatives. We do not expect that the application of SAB 105 will have a material impact on our consolidated financial statements.

2. CONCENTRATIONS OF RISK

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The Company's ability to continue to originate and purchase loans is dependent, in part, upon its ability to securitize and sell loans in the secondary market in order to generate cash proceeds for new originations and purchases. The value of and market for the Company's loans are dependent upon a number of factors, including general economic conditions, interest rates and governmental regulations. Adverse changes in such factors may affect the Company's ability to securitize or sell loans for acceptable prices within reasonable periods of time.

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Geographical Concentration Properties securing the mortgage loans in the Company's servicing portfolio, including loans subserviced, are geographically dispersed throughout the United States. At June 30, 2003 and 2004, approximately 37% and 34%, respectively, of the properties were located in California. The remaining properties securing mortgage loans serviced did not exceed 10% in any other state at any period end.

Loan originations are geographically dispersed throughout the United States. During the six months ended June 30, 2003 and 2004, approximately 35% and 30%, respectively, of the principal balance of loans originated were collateralized by properties located in California. The remaining originations did not exceed 10% in any other state during any of such periods.

3. MORTGAGE LOANS

Mortgage loans held for sale Mortgage loans held for sale were as follows (dollars in thousands):

	December 31, 2003	June 30, 2004
Mortgage loans held for sale - principal balance	\$ 1,288,630	\$ 1,988,050
Basis adjustment for fair value hedge accounting	(1,368)	(7,432)
Net deferred origination costs	2,026	1,721
Market reserve	(12,213)	(13,698)
Mortgage loans held for sale, net	\$ 1,277,075	\$ 1,968,641

Mortgage loans held for investment Mortgage loans held for investment were as follows (dollars in thousands):

	December 31, 2003	June 30, 2004
Mortgage loans held for investment - principal balance	\$ 2,095,398	\$ 3,303,045
Basis adjustment for fair value hedge accounting	17,302	18
Net deferred origination fees	(2,573)	(3,051)
Allowance for loan losses	(19,890)	(40,080)
Mortgage loans held for investment, net	\$ 2,090,237	\$ 3,259,932

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At December 31, 2003 and June 30, 2004, mortgage loans held for investment included \$338.9 million and \$646.1 million, net of basis adjustment for fair value hedging and net deferred origination fees, respectively, in loans held for a securitization.

Provision for losses Activity in the market reserve on loans held for sale was as follows (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2004	2003	2004
Balance, beginning of period	\$ 10,160	\$ 12,833	\$ 6,885	\$ 12,213
Provision for losses	2,970	1,567	7,407	3,661
Chargeoffs, net	(1,875)	(702)	(3,037)	(2,176)
Balance, end of period	\$ 11,255	\$ 13,698	\$ 11,255	\$ 13,698
Reserve % of loans held for sale	0.86%	0.69%	0.86%	0.69%

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Activity in the allowance for loan losses on mortgage loans held for investment was as follows (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2004	2003	2004
Balance, beginning of period	\$ 6,434	\$ 24,686	\$ 4,550	\$ 19,890
Provision for losses	4,275	15,635	6,159	20,692
Chargeoffs, net		(241)		(502)
Balance, end of period	\$ 10,709	\$ 40,080	\$ 10,709	\$ 40,080
Allowance % of mortgage loans held for investment	0.99%	1.23%	0.99%	1.23%

As of December 31, 2003 and June 30, 2004, \$7.5 million and \$12.9 million of mortgage loans held for investment were 90 days or more delinquent under their payment terms, respectively. This increase results from the increased age and size of the Company's securitized loan portfolio.

As of December 31, 2003 and June 30, 2004, \$4.2 million and \$1.8 million of real estate owned, net of the reserve for losses on real estate owned of \$1.7 million and \$1.2 million, respectively, is included in other assets. Activity in the reserve for losses on real estate owned was as follows (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2004	2003	2004
Balance, beginning of period	\$ 1,665	\$ 982	\$ 2,092	\$ 1,684
Provision for losses	491	715	401	527
Chargeoffs, net	(423)	(526)	(760)	(1,040)
Balance, end of period	\$ 1,733	\$ 1,171	\$ 1,733	\$ 1,171

Provision for losses in the accompanying consolidated statements of operations is composed of the following (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2004	2003	2004
Provision market reserve on loans	\$ 3,349	\$ 1,567	\$ 7,786	\$ 3,661
Provision allowance for losses on mortgage loans held for investment	3,896	15,635	5,780	20,692
Provision reserve for real estate owned	491	715	401	527
Provision (recovery) reserve for repurchases	1,734	(72)	1,703	336
Net losses (gains) on real estate owned	401	(2)	709	76
	<u>\$ 9,871</u>	<u>\$ 17,843</u>	<u>\$ 16,379</u>	<u>\$ 25,292</u>

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4. MORTGAGE-RELATED SECURITIES**

Mortgage-related securities consisted of the following (dollars in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2003	2004	2003	2004
Balance, beginning of period	\$ 6,702	\$ 4,286	\$ 8,356	\$ 3,692
Net unrealized gains (losses)	3,378	(561)	5,113	1,629
Interest accretion	175	125	521	233
Cash collected	(3,920)	(825)	(7,655)	(2,232)
Reclassification to other liabilities		840		543
Balance, end of period	<u>\$ 6,335</u>	<u>\$ 3,865</u>	<u>\$ 6,335</u>	<u>\$ 3,865</u>

The Company utilized the following assumptions to revalue all mortgage-related securities that arose from sales of loans by the Company to third party investors outstanding at December 31, 2003 and June 30, 2004 (dollars in thousands):

	December 31,	June 30,
	2003	2004
Annual prepayment speeds	20.0% to 67.5%	20.0% to 65.0%
Discount rate	15%	15%
Expected cumulative credit losses	4.2%	4.2%
Interest rates on adjustable rate loans	Forward LIBOR curve	Forward LIBOR curve
Fair value at period end	\$(297)	\$(840)

The fair value of the mortgage-related securities that arose from the sales of loans to a third party investor (a former related party) of (\$297,000) and (\$840,000) at December 31, 2003 and June 30, 2004, respectively, is included in other liabilities on the balance sheet.

The Company utilized the following assumptions to revalue all mortgage-related securities that arose from the Company's 2000 securitization outstanding at December 31, 2003 and June 30, 2004 (dollars in thousands):

	December 31, 2003	June 30, 2004
Annual prepayment speeds	22.0% to 55.2%	22.0% to 38.0%
Discount rate	15%	15%
Expected cumulative credit losses	4.9%	4.3%
Interest rates on adjustable rate loans	Forward LIBOR curve	Forward LIBOR curve
Fair value at period end	\$3,692	\$3,865

5. MORTGAGE SERVICING RIGHTS

The Company recognizes as a separate asset the rights to service mortgage loans for others once such rights are contractually separated from the underlying loans. Mortgage servicing rights are amortized in proportion to and over the period of the estimated net servicing income and are recorded at the lower of amortized cost or fair value.

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Mortgage servicing rights were as follows (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2004	2003	2004
Balance, beginning of period	\$ 2,551	\$ 812	\$ 3,116	\$ 1,119
Amortization	(546)	(270)	(1,111)	(577)
Balance, end of period	\$ 2,005	\$ 542	\$ 2,005	\$ 542

The fair value of mortgage servicing rights at June 30, 2003 and June 30, 2004 was \$2.5 million and \$578,000, respectively.

The Company periodically evaluates mortgage servicing rights for impairment, which is measured as the excess of cost over fair value. This review is performed on a disaggregated basis based on loan type using prepayment assumptions ranging from 20.0% to 67.5% and 20.0% to 65.0% for December 31, 2003 and June 30, 2004, respectively, and a discount rate of 15% at both December 31, 2003 and June 30, 2004. Impairment, if it occurs, is recognized in a valuation allowance for each pool in the period of impairment. No impairment was identified as of December 31, 2003. As of June 30, 2004, \$17,000 of impairment was recognized.

The Company services 22,131 and 39,153 loans with an outstanding balance of \$2.8 billion and \$5.5 billion as of June 30, 2003 and 2004, respectively. Losses on the Company's servicing portfolio, defined as loans held for sale, loans held for investment and loans held in off balance sheet securitizations, were \$8.0 million and \$7.9 million for the six months ended June 30, 2003 and 2004, respectively, resulting in annualized losses of 0.6% and 0.4% for the comparable periods. As of June 30, 2003 and 2004, the unpaid principal balance of loans sold servicing retained was \$374.2 million and \$203.6 million, respectively.

6. DERIVATIVE FINANCIAL INSTRUMENTS

Derivative Financial Instruments and Hedged Instrument Activity The Company uses hedge accounting as defined by SFAS No. 133 for certain derivative financial instruments used to hedge its mortgage loans held for sale. At December 31, 2003 and June 30, 2004, fair value hedge basis adjustments of (\$1.4) million and (\$7.4) million, respectively, are included in mortgage loans held for sale related to the \$762.9 million and \$705.0 million, respectively, of such loans designated as hedged assets. Hedge ineffectiveness associated with fair value hedges of \$775,000 and \$1.2 million was recorded in earnings during the three and six months ended June 30, 2004, respectively, and is included as an addition to gain on sale of loans in the consolidated statements of operations.

The Company uses hedge accounting as defined by SFAS No. 133 for certain derivative financial instruments used to hedge its loans held for investment. At December 31, 2003 and June 30, 2004, fair value hedge basis adjustments of \$17.3 million and \$18,000, respectively, are included in loans held for investment related to the \$1.2 billion and \$1.6 billion, respectively, of such loans designated as hedged assets. Hedge ineffectiveness associated with fair value hedges of (\$468,000) and (\$573,000) was recorded in earnings during the three and six months ended June 30, 2004 and is included as a reduction in interest income in the consolidated statements of operations.

At June 30, 2004, the Company had outstanding futures contracts with a fair value of \$8.8 million of which contracts with a fair value of \$8.8 million are designated as hedge instruments. The Company is required to maintain a cash deposit in a margin account with its broker related to these derivative transactions. At June 30, 2004, approximately \$7.4 million was on deposit in such margin account, which is included in other receivables. Accordingly, the net liquidation value of the Company's derivative financial instruments and related margin

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

account is \$1.4 million at June 30, 2004. In addition, the Company had option contracts and interest rate cap agreements with a fair value of \$2.0 million and \$1.3 million, respectively, included in other assets at June 30, 2004.

At December 31, 2003, the Company had outstanding futures contracts with a fair value of (\$9.4) million included in accrued liabilities of which contracts with a fair value of (\$8.9) million are designated as hedge instruments. The Company is required to maintain a cash deposit in a margin account with its broker related to these derivative transactions. At December 31, 2003, approximately \$20.4 million was on deposit in such margin account, which is included in other receivables. Accordingly, the net liquidation value of the Company's derivative financial instruments and related margin account is \$11.0 million at December 31, 2003. In addition, the Company had option contracts and interest rate cap agreements with a fair value of \$715,000 and \$160,000, respectively, included in other assets at December 31, 2003.

