

ACCREDITED HOME LENDERS HOLDING CO

Form 10-Q

November 09, 2006

[Table of Contents](#)

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 10-Q**

---

(Mark One)

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

For the quarterly period ended September 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

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

(Address of principal executive offices) (Zip Code)

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

---

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 November 3, 2006 was 25,261,309.

---

**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 September 30, 2006 and December 31, 2005</u>	4
<u>Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2006 and 2005</u>	5
<u>Consolidated Statements of Cash Flows for the Nine months ended September 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 September 30, 2006 and December 31, 2005</u>	34
<u>Statements of Operations for the Three and Nine months ended September 30, 2006 and 2005</u>	35
<u>Statements of Cash Flows for the Nine months ended September 30, 2006 and 2005</u>	36
<u>Notes to Unaudited Financial Statements</u>	37
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	48
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	79
Item 4. <u>Controls and Procedures</u>	79
<b>PART II</b>	
Item 1. <u>Legal Proceedings</u>	80
Item 1A. <u>Risk Factors</u>	80
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	80
Item 3. <u>Defaults Upon Senior Securities</u>	80
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	80
Item 5. <u>Other Information</u>	81
Item 6. <u>Exhibits</u>	81
<u>Signatures</u>	82
<u>Exhibit Index</u>	83
<u>Certifications</u>	

## **Table of Contents**

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

Accredited Home Lenders®, Home Funds Direct®, Axiom Financial Services®, FRONTDOOR®, Inzura<sup>SM</sup>, Common Sense for Uncommon Loans, InformedBroker, LendingBridge<sup>SM</sup>, Accredited Home Lenders Canada® and their related logos are trademarks of Accredited Home Lenders, Inc. ( AHL ), a wholly-owned subsidiary of the registrant.

### **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, mix and performance of the loans we originate; the characteristics of our borrowers; and fluctuations in the real estate market, the 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 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 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 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) (Unaudited)**

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
<b>ASSETS</b>		
Cash and cash equivalents	\$ 201,359	\$ 44,714
Restricted cash	312,459	46,207
Accrued interest receivable	43,502	42,878
Mortgage loans held for sale, net	1,842,248	2,252,252
Mortgage loans held for investment, net of allowance of \$124,173 and \$106,017, respectively	7,230,511	7,195,872
Derivative assets, including margin account	68,953	89,409
Deferred income tax asset, net	98,566	68,024
Other assets	136,647	78,043
Furniture, fixtures and equipment, net	38,300	35,847
<b>Total assets</b>	<b>\$ 9,972,545</b>	<b>\$ 9,853,246</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>LIABILITIES:</b>		
Credit facilities	\$ 2,046,208	\$ 2,805,119
Securitization financing	7,050,283	6,240,820
Income taxes payable, current	15,239	82,479
Accounts payable and accrued liabilities	111,982	73,494
<b>Total liabilities</b>	<b>9,223,712</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 75,000,000 shares; issued and outstanding 21,592,459 shares and 21,312,367 shares, respectively	22	22
Additional paid-in capital	94,312	90,268
Accumulated other comprehensive income	8,252	19,421
Retained earnings	548,325	443,701
<b>Total stockholders' equity</b>	<b>650,911</b>	<b>553,412</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 9,972,545</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)**

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>REVENUES:</b>				
Interest income	\$ 207,343	\$ 164,147	\$ 606,850	\$ 430,194
Interest expense	(138,197)	(84,571)	(377,308)	(207,022)
Net interest income	69,146	79,576	229,542	223,172
Provision for losses on loans and real estate owned	(9,673)	(15,427)	(39,273)	(46,378)
Net interest income after provision	59,473	64,149	190,269	176,794
Gain on sale of loans, net	47,288	81,904	198,514	227,799
Loan servicing income	3,642	3,243	11,081	8,082
Other income	3,906	2,460	9,305	5,800
Total net revenues	114,309	151,756	409,170	418,475
<b>OPERATING EXPENSES:</b>				
Salaries, wages and benefits	54,571	48,378	151,371	140,501
General and administrative expenses	16,285	15,441	46,978	41,019
Occupancy	6,655	5,247	19,392	15,694
Advertising and promotion	5,635	5,388	16,094	13,480
Depreciation and amortization	4,989	3,999	14,110	10,929
Total operating expenses	88,135	78,453	247,945	221,623
Income before income taxes and minority interest	26,174	73,303	161,225	196,852
Income tax provision	5,246	29,517	58,236	77,217
Minority interest dividends on preferred stock of REIT subsidiary	2,495	2,495	7,484	7,484
Net income	\$ 18,433	\$ 41,291	\$ 95,506	\$ 112,151
<b>Earnings per common share:</b>				
Basic	\$ 0.85	\$ 1.95	\$ 4.41	\$ 5.34
Diluted	\$ 0.83	\$ 1.87	\$ 4.28	\$ 5.11
<b>Weighted average shares outstanding:</b>				
Basic	21,739	21,217	21,656	21,017
Diluted	22,292	22,059	22,327	21,932

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>Nine months ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 95,506	\$ 112,151
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	14,110	10,929
Provision for losses on loans	39,273	46,378
Provision for losses on repurchases and premium recapture	21,617	6,902
Minority interest dividends paid on preferred stock of REIT subsidiary	7,484	7,484
Deferred income tax provision (benefit)	(23,418)	29,042
Unrealized losses on derivatives and hedged assets	26,934	7,032
Adjustment into earnings for gain on derivatives from other comprehensive income	(27,101)	(10,029)
Stock-based compensation expense	8,300	4,634
Excess tax benefit from stock-based payment arrangements	(3,600)	
Other	3,666	(2,291)
Changes in operating assets and liabilities:		
Restricted cash	(266,251)	(134,696)
Mortgage loans originated, net of fees	(11,847,469)	(11,870,478)
Cost of loans sold, net of fees	10,263,908	7,850,953
Principal payments received and other changes in loans held for sale	112,031	101,904
Accrued interest receivable	(554)	(10,488)
Derivative assets, including margin account	(232)	(43,155)
Other assets	(29,021)	37,182
Income taxes payable	(63,197)	2,311
Accounts payable and accrued liabilities	15,366	9,549
Net cash used in operating activities	(1,652,646)	(3,844,686)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Principal payments received on loans held for investment	1,790,741	1,403,442
Capital expenditures	(16,344)	(12,132)
Purchase of AaRCS, LLC, net of cash acquired	(2,063)	
Net cash provided by investing activities	1,772,334	1,391,310
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net changes in credit facilities	(764,092)	855,482
Proceeds from issuance of securitization financing	2,627,943	3,003,173
Payments on securitization financing	(1,825,103)	(1,417,245)
Proceeds from issuance of common stock through employee stock plans	818	4,354
Excess tax benefit from stock-based payment arrangements	3,600	
Payment by REIT subsidiary of preferred stock dividends	(7,484)	(7,484)
Net cash provided by financing activities	35,682	2,438,280
Effect of exchange rate changes on cash	1,275	1,466
Net increase (decrease) in cash and cash equivalents	156,645	(13,630)
Beginning balance, cash and cash equivalents	44,714	35,155

Ending balance, cash and cash equivalents	\$ 201,359	\$ 21,525
---	------------	-----------

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 Nine Months Ended September 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., Vendor Management Services, LLC d/b/a Inzura Settlement Services ( "Inzura" ) and AaRCS, LLC, and AHL's wholly owned subsidiaries Accredited Mortgage Loan REIT Trust herein reported separately (the "REIT" ) and Inzura Insurance Services Inc., (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 nine months ending September 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, servicing and selling non-prime and to a lesser degree Alt-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's customers are primarily borrowers closing loans originated by Accredited. Inzura 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**

Effective as of October 1, 2006, Accredited acquired Aames Investment Corporation ( "Aames" ) pursuant to an Agreement and Plan of Merger dated as of May 24, 2006. Aames was a public REIT formed in February 2004 to originate and sell high yielding, non-prime residential mortgage loans. Accredited paid a total of \$77.6 million in cash and issued approximately 4.4 million shares of its common stock to the shareholders of Aames as consideration for the acquisition for a total consideration of \$235 million. Additional information regarding the terms of the merger, its pro forma impact in the financial statements and the risks related to the merger can be found in the registration statement filed on Form S-4 and Form 8-K filed with the Securities and Exchange Commission.

## **Table of Contents**

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

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

##### **For the Three and Nine Months Ended September 30, 2006 and 2005**

On September 29, 2006 (prior to the October 1, 2006 effective date of the merger with Aames) Accredited acquired the stock of AaRCS, LLC, an indirect wholly-owned subsidiary of Aames. The \$12.3 million purchase price is to be paid in November 2006. The resulting liability at September 30, 2006 is included in the consolidated balance sheet in accounts payable and accrued liabilities. The fair value of the net tangible assets acquired was approximately \$9.3 million and the excess over fair value of the assets acquired of \$3 million was allocated to goodwill and included in other assets at September 30, 2006.

#### **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

fair value of assets and liabilities acquired in business combinations

#### **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 (see Note 2).

#### **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.

**Table of Contents**

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

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

**For the Three and Nine Months Ended September 30, 2006 and 2005**

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 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 calls for the execution of securitization transactions as the principal means of increasing the size of its held for investment portfolio. In support of this program, Accredited periodically identifies loans meeting the applicable investor characteristics and transfers those loans from Loans Held for Sale to Loans Held for Securitization (held for investment).

After the loans are designated as held for investment, Accredited 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 expected 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.

Shortly before the execution of a securitization transaction, 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, Accredited closed a \$1.4 billion securitization. Collateral of \$1.05 billion in mortgage loans was delivered in June 2006 with the balance of approximately \$350 million delivered during the quarter ended September 30, 2006.

**Table of Contents**

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

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

**For the Three and Nine Months Ended September 30, 2006 and 2005**

These securitizations are structured legally as sales, but for accounting purposes are treated as financings under SFAS No. 140 *Accounting for Transfer and Servicing of Financial Assets and Extinguishment of Liabilities* a replacement of FASB Statement No. 125. 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 risk 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 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. 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 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 the loans are sold. 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 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

**Table of Contents**

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

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

**For the Three and Nine Months Ended September 30, 2006 and 2005**

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 of 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, miscellaneous loan services and revenues from settlement services fees are recorded as revenue when collected.

**Escrow and Fiduciary Funds**

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 \$145.8 million and \$139.4 million at September 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 Nine Months Ended September 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.

**Other Assets**

Other assets consisted of the following:

	September 30, 2006	December 31, 2005
	(In thousands)	
Real estate owned(a)	\$ 52,468	\$ 16,088
Deferred debt issuance cost	31,673	24,925
Corporate and escrow advances	12,554	10,030
Assets held under Deferred Compensation Plan	13,221	13,159
Goodwill(b)	6,961	
Other	19,770	13,841
<b>Total other assets</b>	<b>\$ 136,647</b>	<b>\$ 78,043</b>

- (a) 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.
- (b) Goodwill represents the excess of purchase price and related costs over the fair value assigned to net assets of the business acquired. The goodwill is not being amortized which is in accordance with generally accepted accounting principles, but is tested for impairment annually.

**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*



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

*Compensation (SFAS 123).* In addition, under the modified prospective method, unearned compensation is not included in stockholders' equity for share-based compensation plans. Instead, 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 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 September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>			
Net income	\$ 18,433	\$ 41,291	\$ 95,506	\$ 112,151
Net unrealized gains (losses) on cash flow hedges, net of taxes of (\$16,438), \$8,027, \$2,981 and \$11,424, respectively	(28,834)	13,180	3,993	18,247
Reclassification adjustment into earnings for realized gain on derivatives, net of taxes of (\$3,855), (\$1,535), (\$10,106) and (\$3,985) respectively	(6,947)	(2,342)	(16,995)	(6,044)
Foreign currency translation adjustments	461	1,615	1,833	1,885
<b>Total comprehensive income (loss)</b>	<b>\$ (16,887)</b>	<b>\$ 53,744</b>	<b>\$ 84,337</b>	<b>\$ 126,239</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. 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 have been reclassified to conform to this presentation.

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



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

	September 30, 2006	December 31, 2005
	(In thousands)	
Asset backed commercial paper collateral account	\$ 286,753	\$ 30,897
Errors and omissions liability insurance	3,500	4,200
Canada financing collateral for loans securitized	16,026	8,157
Cash in escrow on Canada loans pending closing	4,216	779
Other	1,964	2,174
Total restricted cash	\$ 312,459	\$ 46,207

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

During the three months ended September 30, 2006, Accredited sold \$0.8 billion, \$0.8 billion and \$0.4 billion in loans to three separate investors, which represented 22%, 22% and 12%, respectively, of total loans sold. During the three months ended September 30, 2005, Accredited sold \$1.0 billion, \$0.7 billion and \$0.6 billion in loans to three separate investors, which represented 34%, 25% and 19%, respectively, of total loans sold. No other sales to individual investors accounted for more than 10% of total loans sold during the three months ended September 30, 2006 and 2005.

During the nine months ended September 30, 2006, Accredited sold \$2.8 billion, \$1.4 billion, and \$1.3 billion in loans to three separate investors, which represented 27%, 13%, and 13%, respectively, of total loans sold. During the nine months ended September 30, 2005, Accredited sold \$2.0 billion, \$1.8 billion and \$1.0 billion in loans to three separate investors, which represented 26%, 22% and 13%, respectively, of total loans sold. No other sales to individual investors accounted for more than 10% of total loans sold during the nine months ended September 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 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. At September 30, 2006 and December 31, 2005, the reserve for potential future repurchase losses totaled \$17.3 million and \$7.4 million,



**Table of Contents**

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

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

**For the Three and Nine Months Ended September 30, 2006 and 2005**

respectively. During the three months ended September 30, 2006 and 2005 loans repurchased totaled \$61.8 million and \$21.3 million, respectively, and during the nine months ended September 30, 2006 and 2005 loans repurchased totaled \$114.9 million and \$55.3 million, respectively. These repurchased loans are included in mortgage loans held for sale until disposed and included in the lower of cost or market ( LOCOM ) valuation.

***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 September 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 September 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 September 30, 2006, 16% and 12% of loans originated were collateralized by properties located in California and Florida, respectively. During the three months ended September 30, 2005, 18% and 11% of loans originated were collateralized by properties located in California and Florida, respectively. During the nine months ended September 30, 2006, 15% and 12% of loans originated were collateralized by properties located in California and Florida, respectively. During the nine months ended September 30, 2005, 20% 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

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

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.

**4. MORTGAGE LOANS**

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

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
	<b>(In thousands)</b>	
Mortgage loans held for sale principal balance	\$ 1,862,705	\$ 2,267,611
Basis adjustment for fair value hedge accounting	12,214	5,004
Net deferred origination fees	(4,363)	(2,584)
Market valuation allowance	(28,308)	(17,779)
<b>Mortgage loans held for sale, net</b>	<b>\$ 1,842,248</b>	<b>\$ 2,252,252</b>

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

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
	<b>(In thousands)</b>	
Mortgage loans securitized principal balance	\$ 7,252,396	\$ 6,421,805
Mortgage loans held for securitization principal balance(1)	144,423	899,803
Basis adjustment for fair value hedge accounting	(10,515)	(4,766)
Net deferred origination fees	(31,620)	(14,953)
Allowance for loan losses	(124,173)	(106,017)
<b>Mortgage loans held for investment, net</b>	<b>\$ 7,230,511</b>	<b>\$ 7,195,872</b>

(1) Includes \$116.0 million and \$139.3 million of Canadian loans at September 30, 2006 and December 31, 2005, respectively.



Table of Contents

## ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the Three and Nine Months Ended September 30, 2006 and 2005

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

	Balance at	Provision		Balance at
	Beginning	for	Chargeoffs,	End of
	of Period	Losses	net	Period
		(In thousands)		
<b>Three Months Ended September 30,:</b>				
<b>2006:</b>				
Mortgage loans held for investment	\$ 125,389	\$ (778)	\$ (438)	\$ 124,173
Real estate owned	12,784	10,451	(5,940)	17,295
Total	\$ 138,173	\$ 9,673	\$ (6,378)	\$ 141,468
<b>2005:</b>				
Mortgage loans held for investment	\$ 84,228	\$ 11,847	\$ (347)	\$ 95,728
Real estate owned	7,010	3,580	(2,631)	7,959
Total	\$ 91,238	\$ 15,427	\$ (2,978)	\$ 103,687
<b>Nine Months Ended September 30,:</b>				
<b>2006:</b>				
Mortgage loans held for investment	\$ 106,017	\$ 19,254	\$ (1,098)	\$ 124,173
Real estate owned	10,725	20,019	(13,449)	17,295
Total	\$ 116,742	\$ 39,273	\$ (14,547)	\$ 141,468
<b>2005:</b>				
Mortgage loans held for investment	\$ 60,138	\$ 36,129	\$ (539)	\$ 95,728
Real estate owned	4,405	10,249	(6,695)	7,959
Total	\$ 64,543	\$ 46,378	\$ (7,234)	\$ 103,687

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:

September 30, 2006		December 31, 2005	
Total	Delinquent	Total	Delinquent
Principal	Principal	Principal	Principal

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

	Amount	Over	Amount	Over
		90 Days (In thousands)		90 Days
Mortgage loans held for sale(1)	\$ 1,862,705	\$ 94,012	\$ 2,267,611	\$ 20,861
Mortgage loans held for investment	7,396,819	136,839	7,321,608	71,361
Real estate owned	69,763	69,763	26,811	26,811
On balance sheet portfolio	9,329,287	300,614	9,616,030	119,033
Mortgage loans sold servicing retained(2)	65,288	8,772	90,181	10,228
Total serviced portfolio	\$ 9,394,575	\$ 309,386	\$ 9,706,211	\$ 129,261

(1) Includes loans repurchased.

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

**Table of Contents**

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

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

**For the Three and Nine Months Ended September 30, 2006 and 2005**

**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 September 30, 2006 and December 31, 2005 fair value hedge basis adjustments of \$12.2 million and \$5.0 million, respectively, are included in mortgage loans held for sale. Losses from hedge ineffectiveness associated with these fair value hedges of \$0.3 million and (\$0.06 million) were recorded in earnings during the three months ended September 30, 2006 and 2005, respectively, and are included as adjustments to gain on sale of loans in the consolidated statements of operations. Hedge ineffectiveness gains (losses) associated with these fair value hedges of (\$0.6 million) and \$0.3 million were recorded in earnings during the nine months ended September 30, 2006 and 2005, respectively, and are included as adjustments to gain on sale of loans in the consolidated statements of operations.

At September 30, 2006 and December 31, 2005, fair value hedge basis adjustments of (\$10.5 million) and (\$4.8 million), respectively, are included in loans held for investment.

***Cash Flow Hedges***

Accredited uses hedge accounting in accordance with SFAS No. 133 for certain derivative financial instruments used to hedge the variability of the cash flows associated with variable rate portion of securitization debt. Effective unrealized losses associated with cash flow hedges of \$45.2 million, net of tax benefit of \$16.4 million, were recorded in other comprehensive income during the three months ended September 30, 2006. Effective unrealized gains associated with cash flow hedges of \$21.2 million, net of taxes of \$8.0 million, were recorded in other comprehensive income during the three months ended September 30, 2005.

Effective unrealized gains, net of effective unrealized losses, associated with cash flow hedges of \$7.0 million and \$29.7 million, reduced by related tax expense of \$3.0 million and \$11.4 million, were recorded in other comprehensive income during the nine months ended September 30, 2006 and 2005, respectively. These contracts settle on various dates ranging from September 2006 to September 2015. A total of \$15.4 million in net effective gains before taxes, included in other comprehensive income at September 30, 2006, is expected to be recognized in earnings during the next twelve months. Hedge ineffectiveness gains (losses) associated with cash flow hedges of (\$2.4 million) and \$1.5 million was recorded in earnings during the three months ended September 30, 2006 and 2005, respectively, and are included as a component of interest expense in the consolidated statements of operations. Hedge ineffectiveness gains (losses) associated with cash flow hedges of (\$1.3 million) and \$2.0 million was recorded in earnings during the nine months ended September 30, 2006 and 2005, respectively, and are included as a component of interest expense in the consolidated statements of operations.

**Table of Contents****ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****For the Three and Nine Months Ended September 30, 2006 and 2005*****Futures Contracts, Options Contracts, Interest Rate Swap and Cap Agreements and Margin Accounts***

At September 30, 2006 Accredited had outstanding Eurodollar futures contracts, options contracts, interest rate swap agreements and interest rate cap agreements that were designated as hedge instruments. The fair value of the options contracts, interest rate swap and cap agreements, and the fair value of the margin account balances required for these derivatives and the futures contracts were as follows:

	September 30, 2006	December 31, 2005
	(In thousands)	
Options contracts	\$ 3,034	\$ 4,739
Interest rate cap and swap agreements	11,163	14,737
Futures contracts	5,522	8,099
Total fair value of derivatives	19,719	27,575
Margin account balances	49,234	61,834
Derivative assets, including margin account	\$ 68,953	\$ 89,409
Derivative liabilities(1)	\$ (12,545)	\$ (1,815)

(1) Derivative liabilities are included in accounts payable and accrued liabilities.

