

ACCREDITED HOME LENDERS HOLDING CO  
Form 10-Q  
August 09, 2006  
Table of Contents

---

**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, 2006

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-32275

\_\_\_\_\_  
**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

Edgar Filing: ACCREDITED HOME LENDERS HOLDING CO - Form 10-Q

---

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (check one):

Large accelerated filer       Accelerated filer       Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (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 August 4, 2006 was 21,582,082.

---

**Table of Contents**

**TABLE OF CONTENTS**

	<b>Page</b>
<b>PART I</b>	
Item 1. <i>Financial Statements of Accredited Home Lenders Holding Co:</i>	
<u>Consolidated Balance Sheets as of June 30, 2006 and December 31, 2005</u>	4
<u>Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2006 and 2005</u>	5
<u>Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2006 and 2005</u>	6
<u>Notes to Unaudited Consolidated Financial Statements</u>	7
<i>Financial Statements of Accredited Mortgage Loan REIT Trust (the "REIT"):</i>	
<u>Balance Sheets as of June 30, 2006 and December 31, 2005</u>	30
<u>Statements of Operations for the Three and Six Months Ended June 30, 2006 and 2005</u>	31
<u>Statements of Cash Flows for the Six Months Ended June 30, 2006 and 2005</u>	32
<u>Notes to Unaudited Financial Statements</u>	33
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	43
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	70
Item 4. <u>Controls and Procedures</u>	70
<b>PART II</b>	
Item 1. <u>Legal Proceedings</u>	71
Item 1A. <u>Risk Factors</u>	71
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	71
Item 3. <u>Defaults Upon Senior Securities</u>	71
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	71
Item 5. <u>Other Information</u>	71
Item 6. <u>Exhibits</u>	71
<u>Signatures</u>	72
<u>Exhibit Index</u>	73
Certifications	

## **Table of Contents**

### **SERVICE MARKS AND TRADE NAMES**

Accredited Home Lenders<sup>®</sup>, Home Funds Direct<sup>®</sup>, Axiom Financial Services<sup>®</sup>, FRONTDOOR<sup>®</sup> and their related logos are registered service marks of Accredited Home Lenders, Inc. ( AHL ), a wholly-owned subsidiary of the registrant.

Inzura<sup>SM</sup> and Common Sense for Uncommon Loans are service trademarks of AHL, and Informed Broker is a trademark of AHL.

### **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. This report includes 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 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 and mix 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;

the degree and nature of our competition, including without limitation their impact on the rates that we are able to charge our borrowers;

a general deterioration in economic or political conditions, including without limitation any slow down in the national and/or local real estate markets;

our ability to realize cost savings, synergies and economies of scale from our acquisition of Aames Investment Corporation and our ability to improve profitability of the combined operations;

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

our ability to employ and retain qualified employees;

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;

our ability to adapt to and implement technological changes; and

## Edgar Filing: ACCREDITED HOME LENDERS HOLDING CO - Form 10-Q

the other factors referenced in this report, including, without limitation, under the sections 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.

**Table of Contents**

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

**PART I****ITEM 1. Financial Statements****ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands, except par value)

	June 30, 2006 (Unaudited)	December 31, 2005
<b>ASSETS</b>		
Cash and cash equivalents	\$ 63,842	\$ 44,714
Restricted cash	393,620	46,207
Accrued interest receivable	45,990	42,878
Mortgage loans held for sale, net	1,568,985	2,252,252
Mortgage loans held for investment, net of allowance of \$125,389 and \$106,017, respectively	7,640,643	7,195,872
Derivative assets, including margin account	107,748	89,409
Deferred income tax asset, net	77,335	68,024
Prepaid expenses and other assets	116,473	78,043
Furniture, fixtures and equipment, net	36,442	35,847
<b>Total assets</b>	<b>\$ 10,051,078</b>	<b>\$ 9,853,246</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>LIABILITIES:</b>		
Credit facilities	\$ 1,557,109	\$ 2,805,119
Securitization financing	7,643,466	6,240,820
Income taxes payable, current	15,495	82,479
Accounts payable and accrued liabilities	72,853	73,494
<b>Total liabilities</b>	<b>9,288,923</b>	<b>9,201,912</b>
<b>COMMITMENTS AND CONTINGENCIES (Note 13)</b>		
<b>MINORITY INTEREST IN REIT SUBSIDIARY</b>	<b>97,922</b>	<b>97,922</b>
<b>STOCKHOLDERS EQUITY:</b>		
Preferred stock, \$.001 par value; authorized 5,000,000 shares; no shares issued or outstanding		
Common stock, \$.001 par value; authorized 40,000,000 shares; issued and outstanding 21,560,694 shares and 21,312,367 shares, respectively	22	22
Additional paid-in capital	99,865	90,268
Accumulated other comprehensive income	43,572	19,421
Retained earnings	520,774	443,701
<b>Total stockholders equity</b>	<b>664,233</b>	<b>553,412</b>
<b>Total liabilities and stockholders equity</b>	<b>\$ 10,051,078</b>	<b>\$ 9,853,246</b>