The effect of the change in fair value of derivative financial instruments and the related hedged asset recorded in the various statement of operation line items are detailed below (dollars in thousands). The following table is not representative of our hedge ineffectiveness as it excludes the income statement effects attributable to fluctuations in interest rates that have been recognized in premiums on whole loans sales and interest margins.

	Three Months Ended June 30, 2003			
	Interest Income	Gain on Sale	Net Gain (Loss) on MRS	Total
Net unrealized gain	\$ 33	\$ 539	\$ 662	\$ 1,234
Net realized loss	(1,505)	(9,493)	(1,051)	(12,049)
Total	\$ (1,472)	\$ (8,954)	\$ (389)	\$ (10,815)

	Three Months Ended June 30, 2004			
	Interest Income	Gain on Sale	Net Gain (Loss) on MRS	Total
Net unrealized gain (loss)	\$ (903)	\$ (12,195)	\$ 625	\$ (12,473)
Net realized gain (loss)	(901)	18,015	(132)	16,982
Total	\$ (1,804)	\$ 5,820	\$ 493	\$ 4,509

Six Months

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	Ended June 30, 2003			
	Interest Income	Gain on Sale	Net Gain (Loss) on MRS	Total
Net unrealized gain	\$ (1,032)	\$ 4,122	\$ 3,285	\$ 6,375
Net realized loss	(1,697)	(14,410)	(4,010)	(20,117)
Total	\$ (2,729)	\$ (10,288)	\$ (725)	\$ (13,742)

	Six Months Ended June 30, 2004			
	Interest Income	Gain on Sale	Net Gain (Loss) on MRS	Total
Net unrealized gain (loss)	\$ (2,409)	\$ (4,909)	\$ 606	\$ (6,712)
Net realized gain (loss)	(2,692)	5,341	(461)	2,188
Total	\$ (5,101)	\$ 432	\$ 145	\$ (4,524)

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****7. CREDIT FACILITIES**

Credit Facilities The Company had in place the following credit facilities:

	<u>Amount Outstanding</u>	
	<u>December 31, 2003</u>	<u>June 30, 2004</u>
A \$500 million combined warehouse credit facility expiring July 30, 2005, collateralized by performing, aged and delinquent loans and REO property, bearing interest based on one-month LIBOR (rate was 2.6% to 4.9% at June 30, 2004).	\$ 387.9 million	\$ 451.4 million
A \$500 million warehouse credit facility expiring May 27, 2005, collateralized by performing, aged and delinquent loans, bearing interest based on one-month LIBOR (rate was 2.7% to 3.0% at June 30, 2004).	\$ 190.3 million	\$ 374.2 million
A \$40 million warehouse credit facility expiring August 31, 2004, collateralized by performing loans, bearing interest based on the prime rate (rate was 4.75% at June 30, 2004).	\$ 11.0 million	\$ 12.9 million
A \$450 million warehouse credit facility expiring April 18, 2005, collateralized by performing, aged and delinquent loans, bearing interest based on one-month LIBOR (rate was 2.6% to 3.6% at June 30, 2004).	\$ 152.4 million	\$ 413.4 million
A \$150 million non-discretionary; \$150 million discretionary warehouse credit facility expiring November 12, 2004, collateralized by performing, aged and delinquent loans, bearing interest based on one-month LIBOR (rate was 2.5% to 4.1% at June 30, 2004).	\$ 168.4 million	\$ 298.3 million
A \$400 million warehouse credit facility expiring April 20, 2005, collateralized by performing, aged and delinquent loans, bearing interest based on one-month LIBOR (rate was 2.6% to 3.9% at June 30, 2004).	\$ 175.0 million	\$ 353.8 million
A \$300 million warehouse credit facility expiring October 8, 2004, collateralized by performing, aged and delinquent loans, bearing interest based on one-month LIBOR (rate was 2.2% to 2.9% at June 30, 2004).	\$ 214.7 million	\$ 298.5 million
A \$300 million warehouse credit facility expiring January 31, 2005, collateralized by performing, aged and delinquent loans and REO property, bearing interest based on one-month LIBOR (rate was 2.6% to 4.4% at June 30, 2004).	\$ 215.5 million	\$ 299.1 million
Total warehouse credit facilities	\$ 1,515.2 million	\$ 2,501.6 million

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of June 30, 2004, the Company was in compliance with all covenant requirements for each of the facilities. The Company's warehouse and other credit facilities contain customary covenants including minimum liquidity, profitability and net worth requirements and limitations on other indebtedness. If the Company fails to comply with any of these covenants or otherwise defaults under a facility, the lender has the right to terminate the facility and require immediate repayment that may require sale of the collateral at less than optimal terms. In addition, if the Company defaults under one facility, it would generally trigger a default under the Company's other facilities.

The Company anticipates that its borrowings will be repaid from net proceeds from the sale of loans and other assets, cash flows from operations, or from refinancing the borrowings. The Company believes that it can continue to comply with loan covenants and that other alternative sources of credit are available to the Company to repay maturing loans if anticipated asset sales are not completed by loan due dates.

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****8. SECURITIZATION BOND FINANCING**

The following is a summary of the outstanding securitization bond financing, by class (dollars in thousands):

	<u>December 31,</u> <u>2003</u>	<u>June 30,</u> <u>2004</u>	<u>Interest Rate</u>	<u>Stated Maturity</u> <u>Date</u>
Series 2002-1:				
Class A-1	\$ 41,668	\$ 29,948	4.93% *	July 25, 2032
Class A-2	80,849	56,867	One-month LIBOR + 0.32%	July 25, 2032
	<u>122,517</u>	<u>86,815</u>		
Unamortized bond discount	(9)	(6)		
Series 2002-1, net	<u>\$ 122,508</u>	<u>\$ 86,809</u>		
Series 2002-2				
Class A-1	\$ 141,027	\$ 113,005	4.48% *	January 25, 2033
Class A-2	184,892	137,777	One-month LIBOR + 0.49%	February 25, 2033
Class A-3	85,972	63,674	One-month LIBOR + 0.50%	January 25, 2033
	<u>411,891</u>	<u>314,456</u>		
Unamortized bond discount	(39)	(30)		
Series 2002-2, net	<u>\$ 411,852</u>	<u>\$ 314,426</u>		
Series 2003-1:				
Class A-1	\$ 95,244	\$ 76,221	3.58% *	June 25, 2033
Class A-2	99,095	73,110	One-month LIBOR + 0.35%	June 25, 2033
Class A-3	78,916	56,083	One-month LIBOR + 0.38%	June 25, 2033
	<u>273,255</u>	<u>205,414</u>		
Unamortized bond discount	(4)	(3)		
Series 2003-1, net	<u>\$ 273,251</u>	<u>\$ 205,411</u>		
Series 2003-2				
Class A-1	\$ 115,132	\$ 103,379	4.23% *	October 25, 2033
Class A-2	193,938	164,483	One-month LIBOR + 0.35%	October 25, 2033
Class A-3	97,323	81,746	One-month LIBOR + 0.37%	October 25, 2033
	<u>406,393</u>	<u>349,608</u>		
Unamortized bond discount	(34)	(28)		

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Series 2003-2, net	\$ 406,359	\$ 349,580		
<hr/>				
Series 2003-3				
Class A-1	\$ 192,888	\$ 175,847	4.46% *	January 25, 2034
Class A-2	208,048	181,866	One-month LIBOR + 0.38%	January 25, 2034
Class A-3	109,483	93,611	One-month LIBOR + 0.38%	January 25, 2034
<hr/>				
Series 2003-3, net	\$ 510,419	\$ 451,324		
<hr/>				
Series 2004-1				
Class A-1		\$ 236,888	One-month LIBOR + 0.30%	April 25, 2034
Class A-2		238,709	One-month LIBOR + 0.30%	April 25, 2034
<hr/>				
Series 2004-1, net		\$ 475,597		
<hr/>				
Series 2004-2				
Class A-1		\$ 340,381	One-month LIBOR + 0.29%	July 25, 2034
Class A-2		339,861	One-month LIBOR + 0.30%	July 25, 2034
<hr/>				
Series 2004-2, net		\$ 680,242		
<hr/>				
Total securitization bond financing, net	\$ 1,724,389	\$ 2,563,389		
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* The interest rates for the A-1 classes are a result of swap rates plus a spread of 1.02%, 1.30%, 1.32%, 1.25% and 1.35%, respectively.

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The bonds are collateralized by securitized loans with an aggregate outstanding principal balance of \$1.8 billion and \$2.6 billion as of December 31, 2003 and June 30, 2004, respectively. Unamortized debt issuance costs, included in other assets, are approximately \$7.7 million and \$10.0 million at December 31, 2003 and June 30, 2004, respectively.

Amounts collected by the Company as servicer of the mortgage loans are remitted to the trustee, who in turn distributes such amounts each month to the bondholders, together with other amounts received with respect to the mortgage loans, net of fees payable to the Company, trustee and insurer of the bonds. Interest collected each month on the mortgage loans will generally exceed the amount of interest accrued on the bonds. A portion of such excess interest will initially be distributed as principal to the bonds. As a result of such principal distributions, the excess of the unpaid principal balance of the loans over the unpaid principal balance of the bonds (overcollateralization) will increase. The securitization agreements require that a certain level of overcollateralization be maintained. Once a required level has been reached, excess interest will no longer be used to accelerate the amortization of the bonds. Whenever the level of overcollateralization falls below the required level, excess interest will again be paid as principal to the bonds until the required level has been reached. Excess interest that is not paid to the bonds in order to create or maintain the required overcollateralization level, or used to make certain other payments, will be passed through to the Company. The securitization agreements provide that if delinquencies or losses on the underlying mortgage loans exceed certain maximums, the required levels of credit enhancement would be increased. During the six months ended June 30, 2004, the Company received \$26.4 million of excess interest from these securitizations. Therefore, the bonds are not necessarily expected to be outstanding through the stated maturity date set forth above.

The following table summarizes the expected repayment requirements relating to the securitization bond financing at June 30, 2004. Amounts listed as bond payments are based on anticipated receipts of principal and interest on underlying mortgage loan collateral using historical prepayment speeds:

	June 30, 2004
	(dollars in thousands)
Six months ending December 31:	
2004	\$ 219,924
Years ending December 31:	
2005	688,615
2006	693,273
2007	396,327
2008	165,108
2009	95,490
Thereafter	304,719
Discount	(67)
Total	\$ 2,563,389

9. INCOME TAXES

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Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

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The tax effects of significant items comprising the Company's net deferred tax asset were as follows (dollars in thousands):

	December 31, 2003	June 30, 2004
Loans held for sale	\$ 11,408	\$ 30,828
Market reserve on loans held for sale	5,627	6,059
Loan securitizations	4,403	14,662
State taxes	3,419	2,864
Other reserves and accruals	1,712	3,450
	<u>26,569</u>	<u>57,863</u>
Deferred tax assets	26,569	57,863
Mortgage-related securities	(10,517)	(11,356)
Investment in real estate investment trust		(3,635)
	<u>(10,517)</u>	<u>(14,991)</u>
Deferred tax liabilities	(10,517)	(14,991)
Net deferred tax asset	<u>\$ 16,052</u>	<u>\$ 42,872</u>

The components of the income tax (benefit) expense consisted of the following (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2004	2003	2004
Federal:				
Current	\$ 27,194	\$ 38,242	\$ 37,851	\$ 51,784
Deferred	(13,316)	(19,715)	(16,000)	(21,087)
	<u>13,878</u>	<u>18,527</u>	<u>21,851</u>	<u>30,697</u>
State:				
Current	6,483	9,204	9,023	12,902
Deferred	(3,174)	(4,868)	(3,814)	(5,732)
	<u>3,309</u>	<u>4,336</u>	<u>5,209</u>	<u>7,170</u>

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Total	\$ 17,187	\$ 22,863	\$ 27,060	\$ 37,867
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The deferred income tax expense resulted from temporary differences in the recognition of revenues and expenses for tax and financial statement purposes. The primary sources of these differences were the origination and reversal of various reserves, accruals and book/tax differences in the accounting for loans held for sale and mortgage securitizations.