The change in the fair value of derivative financial instruments and the related hedged asset or liability recorded in the consolidated statements of operations was as follows:

	Interest Income	Interest Expense	Gain on Sale (In thousands)	Other Income	Total
<b>Three Months Ended September 30, 2006:</b>					
Net unrealized gain (loss)	\$ 1,883	\$ (8,208)	\$ 5,351	\$	\$ (975)
Net realized gain (loss)		16,613	(12,302)		4,311
Total	\$ 1,883	\$ 8,405	\$ (6,951)	\$	\$ 3,336
<b>2005:</b>					
Net unrealized gain (loss)	\$ (1,046)	\$ (3,970)	\$ (5,464)	\$	\$ (10,480)
Net realized gain		9,372	13,334		22,706
Total	\$ (1,046)	\$ 5,402	\$ 7,870	\$	\$ 12,226



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

	Interest Income	Interest Expense	Gain on Sale (In thousands)	Other Income	Total
<b>Nine Months Ended September 30, 2006:</b>					
Net unrealized gain (loss)	\$ 3,860	\$ (23,604)	\$ (7,191)	\$	\$ (26,934)
Net realized gain		49,413	16,561		65,974
<b>Total</b>	<b>\$ 3,860</b>	<b>\$ 25,809</b>	<b>\$ 9,370</b>	<b>\$</b>	<b>\$ 39,040</b>
<b>2005:</b>					
Net unrealized loss	\$ (4,506)	\$ (11,303)	\$ (2,690)	\$	\$ (18,499)
Net realized gain		24,665	16,324	46	41,035
<b>Total</b>	<b>\$ (4,506)</b>	<b>\$ 13,362</b>	<b>\$ 13,634</b>	<b>\$ 46</b>	<b>\$ 22,536</b>

**6. CREDIT FACILITIES**

Credit facilities consisted of the following:

	September 30, 2006	December 31, 2005
	(In thousands)	
A \$660 million warehouse credit facility expiring December 2007(a)	\$ 272,565	\$ 281,428
A \$650 million warehouse credit facility expiring February 2007(a)	194,443	472,457
A \$650 million warehouse credit facility expiring July 2007(a)	169,691	315,812
A \$600 million warehouse credit facility expiring August 2007(a)	197,607	135,353
A \$600 million warehouse credit facility expiring December 2006(b)	129,549	303,953
A \$500 million warehouse credit facility expiring June 2007(a)	182,516	385,317
A \$300 million warehouse credit facility expiring January 2007(a)	68,541	5,923
A \$75 million credit facility expiring September 2007		
A \$40 million warehouse credit facility expiring November 2006(a)	4,272	9,513
A \$200 million (Canadian dollar) warehouse credit facility expiring June 2007(a)	87,232	127,826
A \$2.5 billion asset-backed commercial paper facility(c)	739,792	767,537
<b>Total credit facilities</b>	<b>\$ 2,046,208</b>	<b>\$ 2,805,119</b>

- (a) The outstanding warehouse facilities bear interest based on one-month or overnight LIBOR (one-month bankers acceptance rate for Canada) plus a spread. The spread over LIBOR varies depending on the mortgage asset class being financed.
- (b) Bears interest at overnight LIBOR plus a specified spread.
- (c) Accredited issues asset-backed commercial paper in the form of (i) short-term secured liquidity notes (SLNs) with initial maturities ranging from one to one hundred eighty days and (ii) subordinated notes, \$40.0 million of which were initially issued with a maturity date

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

of May 26, 2010. In order to issue the debt, Accredited established a special purpose, bankruptcy remote Delaware statutory trust. The trust entered into agreements with third parties who act as back-up liquidity providers. The SLNs bear interest at customary commercial paper market rates (5.43% at September 30, 2006), which vary depending on the prevailing market conditions. During the third quarter 2006, the capacity of this facility was increased to \$2.5 billion and issued an additional \$40.0 million subordinated notes which mature August 25, 2011.

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

The above facilities are collateralized by substantially all mortgage loans held for sale, certain restricted cash (see Note 2) and unsold portions of securitized debt.

At September 30, 2006, Accredited was in compliance with all covenant requirements for each of the facilities. Accredited's warehouse and other credit facilities contain customary covenants including maximum leverage, minimum liquidity, profitability and net worth requirements and limitations on other indebtedness. If Accredited 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 Accredited defaults under one facility, it would generally trigger a default under Accredited's other facilities.

Accredited anticipates that its borrowings will be repaid from net proceeds from the sale or securitization of loans and other assets, cash flows from operations, or from refinancing the borrowings.

**7. SECURITIZATION FINANCING**

Securitization financing consisted of the following:

			Balance		Interest Rate Range		
			September 30, 2006	December 31, 2005	Fixed	Variable (LIBOR+)	Final Stated Maturity
<b>Bond financing:</b>							
2002	two securitizations		\$ 81,845	\$ 136,634	4.48% - 4.93%	.32% - .50%	2033
2003	three securitizations		264,559	406,650	3.58% - 4.46%	.35% - .38%	2034
2004	four securitizations		1,278,576	1,882,537	2.90% - 5.25%	.15% - 2.50%	2035
2005	four securitizations		2,922,695	3,747,597	N/A	.08% - 2.50%	2035
2006	two securitizations		2,215,187		N/A	.04% - 2.10%	2036
Total bond financing(a)			6,762,862	6,173,418			
<b>Other:</b>							
2005	Private placement mortgages(b)	Canadian	61,685	70,934	N/A	CP rate + .27%	None
2006	Private placement mortgages(c)	Canadian	228,630		N/A	CP rate + .25% - .85%	None
			7,053,177	6,244,352			
Unamortized debt discounts			(2,894)	(3,532)			
Total securitization financing, net			\$ 7,050,283	\$ 6,240,820			

(a) Collateralized by U.S. loans securitized with an aggregate outstanding balance of \$7.0 billion and \$6.4 billion at September 30, 2006 and December 31, 2005, respectively.

(b)



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

Collateralized by Canadian loans with an aggregate outstanding balance of \$60.8 million and \$70.9 million at September 30, 2006 and December 31, 2005, respectively.

(c) Collateralized by Canadian loans with an aggregate outstanding balance of \$234.8 million at September 30, 2006.

In addition, \$16.0 million and \$8.2 million of restricted cash at September 30, 2006 and December 31, 2005, respectively, are pledged as collateral in connection with the private placements of Canadian mortgages (see Note 2).

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

Amounts collected on the mortgage loans are remitted to the respective trustees, who in turn distribute such amounts each month to the bondholders, together with other amounts received related to the mortgage loans, net of fees payable to Accredited, the trustee and the insurer of the bonds. Any remaining funds after payment of fees and distribution of principal and interest is known as excess interest.

The securitization agreements require that a certain level of overcollateralization be maintained for the bonds. A portion of the excess interest may be initially distributed as principal to the bondholders to increase the level of overcollateralization. Once a certain level of overcollateralization has been reached, excess interest is no longer distributed as principal to the bondholders, but, rather, is passed through to Accredited. Should the level of overcollateralization fall below a required level, excess interest will again be paid as principal to the bondholders until the required level has been reached.

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.

Due to the potential for prepayments of mortgage loans, the early distribution of principal to the bondholders and the optional clean-up call, the bonds are not necessarily expected to be outstanding through the stated maturity dates set forth above.

The following table summarizes the expected repayments relating to the securitization financing at September 30, 2006 and are based on anticipated receipts of principal and interest on underlying mortgage loan collateral using historical prepayment speeds:

	<b>(In thousands)</b>
Three months ending December 31, 2006	\$ 407,169
Year Ending December 31:	
2007	2,481,040
2008	1,508,885
2009	899,904
2010	551,448
2011	351,882
Thereafter	852,849
Discount	(2,894)
 Total	 \$ 7,050,283

**Table of Contents****ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****For the Three and Nine Months Ended September 30, 2006 and 2005****8. INCOME TAXES**

The income tax provision consists of the following:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>			
<b>Current:</b>				
Federal	\$ 7,567	\$ 24,057	\$ 68,834	\$ 40,580
State	(1,382)	4,017	12,820	7,595
Total current provision	6,185	28,074	81,654	48,175
<b>Deferred:</b>				
Federal	(1,924)	255	(19,985)	22,472
State	985	1,188	(3,433)	6,570
Total deferred provision (benefit)	(939)	1,443	(23,418)	29,042
<b>Total provision</b>	<b>\$ 5,246</b>	<b>\$ 29,517</b>	<b>\$ 58,236</b>	<b>\$ 77,217</b>

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>			
Federal income tax at statutory rate	\$ 9,161	\$ 25,656	\$ 56,429	\$ 68,898
State income tax, net of federal effects	(1,050)	3,383	5,310	9,207
REIT dividends on preferred stock	(873)	(873)	(2,619)	(2,619)
Other	(1,992)	1,351	(884)	1,731
<b>Total provision</b>	<b>\$ 5,246</b>	<b>\$ 29,517</b>	<b>\$ 58,236</b>	<b>\$ 77,217</b>

The deferred income tax (benefit) 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 the following: mortgage securitizations, loans held for sale at quarter-end, and various reserves and accruals where taxable income has been recognized in excess of book income.

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

The tax effects of significant items comprising Accredited's net deferred tax (liability) asset were as follows:

	September 30, 2006	December 31, 2005
	(In thousands)	
Deferred tax assets:		
Loans held for sale	\$ 2,010	\$ 6,303
Market reserve on loans held for sale	14,131	8,639
Loan securitizations	68,957	54,991
State taxes	2,547	6,151
Other reserves and accruals	23,105	12,289
<b>Total deferred tax assets</b>	<b>110,750</b>	<b>88,373</b>
Deferred tax liabilities:		
Mortgage-related securities	(9,760)	(10,800)
Cash flow hedging	(2,424)	(9,549)
<b>Total deferred tax liabilities</b>	<b>(12,184)</b>	<b>(20,349)</b>
<b>Net deferred tax asset</b>	<b>\$ 98,566</b>	<b>\$ 68,024</b>

**9. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES**

Accounts payable and accrued liabilities were as follows:

	September 30, 2006	December 31, 2005
	(In thousands)	
Accrued liabilities - salary, wages and benefits	\$ 27,713	\$ 28,116
Accrued liabilities - general	49,429	32,812
Derivative liabilities	12,545	1,815
Reserve for repurchases and premium recapture	22,295	10,751
<b>Total</b>	<b>\$ 111,982</b>	<b>\$ 73,494</b>

Activity in the reserve for repurchases and premium recapture was as follows:

Balance at	Provision (1)	Chargeoffs,	Balance at
Beginning		net	End of

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

	of Period			Period
	(In thousands)			
Three Months Ended September 30,:				
2006:				
Reserve for repurchases	\$ 8,686	\$ 10,658	\$ (2,068)	\$ 17,276
Reserve for premium recapture	3,876	3,817	(2,674)	5,019
Total	\$ 12,562	\$ 14,475	\$ (4,742)	\$ 22,295
2005:				
Reserve for repurchases	\$ 6,328	\$ 973	\$ (533)	\$ 6,768
Reserve for premium recapture	1,625	1,462	(2,334)	753
Total	\$ 7,953	\$ 2,435	\$ (2,867)	\$ 7,521

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

	<b>Balance at</b>			<b>Balance at</b>
	<b>Beginning</b>		<b>Chargeoffs,</b>	<b>End of</b>
	<b>of</b>	<b>Provision (1)</b>	<b>net</b>	<b>Period</b>
	<b>Period</b>	<b>(In thousands)</b>		
<b>Nine Months Ended September 30,:</b>				
<b>2006:</b>				
Reserve for repurchases	\$ 7,434	\$ 13,570	\$ (3,728)	\$ 17,276
Reserve for premium recapture	3,317	8,047	(6,345)	5,019
Total	\$ 10,751	\$ 21,617	\$ (10,073)	\$ 22,295
<b>2005:</b>				
Reserve for repurchases	\$ 5,126	\$ 2,977	\$ (1,335)	\$ 6,768
Reserve for premium recapture	2,410	3,925	(5,582)	753
Total	\$ 7,536	\$ 6,902	\$ (6,917)	\$ 7,521

(1) Reduces gain on sale of loans

**10. MINORITY INTEREST IN REIT SUBSIDIARY**

The minority interest in the REIT (a wholly owned subsidiary of AHL) represents Series A Preferred Shares issued to outside investors in the aggregate amount of \$102.3 million. The Series A Preferred Shares bear a dividend of 9.75% annually. The preferred shares are reported as minority interest in subsidiary in the consolidated balance sheet.

**11. STOCK-BASED COMPENSATION**

Accredited has three types of equity instruments issued under its share-based compensation programs: stock options, restricted stock units, and restricted stock awards. Accredited discontinued its Employee Stock Purchase Plan on December 31, 2005. Compensation expense included in the consolidated statements of operations for the three and nine months ended September 30, 2006 and 2005, and the related tax benefit is shown in the following table:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands, except per share amounts)</b>			
Stock options	\$ 1,511	\$ 27	\$ 3,932	\$ 190
Restricted stock units (Deferred Compensation Plan)	1,621	1,087	4,010	4,350
Restricted stock awards	119	57	358	94
Total share-based compensation expense	3,251	1,171	8,300	4,634
Income tax benefit recognized	(1,074)	(468)	(2,747)	(1,852)

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

Compensation expense, net of tax benefit	\$ 2,177	\$ 703	\$ 5,553	\$ 2,782
--	----------	--------	----------	----------

## Change in the following due to the adoption of SFAS 123R:

Net income	\$ (1,148)	\$ (2,914)
Basic earnings per share	\$ (0.05)	\$ (0.13)
Diluted earnings per share	\$ (0.05)	\$ (0.13)

For the three and nine months ended September 30, 2006, compensation expense recognized for stock options is based on the fair value provisions of the newly adopted SFAS 123R. For the three and nine months

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

ended September 30, 2005, compensation expense was not recognized for most of Accredited's options in accordance with APB 25. However, compensation cost was recognized in 2005 on options granted to non-employees or when the exercise price of the options was not equal to the market value on the date of grant. The details of the share-based compensation programs are described below.

**Stock Option Plans** Accredited's 1995 Executive Stock Option Plan, 1995 Stock Option Plan, 1998 Stock Option Plan, and 2002 Stock Option Plan (collectively the "Stock Option Plans"), provide for the issuance of stock options to eligible directors, employees and consultants. Accredited's 2002 Stock Option Plan ("2002 Plan") was adopted by the board of directors and approved by the stockholders in 2002. The share reserve established in the 2002 Plan consists of the number of shares remaining available for option grants and the number of options outstanding under all stock option plans.

All options granted in 2006 were granted at an exercise price equal to the closing market price on the date of grant. The options are scheduled to vest over four years and expire no later than 10 years after the grant date. The fair value of each option grant is estimated on the date of grant using the Black-Scholes multiple option model. The assumptions used in the option-pricing model for options granted during the three and nine months ended September 30, 2006 are noted in the following table:

	Three Months Ended	Nine Months Ended
	September 30, 2006	September 30, 2006
Weighted-average risk-free rate	5.67%	4.87%
Weighted-average expected life	3.9 yrs	3.9 yrs
Expected Volatility	43%	43%
Dividend Yield	0%	0%
Weighted-average grant date fair value	\$ 18.45	\$ 19.58

In determining the expected volatility, historical and implied volatility was reviewed. As a result of our analysis, the computation of expected volatility for new grants is based on the historical volatility of Accredited's common stock, excluding 2003, the year Accredited became a public entity. Prior to the first quarter of 2006, Accredited's expected volatility was based on the average of its own volatility and the volatility of several of its closest competitors. The weighted-average expected life assumption was also modified in the first quarter to include an estimate for outstanding options that have not yet been exercised and have not yet reached their full contractual term. The change in computation of volatility and weighted-average expected life was applied on a prospective basis beginning with awards granted after December 31, 2005. A summary of the change in options outstanding under Accredited's Stock Option Plans during the nine months ended September 30, 2006 follows:

	Number of Options (In thousands)	Weighted- Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value (In thousands)
Outstanding at December 31, 2005	1,398	\$ 26.29		
Options granted	533	\$ 50.58		
Options exercised	(173)	\$ 16.61		
Options cancelled	(233)	\$ 43.45		
Outstanding at September 30, 2006	1,525	\$ 33.25	7.74 yrs	\$ 14,013
	1,331	\$ 31.37	7.55 yrs	\$ 13,858



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

Options vested and expected to vest at  
September 30, 2006

Options exercisable at September 30, 2006	644	\$	18.91	6.26 yrs	\$	12,299
Shares authorized for issuance	2,654					
Shares available for grant	1,129					

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

Aggregate intrinsic value disclosed above represents the amount by which Accredited's closing stock price of \$35.94 on September 30, 2006 exceeds the exercise price of the options. The actual intrinsic value of options exercised was \$0.4 million and \$5.9 million for the three and nine-month periods ended September 30, 2006, respectively, and \$2.1 million and \$8.7 million for the three and nine-month periods ended September 30, 2005, respectively. At September 30, 2006, Accredited had \$11.3 million of gross unrecognized compensation expense related to stock option plans that will be recognized over the weighted-average period of 1.8 years. Cash received from stock option exercises was \$0.2 million during the quarter ended September 30, 2006.

**Deferred Compensation Plan** Accredited's Deferred Compensation Plan was adopted by the board of directors and approved by the stockholders in 2002, and became effective on January 1, 2003. The plan is an unfunded, nonqualified deferred compensation plan that benefits directors, certain designated key members of management and key employees. Under the plan, a participant may defer up to 100% of their base salary, director fee, bonus and/or commissions on a pre-tax basis. The Deferred Compensation Plan permits the granting of restricted stock units (RSUs) to eligible participants at fair market value on the date of grant. The per share weighted-average grant date fair value of units awarded was \$45.65 and \$51.76 for the three and nine-month periods ended September 30, 2006, respectively, and \$47.39 and \$43.18 for the three and nine-month periods ended September 30, 2005, respectively. The RSUs generally vest 50% two years from the date of grant and 25% each year thereafter until fully vested and are payable in Accredited's common stock upon distribution. RSUs granted to directors cliff vest two years from the date of grant.

A summary of the change in RSUs outstanding under Accredited's Deferred Compensation Plan during the nine months ended September 30, 2006 follows:

	Units (In thousands)	Aggregate Intrinsic Value (In thousands)
Outstanding at December 31, 2005	774	
Awarded	109	
Released	(146)	
Forfeited	(60)	
Outstanding at September 30, 2006	677	\$ 24,343
Authorized	2,000	
Authorized and not issued	1,844	
Available for grant	1,167	
Units vested not released	166	\$ 5,977
Units vested and expected to vest at September 30, 2006	607	\$ 21,817

The aggregate intrinsic value of restricted stock units is calculated based on the number of units and the quoted market price of \$35.94 at September 30, 2006. The total intrinsic value of net units released was \$0.9 million and \$7.7 million for the three and nine-month periods ended September 30, 2006, respectively, and \$0 and \$25,000 for the three and nine-month periods ended September 30, 2005, respectively. At September 30, 2006, there was approximately \$13.5 million in gross unrecognized compensation expense related to the nonvested units, which is expected to be recognized over 2.2 years.

**Restricted Stock Awards** Accredited issued 41,000 shares of restricted stock shares to two of its officers in 2005 as an inducement to employment. The shares of restricted stock had a value of \$1,540,000 on the issue date.



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

The expense for these shares is recognized over the awards' service period of approximately five-years. As of September 30, 2006, 3,231 awards had vested, and unrecognized compensation related to these stock awards totaled \$0.9 million.

***Pro Forma Information***

Prior to the adoption of SFAS 123R, Accredited accounted for stock-based compensation based on the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25). Under APB 25, recognition of compensation cost was not required for most of Accredited's stock options. However, pro forma disclosures of the effects of recognizing compensation cost under the SFAS 123 fair value method was required. As previously reported for the three and nine months ended September 30, 2005, stock option compensation expense and its effect on income and earnings per share if Accredited had applied SFAS 123 is reflected below.

	Three Months Ended September 30, 2005 (In thousands, except for per share amounts)	Nine Months Ended September 30, 2005
Net income, as reported	\$ 41,291	\$ 112,151
Add: Stock option compensation included in reported net income, net of tax	16	190
Deduct: Stock option compensation expense determined using fair value method, net of tax	(431)	(2,071)
Pro forma net income	\$ 40,876	\$ 110,270
Earnings per share:		
Basic as reported	\$ 1.95	\$ 5.34
Basic pro forma	\$ 1.93	\$ 5.25
Diluted as reported	\$ 1.87	\$ 5.11
Diluted pro forma	\$ 1.85	\$ 5.03

The pro forma effects of estimated share-based compensation reflected above were estimated as of the date of grant using the Black-Scholes multiple option-pricing model. The underlying assumptions used to estimate the fair value were as follows:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Weighted-average risk-free rate	3.88%	3.52%
Weighted-average expected life	2.5 yrs	2.7 yrs
Volatility	46%	45%

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

### Dividend Yield

Weighted-average grant date fair value	\$	14.13	\$	14.08
--	----	-------	----	-------

**Table of Contents****ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****For the Three and Nine Months Ended September 30, 2006 and 2005****12. EARNINGS PER SHARE**

Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding and the weighted average number of vested, restricted common stock units for the period. Diluted earnings per share reflects the potential dilution that could occur if net income were divided by the weighted average number of common shares and vested, restricted common stock units, plus potential common shares from outstanding stock options and unvested restricted stock units where the effect of those securities is dilutive. The computations for basic and diluted earnings per share are as follows:

	<b>Net Income (numerator) (In thousands, except per share amounts)</b>	<b>Shares (denominator)</b>	<b>Per Share Amount</b>
<b>Three Months Ended September 30, 2006:</b>			
Basic earnings per share	\$ 18,433	21,739	\$ 0.85
Effect of dilutive shares:			
Stock options		368	
Restricted stock units		185	
Diluted earnings per share	\$ 18,433	22,292	\$ 0.83
Potentially dilutive stock options not included above since they are antidilutive		1,002	
<b>Three Months Ended September 30, 2005:</b>			
Basic earnings per share	\$ 41,291	21,217	\$ 1.95
Effect of dilutive shares:			
Stock options		610	
Restricted stock units		232	
Diluted earnings per share	\$ 41,291	22,059	\$ 1.87
Potentially dilutive stock options not included above since they are antidilutive		317	
<b>Nine Months Ended September 30, 2006:</b>			
Basic earnings per share	\$ 95,506	21,656	\$ 4.41
Effect of dilutive shares:			
Stock options		439	
Restricted stock units		232	
Diluted earnings per share	\$ 95,506	22,327	\$ 4.28

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

Potentially dilutive stock options not included above since they are antidilutive	593
---	-----

## Nine Months Ended September 30, 2005:

Basic earnings per share	\$ 112,151	21,017	\$ 5.34
--------------------------	------------	--------	---------

Effect of dilutive shares:

Stock options	678
---------------	-----

Restricted stock units	237
------------------------	-----

Diluted earnings per share	\$ 112,151	21,932	\$ 5.11
----------------------------	------------	--------	---------

Potentially dilutive stock options not included above since they are antidilutive	272
---	-----

**Table of Contents**

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

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

**For the Three and Nine Months Ended September 30, 2006 and 2005**

**13. COMMITMENTS AND CONTINGENCIES**

Accredited 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 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 balance sheet. The credit risk is mitigated by Accredited's evaluation of the creditworthiness of potential mortgage loan borrowers on a case-by-case basis. Accredited 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. Accredited commits to originate loans, in many cases dependent on the borrowers satisfying various terms and conditions. These commitments totaled \$741.0 million as of September 30, 2006.

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.

Accredited periodically enters into other loan sale commitments. At September 30, 2006 there were no forward loan sale commitments awaiting settlement.

Accredited's mortgage banking business is subject to certain rules and regulations of the Department of Housing and Urban Development ( HUD ) which require that Accredited maintain a minimum net worth of \$250,000. Accredited is in compliance with this requirement.