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

**Table of Contents****ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share amounts) (Unaudited)**

	Three Months Ended June 30, 2006	2005	Six Months Ended June 30, 2006	2005
<b>REVENUES:</b>				
Interest income	\$ 205,050	\$ 141,154	\$ 399,507	\$ 266,047
Interest expense	(126,976)	(68,124)	(239,111)	(122,451)
Net interest income	78,074	73,030	160,396	143,596
Provision for losses on loans held for investment	(13,062)	(18,100)	(29,599)	(30,950)
Net interest income after provision	65,012	54,930	130,797	112,646
Gain on sale of loans, net	80,673	84,520	151,226	145,896
Loan servicing income	4,032	2,724	7,439	4,839
Other income	3,450	1,508	5,400	3,339
Total net revenues	153,167	143,682	294,862	266,720
<b>OPERATING EXPENSES:</b>				
Salaries, wages and benefits	49,274	49,696	96,800	92,123
General and administrative expenses	15,539	12,486	30,694	25,579
Occupancy	6,338	5,424	12,737	10,447
Advertising and promotion	5,306	3,985	10,459	8,092
Depreciation and amortization	4,693	3,526	9,120	6,930
Total operating expenses	81,150	75,117	159,810	143,171
Income before income taxes and minority interest	72,017	68,565	135,052	123,549
Income tax provision	28,272	26,499	52,990	47,701
Minority interest - dividends on preferred stock of REIT subsidiary	2,495	2,494	4,989	4,989
Net income	\$ 41,250	\$ 39,572	\$ 77,073	\$ 70,859
Earnings per common share:				
Basic	\$ 1.90	\$ 1.89	\$ 3.57	\$ 3.39
Diluted	\$ 1.84	\$ 1.81	\$ 3.45	\$ 3.24
Weighted average shares outstanding:				
Basic	21,676	20,982	21,615	20,917
Diluted	22,358	21,872	22,336	21,860

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

**Table of Contents****ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands) (Unaudited)**

	<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 77,073	\$ 70,859
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	9,120	6,930
Provision for losses on loans held for investment	29,599	30,950
Provision for losses on repurchases and premium recapture	7,143	4,467
Minority interest dividends paid on preferred stock of REIT subsidiary	4,989	4,989
Deferred income tax provision (benefit)	(22,479)	27,599
Unrealized (gains) losses on derivatives and hedged assets	25,959	(6,646)
Adjustment into earnings for gain on derivatives from other comprehensive income	(16,278)	(6,152)
Stock-based compensation expense	5,013	3,589
Excess tax benefit from stock-based payment arrangements	(3,341)	
Other	4,570	(1,360)
Changes in operating assets and liabilities:		
Restricted cash	5,285	(27,831)
Mortgage loans held for sale originated, net of fees	(7,634,129)	(7,374,054)
Cost of loans sold, net of fees	6,597,356	4,888,354
Principal payments received and other changes in loans held for sale	84,239	59,464
Accrued interest receivable	(3,052)	(7,485)
Derivative assets, including margin account	23,545	(18,122)
Prepaid expenses and other assets	(19,660)	16,939
Income taxes payable	(63,227)	(17,035)
Accounts payable and accrued liabilities	(7,823)	4,277
Net cash used in operating activities	(896,098)	(2,340,268)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Principal payments received on loans held for investment	1,134,685	808,122
Capital expenditures	(10,434)	(7,210)
Net cash provided by investing activities	1,124,251	800,912
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net changes in credit facilities	(1,252,990)	503,802
Proceeds from issuance of securitization financing, net of fees and cash withheld as collateral	2,197,532	1,895,674
Payments on securitization financing	(1,154,255)	(812,055)
Proceeds from issuance of common stock through employee stock plans	826	1,082
Excess tax benefit from stock-based payment arrangements	3,341	
Payment by REIT subsidiary of preferred stock dividends	(4,989)	(4,989)
Net cash (used in) provided by financing activities	(210,535)	1,583,514
Effect of exchange rate changes on cash	1,510	426
Net increase in cash and cash equivalents	19,128	44,584
Beginning balance, cash and cash equivalents	44,714	35,155

Edgar Filing: ACCREDITED HOME LENDERS HOLDING CO - Form 10-Q

Ending balance, cash and cash equivalents	\$ 63,842	\$ 79,739
---	-----------	-----------

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

---

**Table of Contents**

**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**For the Three and Six Months Ended June 30, 2006 and 2005**

**1. ORGANIZATION AND 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 subsidiaries Accredited Home Lenders, Inc. ( AHL ), Accredited Home Lenders Canada, Inc. ( AHLCA ) and Vendor Management Services, LLC d/b/a Inzura Settlement Services ( ISS ), AHL 's wholly owned subsidiaries Accredited Mortgage Loan REIT Trust herein reported separately (the REIT ), and Inzura Insurance Services ( IIS ), (collectively referred to as Accredited ).