The following is a reconciliation of the provision computed using the statutory federal income tax rate to the income tax provision reflected in the statements of operations (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2004	2003	2004
Federal income tax at statutory rate	\$ 15,039	\$ 20,005	\$ 23,677	\$ 33,133
State income tax, net of federal effects	2,151	2,819	3,386	4,661
Other	(3)	39	(3)	73
Total	\$ 17,187	\$ 22,863	\$ 27,060	\$ 37,867

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

During the six months ended June 30, 2004, the Company recorded a \$2.7 million reduction in income taxes payable and a corresponding increase to additional paid in capital related to corporate tax deductions arising from the sale by employees of common stock they acquired from the stock option plans and the ESPP prior to the fulfillment of required tax holding periods for such stock.

10. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities were as follows (dollars in thousands):

	December 31, 2003	June 30, 2004
Accrued liabilities payroll	\$ 16,884	\$ 19,590
Accrued liabilities general	12,106	15,834
Futures contracts	9,359	
Reserve for repurchases	5,445	5,468
Reserve for premium recapture	2,470	2,484
Accounts payable trade	385	485
Capital leases	12	
Total	\$ 46,661	\$ 43,861

11. STOCKHOLDERS EQUITY

A summary of the changes in options outstanding under the Company's Stock Option Plans for the six months ended June 30, 2004 follows:

	Number of Options	Weighted Average Exercise Price
Balance, January 1, 2004	1,699,619	\$ 5.80
Options granted	310,200	37.45
Options exercised	(248,055)	2.28
Options cancelled	(145,338)	20.65
Balance, June 30, 2004	1,616,426	\$ 11.08

2002 Employee Stock Purchase Plan The Company's 2002 Employee Stock Purchase Plan (the "2002 ESPP") was adopted effective as of the closing of the Offering by the board of directors and approved by the stockholders in 2002. A total of 1,500,000 shares of common stock are currently authorized and reserved for issuance under the plan, which provides that the plan be cumulatively increased each January 1 through January 1, 2013 according to the formula specified by the 2002 ESPP. Employees, including officers and employee directors, are eligible to participate in the 2002 ESPP if they are employed for more than 20 hours per week and more than five months in any calendar year. The 2002 ESPP permits participants to purchase common stock through payroll deductions of up to 15% of the participant's compensation. Such amounts are applied to the purchase of shares of the Company's common stock at a price of 85% of the fair market value of the common stock as defined in the 2002 ESPP. On June 30, 2004, the Company issued 87,876 shares to employees with proceeds of \$2.1 million.

Deferred Compensation Plan The Company's Deferred Compensation Plan (the "Plan") was adopted by the board of directors and approved by the stockholders in 2002. The Plan was effective as of January 1, 2003. A

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

total of 2,000,000 shares of the Company's common stock is authorized and reserved for issuance under the Plan. The Plan is an unfunded, nonqualified deferred compensation plan that benefits directors, certain designated key members of management and highly compensated employees. Under the Plan, an employee may defer up to 100% of his or her base salary, director fee, bonus and/or commissions on a pre-tax basis. The Company may make both voluntary and/or matching contributions to the Plan on behalf of Plan participants and may make voluntary and/or matching contributions in the form of common stock. All Plan assets are corporate assets rather than individual property and are therefore subject to creditors' claims against the Company. As of June 30, 2004, employees had voluntarily contributed \$1.1 million to the Plan. In January 2004 and April 2004, the Company awarded 158,538 and 48,756 shares net of forfeitures, respectively, of restricted common stock under the Plan that vest 50% two years from the date of grant and 25% each year thereafter until fully vested. In March 2004, the Company granted 9,876 shares of restricted common stock under the Plan to its independent, outside directors and an additional 1,498 shares of restricted common stock to a member of its advisory board of directors, which vest in full two years from the date of grant.

12. EARNINGS PER SHARE (IN THOUSANDS, EXCEPT PER SHARE INFORMATION):

Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common stockholders by the weighted average number of shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted to common stock or resulted in the issuance of common stock that would then share in the earnings of the entity.

	Three Months Ended June 30, 2003		
	Net Income (numerator)	Shares (denominator)	Per Share Amount
Basic EPS	\$ 25,782	19,270	\$ 1.34
Effect of dilutive shares			
Stock options		1,365	
Restricted stock		13	
Diluted EPS	\$ 25,782	20,648	\$ 1.25

	Three Months Ended June 30, 2004		
	Net Income (numerator)	Shares (denominator)	Per Share Amount
Basic EPS	\$ 34,294	20,269	\$ 1.69

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Effect of dilutive shares			
Stock options		1,035	
Restricted stock		98	
	<u> </u>	<u> </u>	<u> </u>
Diluted EPS	\$ 34,294	21,402	\$ 1.60
	<u> </u>	<u> </u>	<u> </u>

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	Six Months Ended June 30, 2003		
	Net Income (numerator)	Shares (denominator)	Per Share Amount
Basic EPS	\$ 40,592	15,876	\$ 2.56
Plus effect of income of assumed conversions			
Interest on convertible debt, net of tax	16		
Effect of dilutive shares			
Warrants *		105	
Stock options		1,249	
Restricted stock		2	
Convertible preferred stock *		1,278	
Convertible debt *		524	
Diluted EPS	\$ 40,608	19,034	\$ 2.13

* Represents the dilutive effect of the shares outstanding prior to the initial public offering at February 14, 2003.

	Six Months Ended June 30, 2004		
	Net Income (numerator)	Shares (denominator)	Per Share Amount
Basic EPS	\$ 56,800	20,194	\$ 2.81
Effect of dilutive shares			
Stock options		1,126	
Restricted stock		139	
Diluted EPS	\$ 56,800	21,459	\$ 2.65

13. COMMITMENTS AND CONTINGENCIES

Leases The Company leases office space for its headquarters in San Diego, California, for various branch offices, executive suites, and record storage facilities across the country, and for certain equipment under operating leases expiring at various dates through 2013.

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At June 30, 2004, the minimum future lease payments under non-cancelable operating leases were as follows (dollars in thousands):

Six Months Ending:	
2004	\$ 4,530
Years ending:	
2005	9,416
2006	7,919
2007	6,214
2008	4,539
2009	2,422
Thereafter	1,744
	<hr/>
Total	\$ 36,784
	<hr/>

Other The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its borrowers. These financial instruments primarily represent

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

commitments to fund loans. These instruments involve, to varying degrees, elements of interest rate risk and credit risk in excess of the amount recognized in the statement of financial position. The credit risk is mitigated by the Company's evaluation of the creditworthiness of potential mortgage loan borrowers on a case-by-case basis. The Company does not guarantee interest rates to potential borrowers when an application is received. Interest rates conditionally approved following the initial underwriting of applications are subject to adjustment if any conditions are not satisfied. The Company commits to originate loans, in many cases dependent on the borrower's satisfying various terms and conditions. These commitments totaled \$177.3 million and \$333.5 million as of December 31, 2003 and June 30, 2004, respectively.

Commitments to sell loans generally have fixed expiration dates or other termination clauses and may require payment of a commitment or a non-delivery fee. The Company periodically enters into other loan sale commitments. Loan sale commitments totaled \$447.2 million and \$1.2 billion at December 31, 2003 and June 30, 2004, respectively.

In connection with various regulatory lending requirements, the Company is required to maintain certain minimum levels of net worth. The Company was in compliance with these requirements at June 30, 2004.

From time to time, the Company enters into certain types of contracts that contingently require the Company to indemnify parties against third party claims and other obligations customarily indemnified in the ordinary course of the Company's business. The terms of such obligations vary and, generally, a maximum obligation is not explicitly stated. Therefore, the overall maximum amount of the obligations cannot be reasonably estimated. Historically, the Company has not been obligated to make significant payments for these obligations and no liabilities have been recorded for these obligations on its balance sheet as of June 30, 2004.

Legal Because the nature of the Company's business involves the collection of numerous accounts, the validity of liens and compliance with various state and federal lending laws, it is subject to various legal proceedings in the ordinary course of business related to foreclosures, bankruptcies, condemnation and quiet title actions, and alleged statutory and regulatory violations. The Company is also subject to legal proceedings in the ordinary course of business related to employee matters. Except as specifically set forth below, the Company does not believe that the resolution of these lawsuits in the ordinary course of business will have a material adverse effect on its financial position or results of operations.

In December 2002, the Company was served with a complaint and motion for class certification in a class action lawsuit, *Wratchford et al. v. Accredited Home Lenders, Inc.*, brought in Madison County, Illinois under the Illinois Consumer Fraud and Deceptive Business Practices Act and the consumer protection statutes of the other states in which Accredited does business. In early January, Accredited removed the case to the United States District Court for the Southern District of Illinois. The complaint alleges that Accredited has a practice of misrepresenting and inflating the amount of fees Accredited pays to third parties in connection with the residential mortgage loans Accredited funds. Plaintiffs claim to represent a nationwide class consisting of all other persons similarly situated, that is, all persons who paid money to Accredited to pay, or reimburse Accredited's payment of, third-party fees in connection with residential mortgage loans and never received a refund for the difference between what they paid and what was actually paid to the third party. Plaintiffs are seeking to recover damages on behalf of themselves and the class, in addition to pre-judgment interest, post-judgment interest, and any other relief the court deems just and proper. Accredited filed an answer to the complaint on January 17, 2003, but a date for hearing the motion for class certification has not yet been established and there has been no ruling on the merits of either the plaintiffs' individual claims or the claims of the class. At the present time, the ultimate outcome of this

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matter and the amount of liability, if any, that may result is not determinable, and no amounts have been accrued in Accredited's financial statements with respect to this matter. Accredited intends to vigorously defend this matter and does not believe it will have a material adverse effect on Accredited's business.