From time to time, Accredited enters into certain types of contracts that contingently require Accredited to indemnify parties against third party claims and other obligations customarily indemnified in the ordinary course of Accredited's business. The terms of such obligations vary and, generally, a maximum obligation is not explicitly stated. Therefore, the overall maximum amount of these obligations cannot be reasonably estimated. Historically, Accredited 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 September 30, 2006.

Accredited irrevocably and unconditionally agrees to pay in full to the holders of each share of the REIT's Series A Preferred Shares: (i) all accrued and unpaid dividends, (ii) the redemption price and (iii) the liquidation preference. See further discussion under Note 10. Minority Interest in REIT Subsidiary.

**Legal Matters** In December 2002, AHL 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, the consumer protection statutes of the other states in which AHL does business and the common law of unjust enrichment. The complaint alleges that AHL has a practice of misrepresenting and inflating the amount of fees it pays to third parties in connection with the residential mortgage loans that it funds. The plaintiffs claim to represent a nationwide class consisting of others similarly situated, that is, those who paid AHL to pay, or reimburse AHL's payments 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. The 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 may grant. On January 28, 2005, the court issued an order conditionally certifying (1) a class of Illinois residents with respect to the alleged violation of the Illinois Consumer Fraud and Deceptive Business Practices Act who, since November 19, 1997, paid money to AHL for third-party fees in connection with residential mortgage loans and never received a refund of the difference between the amount they paid to AHL and the amount AHL paid to the third party and (2) a nationwide class of claimants with respect to an unjust enrichment



**Table of Contents**

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

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

**For the Three and Nine Months Ended September 30, 2006 and 2005**

cause of action included in the original complaint who, since November 19, 1997 paid money to AHL for third-party fees in connection with residential mortgage loans and never received a refund of the difference between the amount they paid AHL and the amount AHL paid the third party. The court conditioned its order limiting the statutory consumer fraud act claims to claimants in the State of Illinois on the outcome of a case pending before the Illinois Supreme Court in which one of the issues is the propriety of certifying a nationwide class based on the Illinois Consumer Fraud and Deceptive Business Practices Act. That case has now been decided in a manner favorable to AHL's position, and, in light of this ruling, AHL intends to petition the Illinois Supreme Court for a supervisory order reversing the lower court's class certification decision, the lower court having denied AHL's motion for reconsideration of (a) the court's order granting class certification and (b) the court's denial of AHL's request for leave to take an interlocutory appeal of such order. There has not yet been a ruling on the merits of either the plaintiffs' individual claims or the claims of the class, and the ultimate outcome of this matter and the amount of liability, if any, that may result is not presently determinable. AHL intends to continue to vigorously defend this matter and does not believe it will have a material adverse effect on its business.

In January 2004, AHL was served with a complaint, *Yturalde v. Accredited Home Lenders, Inc.*, brought in Sacramento County, California. The named plaintiff is a former commissioned loan officer of AHL, and the complaint alleges that AHL violated California and federal law by misclassifying the plaintiff and other non-exempt employees as exempt employees, failing to pay the plaintiff on an hourly basis and for overtime worked, and failing to properly and accurately record and maintain payroll information. The plaintiff seeks to recover, on behalf of himself and all of our 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. AHL has been served with eleven substantially similar complaints on behalf of certain other former and current employees, which have been consolidated with the *Yturalde* action. Subject to court approval, the parties have agreed to a settlement with respect to the named plaintiffs and with respect to a class of current and former AHL employees which the parties will jointly request the court to certify. The amount payable by AHL under the settlement is not material to AHL's financial condition.

In June 2005, AHL was served with a complaint, *Williams et al. v. Accredited Home Lenders, Inc.*, brought in the United States District Court for the Northern District of Georgia. The two named plaintiffs are former commissioned loan officers of AHL, and the complaint alleges that AHL violated federal law by requiring the plaintiffs to work overtime without compensation. The plaintiffs seek to recover, on behalf of themselves and other similarly situated employees, the allegedly unpaid overtime, liquidated damages, attorneys' fees and costs of suit. The plaintiffs' motion to certify a collective class was denied on July 25, 2006, leaving the two named plaintiffs as the only plaintiffs in the lawsuit. On August 24, 2006, plaintiffs filed a Notice of Appeal with the Eleventh Circuit requesting that it reverse the lower court's order denying plaintiffs' motion to certify a collective class. However, the court issued an Order to Show Cause why it had subject matter jurisdiction to hear this issue, and plaintiffs subsequently dismissed their appeal. This will not preclude the filing of other non-class action lawsuits alleging similar claims on behalf of other current or former employees. The ultimate outcome of this matter and any related individual filings, and the amount of liability, if any, which may result, is not presently determinable. AHL intends to continue to vigorously defend this matter and any related filings, and does not believe it or they will have a material adverse effect on its business.

In September 2005, AHL and AHLHC were served with a class action complaint, *Phillips v. Accredited Home Lenders Holding Company, et al.*, brought in the United States District Court, Central District of California. The complaint alleges violations of the Fair Credit Reporting Act in connection with prescreened offers of credit made by AHL. The plaintiff seeks to recover, on behalf of plaintiff and similarly situated

**Table of Contents**

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

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

**For the Three and Nine Months Ended September 30, 2006 and 2005**

individuals, damages, pre-judgment interest, declaratory and injunctive relief, attorneys' fees, and any other relief the court may grant. On January 4, 2006, plaintiff re-filed the action in response to the court's December 9, 2005, decision granting AHL's and AHLHC's motion to (1) dismiss with prejudice plaintiff's claim that AHL's offer of credit failed to include the clear and conspicuous disclosures required by FCRA, (2) strike plaintiff's request for declaratory and injunctive relief, and (3) sever plaintiff's claims as to AHL and AHLHC from those made against other defendants unaffiliated with AHL or AHLHC. Plaintiff's remaining claim is that AHL's offer of credit did not meet FCRA's firm offer requirement. A motion to certify a class has not yet been filed, and there has been no ruling on the merits of either the plaintiff's individual claims or the claims of the putative class. AHL and AHLHC intend to continue to vigorously defend this matter. If, however, a class were to be certified and were to prevail on the merits, the potential liability could have a material adverse effect on Accredited. The ultimate outcome of this matter and the amount of liability, if any, which may result is not presently determinable.

In March 2006, AHL was served with a class action complaint, *Cabrejas v. Accredited Home Lenders, Inc.*, brought in the Circuit Court for Prince George's County, Maryland. The complaint alleges that AHL's origination of second lien loans in Maryland violated the Maryland Secondary Mortgage Loan Law and Consumer Protection Act in that fees charged on such loans exceeded 10% of the respective loan amounts. The plaintiffs seek to recover, on behalf of themselves and similarly situated individuals, damages, disgorgement of fees, pre-judgment interest, declaratory and injunctive relief, attorneys' fees, and any other relief the court may grant. On April 13, 2006, AHL removed the action to the United States District Court, District of Maryland. On May 15, 2006, AHL filed a motion to dismiss plaintiffs' second cause of action alleging a violation of the Maryland Consumer Protection Act on the basis that full disclosure of the fees cannot be an unfair or deceptive trade practice. A hearing date for the motion to dismiss has not been set. A motion to certify a class has not yet been filed, and there has been no ruling on the merits of either the plaintiff's individual claims or the claims of the putative class, and the ultimate outcome of this matter and the amount of liability, if any, which may result is not presently determinable. AHL intends to continue to vigorously defend this matter and does not believe it will have a material adverse effect on its business.

In October 2006, by virtue of the merger of AHLHC and Aames Investment Corporation (AIC), and the related merger of certain subsidiaries of AHLHC and AIC, AHLHC and certain of its subsidiaries succeeded to the litigation interests of AIC and certain of its subsidiaries. Two of those matters, *Webb, et al., v. Aames Investment Corporation, et al.* (U.S. District Court, Central District of California) and *Cooper, et al., v. Aames Funding Corporation* (U.S. District Court, Eastern District of Wisconsin), are class action complaints which allege violations of the Fair Credit Reporting Act in connection with prescreened offers of credit and are similar in nature to the *Phillips* matter referenced above. The *Cooper* matter was transferred to the Central District of California and consolidated with the *Webb* matter by stipulation of counsel on September 29, 2006. A motion to certify a class has not yet been filed, and there has been no ruling on the merits of either the plaintiffs' individual claims or the claims of the putative class. AHLHC and each affected subsidiary intends to vigorously defend this matter. If, however, a class were to be certified and were to prevail on the merits, the potential liability could have a material adverse effect on Accredited. The ultimate outcome of this matter and the amount of liability, if any, which may result is not presently determinable.

In October 2006, as a result of the merger referenced above, AHL succeeded to the position of Aames Funding Corporation (AFC) under a class action complaint, *Miller v. Aames Funding Corporation*, filed in the United States District Court, Eastern District of Texas. The complaint alleges that adjustable-rate home equity loans originated by AFC in Texas violate the Texas Constitution's requirement that such loans be scheduled to be repaid in substantially equal installments. The plaintiffs seek to recover, on behalf of themselves and similarly

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

situated individuals, damages, declaratory and injunctive relief, attorneys' fees, and any other relief the court may grant. On September 29, 2006, the court on its own motion stayed the action, pending the resolution of class certification issues in a similar action pending before the court. A motion to certify a class has not yet been filed, and there has been no ruling on the merits of either the plaintiff's individual claims or the claims of the putative class. AHL intends to vigorously defend this matter. If, however, a class were to be certified and were to prevail on the merits, the potential liability could have a material adverse effect on Accredited. The ultimate outcome of this matter and the amount of liability, if any, which may result is not presently determinable.

Accredited has accrued for loss contingencies with respect to the foregoing matters to the extent it is probable that a liability has been occurred at the date of the consolidated financial statements and the amount of the loss can be reasonably estimated. Management does not deem the amount of such accrual to be material.

In addition, because the nature of our business involves the collection of numerous accounts, the validity of liens and compliance with various state and federal lending laws, we are 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. We are also subject to legal proceedings in the ordinary course of business related to employment matters. We do not believe that the resolution of these lawsuits will have a material adverse effect on our financial position or results of operations.

**14. SUPPLEMENTAL CASH FLOW INFORMATION**

The following represents supplemental cash flow information:

	Nine Months Ended September 30,	
	2006	2005
	(In thousands)	
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	\$ 382,795	\$ 212,664
Income Taxes	\$ 144,849	\$ 45,864
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Transfer of mortgage loans held for sale to mortgage loans held for investment	\$ 1,671,599	\$ 3,233,710
Transfer of mortgage loans held for sale to real estate owned, net of reserve, included in other assets	\$ 30,677	\$ 12,318
Transfer of mortgage loans held for investment to real estate owned, net of reserve, included in other assets	\$ 27,558	\$ 5,537
Unrealized gains on cash flow hedges recorded to other comprehensive income	\$ 6,974	\$ 29,671
Purchase of net assets of AaRCS, LLC:		
Fair value of non-cash assets	\$ 3,043	
Liabilities assumed	\$ 980	

**Table of Contents****ACCREDITED MORTGAGE LOAN REIT TRUST****BALANCE SHEETS****(Dollars in thousands, except par value) (Unaudited)**

	<b>September 30,</b>	<b>December 31,</b>
	<b>2006</b>	<b>2005</b>
<b>ASSETS</b>		
Cash and cash equivalents	\$ 11,289	\$ 6,158
Accrued interest receivable	34,750	32,604
Mortgage loans held for investment, net of allowance of \$120,928 and \$98,399, respectively	6,803,199	6,240,136
Derivative assets, including margin account	46,916	65,347
Other assets	61,540	30,322
Receivable from parent	214,202	99,642
Total assets	\$ 7,171,896	\$ 6,474,209
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>LIABILITIES:</b>		
Credit facilities	\$ 16,368	\$ 15,640
Securitization bond financing	6,759,968	6,169,886
Accounts payable and accrued liabilities	18,327	5,115
Total liabilities	6,794,663	6,190,641
<b>STOCKHOLDERS EQUITY:</b>		
Preferred stock, \$1.00 par value; authorized 20,000,000 shares; 4,093,678 shares designated, issued and outstanding as 9.75% Series A Perpetual Cumulative Preferred Shares with an aggregate liquidation preference of \$102,342 at September 30 2006 and December 31, 2005	4,094	4,094
Common stock, \$.001 par value; authorized 100,000,000 shares; issued and outstanding 100,000 at September 30, 2006 and December 31, 2005	1	1
Additional paid-in capital	314,488	303,180
Accumulated other comprehensive income	6,145	23,991
Retained earnings (deficit)	52,505	(47,698)
Total stockholders equity	377,233	283,568
Total liabilities and stockholders equity	\$ 7,171,896	\$ 6,474,209

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

**Table of Contents****ACCREDITED MORTGAGE LOAN REIT TRUST****STATEMENTS OF OPERATIONS****(In thousands, except per share amounts) (Unaudited)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>REVENUES:</b>				
Interest income (including \$3,034, \$1,151, \$7,081, and \$1,582 from parent)	\$ 147,998	\$ 109,369	\$ 408,623	\$ 288,957
Interest expense	(97,425)	(52,811)	(249,975)	(131,939)
Net interest income	50,573	56,558	158,648	157,018
Provision for losses on loans and real estate owned	(3,107)	(2,578)	(16,158)	(12,624)
Net interest income after provision	47,466	53,980	142,490	144,394
Other income	863	502	2,700	859
Total net revenues	48,329	54,482	145,190	145,253
<b>OPERATING EXPENSES:</b>				
Management fee assessed by parent	9,072	6,750	25,193	18,247
Direct general and administrative expenses	1	51	10	112
Total operating expenses	9,073	6,801	25,203	18,359
Net income	39,256	47,681	119,987	126,894
Dividends on preferred stock	(2,495)	(2,495)	(7,484)	(7,484)
Net income available to common stockholders	\$ 36,761	\$ 45,186	\$ 112,503	\$ 119,410
Basic and diluted earnings per common share	\$ 367.61	\$ 451.86	\$ 1,125.03	\$ 1,194.10
Weighted average shares outstanding for basic and diluted	100	100	100	100

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

**Table of Contents****ACCREDITED MORTGAGE LOAN REIT TRUST****STATEMENTS OF CASH FLOWS****(In thousands) (Unaudited)**

	<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 119,987	\$ 126,894
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of net deferred origination fees on securitized loans	(5,070)	(2,388)
Amortization of deferred costs	9,483	782
Provision for losses	16,158	12,624
Unrealized loss (gain) on derivatives and hedged assets	18,669	(6,808)
Adjustment into earnings for gain on derivatives from other comprehensive income	(25,625)	(10,023)
Changes in operating assets and liabilities:		
Accrued interest receivable	(2,146)	(8,463)
Derivative assets, including margin account	3,681	17,591
Other assets	(11,010)	(8,725)
Accounts payable and accrued liabilities	13,212	335
Net cash provided by operating activities	137,339	121,819
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Principal payments received on mortgage loans held for investment	1,760,681	1,403,252
Net cash provided by investing activities	1,760,681	1,403,252
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from issuance of securitization bond financing, net of fees	2,381,320	3,003,173
Payments on securitization bond financing	(1,804,207)	(1,417,245)
Net change in credit facilities	(2,344,046)	(2,942,626)
Capital contributions from parent	8,388	3,000
Net increase in receivable from parent	(114,560)	(161,806)
Payments of common stock dividends	(12,300)	(5,000)
Payments of preferred stock dividends	(7,484)	(7,484)
Net cash used in financing activities	(1,892,889)	(1,527,988)
Net (decrease) increase in cash and cash equivalents	5,131	(2,917)
Beginning balance cash and cash equivalents	6,158	4,018
Ending balance cash and cash equivalents	\$ 11,289	\$ 1,101

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

**Table of Contents**

**ACCREDITED MORTGAGE LOAN REIT TRUST**

**NOTES TO UNAUDITED FINANCIAL STATEMENTS**

**For the Three and Nine Months Ended September 30, 2006 and 2005**

**1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation**

Accredited Mortgage Loan REIT Trust (the "REIT") was formed on May 4, 2004 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 the REIT are held by Accredited Home Lenders, Inc. ("AHL"), a wholly owned subsidiary of Accredited Home Lenders Holding Co., ("AHLHC").

The accompanying unaudited financial statements of the REIT 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 nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. The unaudited financial statements presented herein should be read in conjunction with the audited financial statements and related notes thereto included in the REIT's Annual Report on Form 10-K for the year ended December 31, 2005.

In August 2004, the REIT completed a public offering of 3,400,000 shares of 9.75% Series A Perpetual Cumulative Preferred Stock. In September 2004 the REIT sold an additional 100,000 Series A preferred shares pursuant to the exercise of the underwriters' over-allotment option. In October 2004, the REIT sold an additional 593,678 Series A preferred shares in a public offering.

The REIT engages in the business of acquiring, holding, financing, and securitizing non-prime mortgage loans secured by residential real estate. Generally, the REIT acquires mortgage assets and assumes related funding obligations from AHL, which are accounted for at AHL's carrying value, as contributions of capital from AHL. These mortgage assets consist primarily of residential mortgage loans, or interests in these mortgage loans, that have been originated or acquired by AHL. AHL 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. AHL originates loans primarily based upon the borrower's willingness and ability to repay the loan and the adequacy of the collateral.

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, the REIT's results of operations or financial condition may not be indicative as if it had operated as an unaffiliated entity.

The REIT has elected to be taxed as a real estate investment trust and to comply with the provisions of the Internal Revenue Code with respect thereto. Accordingly, the REIT is generally not subject to federal or state income tax to the extent that its distributions to shareholders satisfy the real estate investment trust requirements and certain asset, income and share ownership tests are met.

**Use of Estimates**

The preparation of 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 amount of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates and assumptions included in our consolidated financial statements relate to the provision for loan losses, hedging policies and income taxes.

## **Table of Contents**

### **ACCREDITED MORTGAGE LOAN REIT TRUST**

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

##### **For the Three and Nine Months Ended September 30, 2006 and 2005**

#### **Cash and Cash Equivalents**

For purposes of financial statement presentation, the REIT 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.

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

Periodically, Loans Held for Securitization, which are originated by and held in AHL, are contributed at the current 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. The loans remain in Loans Held for Securitization for approximately 10 business days prior to the close of the securitization transaction and are thereafter designated as Loans Held for Investment. In June 2006, Accredited closed a \$1.4 billion securitization. Collateral of \$1.05 billion in mortgage loans was delivered in June with the balance of approximately \$350 million delivered in the quarter ended September 30, 2006.

The securitization is structured legally as a sale, but for accounting purposes is treated as a financing under SFAS No. 140. The securitization does not meet the qualifying special purpose entity criteria under SFAS No. 140 and related interpretations because after the loans are securitized, the securitization trust may acquire derivatives relating to beneficial interests retained by the REIT and, AHL, 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 for accounting purposes, and securitization bond financing replaces the warehouse debt originally associated with the loans held for investment. The REIT records interest income on loans held for investment and interest expense on the bonds issued in the securitization over the life of the securitization. Deferred debt issuance costs and discounts related to the bonds are amortized on a level yield basis over the estimated life of the bonds.

The REIT periodically evaluates the need for or the adequacy of the allowance for loan losses on its mortgage loans held for investment. Provision for loan losses on mortgage loans held for investment is made in an amount sufficient to maintain credit loss allowances at a level considered appropriate to cover probable losses in the portfolio. The REIT 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 the portfolio relating to their contractual delinquency status and applying the REIT's and AHL's historical loss experience. The REIT 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 REIT'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.

#### **Derivative Financial Instruments**

As part of the REIT's interest rate management process, the REIT uses derivative financial instruments such as Eurodollar futures and options. In connection with some of the securitizations structured as financings, the REIT entered into interest rate cap agreements. In connection with six of the securitizations structured as financings, the REIT entered into interest rate swap agreements. It is not the REIT'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 balance sheet at fair value.



**Table of Contents**

**ACCREDITED MORTGAGE LOAN REIT TRUST**

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

**For the Three and Nine Months Ended September 30, 2006 and 2005**

*Fair Value Hedges*

As part of the contribution by AHL of loans held for securitization, the REIT acquires certain fair value hedge derivative financial instruments. The REIT continues fair value hedge accounting on these mortgage loans up to several days prior to the close of the securitization. At this time, the fair value hedge instruments are lifted and the hedge positions are capitalized. These capitalized hedge marks are then amortized to interest income, utilizing an effective yield method, over the life of the securitization transaction.

*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, the REIT 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, the REIT 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 amortized over the life of the loan on a level yield basis for mortgage loans held for investment or recognized when prepayments occur.

**Interest Income**

Interest income is recorded when earned. Interest income represents the interest earned 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.

**Income Taxes**

The REIT has elected to be subject to taxation as a real estate investment trust under the Internal Revenue Code of 1986. As a result, the REIT will generally not be subject to federal or state income tax to the extent that the REIT distributes its earnings to its shareholders and maintains its qualification as a real estate investment trust.

**Table of Contents****ACCREDITED MORTGAGE LOAN REIT TRUST****NOTES TO UNAUDITED FINANCIAL STATEMENTS (Continued)****For the Three and Nine Months Ended September 30, 2006 and 2005****Real Estate Owned**

Real estate acquired in settlement of loans generally results when property collateralizing a loan is foreclosed upon or otherwise acquired by AHL, as servicer, in satisfaction of the loan. Real estate acquired through foreclosure is carried at fair value less estimated costs to dispose. Fair value is based on the net amount that the REIT 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 recognized through a charge to earnings. Legal fees and other direct costs incurred after foreclosure are expensed as incurred. At September 30, 2006 and December 31, 2005, real estate owned amounting to \$35.2 million and \$10.5 million, respectively, net of valuation allowances, is included in Other assets.

**Other Comprehensive Income**

Other comprehensive income includes unrealized gains and losses that are excluded from the statement 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.

Comprehensive income is determined as follows:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>			
Net income	\$ 39,256	\$ 47,681	\$ 119,987	\$ 126,894
Net unrealized gains (losses) on cash flow hedges	(41,010)	20,250	7,778	28,715
Reclassification adjustment into earnings for realized gain on derivatives	(9,919)	(3,871)	(25,624)	(10,023)
Total comprehensive income (loss)	\$ (11,683)	\$ 64,060	\$ 102,141	\$ 145,586

**2. CONCENTRATIONS OF RISK*****Geographical Concentration***

Properties securing mortgage loans held for investment are geographically dispersed throughout the United States. At September 30, 2006, 19% and 12% of the unpaid principal balance of mortgage loans held for investment were secured by properties located in California and Florida, respectively. At December 31, 2005, 23% and 11% of the unpaid principal balance of mortgage loans held for investment were secured by properties located in California and Florida, respectively. The remaining properties securing mortgage loans did not exceed 10% in any other state at September 30, 2006 and December 31, 2005.