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 three and six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. All intercompany balances and transactions are eliminated in consolidation. The unaudited consolidated financial statements presented herein should be read in conjunction with the audited consolidated financial statements and related notes thereto included in AHLHC 's Annual Report on Form 10-K for the year ended December 31, 2005.

Accredited engages in the business of originating, financing, securitizing, selling and servicing non-prime and to a lesser degree At-A mortgage loans secured by residential real estate located in the United States and Canada. Accredited 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. Accredited originates loans primarily based upon the borrower 's willingness and ability to repay the loan and the adequacy of the collateral.

Through its REIT subsidiary, Accredited securitizes non-prime mortgage loans originated by AHL. Generally, the REIT acquires mortgage assets and assumes funding obligations from AHL, which are accounted for at AHL 's carrying value, as contributions from AHL.

In March of 2006 Accredited entered the mortgage settlement services business under the trade name Inzura Settlement Services (Inzura). Inzura 's customers will primarily be borrowers closing loans originated or purchased by Accredited. Inzura is a wholly owned subsidiary of AHLHC and is based in Pittsburgh, PA.

AHL also provides operating facilities, administration and loan servicing for the REIT. The REIT is therefore economically and operationally dependent on AHL, and, as such, its results of operations or financial condition would not be indicative of the conditions that would have existed for its results of operations or financial condition if it had operated as an unaffiliated entity.

**Acquisitions**

On May 25, 2006 the Company entered into a definitive agreement to acquire Aames Investment Corporation ( Aames ) in a stock-and-cash transaction valued at approximately \$340 million, on that date, of which approximately \$109 million or 32% will be paid in cash to Aames stockholders. At the date of the merger agreement, the cash pool will be reduced by the aggregate amount of dividends declared or paid by Aames prior to the closing of the merger. Special meetings of Accredited and Aames stockholders will be held to approve the merger. It is anticipated that the closing of the transaction will be in the fourth quarter of 2006. Additional information regarding the terms of the merger, its pro forma impact on the financial statements and the risks related to the merger can be found in the registration statement filed on Form S-4 with the Securities and Exchange Commission on July 14, 2006.

On June 23, 2006 Accredited Home Lenders Inc. a wholly-owned subsidiary of Accredited purchased the assets of the wholesale operation of Aames for a cash price of \$4 million plus expenses of approximately \$50 thousand. The purchase price, which will be paid on August 31, 2006 is included in Accounts payable and accrued liabilities , was allocated to furniture and fixtures and leasehold assets in the amount of \$89,000 and goodwill in the amount of \$3,961,000. At June 30, 2006 the goodwill is included in Prepaid expenses and other assets .



**Table of Contents**

**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**For the Three and Six Months Ended June 30, 2006 and 2005**

**Use of Estimates**

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. The following areas require significant judgments by management:

lower of cost or market valuation allowance

provisions for losses and repurchase

interest rate risk, market valuation on derivatives and hedging strategies

stock-based compensation expense

income taxes

**Cash and Cash Equivalents**

For purposes of financial statement presentation, Accredited considers all liquid investments with an original maturity of three months or less to be cash equivalents. All liquid assets with an original maturity of three months or less which are not readily available for use, including cash deposits, are classified as restricted cash.

**Mortgage Banking Activities**

Accredited originates, finances, securitizes, services and sells mortgage loans secured by residential real estate. Accredited recognizes interest income on loans held for sale and investment from the time that it originates the loan until the time the loans are sold. Interest income is also recognized over the life of the loans that Accredited has securitized in structures that require financing treatment. Gains on sale of loans are recognized upon the sale of loans for a premium to various third-party investors under purchase and sale agreements. Loan servicing income represents fees from interim servicing for whole loan buyers, and ancillary servicing revenue for loans that Accredited securitizes net of external servicing costs, if any. Accredited does not recognize loan servicing income on its mortgage loans held for investment.

**Mortgage Loans Held for Sale**

Mortgage loans held for sale are carried at the lower of amortized cost or fair value. Accredited estimates fair value by evaluating a variety of market indicators including recent trades, outstanding commitments or current investor yield requirements.

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

## Edgar Filing: ACCREDITED HOME LENDERS HOLDING CO - Form 10-Q

control over the transferred assets through either (a) an agreement that entitles and obligates Accredited to repurchase or redeem them before their maturity or (b) the ability to unilaterally cause the holder to return specific assets.

Gains or losses resulting from loan sales are recognized at the time of sale, based on the difference between the net sales proceeds and the carrying value of the loans sold.

Certain whole loan sale contracts include provisions requiring Accredited to repurchase a loan if a borrower fails to make one or more of the first loan payments due on the loan. In addition, an investor may request that Accredited 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. Accredited records a provision for estimated repurchases and premium recapture on loans sold, which is charged to gain on sale of loans.