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In January 2004, the Company was served with a complaint, *Yturalde v. Accredited Home Lenders, Inc.*, brought in Sacramento County, California. The complaint alleges that Accredited violated California and federal law by misclassifying the plaintiff, formerly a commissioned loan officer for Accredited, as an exempt employee and failing to pay the plaintiff on an hourly basis and for overtime worked. The plaintiff seeks to recover, on behalf of himself and all of the Company's other similarly situated current and former employees, lost wages and benefits, general damages, multiple statutory penalties and interest, attorneys' fees and costs of suit, and also seeks to enjoin further violations of wage and overtime laws and retaliation against employees who complain about such violations. Under California law, a private individual who is not a current or former employee of an employer may bring an action to enforce certain provisions of California law against that employer. Such a complaint regarding this matter has been filed and served upon Accredited. In addition, Accredited has been served with ten substantially similar complaints on behalf of other former and current employees of Accredited, which ten actions have been consolidated with the *Yturalde* action. Accredited has filed or will file motions to compel arbitration of all of the matters, but no hearing has been had on any such motion to date. Accredited does not believe these matters will have a material adverse effect on its business, but, at the present time, the ultimate outcome of the litigation and the total amount of liability is not determinable. Accordingly, Accredited has not accrued any amounts in its financial statements with respect to the litigation. However, Accredited is pursuing settlements directly with current and former employees covered by the allegations of the complaints and, to date, Accredited has effected settlements with many of these current and former employees. Accordingly, Accredited has accrued amounts that are estimable in its financial statements for this group of current and former employees.

In June 2004, Accredited was served with a class action complaint, *Aslam v. Accredited Home Lenders, Inc., et al.*, brought in Cook County, Illinois. The complaint alleges that the purchase money, first priority mortgage loan Accredited made to the plaintiff violated Illinois law because the loan, which had an interest rate in excess of 8%, included a prepayment charge and because Accredited charged certain fees for the loan, which fees allegedly exceeded 3% of the original loan amount. The plaintiff seeks to recover, on behalf of himself and all other individuals to which Accredited made loans with the same alleged violations, the damages allowed by statute, interest, costs and attorneys' fees. The damages allowed by statute include actual economic damage and an amount equal to twice the total of all interest, discount and charges determined by the loan contract or paid by the obligor, whichever is greater. To the extent the plaintiff's loan included any provisions or fees which might otherwise violate Illinois law, Accredited included those provisions or fees in plaintiff's loan on the basis that federal law preempted Illinois law with respect to plaintiff's loan. Accredited's position in this regard was consistent with prior case law and previously announced positions of the Illinois Attorney General and the Illinois Office of Banks and Real Estate. However, in *U.S. Bank, National Association, et al., v. Clark, et al.*, consolidated cases that involve alleged violations of Illinois law similar to those alleged against us, an Illinois appellate court recently held that federal preemption was not available for the non-purchase money, first priority mortgage loans involved in those cases. The *Clark* decision has been appealed. There is a significant risk that if the *Clark* decision is not reviewed or reversed on appeal, the plaintiffs might argue that the rationale by which the *Clark* court reached its decision undermines Accredited's ability to rely on federal preemption with respect to the loan it made to the plaintiff and any other Illinois resident. Accredited intends to vigorously defend this matter. If, however, the plaintiff recovers all or substantially all of the relief he seeks, the potential liability could materially and adversely affect Accredited. A co-defendant in the *Aslam* suit has removed the case to federal court, and Accredited has joined with that co-defendant in a motion to compel arbitration of the matter, but there has not yet been a hearing on that motion. At the present time, the ultimate outcome of the matter and the amount of liability, if any, that may result is not determinable, and Accredited has not accrued any amounts in its financial statements with respect to this matter.

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. SUPPLEMENTAL CONDENSED CONSOLIDATED FINANCIAL INFORMATION

During the second quarter of 2004, Accredited Mortgage Loan REIT Trust (REIT) was formed as a Maryland real estate investment trust for the purpose of acquiring, holding and managing real estate assets. All of the outstanding common shares of beneficial interest of REIT are held by AHL, a wholly-owned subsidiary of AHLHC. AHLHC is the guarantor of REIT's payment obligations under the REIT's Series A Cumulative Preferred Shares issued in August 2004 (see Note 15). Such guarantee is full, unconditional and joint and several. The following supplemental financial information sets forth, on an unconsolidated basis, balance sheet, statement of income, and statement of cash flow information for AHLHC and its subsidiaries. The supplemental financial information reflects the investments of AHLHC in the subsidiaries using the equity method of accounting. The supplemental financial information is presented as of December 31, 2003 and June 30, 2004, and for the three and six months ended June 30, 2003 and June 30, 2004.

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SUPPLEMENTAL SCHEDULE CONSOLIDATING BALANCE SHEET**

AS OF DECEMBER 31, 2003

(unaudited)

(dollars in thousands)

	Accredited Home Lenders Holding Co.	Accredited Home Lenders, Inc.	Eliminations	Consolidated
ASSETS				
Cash and cash equivalents	\$ 741	\$ 26,378	\$	\$ 27,119
Restricted cash	87	122		209
Mortgage loans held for sale, net of market reserve of \$12,213		1,277,075		1,277,075
Mortgage loans held for investment, net of allowance for loan losses of \$19,890		2,090,237		2,090,237
Mortgage-related securities, at fair value		3,692		3,692
Mortgage servicing rights, net		1,119		1,119
Furniture, fixtures and equipment, net		20,674		20,674
Accounts receivable intercompany	44,968	(44,968)		
Other receivables	2	44,909		44,911
Investment in subsidiary	166,425		(166,425)	
Deferred income tax asset		16,052		16,052
Prepaid expenses and other assets		20,329		20,329
TOTAL	\$ 212,223	\$ 3,455,619	\$ (166,425)	\$ 3,501,417
LIABILITIES AND STOCKHOLDERS EQUITY				
LIABILITIES:				
Warehouse facilities	\$	\$ 1,515,195	\$	\$ 1,515,195
Securitization bond financing		1,724,389		1,724,389
Income taxes payable		2,949		2,949
Accounts payable and accrued liabilities		46,661		46,661
Total liabilities		3,289,194		3,289,194
STOCKHOLDERS EQUITY:				
Net contributed capital	54,732	8,934	(8,934)	54,732
Retained earnings	157,491	157,491	(157,491)	157,491
Total stockholders equity	212,223	166,425	(166,425)	212,223

TOTAL	\$ 212,223	\$ 3,455,619	\$ (166,425)	\$ 3,501,417
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Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SUPPLEMENTAL SCHEDULE CONSOLIDATING BALANCE SHEET****AS OF JUNE 30, 2004****(unaudited)****(dollars in thousands)**

	Accredited Home Lenders Holding Co.	Accredited Home Lenders, Inc.	Accredited Mortgage Loan REIT Trust	Eliminations	Consolidated
ASSETS					
Cash and cash equivalents	\$ 870	\$ 31,841	\$ 803	\$	\$ 33,514
Restricted cash	121	4,362			4,483
Mortgage loans held for sale, net of market reserve of \$13,698		1,968,641			1,968,641
Mortgage loans held for investment, net of allowance for loan losses of \$24,422 and \$15,658, respectively		2,150,351	1,109,581		3,259,932
Mortgage-related securities, at fair value		3,865			3,865
Mortgage servicing rights, net		542			542
Furniture, fixtures and equipment, net		30,401			30,401
Accounts receivable intercompany	51,569	(52,899)	1,330		
Other receivables	11	39,149	5,979		45,139
Investment in subsidiary	223,358	39,678		(263,036)	
Deferred income tax asset		42,872			42,872
Prepaid expenses and other assets		23,343	4,756		28,099
TOTAL	\$ 275,929	\$ 4,282,146	\$ 1,122,449	\$ (263,036)	\$ 5,417,488
LIABILITIES AND STOCKHOLDERS EQUITY					
LIABILITIES:					
Warehouse facilities	\$	\$ 2,501,605	\$	\$	\$ 2,501,605
Securitization bond financing		1,481,913	1,081,476		2,563,389
Income taxes payable		32,704			32,704
Accounts payable and accrued liabilities		42,566	1,295		43,861
Total liabilities		4,058,788	1,082,771		5,141,559
STOCKHOLDERS EQUITY:					
Net contributed capital	61,638	9,066	37,137	(45,703)	61,638
Retained earnings	214,291	214,292	2,541	(216,833)	214,291
Total stockholders equity	275,929	223,358	39,678	(263,036)	275,929

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TOTAL	<u>\$ 275,929</u>	<u>\$ 4,282,146</u>	<u>\$ 1,122,449</u>	<u>\$ (263,036)</u>	<u>\$ 5,417,488</u>
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Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SUPPLEMENTAL SCHEDULE CONSOLIDATING STATEMENTS OF OPERATIONS****FOR THE THREE MONTHS ENDED JUNE 30, 2003****(unaudited)****(dollars in thousands)**

	Accredited Home Lenders Holding Co.	Accredited Home Lenders, Inc.	Eliminations	Consolidated
REVENUES:				
Interest income	\$	\$ 40,317	\$	\$ 40,317
Gain on sale of loans		62,909		62,909
Loan servicing income		1,928		1,928
Net gain on mortgage-related securities and derivatives		2,989		2,989
Other income (expense)		94		94
Equity in net earnings of subsidiary	25,782		(25,782)	
Total revenues	25,782	108,237	(25,782)	108,237
EXPENSES:				
Salaries, wages and benefits		26,921		26,921
Interest expense		14,845		14,845
Occupancy		2,597		2,597
Provision for losses		9,871		9,871
Depreciation and amortization		966		966
General and administrative expenses		10,068		10,068
Total expenses		65,268		65,268
INCOME BEFORE INCOME TAXES	25,782	42,969	(25,782)	42,969
INCOME TAXES		17,187		17,187
NET INCOME	\$ 25,782	\$ 25,782	\$ (25,782)	\$ 25,782

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(dollars in thousands)	Accredited Home Lenders Holding Co.	Accredited Home Lenders, Inc.	Accredited Mortgage Loan REIT Trust	Eliminations	Consolidated
REVENUES:					
Interest income	\$	\$ 78,737	\$ 5,936	\$	\$ 84,673
Gain on sale of loans		77,619			77,619
Loan servicing income		1,645	1		1,646
Net gain (loss) on mortgage-related securities and derivatives		(68)			(68)
Other income (expense)		272		(344)	(72)
Equity in net earnings of subsidiary	34,294	2,541		(36,835)	
Total revenues	34,294	160,746	5,937	(37,179)	163,798
EXPENSES:					
Salaries, wages and benefits		39,707			39,707
Interest expense		26,251	1,842		28,093
Occupancy		4,678			4,678
Provision for losses		16,633	1,210		17,843
Depreciation and amortization		2,249			2,249
General and administrative expenses		14,071	344	(344)	14,071
Total expenses		103,589	3,396	(344)	106,641
INCOME BEFORE INCOME TAXES	34,294	57,157	2,541	(36,835)	57,157
INCOME TAXES		22,863			22,863
NET INCOME	\$ 34,294	\$ 34,294	\$ 2,541	\$ (36,835)	\$ 34,294