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, in turn, would increase the risk of delinquency, default or foreclosure on mortgage loans in our portfolio. This could restrict our and AHL's ability to originate, sell, or securitize mortgage loans, and significantly harm our business, financial condition, liquidity and results of operations.



Table of Contents

## ACCREDITED MORTGAGE LOAN REIT TRUST

## NOTES TO UNAUDITED FINANCIAL STATEMENTS (Continued)

For the Three and Nine Months Ended September 30, 2006 and 2005

## 3. MORTGAGE LOANS HELD FOR INVESTMENT

Mortgage loans held for investment were as follows:

	September 30, 2006	December 31, 2005
	(In thousands)	
Principal balance	\$ 6,956,819	\$ 6,350,870
Basis adjustment for fair value hedge accounting	(10,515)	(4,766)
Net deferred origination fees	(22,177)	(7,569)
Allowance for loan losses	(120,928)	(98,399)
Loans held for investment, net	\$ 6,803,199	\$ 6,240,136

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

	Balance at Beginning of Period	Contributions from Parent	Provision for Losses (In thousands)	Chargeoffs, net	Balance at End of Period
<b>Three Months Ended September 30,:</b>					
<b>2006:</b>					
Mortgage loans held for investment	\$ 121,247	\$ 2,863	\$ (2,800)	\$ (382)	\$ 120,928
Real estate owned	7,762		5,907	(3,854)	9,815
Total	\$ 129,009	\$ 2,863	\$ 3,107	\$ (4,236)	\$ 130,743
<b>2005:</b>					
Mortgage loans held for investment	\$ 78,140	\$ 9,685	\$ 317	\$ (394)	\$ 87,748
Real estate owned	2,995		2,261	(847)	4,409
Total	\$ 81,135	\$ 9,685	\$ 2,578	\$ (1,241)	\$ 92,157
<b>Nine Months Ended September 30,:</b>					
<b>2006:</b>					
Mortgage loans held for investment	\$ 98,399	\$ 18,315	\$ 5,323	\$ (1,109)	\$ 120,928
Real estate owned	6,996		10,835	(8,016)	9,815
Total	\$ 105,395	\$ 18,315	\$ 16,158	\$ (9,125)	\$ 130,743

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

<b>2005:</b>					
Mortgage loans held for investment	\$ 54,960	\$ 25,682	\$ 7,691	\$ (585)	\$ 87,748
Real estate owned	2,028		4,933	(2,552)	4,409
Total	\$ 56,988	\$ 25,682	\$ 12,624	\$ (3,137)	\$ 92,157

The following table summarizes delinquency amounts for mortgage loans and real estate owned before valuation allowance:

	At September 30, 2006		At December 31, 2005	
	Total	Delinquent	Total	Delinquent
	Principal	Principal Over	Principal	Principal Over
	Amount	90 Days (In thousands)	Amount	90 Days
Mortgage loans held for investment	\$ 6,956,819	\$ 130,462	\$ 6,350,870	\$ 70,990
Real estate owned	45,047	45,047	17,490	17,490
Total	\$ 7,001,866	\$ 175,509	\$ 6,368,360	\$ 88,480

**Table of Contents****ACCREDITED MORTGAGE LOAN REIT TRUST****NOTES TO UNAUDITED FINANCIAL STATEMENTS (Continued)****For the Three and Nine Months Ended September 30, 2006 and 2005****4. DERIVATIVE FINANCIAL INSTRUMENTS*****Fair Value Hedges***

The REIT uses hedge accounting as defined by SFAS No. 133 for certain derivative financial instruments used to hedge its loans held for investment. At September 30, 2006 and December 31, 2005, fair value hedge basis adjustments of (\$10.5 million) and (\$4.8 million) are included as additions to loans held for investment. No hedge ineffectiveness associated with fair value hedges was recorded in earnings during the three or nine months ended September 30, 2006 or 2005, as the REIT has discontinued fair value hedge accounting on loans held for investment.

***Cash Flow Hedges***

The REIT utilizes cash flow hedging and cash flow hedge accounting on its securitization debt under SFAS No. 133. Effective unrealized (losses) gains associated with cash flow hedges of \$(41.0 million) and \$20.2 million were recorded in other comprehensive income during the three months ended September 30, 2006 and 2005, respectively. Effective unrealized gains, net of effective unrealized losses, associated with cash flow hedges of \$7.8 million and \$28.7 million were recorded in other comprehensive income during the nine months ended September 30, 2006 and 2005, respectively. Other comprehensive income is reported as a component of stockholders' equity. These contracts settle on various dates ranging from September 2006 to September 2015. A total of \$14.6 million in net effective gains, included in other comprehensive income at September 30, 2006, is expected to be recognized in earnings during the next twelve months. Hedge ineffectiveness gains (losses) associated with cash flow hedges of (\$1.6 million) and \$1.5 million was recorded in earnings during the three months ended September 30, 2006 and 2005, respectively, and are included as a component of interest expense in the statements of operations. Hedge ineffectiveness gains (losses) associated with cash flow hedges of (\$0.2 million) and \$2.0 million was recorded in earnings during the nine months ended September 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***

At September 30, 2006, the REIT had outstanding Eurodollar futures contracts, options contracts and interest rate swap agreements that were designated as hedge instruments, as well as interest rate cap agreements. The fair value of the options contracts, interest rate swap and cap agreements, and the fair value of the margin account balances required for these derivatives and the futures contracts were as follows:

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
	<b>(In thousands)</b>	
Options contracts	\$ 3,047	\$ 4,792
Interest rate cap and swap agreements	6,947	12,113
Futures contracts	5,439	8,099
 Total fair value of derivatives	 15,433	 25,004
Margin account balances	31,483	40,343
 Derivative assets, including margin account	 \$ 46,916	 \$ 65,347

**Table of Contents****ACCREDITED MORTGAGE LOAN REIT TRUST****NOTES TO UNAUDITED FINANCIAL STATEMENTS (Continued)****For the Three and Nine Months Ended September 30, 2006 and 2005**

The change in fair value of derivative financial instruments, and the related hedged liability recorded in the statement of operations was as follows:

	<b>Interest Income</b>	<b>Interest Expense (In thousands)</b>	<b>Total</b>
<b><i>Three Months Ended September 30,:</i></b>			
<b>2006:</b>			
Net unrealized gain (loss)	\$ 1,883	\$ (7,339)	\$ (5,456)
Net realized gain		15,703	15,703
<b>Total</b>	<b>\$ 1,883</b>	<b>\$ 8,364</b>	<b>\$ 10,247</b>
<b>2005:</b>			
Net unrealized loss	\$ (1,046)	\$ (3,970)	\$ (5,016)
Net realized gain		9,372	9,372
<b>Total</b>	<b>\$ (1,046)</b>	<b>\$ 5,402</b>	<b>\$ 4,356</b>
<b><i>Nine Months Ended September 30,:</i></b>			
<b>2006:</b>			
Net unrealized gain (loss)	\$ 3,860	\$ (22,529)	\$ (18,669)
Net realized gain		47,930	47,930
<b>Total</b>	<b>\$ 3,860</b>	<b>\$ 25,401</b>	<b>\$ 29,261</b>
<b>2005:</b>			
Net unrealized loss	\$ (4,506)	\$ (11,314)	\$ (15,820)
Net realized gain		24,659	24,659
<b>Total</b>	<b>\$ (4,506)</b>	<b>\$ 13,345</b>	<b>\$ 8,839</b>

**5. CREDIT FACILITIES**

AHL and the REIT have entered into aggregate warehouse facilities to permit the securitization of mortgage loans. AHL is the primary obligor under these facilities until the loans are contributed to the REIT for securitization. The REIT then becomes the primary obligor until the loans are securitized, a period of 30 days or less. Each of the facility agreements has cross-default and cross-collateralization provisions and AHL provides a guarantee of the REIT's obligations under the facilities during the time that the REIT owns the mortgage loans.

Amounts outstanding on these warehouse facilities at September 30, 2006 and December 31, 2005 were collateralized by unsold portions of the securitized debt.





**Table of Contents****ACCREDITED MORTGAGE LOAN REIT TRUST****NOTES TO UNAUDITED FINANCIAL STATEMENTS (Continued)****For the Three and Nine Months Ended September 30, 2006 and 2005****6. SECURITIZATION BOND FINANCING**

Securitization bond financing consisted of the following:

	Balance		Interest Rate Range		Final Stated Maturity
	9/30/2006	12/31/2005	Fixed	Variable (LIBOR+)	
	(in thousands)				
2002 two securitizations	\$ 81,845	\$ 136,634	4.48% - 4.93%	.32% - .50%	2033
2003 three securitizations	264,558	406,650	3.58% - 4.46%	.35% - .38%	2034
2004 four securitizations	1,278,576	1,882,537	2.90% - 5.25%	.15% - 2.50%	2035
2005 four securitizations	2,922,695	3,747,597	N/A	.08% - 2.50%	2035
2006 two securitizations	2,215,188		N/A	.04% - 2.10%	2036
	6,762,862	6,173,418			
Unamortized bond discounts	(2,894)	(3,532)			
Total securitization bond financing, net	\$ 6,759,968	\$ 6,169,886			

The bonds are collateralized by loans held for investment with an aggregate outstanding principal balance of \$7.0 billion and \$6.4 billion as of September 30, 2006 and December 31, 2005, respectively.

Unamortized debt issuance costs, included in other assets, are \$25.9 million and \$19.7 million at September 30, 2006 and December 31, 2005, respectively.

Amounts collected on the mortgage loans are remitted to the respective trustees, who in turn distribute such amounts each month to the bondholders, together with other amounts received related to the mortgage loans, net of fees payable to the REIT, to Accredited Home Lenders, Inc. as servicer, the trustee and the insurer of the bonds. Any remaining funds after payment of fees and distribution of principal and interest is known as excess interest.

The securitization agreements require that a certain level of overcollateralization be maintained for the bonds. A portion of the excess interest may be initially distributed as principal to the bondholders to increase the level of overcollateralization. Once a certain level of overcollateralization has been reached, excess interest is no longer distributed as principal to the bondholders, but, rather, is passed through to the REIT. Should the level of overcollateralization fall below a required level, excess interest will again be paid as principal to the bondholders until the required level has been reached.

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.

Due to the potential for prepayment of mortgage loans, the early distribution of principal to the bondholders and the optional clean-up call, the bonds are not necessarily expected to be outstanding through the stated maturity date set forth above.

**Table of Contents****ACCREDITED MORTGAGE LOAN REIT TRUST****NOTES TO UNAUDITED FINANCIAL STATEMENTS (Continued)****For the Three and Nine Months Ended September 30, 2006 and 2005**

The following table summarizes the expected repayments relating to the securitization bond financing at September 30, 2006. Amounts listed as bond payments are based on anticipated receipts of principal and interest on underlying mortgage loan collateral using historical prepayment speeds:

	(In thousands)
Three months ending December 31, 2006	\$ 430,036
Year Ending December 31:	
2007	2,444,937
2008	1,378,942
2009	797,917
2010	514,034
2011	344,147
Thereafter	852,849
Discount	(2,894)
Total	\$ 6,759,968

**7. INCOME TAXES AND DISTRIBUTION OF EARNINGS**

With the filing of its first Federal income tax return on September 9, 2005, the REIT elected to be treated as a real estate investment trust for income tax purposes in accordance with certain provisions of the Internal Revenue Code of 1986. As a result of this election, the REIT is generally not subject to federal or state income tax to the extent that it distributes its earnings to its shareholders and maintains its qualification as a real estate investment trust. Currently the REIT plans to distribute substantially all of its taxable income to its common and preferred shareholders.

The following is a reconciliation of the income tax provision computed using the statutory federal income tax rate to the income tax provision reflected in the statement of operations:

	Three Months Ended	Three Months Ended	Nine Months Ended	Nine Months Ended
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
	(In thousands)			
Federal income tax at statutory rate	\$ 13,739	\$ 16,688	\$ 41,995	\$ 44,413
Preferred stock dividends at statutory rate	(873)	(873)	(2,619)	(2,619)
Common stock dividends paid deduction and other	(12,866)	(15,815)	(39,376)	(41,794)
Total provision	\$	\$	\$	\$

**8. PREFERRED STOCK**

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

The Board of Trustees, or a duly authorized committee thereof, may issue up to 200,000,000 shares of preferred stock from time to time in one or more classes or series. In addition, the Board of Trustees, or duly authorized committee thereof, may fix the preferences, conversion or other rights, voting powers, restrictions, and limitations as to dividends or other distributions, qualifications and terms and conditions of redemption.

**Table of Contents**

**ACCREDITED MORTGAGE LOAN REIT TRUST**

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

**For the Three and Nine Months Ended September 30, 2006 and 2005**

*9.75% Series A Perpetual Cumulative Preferred Shares*

The REIT's Board of Trustees has classified and designated 4,093,678 preferred shares as Series A Preferred Shares. At September 30, 2006 and December 31, 2005, there were 4,093,678 preferred shares issued and outstanding.

In March, June and September 2006, the REIT's board of trustees declared quarterly cash dividends on the Preferred Shares at the rate of \$0.609375 per share to shareholders of record on March 15, June 15 and September 15, which aggregated \$7.5 million for the nine months ended September 30, 2006 and 2005.

The Series A Preferred Shares contain covenants requiring the REIT to maintain a total shareholders' equity balance and total loans held for investment of at least \$50.0 million and \$2.0 billion, respectively, commencing on December 31, 2004 and at the end of each quarter thereafter. In addition, commencing with each of the four quarters ending December 31, 2005, the REIT is also required to maintain cumulative unencumbered cash flow (as defined in the agreement) greater than or equal to six times the cumulative preferred dividends required in those four quarters. If the REIT is not in compliance with any of these covenants, no dividends can be declared on the REIT's common shares until it is in compliance with all covenants as of the end of two successive quarters. As of September 30, 2006, the REIT was in compliance with the covenants applicable to date in 2006.

AHLHC irrevocably and unconditionally has agreed to pay in full to the holders of each share of the REIT's Series A Preferred Shares, as and when due, regardless of any defense, right of set-off or counterclaim which the REIT or AHLHC may have or assert: (i) all accrued and unpaid dividends (whether or not declared) payable on the REIT's Series A Preferred Shares; (ii) the redemption price (including all accrued and unpaid dividends) payable with respect to any of the REIT's Series A Preferred Shares redeemed by the REIT; and (iii) the liquidation preference, if any, payable with respect to any of the REIT's Series A Preferred Shares. AHLHC's guarantee is subordinated in right of payment to AHLHC's indebtedness, on parity with the most senior class of AHLHC's preferred stock and senior to AHLHC's common stock.

**9. RECEIVABLE FROM PARENT AND ADMINISTRATION AND SERVICING AGREEMENT WITH PARENT**

The REIT has an administration and servicing agreement with its parent company, AHL, whereby AHL provides loan servicing, treasury, accounting, tax and other administrative services for the REIT in exchange for a management fee equal to 0.5% per year on the outstanding principal balance of the loans serviced, plus miscellaneous fee income collected from mortgagors including late payment charges, assumption fees and similar items. Under this agreement, either party agrees to pay interest on the net average balance payable to the other party at an annual rate equal to the six-month LIBOR plus 1.0%. Management fee expense under this agreement totaled \$9.1 million and \$6.8 million for the three months ended September 30, 2006 and 2005, respectively. Interest income under this agreement totaled \$3.0 million and \$1.2 million for the three months ended September 30, 2006 and 2005, respectively. Management fee expense under this agreement totaled \$25.2 million and \$18.2 million for the nine months ended September 30, 2006 and 2005, respectively. Interest income under this agreement totaled \$7.0 million and \$1.6 million for the nine months ended September 30, 2006 and 2005, respectively. The net receivable from parent results from advances of excess cash holdings by the REIT to AHL. AHL utilizes the funds advanced to pay down its warehouse lines. The net receivable will be liquidated at the time the REIT pays common stock dividends to AHL. Pursuant to the right of offset under the agreement between the parties, the net receivable will accrue interest at an annual rate equal to the six-month LIBOR plus 10%.

**Table of Contents****ACCREDITED MORTGAGE LOAN REIT TRUST****NOTES TO UNAUDITED FINANCIAL STATEMENTS (Continued)****For the Three and Nine Months Ended September 30, 2006 and 2005****10. SUPPLEMENTAL CASH FLOW INFORMATION**

The following represents supplemental cash flow information:

	Nine Months Ended September 30,	
	2006	2005
	(In thousands)	
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for interest	\$ 260,828	\$ 144,911
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Transfer of loans held for investment to real estate owned, net of reserves, included in other assets	\$ 27,558	\$ 5,538
Unrealized gains on cash flow hedges recorded to other comprehensive income	\$ 7,778	\$ 28,715
Detail of assets and liabilities contributed from parent:		
Cash contributions	\$ 8,388	\$ 3,000
Mortgage loans, net of reserves	2,376,980	3,019,222
Other net assets (liabilities)	(29,286)	(11,932)
Outstanding balances on warehouse credit facilities	(2,344,773)	(2,942,223)
Assets in excess of liabilities contributed	\$ 11,309	\$ 68,067

## **Table of Contents**

### **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 3 of this Form 10-Q. Our actual results could differ materially from those anticipated by such forward-looking information due to factors discussed under the section entitled "Risk Factors" and elsewhere in this report.

#### **General**

Accredited is a mortgage banking company that originates, finances, securitizes, services and sells non-prime mortgage loans secured by residential real estate throughout the United States, and, to a lesser extent, in Canada. 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 and, to a lesser extent, through our direct sales force in our retail offices. We primarily sell our loans in whole loan sales or hold loans for investment utilizing securitization financing transactions.

#### **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 credit 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 that Accredited services for others, net of servicing costs and amortization of mortgage servicing rights.

Our revenues also include net gain or loss on mortgage-related securities and derivatives, on our loans held for sale, and some of our loans held for investment, which reflect changes in the value of these instruments based on market conditions.

Historically, we have generated the majority of our earnings and cash flows from whole loan sales. During the third quarter, earnings and cash flows from our securitization portfolio exceeded the profit contribution from whole loan sales. We expect our securitization portfolio to contribute significantly to future earnings and cash flows. However, market premiums paid on whole loan sales and the level of whole loan sales could result in the relative profit contribution from our securitization program and whole loan sales to fluctuate in relative size over time. Our securitization transactions will continue to be legally structured as sales, but for accounting purposes will be structured as a financing. Accordingly, the loans remain on our balance sheet, retained interests are not created, and debt securities issued in the securitization replace the warehouse debt originally associated with the securitized mortgage loans. We record interest income on the mortgage loans and interest expense on the debt securities, as well as ancillary fees, over the life of the securitization, instead of recognizing a gain or loss upon closing of the securitization. This portfolio-based accounting closely matches the recognition of income with the actual receipt of cash payments.

**Table of Contents**

We anticipate that our results of operations may fluctuate on a quarterly and annual basis. The timing and degree of fluctuation will depend upon several factors, including competition, economic slowdowns and increased interest rates in addition to those discussed under Risk Factors. Although we have experienced growth in recent years, we cannot assure you that we will be able to sustain revenue growth or maintain profitability on a quarterly or annual basis or that our growth will be consistent with predictions or forecasts.

**Results Of Operations*****Three Months Ended September 30, 2006 Compared to the Three Months Ended September 30, 2005******Executive Summary***

Net income was \$18.4 million for the three months ended September 30, 2006, or \$0.83 per diluted share, a decrease of 55.4% from \$41.3 million, or \$1.87 per diluted share in 2005.

The decrease in net income was primarily driven by a decrease in total revenue of 24.7% and an increase in operating expenses of 12.3% from the three months ended September 30, 2005.

Origination costs net of points and fees declined to 1.53% of loans originated during the three months ended September 30, 2006 from 1.57% during the same period in 2005.

***Net Revenues***

Net revenues and key indicators that affect our net revenues are as follows for the three months ended September 30:

	2006	2005	Change	% Change
	(Dollars in thousands)			
Interest income(1)	\$ 207,343	\$ 164,147	\$ 43,196	26.3%
Interest expense(2)	(138,197)	(84,571)	(53,626)	63.4%
Net interest income	69,146	79,576	(10,430)	(13.1%)
Provision for losses(3)	(9,673)	(15,427)	5,754	37.3%
Net interest income after provision(3)	59,473	64,149	(4,676)	(7.3%)
Gain on sale of loans(3)	47,288	81,904	(34,616)	(42.3%)
Loan servicing income	3,642	3,243	399	12.3%
Other income	3,906	2,460	1,446	58.8%
Total net revenues	\$ 114,309	\$ 151,756	\$ (37,447)	(24.7%)
Net interest income after provision as percentage of net revenues	52.0%	42.3%		
Gain on sale of loans as a percentage of net revenues	41.4%	54.0%		
Mortgage loan originations	\$ 4,229,041	\$ 4,492,719	\$ (263,678)	(5.9%)
Whole loan sales	\$ 3,670,353	\$ 2,979,088	\$ 691,265	23.2%
Mortgage loans securitized	\$ 349,858	\$ 1,120,042	\$ (770,184)	(68.8%)
Average portfolio of mortgage loans	\$ 10,202,292	\$ 8,495,639	\$ 1,706,653	20.1%
Annualized interest income as a percentage of average inventory of mortgage loans	8.13%	7.73%		
Average outstanding borrowings	\$ 9,975,903	\$ 8,131,966	\$ 1,843,937	22.7%

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

- (1) Interest income includes prepayment penalty income and gains and losses from hedging activities.
- (2) Interest expense includes gains and losses from hedging activities and amortization of debt issuance costs.
- (3) We changed the presentation of our 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 have been reclassified to conform to this presentation.



**Table of Contents**

**Interest Income.** Interest income increased 26.3% during the three months ended September 30, 2006 from the comparable period in 2005 reflecting the 20.1% increase in our average portfolio of mortgage loans during the period and an increase in the weighted average interest rates earned on mortgage loans during the three months ended September 30, 2006 when compared to the same period in 2005. The increase in our average inventory of mortgage loans is due to an increase in loans retained on our balance sheet through securitizations.

**Interest Expense.** The increase in interest expense during the three months ended September 30, 2006 of 63.4% reflects an increase in our average outstanding borrowings, which increased from \$8.1 billion during the three months ended September 30, 2005 to \$10.0 billion during the same period in 2006, or 22.7% and an increase in our average borrowing rates. The average rate on our warehouse lines increased from 4.28% during the three months ended September 30, 2005 to 5.84% during the same period in 2006. In addition, the interest cost on our securitizations increased from 4.01% during the three months ended September 30, 2005 to 5.43% during the same period in 2006.