### **Loans Held for Investment, Securitization Financing and Provision for Losses**

Accredited's securitization program typically calls for the execution of one securitization transaction per calendar quarter. In support of this program, each month the Company identifies loans meeting the applicable investor characteristics and transfers those loans from Loans Held for Sale to Loans Held for Securitization (held for investment).

**Table of Contents**

**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**For the Three and Six Months Ended June 30, 2006 and 2005**

After the loans are designated as held for investment, the Company estimates the losses inherent in the portfolio at the balance sheet date and establishes an allowance for loan losses. The provision for loan losses on loans held for securitization is made in an amount sufficient to maintain credit loss allowances at a level considered appropriate to cover probable losses in the portfolio. Accredited defines a loan as non-accruing at the time the loan becomes 90 days or more delinquent under its payment terms. Probable losses are determined based on segmenting loans in the portfolio according to their contractual delinquency status and applying Accredited's historical loss experience. A number of other analytical tools are used to determine the reasonableness of the allowance for loan losses. Loss estimates are reviewed periodically and adjustments, if any, are reported in earnings. As these estimates are influenced by factors outside of Accredited's control, there is uncertainty inherent in these estimates, making it reasonably possible that they could change. Loans foreclosed upon or deemed uncollectible are carried at estimated net realizable value.

Each quarter, the Loans Held for Securitization, which are originated by and to this point have been held in AHL, are contributed at the lower of cost or market (carrying amount), to the REIT. The carrying amount transferred to the REIT consists of the unpaid principal balance, the net deferred origination fees, the basis adjustment for fair value hedge accounting (from funding to contribution date) and the allowance for loan losses and are thereafter designated as Loans Held for Investment. The loans remain in the Loans Held for Securitization for approximately 10 business days prior to the close of the securitization transaction.

Mortgage loans held for investment include loans that Accredited has securitized in structures that are accounted for as financings as well as mortgage loans held for a scheduled securitization. In June 2006 the Company closed a \$1.4 billion securitization. Collateral of \$1.1 billion in mortgage loans was delivered at closing and the balance of approximately \$350 million will be delivered in July and August. In connection with the transaction approximately \$350 million of proceeds from the sale of the bonds were withheld and deposited in an interest bearing account (pre-funding account) until the remaining collateral is delivered. In July 2006, \$173.3 million additional collateral in the form of mortgage loans was delivered. During the three-month period ended June 30, 2005 Accredited completed one securitization of mortgage loans totaling \$0.9 billion.

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 Accredited and, Accredited, 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 as loans held for investment, retained interests are not created, and securitization bond financing replaces the warehouse debt or asset backed commercial paper originally associated with the loans held for investment. Accredited records interest income on loans held for investment and interest expense on the bonds issued in the securitizations over the life of the securitizations. Deferred debt issuance costs and discounts related to the bonds are amortized on a level yield basis over the estimated life of the bonds.

**Derivative Financial Instruments**

As part of Accredited's interest rate management process, Accredited uses derivative financial instruments such as futures contracts, options contracts, interest rate swap and interest rate cap agreements. It is not Accredited'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.

*Fair Value Hedges*

Accredited 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. Accredited has implemented fair value hedge accounting on its mortgage loans held for sale, whereby certain derivatives are designated as a hedge of the fair value of mortgage loans held for sale. This process includes linking derivatives to specific assets or liabilities on the balance sheet. Accredited also assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives used in hedge transactions are highly effective in offsetting changes in fair values of hedged items.

## Edgar Filing: ACCREDITED HOME LENDERS HOLDING CO - Form 10-Q

Changes in the fair value of such derivative instruments and changes in the fair value of the hedged assets, which are determined to be effective, are recorded as a component of gain on sale in the period of change. When it is determined that a derivative is not highly effective as a hedge or that it has ceased to be a highly effective hedge, Accredited discontinues hedge accounting. If hedge accounting is discontinued because it is determined that the relationship between the derivative and the underlying

**Table of Contents**

**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**For the Three and Six Months Ended June 30, 2006 and 2005**

asset no longer qualifies as an effective hedge, the derivative will continue to be recorded on the balance sheet at its fair value. For terminated hedges or hedges no longer qualifying as effective, the formerly hedged asset will no longer be adjusted for changes in fair value and any previously recorded adjustment to the hedged asset will be included in the carrying basis. These amounts will be included in results of operations at the time we sell the loans. Should the hedge prove to be perfectly effective, the current period net impact to earnings would be minimal. Accordingly, the net amount recorded in the statement of operations relating to fair value hedge accounting is referred to as hedge ineffectiveness.