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SUPPLEMENTAL SCHEDULE CONSOLIDATING STATEMENTS OF OPERATIONS****FOR THE SIX MONTHS ENDED JUNE 30, 2003****(unaudited)****(dollars in thousands)**

	Accredited Home Lenders Holding Co.	Accredited Home Lenders, Inc.	Eliminations	Consolidated
REVENUES:				
Interest income	\$	\$ 72,614	\$	\$ 72,614
Gain on sale of loans		106,080		106,080
Loan servicing income		3,810		3,810
Net gain on mortgage-related securities and derivatives		4,388		4,388
Other income(expense)		485		485
Equity in net earnings of subsidiary	40,592		(40,592)	
Total revenues	40,592	187,377	(40,592)	187,377
EXPENSES:				
Salaries, wages and benefits		50,823		50,823
Interest expense		27,012		27,012
Occupancy		4,999		4,999
Provision for losses		16,379		16,379
Depreciation and amortization		2,083		2,083
General and administrative expenses		18,429		18,429
Total expenses		119,725		119,725
INCOME BEFORE INCOME TAXES	40,592	67,652	(40,592)	67,652
INCOME TAXES		27,060		27,060
NET INCOME	\$ 40,592	\$ 40,592	\$ (40,592)	\$ 40,592

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(dollars in thousands)	Accredited Home Lenders Holding Co.	Accredited Home Lenders, Inc.	Accredited Mortgage Loan REIT Trust	Eliminations	Consolidated
REVENUES:					
Interest income	\$	\$ 139,363	\$ 5,936	\$	\$ 145,299
Gain on sale of loans		132,349			132,349
Loan servicing income		3,208	1		3,209
Net gain on mortgage-related securities and derivatives		1,774			1,774
Other income (expense)		474		(344)	130
Equity in net earnings of subsidiary	56,800	2,541		(59,341)	
Total revenues	56,800	279,709	5,937	(59,685)	282,761
EXPENSES:					
Salaries, wages and benefits		75,101			75,101
Interest expense		47,181	1,842		49,023
Occupancy		8,531			8,531
Provision for losses		24,082	1,210		25,292
Depreciation and amortization		4,023			4,023
General and administrative expenses		26,124	344	(344)	26,124
Total expenses		185,042	3,396	(344)	188,094
INCOME BEFORE INCOME TAXES	56,800	94,667	2,541	(59,341)	94,667
INCOME TAXES		37,867			37,867
NET INCOME	\$ 56,800	\$ 56,800	\$ 2,541	\$ (59,341)	\$ 56,800

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SUPPLEMENTAL SCHEDULE CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS****FOR THE SIX MONTHS ENDED JUNE 30, 2003****(unaudited)****(dollars in thousands)**

	Accredited Home Lenders Holding Co.	Accredited Home Lenders, Inc.	Eliminations	Consolidated
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net income	\$ 40,592	\$ 40,592	\$ (40,592)	\$ 40,592
Adjustments to reconcile net income to net cash used in operating activities:				
Depreciation and amortization		2,083		2,083
Amortization of unearned compensation	55	116		171
Loss on disposal of furniture, fixtures, and equipment		88		88
Mortgage loans held for sale originated, net of fees		(2,992,052)		(2,992,052)
Proceeds from sale of mortgage loans held for sale, net of fees		2,643,669		2,643,669
Collection of principal payments on mortgage loans held for sale		13,948		13,948
Net change in fair value hedge basis adjustment on mortgage loans held for sale and securitized loans		(4,825)		(4,825)
Amortization of net deferred origination fees on securitized loans		(274)		(274)
Cash received on mortgage-related securities		7,655		7,655
Net unrealized gain on mortgage-related securities		(5,113)		(5,113)
Accretion of mortgage-related securities		(521)		(521)
Amortization of mortgage servicing rights		1,111		1,111
Provision for losses		16,379		16,379
Deferred income taxes		(19,814)		(19,814)
Income tax deduction for disqualifying stock dispositions				
Equity in (gain)/loss of consolidated subsidiary	(40,592)		40,592	
Net change in assets and liabilities	(39,925)	54,214		14,289
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net cash used in operating activities	(39,870)	(242,744)		(282,614)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
CASH FLOWS FROM INVESTING ACTIVITIES:				
Capital expenditures		(7,263)		(7,263)
Mortgage loans held for investment originated		(398,048)		(398,048)
Principal payments on securitized loans		52,931		52,931
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net cash provided by investing activities		(352,380)		(352,380)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
CASH FLOWS FROM FINANCING ACTIVITIES:				
Net proceeds from warehouse credit facilities		376,413		376,413
Payments of borrowings on residual interest credit facility		(6,858)		(6,858)
Proceeds from issuance of securitization bond financing		303,049		303,049

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Payments of securitization bond financing		(68,916)		(68,916)
Change in restricted cash	(16)	(104)		(120)
Payments on capital leases		(182)		(182)
Proceeds from exercise of stock options	281	6		287
Proceeds from issuance of stock under ESPP	1,873			1,873
Net proceeds from initial public offering and concurrent private placement	38,294			38,294
	<u>40,432</u>	<u>603,408</u>		<u>643,840</u>
Net cash provided by financing activities	40,432	603,408		643,840
NET INCREASE IN CASH AND CASH EQUIVALENTS	562	8,284		8,846
BEGINNING BALANCE, CASH AND CASH EQUIVALENTS		11,300		11,300
ENDING BALANCE, CASH AND CASH EQUIVALENTS	\$ 562	\$ 19,584	\$	\$ 20,146

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

Cash paid during the period for:

Interest	\$ 22,532	\$ 22,532
Income taxes	\$ 29,749	\$ 29,749

SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:

Transfer of loans held for sale to loans held for investment	\$ 397,682	\$ 397,682
Transfer of loans held for sale to real estate owned, included in other assets	\$ 4,923	\$ 4,923
Transfer of mortgage related securities from other liabilities		
Unearned compensation	\$ 241	\$ 241
Deferred compensation		
Conversion of convertible debt to common stock	\$ 3,000	\$ 3,000
Conversion of preferred stock to common stock	\$ 5,113	\$ 5,113
Conversion of warrants to common stock	\$ 1	\$ 1

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SUPPLEMENTAL SCHEDULE CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS****FOR THE SIX MONTHS ENDED JUNE 30, 2004****(unaudited)**

(dollars in thousands)	Accredited Home Lenders Holding Co.	Accredited Home Lenders, Inc.	Accredited Mortgage Loan REIT Trust	Eliminations	Consolidated
CASH FLOWS FROM OPERATING ACTIVITIES:					
Net income	\$ 56,800	\$ 56,800	\$ 2,541	\$ (59,341)	\$ 56,800
Adjustments to reconcile net income to net cash used in operating activities:					
Depreciation and amortization		4,023			4,023
Amortization of unearned compensation	1,413	133			1,546
Loss on disposal of furniture, fixtures, and equipment		35			35
Mortgage loans held for sale originated, net of fees		(3,887,519)			(3,887,519)
Proceeds from sale of mortgage loans held for sale, net of fees		3,489,966			3,489,966
Collection of principal payments on mortgage loans held for sale		31,553			31,553
Net change in fair value hedge basis adjustment on mortgage loans held for sale and securitized loans		23,348			23,348
Amortization of net deferred origination fees on securitized loans		(550)	(15)		(565)
Cash received on mortgage-related securities		2,232			2,232
Net unrealized gain on mortgage-related securities		(1,629)			(1,629)
Accretion of mortgage-related securities		(233)			(233)
Amortization of mortgage servicing rights		577			577
Provision for losses		24,082	1,210		25,292
Deferred income taxes		(26,820)			(26,820)
Income tax deduction for disqualifying stock dispositions	2,694				2,694
Equity in (gain)/loss of consolidated subsidiary	(56,800)	(2,541)		59,341	
Net change in assets and liabilities	(6,610)	35,668	(10,770)		18,288
Net cash used in operating activities	(2,503)	(250,875)	(7,034)		(260,412)
CASH FLOWS FROM INVESTING ACTIVITIES:					
Capital expenditures		(13,785)			(13,785)
Mortgage loans held for investment originated		(1,869,454)			(1,869,454)
Principal payments on securitized loans		321,650	4,606		326,256
Capital contributions		677,011	(677,011)		
Net cash provided by investing activities		(884,578)	(672,405)		(1,556,983)
CASH FLOWS FROM FINANCING ACTIVITIES:					
Net proceeds from warehouse credit facilities		986,410			986,410
Proceeds from issuance of securitization bond financing		505,000	684,920		1,189,920

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Payments of securitization bond financing		(346,242)	(4,678)	(350,920)
Change in restricted cash	(34)	(4,240)		(4,274)
Payments on capital leases		(12)		(12)
Proceeds from exercise of stock options	563			563
Proceeds from issuance of stock under ESPP	2,103			2,103
Net cash provided by financing activities	2,632	1,140,916	680,242	1,823,790
NET INCREASE IN CASH AND CASH EQUIVALENTS	129	5,463	803	6,395
BEGINNING BALANCE, CASH AND CASH EQUIVALENTS	741	26,378		27,119
ENDING BALANCE, CASH AND CASH EQUIVALENTS	\$ 870	\$ 31,841	\$ 803	\$ 33,514

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

Cash paid during the period for:

Interest	\$ 41,730	\$ 484	\$ 42,214
Income taxes	\$ 32,208		\$ 32,208

SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:

Transfer of loans held for sale to loans held for investment	\$ 1,533,903	\$ 1,533,903
Transfer of loans held for sale to real estate owned, included in other assets	\$ 3,478	\$ 3,478
Transfer of mortgage related securities from other liabilities	\$ 543	\$ 543
Unearned compensation	\$ (84)	\$ (84)
Deferred compensation	\$ 7,209	\$ 7,209
Conversion of convertible debt to common stock		
Conversion of preferred stock to common stock		
Conversion of warrants to common stock		

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

15. SUBSEQUENT EVENT

On August 12, 2004, Accredited Home Lenders Holding Co. and its indirect subsidiary, Accredited Mortgage Loan REIT Trust, closed the public offering of 3,400,000 shares of Accredited Mortgage Loan REIT Trust's 9.75% Series A Perpetual Cumulative Preferred Shares. The offering resulted in gross proceeds of \$85 million. The underwriters have been granted a 30-day option to purchase up to 510,000 additional shares of Series A Perpetual Cumulative Preferred Shares solely to cover over-allotments, if any. Payments in respect of the Series A Perpetual Cumulative Preferred Shares will be guaranteed, on a subordinated basis, by Accredited Home Lenders Holdings Co. The Preferred Shares will be classified as Minority interest-preferred securities of subsidiary trust on the Company's consolidated balance sheet.

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

The following discussion should be reviewed in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this report. In addition to historical information, the following discussion and other parts of this document contain forward-looking information that involves risks and uncertainties. Please refer to the section entitled "Forward-Looking Statements" on page 1 of this Form 10-Q. Our actual results could differ materially from those anticipated by such forward-looking information due to factors discussed later in this section and elsewhere in this report.