The components of our net interest margin are as follows for the three months ended September 30:

	2006 Average			2005 Average		
	Interest Income (Expense)	Balance Outstanding	Average Rate (Dollars in thousands)	Interest Income (Expense)	Balance Outstanding	Average Rate
<b>Warehouse:</b>						
Interest income	\$ 57,047	\$ 2,760,936	8.26%	\$ 58,670	\$ 3,115,998	7.53%
Other interest income			0.00	(164)		(0.02)
Interest expense	(36,774)	2,461,845	(5.84)	(32,316)	2,935,474	(4.28)
Other interest expense	(1,795)		(0.29)	(1,227)		(0.17)
Spread	18,478		2.13%	24,963		3.06%
<b>Securitizations:</b>						
Interest income	132,992	7,441,356	7.15%	92,481	5,379,641	6.88%
Other interest income	17,304		0.93	13,160		0.98
Interest expense	(104,102)	7,514,058	(5.43)	(53,304)	5,196,492	(4.01)
Other interest expense	4,474		0.24	2,276		0.18
Spread	50,668		2.89%	54,613		4.02%
Net interest margin	\$ 69,146	\$ 10,202,292	2.83%	\$ 79,576	\$ 8,495,639	3.84%

The net interest spread for our portfolio loans (loans held for sale and loans held for securitization) declined from 3.06% during the three months ended September 30, 2005 to 2.13% for the comparable period in 2006. This is due to a higher borrowing cost, which is indexed to either One-Month, or overnight LIBOR, which outpaced an increase in the average customer loan rate. Other Interest Expense consists primarily of amortized facility fees. The decline in net interest margin resulted from continued pricing pressure in the industry and a flat yield curve.

The net interest spread for our securitized loans declined from 4.02% during the three months ended September 30, 2005 to 2.89% for the comparable period in 2006. The decline reflects higher cost of borrowings due to market interest rates increasing, partially offset by increases in coupon rate. Other interest income consists primarily of prepayment penalties and other interest expense is primarily gains from hedging.

**Table of Contents**

**Provision for Losses.** The provision for losses is comprised of the following for the three months ended September 30:

	2006	2005 (Dollars in thousands)	Change	% Change
Current period provision for:				
Loans held for investment	\$ (778)	\$ 11,847	\$ (12,625)	(106.6%)
Real estate owned	10,451	3,580	6,872	191.9%
Total provision for losses	\$ 9,673	\$ 15,427	\$ (5,754)	(37.3%)
Reserve balance at period end:				
Loans held for investment	\$ 124,173	\$ 95,728	\$ 28,445	29.7%
Principal balance at period end:				
Loans held for investment	\$ 7,396,819	\$ 6,685,780	\$ 711,039	10.6%
Reserve balance on loans as a percentage of the principal balance at period end	1.7%	1.4%		

The decrease in provision for losses on loans held for investment was primarily due to a decline in the loans outstanding for the current quarter versus growth in the loans outstanding for the third quarter of last year. The provision for losses on real estate owned increased 191.9% for the three months ended September 30, 2006, as compared to the same period in 2005 as a result of the increase in the level of real estate owned held at the end of the reporting periods partially offset by lower loss severity levels recently.

The ratio of loss reserve to principal outstanding at September 30, 2006, increased to 1.7% from 1.4% for the same period in 2005. The increase is due primarily to an increase in the average age of the portfolio and higher delinquency levels on recent vintages.

**Gain on Sale of Loans.** The components of the gain on sale of loans is as follows for the three months ended September 30:

	2006 Amount	Percentage (Dollars in thousands)	2005 Amount	Percentage
Gain on whole loan sales(1)	\$ 75,136	2.05%	\$ 84,099	2.82%
Net gain (loss) on derivatives	(6,951)	(0.19)	7,870	0.26
Net premium received on whole loan sales	68,185	1.86	91,969	3.08
Provisions for reserves (2)	(31,026)	(0.85)	(5,203)	(0.17)
Direct loan origination fees (expenses)	10,128	0.28	(4,862)	(0.16)
Total net gain on sale of loans	\$ 47,288	1.29%	\$ 81,904	2.75%
Whole loan sales	\$ 3,670,353		\$ 2,979,088	

(1) The percentage is determined by dividing the gain by whole loan sales.

(2) We changed the presentation of our 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.

Total net gain on sale of loans decreased 42.3% during the three months ended September 30, 2006 from the comparable period in 2005 due to a decrease in net premium received associated with lower net interest margins in the current competitive environment. In addition, the net gain on sales decreased as a result of higher



**Table of Contents**

provisions for repurchases and premium recapture and an increase in the provision for lower of cost of market valuation due to higher delinquencies in loans held for sale offset in part by an increase in the direct loan origination fees earned.

**Loan Servicing Income.** Loan servicing income increased 12.3% during the three months ended September 30, 2006 from the comparable period in 2005 due primarily to the increase in assets serviced on an interim basis on behalf of our whole loan sales customers and an increase in ancillary fees earned.

**Other Income.** Other income increased 58.8% during the three months ended September 30, 2006 from the comparable period in 2005 due primarily to the increase in the earnings on bank accounts as a result of higher interest rates during the current period and an increase in the revenues from the mortgage settlement services business.

**Operating Expenses.** Operating expenses are as follows for the three months ended September 30:

	2006	2005	Change	% Change
		(Dollars in thousands)		
Salaries, wages and benefits	\$ 54,571	\$ 48,378	\$ 6,193	12.8%
General and administrative	16,285	15,441	844	5.5%
Occupancy	6,655	5,247	1,408	26.9%
Advertising and promotion	5,635	5,388	247	4.6%
Depreciation and amortization	4,989	3,999	990	24.8%
Total operating expenses	\$ 88,135	\$ 78,453	\$ 9,682	12.3%
Total serviced loans at period end	\$ 9,394,575	\$ 9,176,234	\$ 218,341	2.4%
Total number of employees at period end	3,164	2,639	525	19.9%

**Salaries, Wages and Benefits.** Salaries, wages and benefits increased 12.8% during the three months ended September 30, 2006 compared to the three months ended September 30, 2005 primarily due to staff growth and the related salaries, partially offset by lower bonuses and commissions.

**General and Administrative.** General and administrative expenses increased 5.5% during the three months ended September 30, 2006 compared to the three months ended September 30, 2005 due primarily to the increase in technology related costs.

**Occupancy.** Occupancy expenses increased 26.9% due to increased leasing costs associated with the expansion of various wholesale, retail, and administrative offices.

**Advertising and Promotion.** Advertising and promotion expenses increased 4.6% during the three months ended September 30, 2006 due primarily to increased spending on referrals and leads to support our growth in retail loan originations.

**Depreciation and Amortization.** Depreciation and amortization increased 24.8% during the three months ended September 30, 2006 due primarily to additional investments in technology and infrastructure.

**Table of Contents**

**Net Cost to Originate.** We monitor our net cost to originate mortgage loans, as we believe that it provides a measurement of efficiency in our mortgage loan origination process. The calculation of this net cost to originate is as follows for the three months ended September 30:

	2006	2005 (Dollars in thousands)	% Change
Total operating expenses	\$ 88,135	\$ 78,453	
Add: deferred direct loan origination expenses(1)	13,416	17,419	
Less: servicing cost(2)	(8,534)	(5,809)	
Loan origination expenses	93,017	90,063	
Less: deferred net origination points and fees(3)	(28,236)	(19,231)	
Net cost to originate	\$ 64,781	\$ 70,832	(8.5%)
Total mortgage loan originations	\$ 4,229,041	\$ 4,492,719	(5.9%)
Net cost to originate as percentage of volume	1.53%	1.57%	

(1) Represents the amount of direct expenses incurred and deferred in the period in accordance with Financial Accounting Standard No. 91. These items are included in origination expenses to reflect the complete economic operating expenses for the period.

(2) Consists of direct expenses and corporate overhead allocated to servicing activities.

(3) Deferred net origination points and fees represent amounts received from borrowers during the period less amounts paid to brokers on all loans originated during the period.

The reduction in our net cost to originate mortgage loans as a percentage of total mortgage loan origination volume from 1.57% for the three months ended September 30, 2005 to 1.53% for the same period in 2006 is a result of increased points and fees collected which more than offsets the increase in loan origination expenses.

**Income Taxes.** The provision for income taxes as a percentage of pre-tax income was 20.0% for the three months ended September 30, 2006, as compared with 40.3% for the same period in 2005. This reduction was caused by refinements in our estimates of the components of book and tax income for the full year 2006. The full impact of these changes was included in our estimate of book and tax income as they occurred or as we became aware of them. Unique to the third quarter of 2006 was our ability to utilize loss carry-forwards generated by our Canadian subsidiary against its operating profit. Other significant changes to our third quarter tax provision included the true-up of our estimated effective state income tax rate and the impact resulting from the settlement or clarification of tax positions taken in prior years. The two major components of our effective tax rate are the Federal corporate tax rate of 35% and the effective state income tax rate. We operate and pay tax in nearly every state. Changes in our effective state tax rate occur due to changes in the relative level of our business activities amongst the various states and the differing tax burden imposed by the states we do business in. These two factors combined to cause a slight increase in our effective 2006 state tax rate as compared to 2005.

**REIT Operating Results.** Net revenues for the REIT were \$48.3 million for the three months ended September 30, 2006, resulting primarily from net interest income after provision for losses on loans held for investment. The REIT incurred expenses of \$9.1 million for the same period related to servicing and management fees charged by AHL in accordance with an administration and servicing agreement between the two parties. Resulting net income for the same period was \$36.8 million.

***Nine Months Ended September 30, 2006 Compared to the Nine Months Ended September 30, 2005***

***Executive Summary***

Net income was \$95.5 million for the nine months ended September 30, 2006, or \$4.28 per diluted share, a decrease of 14.8% from \$112.2 million, or \$5.11 per diluted share in 2005.

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

The decrease in net income was primarily driven by a decrease in net revenues of 2.2% and an increase in operating expenses of 11.9%.

**Table of Contents**

Origination costs net of points and fees declined to 1.48% of loans originated during the nine months ended September 30, 2006 from 1.73% during the same period in 2005.

**Net Revenues**

Net revenues and key indicators that affect our net revenues are as follows for the nine months ended September 30:

	2006	2005	Change	% Change
	(Dollars in thousands)			
Interest income(1)	\$ 606,850	\$ 430,194	\$ 176,656	41.1%
Interest expense(2)	(377,308)	(207,022)	(170,286)	(82.3%)
Net interest income	229,542	223,172	6,370	2.9%
Provision for losses(3)	(39,273)	(46,378)	7,105	15.3%
Net interest income after provision(3)	190,269	176,794	13,475	7.6%
Gain on sale of loans(3)	198,514	227,799	(29,285)	(12.9%)
Loan servicing income	11,081	8,082	2,999	37.1%
Other income	9,306	5,800	3,506	60.5%
Total net revenues	\$ 409,170	\$ 418,475	\$ (9,305)	(2.2%)

Net interest income after provision as percentage of net revenues

	46.5%	42.2%		
Gain on sale of loans as a percentage of net revenues	48.5%	54.4%		
Mortgage loan originations	\$ 11,895,778	\$ 11,862,013	\$ 33,765	0.3%
Whole loan sales	\$ 10,385,612	\$ 7,915,870	\$ 2,469,742	31.2%
Mortgage loans securitized	\$ 2,403,685	\$ 3,045,080	\$ (641,395)	(21.1%)
Average portfolio of mortgage loans	\$ 10,124,856	\$ 7,524,187	\$ 2,600,669	34.6%
Annualized interest income as a percentage of average inventory of mortgage loans	7.99%	7.62%		
Average outstanding borrowings	\$ 9,803,821	\$ 7,139,307	\$ 2,664,514	37.3%

- (1) Interest income includes prepayment penalty income and gains and losses from hedging activities.
- (2) Interest expense includes gains and losses from hedging activities and amortization of debt issuance costs.
- (3) We changed the presentation of our 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.

**Interest Income.** Interest income increased 41.1% during the nine months ended September 30, 2006 from the comparable period in 2005 reflecting the 34.6% increase in our average portfolio of mortgage loans during the period and an increase in the weighted average interest rates earned on mortgage loans during the nine months ended September 30, 2006 when compared to the same period in 2005. The increase in our average inventory of mortgage loans is a result of our securitization program.

**Interest Expense.** The increase in interest expense during the nine months ended September 30, 2006 of 82.3% reflects an increase in our average outstanding borrowings, which increased from \$7.1 billion during the nine months ended September 30, 2005 to \$9.8 billion during the same period in 2006, or 37.3% and an increase in our average borrowing rates. The average rate on our warehouse lines increased from 3.99% during the nine months ended September 30, 2005 to 5.52% during the same period in 2006. In addition, the interest cost on our securitizations increased from 3.71% during the nine months ended September 30, 2005 to 5.11% during the same period in 2006.

**Table of Contents**

The components of our net interest margin are as follows for the nine months ended September 30:

	Interest	2006 Average		Interest	2005 Average	
	Income	Balance	Average	Income	Balance	Average
	(Expense)	Outstanding	Rate (Dollars in thousands)	(Expense)	Outstanding	Rate
<b>Warehouse:</b>						
Interest income	\$ 202,966	\$ 3,309,005	8.18%	\$ 150,314	\$ 2,670,973	7.50%
Other interest income			0.00	4		0.00
Interest expense	(124,405)	2,988,596	(5.52)	(74,258)	2,457,890	(3.99)
Other interest expense	(4,994)		(0.22)	(5,482)		(0.30)
Spread	73,567		2.44%	70,578		3.21%
<b>Securitizations:</b>						
Interest income	361,445	6,815,850	7.07%	249,698	4,853,213	6.86%
Other interest income	42,439		0.83	30,178		0.83
Interest expense	(263,597)	6,815,225	(5.11)	(131,919)	4,681,417	(3.71)
Other interest expense	15,688		0.31	4,637		0.13
Spread	155,975		3.10%	152,594		4.11%
Net interest margin	\$ 229,542	\$ 10,124,855	3.07%	\$ 223,172	\$ 7,524,187	3.99%

The net interest spread for our warehouse loans (loans held for sale and loans held for securitization) declined from 3.21% during the nine months ended September 30, 2005 to 2.44% for the comparable period in 2006. This is due to a higher borrowing cost, which is indexed to either One-Month, or overnight LIBOR, which outpaced an increase in the average customer loan rate. This decline in the margin earned was the result of continuing pricing pressure in the industry and a flat yield curve.

The net interest spread for our securitized loans declined from 4.11% during the nine months ended September 30, 2005 to 3.10% for the comparable period in 2006. The decline reflects higher cost of borrowings due to market interest rates increasing, partially offset by increases in coupon rate. Other interest income consists primarily of prepayment penalties and other interest expense is primarily gains from hedging.

**Provision for Losses.** The provision for losses is comprised of the following for the nine months ended September 30:

	2006	2005	Change	% Change
		(Dollars in thousands)		
<b>Current period provision for:</b>				
Loans held for investment	\$ 19,254	\$ 36,129	\$ (16,875)	(46.7%)
Real estate owned	20,019	10,249	9,770	95.3%
Total provision for losses	\$ 39,273	\$ 46,378	\$ (7,105)	(15.3%)
<b>Reserve balance at period end:</b>				
Loans held for investment	\$ 124,173	\$ 95,728	\$ 28,445	29.7%
<b>Principal balance at period end:</b>				
Loans held for investment	\$ 7,396,819	\$ 6,685,780	\$ 711,039	10.6%



Reserve balance on loans as a percentage of the principal balance at period end	1.7%	1.4%
The provision for losses related to loans held for investment decreased 46.7% for the nine months ended September 30, 2006, as compared to the same period in 2005. The decrease in provision for losses on loans held		

**Table of Contents**

for investment was primarily due to the lower growth rate of securitization assets in 2006 as compared to 2005. The provision for losses on real estate owned increased 95.3% for the nine months ended September 30, 2006, as compared to the same period in 2005 as a result of the increase in the level of real estate owned held at the end of the reporting periods partially offset by lower loss severity levels recently.

The ratio of loss reserve to principal outstanding at September 30, 2006, increased to 1.7% from 1.4% for the same period in 2005. The increase is due primarily to an increase in the average age of the portfolio and higher delinquency levels on recent vintages.

**Gain on Sale of Loans.** The components of the gain on sale of loans are as follows for the nine months ended September 30:

	2006		2005	
	Amount	Percentage	Amount	Percentage
	(Dollars in thousands)			
Gain on whole loan sales(1)	\$ 207,188	1.99%	\$ 234,995	2.97%
Gain on sale of loans required in clean-up call			3,172	.04
Net gain (loss) on derivatives	9,371	0.09	13,634	0.17
Net premium received on whole loan sales	216,559	2.08	251,801	3.18
Provisions for reserves (2)	(41,284)	(0.39)	(14,013)	(0.17)
Direct loan origination fees (expenses)	23,239	0.22	(9,989)	(0.13)
Total net gain on sale of loans	\$ 198,514	1.91%	\$ 227,799	2.88%
Whole loan sales	\$ 10,385,612		\$ 7,915,870	

(1) The percentage is determined by dividing the gain by whole loan sales.

(2) We changed the presentation of our 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.

Total net gain on sale of loans decreased 12.9% during the nine months ended September 30, 2006 from the comparable period in 2005 due to a reduction in premium on loan sold resulting from lower net interest margins in the current competitive environment. In addition, the net gain on sale decreased as a result of higher provisions for repurchases and premium recapture and higher market value allowance caused by higher delinquencies, offset in part by the increased volume of whole loan sales and higher loan origination fees earned.

**Loan Servicing Income.** Loan servicing income increased 37.1% during the nine months ended September 30, 2006 from the comparable period in 2005 due primarily to the increase in assets serviced on an interim basis on behalf of our whole loan sales customers and an increase in ancillary fees earned.

**Other Income.** Other income increased 60.5% during the nine months ended September 30, 2006 from the comparable period in 2005 due primarily to the increase in the earnings on bank accounts as a result of higher interest rates during the current period and an increase in the revenues from the mortgage settlement services business.

**Table of Contents**

**Operating Expenses.** Operating expenses are as follows for the nine months ended September 30:

	2006	2005 (Dollars in thousands)	Change	% Change
Salaries, wages and benefits	\$ 151,371	\$ 140,501	\$ 10,870	7.7%
General and administrative	46,978	41,019	5,959	14.5%
Occupancy	19,392	15,694	3,698	23.6%
Advertising and promotion	16,094	13,480	2,614	19.4%
Depreciation and amortization	14,110	10,929	3,181	29.1%
Total operating expenses	\$ 247,945	\$ 221,623	\$ 26,322	11.9%
Total serviced loans at period end	\$ 9,394,575	\$ 9,176,234	\$ 218,341	2.4%
Total number of employees at period end	3,164	2,639	525	19.9%

**Salaries, Wages and Benefits.** Salaries, wages and benefits increased 7.7% during the nine months ended September 30, 2006 due to the recognition of approximately \$3.9 million in stock option expense as a result of SFAS 123R and an increase in salaries associated with staff growth offset by a decrease in incentive compensation associated with lower revenue per loan.

**General and Administrative.** General and administrative expenses increased 14.5% during the nine months ended September 30, 2006 primarily from increases in technology related costs.

**Occupancy.** Occupancy expenses increased 23.6% due to increased leasing costs associated with the expansion of five of our wholesale origination centers and the consolidation of our San Diego offices in a new office complex.

**Advertising and Promotion.** Advertising and promotion expenses increased 19.4% during the nine months ended September 30, 2006 due primarily to increased spending on referrals and leads to support our growth in retail loan originations.

**Depreciation and Amortization.** Depreciation and amortization increased 29.1% during the nine months ended September 30, 2006 due primarily to additional investments in technology and infrastructure.

**Net Cost to Originate.** We monitor our net cost to originate mortgage loans, as we believe that it provides a measurement of efficiency in our mortgage loan origination process. The calculation of this net cost to originate is as follows for the nine months ended September 30:

	2006	2005 (Dollars in thousands)	% Change
Total operating expenses	\$ 247,945	\$ 221,623	
Add: deferred direct loan origination expenses(1)	40,276	47,345	
Less: servicing cost(2)	(23,527)	(17,507)	
Loan origination expenses	264,694	251,461	
Less: deferred net origination points and fees(3)	(88,050)	(46,132)	
Net cost to originate	\$ 176,644	\$ 205,329	(13.9%)
Total mortgage loan originations	\$ 11,895,777	\$ 11,862,013	0.3%
Net cost to originate as percentage of volume	1.48%	1.73%	

(1) Represents the amount of direct expenses incurred and deferred in the period in accordance with Financial Accounting Standard No. 91. These items are included in origination expenses to reflect the complete economic operating expenses for the period.

(2) Consists of direct expenses and corporate overhead allocated to servicing activities.

(3)

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

Deferred net origination points and fees represent amounts received from borrowers during the period less amounts paid to brokers on all loans originated during the period.

## **Table of Contents**

The reduction in our net cost to originate mortgage loans as a percentage of total mortgage loan origination volume from 1.73% for the nine months ended September 30, 2005 to 1.48% for the same period in 2006 is primarily a result of increased points and fees collected.

**Income Taxes.** The decrease in our effective tax rate from 39.2% for the nine months ended September 30, 2005 to 36.1% for the same period in 2006 was due to refinements in our estimates of the components of book and tax income for the full year 2006. We included the impact of these changes in our estimate of book and tax income as they occurred or as we became aware of them. During the third quarter of 2006 we were able to utilize for the first time loss carry-forwards generated by our Canadian subsidiary against its current operating profit. Other significant changes to our third quarter tax provision included the true-up of our estimated effective state income tax rate and the impact resulting from the settlement or clarification of tax positions taken in prior years.

The two major components of our effective tax rate are the Federal corporate tax rate of 35% and the effective state income tax rate. We operate and pay tax in nearly every state. Changes in our effective state tax rate occur principally as a result of changes in the relative level of our business activities amongst the various states and the differing tax burden imposed by the states we do business in.

**REIT Operating Results.** Net revenues for the REIT were \$145.2 million for the nine months ended September 30, 2006, resulting primarily from net interest income after provision for losses from securitizations. The REIT incurred expenses of \$25.2 million for the same period related to servicing and management fees charged by AHL in accordance with an administration and servicing agreement between the two parties. Resulting net income for the same period was \$112.5 million.