*Cash Flow Hedges*

Pursuant to SFAS No. 133 hedge instruments have been designated as hedging the exposure to variability of cash flows from our securitization debt attributable to interest rate risk. Cash flow hedge accounting requires that the effective portion of the gain or loss in the fair value of a derivative instrument designated as a hedge be reported as a component of other comprehensive income in stockholders' equity, and recognized into earnings in the period during which the hedged transaction affects earnings pursuant to SFAS No. 133. At the inception of the hedge and on an ongoing basis, Accredited assesses whether the derivatives used in hedging transactions are highly effective in offsetting changes in cash flows of the hedged items. When it is determined that a derivative is not highly effective as a hedge, Accredited discontinues cash flow hedge accounting prospectively. In the instance cash flow hedge accounting is discontinued, the derivative will continue to be recorded on the balance sheet at its fair value. Any change in the fair value of a derivative no longer qualifying as an effective hedge is recognized in current period earnings. For terminated hedges or hedges that no longer qualify as effective, the effective portion previously recorded remains in other comprehensive income and continues to be amortized or accreted into earnings with the hedged item. The ineffective portion on the derivative instrument is reported in current earnings as a component of interest expense.

For derivative financial instruments not designated as hedge instruments, unrealized changes in fair value are recognized in the period in which the changes occur and realized gains and losses are recognized in the period when such instruments are settled.

**Loan Origination Costs and Fees**

Loan origination fees and certain direct origination costs are deferred as an adjustment to the carrying value of the loans. These fees and costs are recognized upon sale of loans to third-party investors or amortized over the life of the loan on a level yield basis for loans held for investment.

**Interest Income**

Interest income is recorded when earned. Interest income represents the interest earned on mortgage loans held for sale and on mortgage loans held for investment. For loans that are 90 days or more delinquent, Accredited reverses income previously recognized but not collected, and ceases to accrue income until all past-due amounts are collected. Interest income also includes revenue related to our mortgage loans held for investment (on-balance sheet securitizations), contractually designated as servicing income but classified as interest income for accounting purposes. In addition, Accredited calculates an effective yield based on the carrying amount of our residual interest in off-balance sheet securitizations and Accredited's then-current estimates of future cash flows and recognizes accretion income, which is included as a component of interest income.

**Loan Servicing and Other Fees**

Fees for servicing sold loans are credited to income when received. Costs of servicing loans are expensed as incurred. Other loan fees, which represent income from the prepayment of loans, delinquent payment charges and miscellaneous loan services, are recorded as revenue when collected.

**Escrow and Fiduciary Funds**

## Edgar Filing: ACCREDITED HOME LENDERS HOLDING CO - Form 10-Q

Accredited maintains segregated bank accounts in trust for the benefit of investors for payments on securitized loans and mortgage loans serviced for investors. Accredited also maintains bank accounts for the benefit of borrowers' property tax and hazard insurance premium payments that are escrowed by borrowers. These bank accounts totaled \$165.7 million and \$139.4 million at June 30, 2006 and December 31, 2005, respectively, and are excluded from Accredited's assets and liabilities.

**Table of Contents****ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****For the Three and Six Months Ended June 30, 2006 and 2005****Income Taxes**

Deferred tax assets and liabilities are determined based on temporary differences between financial reporting and tax basis of assets and liabilities and are measured by applying enacted tax rates and laws to taxable years in which such temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

**Real Estate Owned**

Real estate acquired in settlement of loans generally results when property collateralizing a loan is foreclosed upon or otherwise acquired by Accredited in satisfaction of the loan. Real estate acquired through foreclosure is carried at lower of cost or its fair value less costs to dispose. Fair value is based on the net amount that Accredited could reasonably expect to receive for the asset in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Adjustments to the carrying value of real estate owned are made through valuation allowances and charge-offs which impact current earnings. Legal fees and other direct costs incurred after foreclosure are expensed as incurred. At June 30, 2006 and December 31, 2005, real estate owned amounting to \$39.8 million and \$16.1 million, net of valuation allowances, respectively, is included in prepaid expenses and other assets.

**Share-Based Payments**

Effective January 1, 2006, Accredited adopted Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2005), *Share-Based Payments (SFAS 123R)*, which establishes accounting standards for share-based payments issued in exchange for goods and services. SFAS 123R requires companies to measure the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. That cost is recognized over the period during which an employee is to provide service in exchange for the award.

Accredited adopted the provisions of SFAS 123R, using the modified prospective application method. Under this transition method, financial statements for prior periods are not restated and compensation cost is recognized for all new awards and for the portion of prior awards for which the requisite service period was not complete as of the adoption date. Compensation cost for awards issued prior to the effective date is based on the grant-date fair value as determined under the pro forma provisions of SFAS No. 123, *Accounting for Stock-Based Compensation (SFAS 123)*. In addition, under the modified prospective method, unearned compensation is not included in Stockholders' Equity for share-based compensation plans. Rather, the awards are included in Stockholders' Equity when services required are rendered and expensed. Further information regarding share-based compensation can be found in Note 11.

**Other Comprehensive Income**

Other comprehensive net income includes unrealized gains and losses that are excluded from the consolidated Statements of Operations and are reported as a separate component in stockholders' equity. The unrealized gains and losses include unrealized gains and losses on the effective portion of cash flow hedges and foreign currency translation adjustments.