General

We are a nationwide mortgage banking company that originates, finances, securitizes, sells and services non-prime mortgage loans secured by residential real estate. We focus on borrowers who may not meet conforming underwriting guidelines because of higher loan-to-value ratios, the nature or absence of income documentation, limited credit histories, high levels of consumer debt, or past credit difficulties. We originate our loans primarily through independent mortgage brokers across the United States and, to a lesser extent, through our direct sales force in our retail offices. We primarily sell our loans in whole loan sales and, to a lesser extent, we securitize our loans.

Revenue Model

Our operations generate revenues in three ways:

Interest income. We have two primary components to our interest income. We generate interest income over the life of the loan on the loans we have securitized in structures that require financing treatment. This interest is partially offset by the interest we pay on the bonds that we issue to fund these loans. We also generate interest income on loans held for sale and for securitization from the time we originate the loan until the time we sell or securitize the loan. This interest income is partially offset by our borrowing costs under our warehouse facilities used to finance these loans.

Gain on sale of loans. We generate gain on sale of loans by selling the loans we originate for a premium.

Loan servicing income. Our loan servicing income represents all contractual and ancillary servicing revenue for loans we service for others, net of subservicing costs, some of our own servicing costs and amortization of mortgage servicing rights. Subservicing costs are the amounts we pay to others to service loans on our behalf.

Our revenues also include net gain (loss) on mortgage-related securities and derivatives, which reflect changes in the value of these instruments based on market conditions.

Critical Accounting Policies

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The preparation of our financial statements requires us to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although we base our estimates and assumptions on historical experience and on various other factors that we believe to be reasonable under the circumstances, our management exercises significant judgment in the final determination of our estimates. Actual results may differ from these estimates.

Pursuant to our critical accounting policies the following reflect significant judgments by management:

Fair value of mortgage-related securities;

Mortgage servicing rights valuation;

Provision for losses; and

Interest rate risk, derivatives and hedging strategies.

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Fair Value of Mortgage-Related Securities

Our gain on sale of loans consists primarily of cash gain that results from whole loan sales and, in the past has also consisted of, to a lesser extent, non-cash gain that resulted from the fair value of our mortgage-related securities. We also record subsequent changes to the fair value of our mortgage-related securities in our income statement and to the asset on our balance sheet. In each case, the determination of fair value requires significant judgments by our management.

Our sales may be either on a servicing retained or released basis. If we retain the right to service the loans that we have sold, we may also record non-cash gain on sale related to the value of those servicing rights. See our further discussion below and under the heading **Mortgage Servicing Rights Valuations**.

Typically, our gain on sale recorded for whole loan sales has been cash gain. In a transaction structured as a loan sale with retained interests, the majority of the gain on sale we have recorded is non-cash gain based on the fair value of the mortgage-related securities retained in the transaction. We have not structured a transaction as a loan sale with retained interests since January 2002. Typically, the gain on sale we have recorded on securitizations structured as a sale has also been the non-cash gain based on the fair values of the mortgage-related securities we retain. We have not recorded non-cash gain from a securitization structured as a sale since the first quarter of 2000.

Gains or losses resulting from our loan sales are recorded at the time of sale. Upon sale, we allocate the book value of the loans sold among the value of the loans and any mortgage-related securities and mortgage servicing rights we retain in the transaction. The gain on sale that we record is primarily based on the difference between (i) the sum of the cash received plus the value of any mortgage-related securities and mortgage servicing rights generated by the transaction, and (ii) the book value that we had allocated to the loans sold. At the closing of a loan sale with retained interests or a securitization structured as a sale, we remove the mortgage loans held for sale and related warehouse debt from our consolidated balance sheet and add to our consolidated balance sheet the net cash received, the estimated fair value of the mortgage-related securities generated by the transaction, and the allocated book value of any mortgage servicing rights generated by the transaction.

Gain on sale revenue is recorded at the time we sell loans or securitize loans in transactions structured as a sale, but not when we securitize loans in a transaction structured as a financing. Accordingly, our financial results are significantly impacted by the timing of our loan sales and the securitization structure we may elect to implement. If we hold a significant pool of loans at the end of a reporting period, those loans will remain on our balance sheet, along with the related debt used to fund the loans. The revenue that we generate from those loans will not be recorded until the subsequent reporting period when we sell the loans. If we elect to complete a securitization structured as a financing rather than a transaction that would generate gain on sale revenue, our gain on sale revenue will be lower and our interest income will be higher than it would have been otherwise. Since we have completed seven securitizations structured as financings since the third quarter of 2002, we do expect differences in our results of operations as compared to historical results. A number of factors influence the timing of our loan sales, our targeted disposition strategy and the whole loan sale premiums we receive, including the current market demand for our loans, the quality of the loans we originate, the sufficiency of our loan documentation, liquidity needs, and our strategic objectives. Our management has from time to time delayed the sale of loans to a later period, and may do so again in the future.

Accounting for Mortgage-Related Securities

We measure our mortgage-related securities like debt securities classified as trading securities under Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. When we enter into a loan sale transaction that generates a mortgage-related security, we record the fair value of that security as an asset on our balance sheet. Thereafter, we measure the fair

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value of the mortgage-related securities at each reporting date. Any change in fair value since the end of the prior period is recorded in our results of operations as an unrealized gain or loss. The carrying value of mortgage-related securities on our balance sheet is also increased or decreased accordingly.

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How We Determine Fair Value of Mortgage-Related Securities

We are not aware of any active market for the sale of our mortgage-related securities. Accordingly, our estimate of fair value is subjective. We determine the fair value by discounting the estimated net future cash flows using assumptions that market participants would use, including assumptions about interest rates, credit losses, and prepayment speeds. The net future cash flows expected to be received include the interest paid by the borrowers on the loans and prepayment penalties, less amounts paid to other parties with interests in the loans, estimated credit losses, servicing fees, as well as mortgage insurance fees, guarantee fees, and trustee fees for securitizations. Our receipt of such cash flows may be delayed to the extent that the loan sale agreement does not require cash flows to be paid to us until they reach certain levels specified in such agreement.

Our estimate of the fair value of our mortgage-related securities could decrease if our actual cash flows from our mortgage-related securities are different than originally estimated, or if economic factors or market analyses cause us to change the assumptions we use to value mortgage-related securities. In particular, if we increase the loss or discount rate that we apply or if we have a significant increase in our prepayment rates, the fair value of our mortgage-related securities would decrease. Any decrease in the fair value would adversely affect our results of operations and the assets we carry on our balance sheet.

Securitizations Structured as Financings

While we currently generate the majority of our earnings and cash flows from whole loan sales, we intend to increase the percentage of our earnings and cash flows received from securitizations and other transactions in which we retain an interest in the mortgage loans that we have sold. These transactions will continue to be legally structured as sales, but for accounting purposes may be structured as a financing under SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* a replacement of FASB Statement No. 125. This portfolio-based accounting more closely matches the recognition of income with the actual receipt of cash payments. Also, such securitization structures are consistent with our strategy to predominantly generate cash-based earnings rather than non-cash gain on sale revenue. We completed seven securitizations structured as financings since the third quarter of 2002.

Mortgage Servicing Rights Valuations

We recognize as a separate asset the rights to service mortgage loans for others once such rights are contractually separated from the underlying loans. We amortize mortgage servicing rights in proportion to and over the period of the estimated net servicing income and we record these rights at the lower of amortized cost or fair value. We determine the fair value of mortgage servicing rights based upon the present value of estimated net future cash flows related to contractually specified servicing fees, which may include the rights to prepayment penalties.

Key assumptions we use to value mortgage servicing rights include prepayment speeds and discount rates. Actual prepayments generally differ from our initial estimates. If actual prepayment rates are different than we originally estimated, we may receive more or less mortgage servicing income, which could increase or decrease the value of our mortgage servicing rights. We periodically evaluate our mortgage servicing rights for impairment, which is measured as the excess of carrying value over fair value. In the event of impairment, the adjustment is recognized in the consolidated statements of operations.

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When we structure securitizations as financings, we do not record any mortgage servicing rights, and since January 2002, we have not disposed of loans in a manner which requires the mortgage servicing rights to be recognized as a separate asset.

Provisions for Losses

We have provided market valuation adjustments on certain nonperforming loans, other loans we hold for sale and real estate owned. These adjustments are based upon our estimate of expected losses, calculated using

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loss severity and loss frequency rate assumptions, and are based upon the value that we could reasonably expect to obtain from a sale, other than in a forced or liquidation sale. An allowance for losses on mortgage loans held for investment is recorded in an amount sufficient to maintain appropriate coverage for probable losses on such loans. The provision for losses also includes net losses on real estate owned. We also accrue for liabilities associated with loans sold, which we may be requested to repurchase due to breaches of representations and warranties and early payment defaults. We periodically evaluate the estimates used in calculating expected losses, and adjustments are reported in earnings. As these estimates are influenced by factors outside of our control and as uncertainty is inherent in these estimates, it is reasonably possible that they could change.

Our estimate of expected losses could increase if our actual loss experience or repurchase activity is different than originally estimated, or if economic factors change the value we could reasonably expect to obtain from a sale. In particular, if actual losses increase or if values reasonably expected to be obtained from a sale decrease, the provision for losses would increase. Any increase in the provision for losses would adversely affect our results of operations.

Interest Rate Risk, Derivatives and Hedging

We regularly originate, securitize and sell fixed and variable rate loans. We face three primary types of interest rate risk: during the period from approval of a loan application through loan funding; on our loans held for sale from the time of funding to the date of sale; and on the loans underlying our mortgage-related securities and on our securitized loans subject to portfolio-based accounting.

Interest rate risk exists during the period from approval of a loan application through loan funding and from the time of funding to the date of sale because the premium earned on the sale of these loans is partially contingent upon the then-current market rate of interest for loans as compared to the contractual interest rate of the loans. Our use of derivatives is intended to mitigate the volatility of earnings associated with fluctuations in the gain on sale of loans due to changes in the current market rate of interest.

The interest rate risk on the loans underlying our mortgage-related securities and on our securitized loans subject to portfolio-based accounting exists because some of these loans have fixed interest rates for a period of two or three years while the rate passed through to the investors in the mortgage-related securities and the holders of the securitization bonds is based upon an adjustable rate. We also have interest rate risk when the loans become adjustable after their two or three year fixed rate period. This is due to the loan rates resetting every six months, subject to various caps and floors, versus the monthly reset on the rate passed through to the investors in the mortgage-related securities and holders of the securitization bonds. Our use of derivatives is intended to mitigate the volatility of earnings associated with fluctuations in the unrealized gain (loss) on the mortgage-related securities and changes in the cash flows of our securitized loans subject to portfolio-based accounting due to changes in LIBOR rates.

As part of our interest rate management process, we use derivative financial instruments such as options and Eurodollar futures. In connection with three of the securitizations structured as financings, we have entered into interest rate cap agreements. We do not use derivatives to speculate on interest rates. In accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted, derivative financial instruments are reported on the consolidated balance sheets at their fair value.