## **Liquidity And Capital Resources**

As a mortgage banking company, our cash requirements include the funding of mortgage loan originations, interest expense on and repayment of principal on credit facilities and securitization bond financing, operational expenses, servicing advances, hedging margin requirements, and tax payments. Our cash requirements also included the funding of quarterly dividends on preferred shares issued by our REIT subsidiary. We fund these cash requirements with cash received from loan sales, borrowings under warehouse credit facilities and asset backed commercial paper and securitization bond financing secured by mortgage loans, cash, interest collections on loans held for sale and loans held for investment, servicing fees and other servicing income, and points and fees collected from the origination of loans.

On September 14, 2006, the Board of Directors authorized Accredited to repurchase up to 5 million shares of the Company's stock from time to time through October 1, 2007. Under the program adopted by the Board, shares of Accredited's common stock may be repurchased from time to time in both privately negotiated and open market transactions, including pursuant to a 10b5-1 plan, subject to management's evaluation of market conditions, applicable legal requirements and other factors. A 10b5-1 plan allows Accredited to repurchase shares at times when it would ordinarily not be in the market because of its trading policies. The repurchases may be commenced or suspended at any time without prior notice and without further announcement. As of November 8, 2006, Accredited had repurchased 1,000,000 shares.

Our liquidity strategy is to maintain sufficient and diversified credit facilities to finance our mortgage loan originations, to maintain strong relationships with a diverse group of whole loan purchasers, and to maintain the ability to execute our own securitizations. This provides us with the ability to finance our growing origination operations and to maximize our realization of the value of loans we originate. Net cash used in operating activities totaled \$1.7 billion and \$3.8 billion during the nine months ended September 30, 2006 and 2005, respectively. The negative cash flow from these periods reflects primarily our funding of loans held for sale and investment that are either not entirely sold in the same period or financed with proceeds reported in our cash flows from financing activities. At September 30, 2006, Accredited had approximately \$201.4 million of unrestricted cash compared to \$44.7 million at December 31, 2005. The increase was partially due to having approximately \$80 million on hand for the purchase of Aames.

**Table of Contents***Credit Facilities*

We use our various credit facilities to finance the funding of our loan originations. We sell or securitize our mortgage loans generally within one to four months from origination and use the proceeds primarily to pay down the warehouse credit facilities. At September 30, 2006, we had voluntary and recoverable warehouse line paydowns of \$149.4 million that increased our warehouse line availability by a corresponding amount. These voluntary and recoverable warehouse line paydowns plus cash of \$201.4 million brought our total liquidity to \$350.8 million at September 30, 2006. All of our current warehouse credit facilities are committed lines. The majority of our current warehouse credit facilities also contain a sub-limit for wet funding, which is the funding of loans for which the collateral custodian has not yet received the related loan documents.

Except as otherwise noted below, all of our credit facilities accrue interest at a rate based upon one-month LIBOR plus a specified spread and as of November 3, 2006 have other material terms and features as follows:

	Maximum		
	Portion		
	Total	Available	
Facility	for Wet	Expiration	
Amount	Funding (in millions)	Date	
Goldman Sachs Mortgage Company	\$ 660	\$ 120	Dec 15, 2007
Merrill Lynch Bank USA	650	260	Feb 14, 2007
Morgan Stanley Bank and Morgan Stanley Mortgage Capital Inc	650	163	Jul 31, 2007
IXIS Real Estate Capital Inc.	600	240	Aug 14, 2007
Credit Suisse First Boston Mortgage Capital LLC(1)	600	240	Dec 29, 2006
Lehman Brothers Bank, FSB	500	110	Jun 29, 2007
Residential Funding Corporation	300	150	Jan 31, 2007
JP Morgan Chase	75	n/a	Sep 27, 2007
HSBC Mortgage Services Warehouse Lending Inc.	40	40	Nov 30, 2006
Merrill Lynch Canada Capital Inc (Canadian Dollar)(2)	200		Jun 28, 2007
<b>Total</b>	<b>\$ 4,275</b>	<b>\$ 1,323</b>	

(1) Bears interest at overnight LIBOR plus a specified spread.

(2) Bears interest at one-month Bankers' Acceptance rate plus a spread.

One or more of our credit facilities include sublimits for aged and delinquent loans, as well as for real estate owned (properties acquired through foreclosure of defaulted mortgage loans or through deeds in lieu of foreclosure) and subordinated asset-backed bonds.

Our warehouse and other credit facilities contain customary covenants including maximum leverage, minimum liquidity, profitability and net worth requirements, and limitations on other indebtedness. If we fail to comply with any of these covenants or otherwise default 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 we default under one facility, it would generally trigger a default under our other facilities. As of September 30, 2006, we were in compliance with all covenant requirements for each of the facilities.

On November 6, Accredited signed a \$100 million master repurchase agreement with JP Morgan Chase Bank, N.A. The agreement will provide available funds for the financing of certain owner trust certificates and retained bonds related to our securitizations. The advances will accrue interest at one-month libor plus a spread, the amount of which varies according to the advance rate and the collateral.

*Asset Backed Commercial Paper Facility*

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

Accredited maintains a \$2.5 billion asset-backed commercial paper ( ABCP ) program utilizing short-term secured liquidity notes ( SLNs ) with initial maturities ranging from one to one hundred eighty days. As

## **Table of Contents**

additional security under this program, AHL issued \$80.0 million of subordinated notes maturing in \$40 million increments on May 26, 2010 and August 25, 2011. In support of the ABCP program, Accredited established a special purpose, bankruptcy remote Delaware statutory trust. The trust entered into agreements with third parties who act as back-up liquidity providers. The SLNs bear interest at customary commercial paper market rates (5.43% at September 30, 2006), which vary depending on the prevailing market conditions.

At September 30, 2006, Accredited had \$739.8 million outstanding; the facility is collateralized by mortgage loans held for sale or securitization and certain restricted cash balances.

### *REIT Activity*

At September 30, 2006 the REIT had cash of \$11.3 million, an increase of \$5.1 million from December 31, 2005. During the nine months ended September 30, 2006, net cash provided by operating activities totaled \$137.3 million, net cash provided by investing activities totaled \$1.8 billion and net cash used in financing activities totaled \$1.9 billion.

In June 2006, Accredited closed a \$1.4 billion securitization. Collateral of \$1.05 billion in mortgage loans was delivered in June with the balance of approximately \$350 million delivered in the quarter ended September 30, 2006.

The securitizations utilize a senior/subordinated structure consisting of senior and subordinated notes with a final stated maturity date in approximately thirty years. The securitizations are structured as a financing; therefore, both the mortgage loans and the debt represented by the notes will remain on our consolidated balance sheet. We used the proceeds from these securitizations primarily to repay warehouse financing for the mortgage loans.

In March, June and September of 2006, the REIT's Board of Trustees declared a quarterly cash dividend on the preferred shares at the rate of \$0.609375 per share to shareholders of record on March 15, June 15 and September 15, which aggregated \$7.5 million for the nine months ended September 30, 2006.

Accredited irrevocably and unconditionally agrees to pay in full to the holders of each share of the REIT's Series A Preferred Shares, as and when due, regardless of any defense, right of set-off or counterclaim which the REIT or Accredited may have or assert: (i) all accrued and unpaid dividends (whether or not declared) payable on the REIT's Series A Preferred Shares, (ii) the redemption price (including all accrued and unpaid dividends) payable with respect to any of the REIT's Series A Preferred Shares redeemed by the REIT and (iii) the liquidation preference, if any, payable with respect to any of the REIT's Series A Preferred Shares. Accredited's guarantee is subordinated in right of payment to Accredited's indebtedness, on parity with the most senior class of Accredited's preferred stock and senior to Accredited's common stock. At September 30, 2006, the aggregate redemption value of the total preferred shares outstanding was \$102.3 million. Based on total preferred shares outstanding at September 30, 2006, the REIT's current annual dividend obligation totals \$10.0 million.

Subject to the various uncertainties described above, and assuming that we will be able to successfully execute our liquidity strategy, we anticipate that our liquidity, credit facilities and capital resources will be sufficient to fund our operations for the foreseeable future.

### **Market Risk**

Market risks generally represent the risk of loss that may result from the potential change in the value of a financial instrument due to fluctuations in interest and foreign exchange rates and in equity and commodity prices. Our market risk relates primarily to interest rate fluctuations. We may be directly affected by the level of and fluctuations in interest rates, which affect the spread between the rate of interest received on our mortgage loans and the related financing rate. Our profitability could be adversely affected during any period of unexpected or rapid changes in interest rates, by impacting the value of loans held for sale, loans held for



## **Table of Contents**

investment and loans sold with retained interests. A significant change in interest rates could also change the level of loan prepayments, thereby adversely affecting our long-term net interest income and servicing income.

The objective of interest rate risk management is to control the effects that interest rate fluctuations have on the value of our assets and liabilities. Our management of interest rate risk is intended to mitigate the volatility of earnings associated with fluctuations in the unrealized gain (loss) on mortgage-related securities, the market value of loans held for sale and the net interest on loans held for investment due to changes in the current market rate of interest.

We use several internal reports and risk management strategies to monitor, evaluate, and manage the risk profile of our loan portfolio in response to changes in the market risk. We cannot assure you, however, that we will adequately offset all risks associated with interest rate fluctuations impacting our loan portfolio.

### *Derivative Instruments and Hedging Activities*

As part of our interest rate management process, we use derivative financial instruments such as Eurodollar futures and options on Eurodollar futures. In connection with our securitizations structured as financings, we entered into interest rate cap and interest rate swap agreements. It is not our 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*

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 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 or securitization, we use 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. The net amount recorded in the consolidated statement of operations is referred to as hedge ineffectiveness.

### *Cash Flow Hedges*

During the third quarter of 2004, we implemented the use of cash flow hedging on our securitization debt under SFAS No. 133. 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. During the third quarter 2005, Accredited implemented the use of cash flow hedging on its variable rate debt in Canada under SFAS No. 133. Pursuant to SFAS No. 133, hedge instruments have been designated as hedging the exposure to variability of cash flows from our variable rate debt in Canada attributable to interest rates. 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 recorded into earnings in the period during which the hedged transaction affects earnings pursuant to SFAS No. 133. 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.

**Table of Contents***Interest Rate Simulation Sensitivity Analysis*

Changes in market interest rates affect our estimations of the fair value of our mortgage loans held for sale, loans held for investment and the related derivatives. Changes in fair value that are stated below are derived based upon immediate and equal changes to market interest rates of various maturities. All derivative financial instruments and interest rate sensitive financial assets and liabilities have been included within the sensitivity analysis presented. We model the change in value of our derivative financial instruments using outside valuation models generally recognized within the industry. Projected changes in the value of our loans as stated below are determined based on the change in net present value arising from the selected hypothetical changes in market interest rates. We are exposed to interest rate risk from the time the loans are funded to the time the loans are settled because the interest paid on the various warehouse facilities is based on the spot one-month LIBOR rate. The interest rate risk associated with the interest expense paid on the various warehouse facilities has been included based on the average holding period from the time of funding to settlement. Changes in the fair value of our derivative positions with optionality have been included based on an immediate and equal change in market interest rates. The base or current interest rate curve is adjusted by the levels shown below as of September 30, 2006:

	+50 bp	+100 bp (In thousands)	-50 bp	-100 bp
Change in fair value of:				
Mortgage loans committed and held for sale	\$ (28,317)	\$ (56,141)	\$ 28,814	\$ 58,151
Derivatives related to mortgage loans committed and held for sale	23,170	46,340	(23,170)	(46,340)
Warehouse debt and asset backed commercial paper	(1,089)	(2,177)	1,089	2,177
Securitized debt subject to portfolio-based accounting and mortgage-related securities	(52,405)	(104,154)	53,079	106,849
Derivatives related to securitized debt subject to portfolio-based accounting and mortgage-related securities	44,355	88,824	(44,314)	(88,108)
<b>Total</b>	<b>\$ (14,286)</b>	<b>\$ (27,308)</b>	<b>\$ 15,498</b>	<b>\$ 32,729</b>

The simulation analysis reflects our efforts to balance the repricing characteristics of our interest-bearing assets and liabilities.

**Contractual Obligations**

Our March and June 2006 securitizations significantly increased our securitization bond financing balance from the balance at December 31, 2005. The following table summarizes our contractual obligations, excluding future interest, at September 30, 2006, and the effect such obligations are expected to have on our liquidity and cash flows in future periods:

	Total	Payments Due by Period			More than 5 Years
		Less than 1 year	1-3 Years (In thousands)	3-5 Years	
Credit facilities	\$ 2,046,208	\$ 1,966,208	\$	\$ 80,000	\$
Securitization bond financing(1)	7,050,283	2,265,055	2,804,073	1,040,336	940,819
Operating lease obligations	147,917		65,842	38,349	43,726
<b>Total</b>	<b>\$ 9,244,408</b>	<b>\$ 4,231,263</b>	<b>\$ 2,869,915</b>	<b>\$ 1,158,685</b>	<b>\$ 984,545</b>

- (1) Amounts represent the expected repayment requirements based on anticipated receipts of principal and interest on underlying mortgage loan collateral using historical prepayment speeds. The securitization bond financing represents obligations of the respective trusts that issue the notes and the assets sold to these issuers are not available to satisfy claims of Accredited's creditors. The noteholders' recourse is limited to the pledged collateral.



## **Table of Contents**

### **Off-Balance Sheet Financing Arrangements**

In the normal course of business, in order to meet the financing needs of our borrowers, we are a party to various financial instruments with off-balance sheet risk. These financial instruments primarily represent commitments to individual borrowers to fund their loans. These instruments involve, to varying degrees, elements of interest rate risk and credit risk in excess of the amount recognized in the consolidated balance sheets. We seek to mitigate the credit risk by evaluating the creditworthiness of potential mortgage loan borrowers on a case-by-case basis. We do not guarantee interest rates to potential borrowers when an application is received. We quote interest rates to borrowers which are generally subject to change by us. Although we make every effort to honor such quotes, the quotes do not constitute interest rate lock commitments. Interest rates conditionally approved following the initial underwriting of applications are subject to adjustment if any conditions are not satisfied. We commit to originating loans, in many cases dependent upon the borrower's satisfying various conditions. These commitments to fund individual borrower loans totaled \$741.0 million as of September 30, 2006.

Accredited irrevocably and unconditionally agrees to pay in full to the holders of each share of the REIT's Series A Preferred Shares, as and when due, regardless of any defense, right of set-off or counterclaim which the REIT or Accredited may have or assert: (i) all accrued and unpaid dividends (whether or not declared) payable on the REIT's Series A Preferred Shares, (ii) the redemption price (including all accrued and unpaid dividends) payable with respect to any of the REIT's Series A Preferred Shares redeemed by the REIT and (iii) the liquidation preference, if any, payable with respect to any of the REIT's Series A Preferred Shares. Accredited's guarantee is subordinated in right of payment to Accredited's indebtedness, on parity with the most senior class of Accredited's preferred stock and senior to Accredited's common stock. At September 30, 2006, the aggregate redemption value of the total preferred shares outstanding was \$102.3 million. Based on total preferred shares outstanding at September 30, 2006, the REIT's current annual dividend obligation totals \$10.0 million.

### **Critical Accounting Policies**

#### *Accounting for Our Loan Sales*

We generally sell our loans in transactions that are accounted for in our financial statements as securitizations structured as a financing or whole loan sales. The securitization transactions were legally structured as sales of mortgage loans, but for accounting purposes were treated as financings under SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* a replacement of *FASB Statement No. 125*. Under such a structure, the loans remain on our balance sheet, retained interests are not created, and debt securities issued in the securitization replace the warehouse debt originally associated with the securitized mortgage loans. We record interest income on the mortgage loans and interest expense on the debt securities, as well as ancillary fees, over the life of the securitization, instead of recognizing a gain or loss upon closing of the transaction.

When we sell our mortgage loans in whole loan sale transactions, the transaction is structured as a sale of mortgage loans for legal and accounting purposes and we dispose of our entire interest in the loans. Gain on sale revenue is recorded at the time we sell loans, but not when we securitize loans in transactions structured as financings. 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. 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. From time to time, management has delayed the sale of loans to a later period, and may do so again in the future.

## **Table of Contents**

### *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

provision for losses

interest rate risk, derivatives and hedging strategies

income taxes

stock-based compensation expense

fair value of assets and liabilities acquired in business combinations

### *Loans Held for Sale*

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

### *Provisions for Losses*

We provide market valuation adjustments on certain nonperforming loans and real estate owned. These adjustments are based upon our estimate of expected losses, calculated using 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 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 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 periods 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 loans held for investment subject to portfolio-based accounting.

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

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

## **Table of Contents**

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 loans held for investment subject to portfolio-based accounting exists because some of these loans have fixed interest rates for a period of two, three or five 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 for six month adjustable loans and when the loans become adjustable after their two, three or five 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 loans held for investment subject to portfolio-based accounting due to changes in LIBOR rates.

As part of our interest rate risk management process, we use derivative financial instruments such as interest rate swaps and caps, Eurodollar futures and options on Eurodollar futures. In connection with the securitizations structured as financings, we have entered into interest rate cap agreements and interest rate swap 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.

### *Fair Value Hedges*

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 correlation in the hedge relationship. To hedge the effect of interest rate changes on the fair value of mortgage loans held for sale, 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. The net amount recorded in the consolidated statements of operations is referred to as hedge ineffectiveness.

### *Cash Flow Hedges*

During the third quarter 2004, we implemented the use of cash flow hedge accounting on our securitization debt under SFAS No. 133. 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. During the third quarter 2005, Accredited implemented the use of cash flow hedging on its variable rate debt in Canada under SFAS No. 133. Pursuant to SFAS No. 133, hedge instruments have been designated as hedging the exposure to variability of cash flows from our variable rate debt in Canada attributable to interest rates. 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 in other comprehensive income, and that the ineffective portion be reported in current earnings.

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.

## **Table of Contents**

### *Stock-Based Compensation*

As of January 1, 2006, we adopted SFAS 123(R), which requires us to measure compensation cost for stock awards at fair value and recognize compensation over the service period the awards expected to vest. The determination of compensation cost requires us to make highly judgmental assumptions regarding volatility, expected option life, and forfeiture rates. In addition, changes in our stock price or prevailing interest rates will also impact the determination of fair value and compensation cost. If any of our assumptions used to determine fair value change significantly, future share-based compensation may differ materially from that recorded in the current period.

### **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 No. 48 will be January 1, 2007. The impact of FIN No. 48 on the Accredited s financial statements has not been fully analyzed.

### **Risk Factors**

You should carefully consider the following risks, together with other matters described in this Form 10-Q in evaluating our business and prospects. Additional information regarding the risks related to our merger with Aames can be found in the registration statement on Form S-4 that we filed with the Securities and Exchange Commission on July 14, 2006. If any of the events referred to below actually occur, our business, financial condition, liquidity and results of operations could suffer. In that case, the trading price of our common stock could decline. The risks described below are not the only ones we face. Additional risks not presently known to us or that we currently deem immaterial may also impair our business operations. Certain statements in this Form 10-Q (including certain of the following risk factors) constitute forward-looking statements. Please refer to the section entitled Forward-Looking Statements on page 3 of this Form 10-Q.

#### *Risks Related to Our Business*

#### **We face intense competition that could adversely impact our market share and our revenues.**

We face intense competition from finance and mortgage banking companies, Internet-based lending companies where entry barriers are relatively low, and from traditional bank and thrift lenders that offer Alt A loan products or have entered the non-prime mortgage industry. As we seek to expand our business further, we will face a significant number of additional competitors, many of whom will be well established in the markets we seek to penetrate. Some of our competitors are much larger, have better name recognition, and have far greater financial and other resources than us.

The government-sponsored entities Fannie Mae and Freddie Mac are also expanding their participation in the non-prime mortgage industry. These government-sponsored entities have a size and cost-of-funds advantage that allows them to purchase loans with lower rates or fees than we are willing to offer. While the government- sponsored entities presently do not have the legal authority to originate mortgage loans, including non-prime loans, they do have the authority to buy loans. A material expansion of their involvement in the market to purchase non-prime loans could change the dynamics of the industry by virtue of their sheer size, pricing power and the inherent advantages of a government charter. In addition, if as a result of their purchasing practices, these government-sponsored entities experience significantly higher-than-expected losses, such experience could adversely affect the overall investor perception of the non-prime mortgage industry.

The intense competition in the non-prime mortgage industry has also led to rapid technological developments, evolving industry standards and frequent releases of new products and enhancements. As



## Table of Contents

mortgage products are offered more widely through alternative distribution channels, such as the Internet, we may be required to make significant changes to our current retail and wholesale structure and information and technology systems to compete effectively. Our inability to continue enhancing our current Internet capabilities, or to adapt to other technological changes in the industry, could significantly harm our business, financial condition, liquidity and results of operations. In addition, we rely on software and other technology-based programs to gather and analyze competitive and other data from the marketplace. Problems with our technology or inability to implement technological changes may, therefore, result in delayed detection of market trends and conditions.

Competition in the industry can take many forms, including interest rates and costs of a loan, less stringent underwriting standards, offering of loan products which we do not offer, convenience in obtaining a loan, customer service, amount and term of a loan and marketing and distribution channels. The need to maintain mortgage loan volume in this competitive environment creates a risk of price competition in the non-prime mortgage industry. Price competition could prevent us from raising rates in response to a rising cost of funds or cause us to lower the interest rates that we charge borrowers, which could adversely impact our profitability and lower the value of our loans. If our competitors adopt less stringent underwriting standards, we will be pressured to do so as well, which would result in greater loan risk without compensating pricing. If we do not relax underwriting standards in response to our competitors, we may lose market share. Any increase in these pricing and underwriting pressures could reduce the volume of our loan originations and sales and significantly harm our business, financial condition, liquidity and results of operations.

### **Any substantial economic slowdown could increase delinquencies, defaults and foreclosures and reduce our ability to originate loans.**

Periods of economic slowdown or recession may be accompanied by decreased demand for consumer credit, decreased real estate values, and increased rates of delinquencies, defaults and foreclosures. Any material decline in real estate values would increase the loan-to-value ratios ( LTVs ) on loans that we hold pending sale and loans in which we have a residual or retained interest, weaken our collateral coverage and increase the possibility and severity of a loss if a borrower defaults. We originate loans to borrowers who make little or no down payment, resulting in higher LTVs. A lack of equity in the home may reduce the incentive a borrower has to meet his payment obligations during periods of financial hardship, which might result in higher delinquencies, defaults and foreclosures. These factors would reduce our ability to originate loans and increase our losses on loans in which we have a residual or retained interest. In addition, loans we originate during an economic slowdown may not be as valuable to us because potential purchasers of our loans might reduce the premiums they pay for the loans to compensate for any increased risks arising during such periods. Any sustained increase in delinquencies, defaults or foreclosures is likely to significantly harm the pricing of our future loan sales and securitizations and also our ability to finance our loan originations.