Comprehensive income is determined as follows:

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>			
Net income	\$ 41,250	\$ 39,572	\$ 77,073	\$ 70,859

## Edgar Filing: ACCREDITED HOME LENDERS HOLDING CO - Form 10-Q

Net unrealized gains (losses) on cash flow hedges, net of taxes of \$9,570, \$(6,178), \$19,419 and \$3,397, respectively	17,082	(9,310)	32,827	5,067
Reclassification adjustment into earnings for realized gain on derivatives, net of taxes of \$3,510, \$1,533, \$6,251 and \$2,451, respectively	(5,705)	(2,322)	(10,048)	(3,701)
Foreign currency translation adjustments	1,217	277	1,372	270
<b>Total comprehensive income</b>	<b>\$ 53,844</b>	<b>\$ 28,217</b>	<b>\$ 101,224</b>	<b>\$ 72,495</b>

### Segment Reporting

Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance.

**Table of Contents****ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****For the Three and Six Months Ended June 30, 2006 and 2005**

These segments should engage in business activities and have discrete financial information available, such as revenue, expenses, and assets. While Accredited's management monitors originations and sales gains by wholesale and retail channels, it does not record any of the actual financial results other than direct expenses to these groups. Accordingly, Accredited operates in one reportable operating segment.

**Reclassifications**

Certain items in the prior period consolidated financial statements have been reclassified to conform to the current period presentation. These reclassifications had no effect on reported net income. Accredited changed the presentation of its consolidated statements of operations to report provision for losses on repurchases and provision for market reserve on loans held for sale, as reductions to gain on sale of loans for the year ended December 31, 2005. Previously these amounts were included in provision for losses. All interim periods for 2005 are being reclassified to conform to this presentation.

The cash flow statement was reclassified to agree to the presentation described above.

**Recently Issued Accounting Pronouncements**

In July 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN No. 48 ). Fin No. 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes ( FAS 109 ). FIN No. 48 clarifies FAS 109 and establishes criteria for the recognition of benefits for various tax positions. The effective date for applying FIN 48 will be January 1, 2007. The impact of FIN No. 48 on the Company's financial statements has not been fully analyzed.

**2. RESTRICTED CASH**

Restricted cash consisted of the following deposits:

	June 30, 2006	December 31, 2005
	(In thousands)	
Securitization pre-funding account	\$ 352,311	\$
Errors and omissions liability insurance	3,500	4,200
Canada financing collateral for loans securitized	13,710	8,157
Asset backed commercial paper reserve account	14,297	30,897
Cash in escrow on Canada loans pending closing	4,303	779
Other	5,499	2,174
<b>Total restricted cash</b>	<b>\$ 393,620</b>	<b>\$ 46,207</b>

**3. CONCENTRATIONS OF RISK****Significant Customers**

During the three months ended June 30, 2006, Accredited sold \$1.0 billion, \$0.8 billion, \$0.7 billion and \$0.5 billion in loans to four separate investors, which represented 26%, 22%, 19%, and 14%, respectively, of total loans sold. During the three months ended June 30, 2005, Accredited sold \$1.2 billion and \$0.7 billion in loans to two separate investors, which represented 42% and 25%, respectively, of total loans

## Edgar Filing: ACCREDITED HOME LENDERS HOLDING CO - Form 10-Q

sold. No other sales to individual investors accounted for more than 10% of total loans sold during the three months ended June 30, 2006 and 2005.

During the six months ended June 30, 2006, Accredited sold \$2.0 billion, \$1.0 billion, \$1.0 billion, \$1.0 billion, and \$0.7 billion in loans to five separate investors, which represented 29%, 14%, 14%, 14%, and 11%, respectively, of total loans sold. During the six months ended June 30, 2005, Accredited sold \$1.3 billion, \$1.2 billion and \$0.6 billion in loans to three separate investors, which represented 27%, 24% and 13%, respectively, of total loans sold. No other sales to individual investors accounted for more than 10% of total loans sold during the six months ended June 30, 2006 and 2005.

### ***Credit Repurchase Risk***

Accredited's sales of mortgage loans are subject to standard mortgage industry representations and warranties, material violations of which may require Accredited to repurchase one or more mortgage loans. Additionally, certain whole loan sale

**Table of Contents**

**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**For the Three and Six Months Ended June 30, 2006 and 2005**

contracts include provisions requiring Accredited to repurchase a loan if a borrower fails to make one or more of the first loan payments due on the loan. During the three months ended June 30, 2006 and 2005 loans repurchased totaled \$38.6 million and \$15.7 million, respectively, and during the six months ended June 30, 2006 and 2005 loans repurchased totaled \$53.1 million and \$32.3 million, respectively, pursuant to these provisions. At June 30, 2006 and December 31, 2005, the reserve for potential future repurchase losses totaled \$8.7 million and \$7.4 million, respectively.