During 2002, we began using hedge accounting as defined by SFAS No. 133 for certain derivative financial instruments used to hedge our mortgage loans held for sale and for investment to reduce the volatility in revenues due to fluctuations in interest rates. We designate certain derivative financial instruments as hedge instruments under SFAS No. 133, and at trade date, these instruments and their hedging relationship are identified, designated and documented. For derivative financial instruments designated as hedge instruments, we evaluate the effectiveness

of these hedges against the mortgage loans being hedged to ensure there remains a highly effective

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correlation in the hedge relationship. To hedge the effect of interest rate changes on the fair value of mortgage loans held for sale and for investment, we are using derivatives as fair value hedges under SFAS No. 133. Once the hedge relationship is established, the realized and unrealized changes in fair value of both the hedge instrument and mortgage loans are recognized in the period in which the changes occur. Any change in the fair value of mortgage loans held for sale recognized as a result of hedge accounting is reversed at the time we sell the mortgage loans. This results in a correspondingly higher or lower gain on sale revenue at such time. Any change in the fair value of loans held for investment is amortized over the fixed rate period of the loan on a level yield basis. This results in a corresponding adjustment to interest income. The net amount recorded in the consolidated statements of operations is referred to as hedge ineffectiveness. For derivative financial instruments not designated as hedge instruments for purposes of SFAS No. 133, realized and unrealized changes in fair value are recognized in the period in which the changes occur or when such instruments are settled.

Results Of Operations

Six Months Ended June 30, 2003 Compared to Six Months Ended June 30, 2004

Executive Summary

Net income was \$56.8 million, or \$2.65 per diluted share, an increase of 40% from the prior year.

This was driven by a 70% growth in origination volume, to \$5.7 billion, and a 95% growth in our serviced loans to \$5.5 billion.

Growth was achieved by increasing offices by 13 locations, and penetrating new and existing markets through 534 new employees.

Whole loan sales of \$3.5 billion resulted in gains recorded of \$132.3 million, representing an average premium of 4.0%, versus 4.1% in 2003.

Origination costs net of points and fees improved from 2.2% in the six months ended June 30, 2003 to 2.0% in the comparable period in 2004.

Portfolio income (interest income less interest expense and provision for losses) of \$71.0 million, compared to \$29.2 million in the second quarter of 2003, an increase of 147%. As a percentage of total revenue less interest expense and provision for losses, portfolio income increased from 20% in the six months of 2003, to 34% in 2004.

Credit quality as measured by lower delinquency and loss level percentages improved over the prior year.

Revenues

Total Revenues. Total revenues increased 50.9% from \$187.4 million for the six months ended June 30, 2003 to \$282.8 million for the comparable period in 2004. This increase was due to increases in interest income of \$72.7 million and gain on sale of loans of \$26.3 million.

Interest Income. Interest income represents the interest earned on our mortgage loans held for sale and for securitization during the period prior to their sale or securitization, interest earned on securitized loans subject to portfolio-based accounting, prepayment penalty income from the on balance sheet portfolio, the realized and unrealized gain (loss) on derivatives purchased to manage our interest rate risk associated with securitized loans, net of the related fair value basis adjustments recorded due to the use of hedge accounting and, to a lesser extent, interest accreted on our mortgage-related securities. We do not accrue interest for mortgage loans that are 90 days or more delinquent. Interest income increased 100.1% from \$72.6 million for the six months ended June 30, 2003 to \$145.3 million for the comparable period in 2004. The increase in interest income was due to an increase in the average inventory of mortgage loans from \$1.9 billion during the six months ended June 30, 2003 to \$3.9 billion for the comparable period in 2004. Our average inventory of mortgage loans increased as we increased loan production volume, completed seven securitizations of \$3.2 billion of mortgage loans since June of 2002 that are accounted for as financings and intentionally extended the holding period, which was partially offset by a decrease in weighted average interest rate on the inventory of mortgage loans. Interest income of \$30.5 million

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and \$76.7 million was recognized on the securitized loans for the six months ended June 30, 2003 and June 30, 2004, respectively. In the future, to the extent we continue to complete these types of securitizations, our gain on sale revenue will be lower and our interest income will be higher than it would have been otherwise.

	Six Months Ended June 30,			
	2003		2004	
	Amount	Rate	Amount	Rate
	(dollars in thousands)			
Interest income	\$ 72,614	7.67%	\$ 145,299	7.38%
Interest expense	27,012	2.85%	49,023	2.49%
Net interest income	\$ 45,602	4.82%	\$ 96,276	4.89%
Average mortgage loans outstanding	\$ 1,894,247		\$ 3,936,347	

Gain on Sale of Loans. Total gain on sale of loans increased 24.8% from \$106.1 million for the six months ended June 30, 2003 to \$132.3 million for the comparable period in 2004.

The components of the gain on sale of loans are illustrated in the following table:

	Six Months Ended June 30,	
	2003	2004
	(dollars in thousands)	
Gain on whole loan sales	\$ 117,185	\$ 139,110
Provision for premium recapture	(1,305)	(1,553)
Net gain (loss) on derivatives	(10,288)	432
Net origination points and fees	16,320	15,893
Direct loan origination expenses	(15,832)	(21,533)
Gain on sale of loans	\$ 106,080	\$ 132,349

Gain on whole loan sales increased 18.7% from \$117.2 million for the six months ended June 30, 2003 to \$139.1 million for the comparable period in 2004 due to higher sales volume in 2004. Total whole loan sales increased 31.9% from \$2.6 billion for the six months ended June 30, 2003 to \$3.5 billion for the comparable period in 2004. This increase was due to an increase in loan originations of 70.0% from \$3.4 billion for the six months ended June 30, 2003 to \$5.7 billion in the comparable period of 2004, partially offset by \$1.2 billion which were securitized during the six months ended June 30, 2004. The average whole loan sales premium, net of gains (losses) on related derivatives, was 4.05% for

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the six months ended June 30, 2003 and 4.01% for the comparable period in 2004. Our top ten loan purchasers during the six months ended June 30, 2004, were as follows in descending order: Household Mortgage Services, Morgan Stanley Mortgage Capital Inc., Residential Funding Corporation, UBS Paine Weber, Wintergroup, DLJ Mortgage Capital, Inc. (Credit Suisse First Boston), Chase Manhattan, Lehman Brothers Bank, FSB, Bank of America, N.A., and Merrill Lynch.

The components of our net profit margin on whole loan sales are illustrated in the following table:

	Six Months	
	Ended June 30,	
	2003	2004
Gain on whole loan sales (1)(2)	4.44%	4.00%
Net gain (loss) on derivatives (2)	(0.39%)	0.01%
	4.05%	4.01%
Net origination points and fees	0.59%	0.43%
Loan origination expenses	(2.76%)	(2.38%)
	(2.17%)	(1.95%)
Net cost to originate (3)	(2.17%)	(1.95%)
	1.88%	2.06%
Net profit margin on whole loan sales		

(1) Excludes the provision for premium recapture.

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- (2) The percentages hereon are calculated based upon the respective amounts presented in the table above divided by our total whole loan sales of \$2.6 billion and \$3.5 billion for the six months ended June 30, 2003 and 2004, respectively.
- (3) Net cost to originate loans is defined as total operating expenses (total expenses less interest expense and provision for losses), less allocated loan servicing related costs, plus yield spread premiums, less points and fees collected, all prior to any deferrals of origination costs for accounting purposes. This total is divided by total originations of \$3.4 billion and \$5.7 billion for the six months ended June 30, 2003 and 2004, respectively.

Provision for premium recapture represents our estimate of the potential refunds of premium received on loan sales during the period based upon our historical experience. Provision for premium recapture increased 19.0% from \$1.3 million for the six months ended June 30, 2003 to \$1.6 million for the comparable period in 2004. This increase results from the increase in whole loan sales of 31.9% from \$2.6 billion for the six months ended June 30, 2003 to \$3.5 billion for the comparable period in 2004 slightly offset by the recovery of \$178,000 of prior year reserves no longer needed.

Net gain (loss) on derivatives represents the realized and unrealized gain (loss) on the derivatives purchased to manage our interest rate risk associated with our mortgage loans held for sale from the time of funding commitment to sale commitment, net of the related fair value basis adjustments recorded due to the use of hedge accounting. We enter into these transactions to offset fluctuations in interest rates that affect our premiums earned on the sale of these loans. The net gain (loss) on derivatives increased from a \$10.3 million loss for the six months ended June 30, 2003 to a \$432,000 gain for the comparable period in 2004. This increase results from an increase in LIBOR rates, as well as an increase in derivative volume during the six months ended June 30, 2004 as compared to the comparable period in 2003.

Net origination points and fees represent the revenue earned from the origination of mortgage loans held for sale, net of broker rebates paid, which are deferred and recognized in the consolidated statement of operations when the related loans are sold. Net origination points and fees decreased from \$16.3 million for the six months ended June 30, 2003 to \$15.9 million for the comparable period in 2004. This decrease results from an increase in broker fees paid per loan for the six months ended June 30, 2004 as compared to the comparable period in 2003 offset by a 31.9% increase in whole loan sales.

Direct loan origination expenses represent the costs incurred to originate mortgage loans held for sale that are deferred and recognized in the consolidated statement of operations when the related loans are sold. Direct loan origination expenses increased from \$15.9 million for the six months ended June 30, 2003 to \$21.5 million for the comparable period in 2004. The increase results from the 31.9% increase in whole loan sales slightly offset by a decrease in our standard origination expense per loan for the six months ended June 30, 2004 as compared to the comparable period in 2003. The decrease in our standard origination expense per loan results from the increase in production and greater efficiency.

Loan Servicing Income. Loan servicing income represents all contractual and ancillary servicing revenue for loans we service for others, net of subservicing costs, certain of our own servicing costs and amortization of mortgage servicing rights. Subservicing costs are the amounts we pay to others to service loans on our behalf. Loan servicing income decreased 15.8% from \$3.8 million for the six months ended June 30, 2003 to \$3.2 million for the comparable period in 2004. This decrease results from the decrease in prepayment penalties on the off balance sheet portfolio collected due to a decrease in the portfolio balance during the six months ended June 30, 2004 as compared to the six months ended June 30, 2003.

Net Gain (Loss) on Mortgage-Related Securities and Derivatives. Net gain (loss) on mortgage-related securities and derivatives decreased 59.6% from \$4.4 million for the six months ended June 30, 2003 to \$1.8 million for the comparable period in 2004.

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Net gain on mortgage-related securities decreased 68.1% from \$5.1 million for the six months ended June 30, 2003 to \$1.6 million for the comparable period in 2004. This gain represents the increase in fair value of the residual income from these securities due to stronger cash flow received than anticipated, primarily from lower losses. The decrease in the current year is due primarily to increasing interest rates.