### **We finance borrowers with lower credit ratings. The non-prime loans we originate generally have higher delinquency and default rates than prime mortgage loans, which could result in losses on loans that we hold or that we are required to repurchase, the loss of our servicing rights and damage to our reputation as a loan servicer.**

We are in the business of originating, selling, securitizing and servicing non-prime mortgage loans. Non-prime mortgage loans generally have higher delinquency and default rates than prime mortgage loans. Delinquency interrupts the flow of projected interest income from a mortgage loan and default can ultimately lead to a loss if the net realizable value of the real property securing the mortgage loan is insufficient to cover the principal and interest due on the loan. Also, our cost of financing and servicing a delinquent or defaulted loan is generally higher than for a performing loan. We bear the risk of delinquency and default on loans beginning when we originate them until we sell them and we continue to bear the risk of delinquency and default after we securitize loans or sell loans with a retained interest. Loans that become delinquent prior to sale or securitization may become unsaleable or saleable only at a discount, and the longer we hold loans prior to sale or securitization,

## Table of Contents

the greater the chance we will bear the costs associated with the loans' delinquency. Factors that may increase the time held prior to sale or securitization include the time required to accumulate loans for securitizations or sales of large pools of loans, the amount and timing of third-party due diligence in connection with sales or securitizations, and defects in the loans.

We also reacquire the risks of delinquency and default for loans that we are obligated to repurchase. Repurchase obligations are typically triggered in loan sale transactions if an early payment default occurs on the loan after sale or in any sale or securitization if the loan materially violates our representations or warranties. During the three months ended September 30, 2006 and 2005 loans repurchased totaled \$61.8 million and \$21.3 million, respectively, and during the nine months ended September 30, 2006 and 2005 loans repurchased totaled \$114.9 million and \$55.3 million, respectively, pursuant to these obligations. If we experience higher-than-expected levels of delinquency or default in pools of loans that we service, we may lose our servicing rights, which would result in a loss of future servicing income and may damage our reputation as a loan servicer.

We attempt to manage these risks with risk-based mortgage loan pricing and appropriate underwriting policies and loan collection methods. However, if such policies and methods are insufficient to control our delinquency and default risks and do not result in appropriate loan pricing, our business, financial condition, liquidity and results of operations could be significantly harmed. Our total delinquency rate (30 or more days past due, including loans in foreclosure and converted into real estate owned) for our servicing portfolio was 5.44% at September 30, 2006. Historically, our delinquency rate has increased, and may increase in the future, as the mortgage loans in our portfolio age.

**A future increase in interest rates could result in a reduction in our loan origination volumes, an increase in delinquency, default and foreclosure rates and a reduction in the value of, and income from, our loans.**

The following are some of the risks we face related to an increase in interest rates:

A substantial and sustained increase in interest rates could harm our ability to originate loans because refinancing an existing loan would be less attractive and qualifying for a purchase loan may be more difficult.

Existing borrowers with adjustable-rate mortgages or higher risk loan products may incur higher monthly payments as the interest rate increases, or experience higher delinquency and default rates.

If prevailing interest rates increase after we fund a loan, the value that we receive upon the sale or securitization of the loan decreases.

The cost of financing our mortgage loans prior to sale or securitization is based primarily upon the London Inter-Bank Offered Rate (LIBOR). The interest rates we charge on our mortgage loans are based, in part, upon prevailing interest rates at the time of origination, and the interest rates on all of our mortgage loans are fixed for at least the first six months, or two, three or five years. If LIBOR increases after the time of loan origination, our net interest income which represents the difference between the interest rates we receive on our mortgage loans pending sale or securitization and our LIBOR-based cost of financing such loans will be reduced. The weighted average cost of financing our mortgage loans, prior to sale or securitization, was 5.84% during the three months ended September 30, 2006. The weighted average cost of financing our mortgage loans, prior to sale or securitization, was 5.52% during the nine months ended September 30, 2006.

When we securitize loans or sell loans with retained interests, the value of and the income we receive from the loans held for investment subject to portfolio-based accounting and the mortgage-related securities we retain are also based on LIBOR to the extent the underlying loans have an adjustable interest rate. This is because the income we receive from these mortgage loans and mortgage-related securities is based on the difference between the fixed rates payable on the loans for the first two or three years, and an adjustable LIBOR-based yield payable to the senior security holders or loan purchasers. We also have interest rate risk when the loans become adjustable after their two or three

## **Table of Contents**

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. Accordingly, our business, financial condition, liquidity and results of operations may be significantly harmed as a result of increased interest rates.

### **Defective and repurchased loans may harm our business.**

In connection with the sale and securitization of our loans, we are required to make a variety of customary representations and warranties regarding our company and the loans. We are subject to these representations and warranties for the life of the loan and they relate to, among other things:

compliance with laws;

regulations and underwriting standards;

the accuracy of information in the loan documents and loan file; and

the characteristics and enforceability of the loan.

A loan that does not comply with these representations and warranties may take longer to sell, impact our ability to obtain third party financing, and be unsaleable or saleable only at a discount. If such a loan is sold before we detect a non-compliance, we may be obligated to repurchase the loan and bear any associated loss directly, or we may be obligated to indemnify the purchaser against any such losses, either of which could reduce our cash available for operations and liquidity. We believe that we have qualified personnel at all levels and have established controls to ensure that all loans are originated to the market's requirements, but we cannot assure you that we will not make mistakes, or that certain employees will not deliberately violate our lending policies. In addition, the number of loans that we are required to repurchase may increase as a result of our merger with Aames, since we assumed their repurchase obligations upon the closing of the merger. We seek to minimize losses from defective loans by correcting flaws if possible and selling or re-selling such loans. We also create allowances to provide for defective loans in our financial statements. We cannot assure you; however, that losses associated with defective loans will not harm our results of operations or financial condition.

### **Our inability to attract and retain qualified employees could significantly harm our business.**

We depend upon our wholesale account executives and retail loan officers to attract borrowers by, among other things, developing relationships with financial institutions, other mortgage companies and brokers, real estate agents, borrowers and others. We believe that these relationships lead to repeat and referral business. The market for skilled executive officers, account executives and loan officers is highly competitive and historically has experienced a high rate of turnover. More so, the competition often will offer above market sign-on bonuses and above market compensation and incentive plans to attract our employees. Because of the difficulty in retaining qualified management personnel, we currently recruit college graduates to participate in our management trainee program. If we are unable to retain those trainees for a sufficient period following their training, we may be unable to recapture our costs of training and recruitment. In addition, if a manager leaves our company there is an increased likelihood that other members of his or her team will follow. Competition for qualified account executives and loan officers may lead to increased hiring and retention costs. If we are unable to attract or retain a sufficient number of skilled account executives at manageable costs, we will be unable to continue to originate quality mortgage loans that we are able to sell for a profit, which will reduce our revenues.

### **We may not be able to continue to sell and securitize our mortgage loans on terms and conditions that are profitable to us.**

A substantial portion of our revenues comes from the gains on sale generated by sales of pools of our mortgage loans as whole loans. We make whole loan sales to a limited number of institutional purchasers, some

## **Table of Contents**

of which may be frequent, repeat purchasers, and others of which may make only one or a few purchases from us. We cannot assure you that we will continue to have purchasers for our loans on terms and conditions that will be profitable to us. Also, even though our mortgage loans are generally marketable to multiple purchasers, certain loans may be marketable to only one or a few purchasers, thereby increasing the risk that we may be unable to sell such loans at a profit.

We also rely on our ability to securitize our mortgage loans to realize a greater percentage of the full economic value of the loans. We cannot assure you, however, that we will continue to be successful in securitizing mortgage loans. Our ability to complete securitizations of our loans will depend upon a number of factors, many of which are beyond our control, including conditions in the credit and securities markets generally, conditions in the asset-backed securities market specifically, the availability of credit enhancements such as financial guarantee insurance, a senior subordinated structure or other means, and the performance of our loans previously held for investment.

**Our business may be significantly harmed by a slowdown in the economy or a natural disaster in the states of California or Florida, where we conduct a significant amount of business.**

A significant portion of the mortgage loans we have originated, purchased or serviced has been secured by properties in California and Florida. During the three months ended September 30, 2006, 16% and 12% of the principal balance of the loans we originated were collateralized by properties located in California and Florida, respectively. During the nine months ended September 30, 2006, 15% and 12% of the principal balance of the loans we originated were collateralized by properties located in California and Florida, respectively. At September 30, 2006, 18% and 11% of the unpaid principal balance of loans we serviced were collateralized by properties located in California and Florida, respectively. 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 in these states. This, in turn, would increase the risk of delinquency, default or foreclosure on mortgage loans in our portfolio or that we have sold to others. This could restrict our ability to originate, sell, or securitize mortgage loans, and significantly harm our business, financial condition, liquidity and results of operations.

**Our hedging strategies may not be successful in mitigating our risks associated with interest rates.**

We use various derivative financial instruments to provide a level of protection against interest rate risks, but no hedging strategy can protect us completely. When rates change, we expect to record a gain or loss on derivatives which would be offset by an inverse change in the value of loans held for sale and mortgage-related securities, as reflected in the Interest Rate Simulation Sensitivity Analysis in the section entitled Market Risk in ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations. We cannot assure you, however, that our use of derivatives will offset the risks related to changes in interest rates. There have been periods, and it is likely that there will be periods in the future, during which we will not have offsetting gains or losses in loan values after accounting for our derivative financial instruments. The derivative financial instruments we select may not have the effect of reducing our interest rate risk. In addition, the nature and timing of hedging transactions may influence the effectiveness of these strategies. Poorly designed strategies, improperly executed and recorded transactions or inaccurate assumptions could actually increase our risk and losses. In addition, hedging strategies involve transaction and other costs. We cannot assure you that our hedging strategy and the derivatives that we use will adequately offset the risk of interest rate volatility or that our hedging transactions will not result in losses. See discussion under Market Risk in ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

**Our business requires a significant amount of cash and if it is not available our business will be significantly harmed.**

Our primary sources of cash are our warehouse credit facilities, our commercial paper program and the proceeds from the sales and securitizations of our loans. We require substantial cash to fund our loan

## **Table of Contents**

originations, to pay our loan origination expenses and to hold our loans pending sale or securitization. Also, as a servicer of loans, we are required to advance delinquent principal and interest payments, unpaid property taxes, hazard insurance premiums, and foreclosure and foreclosure-related costs. Our warehouse and commercial paper program credit facilities also require us to observe certain financial covenants, including the maintenance of certain levels of cash and general liquidity in our company.

As of September 30, 2006, we financed substantially all of our loans through nine separate warehouse lenders and our commercial paper program. Each of these facilities is cancelable by the lender for cause at any time and at least one is cancelable at any time without cause. These facilities generally have a renewable, one-year term. Because these are short-term commitments of capital, the lenders may respond to market conditions, which may favor an alternative investment strategy for them, making it more difficult for us to secure continued financing. If we are not able to renew any of these warehouse credit facilities or arrange for new financing on terms acceptable to us, or if we default on our covenants or are otherwise unable to access funds under any of these facilities, or if the lenders do not honor their commitments for any reason, we will have to curtail our loan origination activities. This would result in decreased revenues and profits from loan sales.

The timing of our loan dispositions (which are periodic) is not always matched to the timing of our expenses (which are continuous). This requires us to maintain significant levels of cash to maintain acceptable levels of liquidity. When we securitize our loans or sell our loans with a retained interest, we may not receive any amounts in excess of the principal amount of the loan for up to 12 months or longer. Further, any decrease in demand in the whole loan market such that we are unable to timely and profitably sell our loans could inhibit our ability to meet our liquidity demands.

### **Our credit facilities contain covenants that restrict our operations and may inhibit our ability to grow our business and increase revenues.**

Our credit facilities contain extensive restrictions and covenants that, among other things, require us to satisfy specified financial, asset quality and loan performance tests and may prohibit inter-company dividends in certain circumstances. If we fail to meet or satisfy any of these covenants, we would be in default under these agreements and our lenders could elect to declare all amounts outstanding under the agreements to be immediately due and payable, enforce their interests against collateral pledged under such agreements and restrict our ability to make additional borrowings. These agreements also contain cross-default provisions, so that if a default occurs under any one agreement, the lenders under our other agreements could also declare a default.

The covenants and restrictions in our credit facilities may restrict our ability to, among other things:

incur additional debt;

make certain investments or acquisitions;

repurchase or redeem capital stock;

engage in mergers or consolidations;

finance loans with certain attributes;

reduce liquidity below certain levels; and

finance loans for longer than established time periods.

These restrictions may interfere with our ability to obtain financing or to engage in other business activities, which may significantly harm our business, financial condition, liquidity and results of operations.



## **Table of Contents**

**Our rights to cash flow from our loans held for investment subject to portfolio-based accounting are subordinate to senior interests and may fail to generate any cash flow for us if the mortgage loan payment stream only generates enough cash flow to pay the senior interest holders.**

As part of the credit enhancement for our securitizations, the net cash flow that we receive from the loans held for investment generally represents the excess of amounts, if any, generated by the underlying mortgage loans over the amounts required to be paid to the senior security holders or loan purchasers. This excess amount is also calculated after deduction of servicing fees and any other specified expenses related to the sale or securitization. These excess amounts are derived from, and are affected by, the interplay of several factors, including:

the extent to which the interest rates of the mortgage loans exceed the interest rates payable to the senior security holders or loan purchasers;

the level of losses and delinquencies experienced on the underlying loans; and

the extent to which the underlying loans are prepaid by borrowers in advance of scheduled maturities.

Any combination of the factors listed above may reduce the income we receive from and the value of our loans held for investment.

**If we do not manage our growth effectively, our financial performance could be harmed.**

In recent years, we have experienced rapid growth that has placed, and will continue to place, certain pressures on our management, administrative, operational and financial infrastructure. As of December 31, 2002, we had 1,294 employees and by September 30, 2006, we had 3,164 employees. Many of these employees have very limited experience with us and a limited understanding of our systems and controls. The increase in the size of our operations may make it more difficult for us to ensure that we originate quality loans and that we service them effectively. We will need to attract and hire additional sales, servicing and management personnel in an intensely competitive hiring environment in order to preserve and increase our market share. At the same time, we will need to continue to upgrade and expand our financial, operational and managerial systems and controls. We also intend to continue to grow our business in the future, which could require capital, systems development and human resources beyond what we currently have. We cannot assure you that we will be able to:

meet our capital needs;

expand our systems effectively;

allocate our human resources optimally;

identify and hire qualified employees;

satisfactorily perform our servicing obligations; or

effectively integrate the components of any businesses that we may acquire in our effort to achieve growth.

The failure to manage growth effectively would significantly harm our business, financial condition, liquidity and results of operations.

**An interruption in, or breach of, our information systems may result in lost business.**

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

We rely heavily upon communications and information systems to conduct our business. As we implement our growth strategy and increase our volume of loan production, that reliance will increase. Any failure, interruption or breach in the security of our information systems or the third-party information systems on which we rely could cause underwriting or other delays, compromise or leak customer and other confidential information and/or and could result in fewer loan applications being received, slower processing of applications and reduced efficiency in loan servicing. We cannot assure you that such failures or interruptions will not occur, or if they do occur that they will be adequately addressed by us or the third parties on which we rely. The occurrence of any failures or interruptions could significantly harm our business.



## **Table of Contents**

### **The success and growth of our business will depend upon our ability to adapt to and implement technological changes.**

Our mortgage loan origination business is currently dependent upon our ability to effectively interface with our brokers, borrowers and other third parties and to efficiently process loan applications and closings. The origination process is becoming more dependent upon technological advancement, such as the ability to process applications over the Internet, accept electronic signatures, provide status updates instantly and other customer-expected conveniences that are cost-efficient to our business. In addition, competition and increasing regulation may increase our reliance on technology as a means to improve efficiency. Implementing this new technology and becoming proficient with it may also require significant capital expenditures. As these requirements increase in the future, we will have to fully develop these technological capabilities to remain competitive or our business will be significantly harmed.

### **If we are unable to maintain and expand our network of independent brokers, our loan origination business will decrease.**

A significant majority of our originations of mortgage loans comes from independent brokers. During the three and nine months ended September 30, 2006, 88% of our loan originations were originated through our broker network. Our brokers are not contractually obligated to do business with us. Further, our competitors also have relationships with our brokers and actively compete with us in our efforts to expand our broker networks. Accordingly, we cannot assure you that we will be successful in maintaining our existing relationships or expanding our broker networks, the failure of which could significantly harm our business, financial condition, liquidity and results of operations.

### **Our financial results fluctuate as a result of seasonality and other timing factors, which makes it difficult to predict our future performance and may affect the price of our common stock.**

Our business is generally subject to seasonal trends. These trends reflect the general pattern of housing sales, which typically peak during the spring and summer seasons. Our quarterly operating results have fluctuated in the past and are expected to fluctuate in the future, reflecting the seasonality of the industry. Further, if the closing of a sale of loans is postponed, the recognition of gain from the sale is also postponed. If such a delay causes us to recognize income in the next quarter, our results of operations for the previous quarter could be significantly depressed.

### **We are subject to losses due to fraudulent and negligent acts on the part of loan applicants, mortgage brokers, other vendors and our employees.**

When we originate mortgage loans, we rely heavily upon information supplied by third parties including the information contained in the loan application, property appraisal, title information and employment and income documentation. If any of this information is intentionally or negligently misrepresented and such misrepresentation is not detected prior to loan funding, the value of the loan may be significantly lower than expected. Whether a misrepresentation is made by the loan applicant, the mortgage broker, another third party or one of our own employees, we generally bear the risk of loss associated with the misrepresentation. A loan subject to a material misrepresentation is typically unsaleable or subject to repurchase if it is sold prior to detection of the misrepresentation. Even though we may have rights against persons and entities who made or knew about the misrepresentation, such persons and entities are often difficult to locate and it is often difficult to collect any monetary losses that we have suffered as a result of their actions.

We have controls and processes designed to help us identify misrepresented information in our loan origination operations. We cannot assure you, however, that we have detected or will detect all misrepresented information in our loan originations.

We are subject to losses due to fraudulent and negligent acts in other parts of our operations. If we experience a significant number of such fraudulent or negligent acts, our business, financial condition, liquidity and results of operations would be significantly harmed.

## **Table of Contents**

### **If the prepayment rates for our mortgage loans are different than expected, our results of operations may be significantly harmed.**

When a borrower pays off a mortgage loan prior to the loan's scheduled maturity, the impact on us depends upon when such payoff or prepayment occurs. Our prepayment losses generally occur after we sell or securitize our loans and the extent of our losses depends on when the prepayment occurs. If the prepayment occurs:

within 12 to 18 months following a whole loan sale, we may have to reimburse the purchaser for all or a portion of the premium paid by the purchaser for the loan, again resulting in a loss of our profit on the loan; or

after we have securitized the loan or sold the loan in a sale, we lose the future income from that loan.

Prepayment rates on mortgage loans vary from time to time and tend to increase during periods of declining interest rates. Of the U.S. securitized loans we serviced during the three and nine months ended September 30, 2006, 29.3% and 28.4%, respectively, were prepaid. We seek to minimize our prepayment risk through a variety of means, including originating a significant portion of loans with prepayment penalties with terms of two to five years. No strategy, however, can completely insulate us from prepayment risks, whether arising from the effects of interest rate changes or otherwise. See "Statutory and Regulatory Risks" below for a discussion of statutes related to prepayment penalties.

### **We are exposed to environmental liabilities, with respect to properties that we take title to upon foreclosure, that could increase our costs of doing business and harm our results of operations.**

In the course of our servicing activities, we may foreclose and take title to residential properties and become subject to environmental liabilities with respect to those properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. Moreover, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based upon damages and costs resulting from environmental contamination emanating from the property. If we ever become subject to significant environmental liabilities, our business, financial condition, liquidity and results of operations would be significantly harmed.

#### *Statutory and Regulatory Risks*

### **The scope of our operations exposes us to risks of noncompliance with an increasing and inconsistent body of complex laws and regulations at the federal, state and local levels.**

Because we originate mortgage loans in all 50 states, in the District of Columbia and Canada, we must comply with the laws and regulations, as well as judicial and administrative decisions, of all of these jurisdictions, as well as an extensive body of federal and international laws and regulations. The volume of new or modified laws and regulations has increased in recent years, and, in addition, individual cities and counties have begun to enact laws that restrict non-prime loan origination activities in those cities and counties. The laws and regulations of each of these jurisdictions are different, complex and, in some cases, in direct conflict with each other. As our operations continue to grow, it may be more difficult to comprehensively identify, to accurately interpret and to properly program our technology systems and effectively train our personnel with respect to all of these laws and regulations, thereby potentially increasing our exposure to the risks of noncompliance with these laws and regulations.

In addition, recently enacted and changed laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new Securities and Exchange Commission regulations and stock exchange rules, are creating uncertainties for companies like ours. These new or changed laws, regulations and standards are subject to varying interpretations due, in many cases, to their lack of

## **Table of Contents**

specificity. As their applications evolve over time and new guidance is provided by regulatory and governing bodies, we may incur higher costs of compliance resulting from ongoing revisions to our disclosure and governance practices.

Our failure to comply with these laws can lead to:

civil and criminal liability;

loss of approved status;

demands for indemnification or loan repurchases from purchasers of our loans;

class action lawsuits; and administrative enforcement actions.

### **Stockholder refusal to comply with regulatory requirements may interfere with our ability to do business in certain states.**

Some states in which we operate may impose regulatory requirements on our officers and directors and persons holding certain amounts, usually 10% or more, of our common stock. If any person holding such an amount of our stock fails to meet or refuses to comply with a state's applicable regulatory requirements for mortgage lending, we could lose our authority to conduct business in that state.

### **We may be subject to fines or other penalties based upon the conduct of our independent brokers.**

The mortgage brokers from whom we obtain loans are subject to legal obligations which are parallel to, but separate from, the legal obligations that we are subject to as a lender. While these laws may not explicitly hold the originating lenders responsible for the legal violations of mortgage brokers, federal and state agencies have increasingly sought to impose such assignee liability.

For example, the United States Federal Trade Commission ( "FTC" ) entered into a settlement agreement with a mortgage lender in which the FTC characterized a broker that had placed all of its loan production with a single lender as the "agent" of the lender. The FTC imposed a fine on the lender in part because, as "principal," the lender was legally responsible for the mortgage broker's unfair and deceptive acts and practices. Also, the United States Justice Department in the past has sought to hold a non-prime mortgage lender responsible for the pricing practices of its mortgage brokers, alleging that the mortgage lender was directly responsible for the total fees and charges paid by the borrower under the Fair Housing Act even if the lender neither dictated what the mortgage broker could charge nor kept the money for its own account. Accordingly, we may be subject to fines or other penalties based upon the conduct of our independent mortgage brokers.