***Loan Products***

Accredited offers a range of non-prime mortgage and to a lesser degree Alt-A loan programs, including a variety of loan programs for first and second mortgages and several niche programs for 100% combined loan to value ( LTV ) and second mortgages. The key distinguishing features of each program are the documentation required, the LTV, the mortgage and consumer credit payment history, the property type and the credit score necessary to qualify under a particular program. Nevertheless, each program relies upon an analysis of each borrower's ability to repay, the risk that the borrower will not repay, the fees and rates charged, the value of the collateral, the benefit provided to the borrower, and the loan amounts relative to the risk Accredited is taking.

In general, LTV maximums decrease with credit quality and within each credit classification. Additionally, LTV maximums vary depending on the property type. For example, LTV maximums for loans secured by owner-occupied properties are higher than for loans secured by properties that are not owner-occupied. LTV maximums for Lite Documentation and Stated Income Programs are generally lower than the LTV maximums for corresponding Full Documentation programs. Accredited's maximum debt service-to-income ratios range from 50% to 55% for Full Documentation Programs and from 45% to 55% for Lite Documentation and Stated Income Programs.

***Geographical Concentration***

Properties securing the mortgage loans in Accredited's servicing portfolio (loans held for sale, loans held for investment and off-balance sheet securitizations), including loans serviced for others, are geographically dispersed throughout the United States. At June 30, 2006, 18% and 11% of the unpaid principal balance of mortgage loans in Accredited's servicing portfolio were secured by properties located in California and Florida, respectively. At December 31, 2005, 20% and 10% of the unpaid principal balance of mortgage loans in Accredited's servicing portfolio was secured by properties located in California and Florida, respectively. The remaining properties securing mortgage loans serviced did not exceed 10% in any other state at June 30, 2006 and December 31, 2005.

Loan originations are geographically dispersed throughout the United States and, to a much lesser extent, in Canada. During the three months ended June 30, 2006, 15% and 12% of loans originated were collateralized by properties located in California and Florida, respectively. During the three months ended June 30, 2005, 21% and 11% of loans originated were collateralized by properties located in California and Florida, respectively. During the six months ended June 30, 2006, 15% and 12% of loans originated were collateralized by properties located in California and Florida, respectively. During the six months ended June 30, 2005, 21% and 11% of loans originated were collateralized by properties located in California and Florida, respectively. The remaining originations did not exceed 10% in any other state during these periods.

An overall decline in the economy or the residential real estate market, or the occurrence of a natural disaster that is not covered by standard homeowners' insurance policies, such as an earthquake, hurricane or wildfire, could decrease the value of mortgaged properties. This decline, in turn, would increase the risk of delinquency, default or foreclosure on mortgage loans in our portfolio and restrict our ability to originate, sell, or securitize mortgage loans, which would significantly harm our business, financial condition and liquidity.

**Table of Contents****ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****For the Three and Six Months Ended June 30, 2006 and 2005****4. MORTGAGE LOANS***Mortgage loans held for sale* Mortgage loans held for sale were as follows:

	June 30, 2006	December 31, 2005
	(In thousands)	
Mortgage loans held for sale principal balance	\$ 1,591,070	\$ 2,267,611
Basis adjustment for fair value hedge accounting	(2,318)	5,004
Net deferred origination fees	(3,983)	(2,584)
Market valuation allowance	(15,784)	(17,779)
<b>Mortgage loans held for sale, net</b>	<b>\$ 1,568,985</b>	<b>\$ 2,252,252</b>

*Mortgage loans held for investment* Mortgage loans held for investment were as follows:

	June 30, 2006	December 31, 2005
	(In thousands)	
Mortgage loans securitized principal balance	\$ 7,493,838	\$ 6,421,805
Mortgage loans held for securitization principal balance(1)	315,697	899,803
Basis adjustment for fair value hedge accounting	(12,977)	(4,766)
Net deferred origination fees	(30,526)	(14,953)
Allowance for loan losses	(125,389)	(106,017)
<b>Mortgage loans held for investment, net</b>	<b>\$ 7,640,643</b>	<b>\$ 7,195,872</b>

(1) Includes \$141.6 million and \$139.3 million of Canadian loans at June 30, 2006 and December 31, 2005, respectively.

*Allowance for losses on loans held for investment* Activity in the allowance was as follows:

	Balance at Beginning of Period	Provision for Losses	Chargeoffs, net	Balance at End of Period
	(In thousands)			
<b>Three Months Ended June 30, 2006:</b>				
Mortgage loans held for investment	\$ 115,704	\$ 10,109	\$ (424)	\$ 125,389

Edgar Filing: ACCREDITED HOME LENDERS HOLDING CO - Form 10-Q

Real estate owned	13,702	2,953	(3,871)	12,784
<b>Total</b>	<b>\$ 129,406</b>	<b>\$ 13,062</b>	<b>\$ (4,295)</b>	<b>\$ 138,173</b>

**2005:**

Mortgage loans held for investment	\$ 69,298	\$ 15,119	\$ (189)	\$ 84,228
Real estate owned	6,396	2,981	(2,367)	7,010