Net gain (loss) on derivatives represents the realized and unrealized gain (loss) on the derivatives purchased to manage the interest rate risk associated with our mortgage-related securities. The risk arises because the cash we receive from our mortgage-related securities is dependent on the difference between the interest rates on the underlying loans and the yield payable to the senior security holders, or payable to the purchaser of the loans in the case of a sale with retained interests. The majority of the loans underlying our mortgage-related securities have interest rates which are fixed for the first two or three years, while the yield payable to the senior interests or purchaser changes monthly based upon short-term LIBOR. Net gain (loss) on derivatives went from a net loss of \$725,000 for the six months ended June 30, 2003, to a net gain of \$145,000 for the comparable period in 2004 due to an increase in LIBOR rates and a lower mortgage related securities balance during the six months ended June 30, 2004 as compared to the comparable period in 2003.

Expenses

Total Expenses. Total expenses increased 57.1% from \$119.7 million for the six months ended June 30, 2003 to \$188.1 million for the comparable period in 2004. The increase was the result of higher salaries, wages, and benefits expense of \$24.3 million, an increase in interest expense of \$22.0 million, an increase in the provision for losses of \$8.9 million and increases in other variable operating expenses associated with growth in loans originated and serviced.

Salaries, Wages and Benefits. Salaries, wages and benefits increased 47.8% from \$50.8 million for the six months ended June 30, 2003 to \$75.1 million for the comparable period in 2004. The increase was due to growth in the number of employees, as well as higher commission and bonus expenses that are variable expenses dependent upon loan production volume and profits. The total number of employees increased by 32.2% from 1,659 at June 30, 2003 to 2,193 at June 30, 2004. The commission and bonus expense increased by 39.4% from \$28.8 million for the six months ended June 30, 2003 to \$40.2 million for the comparable period in 2004.

Interest Expense. Interest expense represents the interest incurred on all outstanding debt and securitization bond financing, as well as the amortization of bond issue costs on the securitization bond financing and other costs associated with accessing our credit facilities. Interest expense increased 81.5% from \$27.0 million for the six months ended June 30, 2003, to \$49.0 million for the comparable period in 2004. Our average outstanding borrowings, excluding securitization bond financing, increased from \$1.1 billion to \$1.8 billion consistent with the increase in the average inventory of loans held for sale; however our average borrowing rate, excluding securitization bond financing decreased from 2.6% for the six months ended June 30, 2003, to 2.3% for the comparable period in 2004. Our average securitization bond financing increased from \$802.3 million for the six months ended June 30, 2003 to \$2.2 billion for the comparable period in 2004; however our average borrowing rate on the securitization bond financing decreased from 2.8% for the six months ended June 30, 2003, to 2.5% for the comparable period in 2004. For the six months ended June 30, 2003 and June 30, 2004, interest expense of \$11.3 million and \$25.8 million, respectively, was recognized on the securitization bond financing. As we increase the number of loans we securitize in transactions structured as financings, our related bond debt will increase, which will result in an increase in our interest expense.

Occupancy. Occupancy expense increased 70.7% from \$5.0 million for the six months ended June 30, 2003 to \$8.5 million for the comparable period in 2004. The increase resulted from growth in the total number of office sites leased from 40 at June 30, 2003 to 53 at June 30, 2004 due to our penetration in new geographic markets, as well as an increase in square footage in some existing sites.

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Provision for Losses. Provision for losses increased 54.4% from \$16.4 million for the six months ended June 30, 2003 to \$25.3 million for the comparable period in 2004. The increases in our provisions for losses were

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as follows: allowances for losses loans held for investment of \$14.9 million, and reserve for real estate owned of \$126,000, offset by decreases in our market reserve on loans held for sale of \$4.1 million, our reserve for repurchases of \$1.4 million and in the net losses on real estate owned of \$633,000. The increase in our allowance for losses on loans held for investment results from the increase in our securitized loan balance from \$1.1 billion at June 30, 2003 to \$3.3 billion at June 30, 2004. The decrease in our market reserve on loans held for sale results from a decrease in delinquencies at June 30, 2004 compared to June 30, 2003 slightly offset by an increase in the loans held for sale balance. The decrease in our reserve for repurchases results from a refinement to our reserve methodology to better incorporate estimated losses on loans sold, based upon historical data, for which no repurchase request has yet been received.

Depreciation and Amortization. Depreciation and amortization increased 93.1% from \$2.1 million for the six months ended June 30, 2003 to \$4.0 million for the comparable period in 2004. The increase results from our investment in technology and infrastructure resulting from the increase in the number of employees and offices during the six months ended June 30, 2004 as compared to the comparable period in 2003.

General and Administrative. General and administrative expenses increased 41.8% from \$18.4 million for the six months ended June 30, 2003 to \$26.1 million for the comparable period in 2004. This increase resulted from an increase in loan origination volume, an increase in our servicing portfolio, an increase in our number of leased locations and an increase in the number of employees as compared to 2003. Loan originations increased 70.0% from \$3.4 billion for the six months ended June 30, 2003 to \$5.7 billion in the comparable period of 2004. Our servicing portfolio increased 95.3% from \$2.8 billion at June 30, 2003 to \$5.5 billion at June 30, 2004. Our leased locations increased 32.5% from 40 at June 30, 2003 to 53 at June 30, 2004. Additionally, the total number of employees increased by 32.2% from 1,659 at June 30, 2003 to 2,193 at June 30, 2004.

Income Taxes. Income taxes increased 39.9% from \$27.1 million for the six months ended June 30, 2003 to \$37.9 million for the comparable period in 2004. This increase was a result of a 39.9% increase in income before taxes from the six months ended June 30, 2003 to the comparable period in 2004. Our effective tax rate for the six months ended June 30, 2004 was 40.0%. The two major components of our effective tax rate are the federal corporate tax rate of 35.0% and the effective state income tax rates. We operate and pay tax in nearly every state. As our operations and profits have expanded in various states, it has created changes in our effective tax rate depending upon each particular state's tax structure and rate.

Three Months Ended June 30, 2003 Compared to Three Months Ended June 30, 2004

Executive Summary

Net income was \$34.3 million, or \$1.60 per diluted share, an increase of 33% from the prior year.

This was driven by a 75% growth in origination volume, to \$3.4 billion, and a 95% growth in our serviced loans to \$5.5 billion.

Growth was achieved by increasing offices by 13 locations, and penetrating new and existing markets through 534 new employees.

Whole loan sales of \$1.9 billion resulted in gains recorded of \$77.6 million, representing an average premium of 4.3%, versus 4.1% in 2003.

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Origination costs net of points and fees improved from 2.1% in the three months ended June 30, 2003 to 1.8% in the comparable period in 2004.

Portfolio income (interest income less interest expense and provision for losses) of \$38.7 million, compared to \$15.6 million in the second quarter of 2003, an increase of 148%. As a percentage of total revenue less interest expense and provision for losses, portfolio income increased from 19% in the second quarter of 2003, to 33% in 2004.

Credit quality as measured by lower delinquency and loss level percentages improved over the prior year.

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Total Revenues. Total revenues increased 51.3% from \$108.2 million for the three months ended June 30, 2003 to \$163.8 million for the comparable period in 2004. This increase was due to increases in interest income of \$44.4 million and gain on sale of loans of \$14.7 million.

Interest Income. Interest income represents the interest earned on our mortgage loans held for sale and for securitization during the period prior to their sale or securitization, interest earned on securitized loans subject to portfolio-based accounting, prepayment penalty income from the on balance sheet portfolio, the realized and unrealized gain (loss) on derivatives purchased to manage our interest rate risk associated with securitized loans, net of the related fair value basis adjustments recorded due to the use of hedge accounting and, to a lesser extent, interest accreted on our mortgage-related securities. We do not accrue interest for mortgage loans that are 90 days or more delinquent. Interest income increased 110% from \$40.3 million for the three months ended June 30, 2003 to \$84.7 million for the comparable period in 2004. The increase in interest income was due to an increase in the average inventory of mortgage loans from \$2.1 billion during the three months ended June 30, 2003 to \$4.6 billion for the comparable period in 2004. Our average inventory of mortgage loans increased as we increased loan production volume, completed seven securitizations of \$3.2 billion of mortgage loans since June of 2002 that are accounted for as financings and intentionally extended the holding period, which was partially offset by a decrease in weighted average interest rate on the inventory of mortgage loans. Interest income of \$17.0 million and \$41.4 million was recognized on the securitized loans for the six months ended June 30, 2003 and June 30, 2004, respectively. In the future, to the extent we continue to complete these types of securitizations, our gain on sale revenue will be lower and our interest income will be higher than it would have been otherwise.

	Three Months Ended			
	June 30,			
	2003		2004	
	Amount	Rate	Amount	Rate
	(dollars in thousands)			
Interest income	\$ 40,317	7.53%	\$ 84,673	7.37%
Interest expense	14,845	2.77%	28,093	2.44%
Net interest income	\$ 25,472	4.76%	\$ 56,580	4.93%
Average mortgage loans outstanding	\$ 2,141,146		\$ 4,592,523	

Gain on Sale of Loans. Total gain on sale of loans increased 23.4% from \$62.9 million for the three months ended June 30, 2003 to \$77.6 million for the comparable period in 2004.

The components of the gain on sale of loans are illustrated in the following table:

Three Months Ended
June 30,

	2003	2004
	(dollars in thousands)	
Gain on whole loan sales	\$ 73,300	\$ 75,843
Provision for premium recapture	(775)	(947)
Net gain (loss) on derivatives	(8,954)	5,820
Net origination points and fees	9,203	8,061
Direct loan origination expenses	(9,865)	(11,158)
Gain on sale of loans	\$ 62,909	\$ 77,619

Gain on whole loan sales increased 23.4% from \$62.9 million for the three months ended June 30, 2003 to \$77.6 million for the comparable period in 2004 due to higher sales volume in 2004. Total whole loan sales increased 21.5% from \$1.6 billion for the three months ended June 30, 2003 to \$1.9 billion for the comparable period in 2004. This increase was due to an increase in loan originations of 75.3% from \$1.9 billion for the three

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months ended June 30, 2003 to \$3.4 billion in the comparable period of 2004, partially offset by \$707.2 million which were securitized during the three months ended June 30, 2004. The average whole loan sales premium, net of gains (losses) on related derivatives, was 4.1% for the three months ended June 30, 2003 and 4.3% for the comparable period in 2004. These higher gains resulted primarily from better than anticipated whole loan premiums for the interest rate margin delivered at the time of sale, as well as expected hedge gains recognized on the loan sales. Our top ten loan purchasers during the three months ended June 30, 2004, were as follows in descending order: Morgan Stanley Mortgage Capital Inc., Household Mortgage Services, UBS Paine Weber, Residential Funding Corporation, Merrill Lynch, Wintergroup, Saxon, Equity One, Sovereign Bank, and US Bank.

The components of our net profit margin on whole loan sales are illustrated in the following table:

	Three Months Ended June 30,	
	2003	2004
Gain on whole loan sales (1)(2)	4.68%	4.00%
Net gain (loss) on derivatives (2)	(0.57%)	0.31%
Net gain on whole loan sales (1)(2)	4.11%	4.31%
Net origination points and fees	0.56%	0.42%
Loan origination expenses	(2.62%)	(2.17%)
Net cost to originate (3)	(2.06%)	(1.75%)
Net profit margin on whole loan sales	2.05%	2.56%

(1) Excludes the provision for premium recapture.