### **We are not able to rely on the Alternative Mortgage Transactions Parity Act to preempt certain state law restrictions on prepayment penalties, and we may be unable to compete effectively with financial institutions that are exempt from such restrictions.**

The value of a mortgage loan depends, in part, upon the expected period of time that the mortgage loan will be outstanding. If a borrower pays off a mortgage loan in advance of this expected period, the holder of the mortgage loan does not realize the full value expected to be received from the loan. However, a prepayment penalty payable by a borrower who repays a loan earlier than expected helps offset the reduction in value resulting from the early payoff. Consequently, the value of a mortgage loan is enhanced to the extent the loan includes a prepayment penalty, and a mortgage lender can offer a lower interest rate and/or lower loan fees on a loan which has a prepayment penalty. Prepayment penalties are an important feature to obtain value on the loans we originate.

Certain state laws restrict or prohibit prepayment penalties on mortgage loans, and we have relied on the federal Alternative Mortgage Transactions Parity Act (the "Parity Act" ) and related rules issued in the past by the Office of Thrift Supervision (the "OTS" ) to preempt state limitations on prepayment penalties. The Parity Act was enacted to extend to financial institutions, other than federally chartered depository institutions, the federal preemption which federally chartered depository institutions enjoy. However, on September 25, 2002, the OTS



## **Table of Contents**

released a new rule that reduced the scope of the Parity Act preemption as of July 1, 2003, preventing us from relying on the Parity Act to preempt state restrictions on prepayment penalties. The elimination of this federal preemption requires us to comply with state restrictions on prepayment penalties. This may place us at a competitive disadvantage relative to financial institutions that will continue to enjoy federal preemption of such state restrictions because such institutions will be able to charge prepayment penalties without regard to state restrictions and thereby may be able to offer loans with interest rate and loan fee structures that are more attractive than we are able to offer.

### **The increasing number of federal, state and local anti-predatory lending laws may restrict our ability to originate, or increase our risk of liability with respect to, certain mortgage loans and could increase our cost of doing business.**

In recent years, several federal, state and local laws, rules and regulations have been adopted, or are under consideration, that are intended to eliminate so-called predatory lending practices. These laws, rules and regulations impose certain restrictions on loans on which certain points and fees or the annual percentage rate (APR) exceeds specified thresholds, commonly referred to as high cost loans. Some of these restrictions expose a lender to risks of litigation and regulatory sanction no matter how carefully a loan is underwritten. In addition, an increasing number of these laws, rules and regulations seek to impose liability for violations on purchasers of loans, regardless of whether a purchaser knew of or participated in the violation.

We have generally avoided and will continue to avoid originating high cost loans because the rating agencies generally will not rate securities backed by such loans, and the companies that buy our loans and/or provide financing for our loan origination operations generally do not want to buy or finance such loans. The continued enactment or adoption of these laws, rules and regulations may prevent us from making certain loans that we would otherwise make, may cause us to cease operations in certain jurisdictions altogether and may cause us to reduce the APR or the points and fees on loans that we do make. In addition, the difficulty of managing the risks presented by these laws, rules and regulations may decrease the availability of warehouse financing and the overall demand for non-prime loans, making it difficult to fund, sell or securitize any of our loans. If we decide to relax our restrictions on loans subject to these laws, rules and regulations, we will be subject to greater risks for actual or perceived non-compliance with such laws, rules and regulations, including demands for indemnification or loan repurchases from our lenders and loan purchasers, class action lawsuits, increased defenses to foreclosure of individual loans in default, individual claims for significant monetary damages, and administrative enforcement actions. If nothing else, the growing number of these laws, rules and regulations will increase our cost of doing business, as we are required to develop systems and procedures to ensure that we do not violate any aspect of these new requirements. Any of the foregoing could significantly harm our business, financial condition, liquidity and results of operations.

### **As a result of our merger with Aames, our management may be distracted from their focus on our business and operations in order to attend to merger-related matters.**

There is a significant degree of difficulty and management distraction inherent in the process of integrating the Accredited and Aames businesses. These difficulties include:

integrating the Accredited and Aames businesses while carrying on the ongoing operations of each business;

the necessity of coordinating geographically separate organizations;

the challenge of integrating the business cultures of each company, which may prove to be incompatible;

the challenge and cost of integrating the information technology systems of each company; and

the potential difficulty in retaining key officers and personnel of Accredited and Aames.

The process of integrating operations could cause an interruption of, or loss of momentum in, the activities of our business. Members of our senior management may be required to devote considerable amounts of time to



## **Table of Contents**

this integration process, which will decrease the time they will have to manage our business, service existing borrowers and vendors, attract new borrowers and develop new products or strategies. If our senior management is not able to effectively manage the integration process, or if any significant business activities are interrupted as a result of the integration process, our business could suffer.

### **Failure to successfully integrate Aames into Accredited's operations could reduce the surviving company's profitability.**

Realization of the anticipated benefits of the merger will depend on our ability to successfully integrate the businesses and operations of Accredited and Aames. Our integration of the Aames operations will require significant efforts, including the combination of sales and marketing efforts. If we are not able to successfully integrate the business and operations of Aames, our expectations of future results of operations may not be met.

Our management may have to devote significant management attention and resources to integrating the business and operations of Aames. Such diversion of management's attention or difficulties in the transition process could have a material adverse impact on us. Additionally, personnel may leave or be terminated because of the merger. Such employee terminations or resignations or facility closures may require us to make severance or other payments and may result in related litigation. The integration process could result in the disruption of our ongoing business or inconsistencies in standards, controls, procedures and policies that adversely affect our ability to maintain relationships with customers, employees and others with whom we have business dealings. The integration process may also result in additional and unforeseen expenses and may have unanticipated adverse results relating to our existing businesses.

The merger is expected to generate cost savings and expense reductions achieved by eliminating duplicative operations, outside services and redundant staff and by consolidating facilities. Even if we are able to integrate operations, there can be no assurance that these expected synergies will be achieved. The failure to achieve synergies could have a material adverse effect on the business results of operations and financial condition of the combined company.

### *Risks Related to Our Capital Structure*

#### **Our guarantee of the Series A preferred shares of the REIT is senior to claims of our common stockholders.**

Our guarantee of dividend and principal payments on the Series A preferred shares of the REIT is subordinate to all of our existing and future indebtedness but is senior to our common stock. As a result, upon any distribution to our creditors in a bankruptcy, liquidation or reorganization or similar proceeding, the holders of the Series A preferred shares will be entitled to be paid in full under the guarantee before any payment may be made to holders of our common stock.

We are a holding company and our assets consist primarily of investments in our subsidiaries. Substantially all of our consolidated liabilities have been incurred by our subsidiaries. Therefore, our right to participate in the distribution of assets of any subsidiary upon the latter's liquidation or reorganization will be subject to prior claims of the subsidiary's creditors, including trade creditors, except to the extent that we may be a creditor with recognized claims against the subsidiary, in which case our claims would still be subject to the prior claims of any secured creditor of such subsidiary and of any holder of indebtedness of such subsidiary that is senior to that held by us.

#### **If the REIT fails to maintain its status as a real estate investment trust, the REIT will be subject to federal and state income tax on taxable income at regular corporate rates, and the value of our common stock may be adversely impacted as a result.**

The REIT was organized to qualify for taxation as a real estate investment trust under the Internal Revenue Code of 1986, as amended (the Code). The REIT has conducted, and intends to continue to conduct, its operations so as to qualify as a real estate investment trust. Qualification as a real estate investment trust involves the satisfaction of numerous requirements, some on an annual and some on a quarterly basis, established under

## **Table of Contents**

highly technical and complex provisions of the Code for which there are only limited judicial and administrative interpretations and involves the determination of various factual matters and circumstances not entirely within the REIT's control. For instance, in order to qualify as a real estate investment trust, no more than 50% of the value of the outstanding shares of beneficial interest of the REIT may be beneficially owned, directly or indirectly, by five or fewer individuals at any time during the last half of its taxable year (as defined in the Code to include certain entities) (the Ownership Test). Furthermore, each year the REIT must distribute to its shareholders at least 90% of the REIT's taxable income (the Annual Distribution Requirements). We cannot assure you that the REIT will at all times satisfy these rules and tests.

If the REIT were to fail to timely meet the Annual Distribution Requirements, satisfy the Ownership Test or otherwise qualify as a real estate investment trust in any taxable year, the REIT would be subject to federal and state income tax, including any applicable alternative minimum tax, on its taxable income at regular corporate rates. Moreover, unless entitled to relief under certain statutory provisions, the REIT would also be disqualified from treatment as a real estate investment trust for the four taxable years following the year during which the qualification is lost. This treatment would reduce the REIT's net earnings and cash flow available for distribution to shareholders, including to us as holder of the REIT's common shares, because of its additional tax liability for the years involved. Additionally, distributions to shareholders would no longer be required to be made by the REIT. Accordingly, the REIT's failure to qualify as a real estate investment trust could have a material adverse impact on our financial results and the value of the common stock held by our stockholders.

Moreover, in order to satisfy the Ownership Test, the REIT's Declaration of Trust establishes certain ownership restrictions on its shares of beneficial interest. For example, no individual (as described above) may beneficially own more than 9.8% of the value of the REIT. Even with this restriction, depending on the concentration of ownership of our stock and the relative value in the REIT's common and preferred shares, it is possible that our ownership of the REIT's common shares would cause the REIT to fail to satisfy the Ownership Test. In such a situation, the Declaration of Trust would require that the number of the REIT common shares held by us which causes the REIT to fail to satisfy the Ownership Test be transferred to a charitable trust at a price no greater than the fair market value of the REIT common shares as of such date, and we would have no future beneficial interest in such REIT common shares (including the right to vote or receive dividends on such REIT common shares).

### **The market price of our common stock could be volatile.**

The market price for our common stock may fluctuate substantially due to a number of factors, including:

the issuance of new equity securities pursuant to a future offering;

changes in interest rates;

competitive developments, including announcements by us or our competitors of new products or services or significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;

variations in quarterly operating results;

changes in financial estimates and forecasts published by securities analysts;

the depth and liquidity of the market for our common stock;

investor perceptions of our company and the mortgage industry generally (including the non-prime and nonconforming mortgage industry); and



general economic and other national conditions.

**Some provisions of our certificate of incorporation and bylaws may deter takeover attempts, which may limit the opportunity of our stockholders to sell their shares at a favorable price.**

Some of the provisions of our certificate of incorporation and bylaws could make it more difficult for a third party to acquire us, even if doing so might be beneficial to our stockholders by providing them with the opportunity to sell their shares possibly at a premium over the then market price.

## **Table of Contents**

For example, our board of directors is divided into three classes. At each annual meeting of stockholders, the terms of approximately one-third of the directors will expire, and new directors will be elected to serve for three years. The term of the first class expires at the 2007 annual meeting of stockholders, the term of the second class expires in 2008, and the term of the third class expires in 2009. Thus, it will take at least two annual meetings to effect a change in control of our board of directors because a majority of the directors cannot be elected at a single meeting, which may delay, discourage, prevent or make it more difficult or costly to acquire or effect a change in control, even if such a change in control would be favorable to our stockholders.

In addition, our certificate of incorporation authorizes the board of directors to issue up to 5,000,000 shares of preferred stock. The preferred stock may be issued in one or more series, the terms of which may be determined at the time of issuance by our board of directors without further action by the stockholders. These terms may include voting rights including the right to vote as a series on particular matters, preferences as to dividends and liquidation, conversion rights, redemption rights and sinking fund provisions. No shares of preferred stock are presently outstanding. The issuance of any preferred stock in the future could diminish the rights of holders of our common stock, and therefore could reduce the value of our common stock. In addition, specific rights granted to future holders of preferred stock could be used to restrict our ability to merge with, or sell assets to, a third party. The ability of our board of directors to issue preferred stock could delay, discourage, prevent or make it more difficult or costly to acquire or effect a change in control, even if such a change in control would be favorable to our stockholders.

Our bylaws contain provisions that require stockholders to act only at a duly-called meeting and make it difficult for any person other than management to introduce business at a duly-called meeting by requiring such other person to follow certain notice procedures.

Finally, we are also subject to Section 203 of the Delaware General Corporation Law which, subject to certain exceptions, prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years following the date that the stockholder became an interested stockholder. The preceding provisions of our certificate of incorporation and bylaws, as well as Section 203 of the Delaware General Corporation Law, could discourage potential acquisition proposals, or delay or prevent a change of control and prevent changes in our management, even if such things would be in the best interests of our stockholders.

## **ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

See discussion under Market Risk in ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

## **ITEM 4. Controls and Procedures**

### *Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures*

(a) Evaluation of Disclosure Controls and Procedures. Accredited maintains controls and procedures designed to ensure that it is able to collect the information it is required to disclose in the reports it files with the SEC, and to process, summarize and disclose this information within the time periods specified in the rules and regulations of the SEC. Based on an evaluation of Accredited's disclosure controls and procedures as of the end of the period covered by this report conducted by Accredited's management, Accredited's Chief Executive Officer and Principal Financial Officer believe that Accredited's disclosure controls and procedures were effective to ensure that Accredited is able to collect, process and disclose the information it is required to disclose in the reports it files with the SEC within the required time periods.

(b) Changes in Internal Controls. There were no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II****ITEM 1. Legal Proceedings**

See Note 13 to the Notes to Unaudited Consolidated Financial Statements.

**ITEM 1A. Risk Factors**

We have provided updated risk factors in the section labeled "Risk Factors" in Part I, Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations. The "Risk Factors" section provides certain updated information in specific areas (such as delinquency rate and loan repurchases, financing rates, geographic concentration of loans, and prepayment rates), that we do not believe materially change the type or magnitude of the risks we face in comparison to the disclosure provided in our most recent Annual Report on Form 10-K. In addition, we have updated certain risk factors relating to our acquisition of Aames Investment Corporation. We strongly advise the reader to review these risk factors and the risk factors contained in our registration statement on Form S-4 filed with the Securities and Exchange Commission on July 14, 2006, for a more thorough discussion of the merger and related risks.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On September 14, 2006, we announced that our Board of Directors had authorized the repurchase of up to 5 million shares of our common stock (from time to time through October 1, 2007) in both privately negotiated and open market transactions, subject to management's evaluation of market conditions, applicable legal requirements and other factors. No shares were repurchased during the period covered by this Quarterly Report. Through November 8, 2006, we have repurchased a total of 1,000,000 shares as follows:

**ISSUER PURCHASES OF EQUITY SECURITIES**

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
October 1 - October 31, 2006	679,400	\$ 31.05	679,400	4,320,600
November 1 - November 8, 2006	320,600	\$ 30.13	320,600	4,000,000
Total	1,000,000	\$ 30.75	1,000,000	4,000,000

**ITEM 3. Defaults Upon Senior Securities**

None.

**ITEM 4. Submission of Matters to a Vote of Security Holders**

On September 14, 2006, Accredited held a special meeting of stockholders in order to approve (i) the issuance of shares of approximately 4.4 million shares of Accredited common stock in the merger of Aames into AHL Acquisition, LLC ("Merger Sub") pursuant to the Agreement and Plan of Merger, dated as of May 24, 2006 among Aames, Accredited and Merger Sub; and (ii) amendment of the Accredited's Amended and Restated Certificate of Incorporation to increase the number of authorized shares of capital stock from 45 million shares to 80 million shares, consisting of 75 million shares of common stock and 5 million shares of preferred stock. At this meeting, the issuance of shares in connection with the acquisition of Aames was approved by the stockholders, with 18,561,236 shares voting in favor of the proposal, 52,476 shares voting against the proposal and 1,546,749 abstentions and broker non-votes. Additionally, the stockholders approved the amendment of

**Table of Contents**

Accredited s Amended and Restated Certificate of Incorporation with 17,341,903shares voting in favor of the amendment, 2,812,735 shares voting against the amendment and 5,823 abstentions and broker non-votes.

**ITEM 5. Other Information**

None.

**ITEM 6. Exhibits**

For a list of exhibits filed with this Quarterly Report on Form 10-Q, refer to the Exhibit Index beginning on page 83.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: November 9, 2006

ACCREDITED HOME LENDERS HOLDING CO.

BY: /s/ JAMES A. KONRATH  
James A. Konrath

*Chairman of the Board and Chief Executive Officer  
(Principal Executive Officer)*

BY: /s/ STUART D. MARVIN  
Stuart D. Marvin

*Executive Vice President and Secretary  
(Principal Financial Officer)*

**Table of Contents**

**EXHIBIT INDEX**

2.1 <sup>(1)</sup>	Agreement and Plan of Merger.
2.2 <sup>(2)</sup>	Agreement and Plan of Merger, dated as of May 24, 2006, among Aames Investment Corp., Accredited Home Lenders Holding Co. and AHL Acquisition LLC.
3.1 <sup>(3)</sup>	Amended and Restated Certificate of Incorporation of the Registrant.
3.2 <sup>(3)</sup>	Bylaws of the Registrant.
4.1	Amendment No. 1 to the Base Indenture by and between Carmel Mountain Funding Trust and Deutsche Bank Trust Company Americas, dated August 23, 2006.
4.2	Series 2006-A Supplement to Base Indenture by and between Carmel Mountain Funding Trust and Deutsche Bank Trust Company Americas, dated August 23, 2006.
4.3	Amendment No. 1 to the Mortgage Loan Purchase and Servicing Agreement by and among Carmel Mountain Funding Trust, Accredited Home Lenders, Inc., and Accredited Home Lenders Holding Co., dated August 23, 2006.
4.4	Amended and Restated Security Agreement by and between Carmel Mountain Funding Trust and Deutsche Bank Trust Company Americas, dated August 23, 2006.
4.5	Amended and Restated Schedule to the Master Agreement by and between Calyon New York Branch and Carmel Mountain Funding Trust, dated August 23, 2006.
4.6	Amended and Restated Confirmation of Swap Transaction by and between Carmel Mountain Funding Trust and Calyon New York Branch, dated August 23, 2006.
4.7	Amended and Restated Schedule to the Master Agreement by and between Lehman Brothers Special Financing Inc. and Accredited Home Lenders, Inc., dated August 23, 2006 and Guarantee of Lehman Brothers Holdings, Inc., dated August 23, 2006.
4.8	Amended and Restated ISDA Credit Support Annex to the Schedule to the Master Agreement by and between Lehman Brothers Special Financing Inc. and Accredited Home Lenders, Inc., dated August 23, 2006.
4.9	Amended and Restated Confirmation of Swap Transaction by and between Lehman Brothers Special Financing Inc. and Accredited Home Lenders, Inc., dated August 23, 2006.
4.10	Amended and Restated Confirmation of Swap Transaction by and between Calyon New York Branch and Accredited Home Lenders, Inc., dated August 23, 2006.
4.11	Amended and Restated ISDA Credit Support Annex to the Schedule to the Master Agreement between Calyon New York Branch and Accredited Home Lenders, Inc., dated August 23, 2006.
4.12	Amended and Restated Schedule to the Master Agreement between Calyon New York Branch and Accredited Home Lenders, Inc., dated August 23, 2006.
4.13	ISDA Master Agreement and Schedule between Bank of America, N.A. and Carmel Mountain Funding Trust, dated August 23, 2006.
4.14	Confirmation of Swap Transaction by and between Bank of America, N.A. and Carmel Mountain Funding Trust, dated August 23, 2006.
4.15	ISDA Master Agreement and Schedule between HSBC Bank USA and Carmel Mountain Funding Trust, dated August 23, 2006.
4.16	Confirmation of Swap Transaction by and between HSBC Bank USA and Carmel Mountain Funding Trust, dated August 23, 2006.
4.17	ISDA Master Agreement and Schedule between Barclays Bank PLC and Carmel Mountain Funding Trust, dated August 23, 2006.
4.18	Confirmation of Swap Transaction by and between Barclays Bank PLC and Carmel Mountain Funding Trust, dated August 23, 2006.

---

**Table of Contents**

4.19	ISDA Master Agreement and Schedule between Barclays Bank PLC and Accredited Home Lenders, Inc., dated August 23, 2006.
4.20	ISDA Credit Support Annex to the Schedule to the Master Agreement between Barclays Bank PLC and Accredited Home Lenders, Inc., dated August 23, 2006.
4.21	Confirmation of Swap Transaction by and between Barclays Bank PLC and Accredited Home Lenders, Inc., dated August 23, 2006.
4.22	ISDA Master Agreement and Schedule between HSBC Bank USA and Accredited Home Lenders, Inc., dated August 23, 2006.
4.23	ISDA Credit Support Annex to the Schedule to the Master Agreement between HSBC Bank USA and Accredited Home Lenders, Inc., dated August 23, 2006.
4.24	Confirmation of Swap Transaction by and between HSBC Bank USA and Accredited Home Lenders, Inc., dated August 23, 2006.
4.25	ISDA Master Agreement and Schedule between Bank of America, N.A. and Accredited Home Lenders, Inc., dated August 23, 2006.
4.26	ISDA Credit Support Annex to the Schedule to the Master Agreement between Bank of America, N.A. and Accredited Home Lenders, Inc., dated August 23, 2006.
4.27	Confirmation of Swap Transaction by and between Bank of America, N.A. and Accredited Home Lenders, Inc., dated August 23, 2006.
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14 (a).
31.2	Certification of Principal Financial Officer Pursuant to Rule 13a-14(a)/15d-14 (a).
32.1 <sup>(4)</sup>	Certification of Chief Executive Officer Pursuant to Rule 13a-14(b)/15d-14(b) and Section 1350.
32.2 <sup>(4)</sup>	Certification of Principal Financial Officer Pursuant to Rule 13a-14(b)/15d-14(b) and Section 1350.

- 
- (1) Incorporated by Reference to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2002.
- (2) Incorporated by Reference to the Company's Registration Statement on Form S-4 (File No.333-135787) dated July 14, 2006.
- (3) Incorporated by Reference to the Company's Amendment No. 3 to Registration Statement on Form S-1 (File No. 333-91644) dated November 12, 2002.
- (4) The information contained in these certifications is furnished to the Securities and Exchange Commission pursuant to Rule 13a-14(b)/15d-14(b) and Section 1350 and shall not be incorporated by reference into any filing with the Securities and Exchange Commission made by the Company whether before or after the date hereof, regardless of any general incorporation language in such filing.