<b>Total</b>	<b>\$ 75,694</b>	<b>\$ 18,100</b>	<b>\$ (2,556)</b>	<b>\$ 91,238</b>
--------------	------------------	------------------	-------------------	------------------

*Six Months Ended June 30,:*

**2006:**

Mortgage loans held for investment	\$ 106,017	\$ 20,032	\$ (660)	\$ 125,389
Real estate owned	10,725	9,567	(7,508)	12,784

<b>Total</b>	<b>\$ 116,742</b>	<b>\$ 29,599</b>	<b>\$ (8,168)</b>	<b>\$ 138,173</b>
--------------	-------------------	------------------	-------------------	-------------------

**2005:**

Mortgage loans held for investment	\$ 60,138	\$ 24,282	\$ (192)	\$ 84,228
Real estate owned	4,405	6,668	(4,063)	7,010

<b>Total</b>	<b>\$ 64,543</b>	<b>\$ 30,950</b>	<b>\$ (4,255)</b>	<b>\$ 91,238</b>
--------------	------------------	------------------	-------------------	------------------

**Table of Contents****ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****For the Three and Six Months Ended June 30, 2006 and 2005**

The following table summarizes the delinquency amounts for the serviced portfolio, including mortgage loans and real estate owned before valuation allowance, but excluding loans serviced on an interim basis:

	At June 30, 2006		At December 31, 2005	
	Delinquent		Delinquent	
	Total	Principal	Total	Principal
	Principal	Over	Principal	Over
	Amount	90 Days	Amount	90 Days
	(In thousands)			
Mortgage loans held for sale(1)	\$ 1,591,070	\$ 58,768(3)	\$ 2,267,611	\$ 20,861(3)
Mortgage loans held for investment	7,809,535	96,643(3)	7,321,608	71,361(3)
Real estate owned	52,619	52,619	26,811	26,811
On balance sheet portfolio	9,453,224	208,030	9,616,030	119,033
Mortgage loans sold servicing retained(2)	73,511	8,381	90,181	10,228
Total serviced portfolio	\$ 9,526,735	\$ 216,411	\$ 9,706,211	\$ 129,261

(1) Includes loans repurchased.

(2) Includes real estate owned, off balance sheet.

(3) For loans 90 days or more delinquent we cease to accrue interest income and reverse all previously accrued but uncollected income.

**5. DERIVATIVE FINANCIAL INSTRUMENTS*****Fair Value Hedges***

Accredited uses hedge accounting in accordance with SFAS No. 133 for certain derivative financial instruments used to hedge its mortgage loans held for sale and mortgage loans held for investment. At June 30, 2006 and December 31, 2005 fair value hedge basis adjustments of (\$2.3 million) and \$5.0 million, respectively, are included in mortgage loans held for sale. Hedge ineffectiveness associated with these fair value hedges of (\$0.4 million) and \$0.6 million was recorded in earnings during the three months ended June 30, 2006 and 2005, respectively, and is included as adjustments to gain on sale of loans in the consolidated statements of operations. Hedge ineffectiveness associated with these fair value hedges of (\$0.9 million) and \$0.3 million was recorded in earnings during the six months ended June 30, 2006 and 2005, respectively, and is included as adjustments to gain on sale of loans in the consolidated statements of operations.

At June 30, 2006 and December 31, 2005, fair value hedge basis adjustments of (\$13.0 million) and (\$4.8 million), respectively, are included in loans held for investment.

***Cash Flow Hedges***

Accredited utilizes cash flow hedge accounting on the variable rate portion of its securitization debt in accordance with the provisions of SFAS No. 133. Effective unrealized gains, net of effective unrealized losses, associated with cash flow hedges of \$26.7 million and (\$15.5 million), reduced by related tax expense of \$9.6 million and (\$6.2 million), were recorded in other comprehensive income during the three months ended June 30, 2006 and 2005, respectively. Effective unrealized gains, net of effective unrealized losses, associated with cash flow hedges of \$52.2 million and \$8.5 million, reduced by related tax expense of \$19.4 million and \$3.4 million, were recorded in other comprehensive income during the six months ended June 30, 2006 and 2005, respectively. These contracts settle on various dates ranging from June 2006 to June 2015. A total of \$36.5 million in net effective gains before taxes, included in other comprehensive income at June 30, 2006, is expected to be recognized in earnings during the next twelve months. Hedge ineffectiveness associated with cash flow hedges of \$0.6 million and (\$0.6 million) was recorded in earnings during the three months ended June 30, 2006 and 2005, respectively, and are included as a component of interest expense in the consolidated statements of operations. Hedge ineffectiveness associated with cash flow hedges of \$1.1 million and \$0.5 million was recorded in earnings during the six months ended June 30, 2006 and 2005, respectively, and are included as a component of interest expense in the consolidated statements of operations.

***Futures Contracts, Options Contracts, Interest Rate Swap and Cap Agreements and Margin Accounts***